1976

Going Private: An Analysis of Federal and State Remedies

John A. James, Jr.

Follow this and additional works at: https://ir.lawnet.fordham.edu/flr

Part of the Law Commons

Recommended Citation

Available at: https://ir.lawnet.fordham.edu/flr/vol44/iss4/3

This Article is brought to you for free and open access by FLASH: The Fordham Law Archive of Scholarship and History. It has been accepted for inclusion in Fordham Law Review by an authorized editor of FLASH: The Fordham Law Archive of Scholarship and History. For more information, please contact tmelnick@law.fordham.edu.
NOTES
GOING PRIVATE: AN ANALYSIS OF FEDERAL AND STATE REMEDIES

I. INTRODUCTION

Going private is a phenomenon that has sprung up in the last two years, a period of lower market prices for equity securities.\(^1\) Although there are many definitions of going private transactions, it is generally agreed that they involve the "[e]liminat[j]ion of] public stock ownership in a corporation with the intention of continuing the corporation's life and business as a closely held company."\(^2\) As was stated in a recent decision, going private is the "'newest game in town.'"\(^3\)

In a recent speech on going private, Arthur A. Sommer, Jr., Commissioner of the Securities and Exchange Commission, quoted with approval one commentator's opinion of going private: "'It seems to me to be nothing less than scandalous, and a species of downright fraud, for small corporations to go public at higher prices, and then buy back substantial quantities of their stock at lower prices . . . .'"\(^4\) Commissioner Sommer's criticisms of the apparent inequities of certain going private practices have been echoed by other commentators in the field.\(^5\) Nonetheless, there are other authorities who

---

1. See Bender, The Battle Over 'Going Private,' N.Y. Times, July 13, 1975, § 3 (Business and Finance), at 1, col. 4. One going private expert has suggested, however, that the phenomenon has been slowed by two factors: the charges of an SEC commissioner, see note 5 and text accompanying note 4 infra, and a New York lower court decision enjoining a going private transaction, see text accompanying notes 98-106 infra. 1 John Thackray's Corporate Finance Letter, Nov. 17, 1975, at 2.


5. See, e.g., Brudney, A Note on "Going Private," 61 Va. L. Rev. 1019 (1975) [hereinafter cited as Brudney]; Comment, Federal Regulation of the Going Private Phenomenon, 6 Cumberland L. Rev. 141 (1975) [hereinafter cited as Cumberland Comment]. Commissioner Sommer stated: "What is happening is, in my estimation, serious, unfair, and sometimes disgraceful, a perversion of the whole process of public financing, and a course that inevitably is going to make the individual shareholder even more hostile to American corporate mores and the securities markets than he already is." Address by A.A. Sommer, Jr., "Going Private": A Lesson in
stoutly defend, with certain limited exceptions, the right and even the desirability of publicly held corporations going private.\textsuperscript{6}

There are a number of advantages for a corporation in the elimination of public ownership.\textsuperscript{7} The corporation can save the cost of SEC registration\textsuperscript{8} and related expenses.\textsuperscript{9} In addition, the corporation would not be subject to the disclosure requirements imposed by the federal securities laws.\textsuperscript{10} Another advantage is that after having gone private a corporation often experiences an upward revaluation of its own securities.\textsuperscript{11} One commentator has concluded...

\begin{footnotesize}
\begin{itemize}
\item Corporate Responsibility, Law Advisory Council Lecture, Notre Dame Law School, Nov. 20, 1974, [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 80,010, at 84,695 [hereinafter cited as Sommer]. Other commentators have limited their criticism to certain types of going private transactions. Professor Borden, for example, has objected to the transaction instigated by management groups with insubstantial, noncontrolling investments for the purpose of "boot-strap[ping themselves] into complete ownership of the enterprise by expending the corporation's own funds." Borden, supra note 2, at 1014; see Kerr, Tender Offers and Going Private—Ending Public Shareholding an Issue, 172 N.Y.L.J., Dec. 16, 1974, at 25, col. 3; Note, Going Private, 84 Yale L.J. 903, 928 (1975) [hereinafter cited as Going Private].
\item Professor Borden estimated that the average public corporation of the size traded on the American Stock Exchange spends between $75,000 and $200,000 for auditing and legal fees, shareholder relations, annual meetings, transfer agents and stock certificates. Borden, supra note 2, at 1007. These annual costs would be eliminated by going private. See Hershman, Going Private—Or How to Squeeze Investors, 105 Dun's Review, Jan. 1975, at 37. But see Berkowitz v. Power/Mate Corp., 135 N.J. Super. 36, 44-45 n.4, 342 A.2d 566, 571 n.4 (Ch. 1975) (savings of such expenses do not constitute a valid business purpose for going private transaction).
\item Professor Brudney noted that for all practical purposes, the savings of such costs may not outweigh the cost of a forgone public market to the remaining shareholders. Brudney, supra note 5, at 1032-36.
\end{itemize}
\end{footnotesize}
that the most significant motivation for a corporation to go private is "the fundamental incompatibility in many enterprises between prudent management and the constraints imposed by public ownership." However, the ultimate beneficiaries of going private are the insiders, i.e., the controlling shareholders. They benefit directly from any increase in the company's value that results from going private. They also acquire an immediate profit from the net difference between the original public offering price and the repurchase price at the time of the going private transaction.

Insiders can eliminate public ownership in many ways. One method is to initiate an asset sale or a corporate dissolution proceeding, where the assets are sold to a shell corporation owned and controlled by the insiders. Alternatively, the insiders can make a tender offer to purchase all outstanding shares for cash or other securities. If a substantial percentage of the outstanding stockholders refuse to accept the tender offer, one of two "mop-up" techniques can be used. The company can employ a reverse share bear market, "the net effect of buying back all publicly held shares is to increase book value still further. Additionally, book value [is] a relatively stable figure, and . . . advances steadily with the years." Id. at 908-09 (footnote omitted).

12. Borden, supra note 2, at 1006-07. The demands imposed upon a publicly held corporation can cause economically undesirable results when the management's desire to maximize profits in the short run in order to raise the current market price replaces the prudent considerations essential for the long run welfare of the enterprise. Id. at 1008.

13. Id. at 1013-15; Brudney, supra note 5, at 1028-29; Going Private, supra note 5, at 905-06. In Berkowitz v. Power/Mate Corp., 135 N.J. Super. 36, 342 A.2d 566 (Ch. 1975), the original public offering price of the 110,000 shares was five dollars per share. The merger-dictated price for the remaining 89,850 shares was two dollars. Id. at 42, 342 A.2d at 568-69. Thus the net profit on the going private transaction, not including the transaction costs, is approximately three dollars per share, or about $270,000. The court found that the increase in net book value alone was $148,648. Id. at 48, 342 A.2d at 573.

14. For a thorough review of all available techniques, see F. O'Neal & J. Derwin, Expulsion or Opposition of Business Associates §§ 4.01-4.14, at 61-98 (1961); Borden, supra note 2, at 989-1000; Kerr, supra note 2, at 44-45. One unusual freeze-out method is that of a voluntary bankruptcy proceeding. Porterfield v. Gerstel, 222 F.2d 137 (5th Cir. 1955).

15. E.g., Lebold v. Inland Steel Co., 125 F.2d 369 (7th Cir. 1941), cert. denied, 316 U.S. 675 (1942).


17. One commentator stated that most one-step tender offers will be unsuccessful in "freezing out" all remaining stockholders, for in every corporation there exist certain "irrational investors who would never willingly abandon their investment, as well as a certain number of shareholders of record who have apparently disappeared, leaving no forwarding address." Going Private, supra note 5, at 910. But see Borden, supra note 2, at 1016 where a sample of recent going private tender offers indicates a "high frequency of 'success.' Of 31 transactions studied, 25 were successful, resulting in the tender of a very high proportion of the outstanding stock sought." See Cumberland Comment, supra note 5, at 160 & n.115.

18. Securities Act Release, supra note 2, at 85,090-91; Borden, supra note 2, at 994-97, 999-1000; Kerr, supra note 2, at 44-45; Going Private, supra note 5, at 910-11. Either of these
split, so that smaller security holders will receive only fractions of a whole share, which, under most state corporation laws, the corporation may purchase for cash. On the other hand, the majority shareholders can "freeze-out" the remaining minority shareholders by means of a merger. For example, the insiders may transfer their shares in the target corporation to a shell corporation in exchange for all of the latter's stock. A merger between the shell and the target corporation is then consummated. The minority shareholder must either accept the merger-dictated price for his shares, or a statutory right of appraisal. While most going private transactions are in full compliance with the formal requirements for merger or tender offer statutes, the question remains whether such transactions may be enjoined under existing state and federal laws. It is argued that minority shareholders generally have no absolute right to continue their participation in an enterprise; yet the corporation owes a "mop-up" methods can be used as a one-step going private technique if, initially, the insiders control a sufficient percentage of the outstanding stock. To effectuate a long-form merger, for example, most states require a pro-merger vote of two-thirds of the outstanding voting shares. See note 23 infra. 


20. See Securities Act Release, supra note 2, at 85,091; Borden, supra note 2, at 999-1000; Kerr, supra note 2, at 45; Cumberland Comment, supra note 5, at 146-51; Going Private, supra note 5, at 910-11.

21. See, e.g., Del. Code Ann. tit. 8, § 155 (1975); N.Y. Bus. Corp. Law § 513 (McKinney 1963). However, it is conceivable that such a going private tactic could be enjoined, since the cash to be distributed "in lieu of fractional shares" is arguably not within the meaning of the statutory provisions. See Fillman, Cash and Property as Consideration in a Merger or Consolidation, 62 Nw. U.L. Rev. 837, 853 n.62 (1968); cf. Brudney, supra note 5, at 1029.

22. Professor Vorenberg has described the purpose of a freeze-out as being "to force a liquidation or sale of the stockholder's shares, not incident to some other wholesome business goal." Vorenberg, Exclusiveness of the Dissenting Stockholder's Appraisal Right, 77 Harv. L. Rev. 1189, 1192-93 (1964) (emphasis omitted).


26. It is established in the short-form merger context where the minority interests are less
fiduciary duty to these same shareholders to act in good faith in all transac-
tions, and to treat all shareholders of the same class equally by way of
dividends, liquidation distributions and other similar actions. This Note will
analyze existing federal and state approaches to going private tender offers and
mergers as well as the potential changes that may result with the adoption of
the proposed SEC regulations.

II. FEDERAL REMEDIES

Many going private transactions are accomplished by tender offers. In
discussing the plight of the minority stockholder confronted with a going
private tender offer, Commissioner Sommer has stated:

Faced with the prospect of a force-out merger, or a market reduced to glacial
activity and the liquidity of the Mojave Desert, and deprived of most of the benefits of
the federal securities laws, how real is the choice of the shareholder confronting the
offer of management to acquire his shares, usually not with their own resources, but
with the corporation's resources that really belong to him and his fellow shareholders?
In short, he usually decides he damn well better take the money and run.

Minority shareholders realize that if a sufficient response to the offer is
forthcoming, they will lose not only the benefits that normally accrue to
shareholders of a publicly held corporation traded on a national exchange, but also the protection of the federal securities laws. Even if the tender offer
is not wholly successful, because of the threat of a subsequent freeze-out, the
dissenting minority shareholder has no assurance that the eventual merger-
dictated price will be as attractive or as fair as the current tender offer.

than 10% in Delaware and New Jersey, and less than 5% in New York, that the legislative intent
was to authorize the elimination of these minority shareholders without giving them any recourse
other than their right of appraisal. See note 25 supra. In Krafcisin v. LaSalle Madison Hotel Co.,
[1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,586 (N.D. Ill. 1972), the court held that
there was no right in the minority shareholder to continue his participation in the corporation
where the majority of controlling interests of 90% of the outstanding shares voted to dissolve the
corporation. See Coyne v. Park & Tilford Distillers Corp., 37 Del. Ch. 558, 146 A.2d 785 (1958),
aff'd, 38 Del. Ch. 514, 154 A.2d 893 (1959); Willcox v. Stern, 18 N.Y.2d 195, 202, 219 N.E.2d
401, 404, 273 N.Y.S.2d 38, 43 (1966); Beloff v. Consolidated Edison Co., 300 N.Y. 11, 19, 87
N.E.2d 561, 564-65 (1949); Anderson v. International Minerals & Chem. Corp., 295 N.Y. 343,

27. See notes 107-46 infra and accompanying text.
28. See Brudney, supra note 5, at 1021-22; Gibson, How Fixed Are Class Shareholder Rights?,
30. Sommer, supra note 5, at 84,696.
31. Such benefits include improved share marketability, increased use of stock as collateral,
published securities prices, and publicity of corporate affairs. H. Guthmann & H. Dougall,
32. See notes 43-44 infra and accompanying text.
33. The corporation is under no obligation to equate the merger-dictated price with the
current tender offer price. It is submitted, however, that the former will not vary substantially
from the latter, based upon the corporation's awareness of the likely possibility of equitable
intervention, or the threat of costly appraisal litigation.
Consequently, such tender offers have been called "shakedowns," that are "inherently unfair and should be prohibited . . . in the going private area."\(^{34}\)

The SEC has recently proposed rules 13e-3A and 13e-3B which directly deal with "shake-down tender offers."\(^{35}\) One of the most important provisions mandates vigorous disclosure requirements for the offeror. "Certain specified information" must be made public, such as the purpose of the transaction, the source of the funds and market information.\(^{36}\) Although it may be true that this information is similar to the information presently contained "in a carefully prepared tender offer document,"\(^{37}\) the rule, at the very least, establishes standards of information which must be met in every going private transaction. The proposed regulations also provide for a twenty day "waiting period" during which the transaction cannot be effected.\(^{38}\) Thus, the shareholder will not be rushed into a premature decision that is not based upon careful reflection.

The proposed regulations require the appraisal of two independent experts as to the fairness of the proposed consideration.\(^{39}\) Their findings must be disclosed, and the consideration, which must reflect the fair value of the shares, must be no lower than the experts' joint recommendation.\(^{40}\)

A key provision of the proposed regulations grants all minority shareholders who did not accept what later proved to be a successful tender an additional twenty day "take-out period" to tender for the original consideration.\(^{41}\) Thus, regardless of whether the minority shareholder accepts the original offer, he would at least be assured by proposed rules 13e-3A and 13e-3B that he would not be "condemned to languish in an illiquid market."\(^{42}\)

Until the SEC adopts new regulations, however, the only federal remedy available in a tender offer situation seems to be based upon the disclosure

---

34. Borden, supra note 2, at 1006.
35. Securities Act Release, supra note 2, at 85,091-93. The ABA Committee on Federal Regulation of Securities of the Section of Corporation, Banking and Business Law in its comments on the propriety of the proposed rules recommended strongly, on the ground of availability of a state forum, that they not be adopted. See Borden, supra note 2, at 1037-38; Mulvihill, supra note 6, at 1030.
37. Mulvihill, supra note 6, at 1028.
38. Securities Act Release, supra note 2, at 85,092.
39. Id.
40. Whether the "fair value" analysis should take into consideration and disclose forecasts of the corporation's projected performances has not yet been conclusively determined. Compare Brudney, supra note 5, at 1025, with Mulvihill, supra note 6, at 1032.
41. Securities Act Release, supra note 2, at 85,092. Professor Borden's proposal is essentially similar. He believes that the price of the second tender offer should be regulated so that it is slightly lower than the first, in order to discourage minority shareholders from speculating on the possibility of future tender offers at higher prices. Borden, supra note 2, at 1005-06. This view reflects his generally favorable attitude toward going private transactions. The SEC's proposed rules are arguably more neutral toward such transactions, as they eliminate most of the coercive aspects of the "shake-down" tender offer without going so far as to encourage stockholders not to tender their shares upon the first tender offer. See Brudney & Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 Harv. L. Rev. 297, 337 (1974).
42. Borden, supra note 2, at 1006.
requirements imposed by sections 13(a)(1) and 14(e) of the Williams Act,43 and section 10(b) of the 1934 Securities Exchange Act.44 The disclosure requirements dictate that a company intending to go private disclose that the ultimate purpose of its tender offer is to eliminate minority stockholders and go private.45 In addition, the anti-fraud provision of the Williams Act, section 14(e), prohibits fraudulent and deceptive practices in connection with the tender offer.46

On the other hand, where going private is to be accomplished by merger, proposed SEC rule 13e-3B would also require a “valid business purpose” for the transaction.47 Although the SEC has yet to elaborate on what such a purpose would be, the language of the proposed rule suggests that the standard would require “sufficient flexibility to deal with any type of transaction.”48 It is likely that the SEC and the courts in utilizing the valid business purpose test will look for guidance to the case law as developed in the Fifth Circuit.49

That circuit has developed the valid business purpose test as a mode of analysis in a merger situation. This standard was first enunciated in Bryan v. Brock & Blevins Co.,50 where a district court enjoined a proposed freeze-out merger as a course of business “which would operate as a fraud or deceit upon Bryan,” the minority shareholder. The court found that section 10(b) of the 1934 Act and rule 10b-5 were violated by defendant’s “failure to state a material fact,” and its use of corporate procedures amounted to “a device, scheme, or artifice to defraud Bryan of his stock.”51 Relying upon fundamental equitable principles, the court reasoned that the proposed merger could not be permitted when it was solely motivated by the insiders’ desire to eliminate the minority shareholder.52 The court held that such a merger was not

43. 15 U.S.C. §§ 78m(a)(1), n(e) (1970). For a thorough discussion of federal regulation of tender offers, see Kerr, supra note 2, at 34-41.
47. Securities Act Release, supra note 2, at 85,093.
48. Id.
49. See notes 51-73 infra and accompanying text.
51. Id. at 1070.
52. Id. at 1068-70. But see Braasch v. Goldschmidt, 41 Del. Ch. 519, 523, 199 A.2d 760, 763 (1964), where the court stated: “A subsidiary may be created by a domestic corporation for the purpose of effecting a merger.” See Hottenstein v. York Ice Mach. Corp., 136 F.2d 944, 953 (3d Cir. 1943), cert. denied, 325 U.S. 886 (1944) (Delaware corporation may reclassify its stock so as to cancel accrued dividends on preferred stock by merger with a subsidiary created specially for that purpose). Compare Bove v. Community Hotel Corp., 105 R.I. 36, 40-41, 249 A.2d 89, 92-93 (1969), where the court sustained a merger which was resorted to solely for the purpose of freezing-out the preferred shareholders, with Condec Corp. v. Lunkenheimer Co., 43 Del. Ch.
supported by a "plausible business purpose" of the corporation and was therefore enjoinable.53

Although Bryan was affirmed at the appellate level on the basis of Georgia law,54 its "plausible business purpose" test was used by another district court in the Fifth Circuit to sustain a going private merger. In Grimes v. Donaldson, Lufkin & Jenrette, Inc.,55 the defendant initially obtained control of fifty-seven percent of the stock of Meridian Corporation through tender offers in May and September of 1973.56 Five months later, Donaldson, Lufkin & Jenrette, Inc. (DLJ) announced its proposed merger between Meridian and a newly created and wholly owned subsidiary of DLJ.57 The transaction would have eliminated the remaining forty-three percent of the Meridian shareholders by giving them $7.50 in cash for each of their outstanding shares.58 In its analysis, the court distinguished Bryan as involving a close corporation which used a "paper transaction" whose only purpose was to "get rid of the sole minority shareholder."59 In Grimes, the court was confronted with a publicly held corporation whose principal stockholder, DLJ, could arguably contend that a merger with a subsidiary of DLJ would eliminate possible conflicts of interest between the two corporations, and in addition produce savings of over $300,000 per year.60 The court held that the desire of the parent corporation, DLJ, to eliminate potential claims of conflicts of interest with its subsidiaries was a valid business purpose for the proposed merger.61

353, 230 A.2d 769 (1967) which held that issuance of stock for the primary purpose of freezing-out the minority shareholders is actionable without regard to price.

53. 343 F. Supp. at 1068.
56. 392 F. Supp. at 1397-99. The President of Meridian Corporation, on the authority of the Board of Directors, solicited DLJ's original tender offer, as a means of stabilizing Meridian's market price and enabling the company to "take decisive action to make the company profitable." Id. at 1396.
57. Id. at 1400. The court stated that there was no reason to enjoin a merger simply because the newly formed subsidiary was formed specifically for the purpose of effecting the merger. Id. at 1403; see note 52 supra.
58. 392 F. Supp. at 1400. In sustaining the merger price as "fair," the court was undoubtedly influenced by defendant's retention of an investment banking firm to appraise the fair and equitable price of Meridian stock. Id. at 1400-01.
59. Id. at 1402. The court appeared to interpret Bryan as standing for the proposition that a "sham merger," that is, one without a valid business purpose, is fraudulent. Id. Professor Kessler reconciles Bryan and Grimes by pointing out that "the courts are more sympathetic to preserving the minority shareholder's interest where a closely-held corporation is involved (i.e., where the nature of the interests of the minority are more easily ascertained) . . . ." Kessler, supra note 23, at 707.
60. 392 F. Supp. at 1399. The savings would result from a "reduction in salaries, legal and accounting expenses as well as savings in franchise taxes, stock transfer fees, public relations expense, directors' fees . . . ." Id. at 1400. But see Berkowitz v. Power/Mate Corp., 135 N.J. Super. 36, 44-45 n.4, 342 A.2d 566, 571 n.4 (Ch. 1975), discussed at notes 138-45 infra and accompanying text.
61. 392 F. Supp. at 1402-03. The court found that as long as public minority shareholders existed in the target corporation (Meridian), joint ventures and business dealings between parent
In Albright v. Bergendahl, a Tenth Circuit district court used the Bryan test in a fact pattern similar to Grimes. The controlling stockholder of International Service Industry (ISI) sought to use a cash merger to eliminate the public minority shareholders. The merger was to take place between ISI and a shell corporation, Body Contour Inc., which was owned and controlled by the defendant insiders of ISI. The minority shareholders of ISI were to receive eighteen cents per share, with no opportunity to obtain shares in the new corporation. In enjoining the transaction, the court, on the basis of Bryan, held that the stated purpose for the merger, eliminating public ownership, was not a legitimate corporate purpose. Moreover, the transaction violated rule 10b-5, as a "transaction . . . constitut[ing] a 'device, scheme or artifice to defraud' or an 'act, practice or course of business which operates or would operate as a fraud or deceit' upon the public minority stockholders of International Service Industries, Inc."64

As seen in Albright and Bryan, the elimination of minority interests as an end in itself is not a valid business purpose. There is some authority for the proposition that the savings of those costs inherent in a public corporation is also not a valid justification for going private. On the other hand, there would be a valid business purpose where a corporation is forced to go private in order to maintain its solvency. Between these two extremes, however, a and subsidiary would be inhibited by potential claims of conflicts of interest. Id. at 1399. This finding can be challenged on the grounds that the corporate defendants may have "bootstrapped" a valid business purpose by intentionally creating a situation which gave rise to a conflict of interest. See Kessler, supra note 23, at 710-11.

63. Id. The court also relied upon the broad fiduciary principles of Pepper v. Litton, 308 U.S. 295 (1939); see note 107 infra.
64. 391 F. Supp. at 756.
65. Albright and Bryan may be distinguishable in that the sole purpose of the merger in both cases seems to have been the elimination of the minority shareholders. See text accompanying notes 52 & 63 supra.
66. See notes 50-54 supra and accompanying text.
67. See Kessler, supra note 23, at 706.
69. See Matteson v. Ziebarth, 40 Wash. 2d 286, 242 P.2d 1025 (1952) (en banc), discussed at notes 124-27 infra and accompanying text. Commissioner Sommer has advocated the adoption of a rigorous business purpose test: "Specifically, I would suggest that when a corporation chooses to tap public sources of money, it makes a commitment that, absent the most compelling business justification, management and those in control will do nothing to interfere with the liquidity of the public investment or the protection afforded the public by the federal securities laws." Sommer supra note 5, at 84,698; see Comment of Eric C. Little to George A. Fitzsimmons, Secretary of SEC, July 10, 1975, concerning Securities Exchange Act Release No. 5567. It is doubtful if any of the recent going private cases could be sustained under Sommer's standards. It has been suggested by another commentator that such a rigorous standard would be unjust and unfair to many corporate participants in going private transactions. Professor Borden has stated: "This narrow 'commercial purpose' construction of the business-reason test seems to exclude from consideration the inextricable mix of shareholder, insider and corporate community interests . . . .
determination of the validity of the business purpose becomes more difficult. Professor Kessler has argued that validity may be established where the corporation can show that "problems arising out of the existence of minority interests constitute a potential impediment or burden to the future business operations of the company."70 The court in Grimes broadened this standard, holding that the elimination of potential conflicts of interest is a valid business purpose.71

It is significant that the Albright court firmly placed the burden upon the defendant corporation to prove that a valid business purpose existed.72 This procedural requirement, if adopted by other courts, would create serious obstacles for the going private corporation. It may be much more difficult for the corporation to successfully meet the burden than it was formerly, when the minority shareholders had the unenviable task of establishing that no valid purpose existed for the transaction.

The Second Circuit, on the other hand, has limited relief to a guarantee of full disclosure. In Popkin v. Bishop,73 the leading Second Circuit decision, the court refused to enjoin a proposed corporate merger on the ground that the exchange ratios were unfair to the minority shareholders.74 The court described non-disclosure as a "key issue in Rule 10b-5 cases," and stated that the rule was "designed principally to impose a duty to disclose and inform rather than to become enmeshed in passing judgments on information elicited."75 The court further defined the federal role in regulating proposed mergers:

In the context of such transactions, if federal law ensures that shareholder approval is fairly sought and freely given, the principal federal interest is at an end. Underlying questions of the wisdom of such transactions or even their fairness become tangential at best to federal regulation.76

Surely the business-reason test is neither a fair test nor concerned with business if it is used to preclude evaluation of these policies." Borden, supra note 2, at 1022-23.

70. Kessler, supra note 23, at 710. Kerr believed that the elimination of a minority interest as the last step in a corporate amalgamation is a proper purpose. Kerr, supra note 2, at 60. One commentator indicated that a valid purpose is the desire to avoid making business decisions based on "artificial values" such as earnings per share. Cumberland Comment, supra note 5, at 154 & n.80. Other business purposes advanced include a desire to avoid the "negative effect of low stock prices on employees holding stock options." Id. at 154.

71. See note 61 supra and accompanying text.

72. 391 F. Supp. at 756; see Kerr, supra note 2, at 59. Kerr would also require the control group, i.e., the insiders, to demonstrate that any benefit to the fiduciaries would be incidental. Id. Borden, generally a proponent of going private, would require that the burden of proving fairness be on the fiduciary, that there be a showing of a plurality in interest of outside shareholders, that the proponents possess substantial equity (25-30%) and that there be a three month notice period to insure that a better offer is not available. See Borden, Going Private Fad: Infatuation Unlikely to Disappear Soon, 174 N.Y.L.J., Dec. 15, 1975, at 39, col. 7.

73. 464 F.2d 714 (2d Cir. 1972).

74. Id. at 717-18. The merger exchange ratios were established by a reputable investment banking firm hired by the controlling stockholder. Id. at 717.

75. Id. at 719-20.

76. Id. at 720; see Stedman v. Storer, 308 F. Supp. 881, 887 (S.D.N.Y. 1969). The primary congressional purpose underlying the Securities and Exchange Act of 1934 was to "promote free
In *Dreier v. Music Makers Group, Inc.*, a Second Circuit district court seemed to eliminate *any* possibility of a substantive federal evaluation of the "wisdom of the transaction" in the going private context. The court pointed out that since the complaint did not allege any non-disclosure in connection with the merger, it did not state a federal cause of action. The court held that the going private transaction "may well have been grossly unfair but it was completely open."

More recent Second Circuit going private decisions have continued to follow the reasoning of *Popkin* and *Dreier*, declining to use federal securities law to enjoin going private transactions. Even when confronted with blatant overreaching by the controlling shareholders, as in *Marshel v. AFW Fabrics*, the court refused to intervene, holding that rule 10b-5 did not reach the allegations of an unfair and inadequate price for the minority shares. In *Greenberg v. Institutional Investor Systems, Inc.*, the district court restated the Second Circuit view of the effect of the federal securities laws on going private: "[A]ssuming full disclosure has been made there is nothing *per se* illegal under federal law about a merger that eliminates minority public shareholders . . . ." The court examined a corporate transaction where the majority stockholders, controlling eighty-five percent of the outstanding shares, initiated a tender offer followed by a freeze-out merger. The plaintiffs alleged *inter alia* that the proposed going private merger was a violation of section 10(b) of the 1934 Act and rule 10b-5. The court dismissed the minority shareholders' complaint on the authority of *Popkin*.

It can be seen that there are conflicting federal approaches to the going private problem. According to the Second Circuit view, federal relief is limited to the guarantee of full disclosure. The Fifth Circuit's valid business

---

and open public securities markets." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 858 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); see Cumberland Comment, supra note 5, at 150 & n.62.

78. Id. at 95,410.
79. Id.
81. 398 F. Supp. 734 (S.D.N.Y. 1975). AFW Fabrics involved the same going private transaction litigated in *People v. Concord Fabrics, Inc.*, 83 Misc. 2d 120, 371 N.Y.S.2d 550 (Sup. Ct.), aff'd, 174 N.Y.L.J., Dec. 29, 1975, at 6, col. 3 (1st Dep't). In the state court, the proposed merger was enjoined as a fraudulent practice under New York's Blue Sky laws. Id. at 123-25, 371 N.Y.S.2d at 553-54; see notes 98-105 infra and accompanying text.
82. 398 F. Supp. at 738.
84. Id. at 98,221.
85. Id. at 98,221-22.
86. Although the Second Circuit has seemingly eliminated a federal cause of action absent non-disclosure, it is conceivable that imaginative use of the "New Fraud" doctrine could circumvent their position. See Borden, supra note 2, at 1035; Cumberland Comment, supra note
standard as well as the proposed SEC rules provide for substantive federal analysis of the corporate motivations behind the transaction. One advantage of such a standard is that it could provide an alternative cause of action for those minority shareholders who might otherwise be restricted to inadequate state remedies.

III. STATE REMEDIES

In the absence of state enacted going private legislation, one possible remedy for the "shake-down" tender offer may be found in the state stock repurchase laws. When a corporation purchases its own shares, it normally does so under powers granted to it by its state of incorporation. Purchases must come from surplus or capital accounts. One commentator has pointed out that such statutes often contain language to the effect that purchases must be made "in furtherance of its corporate purposes." Thus

87 See generally Bloomenthal, From Birnbaum to Schoenbaum: The Exchange Act and Self-Aggrandizement, 15 N.Y.L.F. 332 (1969); Patrick, Rule 10b-5, Equitable Fraud and Schoenbaum v. Firstbrook: Another Step in the Continuing Development of Federal Corporation Law, 21 Ala. L. Rev. 457 (1969); Comment, Schoenbaum v. Firstbrook: The "New Fraud" Expands Federal Corporation Law, 55 Va. L. Rev. 1103 (1969). Established in Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968), cert. denied, 395 U.S. 906 (1969), this doctrine construes section 10(b) to cover transactions of the directors that are earmarked with self-dealing or conflicts of interest that, although fully disclosed, defraud minority shareholders. Borden, supra note 2, at 1035. In discussing the applicability of "New Fraud" to corporate freeze-outs, Professor Bloomenthal stated: "[F]raud does not in this context [freeze-outs] require deception; it is sufficient if those with fiduciary responsibilities take unfair advantage of minority shareholders in a transaction in which such minority shareholders are forced to sell their shares to the majority." 15 N.Y.L.F. at 375.

88 See, e.g., Del. Code Ann. tit. 8, § 160 (1975); N.Y. Bus. Corp. Law § 202(a) (McKinney 1963). Only one state has adopted regulations specifically dealing with going private. See Wisc. Adm. Code § 5.05, 3 CCH Blue Sky L. Rep. ¶ 52,605, at 48,527-28 (Nov. 4, 1975). While only effective for 120 days, the Wisconsin regulations seem more stringent than the proposed SEC regulations. If extended, they could significantly inhibit any Wisconsin qualified corporations from going private.


Although Delaware law does not specifically require a "corporate purpose" for a stock repurchase, its courts have interpreted section 160 as having such a requirement. See Cheff v. Mathes, 41 Del. Ch. 494, 504, 199 A.2d 548, 554 (Sup. Cl. 1964) (directors' sole motivation for stock repurchase, to maintain control, held improper use of corporate funds); Bennett v. Propp, 41 Del. Ch. 14, 22, 187 A.2d 405, 409 (1962) (stock repurchase must be "primarily in the corporate interest"). The New Jersey statute, N.J. Stat. Ann. § 14A:7-16 (1969), was drafted "broadly to avoid any implication of a 'proper corporate purpose' test, leaving questions of unfairness to be dealt with on equitable principles." Commissioners' Comment, N.J. Stat. Ann. § 14A:7-16 (1969). Since the statute was drafted, no cases have yet explored whether equity will provide such a "proper corporate purpose" test. See Knickerbocker Importation Co. v. State Bd. of Assessors, 74 N.J.L. 583, 586, 65 A. 913, 914 (1907) (legitimate corporate purpose required for capital stock repurchase). Proposed SEC rule 13e-3B would require a "valid business purpose" for a tender offer. Securities Act Release, supra note 2, at 85,093.
conceivable, the "legitimate corporate purpose standard" as developed in the state fiduciary context could be used to test the legality of a coercive tender offer.91

A minority shareholder seeking state relief for an allegedly fraudulent merger is generally limited to an action for an injunction or, in some instances, a right of appraisal.92 In the absence of going private legislation, the state courts must analogize to other applicable statutory and common law corporate duties in order to predicate a cause of action for the minority shareholder.

One remedy may be the Blue Sky laws,93 which frequently bear a close resemblance to rule 10b-5.94 New York's Blue Sky law is slightly different in that it empowers the Attorney General to investigate and bring actions to enjoin fraudulent practices,95 which, depending upon the fact pattern, may include going private.96 The Court of Appeals has found that the New York Blue Sky laws are to be broadly construed so as to include conduct that would not otherwise constitute common law fraud.97

91. See Kerr, supra note 2, at 42-43. The repurchases will ordinarily be analyzed by the "business judgment rule." See notes 112-13 infra, and accompanying text; E. Folk, The Delaware General Corporation Law: A Commentary and Analysis 154 (1972) [hereinafter cited as Folk]. The improper purpose doctrine may apply to going private tender offers, in that a corporation cannot repurchase its own shares where the officers' only purpose is to perpetuate control.


94. The Uniform Securities Act § 101 provides that: "It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly (1) to employ any device, scheme, or artifice to defraud, (2) 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 are made, not misleading, or (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 7 Uniform Laws Ann. 695 (1970). Section 101 has been enacted in twenty-six states as well as the District of Columbia and Puerto Rico. Id. at 152 (Supp. 1974).

95. N.Y. Gen. Bus. Law § 352 (McKinney 1968). The law provides in pertinent part: "Whenever it shall appear to the attorney-general, either upon complaint or otherwise, that . . . in the issuance, exchange, purchase, sale . . . of any stocks . . . or other securities . . . any person . . . corporation, company . . . or any agent or employee thereof, shall have employed . . . any device, scheme or artifice to defraud or for obtaining money or property by means of any false pretense, representation or promise, or . . . shall have employed . . . any deception, misrepresentation, concealment, suppression, fraud, false pretense or false promise, or shall have engaged in or engages in or is about to engage in any practice or transaction or course of business relating to the purchase . . . or sale of securities . . . which is fraudulent or in violation of law and which has operated or which would operate as a fraud upon the purchaser . . . ."


97. People v. Federated Radio Corp., 244 N.Y. 33, 154 N.E. 655 (1926). The protection under this statute is more extensive than under common law fraud. It is not necessary to demonstrate that fraud in the classical sense is present, but it is necessary that there be "the potentiality of the public being misled . . . ." People v. Hooker, 2 Misc. 2d 874, 876, 151
A recent New York case, *People v. Concord Fabrics, Inc.*,98 is apparently the first time a court has applied a state Blue Sky law in the going private context. Concord Fabrics had gone public in 1968, with a sale of 300,000 shares of common stock at fifteen dollars per share. After a second public offering in 1969 of 200,000 shares at twenty dollars per share, the corporation was traded on the American Stock Exchange where its price reached a high of twenty-five dollars in early 1969.99 By late 1974, however, the stock had dropped to a low of about one dollar per share. About this time, the Weinstein family, which controlled sixty-eight percent of the voting shares, decided to go private and return full ownership and control of the corporation to the family.100

The Weinsteins formed a shell corporation, AFW Fabric Company, to which they transferred their controlling interest in Concord Fabrics in exchange for AFW's total outstanding stock. Merger plans were formulated, and Concord's board of directors reached a valuation of three dollars per share based upon an opinion by an investment banking and brokerage firm.101

In enjoining the transaction as fraudulent, the court stated that although full disclosure had been "articulated," the proposed merger violated section 353 of the General Business Law:102

What is disquietingly evident here is the fact that a group of insiders who are directing the reacquisition program, even controlling the appraisal of the stock are the very ones who made the company public originally, and will be the surviving shareholders in the proposed privately-held enterprise.103

The court suggested, without specifically stating, that the fraudulent aspect of the proposed transaction was that the offered consideration for the minority shares was inadequate. A significant factor in the court's reasoning was that the appraisal by the investment banking firm was tainted by a conflict of interest, in that the appraiser was a son of one of the directors.104 The court

---

98. 83 Misc. 2d 120, 371 N.Y.S.2d 550 (Sup. Ct. 1975). For the same going private transaction in federal district court, see *Marshel v. AFW Fabric Corp.*, 393 F. Supp. 734 (S.D.N.Y. 1975). The federal court refused to enjoin the proposed merger, holding that absent disclosure violations, the transaction did not violate federal securities laws. It is interesting to note that the court also held that the only available state remedy for the dissenting minority shareholder was appraisal. Id. at 739.


100. Id. at 736.

101. 83 Misc. 2d at 121-22, 371 N.Y.S.2d at 551-52.


103. 83 Misc. 2d at 125, 371 N.Y.S.2d at 554.

104. Id. at 121, 371 N.Y.S.2d at 551. The court did not indicate whether the use of an impartial appraiser would negate the finding of inadequacy of consideration, or at least firmly establish the burden of proof upon the dissenting stockholder. Proposed SEC rule 13e-3B would require an appraisal by two "qualified independent persons." Securities Act Release, supra note 2, at 85,092.
also found that there was no real corporate purpose for the merger, but it did not indicate whether this fact made the entire merger fraudulent. Thus the court left unanswered whether a going private transaction that is earmarked by self-dealing must have a demonstrable corporate purpose in order to be non-fraudulent under the Blue Sky laws and whether a transaction not marked by self-dealing is, without more, valid. The decision indicated however, that a going private merger is not fraudulent per se, and that evidence of unfairness must be demonstrated. In the future, a case-by-case analysis may well be necessary to determine whether or not a given transaction is fraudulent.

A more traditional state approach to self-dealing involves the corporate fiduciary doctrine. While engaging in corporate transactions, officers, directors and parent corporations are held to have a fiduciary relationship with the corporation and the minority shareholders. Controlling shareholders owe a similar duty, especially in situations where they participate in the firm's policy and management decisions. It is submitted that such participation can be found in virtually all going private transactions, based upon the fact

105. 83 Misc. 2d at 125, 371 N.Y.S.2d at 554.
106. See note 146 infra.
107. In 1939, Justice Douglas set forth the standards of conduct for the fiduciary: "He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis." Pepper v. Litton, 308 U.S. 295, 311 (1939) (emphasis omitted). The fiduciary must observe all rules of "conscientious fairness, morality and honesty in purpose" and are held in official action to the "extreme measure of candor, unselfishness and good faith." Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 193, 123 N.E. 148, 151 (1919); see Brundage v. New Jersey Zinc Co., 48 N.J. 450, 482, 226 A.2d 585, 602 (1967); Maxwell v. Northwest Indus., Inc., 72 Misc. 2d 814, 822, 339 N.Y.S.2d 347, 357 (Sup. Ct. 1972).
110. In Southern Pac. Co. v. Bogert, 250 U.S. 483 (1919), Mr. Justice Brandeis said: "The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers and directors." Id. at 487-88; see, e.g., Allied Chem. & Dye Corp. v. Steel & Tube Co., 14 Del. Ch. 64, 71, 122 A. 142, 145 (1923); Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 194-96, 123 N.E. 148, 151-52 (1919). Contra, Geller v. Transamerica Corp., 53 F. Supp. 625, 630 (D. Del. 1943), aff'd, 151 F.2d 534 (3d Cir. 1945) (per curiam) ("It is the law of [Kentucky] . . . that an officer or director may purchase stock from a minority stockholder without being burdened with the obligations of a fiduciary. The only duty imposed upon such an officer or director is to answer fully and fairly any question addressed to him by the stockholder concerning the affairs of the corporation. But the officer or director is under no obligation to volunteer information.").
that the majority shareholder is inevitably involved, directly or indirectly, in the corporation's initial decision to go private. It is important, therefore, to examine the nature and extent of these fiduciary duties running to the minority shareholder.\textsuperscript{111}

Ordinarily, the fiduciary's actions are presumptively fair,\textsuperscript{112} and the business judgment rule applies.\textsuperscript{113} Since courts refrain from substituting their business judgment for that of management,\textsuperscript{114} in order for a more rigorous judicial analysis to be applied the minority shareholder must establish fraud, bad faith, conflict of interest or self-dealing on the part of the fiduciaries.\textsuperscript{115}

In the going private area, virtually all mergers involve either interlocking directorates or tacit self-dealing because of the insiders' use of the shell corporation to effect the merger. In New York, transactions involving interested directors are subject to "careful judicial scrutiny,"\textsuperscript{116} an analysis which shifts the burden to the fiduciary to prove the fairness of the transaction.\textsuperscript{117} Similarly, in Delaware, interested mergers are subject to "close scrutiny" to establish the "intrinsic fairness" of the merger, with an analogous shift of the burden of proof.\textsuperscript{118} Recent decisions in Delaware have apparently

\textsuperscript{111} In SEC v. Chenery Corp., 318 U.S. 80 (1943), Mr. Justice Frankfurter stated: "But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?" Id. at 85-86.


\textsuperscript{113} In Pollitz v. Wabash R.R., 207 N.Y. 113, 100 N.E. 721 (1912), the court stated: "[The directors'] corporate acts, within the powers of the corporation, in the lawful and legitimate furtherance of its purposes, in good faith and the exercise of an honest judgment, are valid, and conclude the corporation and the stockholders. Questions of policy of management . . . or . . . adequacy of consideration . . . are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned . . ." Id. at 124, 100 N.E. at 723-24; see Bodell v. General Gas & Elec. Corp., 15 Del. Ch. 420, 429-30, 140 A. 264, 268 (1927); 3 W. Fletcher, Cyclopedia of the Law of Private Corporations § 1039 (perm. ed. 1965); Folk, supra note 91, at 75-81.

\textsuperscript{114} 3 W. Fletcher, Cyclopedia of the Law of Private Corporations § 1039 (perm. ed. 1965); Folk, supra note 91, at 75.

\textsuperscript{115} Folk, supra note 91, at 76.


limited the application of this more rigorous analysis to self-dealing situations, at least in the parent-subsidiary context. Since most going private mergers involve a parent-subsidiary relationship, some form of self-dealing can be demonstrated. Commentators have found such self-dealing in most, if not all, going private situations. Thus, one may conclude that the courts in both Delaware and New York will closely scrutinize going private transactions.

Several courts have posited the existence of fraud in the freeze-out context where "the majority use their power to sell to themselves in another guise and thereby carry on in the business without their former associates of the minority . . . ." In Matteson v. Ziebarth, for example, the principal stockholder of Ziebarth, a close corporation, sought to consummate a sale of the company to a third party. Matteson, a minority shareholder, refused to sell his shares, so the controlling stockholders resorted to a freeze-out to effectuate the eventual sale of the corporation. In explaining its holding, the court expressly found that no fraud had been shown and pointed out that the proposed merger and subsequent sale were practically "the only salvation for the hard-pressed Ziebarth Corporation." Ziebarth stands for the proposition that a freeze-out motivated by a valid business reason is a legitimate and


120. Chasin v. Gluck, 282 A.2d 188, 192 (Del. Ch. 1971). In David J. Greene & Co. v. Schenley Indus., Inc., 281 A.2d 30 (Del. Ch. 1971), the court was confronted with an "interested merger" but did not apply the "intrinsic fairness" test, holding that the right of appraisal is adequate where there is no self-dealing. Id. at 33; see Folk, supra note 91, at 333-36. There are two characteristics of self-dealing: "[First] a parent [must be] on both sides of a transaction with its subsidiary. [Second] the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary." Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

121. The shell corporation, as owner of a controlling interest in the target corporation, is the parent.

122. One commentator has found that the fiduciary in a going private transaction receives the following benefits: "[A] substantial solidification of their control, escape from securities laws regulation, or, in the case of the freeze-out transaction, a substantial increase in the value of their investment . . . ."


124. 40 Wash. 2d 286, 242 P.2d 1025 (1952) (en banc).

125. Matteson objected to the President and majority shareholder receiving a salary as an employee of the third party purchaser. Matteson contended that he was entitled to his proportional share of the consideration, approximately $4,000 per year. Id. at 291, 242 P.2d at 1029.

126. Id. at 301, 242 P.2d at 1034.
equitable corporate transaction that does not involve a breach of the controlling shareholders' fiduciary duties. 127

In Bryan v. Brock & Blevins Co., 128 a former employee who refused several offers by the controlling interests for his minority interest in a close corporation became the target of a freeze-out merger. The Fifth Circuit Court of Appeals held that a freeze-out merger, where the sole motivation was to eliminate a minority shareholder, was a violation of the Georgia merger statute and a breach of the majority shareholders' fiduciary duties. 129 The court contended that the statute impliedly authorized only those mergers that are motivated by a legitimate business purpose. 130

A more frequent ground for finding a breach of fiduciary duty is that of "unfairness" in the adequacy of the consideration of the merger-dictated price. 131 In some states the presence of an applicable appraisal statute forecloses any equitable remedy concerning alleged inadequacy of price in a merger situation. 132 In other states, including New York, New Jersey and Delaware, the courts will substantively examine the fairness of a merger, 133 but usually only when the activity is egregious. 134 But fairness is often an elusive concept; there are no blueprints available to determine whether a given transaction is fair or unfair. 135

In New York the test of fairness appears to be that of the "arm's length bargain." 136 Delaware's "intrinsic fairness" test is virtually similar:

---

127. See Vorenberg, Exclusiveness of the Dissenting Stockholder's Appraisal Right, 77 Harv. L. Rev. 1189, 1195-97 (1964). Professor Vorenberg also suggested that the elimination of Matteson as a "troublemaker" might have been a valid business purpose for the squeeze-out. Id. at 1196.


129. Id. at 571.

130. Id. at 570-71.


132. Vorenberg, Exclusiveness of the Dissenting Stockholder's Appraisal Right, 77 Harv. L. Rev. 1189, 1208-13 (1964). Appraisal is an uncertain remedy. Eisenberg, The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking, 57 Calif. L. Rev. 1, 85 (1969); see Cumberland Comment, supra note 5, at 154. Professor Eisenberg stated that appraisal is "a remedy of desperation—generally speaking, no shareholder in a publicly held corporation who is in his right mind will invoke the appraisal right unless he feels that the change from which he dissent is shockingly improvident . . . ." 57 Calif. L. Rev., supra, at 85.


Theoretically, the best definition of "fairness" . . . would be to require that the transaction between the two be reached as though each had in fact exerted its bargaining power against the other at arm's length. It is, of course . . . impossible . . . to approximate what would have been agreed upon at arm's length. On the other hand, it is possible to set outer limits on what is "fair."137

Thus, in Delaware there is a range of fairness within which a given transaction could be sustained as being "intrinsically fair."

A recent New Jersey decision examined the adequacy of the proposed consideration in a going private transaction that involved self-dealing. In Berkowitz v. Power/Mate Corp.,138 the controlling stockholders of Power/Mate corporation formed a shell company, General American Industries, Inc., to which they transferred their shares in exchange for all of General's stock. After a meeting of the boards of directors of Power/Mate and General, both boards consisting of the same persons,139 a merger agreement was reached, providing for payment of two dollars per share to each Power/Mate stockholder with the exception of those shares held by General, which were to be cancelled.

In its analysis of the proposed merger, the court found self-dealing between Power/Mate and General.140 Thus the transaction was subjected to "a searching inquiry," putting the burden on the directors to prove the fairness of the merger.141

The transaction was enjoined as a breach of the directors' fiduciary duties, on the ground that the proposed consideration was unfair. The court stressed three factors in its decision. First, the court noted the "absolute gain to [the directors] of $148,648 in the book value of [defendant's] stock . . . ."142 Second, the court found that the defendants were, in effect, using the funds of Power/Mate to buy out the minority shareholders, since the insiders intended to repay their bank loan with Power/Mate's assets after the successful completion of the merger.143 Finally, the timing of the transaction indicated that the defendants had chosen an "opportunely low price."144

---

139. Id. at 41, 342 A.2d at 569.
140. See id. at 43, 342 A.2d at 570.
141. Id. at 49, 342 A.2d at 574; see notes 116-17 supra and accompanying text.
142. 135 N.J. Super. at 48, 342 A.2d at 573.
143. Id. at 41, 342 A.2d at 569.
144. Id. at 48, 342 A.2d at 573. The court noted that the directors chose to merge at a time when they would benefit greatly because of a depressed market price which they had directly caused by giving themselves $100,000 bonuses in order to reduce the corporation's earnings prior to the merger.
In reaching its decision, the court first determined whether the transaction was fair, \textit{i.e.}, whether adequate consideration was given for the minority shares. The court indicated in dictum that, had there been adequate consideration, it also would have required a showing of a "valid business purpose."\textsuperscript{145}

In every going private transaction, there are fiduciary duties running from the directors or majority shareholders to the minority shareholders. Generally, the presence of interested directors will cause the burden to shift to the fiduciary to establish the "fairness" or "intrinsic fairness" of the transaction. In most instances, a grossly unfair merger-dictated price can provide the opportunity for equitable relief, although the presence of applicable appraisal statutes may foreclose such relief in certain situations. Certainly in those going private transactions that involve reverse share splits or asset sales where appraisal rights are not provided by state statute, equitable intervention is necessary and proper to ensure that the minority shareholder receives fair consideration for his shares.\textsuperscript{146}

\section*{IV. Conclusion}

Going private represents an attractive alternative to corporate management and insiders when the price of equity securities are depressed. Certain types of transactions have aroused more criticism than others. Going private tender offers, sometimes termed "shake-down" tender offers, have been almost universally decried as unfair and coercive. Other methods such as long and short form mergers have generated a mixed reaction from the courts and commentators.

The proposed SEC regulations, if adopted, should give additional protection to the minority shareholders by more rigorous disclosure requirements.

\textsuperscript{145} Id. at 44-45, 342 A.2d at 571. The sole objective, as stated in the proxy, was "save expenses inherent in its status as a publicly held corporation." Id. at 44 n.4, 342 A.2d at 571 n.4. The court stated that, on the facts presented, this was not a valid business reason for the merger. Id. But see Grimes v. Donaldson, Lufkin & Jenrette, Inc., 392 F. Supp. 1393 (N.D. Fla. 1974) (savings of such expense, inter alia, is valid business reason for the proposed merger), discussed at notes 64-70 supra and accompanying text. The court in Berkowitz pointed out that there is New Jersey case law that "suggests that New Jersey may follow the 'business purpose' test to prevent the destruction of minority stockholder rights in this factual setting . . . ." 135 N.J. Super. at 48, 342 A.2d at 573.

\textsuperscript{146} Professor Brudney analyzed the fairness of the proposed consideration for a going private transaction by examining the two distinct costs of the transaction to the minority shareholder. First, is the minority shareholder given the fair present value of what he surrenders? In pointing out the extreme difficulty of an equitable appraisal, Professor Brudney stated that the "issue of fair value turns crucially on whether past trends will be reversed in the future . . . ." Brudney, supra note 5, at 1024-25. Necessarily included in this cost must be the minority shareholders' costs of finding an equivalent investment. Second, are the minority shareholders given their share of the increment of the additional value which automatically accrues to the insiders by their elimination of the minority interests? See id. at 1025, 1027. Thus in order for the proposed consideration to be adequate, it must include both the fair present value of the minority's interests in the corporation plus their proportional share of whatever benefits accrue to the insiders as a result of the going private transactions. See Cumberland Comment, supra note 5, at 155-56.
The twenty day delay provisions of the regulations should help eliminate many of the coercive elements found in going private tender offers. Moreover, the "valid business purpose" requirement imposed upon the going private transaction may, in the long run, prove to have the most impact on both going private tender offers and mergers since it provides for a substantive analysis of the corporate motives behind the decision to go private.

However, the federal approach to going private mergers is presently represented by two different views. The Second Circuit guarantees the minority shareholder nothing more than full disclosure of the transaction. This strict interpretation of the securities laws does not provide minority shareholders with an effective federal substantive remedy to counter the inequities and coerciveness inherent in many going private transactions. The Fifth Circuit, on the other hand, posits the existence of fraud in the absence of a legitimate business purpose underlying the corporate decision. If the SEC adopts its proposed regulations, the Fifth Circuit's case law will be useful in providing guidelines as to the substantive analysis required by the regulations. Since going private is not fairly within the investment risk, the interest of the small investor is better protected by such a rigorous standard.

The states also have approached going private situations from two basic theories. In a novel approach, a New York court enjoined a going private transaction as fraudulent under the state's Blue Sky laws. Future use of this theory will necessarily involve a reliance upon the standards developed in the fiduciary area to determine what circumstances constitute fraud. Perhaps the major objection to the use of the Blue Sky laws in this context, however, is that it requires a broad interpretation of the statutes which, in a sense, is probably unnecessary in view of the ready applicability of the long established corporate fiduciary doctrines.

Imposition of the standards of fiduciary conduct is probably more desirable, especially since going private transactions usually arise in a self-dealing context. Under the corporate fiduciary doctrine, the terms of a going private merger must be "fair" and the courts in most states will use the "arm's length bargain" test to determine a standard of fairness. To the extent that a valid business purpose exists, however, a going private transaction should satisfy state corporate fiduciary standards.

In employing the valid business purpose test, whether in state or federal courts, it will eventually become necessary to determine the minimum standards of corporate purpose that will be sufficient to sustain a going private transaction. Implicit in a resolution of this issue will be a determination of the circumstances when a corporation may eliminate a minority shareholder. As the states, through their legislatures and courts, further elaborate upon the right of the minority shareholder to continue his participation in an enterprise, the valid business purpose standard will provide an equitable method of protecting the minority shareholder while at the same time giving deference to the freedom of the corporation to go private for valid business reasons.

John A. James Jr.