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The **risks** of mergers

Bruce Paulsen, **Edward Horton** and **Jeffrey Dine**, of Seward & Kissel LLP, look at trends in merger activity and litigation risk in shipping

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Against the backdrop of the economic turmoil in the shipping sector, in late July 2011, DryShips Inc made a tender offer for common stock of OceanFreight, Inc, a Marshall Islands corporation whose shares were publicly traded in the US on the NASDAQ stock market.

In connection with the transaction, the consideration offered for each share of OceanFreight's common stock included a combination of cash and stock of a DryShips subsidiary, Ocean Rig, which was valued in the aggregate at more than twice the trading price of OceanFreight's shares.

As structured, the tender offer was immediately followed by the merger of OceanFreight into DryShips. The merger consideration offered would provide holders of OceanFreight stock with a premium of approximately 110% above share value on the day before the merger was announced.

A shareholder seeks to stop the merger

Shortly before the shareholder vote to approve the merger (which was to occur in Athens), an OceanFreight shareholder brought a putative class action lawsuit in New York seeking to prevent it.

Six days before the scheduled shareholder meeting, the plaintiff filed a motion in federal court in New York against DryShips and OceanFreight, seeking a temporary restraining order – an emergency injunction – to stop the merger. The shareholder claimed that the notice of the OceanFreight shareholder meeting required to approve the merger, which provided sufficient advance notice under Marshall Islands law, did not provide adequate notice under the US Securities and Exchange Commission proxy rules applicable to domestic companies registered here.

The plaintiff also claimed that the disclosure in the merger proxy statement omitted information about certain financial projections and other matters used by OceanFreight's investment bankers to evaluate the fairness of the transaction and that OceanFreight's board of directors had breached its fiduciary duties in approving the merger without "canvassing the market" prior to accepting DryShips' offer.

The court allows the merger

The court ordered an expedited briefing and held a hearing two days before the planned merger shareholder vote. The following day, the court issued a 26-page written opinion, denying the shareholder any relief and permitting the shareholder meeting and, subject to requisite shareholder approval, the merger to go forward as scheduled.

The court's opinion is notable for its steadfast application of the US securities laws and rules. Although foreign private (nongovernmental) issuers such as OceanFreight whose securities are registered under the Securities Exchange Act of 1934 and traded on US exchanges are required to file proxy statements in connection with shareholder meetings, they are exempt from the specific rules governing them.

As a result, the court found that OceanFreight could not be subject to claims for material misstatements or omissions

in proxy statements based on violations of the proxy rules applicable to domestic companies, or to the 20 day notice requirement that the shareholder claimed applied.

Notwithstanding that the proxy rules did not apply, the court also looked to the likely merits of plaintiff's claims and found them wanting, finding that OceanFreight had complied with necessary requirements of the proxy filing that eliminated the 20 day notice requirement.

In addition, because the holder of a majority of OceanFreight's shares of common stock had indicated that it would vote in favor of the merger, the court was able to conclude that any misrepresentation in the proxy statement would not have changed the outcome of the shareholder vote and therefore any loss the plaintiff claimed to suffer was not related to the claimed misrepresentations.

Stopping the merger

Finally, the court found that the plaintiff's fiduciary duty claims were unlikely to succeed because OceanFreight had appointed an independent committee of directors who had acted diligently to evaluate and negotiate the proposed merger on terms that were equal for all shareholders and at a substantial premium to the trading price of OceanFreight's common stock.

The court concluded by looking to the minimal harm and availability of monetary relief for the plaintiff were she to ultimately succeed on her claims, as well as the risk to other OceanFreight shareholders that the delay in the shareholder vote may cause the merger to fall through, thereby depriving shareholders of substantial value, given the current state of economic volatility, particularly in the shipping industry and in Greece.

As discussed below, there is currently little merger and acquisition activity in the shipping industry. However, as the global economy and other factors become more favorable for merger activity within the shipping industry, the decision in the OceanFreight litigation may become more important.

This case clearly demonstrates that not only are US courts capable of acting very quickly when the commercial needs of a transaction require it, but that they are also capable even in expedited circumstances of giving both sides of a dispute a fair hearing and ruling in a manner that recognises the importance of business transactions to shareholders.

Are more mergers ahead?

Historically low stock prices of publicly traded shipping companies, many below even the currently depressed net asset values, would suggest that there should be increased consolidation through merger and acquisition activity within the industry given the relatively high number of acquisition opportunities.

However, there have been few such transactions during the current economic downturn and the corporate merger considered by the court in the OceanFreight case is not likely to become a common transaction among publicly traded shipping companies in the near future given current economic conditions. This may be attributable to several factors currently facing the shipping industry.

The first factor relates to continued uncertainty in the shipping sector itself. With few notable exceptions, the current economic downturn has adversely affected all sectors of the shipping industry, including tankers, bulk carriers and containers. Given current global demand for tonnage and the present order books, there is little optimism that the industry will see a significant improvement in the near to medium-term future.

As a result, it is very difficult to evaluate potential acquisition opportunities. In addition, the continuing decline of vessel values across most sectors, together with the gradually growing number of distressed asset sales, has provided opportunities for some companies to acquire one or more individual assets at prices that may be more attractive than through a strategic acquisition of a full fleet.

Another significant factor limiting merger and acquisition activity is the lack of available liquidity. While commercial lending has resumed across many industries since the 2008 financial crisis, lending remains at relatively low levels within the shipping industry. The inability to obtain commercial lending and its adverse impact on merger and acquisition activity has occurred at the same time that nearly all publicly traded companies have seen their stock prices decline.

As a result, companies have not only found themselves unable to utilize debt to fund such transactions, but they have also been unable to utilize their own equity securities as "currency" to fund the acquisitions, a common practice in many merger transactions.

We do not believe that the litigation risk posed by shareholders' actions such as the one brought against OceanFreight is one of the factors limiting business combinations in the shipping arena. Sophisticated managers of publicly-held shipping companies understand and seek to manage litigation risk, which is part of operating any publicly-listed company.

On occasion, shareholders will sue and their cases will either have merit or not. If a publicly-held shipping company embraces good governance and thoughtful legal compliance, it will have a strong shield against shareholder claims when they arise. *MRI*

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