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SANTA FE INDUSTRIES, INC. v. GREEN:
AN ANALYSIS TWO YEARS LATER

Rutheford B. Campbell, Jr.*

I. INTRODUCTION

It has been nearly two years since the Supreme Court decided Santa Fe Industries, Inc. v. Green.1 Although the outcome of that decision should have surprised no one, since the trend of the Court clearly had been to constrict the scope of the federal securities legisla-
tion,2 the case was a major decision that will have a substantial impact on the development of corporate law in this country. Indeed, it may turn out to be one of the most significant corporate cases decided by the Supreme Court in recent years.

Since by this point the dust has settled from the case,3 it seems appropriate to examine the decision in light of the developments that have occurred in the last two years. With the aid of hindsight, this article will analyze the impact of Santa Fe Industries and attempt to show that the decision is likely to generate both confusion and abusive conduct.

II. THE SUPREME COURT'S OPINION IN Santa Fe Industries

Santa Fe Industries, Inc. (Santa Fe) owned 95% of the stock of Kirby Lumber Corporation (Kirby). Under the corporate law of Delaware, a parent owning at least 90% of the outstanding stock of a subsidiary corporation can merge that subsidiary into itself under a simplified procedure referred to as a "short-form merger."4 This procedure requires only the approval of the parent's board of directors and does not require the affirmative vote of the shareholders of either the parent or the subsidiary corporation. Further, the shareholders of the subsidiary can be compensated with cash,5 a maneuver that removes the subsidiary's minority shareholders from continued participation in the enterprise. In 1974, Santa Fe employed the short-form merger procedure to absorb Kirby into itself, offering each minority shareholder of Kirby $150 per share. Although the minority share-

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2. See note 32 infra.
3. Interestingly, the case has not generated the amount of scholarly comment one might imagine. But see Jacobs, How Santa Fe Affects 10b-5's Proscription Against Corporate Mismanagement, 6Sec. Reg. L.J. 3 (1978). There has been, however, some student comment on the case. 48 Miss. L.J. 872 (1977); 9 Tex. Tech. L. Rev. 211 (1978); 52 Tul. L. Rev. 641 (1978); 46 U. Clev. L. Rev. 858 (1977); 29 U. Fla. L. Rev. 761 (1977).
4. DEL. CODE ANN. tit. 8, § 253(a) (1976).
5. Id.
holders who were unhappy with the exchange had an explicit remedy in the appraisal rights afforded shareholders under Delaware law, the plaintiff chose to pursue a remedy under Rule 10b-5 of the Securities Exchange Act of 1934.

The District Court dismissed the complaint for failing to state a claim on which relief could be granted, but the Second Circuit Court of Appeals reversed, holding that neither misrepresentation nor non-disclosure was necessary for recovery under Rule 10b-5. It was the Court of Appeals' view that "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."

The Supreme Court reversed, holding that the underlying statute, section 10(b) of the Securities Exchange Act of 1934, established the limits of an action brought under Rule 10b-5. Since section 10(b) made it "unlawful . . . to use . . . any manipulative or deceptive device," mere unfairness or breach of fiduciary duty could not provide the basis for recovery under Rule 10b-5. Rather, such a recovery required the presence of some manipulation or deception, which the Supreme Court was unable to find in Santa Fe Industries. Because

6. Id. § 262 (Supp. 1978).
7. Rule 10b-5, 17 C.F.R. § 240, 10b-5 (1978), provides:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
10. Id. at 1287.
11. Id. at 1291.
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
   (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
14. At one point the Court stated that there was "no indication that Congress meant to prohibit any conduct not involving manipulation or deception." 430 U.S. at 473.
the case was presented to the Court "on the premise that the complaint failed to allege a material misrepresentation or material failure to disclose," "deceptive" conduct could not be established. Also, the Court was unable to find any "manipulative" conduct within the meaning of section 10(b). The Court described manipulation as "virtually a term of art" and stated that "the 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."

The Court found no such allegation in the Santa Fe Industries complaint, which it characterized as involving "corporate mismanagement . . . , in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary."

It appears, therefore, that civil liability under Rule 10b-5 requires the presence of conduct that is "manipulative" or "deceptive" within the meaning of section 10(b) and that the proscribed conduct may include only misstatements, nondisclosures, and manipulative devices "artificially affecting market activity in order to mislead investors . . . ." Moreover, instances of unfairness, fraud, or breach of fiduciary duty that occur in connection with purchases or sales of securities are not within the proscription of Rule 10b-5 and section 10(b), unless, of course, the conduct involved amounts to manipulation or deception.

III. THE IMPACT OF SANTA FE INDUSTRIES ON THE DEVELOPMENT OF FEDERAL REMEDIES UNDER RULE 10B-5

On its face, Santa Fe Industries appears to be a clear decision. One should be wary, however, in assuming that Santa Fe Industries is without interpretive problems. Indeed, cases have already arisen that suggest the clarity of Santa Fe Industries may be more apparent than real. These decisions indicate that some courts may be unwilling to apply Santa Fe Industries rigidly, especially when faced with compelling circumstances.

For example, in Goldberg v. Meridor, a derivative action, a shareholder of Universal Gas & Oil Company (UGO) alleged that there had been a violation of Rule 10b-5 when UGO sold its stock to its parent, Maritimecor, in exchange for all of Maritimecor's assets and UGO's assumption of Maritimecor's liabilities. The plaintiff claimed, in connection with the exchange, that the terms were unfair to UGO and that there had been a failure to disclose certain material facts regard-

15. Id. at 474.
16. Id. at 476.
17. Id. at 477.
18. Id.
19. The Supreme Court has denied petitions for certiorari in several cases seeking further refinement of the scienter requirement. E.g., Shull v. Dain, Kalman & Quail, Inc., 561 F.2d 152 (8th Cir. 1977), cert. denied, 434 U.S. 1086 (1978); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir. 1977), cert. denied, 434 U.S. 875 (1977).
ing both the value of the consideration received by UGO and the conflict of interest among the parties.

In order to fit the complaint within Rule 10b-5, the Meridor court had to overcome two conceptual difficulties. The first problem, identifying the deceptive or manipulative conduct necessary to meet the standards of Santa Fe Industries, arose because the board of UGO was controlled by Maritimecor (UGO's parent). Thus the board presumably knew of the unfair purchase price and the undisclosed facts, including the alleged conflict of interest among the principals. The court indicated, however, in apparent reliance on the rule derived from Schoenbaum v. Firstbrook,21 that such knowledge by the board of UGO did not negate the possibility of fraud:

[T]here is deception of the corporation (in effect, of its minority shareholders) when the corporation is influenced by its controlling shareholder to engage in a transaction adverse to the corporation's interests (in effect, the minority's shareholders' interests) and there is nondisclosure or misleading disclosures as to the material facts of the transaction.22

This apparently means, then, that knowledge of a board of directors in a conflict situation, such as Meridor, will not be imputed to the corporation, and thus disclosures must be made to the minority shareholders.

This holding, however, raised problems of establishing causation in the particular transaction. The problem was that the board of directors, not the shareholders, was the decisionmaking body for the sale of stock. Because of this it was difficult to establish that any harm was caused to the corporation by the alleged nondisclosures and misstatements made to the shareholders, since they were not the body with the power to authorize the sale.

The Meridor court, however, was able to find the possibility of harm in the transaction. The reasoning of the court was that the shareholders had available certain statutory and common law rights to enjoin the sale of stocks by their corporation at a price that was unfairly low. Since these rights could be enforced by injunctive actions instituted in state courts, the court concluded that the complaining minority shareholders in Meridor were harmed when they were "lulled . . . into security by a deceptive disclosure . . . ."23 and thus prevented from exercising their right to enjoin the unfair transactions.

Wright v. Heizer Corporation,24 a Seventh Circuit case, resembles Meridor. The Heizer Corporation, which controlled International Digisonics Corporation (IDC) through stock ownership and domination of its board, had caused IDC's board to pledge to it (Heizer) all

22. 567 F.2d at 217.
23. Id. at 220.
the stock of Talent & Residuals, Inc., a subsidiary of IDC. Shareholders of IDC brought a derivative suit for violation of Rule 10b-5, claiming a failure to disclose certain material facts to IDC. As in Meridor, the court was faced with the problem of identifying a "deception" of IDC, since IDC's board was controlled by Heizer and thus was presumed to have knowledge of all the terms and facts surrounding the pledge. The court found, however, that failure to disclose to IDC's shareholders constituted the requisite "deception" and determined that Heizer was obliged to disclose the material facts concerning the transaction to the independent shareholders prior to its consummation.

In Heizer, causation was again the problem, since IDC's board, and not the shareholders, had the power to pledge the securities. Thus, it was difficult to see how the corporation could be deceived by a failure to make disclosures to a group without power to authorize the pledge. The Seventh Circuit resolved this dilemma in the same manner employed by the Meridor court. It determined that if the shareholders had known the material facts surrounding the pledge transaction they could have taken action under state law to enjoin the pledge. Accordingly, the corporation had been harmed in fact by nondisclosure to the shareholders, since complete disclosure would have enabled them to prevent the transaction.

It is not impossible to defend the Meridor-Heizer analysis as a proper application of Rule 10b-5 in a derivative suit. In both cases a corporation engaged in securities transactions within the requirements of Blue Chip Stamps. Although the board of directors was fully informed of the facts surrounding the transaction, and although the board of directors was the entity that had the power to sell the corporation's stock, there was another entity that had the power to stop the sale. Because the shareholders could utilize the state courts to enjoin the sale of stock at a price below the fair market value, one can view the shareholders as the ultimate decisionmaker for the corporation and a failure to disclose to them as a failure to disclose to the corporation. Thus, it is possible to say that the corporation was deceived by the failure to disclose to the shareholders, and that there was resulting harm to the corporation, because the improper sale would have been enjoined if the shareholders had known the true facts.

25. It appears that a pledge transaction does constitute a purchase or sale under the securities acts. See S.E.C. v. Guild Films Co., Inc., 279 F.2d 485 (2d Cir. 1960), cert. denied, 364 U.S. 819 (1960).
26. 560 F.2d at 247.
27. In the case of Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), the Supreme Court held that in order to recover under Rule 10b-5 the plaintiff must be a purchaser or seller of securities.
28. The action of the board of directors in selling the corporation's stock at below its fair value would violate the rule of equitable contribution. See N. LATTIN, CORPORATIONS 471 (2d ed. 1971).
This analysis, however compelling, seems too great a departure from *Santa Fe Industries*, perhaps to the point of rupture. The problem, of course, is that *Meridor* and *Heizer* are really cases in which the very nub of the complaint was that the corporation had been treated unfairly by its fiduciaries. A corporate fiduciary acting on behalf of the corporation treated that corporation unfairly by selling stock for a price below the fair market value. There was no deception of the corporation in any real sense, since the entity responsible for determining the terms of the sale was fully informed. Accordingly, the decisionmaking process was not contaminated by any undisclosed information or manipulation, but rather by a breach of management's fiduciary duty to obtain a fair price for the stock.\(^29\)

It is difficult to assess the impact of *Meridor* and *Heizer* on the development of the law in this area. Although one could view these cases merely as insignificant aberrations, a critical analysis may lead one to view them as symptomatic of a significant defection from the rationale of *Santa Fe Industries* that will be followed by other lower federal courts. Simply stated, *Meridor* and *Heizer* may reflect an unwillingness on the part of federal courts to dismiss compelling cases under the *Santa Fe Industries* decision.

It is easy to understand why a court would be reluctant to dismiss claims such as those in *Meridor* and *Heizer*. In each case the allegation before the court indicated that clear "wrongs" had been committed against the corporation in the context of a securities transaction. The wrongs, however, involved unfairness rather than any deception of the corporate decisionmaker. Thus, *Santa Fe Industries* would seem to necessitate a dismissal. Such a disposition, however, may rankle some judges, since it would require the court to divest itself of jurisdiction over a securities transaction where a clearly identifiable wrong has been committed to the detriment of the real party in interest. It appears that the courts in *Meridor* and *Heizer* were unwilling to take that step, and it is not difficult to imagine that some other federal courts would respond similarly to such compelling cases. If this turns out to be true, so that *Meridor* and *Heizer* are not merely isolated eruptions from lower federal courts, the apparent clarity of *Santa Fe Industries* will be lost.\(^30\)

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\(^29\) It should be recalled that in *Santa Fe Industries* the Supreme Court found a complaint inadequate where "the essence of the complaint [was] that shareholders were treated unfairly by a fiduciary." 430 U.S. at 477.

\(^30\) Already there have been a number of cases attempting to define the types of conflicts in a board of directors that necessitate disclosures to shareholders. Maldonado v. Flynn, 448 F. Supp. 1032 (S.D.N.Y. 1978); Tyco Labs., Inc. v. Kimball, 444 F. Supp. 292 (E.D. Pa. 1977); Falkenberg v. Baldwin, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) 96,086 (S.D.N.Y. 1977). The cases, however, probably should not be read as manifestations of unnecessary confusion, but rather as a refinement of a more general rule that conflicts in the board require disclosures to shareholders.
IV. A CRITICAL ANALYSIS OF SANTA FE INDUSTRIES

Surely, one should be concerned about the potential for confusion described in the preceding section of this paper. Such confusion can deflect and delay the orderly development of the law in this area and can result in disparate resolutions of similar issues.

This confusion, however, is merely symptomatic of a more fundamental flaw in the SANTA FE INDUSTRIES decision. Simply stated, the Court reached an unsound conclusion in that case, and as a result minority shareholders of corporations are now more vulnerable to the machinations of the majority interests in the corporation. By denying minority shareholders the right to enforce a fairness constraint under Rule 10b-5, the Supreme Court has denied minority shareholders a meaningful protection from majority oppression and thus has increased the probability that minority shareholders will be mistreated by the majority.

As described earlier, the Court's basis for the decision in SANTA FE INDUSTRIES appears quite simple, since the Court seems to have placed principal emphasis on the words "deceptive" and "manipulative" from section 10(b) of the Securities Exchange Act of 1934. Such a simplistic explanation of the case, however, ignores a significant trend in the Supreme Court. This trend, which involves nearly a dozen cases, has resulted in a substantial constriction of the protections afforded by the federal securities legislation. Considered as a group, these cases strongly manifest notions of federalism and indicate that the Supreme Court is determined to relegate corporate shareholders to state remedies for many of the wrongs that arise in securities transactions.

More specifically, SANTA FE INDUSTRIES seems to indicate that Rule 10b-5 cannot be utilized to relieve a shareholder from unfairness that occurs in securities transactions. Thus, Rule 10b-5 provides no relief if one shareholder with power bludgeons a powerless shareholder into participating in an unfair securities transaction, unless the sale is effected through some misstatement, nondisclosure or

31. See text accompanying notes 12-18 supra.
34. See, e.g., Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 478-80 (1977).
35. One author has suggested that the Court in SANTA FE INDUSTRIES intended to include under the rubric of "deception" certain conduct that does not involve misstatements or nondisclosures. The writer stated:

Mr. Justice White must have intended "deception" to mean something in
The abused shareholder must look to the states for some remedy. Unfortunately, there often are no effective state remedies for shareholders who are treated unfairly in the context of a securities transaction.

Generally, shareholders who have attempted to protect themselves in state forums against unfairness have relied on common law fiduciary obligations, as opposed to any state statute. The reason is rather obvious. Other than voting and appraisal rights, which are applicable in certain situations and will be discussed later in this paper, state statutes provide little protection from unfairness for shareholders. Accordingly, the focus of this discussion will be the inadequacy of the relief available under state common law to shareholders who claim they have been treated unfairly.

In describing the plight of minority shareholders under state common law, one is forced to rely on some generalizations for at least two reasons. First, since each state’s highest appellate court makes final decisions on these issues, uniformity among the states in law or philosophy is most unlikely. Second, even within a single jurisdiction, there are numerous corporate configurations in which powerless shareholders can be treated unfairly in securities transactions. Freezeouts, single company recapitalizations, and mergers between

addition to misrepresentations and omissions; otherwise, he would not have used all three terms in the disjunctive. He undoubtedly chose his words carefully, for lower courts had established a meaning for the word “deception.” The scope of deception included nonverbal acts and was not limited to the common-law sense.


36. In Santa Fe Industries, the Court seemed to limit manipulation to conduct “intended to mislead investors by artificially affecting market activity.” 430 U.S. at 476.

37. In describing state statutory laws, Professor Folk has stated:

Almost without exception, the key movement in corporation law revisions is toward even greater permissiveness . . . . Explicitly positing an objective of “flexibility,” statutory revisers . . . have usually sought to enlarge the ambit of freedom of corporate management to take whatever action it may wish . . . . Indeed the new statutes seem to be exclusively concerned with only one constituent of the corporate community - management - and have disregarded the interests of shareholders and creditors, let alone more tangentially interested parties, such as employees, customers, and the general public.


38. In describing the protection provided by state courts one noted commentator has stated that “on only rare occasions in the last decade has a state appellate court been moved to consider the inadequacy of some of the traditional theories of fiduciary obligation and to formulate new concepts to cope with the increasingly complex transactions of the business and financial communities.” Jennings, Federalization of Corporation Law: Part Way or All the Way, 31 BUS. L. 991, 999-1000 (1976).

39. Within recent years there has been a substantial amount of literature on freezeouts. See Borden, Going Private - Old Tort, New Tort or No Tort?, 49 N.Y.U.L. REV. 987 (1974); Brudney, A Note on “Going Private”, 61 VA. L. REV. 1019 (1975);
affiliated companies are examples of situations in which powerless shareholders may be called upon to make unfair concessions to the majority interests of the corporations. Because of these factors, it is impossible to deal exhaustively with every potentially abusive configuration in every jurisdiction. Nevertheless, by examining certain jurisdictions and certain configurations, one may draw conclusions about the probable relief available to shareholders foreclosed from a federal remedy under Santa Fe Industries.

Although it would be a substantial exaggeration to claim that states never provide remedies for shareholders who have been treated unfairly, it is apparent that the protection afforded by state remedies has been less than perfect. Professor Cary's classic piece, Federalism and Corporate Law: Reflections upon Delaware, contains the best exposition of one state's failure to protect shareholders from the unfairness that can be foisted on them. Cary treats a number of situations in which minority shareholders of Delaware corporations have attempted to hold the management and majority interests in a corporation to a fairness standard. His conclusion is that the


40. While it is not the purpose of this article to explore the procedural differences between pressing a federal claim under Rule 10b-5 and pressing a state claim, it seems to be conceded generally that plaintiffs have a distinct advantage in the federal system. Professor Bromberg has stated that 10b-5 is "more attractive in many cases because of its ability to cross borders for jurisdiction, venue and process. Other factors on the federal side include a background and framework sympathetic to the investor and discovery proceedings more liberal than those in some states." 1 A. BROMBERG, SECURITIES LAW: FRAUD, S.E.C. RULE 10b-5 § 2.7(2), at 67 (1977). See also 1 A. BROMBERG, supra, § 4.7(120), at 84.3; Bloomenthal, From Birnbaum to Schoenbaum: The Exchange Act and Self-Aggrandizement, 16 N.Y.L.F. 332, 333-35 (1969); Jennings, supra note 38, at 1000. See text accompanying notes 84-95 infra.

41. For example, the rule of equitable contribution is a state common law doctrine that provides remedies against directors who sell their company's stock for less than the fair value of the stock. See N. LATTIN, supra note 28, at 471. One writer concluded that: "While the criticisms of state law are not without foundation, it is also true that it has been far from impotent." Sherrard, Fiduciaries and Fairness Under Rule 10b-5, 29 VAND. L. REV. 1385, 1418 (1976).

42. Although not directly on point, it is at least instructive to consider the way state courts have protected shareholders from the negligence of the corporation's officers and directors. While it is clear that directors and officers of a corporation owe a duty of reasonable care when acting on behalf of the corporation, the application of that standard has been so loose that one writer has characterized the potential liability for negligence as "largely fictional in practical terms." Scott, Fears and Phobias: Management Liability and Insurance in Thrift Institutions, 88 BANKING L.J. 124, 130 (1971).

Professor Cary has stated: "The standard of duty of care in this country is indeed at a low level." Cary & Harris, Standards of Conduct Under Common Law, Present Day Statutes and the Model Act, 27 BUS. LAW. 61 (Special Issue 1972). Mr. Harris responded, however, that the exposure of a director or officer may not be properly evaluated merely by examining decided cases—and failing to account for out of court settlements and suits currently pending. Id. at 66-67.

Delaware courts have not provided adequate protection to the shareholders of Delaware corporations, since the cases indicate that "[c]onsciously or unconsciously, fiduciary standards and the standards of fairness generally have been relaxed." 44

Although Cary limits his critique to cases arising in Delaware, the pressures Cary describes as causing or at least contributing to this relaxation of the fairness constraint are not necessarily limited to that state. His point, restated in somewhat less refined terms, is that states may fear the corporate relocation likely to follow any attempt to enforce strict fairness standards. This simple and substantial economic pressure, he concludes, dampens any realistic hope that states like Delaware will be responsive to claims of unfairness raised by shareholders.45

There have been recent Delaware cases testing Cary's insight concerning the predilection of the Delaware judiciary. In Singer v. Magnavox Co.46 the minority shareholders of Magnavox had been frozen out47 of the company by a merger between Magnavox and an affiliated corporation. The shareholders brought suit to have the transaction set aside, claiming that the merger's only purpose was to remove them from the corporation at a grossly inadequate price.48 The Supreme Court of Delaware reversed the lower court's dismissal for failure to state a claim, holding that a "merger, made for the sole purpose of freezing out minority stockholders, is an abuse of the corporate process; and the complaint, which so alleges in this suit,

44. Id. at 670.
45. Cary is not the only commentator to suggest that Delaware provides inadequate safeguards for shareholders. Professor Kaplan, while purporting not "to verify or comment upon" Cary's conclusions, has stated that "in general I share the view that Delaware has diligently engendered a corporate climate too favorable to management . . . ." Kaplan, Fiduciary Responsibility in the Management of the Corporation, 31 Bus. L.W. 883, 889 (1976).
46. 380 A.2d 969 (Del. 1977).
47. In a recent article, Professors Brudney and Chirelstein have suggested that the constraints applied to freezeouts should not be uniform but instead should be determined by the particular type of freezeout involved. In the case of "two-step, or integrated" mergers (where an independent company acquires control of a target through a tender offer and then proceeds to freeze out the remaining shareholders), the authors suggest that no fiduciary obligation should be owed to the shareholders of the acquired company, since it is essentially an arms length transaction. As for "pure going private" transactions (where majority simply freezes out minority), the authors suggest they should be forbidden, since the only purpose of such a transaction is to permit the majority to seize the interest of the minority at a bargain price. In the case of "mergers of longheld affiliates," the authors suggest that the transaction should be subjected to a fairness constraint, since there is a chance for abuse, but there is also the possibility of resulting economies, which are beneficial and should be encouraged. Brudney & Chirelstein, A Restatement of Corporate Freezeouts, 87 Yale L.J. 1354 (1978).
48. Although Singer involved a long-form merger, a subsequent case in Delaware has indicated that the same fiduciary standard is applicable in short form mergers. Najjar v. Roland Int'l Corp., 387 A.2d 709 (Del. Ch. 1978).
states a cause of action for violation of fiduciary duty for which the Court may grant . . . relief . . . ."49

Although the holding in Singer appears to establish an important new precedent in Delaware,50 arguably the more important facet of the case is the general attitude reflected by the opinion. Not only does the holding itself reflect a concern with fair treatment for minority shareholders, but the court also went to some lengths to proclaim that the judiciary of Delaware does indeed demand high standards of fairness in corporate actions.51 One could infer from this shift in attitude by the Delaware court that Professor Cary’s criticism had been effective; it appears that the Delaware court was attempting to vindicate its past behavior and demonstrate and effect a new attitude of fairness.52

Within one month, however, a second opinion by the Delaware court effectively limited Singer’s impact. Tanzer v. International General Industries, Inc.53 involved a fact pattern similar to Singer’s. The minority shareholders of Kliklok Corporation, which was 81% owned by International General Industries, Inc. (IGI), were attempt-

49. 380 A.2d at 980. It is interesting to note that there are some differences in language between the Magnavox opinion as first reported in Securities Regulation & Law Report and the final rendering of the opinion in the Atlantic Reporter. The case as reported in Securities Regulation & Law Report reads: “Use of corporate power to eliminate the minority is a violation of that duty, if done without a valid business purpose.” [1977] Sec. Reg. & L. Rpt. (BNA) 422 § E-6. As finally reported in Atlantic Reporter, the last seven words of the preceding passage are eliminated, and the sentence reads: “use of corporate power solely to eliminate the minority is a violation of that duty.” 380 A.2d at 980. One could speculate that the elimination of the last words, “if done without a valid business purpose,” was due to a possible conflict with Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121 (Del. 1977), which was decided one month after Magnavox. Tanzer is discussed at text accompanying notes 53-56.


51. At one point the court stated: “Delaware courts have long announced and enforced high standards which govern the internal affairs of corporations chartered here . . . .” 380 A.2d at 976.

52. Brudney & Chirelstein, supra note 47. The authors have criticized the result in Singer, since it involved a “two-step merger” (i.e., the freezeout followed a tender offer by North American Phillips Corporation, which resulted in North America’s having acquired control of Magnavox). As described earlier in these footnotes, Brudney and Chirelstein believe no fiduciary obligation should attach to such a transaction. Brudney & Chirelstein, supra note 47, at 1362-63.

53. 379 A.2d 1121 (Del. 1977). One writer has concluded that the Delaware court’s “decision in Tanzer is consistent with its reasoning in Singer.” McBride, supra note 50, at 2239. It seems to this writer, however, that the spirit of the two cases is markedly different.
ing to stop a merger that would have resulted in their being frozen out of Kliklok. The Supreme Court of Delaware affirmed a Court of Chancery opinion refusing the plaintiffs' request for a preliminary injunction. In the course of the opinion the Delaware court indicated that it would enjoin a freeze out if the corporation's "real purpose . . . [were] to rid itself of unwanted minority shareholders . . . ."54 That, however, seems to be the limit of the constraint, since the court held that "IGI, as a stockholder of Kliklok, 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."55 Thus, it appears that a Delaware court will enjoin a proposed freezeout under Singer only if the sole purpose of the transaction is to freeze out the minority; if the majority shareholder can demonstrate that the merger served any other purpose, even the satisfaction of some selfish and unique need of the parent (or majority shareholder), the injunction will not issue. The parent's successful claim in Tanzer, for example, that the merger would "facilitate [its] long term debt financing,"56 suggests how easily a majority shareholder can justify a freezeout.

Since Tanzer, however, there has been one case where the Chancellor looked critically at the alleged business purpose justifying a freezeout. In Young v. Valhi, Inc.,57 which involved the freezing out of the minority interests of a subsidiary corporation, the parent company justified the action as a means to eliminate the risk of conflict transactions between the parent and the subsidiary and to gain a savings through filing consolidated tax returns. The court rejected this as a valid business purpose that would justify a freezeout, holding that the savings were small and attainable by other means, and that the conflict rationale was in fact contrived.

A critical analysis of these cases, however, indicates no fundamental shift in the attitude of the Delaware court that Professor Cary found offensive. Although Singer at first appeared to reflect a new attitude for Delaware, Tanzer quickly and substantially limited the Singer decision. While one could interpret the Valhi decision as a sound and rigorous application of Tanzer, it is better read as a case that arose before corporate lawyers had learned the proper terms to employ in defense of freezeouts or the type of proof required to legitimize them. As counsel becomes more sophisticated in the teachings of Tanzer, it seems probable that freezeouts will continue substantially unimpeded.

Certainly there is historic precedent in Delaware for such an assumption. One need only read the Delaware cases involving mergers among affiliated companies to discover that high-sounding principles often break down in application. Thus, although an early case pro-

54. 379 A.2d at 1124.
55. Id.
56. Id.
57. 382 A.2d 1372 (Del. Ch. 1978).
claimed that in a merger between affiliated corporations the parent corporation must "bear the burden of establishing its entire fairness," that principle atrophied to the point that Delaware courts would intervene only if there was fraud in the merger. The situation deteriorated so badly that one commentator, a member of the Delaware bar, was forced to admit that "some confusion developed as to whether the [fairness] doctrine had any continued viability."

In light of this, it would be premature to cite the Singer case as any signal that Delaware courts have altered their fundamental posture in business cases. If history is any guide, Tanzer, not Singer, is the lodestar for future development in corporate freezeouts in the Delaware courts.

One may be inclined, however, to view Delaware to something of an aberration, since the state does have a unique place in the scheme of corporate regulation in this country. Clearly, other states can not compare with Delaware in the corporate activity that takes place inside her borders. Thus, one might conclude that the pro-management posture of the Delaware decisions may not be matched in the same way in her sister states, where there is likely to be correspondingly more hope of protection from unfairness.

Unfortunately, there is little evidence that shareholders outside Delaware can expect much better treatment than the fate described by Professor Cary. Instead, the cases indicate that state courts have been rather unsuccessful in assuring that powerless shareholders are treated fairly by the controlling interests of a corporation. The problem can best be seen in the context of organic corporate changes.

In those situations shareholders without substantial power are often called upon to exchange their stock for new securities in the existing corporation, if the alteration is a single company recapitalization, for new securities in another company, if a merger is in-

60. McBride, supra note 50, at 2250.
61. In describing the importance of Delaware, Professor Jennings has stated that "40 percent of the companies listed on the New York Stock Exchange are Delaware Corporations. And it has been estimated that over 200 of the Fortune 500 largest industrial corporations are . . . incorporated in Delaware." Jennings, supra note 38, at 992-93. See also Cary, supra note 43, at 668.
involved, or perhaps even for cash, if a freezeout is involved. Although the affected shareholders typically have voting rights relative to the proposed change, those rights alone may prove ineffective to protect them against the unfairness of the proposed alteration. For example, if a parent merges with a subsidiary of which it owns 51% or more of the stock, it is obvious that a disgruntled minority shareholder of the subsidiary could not stop the merger through the exercise of his voting rights. Similarly, if a single company recapitalization is involved, a preferred shareholder who owns 5% of the preferred stock cannot vote down a proposal to change his liquidation rights.

Even shareholders with the raw voting power to throttle a proposed change may be unable to protect themselves effectively from unfairness, since economic pressures and realities can cause them to forgo exercising their power to reject the proposed alteration. For example, much has been written about the disadvantageous position of preferred shareholders in single company recapitalizations vis-a-vis the common shareholders. Thus, even though under modern corporate statutes a recapitalization altering the rights of preferred shareholders cannot be effected without the consent of a majority of the pre-


64. Two of the most recent cases involving freezeouts are Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121 (Del. 1977), and Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977). See text accompanying notes 46-60 supra.

65. Under the Model Act, for example, shareholders affected by mergers and recapitalizations must approve the alteration by a majority vote. MODEL BUS. CORP. ACT ANN. 2D §§ 59, 60, 73 (1971).

66. David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427 (Del. Ch. 1968) and David J. Greene & Co. v. Schenley Indus., Inc., 281 A.2d 30 (Del. Ch. 1971), are examples of cases in which minority shareholders were unable to protect themselves through voting and thus were forced to attempt to enjoin the merger under general standards of fairness.

67. In describing the position of minority shareholders subjected to a freezeout through a merger, Brudney and Chirelstein have stated that "even if the merger plan were made effective only when approved by a majority of the public stockholders, as if the latter were a separate class, the barriers to concerted stockholder action in the context of management's exclusive control of the proxy machinery would almost always assure a favorable vote." Brudney & Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 HARV. L. REV. 297, 300 (1974).

68. Brudney, Standards of Fairness and the Limits of Preferred Stock Modifications, 26 RUTGERS L. REV. 445 (1973); Dodd, Fair and Equitable Recapitalizations, 55 HARV. L. REV. 780 (1942); Lattin, A Primer on Fundamental Corporate Changes, 1 W. RES. L. REV. 3 (1949); Meck, Accrued Dividends on Cumulative Preferred Stocks: The Legal Doctrine, 55 HARV. L. REV. 71 (1941); Note, Protection for Shareholder Interests in Recapitalizations of Publicly Held Corporations, 58 COLUM. L. REV. 1030 (1958); Note, Accrued Dividends in Delaware Corporations — From Vested Right to Mirage, 57 HARV. L. REV. 894 (1944).

69. For descriptions of the disadvantages of preferred shareholders, see Brudney, supra note 68, at 460-61; Dodd, supra note 68, at 791-93.
ferred shares,70 "disadvantages of economic position and of political posture [enable] the commons to dominate the bargaining and effectively to determine the result."71

It is not difficult to understand how the preferred shareholders can be persuaded to accept an unfair bargain in a recapitalization if one recalls that corporate management is typically chosen by the common shareholders.72 Management, the surrogate of the common shareholder, has the power to declare and pay (or not to declare and pay) dividends to the preferred shareholders and has control over the proxy machinery. Management's potential adversaries, the preferred shareholders, are usually both unorganized and widely scattered. It is little wonder, in light of these factors, that preferred shareholders have suffered at the hands of common shareholders in recapitalizations.73

Notwithstanding the apparent abuse that has occurred in recapitalizations, and notwithstanding the persistent well-reasoned criticism of commentators,74 the state courts generally have been ineffective in containing the unfairness that is often present in these situations.75 In some of the cases, it is even unclear whether the court is applying an unfairness norm or a fraud norm as the test for enjoining a recapitalization.76 More typically, the norm is relatively clear, but the analysis is unsound, as the court merely lists the pre-recapitalization rights and the post-recapitalization rights of the preferred shareholders and then summarily decides that the recapitalization does or does not pass muster.77 Usually, courts find that the plans are fair,78 even where the evidence does not support that result.

71. Brudney, supra note 68, at 448.
72. Typically, the contract of preferred shareholders does not provide for them to vote. Accordingly, the common shareholders elect the directors. Model Bus. Corps. Act Ann. 2d § 36 (1971). Usually the directors then elect the officers of the corporation. Id. § 50.
73. For a description of the disadvantages of preferred shareholders, see V. Brudney & M. Chebelske, Cases and Materials on Corporate Finance 209-11 (1972); Brudney, supra note 68, at 448.
74. See authorities cited in note 68 supra.
75. For example, in Western Foundry Co. v. Wicker, 403 Ill. 260, 85 N.E.2d 722 (1949), a state court approved a recapitalization eliminating the accrued dividends of preferred shareholders. The court apparently held the plan was fair because it had been approved by a majority of the preferred shareholders, the company had no earned surplus to pay dividends, and there had been a 50% reduction in the par value of the common stock.
While the abuses growing out of recapitalizations have perhaps been the most apparent, transactions structured as mergers also have generated claims of abuse. Basically, the claims have arisen in situations similar to a recapitalization where the parties with the effective power to set the terms of the merger have forced allegedly unfair terms on the minority shareholders. As in the recapitalization cases, courts generally have done a poor job protecting minority shareholders from overreaching.\textsuperscript{80}

Typically, the cases involve mergers between affiliated corporations, usually a parent and a subsidiary,\textsuperscript{81} or two corporations under the common control of a parent or an individual. An example of the latter is \textit{Matteson v. Ziebarth},\textsuperscript{82} where Mr. Ziebarth, the controlling shareholder of Ziebarth Corporation, caused that company to be merged into a newly formed company, Snowy, Inc., which was wholly owned by Mr. Ziebarth and had been formed specifically to effect the merger. The court refused to enjoin this merger, even though there was evidence that Mr. Matteson, a minority shareholder of Ziebarth Corporation, received new stock having a value that was substantially less than the stock he surrendered. Specifically, Mr. Matteson received new stock valued at 20 cents per share, while it appeared that the only potential purchaser for his old stock had valued his stock at about $3 per share.\textsuperscript{83}

\textsuperscript{80} For an especially bad decision, see Donohue v. Heuser, 239 S.W.2d 238 (Ky. 1951). The case was also unusual in that the abuse occurred in a consolidation between two companies that apparently were not affiliated. All of the shareholders of Capital Transit Company of Frankfort (Capital) approved a proposed consolidation between Capital and Louisville Railway Company (Railway). All of Railway's common shareholders and 91% of Railway's preferred shareholders also approved the consolidation. Notwithstanding that vote, the disgruntled preferred shareholders who had voted against the consolidation sued to enjoin the consolidation as unfair. The old preferred stock had a $100 par value, a 5% cumulative dividend, no preference on dissolution, and was non-callable. Importantly, there were arrearages of $100 per share owed to the preferred, and it was clear that the common shareholders of Railway were using this consolidation to eliminate that arrearage. The terms of the consolidation provided that the old preferred shareholders would receive $2.50 in cash and one new share of preferred in the consolidated company that would have $80 par value, a 5% dividend rate, and a preference to dividends on distribution. Additionally, the new preferred would be callable.

Notwithstanding, \textit{inter alia}, the loss of the $100 in accrued dividends, the court approved the plan as fair.

The court did not attempt to quantify the value of the securities surrendered or received by the preferred shareholders. Instead, it seemed to base its fairness decision on the testimony of businessmen that the exchange was fair, the protection afforded by the independent judgment of Railway's board of directors, and the fact that some preferred shareholders favored the exchange.


\textsuperscript{82} 40 Wash. 2d 286, 242 P.2d 1025 (1952).

\textsuperscript{83} In the exchange, the court admitted "[t]he Ziebarth Corporation stock was valued at twenty cents a share . . . ." \textit{Id.} at 301, 242 P.2d at 1035. On the other hand, the Gold Seal Corporation wanted (and later received) an option to purchase all of
In short, state fiduciary concepts have not been the basis for substantial protection to minority shareholders in mergers. Notwithstanding occasional high-sounding rhetoric, there has been little realistic protection provided by state fairness concepts. As Professor Kaplan has stated:

Judicial review of the fairness of the terms of a merger is seldom available in the absence of actual fraud unless there is the grossest kind of disparity in exchange terms which can be considered equivalent to constructive fraud. A few states still entertain injunction proceedings against mergers on the basis of unfair and inequitable terms but this is usually, in practice, a very barren potential for remedy.

To this point, no mention has been made of the availability of appraisal rights as a protection against unfairness. Obviously, these rights are intended to protect disgruntled shareholders against unfairness in certain instances and to provide a means for those shareholders to withdraw from the corporation and receive fair compensation for their shares. Unfortunately, appraisal rights are an incomplete protection against unfairness.

In the first place, questions have been raised about the effectiveness of appraisal rights as a mechanism for protecting shareholders from overreaching. One author stated that the appraisal remedy is
technical; . . . expensive; . . . uncertain in result, and, in the case of a publicly held corporation, is unlikely to produce a better result than could have been obtained on the market . . . . It is, in short, a remedy of desperation." Because of the technicalities, expense and time involved in exercising one’s appraisal rights, Professor Jennings has concluded that the appraisal "remedy, though better than nothing, cannot possibly be an adequate substitute for an equitable review based upon fairness." 89

Even if one were convinced that appraisal rights effectively protect disadvantaged shareholders, the protection afforded is limited by the unavailability of appraisal rights in numerous instances where unfairness to minority shareholders is likely. For example, the alteration of a shareholder’s rights by means of a single company recapitalization generally does not trigger any appraisal rights. 90 The Model Act, as presently adopted by the states, provides that shareholders have no right to dissent from an organic corporate change if their stock is traded on a national exchange. 91 The Model Act also prohibits dissent from a sale of all of a company’s assets if the sale is for cash and the proceeds are to be distributed within one year. 92 A few states deny appraisal rights if the shares were held by more than 2000 shareholders. 93

The point of all this is not to prove that appraisal rights are worthless, since it is clear that they do provide at least some protection against unfairness. 94 The problem, however, is that the protection is incomplete. Notwithstanding the attempt to ensure that shareholders receive fair value for their shares, the gaps in coverage and the

88. Eisenberg, supra note 87, at 85.
89. Jennings, supra note 38, at 999.
90. Under the Model Business Corporation Act 2d, as presently adopted by the states, there are no rights to dissent and appraisal if the rights of shareholders are altered by amendments to the articles of incorporation. In a few states, however, certain alterations in the rights of such shareholders do trigger appraisal procedures. For example, the Idaho statute permits a shareholder to dissent from certain corporate changes, including "changes [in] the rights of the holders of any outstanding shares." IDAHO CODE § 30-150 (1967). New amendments to the Model Act, not yet adopted by the states, would permit appraisal in certain instances involving a single company recapitalization. See Conard, supra note 86, at 2591.
91. MODEL BUS. CORP. ACT ANN. 2D § 80 (1971). This exception has been eliminated from the Model Act by recent amendments. See Conard, supra note 86, at 2591, 2636.
92. MODEL BUS. CORP. ACT ANN. 2D § 80 (1971).
93. E.g., DELAWARE CODE ANN. tit. 8, § 262 (Supp. 1978).
94. One cannot easily dismiss the concerns of Jennings and Eisenberg, supra notes 38 and 87. Those commentators contend that the technical nature of appraisal rights, the expense of exercising those rights, and the delay before a dissenting shareholder receives his cash payment are factors that make the appraisal remedy less than perfect. Clearly they are right, since those factors may cause a disgruntled shareholder to opt for the more certain and immediate offer in the merger rather than take the uncertainty and expense of appraisal. In some instances, however, the appraisal rights do protect shareholders. Specifically, it may be that the threat of a large cash drain caused by the exercise of appraisal rights will cause the merging companies to provide exchange ratios that are at least fair enough to avoid massive appraisals.
realities of exercising appraisal rights often leave shareholders unprotected from overreaching.

Without belaboring this point further, it is possible to draw certain conclusions from the foregoing discussion. Generally, it appears that the application by state courts of statutory and common law constraints has been ineffective in protecting shareholders involved in organic corporate changes. The problems have arisen in those situations where powerful parties involved in such changes are in a conflict of interests situation and utilize their strategic advantage to bludgeon the minority owners into concessions. In those situations the protection provided by state tribunals has been slight.

It is in this context that the serious flaw in the Santa Fe Industries case becomes apparent. The Court, by refusing to litigate fairness questions under Rule 10b-5 and thus relegating those questions to state forums enforcing state standards, has ensured that minority shareholders will continue to receive unfair compensation and inadequate protection. Simply stated, the Court has forced disgruntled shareholders who claim they have been treated unfairly to look to state laws for protection, and those state laws are demonstrably inadequate to protect those shareholders.

One could raise the question, however, of whether the protection of shareholders would be increased by enforcing fairness under Rule 10b-5. Emphatically, this writer believes fairness would increase under federal supervision. Many lawyers and commentators consider the federal courts a superior forum in which to litigate complex questions of fairness among parties to commercial transactions. Professor Kaplan has cited the superior skill and experience of the federal judiciary: "[F]ederal judges are likely to be more sophisticated in understanding the complexities of commercial and financial transactions. After all, wrestling with the federal income tax makes corporate and securities litigation seem almost child's play."5

There also seems to be the feeling that state judges' biases may make them less likely to provide protection for shareholders. Professor Jennings has stated:

Many counsel . . . have the suspicion, despite announced judicial professions concerning fiduciary doctrine, that state court judges may in reality be somewhat less receptive and less likely to enforce fiduciary doctrine to its fullest extent and are somewhat more likely to manipulate findings of fact in such a fashion that the doctrine does not apply broadly.6

While this writer is convinced that the federal judiciary is better equipped to handle fairness cases, there is another benefit that would have been recognized if the Supreme Court had assumed jurisdiction

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5. Kaplan, supra note 45, at 1000.
6. Jennings, supra note 38, at 893. As a specific example of the difference between state and federal courts, one could cite Barrett v. Denver Tramway Corp., 53 F. Supp. 198 (D. Del. 1943), aff'd, 146 F.2d 701 (3d Cir. 1944), where it appeared quite clear that one federal judge would like to apply a more rigorous standard in a recapitalization case than the standard applied in Delaware.
under Rule 10b-5. Specifically, the Court would have adopted a federal standard of fairness, which would have been a new standard unencumbered by existing state precedents on the matter. The result would have been a fresh look at a complex problem taken in a forum that appears better equipped to articulate and apply fairness constraints.

Unfortunately, the Supreme Court declined this opportunity to bring fairness and intelligibility to an area of the law in which abusive conduct has gone unconstrained for decades. One can only wonder whether the Court's rush to "de-federalize" corporate law justifies a disregard for basic fairness.

V. Conclusion

It is quite possible that the Supreme Court may continue to restrict the scope of the securities acts and thus continue to push more corporate questions into state forums. While the present Court seems unable to resist this impulse, one must question the apparent blind vigor with which the goal is being pursued. Without some governor, the result will be more cases like Santa Fe Industries, in which it appears that notions of federalism caused the Court to deny effective relief to powerless shareholders.