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Decision 83 11 069 November 22, 1983

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of )
CONTINENTAL TELEPHONE COMPANY OF )
CALIFORNIA, a California corporation,) Application 83-08-36
for authorization to merge with ) (Filed August 12, 1983)
Continental Transition Corporation. )

Orrick, Herrington & Sutcliffe, by James F. Craft. Jr., Attorney at Law, for Continental Telephone of California, applicant.

## OPINION

Continental Telephone Company of California (Continental) is a California corporation and is a subsidiary of Continental Telecom Inc. (Telecom), a Delaware corporation. Continental owns and operates telephone systems in California, Nevada and Arizona. Continental Transition Corporation (CTC) is a California corporation, and a wholly owned subsidiary of Continental. CTC was organized solely for the purpose of effecting the merger transaction for which authority is sought in this application. Telecom owns 99.8% of the outstanding common stock of Continental. Telecom's principal business is to provide equity capital and management and other services to its operating telephone subsidiaries.

On August 10, 1983 the Board of Directors of Continental and CTC approved an agreement and plan of merger (Merger Agreement) under which CTC, as the disappearing corporation, will be merged into Continental, which will be the surviving corporation. Telecom is also a party to the merger agreement.

Under the merger agreement, upon the effective date of the proposed merger all of the shares of Continental's common stock owned by Telecom will remain outstanding.[1] Also: (a) for each share of the common stock of Continental not then owned by Telecom, Telecom will pay an amount of cash equal to the book value per share of such common stock on the last day of the month preceding the month in which we enter an order approving the terms and conditions of the merger (such cash payment will not be less than $67.63, the book value per share for the common stock of Continental as of June 30, 1983), and (b) each share of the common stock of Continental not then owned by Telecom will be converted by operation of law into a right to receive such cash payment.

Following the merger, Telecom will own all of the issued and outstanding shares of common stock of Continental but the existing shares of preferred stock of Continental will remain outstanding and unaffected. Some of the outstanding shares of Continental's preferred stock have general voting rights but it is not considered either necessary or desirable by applicants to retire such shares of preferred stock. Any holders of Continental's common stock who qualify as dissenting shareholders will be entitled to dissenters' rights as provided by California law and by the merger agreement.

A copy of the merger agreement is attached to the application as Exhibit E. Applicants assert that the merger will have no appreciable effect on the balance sheet of Continental (attached as Exhibit A to the application) since Telecom will provide substantially all the funds required to acquire the outstanding shares of common stock of Continental not now owned by Telecom.

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[1] As of June 30, 1983, Telecom owned 2,503,667 shares of common stock of Continental.

A duly noticed public hearing was held by Administrative Law Judge Mallory in San Francisco on September 26, 1983 and the matter was submitted. Minority stockholders of Continental were notified by Continental of the time and place of the hearing and advised of their opportunity to be heard concerning the effect of the merger on such persons. No appearance was made on behalf of minority stockholders or by the Commission staff. Evidence was presented on behalf of applicants by Kenneth D. Veitch, vice president of Contel Service Corporation and financial director of Continental.

Reasons for the Merger

Continental and Telecom believe that the merger will be in the best interests of Continental's customers in view of the dramatic changes which are occurring in the telecommunications industry under which the entire industry is being restructured as a result of the Consent Decree entered into by American Telephone & Telegraph Company (AT&T). They assert that Continental must be able to move quickly in this changing environment and cannot be in a position of having the decisions which it must make to protect the interest of its customers affected by concerns as to the impact of such decisions on a very small body of minority holders of common stock. They allege that actions which Continental may be required to take include the organization of subsidiary coporations for various purposes and the transfer of assets to such subsidiaries or to affiliates of Continental. The witness testified that Continental and Telecom must be able to deploy their assets in the manner that will best serve their customers and enable them to continue to provide service that is as close to universal service as possible. The witness stated that no one is certain at this point what the effects of the breakup of the Bell System, which is scheduled to occur January 1, 1984, will be. It may be necessary for Continental to transfer some of its assets to unregulated affiliates. Such arrangements may become mandated by either the Federal Communications Commission (FCC) or this Commission. The witness testified that affiliates are already operating or proposing to operate in businesses which a minority shareholder might contend should be properly a part of the Continental's business or in conflict with Continental's business. The sale of terminal equipment and cellular mobile telephone service are examples. The witness stated that similar problems will arise with respect to the disposition of customer premises wiring. Also, Continental operates some facilities which technically provide an inter-LATA service. Continental's decision as to how best to deal with this problem and the host of other related problems assertedly must be made free of the constraints which the existence of minority shareholders impose.

The witness stated that this Commission considered this problem in some detail in 1982 when it authorized a merger that resulted in AT&T owning all of the common stock of Pacific Telephone (PT&T) (D.82-05-07, dated May 4, 1982.) That decision states that PT&T's merger would "enhance the company's flexibility in responding to the requirements of the new consent decree, proposed legislation and FCC orders." That decision also recognized that the existence of minority shareholders would be a complicating factor "due to the possibility of frivolous shareholder suits... and related problems." We found that "the continued existence of minority shareholders would not significantly protect the interests of PT&T and its ratepayers." We recognized that the interests of ratepayers and the minority shareholders were probably divergent.

The witness testified that Continental's need to have all of its outstanding common equity owned by the parent corporation is even more obvious; the minority stockholders have a very small interest in Continental and their impact on Continental's decision-making could be very disproportionate to the interest involved.

Fairness of Proposed Merger

The witness testified that Telecom proposes to pay for the relatively small block of minority common stock an amount equal to the full book value of the common stock. According to the witness, more than 15% of the book value which will form the basis of the price to the minority stockholders is directly attributable to the large contributions of equity capital by Telecom during the past 11 years. Retained earnings and dividends have also increased during this period, due in part to the earnings generated by the additional capital contributed by the parent company.

Exhibit F to the application, developed by the witness, shows that common dividend payments which have been paid to minority stockholders subsequent to 1971 would have been $40,000 less had shares of stock been issued to Telecom each time.

The reasons for contributions to capital were made by Telecom in lieu of issuing additional common shares are the following: In 1969, § 1904.1 was added to the Public Utilities Code to require the Commission to collect fees for authorizations for the issuance of stock by public utilities. When Continental issued approximately 204,000 shares of common stock to Telecom in 1970 and 1971 to provide additional equity capital, Continental paid fees of approximately $10,200 as required by § 1904.1. After giving effect to the issuance of the 204,000 shares of common stock and the subsequent acquisition of Golden West Telephone Company by Continental, Telecom owned 99.7% of the outstanding common stock of Continental and the minority holders owned .3%. At that time, Continental anticipated that it would require substantial amounts of additional equity capital during the 1970's. If common stock were sold to Telecom to raise such equity capital, the aggregate fees payable under § 1904.1 of the Public Utilities Code could have been as much as $40,000. Accordingly, Continental suggested, and Telecom agreed, that equity capital provided to Continental after 1971 should be furnished by means of contributions to the capital of Continental, thus eliminating the expense of obtaining orders from the Commission authorizing the issuance of additional common stock and the fees payable in connection with such issuance. The cost to Continental of raising equity capital was thereby substantially reduced.

Contributions by Telecom to Continental's equity capital since 1971, aggregating approximately $35,000,000, have increased the book value of Continental's outstanding common stock by approximately $12.50 per share. Minority holders of common stock of Continental have benefited from this increase in book value without any cost to them whatsoever and without any decrease in their proportionate interest in Continental. Continental's retained earnings and cash dividends have also increased over this period, due in part to the additional earnings generated by the substantial equity capital contributed by Telecom. The minority holders of Continental's common stock now own the same percentage interest in a much larger and financially stronger enterprise as a result of contributions to Continental's equity capital by Telecom.

If Continental had issued additional common stock to Telecom during this period at prices approximating the book value of Continental's common stock, the percentage interest of the minority stockholders in Continental would have been reduced from approximately .0022 to approximately .0016; and the total dividends paid to the minority stockholders would have been more than $40,000 less (assuming the same aggregate dollars of cash dividends during the period).

It is applicants' position that the acquisition of the minority stock as provided under the proposed merger is fair and appropriate. They state that the proposed merger provides for the payment to the minority holders of common stock of Continental of an amount approximating the present book value of the common stock of Continental, as more than $12 per share of that book value has been contributed by Telecom without cost to the minority stockholders.

The witness pointed out that the merger has been designed so that the minority stockholders will have an appraisal remedy under California law if they do not believe that the amount being paid to them is equal to the fair market value of their shares. Applicants were advised by their counsel that the merger could be structured so that no appraisal remedy would have been available to the minority stockholders. However, applicants elected to structure the merger so that the appraisal remedy would be available even though they believe the amount being paid is at least equal to the fair market value of the stock.

Applicants expect the merger to be completed within two months after the effective date of the Commission's order. At that time the minority stockholders would be furnished with a notice of the merger, a transmittal form for use in mailing in their stock certificates, and information concerning their appraisal rights. Payment for the minority stock would be made promptly after the stock certificates are deposited with the company.

Discussion

The reasons advanced for the merger appear reasonable. No one appeared at the duly noticed public hearing, and the Commission has received no written communications from minority stockholders indicating dissatisfaction with the merger or the price offered for their common stock.

The minimum price offered for the minority shareholders' common stock of $67.63 per share is based on the June 30, 1983 book value per share, as the payout of the majority of common dividends is postponed to December 1983. The greater book value (equal to the postponed dividend) will be taxed as capital gains, rather than ordinary income, thus lessening the minority shareholders' tax liability. The price offered to minority shareholders appears fair.

We conclude that the proposed merger will not be adverse to the public interest, and that the application should be granted.

Findings of Fact

1. Continental is a California corporation operating as a public utility subject to the jurisdiction of this Commission.

2. CTC is a California corporation and a wholly owned subsidiary of Continental. CTC was formed solely for the purpose of merging with Continental, and will go out of business when the merger is completed.

3. Telecom is a Delaware corporation which furnishes management services and capital to subsidiary corporations in several states. Telecom is not subject to the jurisdiction of this Commission.

4. Continental is a subsidiary of Telecom. Telecom owns 99.8% of the common shares of Continental. The balance of Continental's common shares are owned by the public.

5. Continental seeks authority to merger with CTC into Telecom.

6. The terms of the proposed merger and the acquisition of the common stock of minority shareholders is set forth in the merger agreement attached to the application.

7. The merger is structured so that minority shareholders will receive cash for their shares, and Telecom will become the sole common shareholder of Continental.

8. Under the merger agreement, Continental's preferred shares will remain outstanding.

9. The principal purpose for the proposed merger is to eliminate minority common shareholders who may exercise their voting rights to negate changes in operations made in the best interests of Continental as a result of the current rapid changes in the structure and regulation of the telecommunications industry, both nationwide and in California.

10. The merger will have no adverse affect on competition as Pacific Telesis and other telephone corporations are experiencing changes in corporate ownership and need to establish operating subsidiaries to perform nonregulated operations in the same manner as Continental.

11. Since 1971 Telecom has made contributions of equity capital to Continental in lieu of issuance of additional common shares. This has increased the book value of common shares and also has increased the dividends per share over those which would have been declared if additional common shares in proportion to the capital contributions had been issued.

12. The proposed minimum purchase price per share of $67.63 is based on Continental's June 30, 1983 book value per share.

13. The offered price for outstanding shares of minority shares is fair and reasonable.

14. The proposed merger is not adverse to the public interest.

Conclusions of Law

1. The proposed merger is for legitimate corporate purposes.

2. The proposed merger and purchase of minority common shares will not adversely affect minority common shareholders.

3. The proposed merger should be authorized, and the terms and conditions of the exchange of securities for cash should be approved.

4. Inasmuch as there is no opposition to the application and as applicants desire to effect the acquisition of minority shares as soon as possible, this order should become effective immediately.

O R D E R

IT IS ORDERED that:

1. Continental Telephone Company of California, is authorized to merge with Continental Transition Corporation in accordance with the Agreement and Plan of Merger attached as Exhibit E to A.83-08-36.

2. The terms and conditions set forth in A.83-08-36 for the exchange of securities for cash are approved.

This order is effective today.

Dated NOV 22 1983, at San Francisco, California.

LEONARD M. GRIMES, JR.
President
VICTOR CALVO
PRISCILLA C. GREW
WILLIAM T. BAGLEY
Commissioners

Commissioner Donald Vial, being necessarily absent, did not participate.

I CERTIFY THAT THIS DECISION WAS APPROVED BY THE ABOVE COMMISSIONERS TODAY.

Joseph E. Bodovitz

Joseph E. Bodovitz, Executive Director

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It is applicants' position that the acquisition of the minority stock as provided under the proposed merger is fair and appropriate. They state that the proposed merger provides for the payment to the minority holders of common stock of Continental of an amount approximating the present book value of the common stock of Continental ~~($69.77 per share)~~, as more than $12 per share of that book value has been contributed by Telecom without cost to the minority stockholders.

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