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Federal "Going Private" Standards: A New Direction for the Second Circuit?

Claudia L. Taft

FEDERAL "GOING PRIVATE" STANDARDS: A NEW DIRECTION FOR THE SECOND CIRCUIT?

I. INTRODUCTION

Section 10(b) of the Securities Exchange Act of 1934[1] and its corollary, rule 10b-5,[2] which prohibit fraud in connection with the purchase and sale of securities, have become the basis of what has been termed a new federal common law of corporations.[3] Under their authority, the process of "going private"—the procedure by which a public company eliminates its public shareholders through, most commonly, corporate mergers, tender offers, reverse stock splits or some combination thereof[4]—recently has come under

1. 15 U.S.C. § 78j(b) (1970) 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—

(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."

2. 17 C.F.R. § 240.10b-5 (1976) 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." It has been noted that the rule is broader than the section 10(b) enabling language and has "modernized the 1934 Act to keep pace with the development or discovery of securities practices which undermined the integrity of the market." Comment, Schoenbaum v. Firstbrook: The "New Fraud" Expands Federal Corporation Law, 55 Va. L. Rev. 1103, 1118 (1969) [hereinafter cited as New Fraud].

3. McClure v. Borne Chem. Co., 292 F.2d 824, 834 (3d Cir.), cert. denied, 368 U.S. 939 (1961); In re Cady, Roberts & Co., 40 S.E.C. 907, 910 (1961). See generally Borden, Going Private—Old Tort, New Tort or No Tort?, 49 N.Y.U.L. Rev. 987, 1037-39 (1974) [hereinafter cited as Borden]; Cary, Federalism and Corporate Law: Reflections upon Delaware, 83 Yale L.J. 663 (1974) [hereinafter cited as Cary]; Cohen, The Development of Rule 10b-5, 23 Bus. Law. 593 (1968) [hereinafter cited as Cohen]; Fleischer, "Federal Corporation Law": An Assessment, 78 Harv. L. Rev. 1146 (1965) [hereinafter cited as Fleischer].

4. For a general discussion of the means, methods and advantages of the "going private" procedure see 1 A. Bromberg, Securities Law, passim (1975) [hereinafter cited as Bromberg]; F. O'Neal & J. Derwin, Expulsion or Oppression of Business Associates 3-139 (1961) [hereinafter cited as O'Neal & Derwin]; Greene, Corporate Freeze-Out Mergers: A Proposed Analysis, 28 Stan. L. Rev. 487, 491-96 (1976) [hereinafter cited as Greene]; Swanson, The Elimination of Public Shareholders: Going Private, 7 Conn. L. Rev. 609 (1975) [hereinafter cited as Swanson]; Note, Going Private: An Analysis of Federal and State Remedies, 44 Fordham L. Rev. 796, 796-800 (1976).

The return to private ownership has been spurred by the expense involved in complying with rigid SEC registration and disclosure requirements; the collapse of investor interest following the federal scrutiny. Increasingly, these transactions have been attacked by minority shareholders claiming such transactions violate the fraud provisions of the section and the rule, despite the fact that, in most cases, the procedure utilized is one expressly authorized by the law of the state of incorporation.[5] Though several circuits have indicated a willingness to entertain such claims,[6] until recently, the Second Circuit (in which most of the "going private" cases arise) has fairly consistently held that full compliance with the disclosure requirements of section 10(b) and rule 10b-5, and with applicable state law, bars a federal action for fraud,[7] notwithstanding the patent unfairness of the transaction.[8] This attitude probably was based on two fundamental uncertainties: first, whether section 10(b) was intended to encompass the questions raised by the "going private" phenomenon;[9] second, whether scrutiny of such transactions should be left to state courts,[10] which historically have had

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"going public" rush of the 1960's; tax savings; disappointment with the public; the inappropriateness of being public experienced by some companies; and the lure of greater freedom of action and increased benefits to insiders following the return to private ownership. Swanson, supra at 613.

5. Many state laws permit the merger of two domestic corporations without shareholder approval if one owns the requisite percentage of the outstanding stock of the other. See, e.g., Del. Code Ann. tit. 8, § 253 (1975) (90%); N.Y. Bus. Corp. Law § 905(a) (McKinney Supp. 1975) (95%). In a typical "going private" transaction, minority shareholders in X corporation will be offered a fixed sum for their shares by Y corporation (which may itself be controlled by the same group which controls X corporation). When enough shares are tendered, Y will announce its plan to merge with X under the applicable state law, cancelling all X corporation shares not tendered and giving the minority (public) shareholders cash for their holdings. Where shareholder approval is not required, the merger is termed a short-form merger; where less than the required percentage of the target company is acquired, shareholder approval is necessary and the merger is called a long-form merger.

6. See, e.g., Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir.), cert. denied, 419 U.S. 844 (1974), aff'g 343 F. Supp. 1062 (N.D. Ga. 1972); Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970); Rekant v. Desser, 425 F.2d 872 (5th Cir. 1970); Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), cert. denied, 389 U.S. 977 (1967); McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir.), cert. denied, 368 U.S. 939 (1961).

7. Popkin v. Bishop, 464 F.2d 714, 718 (2d Cir. 1972); O'Neill v. Maytag, 339 F.2d 764, 767-68 (2d Cir. 1964); Kaufmann v. Lawrence, 386 F. Supp. 12, 17 (S.D.N.Y. 1974), aff'd, 514 F.2d 283 (2d Cir. 1975) (per curiam); Dreier v. Music Makers Group, Inc., [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,406, at 95,410 (S.D.N.Y. 1974).

8. Popkin v. Bishop, 464 F.2d 714, 720 (2d Cir. 1972); Kaufmann v. Lawrence, 386 F. Supp. 12, 17 (S.D.N.Y. 1974), aff'd, 514 F.2d 283 (2d Cir. 1975) (per curiam); Dreier v. Music Makers Group, Inc., [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,406, at 95,410 (S.D.N.Y. 1974).

9. O'Neill v. Maytag, 339 F.2d 764, 767-68 (2d Cir. 1964); Birnbaum v. Newport Steel Corp., 193 F.2d 461, 462-64 (2d Cir.), cert. denied, 343 U.S. 956 (1952) (rule 10b-5 does not extend beyond simple disclosure requirements); see notes 22-26 infra and accompanying text.

10. Since "going private" transactions often implicate questions of corporate mismanagement and fiduciary duty as well as more traditional concepts of fraud, it was believed that state court determinations should prevail. As one commentator succinctly stated: "A desire to permit state policy determinations to predominate may explain the reluctance of some [federal] courts to expand further the application of Rule 10b-5 to mismanagement." Jacobs, The Role of Securities

exclusive jurisdiction over substantive fiduciary corporation law.[11]

However, the Second Circuit approach changed dramatically in early 1976 with *Marshel v. AFW Fabric Corp.*[12] Minority shareholders of Concord Fabrics, a New York corporation, challenged the legality of a proposed long-form merger[13] between Concord and AFW, a "shell" corporation which had been formed by Concord's majority shareholders for the sole purpose of returning the company to private ownership. In enjoining the proposed merger as a violation of section 10(b) and rule 10b-5, the court held that although the merger fully complied with the applicable New York statute and the federal disclosure laws, it nevertheless constituted a scheme by the controlling shareholders to defraud the corporation and the minority shareholders to whom they owed fiduciary obligations "with no justification in the form of a valid corporate purpose."[14] Five days later, the Second Circuit, in *Green v. Santa Fe Industries, Inc.*,[15] upheld a similar claim challenging the legality of a state-sanctioned short-form merger since the majority shareholders had committed a breach of their fiduciary duty to the minority by consummating the merger without any justifiable business purpose.[16] In so holding, the court strongly denied the power of the states "to preempt Congress in the creation of substantive rights and remedies arising from purchases and sales of securities . . . ."[17]

Although the problems of federalism in corporation and securities law have been discussed elsewhere,[18] the standards espoused by the Second Circuit in *Green* and *Marshel* seemingly undercut to an unprecedented degree the role of the state courts and legislatures in defining corporate fiduciary standards.[19]

Exchange Act Rule 10b-5 in the Regulation of Corporate Management, 59 Cornell L. Rev. 27, 33 (1973) [hereinafter cited as Jacobs]. See Marsh v. Armada Corp., 533 F.2d 978, 984 (6th Cir. 1976), petition for cert. filed, 45 U.S.L.W. 3011 (U.S. July 6, 1976) (No. 76-5); Lewis v. Siegel, [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,992 (S.D.N.Y. 1973); Kerr, Going Private: Adopting a Corporate Purpose Standard, 3 Sec. Reg. L.J. 33, 57 (1975) [hereinafter cited as Kerr].

11. " 'The primary source of the law in this area ever remains that of the State which created the corporation.' " Borden, supra note 3, at 1037, quoting Diamond v. Oreamuno, 24 N.Y.2d 494, 503-04, 248 N.E.2d 910, 915, 301 N.Y.S.2d 78, 85 (1969); see Jacobs, supra note 10, at 30; New Fraud, supra note 2, at 1120.

12. 533 F.2d 1277 (2d Cir. 1976), vacated and remanded, 45 U.S.L.W. 3279 (U.S. Oct. 12, 1976) (No. 75-1782).

13. See note 5 supra.

14. 533 F.2d at 1280-82.

15. 533 F.2d 1283 (2d Cir. 1976), cert. granted, 45 U.S.L.W. 3249 (U.S. Oct. 5, 1976) (No. 75-1753).

16. Id. at 1291.

17. Id. at 1286.

18. See, e.g., Bloomenthal, From Birnbaum to Schoenbaum: The Exchange Act and Self-Aggrandizement, 15 N.Y.L.F. 332 (1969) [hereinafter cited as Bloomenthal]; Cary, supra note 3; Cohen, supra note 3; Fleischer, supra note 3; Note, Civil Liability under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity, 74 Yale L.J. 658, 680-89 (1965) [hereinafter cited as Privity].

19. Brodsky, State Going-Private Laws—Dead or Alive?, 175 N.Y.L.J., Feb. 27, 1976, at 14, col. 2; Greene, supra note 4, at 498 n.37 ("the Second Circuit's decision [in Green] sanctions

The two decisions, however, perhaps raise more questions than they attempted to answer.[20]

This Note will examine *Green* and *Marshel* in light of the expanding federal role in corporate securities law; review state and federal "going private" cases which have followed *Green* and *Marshel* in order to illumine the relationship between state and federal laws and remedies and evaluate their responsiveness (or lack of it) to "going private" problems; and briefly examine section 10(b) and rule 10b-5 in order to determine whether they provide a substructure adequate to carry the weight of the federal standards adopted in *Green* and *Marshel,* or whether the intricacies of the "going private" process call for a different approach.

II. Pre-*Green* and *Marshel* Developments: Going Private and Rule 10b-5

An examination of federal decisions preceding *Green* and *Marshel* reveals two countervailing trends: an increasing liberalization of the elements traditionally required to prove fraud;[21] and reluctance by the federal courts to define section 10(b) and rule 10b-5 liability in terms of corporate fiduciary duties,[22] an historically exclusive state concern.[23]

an unprecedented intrusion of federal securities laws into traditional areas of state regulation."). It has been argued that concern over displacement of state corporate behavior law is "misplaced" (Bloomenthal, supra note 18, at 349) since the federal courts are not preempting the state courts' jurisdiction (Cohen, supra note 3, at 594) but rather "[occupying] an otherwise vacant niche." Fleischer, supra note 3, at 1151. It is unlikely, however, that these commentators would adhere to this position today, at least as far as Green is concerned.

20. For example, what is a justifiable corporate purpose? Will minority shareholders always have standing to bring such suits? When, if ever, will a showing of deception be required? What remedies will be appropriate if liability is found? Is there a federal right to continue as a minority shareholder in perpetuity? More importantly, do the federal standards for "going private" enunciated in Green and Marshel represent the outer limits of federal expansion into the corporate responsibility area, or will they be treated as jumping off points for even greater federal intervention in what has been traditionally an exclusive state concern?

21. Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-53 (1972) (reliance on misrepresentation need not be shown); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 192 (1963), rev'g 306 F.2d 606 (2d Cir. 1962) (en banc); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 855 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969) (specific intent to defraud not required); A.T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (2d Cir. 1967); O'Neill v. Maytag, 339 F.2d 764, 768 (2d Cir. 1964) (strict common law deception need not be shown).

22. Popkin v. Bishop, 464 F.2d 714, 718 (2d Cir. 1972) (the rule does not protect shareholders from overreaching by majority absent nondisclosure); O'Neill v. Maytag, 339 F.2d 764, 768 (2d Cir. 1964) (the rule does not "mandate [inquiry] into every allegation of breach of fiduciary duty respecting . . . securities."); Birnbaum v. Newport Steel Corp., 193 F.2d 461, 462-63 (2d Cir.), cert. denied, 343 U.S. 956 (1952). But see Rekant v. Desser, 425 F.2d 872, 880 (5th Cir. 1970) (distinguishing O'Neill in reversing district court finding that corporate mismanagement is not covered by rule 10b-5); Schoenbaum v. Firstbrook, 405 F.2d 215, 219-20 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969) ("controlling influence" by majority of board constitutes rule 10b-5 fraud); Ruckle v. Roto Am. Corp., 339 F.2d 24, 28 (2d Cir. 1964) (corporation may be defrauded by a majority of its own directors).

23. See note 11 supra.

In the landmark case of *Birnbaum v. Newport Steel Corp.*,[24] the controlling shareholder, who also controlled Newport's board of directors, had sold his Newport stock at twice its market value to a second company in an alleged scheme to allow the latter to use Newport as a captive steel supply source. In upholding the district court's dismissal of the minority shareholders' derivative claims of breach of fiduciary duty and fraud in failing to disclose the purpose of the stock sale, the Second Circuit held that rule 10b-5 was "aimed only at 'a fraud perpetrated upon the purchaser or seller' of securities and . . . [has] no relation to breaches of fiduciary duty by corporate insiders resulting in fraud upon those who were not purchasers or sellers."[25] The court further found that section 10(b) was intended as a remedy only for that fraud "usually" associated with the purchase or sale of securities, and not for corporate mismanagement.[26] This dual holding—the strict purchaser/seller standing requirement, and the "usual" fraud limitation—became a barrier to federal examination of corporate fiduciary standards for many years, particularly in the Second Circuit.

Erosion of the standing requirement began in *Pettit v. American Stock Exchange*.[27] There, in a rule 10b-5 suit alleging fraud in the distribution and sale of stock, the district court granted standing to a corporate trustee in order "to accomplish what Congress intended—the protection of the integrity of stock transactions."[28] Shortly afterwards, the Second Circuit decided *Ruckle v. Roto American Corp.*,[29] a shareholders' derivative suit alleging that the board of directors' failure to disclose pertinent information regarding a corporate stock issuance constituted fraud under rule 10b-5. In sustaining the claim, the court specifically found that a corporation's issue of its own stock constituted a "sale" for 10b-5 purposes,[30] and that a majority of its directors could conceivably defraud the corporation.[31]

Thus, while *Pettit* may have relaxed *Birnbaum*'s strict standing requirement by expanding the class of cases entertained pursuant to section 10(b) and rule 10b-5, *Ruckle*, by refusing to impute the directors' knowledge to the corporation, recognized that the corporate entity exists primarily for its shareholders. Undeniably, the interests of directors are not always identical to those of shareholders. To a certain extent, then, the Second Circuit firmly applied the established principle—corporate directors and controlling shareholders owing a fiduciary duty to minority shareholders[32]—to a rule 10b-5 action.

24. 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).
25. Id. at 463.
26. Id. at 463-64.
27. 217 F. Supp. 21 (S.D.N.Y. 1963).
28. Id. at 28.
29. 339 F.2d 24 (2d Cir. 1964).
30. Id. at 27-28.
31. Id. at 29.
32. "A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. . . . Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its

The circuit court substantially completed this erosion process when it rendered its decisions in *A.T. Brod & Co. v. Perlow*[33] and *Vine v. Beneficial Finance Co.*[34] In *Perlow,* the Second Circuit, reversing the district court's holding that rule 10b-5 protection did not extend to non-investors,[35] stated that such a limitation "would not be in harmony with the Supreme Court's postulation that the securities laws should be construed 'not technically and restrictively, but flexibly to effectuate . . . [their] remedial purposes.' "[36] *Vine* involved a rule 10b-5 complaint by a minority shareholder in a New York corporation which had been merged into a larger company under the New York short-form merger statute.[37] Under the terms of the merger, the plaintiff would be required to receive cash for his shares either at the merger-dictated price, or that set in a state appraisal proceeding.[38] Since Vine had neither sold nor surrendered his shares by the commencement of the suit, the district court, asserting lack of standing, dismissed the complaint.[39] The Second Circuit, holding that the plaintiff necessarily at some time must become a party to a "sale," reversed the lower court and opined that requiring one to sell his shares prior to commencing a suit "seems a needless formality."[40]

The liberalization of the *Birnbaum* standing requirement evidenced by these cases was, per force, matched by a liberalization in the construction of rule 10b-5's "in connection with" language. Although purchases or sales of stock were at the heart of the alleged "fraudulent" activity in *Pettit* and *Perlow,* this was true to a much lesser extent in *Vine* and *Ruckle.* In those cases, the directors' questionable conduct and the propriety of the merger were, arguably, at the core of the respective complaints; the issuance or sale of stock were mere incidents of the transactions.[41]

The increasing willingness by courts to construe liberally the "in connection with" language of rule 10b-5 received impetus from the Supreme Court's

inherent fairness . . . ." Pepper v. Litton, 308 U.S. 295, 306 (1939) (citations omitted); see Mason v. Pewabic Mining Co., 133 U.S. 50, 58-59 (1890); cf. In re Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961).

33. 375 F.2d 393 (2d Cir. 1967).

34. 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967).

35. 375 F.2d at 396.

36. Id., quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963).

37. 374 F.2d at 631; see note 5 supra.

38. State appraisal statutes typically provide a procedure by which a dissenting minority shareholder who must surrender or sell his shares may apply to the court to insure that he receives adequate compensation for the shares. See, e.g., N.Y. Bus. Corp. Law § 623 (McKinney 1963), as amended, § 623(d), (g), (k) (McKinney Cum. Supp. 1976). The adequacy of the appraisal remedy as a correction for "going private" abuses, has, however, been seriously questioned; see notes 120-24 infra and accompanying text.

39. Vine v. Beneficial Fin. Co., 252 F. Supp. 212, 214-15 (S.D.N.Y. 1966), rev'd, 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967).

40. 374 F.2d at 634.

41. See New Fraud, supra note 2, at 1108-10. At least one commentator has suggested that extending rule 10b-5 liability to transactions in which the purchase or sale of securities was merely incidental, would be an unjustifiable undercutting of state interests. Privity, supra note 18, at 681-82.

decision in *Superintendent of Insurance v. Bankers Life & Casualty Co.*[42] This case involved a scheme by an insurance company's sole stockholder to sell its interest in the company to a third party who, in turn, used the assets (bonds) of the company, rather than private funds, to complete the deal. A unanimous Court held that the defrauded corporation was a "person" for rule 10b-5 purposes and had standing to bring suit,[43] even though it had not "sold" stock in the ordinary sense, and the transaction was not implemented through a national securities exchange or organized market.[44] Impliedly, the decision represented the death-knell of a strict standing requirement when the Court announced that "[s]ince there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under § 10(b) . . . ."[45]

Birnbaum's second holding—that 10b-5 was not intended to remedy corporate mismanagement, but limited to fraud "usually" found in connection with securities transactions—proved to be a greater obstacle. Over strong objections from the Securities and Exchange Commission (SEC), the Second Circuit early held that, absent nondisclosure, allegations that corporate insiders used corporate funds solely for obtaining greater control did not state a federal claim under rule 10b-5.[46] Relying upon *Birnbaum,* the court viewed section 10(b) and rule 10b-5 as imposing only an affirmative duty of "honest disclosure";[47] anything beyond was, at best, a claim for breach of fiduciary duty remediable only under state law.[48] The question of what remedy would exist should the applicable state law disallow actions for such breach, absent deception, remained unresolved.[49]

Although stating that deception was required to sustain a rule 10b-5 claim, the court added that it "need not be deception in any restricted common law

42. 404 U.S. 6 (1971). Bankers Life "has definitely taken an expansionist approach to the interpretation of [rule 10b-5]" by recognizing a federal claim where the connection between the fraud and the transaction questioned is "tenuous." O'Neal & Janke, Utilizing Rule 10b-5 for Remedying Squeeze-Outs or Oppression of Minority Shareholders, 16 B.C. Ind. & Com. L. Rev. 327, 341 (1975).

43. 404 U.S. at 9-14.

44. Id. at 10.

45. Id. at 12. Although it can now be said that Birnbaum's " 'buyer-seller requirement . . . has been much reduced' " (Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975)), it has not been entirely repudiated. The attitude of the federal courts today was best summed up by the Sixth Circuit in James v. Gerber Prods. Co., 483 F.2d 944 (6th Cir. 1973): "[W]here the alleged deceptive practices have led . . . the shareholder into a completed transaction giving rise to a § 10(b) suit, the courts have generally inclined to a logical and flexible construction of the term 'purchaser-seller' in order to accommodate the avowed purpose of § 10(b) of protecting the investing public and of ensuring honest dealings in securities transactions." Id. at 948.

46. O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964). But cf. United Funds, Inc. v. Carter Prods., Inc., [1961-1964 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,288 (Baltimore City Cir. Ct. 1963).

47. 339 F.2d at 767.

48. Id. at 767-68.

49. See notes 115-31 infra and accompanying text for a general discussion of the adequacy or inadequacy of state statutory and equitable remedies.

sense; one of the central purposes of federal securities legislation would otherwise be seriously vitiated."[50] Thus, arguably, the Second Circuit attempted to modify *Birnbaum's* "usual" fraud limitation by expanding the concept of deception actionable under the rule.[51] It was not until its decision in *Schoenbaum v. Firstbrook,*[52] however, that the prescription against breach of fiduciary duty as a rule 10b-5 violation was seriously shaken. *Schoenbaum* involved an action brought by minority shareholders on behalf of Banff Oil Ltd. Through successful tender offers, Aquitaine Company of Canada had acquired control both of Banff and three of its eight directors. Shortly after voting to sell a large block of Banff stock to Aquitaine at $1.35 per share, Banff's directors publicly announced a major oil discovery, causing a marked increase in the stock's value.[53] The complaint alleged that Aquitaine and the Banff directors, knowing of the oil discovery, had conspired to sell Banff stock at grossly inadequate prices in order to enrich Aquitaine at the expense of Banff and its minority shareholders.[54]

Initially, the court held the complaint merely alleged breach of fiduciary duty.[55] A rule 10b-5 claim was not maintainable absent a showing that the corporation had been deceived (concededly, the directors were in possession of the material facts) or that the transaction was not conducted at arm's-length.[56] The dissent argued, however, that

> [the majority does] not absolve the defendants of fraud by calling their action a breach of fiduciary duty. There is no reason for making that distinction since such a breach of fiduciary duty as is here alleged clearly constitutes fraud.

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50. 339 F.2d at 768.

51. According to one commentator, "O'Neill . . . may soon be written off as an aberration." Bloomenthal, supra note 18, at 339. The decision exemplified the trend of federal courts to fail "to recognize the 'fraud' provisions of Rule 10b-5 and [rely] solely on the disclosure provision . . . [which resulted in] reading those provisions out of the statute." Brodsky, State Going-Private Laws—Dead or Alive?, 175 N.Y.L.J., Feb. 27, 1976, at 14, col. 1. Later courts, unwilling to overrule O'Neill, were forced to adopt "strained rationalizations in order to find such deception." Bloomenthal, supra note 18, at 375.

For example, in Voege v. American Sumatra Tobacco Corp., 241 F. Supp. 369 (D. Del. 1965), the court found that "[p]laintiff . . . was the subject of deception for when she acquired her stock she did so upon the justifiable assumption that any merger would deal with her fairly . . . ." Id. at 375. And in Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967), the court held that although no misrepresentations had been made to the plaintiff, the fact that fraud on other shareholders resulted eventually in the plaintiff being forced to sell his shares "justif[ied] holding that fraud on A is 'in connection with' the forced sale by B" and stated a 10b-5 claim. Id. at 635.

Professor Bloomenthal suggests that the Voege and Vine courts simply should have held that where fiduciaries take unfair advantage of minority shareholders who are forced to sell their shares to the majority, no deception should be required. Bloomenthal, supra note 18, at 375.

52. 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969).

53. The stock increased from its original value of $1.35 to $18.00 per share. Id. at 217-18.

54. Id. at 218.

55. Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir.), rev'd, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969).

56. Id. at 209, 211-13.

. . . In order to establish fraud it is surely not necessary to show that the directors deceived themselves. It must be enough to show that they deceived the shareholders, the real owners of the property with which the directors were dealing.[57]

An en banc rehearing reversed the panel's earlier determination,[58] but, significantly, did not equate fraud with breach of fiduciary duty.[59] Instead, relying largely upon *Ruckle,* the court held that Aquitaine had exercised a "controlling influence"[60] in causing the Banff stock to be issued for grossly inadequate consideration and therefore was an "act, practice or course of business which operates or would operate as a fraud"[61] under 10b-5.

This position highlights what may be the most significant contribution of the *Schoenbaum* decision—a shift in focus from the strictly legal propriety of the securities transaction, to the motives and fiduciary duties of the group controlling the transaction.

However, if *Schoenbaum,* heralded for introducing what has been commonly called the "new fraud,"[62] seemed to imply that the Second Circuit might explicitly make fiduciary duty the basis of a rule 10b-5 action, *Popkin v. Bishop*[63] dispelled such hopes. In that case, minority shareholders of Bell Corporation claimed that proposed merger terms between Bell and Equity Corporation, which controlled 51.7 per cent of the outstanding Bell stock, were unfair to all of the Bell shareholders except Equity. Although there was no allegation of misrepresentation or nondisclosure either in the merger proposal or the joint proxy statement,[64] the plaintiffs urged that rule 10b-5 " 'is more than a [mere] disclosure provision' and that . . . [it] affords minority shareholders protection against overreaching by majority shareholders and directors '[w]hether the facts remain hidden from the minority or are ultimately revealed in a Proxy Statement.' "[65] The Second Circuit rejected the argument by distinguishing corporate transactions requiring, under applicable state law, shareholder approval (as was true in *Popkin*) from those which do not.[66] Since rule 10b-5 was "designed principally to impose a duty to disclose and inform,"[67] once shareholder approval had been "fairly sought and freely given, the . . . federal interest is at an end. Underlying questions of the

57. Id. at 214-15 (Hays, J., dissenting).

58. Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969).

59. Indeed, the court "carefully avoided stating that wrongful conduct alone is actionable under 10b-5." Greene, supra note 4, at 498 n.37. Thus, although the Green court relied extensively on Schoenbaum, as a matter of fact it went far beyond the careful holding enunciated in that case; see notes 101-05 infra and accompanying text.

60. 405 F.2d at 219.

61. Id. at 219-20.

62. See Jacobs, supra note 10, at 59; New Fraud, supra note 2, passim.

63. 464 F.2d 714 (2d Cir. 1972).

64. Id. at 718.

65. Id.

66. Id. at 719.

67. Id. at 719-20.

wisdom of such transactions *or even their fairness* become tangential at best to federal regulation."[68]

Plaintiffs also contended that where shareholder approval of the proposed merger is, in essence, meaningless (Equity controlled outright 51.7 per cent of the Bell stock), any distinction between short and long-form mergers is irrelevant, since the effectiveness of the minority's role is illusory.[69] The court, in rejecting this argument, stated that plaintiffs could sue to enjoin the merger in state court, the "federal injunctive remedy . . . offer[ing] . . . no greater protection."[70]

With respect to long-form mergers, the *Popkin* court thus precluded federal scrutiny into the intrinsic fairness of an insider-controlled "going private" transaction[71]—thereby repudiating the suggestion implicitly raised by *Schoenbaum.* Its sweeping statements regarding the availability of federal relief under 10b-5[72] lose impact, unless there is deception or nondisclosure of material facts.

Thus, before *Green* and *Marshel* were decided, two distinct trends were evident in the Second Circuit's treatment of claims under section 10(b) and rule 10b-5. First, the court was reluctant to scrutinize the motives, interests or fiduciary duties of corporate insiders, even if overreaching or breach of duty were alleged.[73] The court examined fraudulent activity only to that extent necessary to determine whether there was full disclosure of all material facts.[74] Deception would sustain allegations of fraud;[75] unfairness in the offer or merger was not a federal concern.[76] Second, three important developments evolved: fraud need not be of the "typical garden variety";[77] the class of

68. Id. at 720 (emphasis added).

69. It has been stated that "stockholder approval as a protective procedure . . . . affords no protection when a parent combines with a subsidiary and the parent owns the amount of the subsidiary's stock required to approve the transaction." Brudney & Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 Harv. L. Rev. 297, 299-300 (1974) (footnote omitted) [hereinafter cited as Brudney & Chirelstein]. This may be true even if the parent owns less than the required amount, due to 1) the atomized nature of the minority, 2) the salability of stock, 3) lack of participation in merger discussions and 4) the fact that the timing of the transaction is dictated by management. Id. at 300. But see Laurenzano v. Einbender, 448 F.2d 1 (2d Cir. 1971).

70. 464 F.2d at 720.

71. In Lewis v. Siegel, [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,992 (S.D.N.Y. 1973), the court rejected the contention that Popkin applies only in "merger or other situations where stockholder approval has been required and given pursuant to state corporation law." Id. at 93,985. It further held that there is no exception to the rule 10b-5 nondisclosure requirement "[a]bsent any allegation that disclosure of relevant information was 'in a real sense' withheld from the public . . . ." Id. It has been suggested that together, Popkin and Lewis "appear effectively to bar federal review of take-out transactions in the absence of a disclosure violation." Borden, supra note 3, at 1034.

72. See 464 F.2d at 718.

73. See notes 24-26, 46-48, and 63-71 supra and accompanying text.

74. See notes 47, 65-67 supra and accompanying text.

75. See notes 50-51 supra and accompanying text.

76. See note 68 supra and accompanying text.

77. See note 50 supra and accompanying text.

persons and types of transactions covered by rule 10b-5 had been greatly expanded;[78] and finally, under *Schoenbaum*'s "controlling influence" standard, the court recognized a need to protect minority shareholders from corporate insiders seeking to take advantage of their control to the detriment of the minority.[79]

III. *Marshel v. AFW Fabric Corp.*: Fiduciary Duty and the Long-Form Merger

The facts of *Marshel v. AFW Fabric Corp.*[80] are not complicated. In 1968, Concord Fabrics, a privately owned corporation, made a successful public offering, the previous owners retaining 68 per cent of the now publicly issued stock. In 1975, desiring to return the company to private ownership, the controlling shareholders formed AFW Fabric Corporation and transferred their Concord shares to AFW in exchange for 100 per cent of the new AFW stock. AFW's sole asset was, after this exchange, its 68 per cent interest in Concord. The new corporation then made a tender offer for all publicly owned Concord shares. Its purchase offer accurately stated that, whether or not the tender offer was successful, AFW intended to merge with Concord at the expiration of the offer. Under the terms of the merger, all publicly held Concord shares would be cancelled, their holders to receive $3 per share, the identical price quoted in the tender offer. The offer also stated that under New York law the merger could, and would, be consummated whether or not the minority shareholders approved.[81] The plaintiff, a dissenting minority shareholder, sought to enjoin the proposed merger on the grounds that it would both violate the provisions of section 10(b) and rule 10b-5, and constitute fraud and breach of fiduciary duty under New York law.[82] AFW thereupon withdrew its tender offer and mailed out a proxy statement stating

78. See notes 21, 27-31, and 33-40 supra and accompanying text.

79. See notes 52-61 supra and accompanying text.

80. 533 F.2d 1277 (2d Cir. 1976), vacated and remanded, 45 U.S.L.W. 3279 (U.S. Oct. 12, 1976) (No. 75-1782).

81. Id. at 1278-79.

82. The merger had been temporarily enjoined by a New York court in an action brought by the state Attorney General pursuant to the Martin Act, N.Y. Gen. Bus. Law § 353 (McKinney 1968), which prohibits fraudulent practices in connection with the purchase and sale of securities. People v. Concord Fabrics, Inc., 83 Misc. 2d 120, 371 N.Y.S.2d 550 (Sup. Ct.), aff'd mem., 50 App. Div. 2d 787, 377 N.Y.S.2d 84 (1st Dep't 1975). The state court decision stated that federal securities laws "do not seem sufficiently broad to deal with the problem of going private" (id. at 123, 371 N.Y.S.2d at 552), but that state law would enjoin the transaction regardless of full disclosure since it was "disquietingly evident . . . that a group of insiders who are directing the reacquisition program . . . are the very ones who made the company public originally . . . Adding to the odium of the scheme is that fact that no real corporate purpose has been demonstrated and that the credit of a now public corporation will be used to finance a merger for the benefit of a private group." Id. at 125, 371 N.Y.S.2d at 554. But see Beloff v Consolidated Edison Co., 300 N.Y. 11, 19, 87 N.E.2d 561, 564 (1949) (merged corporation's shareholder's only right is to have value of his holding protected); Blumenthal v. Roosevelt Hotel, Inc., 202 Misc. 988, 993, 115 N.Y.S.2d 52, 57 (Sup. Ct. 1952) (bad faith in invoking merger statute raises no issue of illegality). See generally Brodsky, 'Going Private,' 175 N.Y.L.J., Feb. 5, 1976, at 1, col. 1.

that the merger would go through, and that its sole purpose was to return the company to private ownership.[83]

The district court denied plaintiff's motion for a preliminary injunction and held that since the tender offer and proxy statement fully disclosed all material facts, no federal claim would lie.[84] The Second Circuit reversed, holding that the proposed merger did constitute a violation of section 10(b) and rule 10b-5. Two factors were determinative: the controlling shareholders, having taken advantage of public financing in 1968, were using corporate funds to squeeze-out minority shareholders at a price and time determined solely by them;[85] and the merger benefitted only the controlling shareholders.[86] When viewed together, these factors constituted "a scheme to defraud [the] corporation and the minority shareholders to whom [the controlling shareholders] owe fiduciary obligations by causing Concord to finance the liquidation of the minority's interest with no justification in the form of a valid corporate purpose."[87] Although acknowledging that rule 10b-5 does not extend to corporate mismanagement, the court found that in the instant case a purchase and sale of securities "is at the heart of the fraudulent scheme."[88] While this may in a sense be true, clearly the "fraud" was not intrinsic to the purchase or sale per se, but rather to the merger itself, in the form of "an attempt by the majority stockholders to utilize corporate funds for strictly personal benefit."[89] Thus, it may be contended that *Marshel* reaffirms that shift in focus from the legality of the securities transaction itself (arguably the intent of rule 10b-5) to the concept of fiduciary responsibility suggested by *Vine, Ruckle* and *Schoenbaum* but abruptly stifled by *Popkin.*

Marshel is striking in two other aspects. First, AFW argued that the purpose of the merger was irrelevant, since its consummation would fully comply with the applicable long-form merger statute. Moreover, the state appraisal remedy was adequate and exclusive. In rejecting both contentions, the court held that whether the merger was valid under state law was not a question it need decide,[90] and that the existence of a state remedy does not negate federally created rights,[91] including injunctive relief where

83. 533 F.2d at 1279.

84. Marshel v. AFW Fabric Corp., 398 F. Supp. 734, 738-39 (S.D.N.Y. 1975), rev'd, 533 F.2d 1277 (2d Cir. 1976), vacated and remanded, 45 U.S.L.W. 3279 (U.S. Oct. 12, 1976) (No. 75-1782).

85. 533 F.2d at 1280; see note 82 supra.

86. 533 F.2d at 1280-81.

87. Id. at 1282.

88. Id.

89. Id.

90. Id. at 1280. The court's disclaimer notwithstanding, "it is easier to find a Rule 10b-5 violation in a transaction which the state court has found to be 'fraudulent' and in violation of state law then [sic] it is in a transaction . . . in . . . which the Court assumes compli[ance] with state law." Brodsky, State Going-Private Laws—Dead or Alive?, 175 N.Y.L.J., Feb. 27, 1976, at 14, col. 2; see note 82 supra.

91. 533 F.2d at 1281. See Popkin v. Bishop, 464 F.2d 714, 718 (2d Cir. 1972); Vine v.

proper.[92] Second, and more importantly, the court dismissed defendants' contention that full disclosure of all material facts bars a claim under section 10(b).[93] *Popkin* was distinguished in that the propriety of the merger was not challenged, but rather the fairness of the exchange ratios; whereas in *Marshel*, the fraudulent scheme was inherent in the merger itself.[94] Thus the court concluded that "it would surely be anomalous to hold that a cause of action [*sic*] is stated under § 10(b) and Rule 10b-5 when the fraudulent conduct . . . includes deception but that similarly fraudulent practices carried out with prior disclosure to the helpless victim do not give rise to a Rule 10(b)-5 [*sic*] claim."[95]

IV. *Green v. Sante Fe Industries, Inc.*: FIDUCIARY DUTY AND THE SHORT-FORM MERGER

Unlike *Marshel, Green v. Sante Fe Industries, Inc.*[96] involved a Delaware short-form merger.[97] Sante Fe Natural Resources owned 95 per cent of Kirby Lumber Company, a Delaware corporation. After forming a "shell" corporation, Sante Fe transferred its Kirby stock to the "shell" in exchange for 100 per cent of its stock. Under Delaware law, a corporation owning at least 90 per cent of another may merge with that corporation without shareholder approval.[98] Accordingly, a merger was effected and Kirby's minority shareholders were informed that under the terms of the already consummated merger, they would receive $150 per share for their stock, or, alternatively, could seek appraisal under the state statute. Plaintiffs, Kirby minority shareholders, sought to rescind the merger and recover money damages. They alleged that the Delaware procedure is a device to defraud because it forces minority shareholders to sell their shares for less than true value, and that, even absent misrepresentation, the merger violated rule 10b-5 since it served no valid corporate purpose.[99]

As in *Marshel*, the lower court dismissed the complaint for failure to state a federal claim.[100] Once again the Second Circuit reversed and held that "a

Beneficial Fin. Co., 374 F.2d 627, 635-36 (2d Cir.), cert. denied, 389 U.S. 970 (1967); McClure v. Borne Chem. Co., 292 F.2d 824, 833 (3d Cir.), cert. denied, 368 U.S. 939 (1961).

92. 533 F.2d at 1281. Granting injunctive relief, of course, "is extraordinary relief" and requires showings of irreparable harm, likelihood of success on the merits, balancing of hardships, and an inadequate remedy at law. Sanders v. Air Line Pilots Ass'n, Int'l, 473 F.2d 244 (2d Cir. 1972).

93. 533 F.2d at 1282.

94. Id. This distinction has been criticized as a matter of semantics not justifying the result. Tanzer Economic Assoc., Inc. v. Universal Food Specialties, Inc., —— Misc. 2d ——, 383 N.Y.S.2d 472, 478 (Sup. Ct. 1976).

95. 533 F.2d at 1282.

96. 533 F.2d 1283 (2d Cir. 1976), cert. granted, 45 U.S.L.W. 3249 (U.S. Oct. 5, 1976) (No. 75-1753).

97. Del. Code Ann. tit. 8, § 253 (1975).

98. Id.

99. 533 F.2d at 1288.

100. Green v. Sante Fe Indus., Inc., 391 F. Supp. 849 (S.D.N.Y. 1975), rev'd, 533 F.2d 1283 (2d Cir. 1976), cert. granted, 45 U.S.L.W. 3249 (U.S. Oct. 5, 1976) (No. 75-1753).

complaint alleges a claim under Rule 10b-5 when it charges, in connection with a . . . 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.*"[101] Echoing *Marshel*, the court emphasized the fact that corporate funds had been used to finance the expulsion of the minority, the benefit accruing solely to the controlling insiders.[102] The court further stated that where a rule 10b-5 claim is based on breach of fiduciary duty, there need be no allegation of misrepresentation or nondisclosure.[103] In so holding, the court turned *Popkin* to its own advantage by construing that decision to require lack of disclosure where shareholder approval was necessary. The implication, therefore, is that where no approval is required, nondisclosure need not be shown in a rule 10b-5 claim.[104]

> [I]t is the merger and the undervaluation which constitute the fraud, and not whether or not the majority determines to lay bare their real motives. If there is no valid corporate purpose for the merger, then even the most brazen disclosure of that fact to the minority shareholders in no way mitigates the fraudulent conduct.[105]

The court declined to decide whether the inevitability of approval made any nondisclosure requirement illusory.[106]

Perhaps even more significant than its finding of fraud in the absence of nondisclosure was the court's reaction to the unique allegation that the

101. 533 F.2d at 1291 (emphasis added).

102. Id. at 1290; see text accompanying note 89 supra.

103. 533 F.2d at 1287. In a vehement dissent, Judge Moore found this "an untenable hypothesis" (id. at 1301), calling the majority's reasoning "legal legerdemain." Id. at 1304.

104. Id. at 1291-92. The reasoning behind this statement is rather ambiguous, particularly since no showing of nondisclosure was required in Marshel, a case in which shareholder approval *was* required. The fact that the minority did not have enough votes to stop the merger there may have been significant.

It is interesting to note that neither Green nor Marshel expressly overruled Popkin. That fact has been determinative in at least one federal case which held that breach of fiduciary duty was not actionable under rule 10b-5 as long as the merger was a "true combining" of business; see note 155 infra. On the other hand, it has been stated that by Green and Marshel, "Popkin has been overruled sub silentio . . . ." Greene, supra note 4, at 498 n.37.

105. 533 F.2d at 1292.

106. Id.; see note 69 supra. Popkin was also distinguished in that there was a business purpose for the merger so strong as to be "compelling" since the merger was part of a court-ordered settlement agreement. Id. at 1291.

What will constitute a justifiable corporate purpose for purposes of defining federal "going private" standards is, of course, one of the main questions left unanswered by Green and Marshel. Although such a standard has been suggested (Note, Going Private, 84 Yale L.J. 903, 931 (1975)), a "compelling" purpose such as the Green court found in Popkin is probably too restrictive a test. Suggested alternatives have been a "plausible" purpose other than the elimination of minority shareholders (Vorenberg, Exclusiveness of the Dissenting Stockholder's Appraisal Right, 77 Harv. L. Rev. 1189, 1204 (1964) [hereinafter cited as Vorenberg]), "commercial" corporate purpose associated with immediate business advantage (rejected as too narrow in Borden, supra note 3, at 1022-23), and "substantial" corporate purpose, with the burden of proof on the fiduciaries to show that "any benefit to [them] would be incidental." Kerr, supra note 10, at 59.

applicable state short-form merger statute was, in itself, a device to defraud since notice is dispensed with, the stock is undervalued, and no corporate purpose for the merger is served.[107] Although compliance with state law had never been considered a defense to a federal action,[108] no federal court had ever taken the opportunity to determine the effect of state law on federal "going private" standards, mainly because it was consistently held that there was no federal claim absent nondisclosure.

The *Green* court, therefore, struck a blow for the power of the federal courts by holding that

> the states have no power to preempt Congress in the creation of substantive rights and remedies arising from purchases and sales of securities in interstate commerce. . . . The remedies available to redress violations under the Securities Exchange Act are *supplementary* to those provided by the states and they may not be abrogated merely by the coincidental availability of an alternate or corollary state remedy. . . . [T]he fact that a shareholder claiming fraud both in the consummation of a merger not based on any justifiable corporate purpose and in the undervaluation of his shares may under state law only resort to an appraisal proceeding that merely ameliorates the undervaluation does not foreclose the right of the Congress and the federal courts to provide that claimant an additional right and remedy to redress any injury flowing from a fraud inherent in the merger itself.[109]

By defining the relationship between federal and state remedies in the "going private" area in this language, the court strongly indicated that federal injunctive relief is not merely a federal analogue to the state appraisal procedure, but a separate federal weapon which could be utilized to remedy fraud inherent in the merger itself. Earlier decisions—*Perlow, Schoenbaum* and perhaps even *Marshel*—left the impression that they were only superimposing a federal remedy on an already state-created one. The *Green* court, however, addressed itself to wrongs never contemplated by the state appraisal procedures[110] when it distinguished simple undervaluation from the fraud inherent in the merger. Whether the ultimate relief awarded for such "fiduciary-fraud" will differ from the monetary figure set in an appraisal proceeding was not discussed by the court.[111]

107. A similar claim was made in Blumenthal v. Roosevelt Hotel, Inc., 202 Misc 988, 115 N.Y.S.2d 52 (Sup. Ct. 1952), in which the plaintiffs contended that the bad faith of the fiduciaries in using a state statute to eliminate minority shareholders at an inadequate price tainted the statute itself with illegality. Id. at 991, 115 N.Y.S.2d at 55. The court found that as long as the depreciation of the plaintiffs' stock was remediable under the appraisal procedure, there was no basis for injunctive relief. Id. at 992, 115 N.Y.S.2d at 57.

108. "[A fiduciary] cannot use his power for . . . personal advantage and to the detriment of the stockholders . . . no matter how meticulous he is to satisfy technical requirements " Pepper v. Litton, 308 U.S. 295, 311 (1939); accord, Popkin v. Bishop, 464 F.2d 714, 719 (2d Cir. 1972)

109. 533 F.2d at 1286 (emphasis added). The dissent, however, was seriously alarmed by this usurpation of the state's corporate laws and "the astonishing and impermissible establishment of a federal common law of corporations." Id. at 1304 (Moore, J., dissenting); see note 103 supra.

110. See notes 118-19 infra and accompanying text.

111. According to one commentator, Green suggests that revaluation of the surrendered shares, and not injunctive relief, is the proper remedy. Brodsky, State Going-Private Laws—Dead or Alive?, 175 N.Y.L.J., Feb. 27, 1976, at 14, col. 4. This view seems borne out by a later

Whether *Green* and *Marshel* have in fact created a new federal remedy for "going private" abuses[112] will be a matter of interpretation as future cases arise. Compared with prior law, they at least leave no doubt as to the liberalization of standing requirements and expand the definitions of fraud espoused by *Perlow* and *Schoenbaum.* Perhaps more importantly, they bring to the center of the federal stage the concept of breach of fiduciary duty as a basis for finding a rule 10b-5 fraud. They also dramatically demonstrate the Second Circuit's willingness to find liability where the fraud is found not in the purchase or sale of securities per se, but in the essential unfairness of a transaction whose relationship to the securities market may be only tangential.[113] Moreover, this new concept is now recognized as one of overriding federal interest, which cannot be abridged or delimited by the existence of state law in the area.[114]

V. *Green* AND *Marshel* AS RESPONSES TO INADEQUATE STATE REMEDIES

Since corporate taxes are an important source of revenue, many state laws governing the regulation of corporations have been enacted to make incorporation in the home state as attractive as possible.[115] Consequently, stockholder protection was considered only a secondary concern.[116] These corporate laws, usually taking the form of "enabling" acts, have "watered the rights of shareholders vis-à-vis management down to a thin gruel."[117] In recognition of this fact, many states have created the appraisal procedure in order to provide some balance to the broad powers conferred on management by the enabling acts.[118] These laws provide a partial remedy for shareholders who are forced to receive cash for their stock by assuring, theoretically at least, that full value is given.[119]

Second Circuit case, Merrit v. Libby, McNeill & Libby, 533 F.2d 1310, 1313-14 (2d Cir. 1976), which so interpreted Green and Marshel.

112. "Green and Marshel when read together, lead to the conclusion that both long and short-form mergers designed to eliminate minority positions with no justifiable corporate purpose violate Rule 10b-5 although full disclosure is made and the price set by the majority is fair to the minority." Brodsky, Going Private—Is It Over?, 175 N.Y.L.J., Mar. 3, 1976, at 2, col. 3. "[I]t is safe to say that the vast majority of corporate lawyers would have advised their clients that the merger in Green did not violate state or federal law." Id. at 2, col. 1.

113. See notes 88-89 supra and accompanying text.

114. See note 109 supra. Undoubtedly, it was "the federal court's skepticism and growing dissatisfaction with state remedies, particularly appraisal" which was the prime motivation behind the Green decision. Greene, supra note 4, at 499 n.37.

115. Cary, supra note 3, at 665-66.

116. Id.

117. Id. at 666.

118. "Under [state] statutes there is considerable leeway for majority shareholders to take unfair advantage of a minority.

The risk of hardship or injustice . . . is mitigated somewhat, however, by so-called 'appraisal statutes . . . .' " O'Neal & Derwin, supra note 4, at 62 (footnote omitted).

119. It has been noted, however, that "resort to appraisal will . . . often give the stockholder less than his stock is worth." Vorenberg, supra note 106, at 1201.

Appraisal, as the exclusive remedy to the possible abuses in "going private" transactions, has been poignantly criticized. The proceedings, even if conducted fairly, tend to undervalue the true worth of the shares[120] and are often time consuming, particularly in states requiring dissenting shareholders initially to demand satisfaction from the board of directors.[121] Typical state statutes require a plaintiff to post security for costs as a condition to commencing the suit.[122] More importantly, the appraisal procedure fails to remedy the minority's lack of participation in the merger proposal, timing or terms,[123] nor does it adequately compensate for their elimination from further participation in the company's growth.[124]

Some state courts, or federal courts guided by state law, have shown a willingness to provide injunctive relief in "going private" cases, even where appraisal rights exist. For example, in *Bryan v. Brock & Blevins Co.*,[125] a leading Fifth Circuit case decided on Georgia law, the court enjoined a proposed merger since its sole purpose was to eliminate the plaintiff's interest in the corporation. The court found that the scheme constituted a device or artifice to defraud and a breach of the controlling shareholders' fiduciary duty to the minority.[126]

This willingness was also exhibited in a New Jersey decision. *Berkowitz v. Power/Mate Corp.*[127] involved a proposed "going private" merger between two corporations, one of which was a "shell" formed solely to effect the merger. The court declined to follow *Bryan's* holding that a merger effected solely to eliminate minority shareholders was a per se breach of fiduciary duty where it complies with state law.[128] Nevertheless, the merger was enjoined. Noting the immediate financial gain accruing to the insiders as a result of the merger and the large bonuses they awarded themselves shortly beforehand,[129] the court held that "[a]t a minimum [the insiders'] conduct is subject to a searching inquiry to determine whether it conforms to accepted concepts of fairness and equity."[130] Significantly, the court declined to presume a "going

120. Id.

121. See New Fraud, supra note 2, at 1120.

122. Id.; see McClure v. Borne Chem. Co., 292 F.2d 824, 827-29 (3d Cir.), cert. denied, 368 U.S. 939 (1961).

123. See Brudney & Chirelstein, supra note 69, at 304.

124. See O'Neal & Derwin, supra note 4, at 73 (appraisal cannot remedy shareholder's dilution of proprietary interest or control); Brudney & Chirelstein, supra note 69, at 305 (where merger produces gains to company, appraisal does not allow eliminated minority to share in same).

Even were the procedure an adequate one, some states either provide no appraisal right at all, or are not aggressive in enforcing it. Cohen, supra note 3, at 595-96; Fleischer, supra note 3, at 1153; New Fraud, supra note 2, at 1120-21.

125. 490 F.2d 563 (5th Cir.), cert. denied, 419 U.S. 844 (1974), aff'g 343 F. Supp. 1062 (N.D. Ga. 1972).

126. Id. at 571.

127. 135 N.J. Super. 36, 342 A.2d 566 (Ch. 1975).

128. Id. at 47-48, 342 A.2d at 573.

129. Id. at 48, 342 A.2d at 573.

130. Id. at 49, 342 A.2d at 574.

private" procedure was free from illegality simply because it complied with the merger statute and the price paid was fair.[131]

Unfortunately, application of state "going private" standards has been confusing at best. Hopefully, *Green* and *Marshel* will accelerate the trend of commencing suits in federal, and not state court, especially since many factors favor such a choice. There is need for uniformity and a single set of fiduciary standards;[132] federal venue provisions and service rules are liberal;[133] the federal judiciary enjoys a greater disinterest than its state brethren;[134] state courts are inadequate to effectuate federal policy;[135] and federal courts are now willing to intervene in "going private" transactions notwithstanding complete compliance with state law and material disclosure.

VI. DEFINING AND APPLYING *Green* AND *Marshel* STANDARDS: IMPACT OF AND ON STATE LAW

The effect *Green* and *Marshel* will have on the future roles of state and federal courts in defining "going private" standards and remedying "going private" abuses depends upon whether the federal role continues to expand. It is possible that federal courts will borrow freely from state court standards,[136] and therefore *Green* and *Marshel's* effectiveness may hinge upon the forcefulness with which state courts enforce and define the fiduciary duties owed to minority shareholders. On the other hand, federal courts may interpret and apply *Green* and *Marshel* de novo, emphasizing a purely federal approach. An examination of recent federal and state court decisions interpreting *Green* and *Marshel* reveals widely varying standards depending upon a particular court's approach.

In *Box v. Northrop Corp.*,[137] a federal district court case, the plaintiff alleged that as a result of two mergers, the last involving a "shell" corporation and the Delaware short-form merger statute, his shareholder's equity in the corporation had been reduced from 20 per cent to .257 per cent.[138] Plaintiff charged violations of rule 10b-5 and state claims of breach of fiduciary duty in that the sole purpose of the merger was to effect a squeeze-out. Ruling on defendant's motion to dismiss the complaint for failure to state a federal

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131. Id. at 50, 342 A.2d at 574.

132. "[T]he policy of uniformity within the federal system is stronger than any policy of conformity with local rules. . . . Congress intended uniform enforcement of rights arising under The Securities Exchange Act of 1934 . . . ." McClure v. Borne Chem. Co., 292 F.2d 824, 833 (3d Cir.), cert. denied, 368 U.S. 939 (1961); see Bloomenthal, supra note 18, at 349-50; Cohen, supra note 3, at 595; Privity, supra note 18, at 670.

133. Bromberg, supra note 4, § 2.7(3); Privity, supra note 18, at 670.

134. "[F]ederal courts have a tradition of independence and impartiality . . . . [Federal judges] do not resign to return to private practice and they would not entertain any feelings of disloyalty even if they were aware that their state or region would suffer by their judgements." Cary, supra note 3, at 695.

135. See New Fraud, supra note 2, at 1120-21; Privity, supra note 18, at 671.

136. See Borden, supra note 3, at 1038-39.

137. No. 74 Civ. 4373 (S.D.N.Y., Feb. 26, 1976).

138. Id. at 4.

claim, the court held that under *Green*, allegations of "breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure are sufficient to state a claim."[139] The court opined that a rule 10b-5 claim is sustained when, "in connection with a . . . short-form merger, . . . 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."[140]

It is not clear from *Northrop* whether every breach of fiduciary duty, or only one stemming from lack of any justifiable corporate purpose, will be actionable. Arguably, the decision represents an expansion of *Green* not intended by that court, since the minority shareholder was not totally eliminated. However, a significant factor in the court's decision may have been the extreme dissipation of the minority's equity—elimination in substance, though not in form.

In contrast to the liberalized federal view, a New York court, shortly after the *Marshel* decision, refused to enjoin a proposed Delaware short-form merger which would result in the elimination of the minority public shareholders.[141] The court agreed that lack of a "proper corporate purpose" had become a bar to short-form mergers which otherwise comply with state law,[142] and conceded that a basis for state injunctive relief exists where

> (1) fraud or illegality clearly [can] be shown, or (2) there has been concealment or non-disclosure of material facts, or (3) . . . the merger is merely a device to deal inequitably with the minority and has no valid business purpose, or (4) . . . there has been a breach of fiduciary responsibility.[143]

Nevertheless, it found that the instant case did not call for intervention since "the merger . . . was not actuated solely by motives of personal greed";[144] there was no "apparent effort to milk the assets";[145] the price offered for the cancelled shares was not "palpabl[y] or gross[ly] undervalu[ed]";[146] corporate funds were not financing the acquisition;[147] there were legitimate business purposes "over and above the self-interest of the investors, [which tend] to negate" justifiable equitable intervention.[148]

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139. Id. at 7. Contra, Marsh v. Armada Corp., 533 F.2d 978 (6th Cir. 1976), petition for cert. filed, 45 U.S.L.W. 3011 (U.S. July 6, 1976) (No. 76-5), which refused to equate a breach of fiduciary duty in formulating the terms of a merger proposal with fraud where there was no showing of nondisclosure. Green was distinguished in that the state merger statute there required no notice to the minority shareholders. Id. at 985-86.

140. No. 74 Civ. 4373, at 7 (citation omitted).

141. Tanzer Economic Assoc., Inc. v. Universal Food Specialties, Inc., —— Misc. 2d ——, 383 N.Y.S.2d 472 (Sup. Ct. 1976).

142. Id. at ——, 383 N.Y.S.2d at 478.

143. Id. at ——, 383 N.Y.S.2d at 479.

144. Id.

145. Id. at ——, 383 N.Y.S.2d at 480.

146. Id. at ——, 383 N.Y.S.2d at 481.

147. Id.

148. Id. at ——, 383 N.Y.S.2d at 482. Factors constituting a "justifiable purpose" included: improvement of management personnel and corporate planning; realization of savings by pooling

The court also elaborated on the state's role in formulating "going private" standards and refused to take into account "what a federal court might do if Rule 10b-5 were to be invoked."[149] It expounded that "[w]hether a merger meets the statutory and equitable requirements of state law is solely a matter for the state courts."[150] Additionally, the court evinced reluctance to "[act] precipitously to upset a procedure which has been given express legislative sanction,"[151] obviously disapproving of *Green's* superimposition of federal standards on Delaware's statutorily sanctioned requirements.[152]

The Second Circuit had occasion to review a related case in *Merrit v. Libby, McNeill & Libby,*[153] an appeal from the denial of a preliminary injunction of the Libby merger. In affirming the lower court, the appellate court sharply delineated the situations in which *Green* and *Marshel* should be *applied* and also shed light on the remedies they *implied.* The court adroitly distinguished *Green* because an appeal from a dismissed complaint must be construed in the appellant's favor,[154] and differentiated *Marshel* in that the instant case did not involve a situation

> where a shell corporation is used as a conduit for a forced merger by the simple device of transferring the shares owned in the transferor corporation to the transferee shell and the controlling shareholders put up no money but use corporate funds for their personal advantage.[155] It is also not a case where the defendants admit that their *sole*

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management experience, raw material resources, warehousing facilities and advertising talent; elimination of conflict of interests problems; diversification of products; and, significantly, elimination of SEC compliance. Id. at ——, 383 N.Y.S.2d at 483.

Compliance with SEC registration and disclosure requirements is expensive and time consuming, and, consequently, is one of the foremost incentives to return a corporation to private ownership. Brodsky, Going Private—Is It Over?, 175 N.Y.L.J., Mar. 3, 1976, at 2, col. 2. Typically, savings are estimated from $40,000 to $100,000 per year. Swanson, supra note 4, at 615. If the savings realized by "going private" constitute a justifiable corporate purpose, then "Green may be avoided in virtually every case by proper pleading and the decision is a tempest in a teapot." Brodsky, supra at 2, col. 2. There seems to be a general consensus that elimination of the need for SEC compliance, by itself, will not be a sufficient purpose. Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir.), cert. denied, 419 U.S. 844 (1974), aff'g 343 F. Supp. 1062 (N.D. Ga. 1972); Address by A. A. Sommer, Jr., "Going Private": A Lesson in 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 84,699. See House of Adler, Inc., [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,515 (SEC 1971) (no action letter). But see Swanson, supra note 4, at 653.

149. —— Misc. 2d at ——, 383 N.Y.S.2d at 479.

150. Id. at ——, 383 N.Y.S.2d at 478.

151. Id.

152. Id. at ——, 383 N.Y.S.2d at 478-79 & n.1.

153. 533 F.2d 1310 (2d Cir. 1976).

154. Id. at 1312.

155. The court emphasized the fact that the corporation orchestrating the merger was not a mere "conduit" for the purpose of forcing a merger financed with corporate funds, but rather an active corporation involved in a business related to that of the merged corporation. Similar reasoning was used in a recent Sixth Circuit case, Marsh v. Armada Corp., 533 F.2d 978 (6th Cir. 1976), petition for cert. filed, 45 U.S.L.W. 3011 (U.S. July 6, 1976) (No. 76-5), which held

motive is to rid themselves of the minority.[156]

Furthermore, valid business purposes justified defendants' conduct.[157]

The heart of the decision, however, rested in the court's conviction that damages at law could adequately compensate were plaintiffs to prevail on the merits.[158] Simultaneously, the court did not intend to limit such damages to those available through the state appraisal proceeding. "[The plaintiffs'] damages can be measured in terms different from those applicable in state appraisal proceedings. Such restrictive theories of valuation are not binding on federal courts when actual damages are sought for violations of the federal securities laws."[159] The court declined, however, to speculate on the proper measure of damages.[160]

Whether *Merrit* implies that *Green* and *Marshel* merely provide for a federal appraisal proceeding when the merger is not consummated through a shell and evinces a plausible business purpose, though inherently unfair, is still too early to discern. It is at least possible to read *Green* without such circumscription.[161]

The *Merrit* limitation appears to have been more strictly applied in *Schulwolf v. Cerro Corp.*,[162] a New York case involving a proposed long-form merger between two active corporations, forty-five per cent owned by the Pritzker family. Under the terms of the merger, the Pritzkers would gain control of the new corporation and all of its residual equity, while the fifty-five per cent "minority" shareholders would receive preferred (non-growth) stock in exchange for their common. The court refused to enjoin the merger since "there is no violation of the fiduciary duty owed by the dominant stockholders to the public stockholders if there is a proper corporate purpose for the merger and there has been neither fraud, self-dealing nor price manipulation and the alternatives afforded to the public shareholders are a fair price fairly determined or the statutory right to an appraisal."[163] This is particularly true where the public shareholders, owning 55 per cent of the

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that a breach of fiduciary duty in formulating the terms of a merger between two Michigan corporations did not raise a rule 10b-5 claim. Id. at 984. Seizing upon the Second Circuit's failure to overrule Popkin in either Green or Marshel, the court concluded that the latter were inapposite where the merger is not a "sham transaction designed to expropriate the ownership interests of the minority shareholders. . . . [but rather] a true combining of two businesses . . . ." Id. at 986. The true combining/related business test was also adopted in Schulwolf v. Cerro Corp., 86 Misc. 2d 292, 380 N.Y.S.2d 957 (Sup. Ct. 1976); see note 165 infra and accompanying text. Interestingly, New York's short-form merger statute, N.Y. Bus. Corp. Law § 905 (McKinney 1963), eliminated its predecessor's requirement that the two corporations be engaged in similar or incidental businesses. Whether Schulwolf modifies the present statute is an open question.

156. 533 F.2d at 1312.

157. Id.

158. Id. at 1313.

159. Id. at 1314 (footnote omitted).

160. Id.

161. See notes 109-11 supra and accompanying text.

162. 86 Misc. 2d 292, 380 N.Y.S.2d 957 (Sup. Ct. 1976).

163. Id. at 297, 380 N.Y.S.2d at 962.

outstanding stock, have the power to veto the merger.[164] Furthermore, combining the management and resources of related businesses so that intercompany transactions benefit both, served a "proper corporate purpose."[165] Although corporate funds financed the merger, the court, nevertheless, found this irrelevant since the insiders were not the sole beneficiaries.[166]

Schulwolf may be distinguished in that the public shareholders received new stock for their shares and were not forced to receive cash—the situation in *Green* and *Marshel*. Also, the fact that the Pritzker family controlled only 45 per cent of the corporation may have strongly influenced the court.[167] Nevertheless, if the definitions of "proper corporate purpose" espoused by the New York judiciary are adopted by federal courts,[168] then applying the "new" *Green* and *Marshel* standards simply may require adroit proxy statement drafting so as to include any plausible business purpose. If *Green* stands for the proposition that mergers are enjoinable only where the sole purpose is insider benefit, as *Schulwolf* implies it does, then any allegation of savings, or perhaps even administrative convenience, may be sufficient to save the merger. This will be true even though the minority is forced out of their company with their own funds at a price and time set by those realizing the greatest benefit from the transaction.[169] Moreover, if application of *Green* and *Marshel* is strictly limited to short-form mergers or those where approval is virtually assured, or to situations in which the insider group is the one which originally took the company public, then their effectiveness is severely curtailed.[170] Obviously, the degree to which state courts are allowed to define

164. Id. This is often an illusory power, however; see note 69 supra and accompanying text.

165. 86 Misc. 2d at 297-98, 380 N.Y.S.2d at 962; see note 148 supra.

166. 86 Misc. 2d at 298-99, 380 N.Y.S.2d at 963.

167. Given the atomized nature of the remaining 55% and the practical difficulty of attaining any sort of concerted action by the "majority," this seems, however, a distinction without substance.

168. This approach has been recommended since the question is, or should be, one of state law. Brodsky, Going Private, 175 N.Y.L.J., April 7, 1976, at 2, col. 4.

169. The question, obviously, is one of fairness. Green and Marshel did not, ostensibly, go so far as to state that there exists "a right in virtual perpetuity to continue as [a minority shareholder] . . . ." Brodsky, State Going Private Laws—Dead or Alive?, 175 N.Y.L.J., Feb. 27, 1976, at 14, col. 3. That such a right exists where the shareholders' interest is compensable has long been denied. Grimes v. Donaldson, Lufkin & Jenrette, Inc., 392 F. Supp. 1393, 1403 (N.D. Fla. 1974), aff'd, 521 F.2d 812 (5th Cir. 1975); Willcox v. Stern, 18 N.Y.2d 195, 202, 219 N.E.2d 401, 404, 273 N.Y.S.2d 38, 43 (1966); Borden, supra note 3, at 1020-21 ("[t]he significant vested rights that orthodoxy once attributed to the shareholder interest . . . have long since been sacrificed on the altar of corporate flexibility.") (footnote omitted). But where the elimination of minority shareholders' interests can be accomplished despite their rigorous opposition and at a price determined by those who stand to gain the most from the transaction, unquestionably "there is an element of unfairness." Id. at 1017. Arguably, it was at this element that Green and Marshel were directed, not at "fraud" as the term is commonly used. Whether rule 10b-5 is the proper vehicle for fairness standards is the more important question; see notes 172-92 infra.

170. Logically, these considerations should be immaterial. If a fraud has been perpetrated, the fact that the shareholders can "ratify" that fraud through their votes should make no difference. Brodsky, Going Private, 175 N.Y.L.J., April 7, 1976, at 2, col. 2. Similarly, "[t]here

federal standards in the "going private" area will be largely determinative of the rights of minority shareholders in the post-*Green* and *Marshel* era.[171]

VII. Statutory Limitations of Section 10(b) and Alternatives to its Continued Expansion

Many commentators have championed an increased federal role in defining "going private" standards,[172] based largely on the need for a uniform nationwide standard which the spotty state approach cannot provide. At present, judicial interpretation of section 10(b) and rule 10b-5 has been the sole basis for the expanded federal role. As one observer philosophized: "[Rule 10b-5]—like the universe, as some scientists conceive it—has limits, but they are expanding so fast, that we never reach them."[173]

Section 10(b) has been generally recognized as a "panacea" designed to cover fraudulent conduct not otherwise prohibited,[174] and its enforcement has been left to the regulatory power of the SEC, which promulgated rule 10b-5.[175] It is believed, however, that "standards presently enforced under the Rule do not accurately express congressional intent as it existed at the time of the enactment of the Securities Act of 1933, and the Securities Exchange Act of 1934."[176] Indeed, it is unlikely that the concept of "fraud" encompas-

is no more 'fraud' on the minority when a person who had been a stranger to the company eliminates the minority than when a person who originally took the company public eliminates the minority." Id. at 2, col. 4.

171. Professor Borden has recommended that standards in the field be defined by state statutory or case law, and that federal machinery simply be made available for the purpose of enforcing state law. Borden, supra note 3, at 1037-39. However, the success of this approach is contingent upon the sufficiency of each state's remedies and the zeal with which those remedies are enforced; see note 124 supra. Another commentator has urged that while federal courts should feel free to borrow "fairness" standards from the states, they should not hesitate to use "federal corporation law" where state law is not sufficient. New Fraud, supra note 2, at 1123. Conversely, Professor Bromberg has suggested that the state courts might use federal rule 10b-5 precedents in applying their own common law concepts and statutory fraud provisions. Bromberg, supra note 4, § 2.7(4).

172. See O'Neal & Derwin, supra note 4, at 209 ("American courts have been singularly unimaginative in providing remedies for oppressed minority shareholders."); Cary, supra note 3, at 668 ("[s]tate action cannot be effective in providing a responsible corporate statute."); Cohen, supra note 3, at 596 ("one of the principal reasons for the various anti-fraud provisions of the federal securities laws . . . was the realization that national problems could not be dealt with adequately by the states."). But see Privity, supra note 18, at 681-82 (extending 10b-5 suits into corporate fiduciary area where securities transaction is incidental unjustifiably undercuts state interests). See also Address by A. A. Sommer, Jr., Further Thoughts on "Going Private," Second Annual Securities Seminar of the Detroit Institute for Continuing Legal Education, Mar. 15, 1975, BNA Sec. Reg. & L. Rep. No. 294, at D-2 (March 19, 1975).

173. Bromberg, Are There Limits to Rule 10b-5?, 29 Bus. Law. 167, 177 (1974).

174. See, e.g., Herpich v. Wallace, 430 F.2d 792, 801-02 (5th Cir. 1970); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 859 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); In re Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961) (rule 10b-5 is "designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others.").

175. See note 2 supra.

176. Ruder, Civil Liability under Rule 10b-5: Judicial Revision of Legislative Intent?, 57

sing breach of fiduciary duty, espoused by the Second Circuit in *Green* and *Marshel*, was what Congress originally intended. At the same time, as both cases suggest, there is an overriding need for uniform corporate fiduciary standards to deal with the new species of "fraud" inherent in "going private" transactions. Alternatives to continued expansion of liability under the guise of construing section 10(b) and rule 10b-5 have been suggested in the form of a return of power to the states,[177] some species of federal incorporation law,[178] a re-examination and frontal statutory attack by Congress,[179] or new regulations by the SEC.[180] The most practical would appear to be the regulatory route.

Although the SEC has fairly consistently taken the position that section 10(b) and rule 10b-5 are broad enough to remedy abuses found in some "going private" transactions,[181] it has proposed new rules 13e-3A and 13e-3B[182] to

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Nw. U.L. Rev. 627, 628 (1963) (footnote omitted). For example, it is generally acknowledged, but largely and conveniently overlooked, that section 10(b) probably was not intended to confer a private right of action (Bromberg, Are There Limits to Rule 10b-5?, 29 Bus. Law. 167 (1974)), and that rule 10b-5 was intended as an administrative enforcement provision only. Bromberg, supra note 4, § 2.2(420); Manne, Insider Trading and the Administrative Process, 35 Geo. Wash. L. Rev. 473, 474-76 (1967). Professor Manne has strongly criticized the tendency of courts, litigators and commentators to treat rule 10b-5 as if it were a statute (Manne, supra at 474), and has urged that the rule should be extended only if in each case "the Commission [can] show that it has complied with the requirements of the [Administrative Procedure Act] or their equivalent." Id. at 511.

177. See Borden, supra note 3, at 1037.

178. See Note, Federal Chartering of Corporations: A Proposal, 61 Geo. L.J. 89 (1972). Cary rejects this proposal as "politically unrealistic" (Cary, supra note 3, at 700) and suggests as an alternative a "Federal Corporate Uniformity Act" which would impose nationwide uniform corporate responsibility standards. Id. at 701-03.

179. See Entel v. Allen, 270 F. Supp. 60, 70 (S.D.N.Y. 1967); Brodsky, 'Going Private,' 175 N.Y.L.J., Feb. 5, 1976, at 4, col. 4; Cary, supra note 3, at 700; Henkel. Codification—Civil Liability under the Federal Securities Laws, 22 Bus. Law. 866, 875 (1967); Privity, supra note 18, at 665. It has been suggested that federal standards be guided by four principles: 1) the importance of an independent and impartial judiciary, 2) the preservation of public policy as a standard for the courts, 3) the need for uniformity and 4) an equal concern for the management and shareholders of the public company as for the investors engaged in the purchase and sale of its stock. Cary, supra note 3, at 697.

180. See Kerr, supra note 10, at 57.

181. See, e.g., Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 738 (1975); O'Neill v. Maytag, 339 F.2d 764, 768 (2d Cir. 1964); People v. Concord Fabrics, Inc., 83 Misc. 2d 120, 122-23, 371 N.Y.S.2d 550, 552 (Sup. Ct.), aff'd, 50 App. Div. 2d 787, 377 N.Y.S.2d 84 (1st Dep't 1975) (per curiam); Address by A. A. Sommer, Jr., "Going Private": A Lesson in 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 84,698. A recent Article stated that "S.E.C. officials have debated the question of going private for some time but have come to no clear position. The Division of Enforcement, however, is known to look askance at the practice on the ground that management controls the timing of such transactions and that the public stockholder is often asked to finance the process by which he is forced out of his investment." N.Y. Times, May 6, 1976, at 55, col. 8.

182. SEC Securities Exchange Act Release No. 5567 (Feb. 6, 1975), [1974-1975 Transfer

deal specifically with those problems. The proposed rules provide, *inter alia*, for vigorous disclosure requirements for tender offerors,[183] a twenty-day waiting period during which the proposed transaction cannot be effected,[184] mandatory independent expert appraisal as to the fairness of the offered consideration,[185] and, significantly, that every "going private" merger have a valid business purpose.[186]

The proposed rules, however, have been severely criticized, partly as overreaching by the SEC.[187] In particular, proposed rule 13e-3B has been attacked as being too vague,[188] failing to distinguish between different types of mergers, adopting state fairness/business purpose standards without taking into account their administrative and analytical difficulties, and failing to justify adoption of these standards into federal law.[189] Although proposed rule 13e-3A has been viewed more favorably,[190] by mandating a federal appraisal remedy without inquiry into the motives behind the transaction,[191] it seemingly does less than what was already accomplished in *Green*. As one commentator stated: "[The proposed rules] would not be a substantial improvement because they primarily adopt existing . . . standards."[192] If fairness is indeed at the heart of the "going private" question, rules 13e-3A and -3B only *begin* to provide the answers.

VIII. CONCLUSION

The phenomenon of public companies eliminating their minority (public) shareholders in order to return to private ownership has increased in recent

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Binder] CCH Fed. Sec. L. Rep. ¶ 80,104, at 85,091-93 [hereinafter cited as Release]; see Note, Going Private: An Analysis of Federal and State Remedies, 44 Fordham L. Rev. 796, 801-02 (1976).

183. Release, supra note 182, at 85,092.

184. Id.

185. Id.

186. Id. at 85,093. The SEC has not defined, however, what such a purpose might be, and it is doubtful that it has the power to do so; see note 187 infra and accompanying text.

187. See Greene, supra note 4, at 507; Note, SEC Rulemaking Authority and the Protection of Investors: A Comment on the Proposed "Going Private" Rules, 51 Ind. L.J. 433, 446 (1976) [hereinafter cited as Protection]; Note, The Developing Law of Corporate Freeze-Outs and Going Private, 7 Loyola U.L.J. 431, 457 (1976). See also Brown, The Scope of the Williams Act and Its 1970 Amendments, 26 Bus. Law. 1637, 1643 (1971).

188. Protection, supra note 187, at 447.

189. Greene, supra note 4, at 507. The latter criticism clearly embraces the view that federal preemption of state corporate common law can only be justified by a "federal statute [which] clearly evidences a congressional interest in leaving a particular issue resolved by federal law." Note, The Developing Law of Corporate Freeze-Outs and Going Private, 7 Loyola U.L.J. 431, 451 (1976). If this is true, any attempts by either the SEC or the federal courts to inject fairness or fiduciary standards into the "going private" arena will be (or have been) extra-legal and congressional action would be clearly called for. But see Fleischer, supra note 3, at 1179, and New Fraud, supra note 2, at 1123, both arguing that the federal courts should be free to supply remedies where, as here, they are clearly needed.

190. Protection, supra note 187, at 451.

191. Id. at 443.

192. Greene, supra note 4, at 499. But see Note, Going Private: An Analysis of Federal and State Remedies, 44 Fordham L. Rev. 796, 801-02 (1976).

years. Similarly, protection of minority shareholder rights and vindication of the fiduciary duty owed them has been a growing federal concern. Since the anti-fraud provisions of section 10(b) and rule 10b-5 are, at present, the sole bases for the expanded federal role, the Second Circuit's reluctance to apply the section and the rule to "going private" transactions challenged solely on their inherent unfairness or on allegations of breach of fiduciary duty has, until recently, relegated dissident minority shareholders to apparently inadequate state remedies. *Green* and *Marshel* have, arguably, created a new federal remedy for "going private" abuses by holding that a breach of fiduciary duty is actionable under rule 10b-5 regardless of compliance with state-sanctioned procedures. Implicit in the decisions is the Second Circuit's recognition of the need for uniform (federal) standards dealing with corporate conduct in an era when corporate entities are rarely confined within a state's borders and opportunities for abuse are prevalent.

Ultimately, the full impact of *Green* and *Marshel* will be determined by the degree to which federal courts borrow from the state courts (and vice versa) in defining and implementing the standards the Second Circuit espoused. As *Green* and *Marshel* imply, the essence of the "going private" problem is the ability of controlling shareholders to take unfair advantage of the minority under the guise of compliance with state law. It is submitted that state courts, by virtue of their vested interest in attracting business to their locale and by their limited geographical jurisdiction, are ill-equipped to afford minority shareholders the protection needed. Perhaps the most valuable contribution of *Green* and *Marshel* is their espousal of minority shareholder protection as an object of overriding federal interest, thereby providing minority shareholders with a federal forum in which to vindicate their rights and with federal standards with which to implement them. This objective will be most difficult to achieve if state law predominates as those standards are developed.

Claudia L. Taft