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NOTES

Fairness in Freezeout Transactions: Observations on Coping with Going Private Problems

INTRODUCTION

An area of expanding importance in corporate law involves attempts by state and federal entities to deal with the problem of corporate "freezeouts," especially in the context of a "going private" transaction. Generally, a corporate freezeout refers to purposeful activity on the part of some owners of a business enterprise aimed at eliminating other owners or participants. A "going private" transaction is a species of freezeout that involves a particular set of circumstances, which have been described as follows:

The essence of a freezeout [in the going private context] is the displacement of public investors by those who own a controlling block of stock of a corporation, whether individuals or a parent company, for cash or senior securities. The public investors are thus required to give up their equity in the enterprise, while the controllers retain theirs. Freezeouts most commonly take the form of a merger of a corporation into its existing parent or into a shell corporation newly formed for the purpose by those who control the merged entity.

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1 As noted in F. O'NEAL, "SQUEEZE-OUTS" OF MINORITY SHAREHOLDERS at iii (Supp. 1979): "Since the publication of this treatise in 1975, the volume of litigation grounded on minority shareholder oppression—actual, fancied or fabricated—has grown enormously."

2 Id. at 1 (1975).

3 One problem with discussing going private transactions as a species of freezeout is that a number of cases and commentaries use the terms interchangeably. As will become apparent shortly, however, there are several different types of freezeouts, of which going private is but one. Further discussion of this point is contained at notes 22-47 infra and accompanying text.

4 Brudney & Chirelstein, A Restatement of Corporate Freeze-outs, 87 Yale L.J. 1354, 1357 (1978). As noted in Vorenberg, Exclusiveness of the Dissenting Stock-
Going private transactions recently have aroused great interest for two reasons. First, it often appears that the corporation is taking unfair advantage of certain market fluctuations. Second, such transactions are perceived as harmful to the public shareholders who are eliminated. As a result, both state and federal entities have become involved in an effort to obtain some degree of control over going private transactions.

In the state law context, Delaware took the lead in controlling going private mergers with two 1977 decisions by its supreme court: Singer v. Magnavox Co. and Tanzer v. International General Industries, Inc. Those cases held that it

holder's Appraisal Right, 77 HARV. L. REV. 1189, 1192-93 (1964), a freezeout or going private transaction "has come to imply a purpose to force a liquidation or sale of stockholder's shares," and not just any action of those in control of the corporation which results in the termination of the shareholder's interest in the corporation.

It is noted at 42 Fed. Reg. 60090, 60090-91 (1977) that a number of the going private transactions which occurred during the depressed stock market of 1974 involved corporations which only recently had offered securities to the public for the first time. This knowledge leads to the conclusion that such corporations, or the controlling interests therein, took advantage of the high securities prices of the 1960’s market to obtain the benefits of public financing, only to go private again in the depressed market of the 1970’s. In essence, the corporation sold when the market price was unusually high and then forced the public to sell back when the price became depressed. See, e.g., Note, Delaware Reexamines its Merger Laws: New Protection for Minority Shareholders?, 6 HOFSTRA L. REV. 973, 978 (1978) [hereinafter cited as Rights of Minority Shareholders]; Note, Corporate Freezeouts: A New Limitation Imposed by the "Entire Fairness" Standard, 1978 ILL. L.F. 686, 690-91 [hereinafter cited as Corporate Freezeouts]; Comment, Protection of Minority Shareholders from Freezeouts Through Merger, 22 WAYNE L. REV. 1421, 1429-34 (1976).

The following harmful effects are outlined by the commentators: 1) the minority's equity participation in the enterprise is ended at the time and under terms chosen by the majority; 2) any benefits which may arise inure to the benefit of the majority alone; 3) the minority is put to the risk of finding a new investment which is comparable to that surrendered; and 4) the minority stockholder is forced to face the income tax consequences of liquidation at a time which is not of his choosing. See, e.g., Brudney, A Note on "Going Private," 61 VA. L. REV. 1019, 1023-25 (1975); Note, The Fiduciary Duty of Majority Shareholders in Freezeout Mergers: A Suggested Approach, 47 FORDHAM L. REV. 223, 227-28 (1978) [hereinafter cited as Freezeout Mergers]; Corporate Freezeouts, supra note 5, at 694-99; Comment, Going Private—Juggling Shareholder Protection with Corporate Flexibility: Will the States Drop the Ball?, 1973 WIS. L. REV. 797, 801-05.

Perhaps the most harmful effect of going private transactions is the potential loss of investor confidence in the capital markets. 42 Fed. Reg. 60090, 60091 (1977); Comment, supra note 6, at 804.

7 380 A.2d 969 (Del. 1977).
8 379 A.2d 1121 (Del. 1977).
was a breach of fiduciary duty for the majority stockholders to approve a merger for the sole purpose of freezing out the minority interests. The court also held that a complaint alleging such a singular purpose would justify judicial scrutiny to determine the "entire fairness" of the transaction. More recently, the Delaware Supreme Court extended its Singer-Tanzer rulings to cover short form mergers under the Delaware corporation statute. This extension was accomplished in Roland International Corp. v. Najjar, a decision which illuminated the underlying considerations of Singer and Tanzer.

On the federal side, the watershed opinion was delivered by the Supreme Court in 1977, when it decided Santa Fe Industries, Inc. v. Green. In reversing a decision of the Second Circuit, the Court ruled that section 10(b) of the Securities Exchange Act and rule 10b-5 promulgated thereunder had very limited applicability to freezeout situations. As a result, the Securities and Exchange Commission has promulgated new rules which will provide the basis for future federal in-

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9 380 A.2d at 978; 379 A.2d at 1123. Both cases, however, did suggest that if a legitimate business purpose existed for the merger, then that part of the test would be satisfied.

10 380 A.2d at 980; 379 A.2d at 1125.

11 The Delaware short form merger statute is contained in DEL. CODE ANN. tit. 8, § 253 (1974). A short form merger is a statutory procedure which allows a parent corporation and its subsidiary to merge pursuant to certain shortened procedures. For example, unlike the long form merger statute, DEL. CODE ANN. tit. 8, § 251 (Supp. 1978), the short form merger does not require approval by the stockholders of the subsidiary corporation. The short form merger does require, however, that the parent own a certain minimum percentage of the stock of the subsidiary (90% in Delaware).

12 407 A.2d 1032 (Del. 1979).


17 44 Fed. Reg. 46741 (1979), rule 13-3 (to be codified in 17 CFR § 240.13e-3). The SEC has also approved a schedule for use in meeting the rule 13e-3 disclosure requirements. 44 Fed. Reg. 46743 (1979), schedule 13e-3 (to be codified in 17 CFR § 240.13e-100).

It is also noteworthy that the SEC has promulgated a new rule and schedule regarding tender offers by certain issuers which might have an impact in the going private area. 44 Fed. Reg. 49410 (1979), rule 13e-4 (to be codified in 17 CFR § 240.13e-4); 44 Fed. Reg. 49412 (1979), schedule 13e-4 (to be codified in 17 CFR §
volvement in going private transactions.

The purpose of this Note is to discuss these most recent developments concerning going private types of freezeout transactions. The primary focus will be on the particular characteristics of the going private transaction—particularly, the going private mergers—as distinguished from freezeout transactions in other factual milieux. Accordingly, the critical analysis which follows will involve several distinct steps. First, the various factual contexts in which freezeouts occur will be set out. This discussion will provide a background against which the going private transaction can be more fully understood. Second, the historical impetus behind the treatment of going private mergers will be outlined. An analysis of the Singer-Tanzer state law approach, in terms of both judicial and legislative precedent, will follow. This analysis will include an examination of the posture of public shareholders in a going private transaction. Finally, there will be a general discussion of the new federal rule and the types of transactions it covers.

I. FACTUAL VARIATIONS OF FREEZEOUT TRANSACTIONS

A discussion of the various contexts in which freezeouts occur is essential in understanding the unique issues raised by going private mergers and in determining the applicability of legal standards to such mergers. Basically, there are three
factual considerations which serve to shape the analysis of a given freezeout transaction. The first is whether the freezeout involves closely-held (as opposed to publicly-owned) corporations. The second concerns the mechanism by which the minority shareholders are eliminated. The last is whether the freezeout is precipitated by corporate insiders or outsiders.

A. Close Corporations Versus Public Corporations

It almost goes without saying that a going private transaction can occur only in a publicly-owned corporation, where there are public shareholders to force out. A close corporation is, by definition, already private. There may be, however, a freezeout in a closely-held corporation; this can occur whenever certain shareholders are forced out of the enterprise.

A fundamental distinction between privately- and publicly-held corporations is the typical role played by the stockholder in each type of enterprise. In a close corporation, many stockholders, even those with only a minority interest in the business, participate in a number of capacities. Such a stockholder may have not only an investment interest in the corporation qua stockholder, but important "subsidiary" relationships to the business as well, such as full time employment. In a close corporation, it is conceivable that this subsidiary relationship may be financially more rewarding than the actual stock ownership, and its loss may be more devastating than loss of the investment interest.

On the other hand, the public investor in a public corporation typically has only a stockholder relationship to the corporation. Generally, his interest is an investment interest only, and he has no real voice in the manner in which the

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23 F. O'Neal, supra note 1, at 361-65 (1975).
24 Id. at 2 n.1.
25 Id. at 4.
26 Id. at 4-5; Vorenberg, supra note 4, at 1203.
corporation is run. No significant subsidiary relationships exist between himself and the corporation through which he receives a return on his investment.\textsuperscript{27}

As a consequence of these various stockholder-corporation relationships, the reasons behind a minority freezeout in each context may differ greatly. In a closely-held corporation, the reasons behind a freezeout may be based on very personal considerations or on activities of a stockholder in a role other than that of stockholder.\textsuperscript{28} In a going private situation, the motivating factors are less personal and can easily be divided into two basic categories. If the enterprise is one which is potentially highly prosperous, the freezeout may be aimed at appropriating the future profit for the majority stockholders.\textsuperscript{29} Alternatively, the goal may be to eliminate a sufficient number of public stockholders in order to obtain relief from SEC


Today, however, the public shareholder's investment is primarily speculative in nature. Generally he is neither employed by the corporation nor does he meaningfully participate in its growth. The investor's reasonable expectations are focused on the corporation's ability to achieve a profitable return on his investment. Thus, the right of continued participation reflects neither the investor's interest within the corporation nor his reasonable expectations concerning his investment.

\textit{Id.} (footnotes omitted). \textit{See also} Gibson, \textit{How Fixed are Class Shareholder Rights?}, 23 L. & CONTEMP. PROB. 283 (1958); Comment, supra note 6.

\textsuperscript{28} F. O'Neal, supra note 1, at 11-56 (1975). In this chapter the author outlines and discusses a number of incentives for freezing out a particular stockholder in a closely held or a family corporation. The reasons he lists are based to a great extent on the types of personalities in the business. Enumerated are such motivations as the drive of superior talent to oust the oldsters and the desire to remove an uncooperative stockholder creating controversy in the business.

\textsuperscript{29} The future profitability of the corporation, as respects the majority, may be enhanced by freezing out the minority in several ways. There might be a synergistic gain as a result of merging the businesses. A merger may also facilitate long-term debt financing or it may increase economic efficiency by reducing the duplication of activities between the corporations. Furthermore, conflicts of interest may be eliminated between the two corporations. Since the minority is removed as a consequence of the merger, however, the result is that the profitability of these factors inures primarily to the benefit of the remaining majority.

This point is most evident in the pure going private transaction, i.e., merger with a sham corporation. The profitability in this instance lies almost entirely in getting rid of the minority and retaining control in the hands of the majority. \textit{See} McClure, \textit{Are Freeze-Outs Thawing in Going Private Transactions?}, 15 Hous. L. Rev. 907, 910-11 (1978); Freezeout Mergers, supra note 6, at 225-26.
B. The Mechanics of Going Private

The close corporation-public corporation distinction has some impact on determining what mechanisms are available for freezing out minority stockholders. In a privately-owned corporation, a stockholder may be effectively frozen out of the enterprise without losing his stockholder status. For example, if the stockholder is an employee of the corporation and gets most of his return through his salary, he could be frozen out simply by the loss of his job. In a public corporation, however, the primary result is that the target owner is pushed completely out of his stockholder status. This may be accomplished by a merger, a tender offer, or a reverse stock split. Each method deserves further attention.

1. Mergers

Statutory mergers or consolidations frequently are used as a freezeout device. Every state has a statute which permits two or more corporations to combine as one without unanimous approval by the stockholders. Some statutes provide for two different merger procedures: a long form and a short form.

In a long form merger, the directors of each corporation

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30 Briefly, the Securities Exchange Act of 1934 (15 U.S.C. § 78a) requires registration with the SEC whenever the corporation meets certain criteria regarding the number of stockholders and the amounts of assets. Registration entails certain reporting requirements and restrictions on trading in the securities, which in turn benefit the public stockholder. By reducing the number of stockholders below 300, the corporation is relieved of these restrictions, and those benefits to the public stockholders are lost. See F. O'Neal, supra note 1, at 364 (1975); McClure, supra note 29, at 908-09; Terrell & Ranney-Marinelli, What Constitutes a Valid Purpose for a Merger?, 51 Temp. L.Q. 852, 868-70 (1978); Note, Going Private, 84 Yale L.J. 903, 904-05 (1975).

31 F. O'Neal, supra note 1, (1975), deals almost exclusively with the various types of freezeout techniques which might be effective in a close corporation. As the author notes, in the context of the close corporation, "partial squeezeouts" also occur; in these situations, the majority merely reduces the participation of certain groups without completely forcing them out. Id. at 1.

32 Id. at 254.

33 Id.
must approve the plan of merger, including the formula by which the stockholders receive shares, obligations, or other securities of the surviving corporation. The plan must then be approved by the requisite number of stockholders, a number which is provided by the applicable statute. If the plan is approved, it then is filed in the appropriate public office.\textsuperscript{34} In order for a short form merger to occur, one corporation must own a certain percentage of the stock of the other, usually around 90%. If that requirement is met, then all that is needed to effectuate the merger is approval by the parent corporation's board of directors. The stockholders of the target corporation do not vote regarding the merger.\textsuperscript{35} Any dissenting stockholder, however, may force the corporation to pay him the appraised value of his stock.\textsuperscript{36}

The merger is an attractive freezeout device because many merger statutes permit an exchange of securities or obligations of the surviving corporation with markedly different rights than those attending the stockholder's original shares. In exchange for his original shares, a stockholder might receive debentures, bonds, or redeemable preferred shares; these amount to little more than a promise to pay cash with interest at some future date.\textsuperscript{37} In such a case, the continued participation of the minority shareholder is largely fictional. In addition, some merger statutes allow an outright exchange of cash for the shares of the minority.\textsuperscript{38} In this manner, the public stockholders in a going private merger may be removed completely from continued equity participation in the corporation.\textsuperscript{39}

\textsuperscript{34} Id. at 255. See, e.g., Del. Code Ann. tit. 8, § 251 (Supp. 1978).


\textsuperscript{37} F. O'Neal, supra note 1, at 255 (1975).

\textsuperscript{38} Del. Code Ann. tit. 8, §§ 251 & 253 (1974); F. O'Neal, supra note 1, at 256 (1975); McClure, supra note 29, at 914-15.

2. Tender Offers

Basically, a tender offer is a formal offer by a certain party to purchase all or substantially all of the outstanding publicly-held shares of a corporation at a designated price per share. Technically, this is a voluntary transaction; that is, any stockholder who does not wish to sell his shares may refuse the tender offer despite what other stockholders may choose to do. Realistically, however, a tender offer can be highly coercive and for this reason is useful as a freezeout device.

A tender offer may be coercive in at least two respects. First, it may be only the first step in a two-step transaction. In such a case, it is used by the majority only to obtain sufficient voting power to consummate a cash out merger. When this occurs, the minority stockholders are compelled to participate for fear of being pushed out in a subsequent merger at even less desirable terms. Furthermore, even if no second step is contemplated in a given instance, the targets of the tender offer are faced with the prospect that the stock will become worthless if they do not participate. If the tender proves reasonably successful, the market for the remaining stock will become so small that the stock will lose its liquidity in the hands of nonparticipating stockholders. Requiring disclosure of these possibilities is no help; it merely increases the fears of the target shareholders. In fact, disclosure has a “whipsaw” effect in which the stockholders rush to sell to the offeror even though they may not be satisfied with the terms of the offer.

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40 F. O’Neal, supra note 1, at 230, 361 (1975); McClure, supra note 29, at 911.
41 See generally 1 M. Lipton & E. Steinberger, supra note 35, at 422-32; F. O’Neal, supra note 1, at 230-31 (1975); Brudney, supra note 6, at 1039-44; Brudney & Chirelstein, supra note 4, at 1360-65; Greene, supra note 22, at 509 n.69; Corporate Freezeouts, supra note 5, at 690-93; Note, supra note 30, at 916-19.
42 Brudney & Chirelstein, supra note 4, at 1361-62; Greene, supra note 22, at 509 n.69.
43 Corporate Freezeouts, supra note 5, at 690-93; Note, supra note 30, at 916-19.
44 Brudney, supra note 6, at 1040-41; Corporate Freezeouts, supra note 5, at 692-93. On the other hand, Brudney & Chirelstein, supra note 4, at 1360-62 and Greene, supra note 22, at 509 suggest that disclosure of the subsequent merger and the fact that the price at merger will be no lower than the tender offer will help to
3. Reverse Stock Splits

Reverse stock splits usually are employed in states where no short form merger is available.\(^4\) This procedure involves a recapitalization of the corporation in which the number of outstanding shares is significantly reduced, leaving certain minority stockholders who held only small amounts of the old stock holding fractional shares of the new stock. The corporation then exercises its statutory power to repurchase the fractional shares, thereby cashing out the minority.\(^4\)

C. The Insider-Outsider Dichotomy

The approval of the majority shareholders is necessary to the completion of any freezeout transaction. Thus, in one sense, all freezeout situations will involve corporate insiders. The impetus for the freezeout, however, may come from those outside the corporation as well. This is particularly likely at the first stage of a two-step transaction, at which point an outside corporation or individual may be instrumental. Whether the freezeout is precipitated by insiders or outsiders is a crucial distinction in the analysis of a given transaction.

The importance of this distinction is its effect on the paradigm of the arm’s length bargain. If an outsider is attempting to gain control of a corporation, the majority on the inside of the corporation will bargain with the outsider regarding the terms of the takeover. While the majority is primarily protecting its own interests, the result, absent any fraudulent self-dealing, is a degree of protection for the minority position as well. When the inside majority is trying to appropriate the minority interests for itself, however, the insiders may well be on both sides of the transaction. This situation contains the potential for self-dealing and is inconsistent with the concept of

avoid the coercive whipsaw effect. Brudney & Chirelstein suggest therein that Singer was in fact such a case.

\(^4\) 2 J. FLOM, M. LIPTON & E. STEINBERGER, TAKEOVERS AND TAKEOUTS—TENDER OFFERS AND GOING PRIVATE 14 (1976); 1 M. LIPTON & E. STEINBERGER, supra note 35, at 423.

\(^4\) 1 M. LIPTON & E. STEINBERGER, supra note 35, at 423. An example of this type of transaction is Teschner v. Chicago Title & Trust Co., 322 N.E.2d 54 (Ill. 1974).
D. The Importance of Factual Variations

The different factual possibilities heretofore discussed illustrate the complexity of the freezeout problem. Any attempt to control minority freezeouts which is not geared to these different factual contexts will run the risk of being ineffective or of unduly restricting legitimate activities of the corporation.

The focus of this Note is on only one of the freezeout variations—the going private merger. Such transactions usually are precipitated by insiders and accomplished by cashing out the minority. The purpose of discussing the various factual contexts of freezeout transactions was to place the going private merger in proper perspective vis-a-vis corporate law attempts to deal with the problems of going private.

II. An Analysis of State Law Attempts to Control Going Private

After the United States Supreme Court ruled in *Santa Fe Industries, Inc. v. Green* that section 10(b) of the Securities

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47 The best discussion of this aspect of going private transactions is in Brudney & Chirelstein, supra note 4, at 1357-59. That commentary suggests that the legitimacy of a going private transaction is measured by the extent to which it approaches an arm's length bargain. According to this analysis, a two-step transaction (tender offer by outsider followed by merger) is the closest to an arm's length bargain. It requires no fiduciary duty analysis. On the other hand, an "inside" merger with a sham corporation is far removed from the concept of an arm's length bargain and should be entirely prohibited.

48 One state law approach to the going private problem which will not be discussed involves the application of blue sky laws. The most interesting application of this approach can be found in the New York case of People v. Concord Fabrics, Inc., 371 N.Y.S.2d 550 (Misc. 1975). In that case, the state attorney general brought an action under the New York Martin Act (or blue sky law) and was able to enjoin the merger as fraudulent.

Blue sky laws are very limited in their application to going private transactions and generally are not geared toward the issues involved in going private. The Wisconsin statute, Wis. Adm. Code § 6.05 (1978), is one of the few statutes that deals directly with the problem. See 2 J. Flom, M. Lipton & E. Steinberger, supra note 45, at 43-45; 1 M. Lipton & E. Steinberger, supra note 35, at 455-56; Kaplan, Fiduciary Responsibility in the Management of the Corporation, 31 Bus. Law. 883, 884 n.3 (1976); Corporate Freezeouts, supra note 5, at 690-91 n.33.

Act and rule 10b-5 were not designed to cover going private transactions challenged on the basis of substantive fraud, the Delaware Supreme Court became the leader in dealing with corporate freezeouts. The Delaware approach, however, is not a novel one; other courts have taken a similar course.

A. Present Delaware Law

The first important post-Green Delaware case was Singer v. Magnavox Co. The plaintiffs therein challenged the procedure used by T.M.C. Development Corporation (T.M.C.) to merge with Magnavox Co., the merger being part and parcel of a larger effort by North American Philips Corporation (North American) to acquire Magnavox. T.M.C. was a wholly-owned subsidiary of North American Philips Development Corporation (Development), which was entirely owned by North American. The subsidiaries were created by North American solely to aid in acquiring Magnavox. The acquisition began with a tender offer by Development, which was approved (after some negotiation) by the board of Magnavox. The offer included statements of the intention of Development to obtain full control of Magnavox by subsequent means as well, i.e., a merger. As a result of the tender offer, Development acquired 84.1% of the total Magnavox stock. Development planned a long form merger between Magnavox and T.M.C. in which the remaining stockholders would get cash for their shares at the same rate provided in the tender offer.

The plaintiffs were minority stockholders of Magnavox who sought to nullify the merger. The case reached the Delaware Supreme Court on appeal from the court of chancery, which had granted defendant’s motion to dismiss for failure to state a claim.

The starting point of the court’s analysis was the fiduci-
ary duty which the majority stockholders owed to the minority. As a consequence of this fiduciary relationship, it was found to be "within the responsibility of an equity court to scrutinize a corporate act when it is alleged that its purpose violates the fiduciary duty owed to minority stockholders." Out of this fiduciary duty, the court derived two standards. First, it was said to be a clear violation of the fiduciary duty to consummate a merger solely to freeze out the minority shareholders. A separate and proper business purpose must be found to exist. Second, regardless of the purpose of the merger, the circumstances of the merger must meet a test of intrinsic fairness.

All that was really decided by the Singer court, however, was that a complaint was sufficient if it alleged that a cash out merger had as its sole purpose freezing out the minority.

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54 380 A.2d at 976. This duty is described in Comment, Corporate Freeze-Outs Effected by Merger: The Search for a Rule, 37 U. Pri. L. Rev. 115, 120 (1975). Although writing prior to the Singer decision, that author felt that the fiduciary duty concept was being expanded beyond its traditional bounds: The traditional theory of fiduciary obligation as the test of majority shareholder responsibility to the minority has come under attack in view of the increasingly complex transactions effected in the business community. An argument which has gained support in recognition of the validity of such criticism is based on an "expanded" fiduciary theory; i.e., the majority, like a director, assumes a position of trust with respect to all transactions involving the corporation. This theory is clearly a departure from the traditional view that imposed a fiduciary duty upon the majority only with respect to transactions with the corporation. Even the few jurisdictions holding corporate insiders to fiduciary standards in their dealings with shareholders have traditionally required only disclosure of all material facts. The expanded fiduciary theory, in addition to imposing a duty of disclosure, would further require the controlling shareholders to prove that every transaction affecting the minority was executed in good faith and was inherently fair. While it is at least arguable that such a standard should be legally enforceable in all transactions because it reflects a fundamental interest of society, it is clear that imposition of such a standard represents a departure from the traditional concept of majority responsibility to the minority.

Id. (footnotes omitted). This reasoning suggests that although the Singer court attempted to keep its rule within traditional corporate law concepts, it in fact altered the notion of fiduciary duty.

55 380 A.2d at 979.

56 Id. at 980.

57 Id.

58 We hold, therefore, that a § 251 merger, made for the sole purpose of
The court did not elaborate further on either the business purpose or the intrinsic fairness test, since further discussion was unnecessary in light of the issue presented.69

The business purpose test surfaced again in Tanzer v. International General Industries Inc.60 In Tanzer, the plaintiffs, stockholders of Kliklok Corporation, were seeking to enjoin a merger of Kliklok and KLK Corporation, a subsidiary of International General Industries, Inc. (IGI). KLK had been formed to effectuate the merger. IGI owned 81% of the stock of Kliklok and was proceeding with the long form merger between Kliklok and KLK, intending to cash out the minority stockholders of Kliklok. The complaint alleged that the merger was fraudulent in that it was pursued solely in the interests of IGI, the parent corporation.61

The court adopted the Singer fiduciary duty analysis as its starting point but noted that majority stockholders also have certain interests to be protected. Accordingly, a majority stockholder has the right to vote his shares pursuant to his own interests, as long as his actions are within the confines of the applicable fiduciary duty.62 Thus, the court concluded, while the parent may not merge with the subsidiary for the sole purpose of freezing out the minority, it may do so for a bona fide purpose which is solely in the interests of the parent.63 The court then found that the purpose recited by the defendants—facilitation of long-term debt financing by IGI —was a bona fide purpose.64 Even so, the defendants were left

freezing out minority stockholders, is an abuse of the corporate process; and the complaint, which so alleges in this suit, states a cause of action for violation of a fiduciary duty for which the Court may grant such relief as it deems appropriate under the circumstances.

Id.

69 Id. at 980 n.11. See Freezeout Mergers, supra note 6, at 233; Rights of Minority Shareholders, supra note 5, at 995.
60 379 A.2d 1121 (Del. 1977).
61 Id. at 1122-23.
62 Id. at 1123-24.
63 Id. at 1124. Freezeout Mergers, supra note 6, at 233; Comment, Freeze Out Mergers Under Section 251 of the Delaware General Corporation Law—The Effect of Singer and Tanzer, 23 Vill. L. Rev. 1159, 1164-66 (1977-78)(analysis of the Tanzer approach).
64 379 A.2d at 1124-25.
with the burden of showing the intrinsic fairness of the transaction, the second branch of the Singer test.\(^6\)

The most recent pronouncement of the Delaware Supreme Court regarding going private mergers is contained in \textit{Roland International Corp. v. Najjar}.\(^6\) As in Singer, the case involved a motion by the defendants to dismiss the complaint of the minority stockholders for failure to state a cause of action.\(^7\) Unlike Singer, however, the case involved a short form merger.\(^8\)

In \textit{Najjar}, the holders of 97.6\% of the stock of \textit{Roland International Corp.} (Roland), consisting of Hyatt Corporation and certain individuals, chartered Landro Corporation for the purpose of merging with Roland. These stockholders exchanged their Roland stock for Landro stock and proposed a short form merger between the two, intending that the minority stockholders be cashed out of the enterprise.\(^9\)

The Delaware court held that the complaint stated a cause of action to the extent that it stated the sole purpose of the merger was to freeze out the minority and that the exchange price was grossly inadequate.\(^7\) In so holding, the court expanded the Singer-Tanzer principles to cover short form mergers as well as long form mergers. The court held that the extent of the minority holdings did not alter the fiduciary obligation which existed.\(^7\) Thus, the bona fide purpose and intrinsic fairness tests of Singer applied equally to the \textit{Najjar} situation.

Not only did these three cases provide certain standards by which to control going private mergers, they further served to establish two basic rules of corporate law. First, these cases explicitly decided that an exercise of corporate power by the

\(^{6}\) Id. Cf. Comment, supra note 63, at 1167, wherein the commentator suggests that Singer did not actually stand for the proposition that a showing of a proper business purpose would be sufficient to meet the fiduciary duty. It is suggested that to the extent Tanzer holds this, a separate defense was made available.

\(^{6}\) 407 A.2d 1032 (Del. 1979).

\(^{7}\) Id. at 1034.

\(^{8}\) Id. at 1033.

\(^{9}\) Id. at 1033-34.

\(^{7}\) Id. at 1037.

\(^{7}\) Id. at 1036.
majority was not beyond attack merely because the statutory procedures were strictly followed. The fiduciary duty applies to all corporate transactions and gives an equity court a basis for scrutinizing a transaction even though statutory requirements are met. Second, the court held that the fiduciary duty could not be satisfied simply by relegating any disgruntled minority stockholders to the statutory appraisal remedy. In effect, the court held that appraisal was not an exclusive remedy. These holdings were essential in view of legislative history as it then existed.

B. Historical Milieu of Singer, Tanzer and Najjar

The response of the court in Singer, Tanzer and Najjar resulted from a clash between the general trend toward flexibility in corporate power and judicial distaste for the going private transaction. Thus, Delaware's going private law was shaped by legislative and judicial trends which predated Singer.

1. Legislative Developments Favoring Corporate Flexibility

The legislative trend toward corporate flexibility is best shown by the development of merger statutes. At common law a corporation could participate in a merger only if it were able to get unanimous approval of its stockholders. Thus, a single stockholder could block a merger deemed to be desirable by an overwhelming majority of the stockholders; the stockholder

essentially had a vested right in the form of his investment. State legislatures responded by passing merger statutes which required less than a unanimous vote to approve the merger. New York was first to do so in 1890. Delaware did not follow suit until much later. The various voting requirements were reduced repeatedly until, at present, the Delaware statute requires only a majority vote.

Short form mergers were equally significant innovations, serving to increase corporate flexibility while simultaneously weakening the ability of the stockholders to avoid a merger. New York was again the pacesetter, providing a short form statute for public utilities in 1923 and expanding it to include corporations generally in 1949. In 1937 Delaware adopted its first short form merger statute, applicable only to wholly-owned subsidiaries. In 1957 Delaware reduced the ownership requirement to its present level of 90%.

Until 1941, the Delaware merger statute required an exchange of shares in the resulting corporation for shares in the old corporations. In that year the statute was amended to also allow conversion into securities. In 1955, the statute was again amended, this time to permit an exchange of cash for fractional shares. In 1967 Delaware first allowed an exchange of cash for whole shares.

It should be clear from the developments mentioned above that the legislative trend has been to erode the absolute right of the stockholder to maintain the form of his investment. The intention was to increase the flexibility of the corporate form, but the result has been to substantially alter the nature of the stockholders' interest.

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75 1890 N.Y. Laws 1060.
76 36 Del. Laws ch. 135 (1929).
78 1923 N.Y. Laws ch. 9, art. 8, § 85 (applicable only to public utility companies).
79 1949 N.Y. Laws ch. 762, art. 8, § 85.
80 50 Del. Laws ch. 131 (1937).
82 36 Del. Laws ch. 135 (1929).
83 43 Del. Laws ch. 132, § 12 (1941).
85 56 Del. Laws ch. 186, § 16 (1967).
2. Delaware Case Law Developments Regarding Vested Rights

State legislatures were not alone in their efforts to expand corporate flexibility; the judiciary matched them step for step. A line of cases dealing with the right to accrued cumulative preferred dividends illustrates this point. In *Keller v. Wilson & Co.*, the common stockholders attempted to alter the accrued dividend rights of the holders of cumulative preferred stock through an amendment of the certificate of incorporation. At the time the corporation was formed and the preferred stockholders obtained their stock, the corporation statute did not provide for such an amendment of the charter. Subsequently the statute was revised to recognize the desired procedure, and the common stockholders attempted to take advantage of this change to the detriment of the preferred stockholders. The Delaware Supreme Court refused to permit this on the ground that the accrued cumulative dividends were vested property rights:

> While many interrelations of the State, the corporation, and the shareholders may be changed, there is a limit beyond which the State may not go. Property rights may not be destroyed; and when the nature and character of the right of a holder of cumulative preferred stock to unpaid dividends, which have accrued thereon through passage of time, is examined in a case where that right was accorded protection when the corporation was formed and the stock was issued, a just public policy, which seeks the equal and impartial protection of the interests of all, demands that the right be regarded as a vested right of property secured against destruction by the Federal and State Constitutions.

In a broader sense this type of vested rights theory appears to focus on protecting the form of the stockholder’s investment from encroachments by those who control the corporate machinery.

The vested rights theory did not last. In *Federal United*
Corp. v. Havender, the holders of the common stock sought to destroy the accrued cumulative dividend rights of the preferred stockholders through a merger of the corporation with an inactive wholly-owned subsidiary. The court approved, distinguishing Keller and limiting it to its particular facts, i.e., where no power to amend the charter exists prior to the issuance of the preferred stock. The court then held that the right of the corporation to merge is part of the stockholder's contract, of which he is presumed to be aware. Even more interesting is the court's suggestion that the statutory provisions for amendment of the charter and merger are to be considered independently. Thus, a result which could not be accomplished by amendment could be achieved through merger. A further corollary of this rule was added by the Third Circuit in Hottenstein v. York Ice Machinery Corp., applying Delaware law. The Hottenstein court concluded that a merger which destroyed accrued cumulative dividend rights was permissible, even though it was accomplished with an inactive subsidiary created specifically for the purpose of such a merger.

These legislative and judicial developments established the framework within which the Delaware court was working when faced with similar situations in the freezeout context.
Clearly the impetus of these developments was away from the idea that a stockholder had a vested interest in the form of his investment. The trend was in favor of corporate flexibility, the upshot being that a corporation could legally accomplish indirectly that which it could not do directly. That the same reasoning could be applied to going private mergers is a notion not easily dismissed.

C. Analysis of Standards Applied in the State Law Approach

When the Delaware Supreme Court first faced the problem of the going private merger in Singer, it needed to provide some control over an undesirable situation while respecting the force of precedent concerning corporate power. While it is arguable that the court failed to deal effectively with the precedent it discussed, it is clear that the court attempted to fit the going private issue into the mainstream of corporate law by relying on traditional concepts like fiduciary duty. It was from this fiduciary duty that the court derived the business (or bona fide purpose) and intrinsic fairness tests.

An analysis of the Delaware approach, therefore, must center around the traditional categories used in Singer. Although such an approach may not provide effective control over going private mergers, it does provide a logical foundation upon which one may examine alternative methods of coping with the going private problem.

1. Fiduciary Duty

The fiduciary duty owed by the majority stockholders serves as the basis for controlling going private transactions. As a result of this fiduciary duty, the majority is required to have a bona fide business purpose for the merger and is required to prove the intrinsic fairness of the terms of the

Lynch, supra note 74, at 40-41.

95 Note, supra note 27, at 583-84.

96 Terrell & Ranney-Marinelli, supra note 30, at 854-55.

97 "The unmistakable focus in Singer was on the law of fiduciary duty." Roland Int'l Corp. v. Najjar, 407 A.2d 1032, 1034 (Del. 1979).
merger. These standards are largely meaningless, however, until defined in specific freezeout situations.

In *Singer* the fiduciary duty was described as the obligation the majority stockholders “owed to the minority stockholders of that corporation . . . in dealing with the latter’s property.” As suggested by the reference to the minority’s property, this concept of fiduciary duty is akin to the duties owed by a trustee to the cestui que trust. This duty at first applied only to corporate directors, being later extended to majority stockholders. In fact, the court in *Singer* defined the fiduciary duty with a long quote from a director’s duty case, adding that “the spirit of the definition is equally applicable to a majority stockholder in any context in which the law imposes a fiduciary duty on that stockholder for the benefit of minority stockholders.” The extent to which a duty meant for trustees and directors in their dealings with the property of others is applicable to the dynamic relations between stockholders in a corporation, all of whom have property interests in the corporation, is a pivotal consideration.

In *Tanzer* the court noted the existence of a fiduciary duty but went on to consider the realities of the majority-minority stockholder relationship. The *Tanzer* court recognized that the majority stockholders have certain rights as stockholders, i.e., they may vote their stock in a self-interested manner. Such stockholders, unlike directors, have the right to vote their shares in a fashion designed to suit their personal interests. This is coextensive with the right that mi-

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98 [The] Supreme Court of Delaware reaffirmed the recently eroded “entire fairness” standard which places upon the majority shareholders standing on both sides of the transaction the burden of proving the merger’s fairness to the minority. The court also established a new “valid purpose” test which requires the majority to prove some economic purpose for the merger. Together, these two standards set forth the fiduciary duty owed to minority shareholders.

Freezeout Mergers, supra note 6, at 224-25 (footnotes omitted).

99 380 A.2d at 976.

100 Id. at 976-77; F. O’Neal, supra note 1, at 508-11 (1975); Comment, supra note 54, at 120.

101 380 A.2d at 977.

102 Id.

103 379 A.2d at 1123.
nority stockholders have to vote for activities which they perceive to be in their interests and to their profit.\textsuperscript{104} As a matter of corporate democracy, it is the majority which rules, yet this is no reason to lose sight of the fact that the majority consists of stockholders.\textsuperscript{105}

Although this discussion is somewhat simplified, it does serve to demonstrate the inappropriateness of dealing with the going private problem on the basis of fiduciary duty. This was tacitly recognized by the Tanzer court, which noted that the majority have interests as stockholders which may be inconsistent with their fiduciary status. Accordingly, the court relaxed the business purpose test somewhat, allowing some “selfishness” on behalf of the majority.\textsuperscript{106} The resulting test is much more consistent with the realities of the going private problem. Unfortunately, this initial step toward focusing on the dynamics of the majority-minority stockholder relationship may be limited to those mergers occurring in the parent-subsidiary context. The Najjar court, dealing with a merger not of the parent-subsidiary variety, found that the “unmistakable focus” was on the law of fiduciary duty.\textsuperscript{107}

The fiduciary duty concept seems more a statement of a result than a definition of the relationship between majority and minority stockholders. The focus should be on a more fundamental level, based as such on the connections between the minority stockholders and the corporation and the reasonable expectations which that relationship entails.\textsuperscript{108} In a close corporation, these connections can be multi-faceted and highly significant. The minority stockholder may be an officer or an employee. He may devote large amounts of time to working for the corporation and receive his return primarily in the

\textsuperscript{104} Id. at 1123-24. The court then quoted from Ringling Bros.—Barnum & Bailey Com. Shows v. Ringling, 53 A.2d 441 (Del. 1947), noting that, “Generally speaking, a shareholder may exercise wide liberality of judgment in the matter of voting, and it is not objectionable that his motives may be for personal profit, or determined by whims or caprice, so long as he violates no duty owed his fellow shareholders.” Id. at 447.

\textsuperscript{105} Note, supra note 27, at 604-05.

\textsuperscript{106} 379 A.2d at 1123-24.

\textsuperscript{107} 407 A.2d at 1034.

\textsuperscript{108} Note, supra note 27, at 598.
form of salary. Such a stockholder is not in any real sense comparable to the public stockholder, whose only connection to the corporation is as an investor. In fact, the cases distinguish between stockholders on this basis by requiring a stricter fiduciary duty among stockholders in a close corporation.

To a great extent the concept of fiduciary duty is closely linked to a vested rights theory of stock ownership. In Singer, the court expressly states that the stockholder has an interest in the form as well as the value of his investment. Singer is not wrong in this respect; it is simply that the form of the investment being protected is not a vested property right. As was noted in the discussion of the legislative and judicial history which preceded the Singer line of cases, the absolute right of a stockholder to prevent a change in the form of his investment is an historical anachronism. In addition, the rights of the stockholder to be protected via the fiduciary duty of the majority differ with the context in which the stock is owned. The public stockholder in a public corporation is in reality concerned only with the value of his stock as an investment. His interest is in a sense one-dimensional. Where a close corporation is concerned, the court should be more solicitous of the minority stockholder's position, since the form of his investment includes a variety of connections to the enterprise. In any event, to state that a fiduciary duty exists vis-a-vis the form of the minority's investment is meaningless unless the actual nature of that investment is investigated. Only then can the stockholder's damage be accurately assessed in

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108 See notes 23-26 supra and accompanying text for a discussion of the role of minority stockholders in a close corporation.
110 Terrell & Ranney-Marinelli, supra note 30, at 866-67; Note, supra note 27, at 602-04; Comment, supra note 54, at 130-32; Comment, supra note 6, at 813-14.
112 1 M. Lipton & E. Steinberger, supra note 35, at 444; Note, supra note 27, at 600-02.
113 380 A.2d at 977-78.
114 See notes 74-85 supra and accompanying text for a discussion of the legislative precedent prior to Singer.
115 Note, supra note 27, at 602-04.
the freezeout context.\textsuperscript{116} If a stockholder's interest in the enterprise is only an investment interest, protection of the form of the investment is overbroad.

2. Business Purpose

The business or bona fide purpose test provides much of the content of the fiduciary duty approach of Singer-Tanzer-Najjar.\textsuperscript{117} In order to protect the form of the minority stockholder's investment from undue encroachment by the majority, the latter must demonstrate compliance with the bona fide purpose test. Only then may the cash out merger be completed.\textsuperscript{118} The bona fide purpose test means two things. It means that no merger will be permitted where the sole purpose is to freeze out the minority. Additionally, it requires that the majority demonstrate a bona fide purpose for engaging in the merger transaction. The test is perceived as a compromise between the property interest of the minority stockholder and the need for a degree of corporate flexibility.\textsuperscript{119}

Although the second part of the test is more complex, it is the first part of the test upon which Najjar has had the most impact. Singer held that a long form merger could not be pursued for the sole purpose of cashing out the minority. It was unclear prior to Najjar whether that rule would be applied to

\textsuperscript{116} Ultimately, minority shareholder protection which extends beyond the fair value of the investor's shares assumes that the minority's interest within the corporation is not exclusively economic. Neither courts nor commentators, however, have identified the nature of the shareholder's noneconomic interest. . . . A breach of fiduciary duty which produces no injury surely is not actionable. Furthermore, the implication that the shareholder's elimination itself is the injury merely begs the question. Aside from investment valuation, the issue critically posed is whether the shareholder's elimination is an injury.

\textit{Id.} at 599-600 (footnotes omitted).

\textsuperscript{117} \textit{Freezeout Mergers}, supra note 6, at 224-25.


short form mergers.

At the time the Najjar litigation arose, the seminal Delaware case on short form mergers was Stauffer v. Standard Brands, Inc., which involved a merger between parent and subsidiary. The minority stockholders in the subsidiary were given cash for their stock. A minority stockholder brought suit claiming that the cash offered for the stock was grossly inadequate and asked that the merger be set aside. The court rejected the argument of the stockholder and affirmed a chancery ruling that appraisal was his sole remedy, absent fraud or illegality. The decision was based on two New York cases construing that state’s statute because, as explained in Coyne v. Park & Tilford Distillers Corp., the Delaware statute borrowed from New York law. The court then went on to establish this rule:

Indeed it is difficult to imagine a case under the short merger statute in which there could be such actual fraud as would entitle a minority to set aside the merger. This is so because the very purpose of the statute is to provide the parent corporation with the means of eliminating the minority shareholder’s interest in the enterprise.

The actual holding, however, was not so broad. The court found that the dispute concerned only the value of the minority’s stock; therefore appraisal was the only available relief.

Although Singer dealt with a long form merger, the court of chancery seized upon Singer’s language and applied its reasoning to short form mergers in Young v. Valhi, Inc. and Kemp v. Angel. Thus, it was not surprising that when the

120 187 A.2d 78 (Del. 1962).
121 Id. at 80.
122 Id.
124 154 A.2d 893 (Del. 1959).
125 187 A.2d at 80.
126 Id.
127 382 A.2d 1372 (Del. Ch. 1978).
128 381 A.2d 241 (Del. Ch. 1977). For a discussion of these two cases, see 1 M. Lipon & E. Steinberger, supra note 35, at 445, 449-50; McClure, supra note 29, at 929-31; Note, supra note 27, at 594-97; Comment, Freeze-Out Merger—Allegation
Delaware Supreme Court again faced the issue in *Najjar* it overruled any contrary implications of *Stauffer* and held that the *Singer* reasoning applied to short form mergers as well.\(^{129}\)

Thus, a short form merger effectuated solely to freeze out the minority is a violation of fiduciary duty. This fiduciary duty is not lessened just because the minority holdings are very small.\(^{130}\) Consequently, the bona fide purpose test must be met. The short form merger statute is not a means by which the parent corporation may indiscriminately cash out minority interests in the subsidiary, nor, the court concluded, did the legislature intend it to be.\(^{131}\)

Given the wisdom of hindsight, this final conclusion may well be untenable. The General Corporation Law Committee of the Delaware legislature has since proposed legislation designed to negate *Singer* in short form merger situations.\(^{132}\)

The *Najjar* opinion resolved most issues surrounding the first part of the bona fide purpose test. There are no exceptions to the rule that a merger cannot be justified for the sole purpose of freezing out the minority. At this point it is the second part of this test, requiring as it does a bona fide purpose for the merger, that merits careful consideration.

The concept of business purpose is not unique to Delaware law;\(^{133}\) other jurisdictions applied a business purpose test to freezeout mergers long before *Singer*. The leading case in

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\(^{129}\) 407 A.2d at 1036.

\(^{130}\) Id.

\(^{131}\) Id.

\(^{132}\) Note, supra note 27, at 597.

\(^{133}\) For a discussion of the cases dealing with the business purpose test prior to *Singer*, see 2 J. FLOM, M. LIPTON & E. STEINBERGER, supra note 45, at 17-43; Note, The Second Circuit Adopts a Business Purpose Test for Going Private: Marshel v. AFW Fabric Corp. and Green v. Santa Fe Industries, Inc., 64 CAL. L. REV. 1184 (1976) [hereinafter cited as Business Purpose Test]; Rights of Minority Shareholders, supra note 5, at 988-93; Comment, Going Private: Santa Fe Industries, Inc. v. Green—The Supreme Court Decision in Rule 10b-5 Actions, 30 OKLA. L. REV. 593 (1977); Comment, supra note 54, at 121-26; Comment, supra note 63, at 1166; Comment, supra note 5, at 1426-27.
this regard was Bryan v. Brock & Blevins Co.,\textsuperscript{134} a case in which all the stockholders of the corporation except one created a new corporation to which they contributed their stock. They then attempted to merge the new corporation with the old and cash out the remaining stockholder. The court, applying Georgia law, held that such a merger was an illegal attempt to circumvent the rule prohibiting the majority from cashing out the minority in the absence of a business purpose for the merger.\textsuperscript{135} A business purpose was also required by the Second Circuit in Green v. Santa Fe Industries, Inc.,\textsuperscript{136} on the basis of rule 10b-5.

Certain Delaware cases have also applied a version of the business purpose rule to other types of transactions.\textsuperscript{137} In Bennett v. Breuil Petroleum Corp.,\textsuperscript{138} the majority interests caused the issuance of additional stock in the corporation and denied the minority stockholder his preemptive right to buy some of the new issue. In a suit to cancel the new issue of stock, the court stated that any “action by majority shareholders having as its primary purpose the ‘freezing out’ of a minority interest is actionable.”\textsuperscript{139} Similarly, in Condec Corp. v. Lunkenheimer Co.,\textsuperscript{140} the court applied this reasoning when the purpose for an issue of stock was alleged to be retention of corporate control by the majority interests.

Although there is ample precedent to support the application of a business purpose test, the substance of the test itself is discomfortingly unclear. Though there are many areas which have been left untouched in describing the business purpose, there are three problematical inquiries which must be made in order to apply it. It must be determined: 1) whose purpose may be served; 2) what will suffice as a business purpose; and 3) what activity must be justified.

\textsuperscript{134} 490 F.2d 563 (5th Cir. 1974).
\textsuperscript{135} Id. at 570.
\textsuperscript{136} 533 F.2d 1283 (2d Cir. 1976), rev'd, 430 U.S. 462 (1977).
\textsuperscript{137} For a discussion of these cases, see Balotti, supra note 75, at 66-67; Lynch, supra note 74, at 39-40; Note, supra note 27, at 583-84; Note, supra note 119, at 724-25.
\textsuperscript{138} 99 A.2d 236 (Del. Ch. 1953).
\textsuperscript{139} Id. at 239.
\textsuperscript{140} 230 A.2d 769 (Del. Ch. 1967).
a. The Source

The first determination focuses mainly upon whether the business purpose must stem from the corporation itself or merely from the individual stockholders in the majority. Arguably this issue was resolved in Tanzer, in which the court held that a parent corporation, "as a stockholder of [the subsidiary], had a right to look to its own corporate concerns in determining how to conduct the latter's affairs, including a decision to cause it to merge."

It is clear, therefore, that in the parent-subsidiary context a business purpose of the parent as a stockholder will justify the merger. If the majority consists of individual stockholders, however, as was the case in Najjar, resolution of this issue is not so clear. The cloudiness is the result of the approach taken by the Najjar court, an approach which failed to adopt the Tanzer reasoning set forth above.

Apparently the Najjar decision was based on the fact that a sham corporation was created to facilitate a short form merger. That the merger was of the insider type, presumably for the sole purpose of freezing out the minority, was emphasized. Even so, the court might well have borrowed from the language of the Tanzer opinion. In failing to extend the Tanzer concept to situations outside the parent-subsidiary context, the Najjar court overlooked two factual consistencies in the cases. In both instances a new corporation was formed to effectuate the merger.

Furthermore, one of the "individual" shareholders in Najjar was a corporate entity (Hyatt Corp.), thereby likening the circumstances to that of the parent-subsidiary context.

Moreover, there is no apparent reason why the Tanzer holding should be limited to the parent-subsidiary situation. Clearly, individual stockholders are equally entitled to vote their stock "selfishly." Implicit in a limitation of Tanzer to

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141 379 A.2d at 1124.
142 407 A.2d at 1037. The court described the merger involved as "a classic 'going private' transaction." Id.
143 In Tanzer the parent corporation, IGI, formed KLK for the purpose of merging with Kliklok and freezing out the minority. 379 A.2d at 1122.
144 Ringling Bros.—Barnum & Bailey Com. Shows v. Ringling, 53 A.2d 441 (Del.
the parent-subsidiary context is the notion that the business purpose need be that of a *corporation*. This notion is inconsistent with the rationale of *Tanzer*, that all *stockholders*, even those in the majority, may vote their stock pursuant to their own interests. Ultimately, even in the parent-subsidiary context, it is the stockholders of the parent corporation who benefit at the expense of the minority stockholders of the subsidiary. As long as the purpose is bona fide, it would seem to be of no real consequence to the minority stockholder whether the source of that purpose is a corporate or an individual stockholder.

b. *The Content*

In any event, no matter what the source of the business purpose, it must be bona fide. Just what type of motivation is proper is unclear. The first point to note is that even though *Singer* uses the older "business purpose" terminology,¹⁴⁵ *Tanzer* and *Najjar* require only that the purpose be "bona fide."¹⁴⁶ This distinction is not merely semantic; it represents a substantive change between *Singer* and *Tanzer*. The *Tanzer* court discusses the distinction in two separate statements, beginning:

> The parties, following the language of some of the cases, have analyzed the problem in terms of "business purpose" (or "business reason"), but it seems to us that that is not helpful because, at best, the phrase is ambiguous and, at worst, it states a result and not a right or duty.¹⁴⁷

And concluding with:

> Although we have stated that IGI [the parent] is entitled as majority stockholder to vote its own corporate concerns, it should be noted that IGI's purpose in causing the merger must be *bona fide*. As a stockholder, IGI need not sacrifice its own interest in dealing with a subsidiary; but that interest must not be suspect as a subterfuge, the real purpose of

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¹⁴⁶ 380 A.2d at 976, 978.
¹⁴⁷ 379 A.2d at 1123.
which is to rid itself of unwanted minority stockholders in the subsidiary.\footnote{Id. at 1124.}

This change in terminology was in part intended to reflect the shift from the corporation as the source of the proper purpose to a focus on the parent as stockholder. Whether a further change was intended is uncertain, since a substantive definition of business purpose never really has been clear.

A few types of business or bona fide purposes have been suggested (and criticized) in cases and commentaries, with only a very few having been approved in the cases. In Tanzer, the court found that improving the long-term debt financing posture of the parent corporation was a bona fide reason for a freezeout merger between parent and subsidiary.\footnote{Id. at 1124-25. See Comment, supra note 63, in which it is suggested that this is a consequence of any merger.} In Grimes v. Donaldson, Lufkin & Jenrette, Inc.,\footnote{392 F. Supp. 1393 (N.D. Fla. 1974), aff'd, 521 F.2d 812 (5th Cir. 1975).} the court distinguished Bryan v. Brock & Blevins Co.,\footnote{490 F.2d 563 (5th Cir. 1974).} on the ground that there was a valid business purpose for the merger in the former. The approved purpose was twofold. The corporations were engaged in the same business, and the merger was in part meant to remove potential conflicts which existed as long as there were public shareholders in the subsidiary. Additionally, the merger led to savings in the day-to-day operations of the corporation amounting to $300,000 yearly.\footnote{392 F. Supp. at 1402. See Freezeout Mergers, supra note 6, at 225-26, which suggests that these purposes do not require a cashing out of the minority.} It is certainly arguable that both reasons inured solely to the benefit of the parent in its capacity as stockholder. The only purpose mentioned in the cases which cannot be said to inure solely to the benefit of the majority stockholder was outlined in Polin v. Conductron Corp.\footnote{552 F.2d 797 (8th Cir. 1977).} and Matteson v. Ziebarth.\footnote{242 P.2d 1025 (Wash. 1952).} In those cases the court accepted, as a legitimate business purpose, avoidance of the imminent financial collapse of one of the corporations involved.

The commentators discuss other potential purposes. For
instance, some argue that the savings to the corporation incident to relief from the registration requirements of the SEC should be deemed a proper purpose for going private.\textsuperscript{155} Others argue that it is incongruous to justify pushing out public investors to avoid SEC regulations designed for their protection.\textsuperscript{156} Some commentators argue that corporate benefits are obtained from changing the value of the corporate stock from a depressed market value to a higher book value.\textsuperscript{157} The dissenters claim that the only justification for increasing stock values is to attract public investors, and, in any event, in a going private transaction all of this benefit would inure to the remaining majority.\textsuperscript{158}

The value of the business purpose test is greatly reduced by these divergent views. Not only does this divergence hamper a court's analysis of a given transaction, but the deterrent effect of the entire legal theory is abated as well.\textsuperscript{159} A great deal of the disagreement is caused by a failure to address the fundamental issues involved. A part of this problem, the failure to determine the source of the business purpose, has been discussed previously.\textsuperscript{160} A much more perplexing problem is created by the failure to consider exactly what activity must be justified by a business purpose.

c. The Activity

Ordinarily, two distinct events comprise a going private transaction. There is the basic corporate change—usually a merger—and there is the cashing out of minority stockholders. As yet no court has said which event must be justified by a business purpose.\textsuperscript{161} The \textit{Najjar} opinion exemplifies this

\textsuperscript{155} Note, \textit{supra} note 27, at 571-72.

\textsuperscript{156} Brudney, \textit{supra} note 6, at 1032-34; Note, \textit{supra} note 30, at 907; Comment, \textit{supra} note 5, at 1439-41.

\textsuperscript{157} Note, \textit{supra} note 27, at 574-75; Comment, \textit{supra} note 5, at 1444-45.

\textsuperscript{158} Brudney, \textit{supra} note 6, at 1035-36; Note, \textit{supra} note 30, at 908-09.

\textsuperscript{159} Comment, \textit{supra} note 6, at 811. See Note, \textit{supra} note 27, at 581.

\textsuperscript{160} See notes 141-44 \textit{supra} and accompanying text for the discussion of whose purpose must be justified.

\textsuperscript{161} McBride, \textit{supra} note 118, gives an example of the confusion caused by the failure to make such a distinction:

\begin{quote}
In a variety of circumstances, the sole purpose of the merger may be to
\end{quote}
oversight. In discussing its earlier Tanzer decision, the court spoke of the bona fide purpose test as if it had been applied to both events, failing to note a distinction. The following discussion is taken from the same paragraph:

In Tanzer we held that even when a parent corporation has a bona fide purpose for merging with its subsidiary, the minority shareholders . . . are entitled to a judicial review for "entire fairness". . . . In other words, the fiduciary duty exists even if the majority has a bona fide purpose for eliminating the minority. . . . 162

Focus on this point is crucial, and continuing to ignore it will merely obfuscate the theory. Requiring a business purpose for the merger itself involves the court in an unnecessarily complex balancing process between the legislative policy of corporate flexibility and the minority interest in continued participation in the enterprise. As is expressly stated in Singer, the minority stockholder has some type of interest in the form of his investment.163 It is equally clear, however, that this interest does not outweigh the unequivocal right to merge granted by state corporation statutes.164 Thus, the desire of a minority stockholder to retain the present form of his investment is insufficient to prevent a properly approved merger.

eliminate the minority shareholders, but there is a business reason for eliminating the minority shareholders. For instance, it has been suggested that avoiding the expense of SEC registration may be justification for "going private." In one sense, a merger in this situation is for the sole purpose of eliminating minority shareholders. On the other hand, there is a business purpose behind the elimination of the minority shareholders. Again, Singer contains no explicit holding on this point.

Id. at 2244.

407 A.2d at 1034-35.

380 A.2d at 977-78.

See notes 78-85 supra and accompanying text for a discussion of the right of a corporation to merge under the corporation statutes.

In this regard, the Singer court noted that:

To state the obvious, under § 251 two (or more) Delaware corporations "may merge into a single corporation." Generally speaking, whether such a transaction is good or bad, enlightened or ill-advised, selfish or generous—these considerations are beside the point. Section 251 authorizes a merger and any judicial consideration of that kind of togetherness must begin from that premise.

380 A.2d at 973.
Concentrating on the merger phase also limits the remedial response of the court. If no proper purpose is found, the natural response is to enjoin the merger. This is wholly inconsistent with the court’s equity role, as was noted in the *Najjar* dissent:

>[T]he Court is tending to flesh out broad equitable principles into rules and formats that automatically hold mergers “made for the sole purpose of freezing out minority stockholders [are] an abuse of the corporate process,” that anticipate and delineate matters “reserved for another day,” that require “fairness hearing[s]” without express reference to any specific allegations, and that establish, as the majority opinion illustrates here, preconceived “threshold requirement[s].” The very uniqueness of equity is its ability to react on a case-by-case basis without the rigidity of pigeonholes.^^155^ ^^2^6

The *Najjar* dissent further noted that the basis for the imposition of judicial scrutiny is the breach of fiduciary duty, not the violation of a vested property right.^^166^ Emphasis on maintaining the form of the investment, as occurred in *Singer*, actually comes very close to acceptance of the type of outmoded vested rights concept once supported by *Keller*.^^167^

The focus of the bona fide purpose test should be on the cash out phase of the merger. Given that mergers are encouraged transactions regardless of purpose,^^168^ the pivotal question should be whether the minority stockholders may be cashed out as a consequence of the merger. Even so, certain problems arise. The legislature (at least in Delaware) has clearly approved the use of cash or instruments of debt, as well as stock, as the medium of exchange in a merger.^^169^ The statute places no additional restrictions on the use of cash, such as the imposition of a special business purpose requirement.^^170^

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^^155^ 407 A.2d at 1038 (Quillen, J., dissenting).

^^166^ Id. at 1038 n.4.

^^167^ This is precisely the argument made by the commentator in Note, supra note 27, at 601-02.

^^168^ Such was the indication of the court in *Singer*, 380 A.2d at 978.


^^170^ This point is discussed in *Singer*, 380 A.2d at 975.
It is difficult to conceive of a bona fide purpose which would justify cashing out the public stockholders per se.\textsuperscript{171} One can never be found by concentrating on the merger phase. For instance, consider the purpose accepted in \textit{Grimes v. Donaldson, Lu\&kern Jenrett, Inc.},\textsuperscript{172} i.e., the avoidance of conflicts of interests between the parent and the minority stockholders of the subsidiary. Presumably the parent has minority stockholders of its own. The conflicts between the parent and subsidiary, then, could just as easily have been removed by giving the minority stockholders shares in the parent corporation, as opposed to cashing them out.\textsuperscript{173}

In light of this discussion of bona fide purpose, it is helpful at this point to examine the Brudney-Chirelstein approach to the going private problem.\textsuperscript{174} According to the view of these authors, there are three basic types of going private mergers. These are the tender offer and subsequent merger by an outside corporation; the absorption of a subsidiary by its parent; and, last, the merger effectuated by the creation of a sham corporation solely for that purpose.\textsuperscript{175} The authors feel that in any going private transaction the degree of judicial scrutiny should be controlled by the type of merger involved, adjusted slightly by the facts of each case. In the tender offer situation, absent some element of overreaching, the court

\textsuperscript{171} Failing to distinguish the merger phase from the cash out phase in applying the business purpose test has led to the argument by some commentators that a merger should not be permitted where the business purpose it would further could be accomplished by an alternative device. McBride, supra note 118, at 2244; Comment, supra note 54, at 132-33. It is not really the merger which is the "distasteful" transaction; it is the cashing out of the minority. The inquiry should not be whether there exists some alternative to the merger, but whether the actual cash out phase of the merger is necessary.

\textsuperscript{172} 392 F. Supp. 1393, 1402 (N.D. Fla. 1974).

\textsuperscript{173} In \textit{Grimes}, it was accepted as a valid business purpose "that there is a justified concern that as long as a public minority exists in Meridian [the subsidiary], joint ventures and business dealings between the corporations will be inhibited by potential claims of conflict of interest by either Meridian or DLJ [the parent] shareholders." \textit{Id.} Even so, it should be recognized that the conflict problem will be removed whenever the parent company obtains complete control over the subsidiary. In terms of the benefit derived, therefore, it should not matter whether the minority shareholders are given cash or equity. \textit{Freezeout Mergers}, supra note 6, at 225-26.

\textsuperscript{174} Brudney & Chirelstein, supra note 4. A similar approach is offered in Greene, supra note 22.

\textsuperscript{175} Brudney & Chirelstein, supra note 4, at 1356.
should not tamper with the merger as long as the cash out price is the same as the tender offer price; the rationale being that since the tender offer price is approved by an independent board of directors, it is the result of an arm's length bargain. In the parent-subsidiary merger, the potential for self-dealing is greater; therefore, it is felt that the court should scrutinize the fairness of the merger terms, yet ignore its purpose. The authors feel that in the sham merger situation the court should automatically enjoin the merger. This approach is not concerned with finding a specific business purpose. The authors argue that a business purpose is presumed in the first two situations, but is presumed to be absent in a sham merger. Although the factual distinctions which these commentators draw are open to dispute, their approach is a conscious attempt to maintain the integrity of the merger process per se, while focusing judicial concern on the cash out phase of the transaction.

3. Intrinsic Fairness and Fairness Hearings

The second requirement of the Singer-Tanzer-Najjar line is that the majority prove the intrinsic fairness of the transaction. The fairness requirement is an additional burden which operates independently of the bona fide purpose inquiry. As such, the fairness test may remain unsatisfied even after a business purpose is found; thus, "proof of a purpose, other than . . . [a] freezeout, without more, will not nec-

\[\text{\textsuperscript{178}}\text{ Id. at 1361-62.}\]
\[\text{\textsuperscript{177}}\text{ Id. at 1359-61.}\]
\[\text{\textsuperscript{176}}\text{ Id. at 1371-73.}\]
\[\text{\textsuperscript{175}}\text{ Id. at 1367.}\]
\[\text{\textsuperscript{174}}\text{ Id. at 1356.}\]
\[\text{\textsuperscript{180}}\text{ Id. at 1357-59.}\]
\[\text{\textsuperscript{181}}\text{ Roland v. Najjar, 407 A.2d at 1034; Singer v. Magnavox, 380 A.2d at 980; Tanzer v. IGI, 379 A.2d at 1125.}\]
essarily discharge [the majority's fiduciary duty]. In such case the court will scrutinize the circumstances for compliance with the . . . rule of 'entire fairness'. . . ."\textsuperscript{184}

The test was derived from prior Delaware cases, primarily \textit{Sterling v. Mayflower Hotel Corp.}\textsuperscript{185} \textit{Sterling} did not involve a freezeout. Instead it concerned the attempt of Hilton Hotels Corporation to merge with Mayflower, its subsidiary, via a share-for-share exchange. The boards of both corporations approved the terms of the merger, but the minority stockholders of Mayflower sued to enjoin the merger on the grounds of unfairness. Hilton relied on the approval of the boards.\textsuperscript{186} The court held that the Hilton-elected directors stood "on both sides of the transaction, [so] they bear the burden of establishing its entire fairness, and it must pass the test of careful scrutiny by the courts."\textsuperscript{187} The case, therefore, stood for the proposition that intrinsic fairness must be proven in an interested merger, \textit{i.e.}, in which one party stands on both sides of the transaction.

This reasoning was followed in subsequent Delaware cases as well. In \textit{Bastian v. Bourns, Inc.}\textsuperscript{188} an individual, Marlan Bourns, had controlling interests in both corporations intending to merge. The minority stockholders attacked the proposed rate of exchange. The court held that Bourns, being on both sides of the transaction, had the burden of proving intrinsic fairness.\textsuperscript{189} Similarly, in \textit{David J. Greene & Co. v. Dunhill International, Inc.}\textsuperscript{190} the court held that the party that "stands upon both sides of the proposed merger, . . . (a) has the burden of proof, (b) to show that the transaction is fair, (c) after a careful scrutiny by the Court."\textsuperscript{191}

\textsuperscript{184} 380 A.2d at 980.
\textsuperscript{185} 93 A.2d 107 (Del. 1952). For a discussion of the fairness cases prior to \textit{Singer}, see McBride, \textit{supra} note 118, at 2250-53; McClure, \textit{supra} note 29, at 918; \textit{Freezeout Mergers, supra} note 6, at 229-32; \textit{Corporate Freezeouts, supra} note 5, at 699-701; \textit{Note, supra} note 119, at 719-22; \textit{Note, supra} note 30, at 925-28.
\textsuperscript{186} 93 A.2d at 109.
\textsuperscript{187} \textit{Id. at 110.}
\textsuperscript{188} 256 A.2d 680 (Del. Ch. 1969).
\textsuperscript{189} \textit{Id. at 681.}
\textsuperscript{190} 249 A.2d 427 (Del. Ch. 1968).
\textsuperscript{191} \textit{Id. at 431.}
Another line of cases, however, did not apply the intrinsic fairness test, holding instead that appraisal was the sole remedy for a dissenting stockholder. In *Bruce v. E. L. Bruce Co.*\(^{192}\) the minority shareholders of the subsidiary sought to enjoin a planned merger with the parent corporation. The plaintiffs argued that the exchange ratio was an undervaluation of their stock.\(^{193}\) The court, much to the minority's chagrin, held that statutory appraisal was their sole remedy because:

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\text{[A]bsent fraud or a showing that the terms of a proposed merger are so unfair as to shock the conscience of the court it is the policy of the courts of Delaware to permit contracting corporations to take advantage of statutory devices for corporate consolidation furnished by legislative act. . . . Judicial interference is inappropriate in most instances of merger because an efficient and fair method has been provided which permits judicially protected withdrawal by stockholders from a proposed consolidation.}\(^{194}\)
\]

The Delaware Supreme Court followed similar reasoning in *Stauffer v. Standard Brands Inc.*, discussed *supra*, holding therein that appraisal was the sole and exclusive remedy in a short form cash out merger situation.\(^{195}\)

The court was confronted with these two conflicting lines of authority when it next dealt with freezeout mergers in *Singer*.\(^{196}\) The court opted for an attempt at controlling freezeouts, adopted the *Sterling* viewpoint, and required a fairness hearing to justify the terms of a merger.\(^{197}\) The court also stated specifically that the majority stockholders could not satisfy their fiduciary duty merely by relegating the minority to statutory appraisal.\(^{198}\)

At least part of the reason for abandoning appraisal as the exclusive remedy rests with the shortcomings of the appraisal process itself.\(^{199}\) The statutes require that the dissent-

\(^{192}\) 174 A.2d 29 (Del. Ch. 1961).
\(^{193}\) Id. at 30.
\(^{194}\) Id.
\(^{195}\) 187 A.2d 79, 80 (Del. 1962).
\(^{197}\) 380 A.2d at 976.
\(^{198}\) Id. at 977.
\(^{199}\) *Najjar* suggested some of the problems with the appraisal remedy: 1) it is
ing stockholder follow certain specific procedures, and the cases require strict and technical compliance with those procedures. Furthermore, the recovery of the appraisal remedy is reduced by attorneys' and appraisers' fees. The most difficult problems with the appraisal remedy, however, arise from the inadequacy of the valuation process. Timing is completely controlled by the majority. Thus, the dissenting stockholder may suffer inopportune tax consequences. Furthermore, the merger frequently occurs when the corporation is on the verge of significant growth or profit which has not yet manifested itself in the market. The appraising court values the stock as of the time of the merger, thus failing to account for any appreciation in stock value caused by the impending merger or prospective earnings of the corporation. Therefore, the dissenting stockholder generally is not given a value for his stock which reflects an arm's length bargain, and there is no assurance of fairness.

Although the fairness hearing could be construed as a substitute for the appraisal remedy, the cases are unclear about this. The Tanzer court held that a fairness hearing which concentrated solely on the price offered for the stock was overly restrictive and that the fairness hearing requires a court to scrutinize "all aspects of the transaction." Commentators have been more helpful in describing a fairness hearing. Generally, it is conceived as a broad balancing of the factors involved in the freezeout merger. It is gen-

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202 F. O'Neal, supra note 1, at 332 (1975); Greene, supra note 22, at 503; Lynch, supra note 74, at 53-57; Corporate Freezeouts, supra note 5, at 698-99.
203 F. O'Neal, supra note 1, at 334 (1975); Lynch, supra note 74, at 53-57; Vor- enberg, supra note 4, at 1200-05; Corporate Freezeouts, supra note 5, at 697-99.
204 Lynch, supra note 74, at 53-57.
205 Id.; Corporate Freezeouts, supra note 5, at 698.
206 Comment, supra note 6, at 809.
207 379 A.2d at 1125.
208 See Freezeout Mergers, supra note 6, at 236; Corporate Freezeouts, supra note 5, at 707.
erally seen as a vehicle by which the court can properly exercise its equitable powers, allowing, as it does, scrutiny of all the facts unique to each case.\textsuperscript{209} There are a number of factors to be considered, among them, the existence of any coerciveness or overreaching by the majority, the condition of the market and the timing of the transaction, the presence or absence of any selfdealing by the majority, and any relevant tax consequences.\textsuperscript{210} It is clear, however, that the two most important factors will still be the adequacy of the business purpose and the price.

The importance of the business purpose is reflected in terms of whether that purpose can be satisfied short of freezing out the minority.\textsuperscript{211} This issue reveals the defects in the business purpose test which have already been discussed, \textit{i.e.}, whether the focus should be on the merger or the cash out phase.\textsuperscript{212} Another concern is just what impact the business purpose should have in the fairness hearing. On the one hand, it may be considered a threshold issue which, if found to exist, proves the absence of intrinsic unfairness. The burden of proof would then be shifted to the minority stockholders.\textsuperscript{213} On the other hand, it may be considered just one of many factors.\textsuperscript{214} The courts should be careful not to put undue emphasis on business purpose.\textsuperscript{215} Clearly, since the fairness issue invokes the equity powers of the court, overemphasis of strict standards and pigeonholes should be avoided.\textsuperscript{216} The flexibility of the equity courts must be maintained in order to deal with the unique and varying fact patterns that arise in the going private context.

The adequacy of the price is clearly the single most important issue, especially in the going private context. The interest of the public stockholder lies only in the value of his

\begin{itemize}
\item \textsuperscript{209} \textit{Freezeout Mergers}, supra note 6, at 236.
\item \textsuperscript{210} \textit{Id.}; \textit{Corporate Freezeouts}, supra note 5, at 707.
\item \textsuperscript{211} \textit{See Comment}, supra note 54, at 132-33.
\item \textsuperscript{212} \textit{See notes} 161-82 supra and accompanying text for a discussion of this issue.
\item \textsuperscript{213} \textit{Comment}, supra note 54, at 132-33.
\item \textsuperscript{214} \textit{Corporate Freezeouts}, supra note 5, at 707.
\item \textsuperscript{215} \textit{Id.}
\item \textsuperscript{216} Roland v. Najjar, 407 A.2d at 1038 (Quillen, J., dissenting).
\end{itemize}
investment. Most commentators argue that consideration of the fairness of the price should move away from the appraisal-type approach. This movement should be toward a formula which gives the minority stockholder some recognition of the future prosperity of the corporation which he is being forced to leave. The fairness of the price should be determined by the arm’s length bargain standard. The value of the stock should not depend solely on pre-merger indicia (such as market price, past earnings, and dividend records) but should also consider the value of the corporation as a going concern, the value of the stock as affected by the pending merger, and the potential for future earnings. An evaluation of this type is more consistent with the realistic expectations of public stockholders regarding the value and the nature of their interest in the stock.

4. An Overview of the State Law Approach

The requirement of a fairness hearing is the most reasonable upshot of the Singer line of cases, proposing as it does to look at each going private transaction in terms of the relevant facts involved. By the same token, the fairness hearing, as herein interpreted, does no more than describe the traditional functions of a court of equity. This conception of the fairness test minimizes the impact of a separate business purpose test with its attendant problems. Moreover, this approach also provides the flexibility of relief found lacking by the dissenter in Najjar.

217 See Freezeout Mergers, supra note 6, at 235-36.
218 Toms, Compensating Shareholders Frozen Out in Two-Step Mergers, 78 Colum. L. Rev. 548, 575-77 (1978); Business Purpose Test, supra note 133, at 1216-17; Rights of Minority Shareholders, supra note 5, at 1000-01; Comment, supra note 6, at 809-10.
219 Comment, supra note 6, at 809.
220 Toms, supra note 218, at 575-77; Business Purpose Test, supra note 133, at 1216-17; Rights of Minority Shareholders, supra note 5, at 1000-01; Comment, supra note 6, at 809-10.
221 407 A.2d at 1038 (Quillen, J., dissenting).
III. The Federal Contribution

Federal participation in going private law has been inconsistent and varied. After some decisions of the Second Circuit promised to provide a basis for extensive federal intervention in the area, the Supreme Court decided *Green v. Santa Fe Industries, Inc.* an opinion which put severe limits on the Second Circuit approach. As a result, recent federal developments represent the first steps toward renewed involvement.

A. The Background of the Federal Approach

Federal securities law is generally adequate to control a going private merger where there are material misstatements or omissions or where actual fraud surrounds the transaction. The courts attempted to broaden established securities law concepts so as to cover going private transactions even where there were no material misleading statements made nor deception practiced by those in control of the corporation. The two cases which initiated this movement were the Second Circuit decisions in *Green v. Santa Fe Industries, Inc.* and *Marshel v. AFW Fabric Corp.*

The *Green* case involved a short form merger under Delaware law in which the minority stockholders of Kirby Lumber Corporation were cashed out. The plaintiffs, minority stockholders, sued under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 to enjoin the merger, claiming the merger was a scheme to defraud them. The primary grievance of the plaintiffs was that their stock was grossly undervalued, as opposed to any claim of misrepresentation in the proxy materials. Despite the absence of deceptive conduct, the court found:

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224 F. O'Neal, *supra* note 1, at 63-64 discusses freezeout mergers dealing with misstatements and omissions in proxy materials.


227 533 F.2d at 1285-89.
[T]hat a complaint alleges a claim under Rule 10b-5 when it charges, in connection with a Delaware short-form merger, that the majority has committed a breach of its fiduciary duty to deal fairly with minority shareholders by effecting the merger without any justifiable business purpose.228

Marshel involved a similar situation. Therein the plaintiffs, minority stockholders in Concord Fabrics, Inc., sought to enjoin a merger between Concord and AFW Fabric Corp. Again the basis for the claim was section 10(b) and rule 10b-5. The plaintiffs alleged that the sole purpose of the merger was to make Concord private by cashing out the public stockholders. The defense was that there were no deceptive statements made and that the state merger law was strictly followed.229 The court held that rule 10b-5 applied despite the absence of deceptive statements, stating in the course of its opinion:

In the present case the "merger" itself constitutes a fraudulent scheme because it represents an attempt by the majority stockholders to utilize corporate funds for strictly personal benefit. Under these circumstances it would surely be anomalous to hold that a cause of action is stated under §10(b) and Rule 10b-5 when the fraudulent conduct in connection with a purchase or sale of securities includes deception but that similarly fraudulent practices carried out with prior disclosures to the helpless victim do not give rise to a Rule 10b-5 claim.230

The final word, however, came from the Supreme Court in Green. The Supreme Court saw the determining factor as whether a material misrepresentation was made or whether there was a material failure to disclose.231 The Court held that a violation of rule 10b-5 occurred only if the conduct complained of was manipulative or deceptive within the meaning of the statute.232 The activity was found not deceptive because it did not involve a material non-disclosure.233 Furthermore,

228 Id. at 1291.
229 533 F.2d at 1278-80.
230 Id. at 1282.
231 430 U.S. at 473-74.
232 Id.
233 Id. at 474-76.
there was no manipulation since that term "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." As a result, the holding was that absent an allegation of misstatement or omission, no cause of action was stated under federal law. Thus, the Supreme Court put an end to any realistic possibility of using rule 10b-5 and section 10(b) to attack a going private transaction.

B. New Rule 13e-3: The Beginnings of a New Federal Approach

The Supreme Court in Green reserved decision on whether the SEC had authority to promulgate rules under other sections of the securities acts respecting going private transactions. Both before and after Green, the SEC proposed various rules to deal with going private transactions. On August 8, 1979, the SEC released rule 13e-3 and accompanying schedule 13e-3 as a first step in dealing with going private transactions under the securities laws. This rule was much the same as the proposal released for comment in 1977.

1. The General Approach of the New Rule

The purpose of the new rule is:

[t]o augment and implement the present statutory provisions by prohibiting fraudulent, deceptive and manipulative

234 Id. at 476.
235 Id. at 473-74.
236 Id. at 473 n.12.
237 See 42 Fed. Reg. 60090 (1977) for a list of the SEC releases which deal with the going private rule-making process. See 1 M. Lipton & E. Steinberger, supra note 35, at 471-81, regarding the 1977 proposed version of rule 13e-3.
240 Compare 44 Fed. Reg. 46736-43 (1979) with 42 Fed. Reg. 60100-02 (1977). The new rule as finally adopted closely parallels the proposal in terms of both its coverage and its requirements. While most of the changes that have been made are relatively minor, the new rule does provide certain exceptions to its coverage which were not included in the proposal. 44 Fed. Reg. at 46743, rule 13e-3(g)(1)-(2). These two additional exceptions are discussed in 44 Fed. Reg. at 46738.
acts or practices in connection with going private transactions and by prescribing new filing, disclosure and dissemination requirements as a means reasonably designed to prevent such acts and practices.\textsuperscript{241}

More specifically, the rule is meant to ensure full disclosure in any transaction which may have the effect of delisting a class of securities from a national exchange or suspending registration under the Securities Exchange Act.\textsuperscript{242} The rule is not intended to cover transactions which will not lead to these results.

On the other hand, the SEC has not attempted to establish any substantive controls over going private transactions by enacting this rule.\textsuperscript{243} This lack is due not only to an increase in available state remedies, the result of Singer and progeny, but also exists because the SEC staff is inexperienced in making decisions regarding the fairness of going private transactions.\textsuperscript{244} The deferral to state court remedies may last only until the effectiveness of the disclosure requirements can be determined.\textsuperscript{246}

2. \textit{The Scope of Rule 13e-3}

The actual mechanics of rule 13e-3 are explained in detail in the SEC releases concerning the rule.\textsuperscript{246} There are, however, certain points which merit discussion concerning going private transactions. One such point is the scope of the rule,

\begin{itemize}
  \item \textsuperscript{241} 44 Fed. Reg. 46736 (1979).
  \item \textsuperscript{242} \textit{Id.} at 46741, rule 13e-3(a)(4)(ii)(A)-(B) (to be codified in C.F.R. § 240.13e-3).
  \item \textsuperscript{244} \textit{See} 44 Fed. Reg. at 46736, wherein it is noted: 1) that the Commission will avoid making any judgments concerning the fairness of individual transactions until the effectiveness of the new rule can be determined; and 2) that further developments in available state court remedies may obviate the necessity of the Commission ever making such judgments. \textit{But see} 44 Fed. Reg. 46743, 46745, schedule 13e-3, item 8, which requires the issuer or affiliate filing pursuant to schedule 13e-3 to state whether it is reasonably believed that the transaction is fair \textit{vel non} to unaffiliated security holders. Supporting data must be filed along with the issuer or affiliate’s opinion. A discussion of this filing requirement is contained in 44 Fed. Reg. at 46740.
  \item \textsuperscript{245} \textit{Id.}
  \item \textsuperscript{246} \textit{Id.} at 46737-41.
\end{itemize}
FAIRNESS IN FREEZEOUTS

i.e., the types of transactions that are within its coverage.\textsuperscript{247}

There are basically three requirements which must be met if a transaction is to come within the rule. It must fit within the definition of a rule 13e-3 transaction; it must not fit into a listed exception to the rule; and the securities must be of a class which requires registration under section 12 or periodic reports under section 15(d) of the Securities Exchange Act.\textsuperscript{248}

To be a 13e-3 transaction, the conduct must involve certain listed transactions\textsuperscript{249} and lead to certain listed results.\textsuperscript{250} The transactions cover virtually all of the important going private devices. Included are tender offers\textsuperscript{251} and all purchases of securities by the issuer pursuant to "any acquisition subject to the control of an issuer,"\textsuperscript{252} including, \textit{inter alia}, mergers and reverse stock splits,\textsuperscript{253} as well as solicitation of proxies and distributions of information in connection with corporate reorganizations, such as mergers or reclassifications.\textsuperscript{254}

It is the effects which must flow from these transactions that serve as the primary limitation on the applicability of the rule. If, prior to the transaction, the class of securities involved is held of record by more than 300 persons; listed on a national exchange; or quoted in an inter-dealer quotation system (therefore subject to section 12 or 15(d)), and, following the exchange, is no longer in one of these categories, the transaction is within the rule.\textsuperscript{255} If these effects do not flow from the transaction, it is outside of rule 13e-3. By so limiting the rule, the SEC has effectively focused on the specific

\textsuperscript{247} The rule also outlines the disclosure and dissemination requirements which apply if the transaction is a rule 13e-3 transaction. 44 Fed. Reg. at 46742, rule 13e-3(d), (f); 44 Fed Reg. at 46743, schedule 13E-3. However, for the purposes of this Note it is important only that the approach of the rule is one of disclosure; the details of that disclosure are irrelevant. The primary concern of this Note, given the disclosure approach, is the type of transactions which are covered.

\textsuperscript{248} 44 Fed. Reg. at 46737.

\textsuperscript{249} Id. at 46741, rule 13e-3(a)(4)(i).

\textsuperscript{250} Id., rule 13e-3(a)(4)(ii).

\textsuperscript{251} Id., rule 13e-3(a)(4)(i)(B).

\textsuperscript{252} Id., rule 13e-3(a)(3)(iv).

\textsuperscript{253} Id., rule 13e-3(a)(3)(ii)-(iii).

\textsuperscript{254} Id., rule 13e-3(a)(4)(i)(C).

\textsuperscript{255} Id., rule 13e-3(a)(4)(ii)(A)-(B).
problems of the minority stockholder, such as loss of the marketability of his stock and loss of the shares themselves without fair remuneration.

The rule also provides exceptions to its applications, structured around those situations which have been shown by experience to involve no substantial unfairness to or over-reaching of public stockholders. These exclusions cover tender offers and subsequent cash out mergers by an outsider of the target corporation, provided the plan is disclosed in advance and is consummated within a specified period of time. In addition, share-for-share exchanges are excluded, provided the terms of both securities are substantially the same. These, and the other available exclusions, help to maintain the flexibility of corporate activities and protect legitimate corporate reorganizations from the burdens of disclosure. This protection extends to corporate activities which are technically 13e-3 transactions but which, by their nature, approach the ideal of an arm’s length bargain.

CONCLUSION

The problem created by going private mergers and by going private transactions in general is one of grave concern if confidence in the securities markets is to be maintained and the value of the public stockholders investment is to be protected. By the same token, control of such transactions cannot be based on ambiguous and overbroad standards which threaten to hinder corporate flexibility in legitimate activities.

The state law approach typified by the Singer line of cases, while a valuable first step in dealing with going private, is severely overdependent on traditional corporate law principles which are inappropriate in the going private context. As a consequence, it is limited in its flexibility. At present, the state law approach cannot provide appropriate remedies in all cases and still maintain the integrity of the statutory powers which exist in favor of the corporation. The state approach

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256 44 Fed. Reg. at 46738.
257 Id. at 46743, rule 13e-3(g)(1).
258 Id., rule 13e-3(g)(2).
should be keyed more toward the realistic nature of public stock ownership and less toward an outdated vested rights outlook.

The effectiveness of the federal approach embodied in rule 13e-3 has not yet been determined. Ultimately its chief contribution may be to discourage those corporations with marginal reasons for going private from doing so in the first place. The federal rule is more in tune with reality in that it excludes from its coverage transactions which do not contain the potential for abuse. The federal concept of fairness, however, remains linked to the concepts of business purpose and fairness contained in the state approach.

At best, both approaches are but steps in the evolution of effective going private law. They each leave significant problem areas to be explored and resolved. They have yet to deal with the issue of state-federal interaction in the area, an issue raised by the Supreme Court in Green. The only thing that may be said with confidence is that, despite all the commentary, the last word has not been uttered.

James Robert Lyons, Jr.

259 Many corporations that first went public in the years 1968-1972 did so ill-advisedly and should have sought funds from private sources. As a result, when the securities market fell in 1974, these corporations no longer obtained benefits by being public, yet were saddled with the corresponding burdens. Comment, supra note 5, at 1430-32.