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THE FIDUCIARY DUTY OF MAJORITY SHAREHOLDERS IN FREEZEOUT MERGERS: A SUGGESTED APPROACH

INTRODUCTION

The power of minority shareholders to protect their interests when faced with an imminent merger has over the years yielded to the economic interests of the majority shareholders. Until state merger statutes were enacted, the common-law rule was that the merger of one corporation into another could be prevented by the vote of a single shareholder of the acquired corporation.[1] A single shareholder, therefore, could not be forced to continue in a changed enterprise. Today, however, it is generally recognized that majority shareholders have valid economic reasons for merging and that the minority shareholders have lost their veto power.[2] In fact, mergers today are "encouraged and favored"[3] as demonstrated by short-form merger statutes which are designed to eliminate "the minority shareholder's interest in the enterprise."[4]

Considerable controversy, however, has surrounded one particular form of merger—the freezeout merger. In a freezeout merger the acquiring company pays cash or debt to the minority shareholders of the acquired company for their equity interest. These mergers are "interested" in that the acquiring company, or sometimes its shareholders, is the majority shareholder of the acquired company. Thus, the acquiring company, which stands on both sides of the transaction, can dictate the terms of the merger agreement and force

1. E. Folk, The Delaware General Corporation Law § 251, at 331 (1972).

2. In addition to the existence of economic justifications for freezeout mergers, *see* pt. I *infra*, the majority shareholder has a fundamental "right to vote his shares in his own interest, including the expectation of personal profit, limited, of course, by any duty he owes to other stockholders." Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121, 1124 (Del. 1977); *accord*, Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 29 Del. Ch. 610, 622, 53 A.2d 441, 447 (Sup. Ct. 1947).

3. MacFarlane v. North Am. Cement Corp., 16 Del. Ch. 172, 178, 157 A. 396, 398 (Ch. 1928); *accord*, Federal United Corp. v. Havender, 24 Del. Ch. 318, 334, 11 A.2d 331, 338 (Sup. Ct. 1940).

4. Stauffer v. Standard Brands, Inc., 41 Del. Ch. 7, 11, 187 A.2d 78, 80 (Sup. Ct. 1962); *see* Comment, *Protection of Minority Shareholders from Freezeouts Through Merger*, 22 Wayne L. Rev. 1421, 1423 (1976).

Short-form merger statutes, which have been enacted in many states, permit the merger of a 90%- or 95%-owned subsidiary with the parent company by the unilateral act of the board of directors of the parent. *See, e.g.*, Del. Code Ann. tit. 8, § 253 (1975 & Supp. 1977) (90% ownership); N.Y. Bus. Corp. Law § 905 (McKinney 1963 & Supp. 1977) (95% ownership). When the percentage of ownership is not sufficient to comply with the short-form merger statute, the merger must comply with the long-form merger statute which allows a merger only when a majority, or in some states two-thirds, of the outstanding stock of both the acquiring and the acquired company vote in favor of the merger. *See, e.g.*, Del. Code Ann. tit. 8, § 251(c) (Supp. 1977) (majority vote required); N.Y. Bus. Corp. Law § 903(a)(2) (McKinney Supp. 1977) (two-thirds vote required).

the minority to receive debt or cash consideration.[5] As a result, the minority shareholders of the acquired company are frozen out of their equity interest, and the acquiring company achieves complete control of the acquired company's assets.[6] The inherent potential for unfairness to the minority due to the coerciveness of such transactions is readily apparent.[7]

In order to balance the competing interests of the majority and minority shareholders in freezeout mergers, some courts have held that complete compliance with the applicable merger statute does not in itself make the action legally valid and have recognized a common-law fiduciary duty owed by majority shareholders to the minority.[8] Two recent Delaware decisions, *Singer v. Magnavox Co.*[9] and *Tanzer v. International General Industries, Inc.*,[10] have attempted to clarify and expand the majority shareholders' fiduciary duty under Delaware corporation law. In both cases, the Supreme Court of Delaware reaffirmed the recently eroded[11] "entire fairness" standard which places upon the majority shareholders standing on both sides of the transaction the burden of proving the merger's fairness to the minority.[12] The court also established a new "valid purpose" test which requires the majority

5. *See* Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 298, 93 A.2d 107, 109-10 (Sup. Ct. 1952); Bastian v. Bourns, Inc., 256 A.2d 680, 681 (Del. Ch. 1969), *aff'd*, 278 A.2d 467 (Del. 1970); David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 430 (Del. Ch. 1968). Because of this characteristic, the freezeout merger has been likened to "a sort of private eminent domain proceeding." Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 Harv. L. Rev. 1189, 1191 (1964) (footnote omitted); *cf.* Federal United Corp. v. Havender, 24 Del. Ch. 318, 334, 11 A.2d 331, 338-39 (Sup. Ct. 1940) (upholding a merger in which a preferred stockholder lost his right to accumulated dividends).

6. *Cf.* Cole v. National Cash Credit Ass'n, 18 Del. Ch. 47, 57, 156 A. 183, 188 (Ch. 1931) (parent-subsidiary merger treated as a sale by the subsidiary of its assets to the parent).

7. Despite this potential for unfairness, some state statutes specifically allow mergers in which cash is given as consideration for the acquired company's stock. *See, e.g.*, Del. Code Ann. tit. 8, § 251(b)(4) (Supp. 1977); N.J. Stat. Ann. § 14A:10-1(2)(c) (West Supp. 1977); N.Y. Bus. Corp. Law § 902(a)(3) (McKinney 1963).

In some situations, a share-for-share merger is the functional equivalent of a freezeout merger. In a share-for-share merger, the shareholders of the acquired corporation receive equity. If the terms of the merger are unfair, a dissenting shareholder's sole remedy is to sell his shares at a judicially appraised price. *See, e.g.*, Cal. Corp. Code § 1300 (West 1977); Conn. Gen. Stat. Ann. § 33-373 (West 1960 & Supp. 1978), *as amended by* 1978 Conn. Pub. Acts No. 78-204, § 3; Del. Code Ann. tit. 8, § 262 (1975 & Supp. 1977); N.Y. Bus. Corp. Law § 623(h) (McKinney 1963); 15 Pa. Cons. Stat. Ann. § 1515(B) (Purdon Supp. 1978). Thus, in either a freezeout merger or an unfair share-for-share merger, a minority shareholder may lose his equity interest. Freezeout mergers, however, are more coercive in nature than share-for-share mergers; in the latter the minority shareholder at least retains the option of continuing as a shareholder.

8. *See, e.g.*, Singer v. Magnavox Co., 380 A.2d 969, 975 (Del. 1977); Berkowitz v. Power/Mate Corp., 135 N.J. Super. 36, 44-45, 342 A.2d 566, 571 (Ch. Div. 1975); *cf.* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) (advancement of annual meeting date in complete compliance with relevant statute held to violate directors' duty to minority shareholders); Brundage v. New Jersey Zinc Co., 48 N.J. 450, 470, 226 A.2d 585, 595-96 (1967) (merger must satisfy requirements of equity and good faith as well as comply with merger statute).

9. 380 A.2d 969 (Del. 1977).

10. 379 A.2d 1121 (Del. 1977).

11. *See* notes 46-53 *infra* and accompanying text.

12. *See* note 64 *infra* and accompanying text.

to prove some economic purpose for the merger.[13] Together, these two standards set forth the fiduciary duty owed to minority shareholders. *Singer* and *Tanzer*, therefore, represent an important development in corporate law because they broaden the needed protection for minority shareholders in freezeout mergers.[14]

The purpose of this Note is to analyze the impact of *Singer* and *Tanzer* on the determination of the fairness of freezeout mergers. Part I will examine the competing interests of minority and majority shareholders in the two general kinds of freezeout mergers—parent-subsidiary mergers and shell corporation mergers. Part II will consider the judicial solution to this problem of conflicting interests as set forth in *Singer* and *Tanzer*. Part III will discuss the future implications of these two decisions and will argue that the valid purpose requirement is confusing and unnecessary because the entire fairness standard, if broadly interpreted, may itself be sufficient to balance adequately the competing interests of majority and minority shareholders in freezeout mergers.

I. Competing Interests of Majority and Minority Shareholders in Freezeout Mergers

A. *Reasons for Parent-Subsidiary Mergers*

A parent-subsidiary merger is a merger between two companies, one of which is the majority shareholder of the other. Through its control of both sides of the transaction, the parent company may force the shareholders of the subsidiary to accept cash for their shares, thereby freezing the minority out of their equity interest.[15] The parent, which effectively controlled the subsidiary prior to the merger, thus acquires complete control over the combined entities.

When complete control replaces stock affiliation, particularly when the parent and subsidiary are engaged in similar business activities, the change may create a synergistic gain—that is, the value of the combined entity may exceed the sum of the values of the parent and subsidiary operated separately.[16] For example, a parent-subsidiary merger may facilitate the parent's long-term debt financing because complete control over the subsidiary's assets enables the parent to pledge those assets as collateral for loans.[17] Synergistic gain also occurs in the form of operating economies achieved through the elimination of duplicative functions or through the creation of tax savings.[18]

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13. *See* note 69 *infra* and accompanying text.

14. Because of the importance of these two Delaware cases, this Note will focus primarily on Delaware law.

15. *See* note 6 *supra* and accompanying text.

16. Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 Harv. L. Rev. 297, 308 (1974) [hereinafter cited as *Fair Shares*]; *see* Grimes v. Donaldson, Lufkin & Jenrette, Inc., 392 F. Supp. 1393, 1402 (N.D. Fla. 1974), *aff'd*, 521 F.2d 812 (5th Cir. 1975) (greater control of subsidiary assets as a result of the parent-subsidiary merger generated savings of more than $300,000 per year).

17. *See* Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121, 1124 (Del. 1977); Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 Yale L.J. 1354, 1375 (1978).

18. *Fair Shares*, *supra* note 16, at 308. One example of such tax savings is the elimination of a double tax whereby the subsidiary is taxed on its profits which in turn are taxed to the parent as

Parent-subsidiary mergers may also eliminate potential conflicts of interest between the two companies. A danger of self-dealing arises when the two companies engage in significant business transactions with each other. The absence of arm's length bargaining may result in transfers of assets that are unfair to the subsidiary. On the other hand, efforts to avoid self-dealing may inhibit otherwise valid transactions between the two companies.[19] Merger of the two companies, however, creates a single corporate entity within which assets can be freely transferred, thereby eliminating any potential self-dealing.

Although synergistic gains and the elimination of self-dealing are valid economic reasons for parent-subsidiary mergers, neither benefit requires cashing out the minority. These benefits will occur whenever the parent company obtains complete control over the subsidiary. Thus, they can be achieved regardless of whether the minority shareholders receive cash or equity.[20] Moreover, in the case of synergistic gains, freezing out the minority yields greater profitability for the majority without giving the minority their corresponding share. The majority, therefore, achieve some of this profitability at the direct expense of the minority shareholders being cashed out. Offering equity rather than cash or debt would avoid this unfairness to the minority.

B. *Reasons for Shell Corporation Mergers*

Shell corporation mergers (also known as pure going private mergers) are accomplished through the use of a shell corporation set up by the majority shareholders of an existing company. The shell corporation conducts no business of its own, and its sole initial purpose is to serve as a vehicle for effectuating a merger. Through their control of both companies, the majority shareholders merge the original company into the shell company under terms that give the minority shareholders of the original company cash for their stock, thereby eliminating their interest.[21] Unlike a parent-subsidiary merger, synergistic gains are not possible in a shell corporation merger because the acquiring company is a shell without any operating business or assets. Therefore, the profitability of a shell corporation merger depends solely upon the elimination of the minority shareholders.

Cashing out the minority enables the majority shareholders to decrease the

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dividends when they are distributed to it as a shareholder. After a parent-subsidiary merger, the second tax on the subsidiary's dividends is eliminated and the parent pays only the single profits tax. I.R.C. § 243, however, renders this tax advantage of parent-subsidiary mergers less significant by allowing a corporation to deduct 85% of the dividends received from its domestic subsidiaries. Therefore, the 15% of the dividends received that is treated as taxable income to the parent would be eliminated from the parent corporation's taxable income by a parent-subsidiary merger. Whether this 15% dividend tax savings represents a significant economic justification for a particular parent-subsidiary merger will depend on the value of the parent's stock in its subsidiary in relation to the value of the parent's other income-producing assets.

19. *See, e.g.*, Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 887 (Del. 1970) (parent avoided dealings with its subsidiary); *cf.* Wolfensohn v. Madison Fund, Inc., 253 A.2d 72 (Del. 1969) (filing of consolidated tax returns by a parent and subsidiary caused suit for self-dealing).

20. *See* Borden, *Some Comments on Singer v. Magnavox*, N.Y.L.J., Oct. 4, 1977, at 5, col. 1.

21. *See, e.g.*, Albright v. Bergendahl, 391 F. Supp. 754 (D. Utah 1974); People v. Concord Fabrics, Inc., 83 Misc. 2d 120, 371 N.Y.S.2d 550 (Sup. Ct.) (mem.), *aff'd*, 50 A.D.2d 787, 377 N.Y.S.2d 84 (1975); Matteson v. Ziebarth, 40 Wash. 2d 286, 242 P.2d 1025 (1952).

total number of shareholders and thereby obtain several advantages. Reduction of the number of shareholders to less than three hundred exempts the company from certain Securities and Exchange Commission (SEC) registration requirements.[22] The corporation would then not have to send proxy statements and annual reports to its shareholders.[23] Additional costs that would be eliminated include auditing and legal fees associated with the filing of monthly, quarterly, and annual reports with the SEC.[24] Costs of annual meetings, transfer agents, and stock certificates could also be reduced when a company decreases the number of its shareholders.[25] The total possible reduction of these costs has been estimated to be in the range of $75,000 to $200,000 per year for an average-sized public company listed on a national exchange before the merger.[26]

Another advantage of the shell corporation merger is that the corporation can delist its stock.[27] This permits the management to conduct business without considering the impact of its business decisions on the market price of the company's stock. This freedom enables a corporation to adopt a policy of long-term speculative capital development rather than short-term earnings growth or large dividend payouts, and to adopt more conservative accounting practices that would lower the corporation's taxes.[28]

Finally, majority shareholders in shell corporation mergers can obtain considerable profits by using stock market fluctuations to eliminate minority shareholders at a low price.[29] This situation arises when a company, which previously went public by issuing stock during a boom market, forces the

22. *See* 15 U.S.C. § 78*l*(g)(4) (1976).

23. This cost reduction has been found to be the biggest advantage of going private. *See* Note, *Going Private,* 84 Yale L.J. 903, 904 (1975) [hereinafter cited as *Going Private*].

24. These reports are required by §§ 13(a) and 15(d) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78m(a)(2), 78o(d) (1976). On the other hand, these savings may be offset by the immediate costs of effectuating a going private merger, including legal, accounting, and brokerage expenses. *See Going Private, supra* note 23, at 907-08.

25. *See* Borden, *Going Private—Old Tort, New Tort or No Tort?,* 49 N.Y.U. L. Rev. 987, 1007 (1974). In a parent-subsidiary merger, whether the parent is publicly or privately held is important in evaluating the economic justifications for the merger, *see id.* at 1018-19, because if the parent is privately held, a merger with its publicly held subsidiary results in these same costs reductions. When the parent is publicly held, however, the costs of disclosure, auditing and legal fees, transfer agents and stock certificates remain and are merely transferred to the parent corporation. *See Fair Shares, supra* note 16, at 308.

26. *Fair Shares, supra* note 16, at 308. Costs of SEC registration and compliance alone have been estimated to be in excess of $100,000 annually for a similarly sized company. *Going Private, supra* note 23, at 907.

27. *See* Securities Exchange Act of 1934 § 12(d), 15 U.S.C. § 78*l*(d) (1976); New York Stock Exchange, Inc., Company Manual § A 16, at A-291 to -292.1 (1978).

28. By contrast, when the number of shareholders in a company is larger, many shareholders will desire short-run profitability for their stock, a factor which in turn influences corporate decisionmaking on the management level. Borden, *supra* note 25, at 1006-07.

29. *See* Berkowitz v. Power/Mate Corp., 135 N.J. Super. 36, 43, 342 A.2d 566, 570 (Ch. Div. 1975); Comment, *Protection of Minority Shareholders from Freezeouts Through Merger,* 22 Wayne L. Rev. 1421, 1432-33 (1976); *Going Private, supra* note 23, at 905-06, 923; Address by A. A. Sommer, Jr., *"Going Private": A Lesson in Corporate Responsibility,* Law Advisory Council Lecture, Notre Dame Law School (Nov. 20, 1974), *reprinted in* [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,010.

minority, at a time when the stock market is depressed, to sell back their shares at a fraction of the original purchase price. Although this type of shell corporation merger may be very profitable for the majority shareholders, commentators do not consider the economic reasons supporting it to be acceptable because the advantages to the majority are achieved at the direct expense of the cashed-out minority.[30] The use of stock market fluctuations to eliminate minority shareholders at depressed prices results in obvious unfairness to the minority because they are forced to sell at a time unilaterally determined by the majority and are unable to wait for a more propitious moment.[31] Because the potential for unfairness to the minority shareholders in such stock-market-manipulating mergers is great, courts, on occasion, have carefully scrutinized the timing of shell corporation mergers in relation to the market price of the acquired company's stock.[32]

If the majority have taken advantage of a depressed stock market, the chances are great that the minority shareholder's basis will exceed the amount realized and that he will incur a capital loss when forced to sell his stock in the merger. Although this ability to take a loss has been considered a benefit to minority shareholders in freezeout mergers,[33] the tax consequences are, in fact, disadvantageous to minority shareholders. The unfairness arises from the fact that the minority shareholders are unable to choose when to realize the loss and may, therefore, be unable to use it at the time of merger.[34] Alternatively, if the stock has appreciated by the time of the merger, the tax consequences will be even more disadvantageous to the minority shareholder who is cashed out, for he will be unable to choose the most advantageous time in which to recognize a taxable gain on the sale.[35]

Given the possibility that both parent-subsidiary and shell corporation freezeout mergers may be unfair to minority shareholders in price offered, in tax consequences, or in their general coercive nature, there is a need for some kind of mechanism to protect the minority's interests. At present, minority shareholders have three options when confronted with an unfair freezeout merger: (1) accept the terms of the merger agreement; (2) seek an appraisal of his shares under the state's appraisal statute;[36] or (3) sue for an injunction,

30. For a list of commentary on this point, see Berkowitz v. Power/Mate Corp., 135 N.J. Super. 36, 43, 342 A.2d 566, 570 (Ch. Div. 1975).

31. This may also be the case in parent-subsidiary mergers. *See* Greene, *Corporate Freeze-out Mergers: A Proposed Analysis*, 28 Stan. L. Rev. 487, 493 (1976).

32. *See* Berkowitz v. Power/Mate Corp., 135 N.J. Super. 36, 48, 342 A.2d 566, 573 (Ch. Div. 1975). *See generally* Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir.), *cert. denied*, 419 U.S. 844 (1974); Albright v. Bergendahl, 391 F. Supp. 754 (D. Utah 1974).

33. *See* David J. Greene & Co. v. Schenley Indus., Inc., 281 A.2d 30, 35 (Del. Ch. 1971).

34. If the minority shareholders had wanted a capital loss, they would have taken it voluntarily by selling their stock on the open market. The fact that the shareholders are being forced out indicates that they had no desire to take the loss at that particular time.

35. The tax itself is not at issue because the minority shareholder (or his donee or devisee) would have to pay the tax eventually. Prior to 1976 the shareholder could have completely avoided capital gains taxes on the appreciation during his lifetime by holding the stock until death, thus giving his beneficiaries a step-up in basis equal to the fair market value of the stock at the time of death. I.R.C. § 1014(a). This tax advantage, however, is no longer possible for shareholders dying after December 31, 1976. I.R.C. §§ 1014(d), 1023(a)(1).

36. An appraisal right is a statutory right that permits shareholders who dissent from certain

damages, or other appropriate remedy.[37] Appraisal statutes are generally considered inadequate because of the delay, expense, and uncertainty of the appraisal process.[38] However, even if an appraisal gives the minority a fair price for their stock,[39] the coercive character of the merger remains.[40] Because freezeout mergers are potentially unfair and the appraisal remedy is frequently inadequate, seeking relief in the courts is usually the only option left open to the minority shareholders for obtaining complete redress.

II. JUDICIAL PROTECTION OF THE MINORITY SHAREHOLDERS

A. *Prior Developments*—Sterling *to* Sante Fe

Protection of minority shareholders in interested mergers originated in *Sterling v. Mayflower Hotel Corp.*[41] In *Sterling*, the Supreme Court of Delaware first enunciated the entire fairness standard for interested mergers of all types, be they freezeout or share-for-share mergers. In that case, a parent company merged with an eighty-five-percent-owned subsidiary and offered one share of the parent's stock for each share of the subsidiary's stock.[42] Although the minority shareholders were unsuccessful in enjoining the merger, the court held that because the parent company and its directors "stand on both sides of the transaction, they bear the burden of establishing [the merger's] entire fairness, and it must pass the test of careful scrutiny by

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corporate actions, including mergers, and who believe the consideration offered is inadequate, to require the corporation to purchase their shares at a court approved appraisal price. *See* Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 Yale L.J. 223, 226 (1962).

37. These remedies are possible only when the applicable appraisal statute is not exclusive. Some state appraisal statutes expressly provide that they are exclusive remedies. *See, e.g.*, Conn. Gen. Stat. Ann. § 33-373(f) (West 1960); Ill. Ann. Stat. ch. 32, §§ 157.70, .73 (Smith-Hurd Supp. 1978); 15 Pa. Cons. Stat. Ann. § 1515(B) (Purdon Supp. 1978). On the other hand, the North Carolina statute expressly states that it is not exclusive. N.C. Gen. Stat. § 55-113 (1975). In the leading states of incorporation, however, the appraisal statutes are silent as to exclusivity. *See, e.g.*, Del. Code Ann. tit. 8, § 262 (1975 & Supp. 1977); N.Y. Bus. Corp. Law § 623(h) (McKinney 1963).

38. Manning, *supra* note 36, at 233; Vorenberg, *supra* note 5, at 1201. If the stock of the acquired company is listed on a national exchange or is widely held, appraisal is sometimes not even available. *E.g.*, Del. Code Ann. tit. 8, § 262(k) (Supp. 1977). Although the company is often forced to pay the cost of the appraisal, counsel, and expert fees, minority shareholders may sometimes be forced to pay all or a portion of these costs. *Compare* N.Y. Bus. Corp. Law § 623 (h)(7) (McKinney 1963) (corporation pays the cost of appraisal unless dissenter's "refusal to accept the corporate offer was arbitrary, vexatious or otherwise not in good faith") *with* Del. Code Ann. tit. 8, § 262(h) (Supp. 1977) (costs may be taxed to either party as court deems equitable). This possibility may further discourage a minority shareholder from demanding an appraisal.

39. Because the appraiser is usually unable to assess the real value of the minority stock, it is often underestimated. Vorenberg, *supra* note 5, at 1202-03.

40. For example, the minority shareholder who dissents may still suffer adverse tax consequences. *See* notes 33-35 *supra* and accompanying text.

41. 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952).

42. Although *Sterling* and other early Delaware decisions that applied the fairness standard to interested mergers were not freezeout mergers, and therefore lacked certain elements usually present in freezeout mergers, the standard and most of the factors involved are equally applicable to freezeout mergers. *See* notes 66-68 *infra* and accompanying text.

the courts."[43] The court did not attempt to define its concept of entire fairness, but it did hold that all relevant circumstances must be considered and that the liquidation value of the minority shares of the acquired corporation is not the sole determining factor.[44]

Subsequent decisions by the Delaware Court of Chancery involving interested mergers left the status of the *Sterling* rule in doubt. In *Bruce v. E. L. Bruce Co.*,[45] the court appeared to undercut the requirements enunciated in *Sterling*, holding that "absent fraud or a showing that the terms of a proposed merger are so unfair as to shock the conscience of the court," an interested merger will not be enjoined.[46] Although *Bruce* appeared to be in direct conflict with the *Sterling* rule, the court in *David J. Greene & Co. v. Dunhill International, Inc.*[47] distinguished it by the fact that the plaintiffs in *Bruce* did not allege intrinsic unfairness as did the plaintiffs in *Sterling*. In *Dunhill*, the court reaffirmed the *Sterling* entire fairness test and granted the minority shareholders a preliminary injunction because the parent company had not met its burden of proving to the court's satisfaction that the transaction was fair.[48]

In *David J. Greene & Co. v. Schenley Industries, Inc.*,[49] the Delaware Court of Chancery again appeared to reverse its position. In that case, involving a parent-subsidiary freezeout merger, the parent company had merged with its eighty-six-percent-owned subsidiary and had given the minority shareholders cash and subordinated debentures for their stock. The court held that the minority shareholders had to prove fraud or blatant overreaching by the parent in order to enjoin the merger because they were contesting only the value placed on their shares by the parent company and had not alleged any self-dealing in the transaction.[50] The court distinguished *Dunhill* as involving more than a dispute as to value because the minority shareholders there had alleged that the parent company had seized a corporate opportunity of its subsidiary prior to the merger in order to depress the value of the subsidiary's stock.[51] Although the *Schenley* court did not expressly define its standards of fraud or blatant overreaching, the factors on which *Dunhill* was distinguished suggest that minority shareholders would have to show self-dealing either by circumstantial evidence of grossly inadequate consideration or by direct evidence of actions by the parent that depressed the value of its subsidiary before the merger.[52]

43. 33 Del. Ch. at 298, 93 A.2d at 110 (citations omitted).
44. *Id.* at 305, 93 A.2d at 113.
45. 40 Del. Ch. 80, 174 A.2d 29 (Ch. 1961).
46. *Id.* at 82, 174 A.2d at 30.
47. 249 A.2d 427, 431 (Del. Ch. 1968).
48. *Id.* at 436.
49. 281 A.2d 30 (Del. Ch. 1971).
50. *Id.* at 35.
51. *Id.* The court found a further distinction in that the combination in *Dunhill* would have caused a drastic reduction of the pro forma earnings of the subsidiary. *Id.* The plaintiffs in *Dunhill*, in addition to claiming that the parent preempted a corporate opportunity of its subsidiary, alleged that the parent company, through its stock control, had forced the subsidiary to pay inadequate dividends before the merger, thereby depressing the price of the subsidiary's stock. 249 A.2d at 429-30.
52. An example of this type of self-dealing occurs when a parent, prior to the merger, causes

Schenley, therefore, created an exception to the *Sterling* rule of entire fairness when the minority allege only unfairness of price without showing any self-dealing. This exception appears unsound because minority shareholders often cannot allege more than unfairness of price since they lack the necessary financial information concerning the parent's or subsidiary's activities before and after the merger.[53] Thus, the exception virtually engulfed the rule. *Schenley,* therefore, along with *Bruce,* afforded little protection to minority shareholders in interested mergers.

In addition, minority shareholders have had great difficulty in receiving the needed protection under federal law. The Supreme Court in *Sante Fe Industries, Inc. v. Green,*[54] held that, even if the majority shareholders had breached their fiduciary duty under state law, a merger does not involve deception or manipulation within the strictures of rule 10b-5[55] merely because the minority shareholders are cashed out without a legitimate business purpose.[56] The Court therefore left protection of minority shareholders to the state courts.[57]

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an unfair distribution of tax benefits between itself and its subsidiary such that the value of the subsidiary is depressed. *See, e.g.,* Meyerson v. El Paso Natural Gas Co., 246 A.2d 789 (Del. Ch. 1967); Case v. New York Cent. R.R., 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965).

53. Not only does the exception restrict the protection for minority shareholders in interested mergers, but it is also unsound because the burden of proof should be upon the party who has easier access to information. One commentator has suggested that in order to enable minority shareholders to judge whether they have been dealt with fairly in a freezeout merger, a company which goes public should be required to covenant that, in the event it subsequently goes private, financial statements covering a one-year period after the freezeout will be available to former shareholders. *See* Borden, *supra* note 25, at 1030. Although the commentator was considering only shell corporation mergers, a similar procedure might apply to parent-subsidiary mergers.

54. 430 U.S. 462 (1977) (parent-subsidiary merger).

55. 17 C.F.R. § 240.10b-5 (1977).

56. 430 U.S. at 474. The Court said that to hold otherwise "would be to bring within the Rule a wide variety of corporate conduct traditionally left to state regulation. . . . [T]his . . . would overlap and quite possibly interfere with state corporate law." *Id.* at 478-79. The Court followed its earlier language to the effect that unless "federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation." Cort v. Ash, 422 U.S. 66, 84 (1975) (implied right of action does not exist under 18 U.S.C. § 610 (1970 & Supp. III 1973) (current version at 2 U.S.C. § 441b (1976)), which prohibits corporations from making contributions in connection with federal elections). The lower court in *Santa Fe* had given protection to minority shareholders by construing rule 10b-5, 17 C.F.R. § 240.10b-5 (1977), to include cashing out minority interests without a legitimate business purpose. Green v. Santa Fe Indus., Inc., 533 F.2d 1283 (2d Cir. 1976), *rev'd,* 430 U.S. 462 (1977); *accord,* Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir.), *vacated and remanded,* 429 U.S. 881 (1976). *See generally* Note, *Federal "Going Private" Standards: A New Direction for the Second Circuit?* 45 Fordham L. Rev. 427, 437-42 (1976).

57. The SEC, however, has recently proposed a new rule, SEC Release No. 33-5884 (Nov. 17, 1977), *reprinted in* [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,366, which would require the majority shareholders or the parent company that force a freezeout merger upon the minority to disclose in advance of the merger the terms of the transaction, the source and amount of funds used, and the method used by the parent to determine the consideration to be given to minority shareholders. *Id.* at 88,751-53. The rule would also require that the transaction be substantively fair as determined by such factors as the percentage of disinterested shareholders and directors who approved the merger, the current and historical market prices of

B. *The Delaware Response in* Singer *and* Tanzer

The Supreme Court of Delaware, recognizing the need for state protection of minority shareholders in freezeout mergers, reacted to *Sante Fe* in two recent decisions, *Singer v. Magnavox Co.*[58] and *Tanzer v. International General Industries, Inc.*[59] In *Singer,* the court held that elimination of minority shareholders without a valid business purpose was a violation of the majority shareholders' fiduciary duty to the minority. In that case, T.M.C. Development Corp. had merged with its eighty-four-percent-owned subsidiary, Magnavox Co., in compliance with Delaware's long-form merger statute.[60] The minority shareholders of Magnavox were offered $9.00 per share under the merger agreement. Plaintiff, one of the minority shareholders, sought an order nullifying the merger and granting compensatory damages.[61] The lower court dismissed the action, deciding that plaintiff's sole remedy was to seek appraisal under Delaware's appraisal statute.[62] The supreme court reversed and held that the plaintiff had stated a cause of action when he alleged that the merger had been effectuated for the sole purpose of freezing out the minority shareholders.[63] The court thus reaffirmed the entire fairness standard which had been established twenty-five years earlier in *Sterling v. Mayflower Hotel Corp.*[64] The fairness standard places upon the "majority stockholder standing on both sides of the merger transaction . . . 'the burden of establishing its entire fairness' to the minority shareholders, sufficiently to 'pass the test of careful scrutiny by the courts.' "[65] Although *Sterling* involved an interested share-for-share merger while *Singer* involved an interested freezeout merger, the fairness standard is even more appropriately applied to freezeout mergers because, in addition to the potential for self-dealing involved,[66] freezeout

the stock, the book value and going concern value of the acquired company, and the likely tax consequences of the merger. *Id.* at 88,752.

The SEC has attempted to circumvent *Sante Fe* by promulgating the new rule under § 13(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78m(e) (1976), rather than § 10(b), 15 U.S.C. § 78j(b) (1976). The SEC chose § 13(e) because it uses the broader term "fraudulent" practices, whereas § 10(b) refers only to "manipulative or deceptive" practices. The use of this distinction to federalize substantive law on freezeout transactions has been criticized. *See* Fogg, *SEC Seeks Federal Role Despite Sante Fe Ruling,* N.Y.L.J., Dec. 19, 1977, at 44, col. 1. Whether the rule will be adopted will probably depend upon the degree to which states increase and define their protection for minority shareholders in the near future.

58. 380 A.2d 969 (Del. 1977).

59. 379 A.2d 1121 (Del. 1977).

60. Del. Code Ann. tit. 8, § 251 (1975). The long-form merger statute requires approval by the board of directors of each company and by those shareholders of each company who represent a majority of the outstanding stock. *Id.*

61. 380 A.2d at 972.

62. Singer v. Magnavox Co., 367 A.2d 1349, 1362 (Del. Ch. 1976).

63. 380 A.2d at 980.

64. 33 Del. Ch. 293, 298, 93 A.2d 107, 109-10 (Sup. Ct. 1952), *discussed at* notes 41-44 *supra* and accompanying text.

65. Singer v. Magnavox Co., 380 A.2d at 976 (quoting Sterling v. Mayflower Hotel Corp., 33 Del. Ch. at 298, 93 A.2d at 109-10).

66. In *Singer,* for example, although the court did not discuss the issue, there was evidence of self-dealing by the parent company. The directors of the subsidiary had initially voted to oppose the merger on the ground of inadequacy of price, but withdrew their opposition after they were offered two-year employment contracts by the parent company. *Id.* at 971.

mergers may lead to adverse tax consequences for the minority shareholders.[67] Furthermore, they constitute a method whereby the parent company can force the minority shareholders to sell their shares when the stock market is depressed.[68]

To ensure that elimination of the minority shareholders was not the sole purpose, the *Singer* court created a requirement of a valid business purpose for long-form freezeout mergers.[69] The court gave no clue, however, as to what would constitute a valid business purpose and even warned that an inquiry into such a requirement might result in confusion.[70] It expressly left open whether the business purpose accomplished by the merger could be that of the subsidiary rather than that of the parent.[71]

One month after the *Singer* decision, the Supreme Court of Delaware answered this question in *Tanzer v. International General Industries, Inc.*[72] The court held that the requirement is satisfied when the merger is effected solely to advance the business purpose of the parent corporation.[73] The court also substituted the words "bona fide purpose" for the "business purpose" language used in *Singer*.[74] The effect of this change in language is undetermined at present. It is clear, however, that, by allowing mergers that benefit only the parent corporation, the court in *Tanzer* broadened the permissiveness of the purpose requirement enunciated in *Singer*. The only reason for the merger in *Tanzer* was to facilitate the parent's long-term debt financing, a purpose which the court held to be valid.[75]

Although neither *Singer* nor *Tanzer* dealt directly with the *Schenley* exception,[76] the court's affirmation of the *Sterling* entire fairness standard would seem to indicate that the Supreme Court of Delaware has rejected the exception. The lower court in *Singer* followed the *Schenley* exception by holding that the minority shareholders must allege fraud or blatant overreach-

67. *See* notes 33-35 *supra* and accompanying text.

68. *See* notes 29-32 *supra* and accompanying text.

69. 380 A.2d at 978-80. The court first stated that complete compliance with the merger statute did not necessarily make the merger valid, *id.* at 975, and that the appraisal remedy is not exclusive in Delaware, *id.* at 977. This holding creates the possibility of injunction which in turn gives the minority shareholders greater bargaining power against the majority than they had with the appraisal remedy. In addition, while the appraisal remedy allows the courts to consider only the adequacy of the consideration offered to the minority, a fairness standard takes into account additional relevant factors such as the economic necessity of the merger, any evidence of self-dealing by the majority, and any adverse tax consequences to the minority.

70. *Id.* at 976.

71. "Plaintiffs contend that a 'business purpose' is proper in a merger only when it serves the interests of the subsidiary corporation; defendants contend, on the other hand, that if any [business] purpose is relevant, it is only that of the parent corporation. . . . [W]e leave [this question] to another day." *Id.* at 980 n.11.

72. 379 A.2d 1121 (Del. 1977). *Tanzer*, like *Singer*, involved a long-form freezeout merger in which the parent corporation owned eighty-one percent of its subsidiary's stock before merging.

73. *Id.* at 1123.

74. *Id.* at 1124-25.

75. *Id.* at 1124; *see* note 17 *supra*.

76. When the minority shareholders complain only that the consideration offered in an interested merger is inadequate, the *Schenley* exception provides that the appraisal remedy is adequate and exclusive. *See* notes 49-52 *supra* and accompanying text.

ing in order to state a cause of action.[77] Although this language of the lower court indicates its findings that the *Schenley* exception was completely applicable to the merger in *Singer,* the supreme court refused to apply it. Instead, the court distinguished the facts of *Schenley* on the ground that *Schenley* did not involve a freezeout merger because the minority were offered debt and cash rather than cash alone.[78] This was a mischaracterization, however, because debt does not represent a permanent voting interest in the combined entity, as does stock.[79] Thus, in both *Singer* and *Schenley* the minority shareholders were frozen out of their equity interest. Therefore, the broad fiduciary duty imposed on majority shareholders by *Singer* should apply with equal force to the *Schenley* facts.

In short, *Singer* and *Tanzer* have affected freezeout mergers in two ways. First, they reaffirmed the entire fairness standard which had been eroded since its enunciation in *Sterling.*[80] Second, they established a new valid purpose requirement for long-form freezeout mergers.[81] These two cases thus represent a restriction on the use of the merger statute to eliminate minority shareholders. Although both *Singer* and *Tanzer* arose out of long-form freezeout mergers, lower court cases have applied the purpose requirement and the entire fairness standard to short-form freezeout mergers as well.[82] This development is clearly warranted once it is recognized that the unfairness to the minority shareholders is just as great when the majority own ninety percent of the stock (the minimum required under Delaware's short-form merger statute) as when they own eighty percent of the stock.[83]

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77. "[The plaintiffs were seeking] to set aside the merger as being fraudulent because the cash price per share to be paid to minority shareholders was inadequate.

"When this is the basis for objection to a corporate merger, it is established law that the remedy of the dissatisfied shareholders is to seek an appraisal of the value of their shares pursuant to the procedures set forth under the appraisal statute." Singer v. Magnavox Co., 367 A.2d 1349, 1362 (Del. Ch. 1976).

78. 380 A.2d at 979.

79. Professors Brudney and Chirelstein define freezeouts to include mergers in which minority shareholders receive debt. Brudney & Chirelstein, *supra* note 17 at 1357.

80. *See* notes 45-53 *supra* and accompanying text.

81. The valid purpose requirement is not to be confused with the business judgment rule for which the defendants had argued unsuccessfully in *Tanzer. See* 379 A.2d at 1124. The business judgment rule requires a showing of gross and palpable overreaching on the part of the management in order to overturn a business decision. Thus, in Delaware it has been applied only when a disinterested third party sets the terms of the transaction. *See* Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Del. 1970).

82. *See* Najjar v. Roland Int'l Corp., 387 A.2d 709 (Del. Ch. 1978) (denial of motion to dismiss because complaint alleged that sole purpose of short-form freezeout merger was elimination of minority interests); Kemp v. Angel, 381 A.2d 241 (Del. Ch. 1977) (preliminary injunction granted against proposed short-form freezeout merger).

83. *See* Kemp v. Angel, 381 A.2d 241 (Del. Ch. 1977). In *Kemp,* the court said that it "fail[ed] to see how a determination as to whether or not the duty now imposed on a majority stockholder in a merger based on [the short-form merger statute] has been properly carried out requires any less scrutiny by the Trial Court than that called for in a case in which the rights of minority stockholders have been allegedly diminished by a merger based on [the long-form merger statute]." *Id.* at 244.

The court in *Singer,* however, did not seem to recognize this point. In an earlier decision,

III. Further Implications

A. *The Entire Fairness Standard*

Although *Singer* and *Tanzer* reaffirmed the entire fairness standard, neither decision clearly established the factors to be used in determining the fairness of a particular merger. Therefore, further analysis of the standard is warranted.

At the outset, it should be noted that the entire fairness standard only applies to "interested" mergers, like shell corporation and parent-subsidiary mergers, in which the majority shareholders stand on both sides of the transaction.[84] In contrast, when a merger is accomplished between two unrelated companies dealing at arm's length, the standard for judicial disapproval is fraud or the equivalent thereof[85] because "[i]n the absence of divided interests, the judgment of the majority stockholders and/or the board of directors . . . is presumed made in good faith and inspired by bona fides of purpose."[86] On the other hand, when the majority shareholders stand on both sides of a transaction and control its terms, the potential for unfairness is greater,[87] and the presumption of bona fides of purpose no longer exists.[88]

Adequacy of consideration paid for the minority's shares—the primary concern of courts applying the entire fairness standard prior to *Singer* and *Tanzer*[89]—will probably continue to be a central criterion. The rationale underlying a court's examination of the adequacy of consideration was to ensure that minority shareholders in an interested merger would receive the same consideration for their shares as they would have received had they been dealing at arm's length. To determine adequacy of consideration courts considered the fair market price of the stocks involved, particularly when traded in an open market,[90] the value of each company as a going concern,[91]

Stauffer v. Standard Brands, Inc., 41 Del. Ch. 7, 187 A.2d 78 (Sup. Ct. 1962), the court had held that the appraisal remedy was exclusive for short-form freezeout mergers absent a showing of actual fraud. Instead of overruling the decision, the court in *Singer* simply said that "[a]ny statement in *Stauffer* inconsistent herewith is held inapplicable to a [long-form] merger." 380 A.2d at 980. This statement seems to imply that the court was distinguishing between long-form and short-form freezeout mergers.

84. Bastian v. Bourns, Inc., 256 A.2d 680, 682 (Del. Ch. 1969), *aff'd*, 278 A.2d 467 (Del. 1970). *See generally* Keenan v. Eshleman, 23 Del. Ch. 234, 243-44, 2 A.2d 904, 908 (Sup. Ct. 1938).

85. Cole v. National Credit Ass'n, 18 Del. Ch. 47, 156 A. 183 (Ch. 1931).

86. David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 430 (Del. Ch. 1968).

87. The reason for this is that the majority can unilaterally set the terms of the merger agreement. *See* notes 6, 15, 21 *supra* and accompanying text.

88. David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 430-31 (Del. Ch. 1968) (dictum).

89. *See, e.g.*, Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952); David J. Greene & Co. v. Schenley Indus., Inc., 281 A.2d 30 (Del. Ch. 1971).

90. *See* David J. Greene & Co. v. Schenley Indus., Inc., 281 A.2d 30, 34 (Del. Ch. 1971). *See generally* Mills v. Electric Auto-Lite Co., 552 F.2d 1239 (7th Cir.), *cert. denied*, 434 U.S. 922 (1977).

91. *See* Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 20, 28, 89 A.2d 862, 867 (Ch.), *aff'd*, 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952).

past earnings and dividend records,[92] and the liquidity value of the minority's stock.[93]

Even though the adequacy of consideration factor of the entire fairness standard was developed in the share-for-share interested merger context, it is equally applicable to freezeout mergers.[94] The *Tanzer* court, however, in applying the entire fairness standard to a freezeout merger, stated that all features of the transaction, rather than just adequacy of consideration, are relevant.[95] This extension appears sound in light of the coerciveness of freezeout mergers that is absent in share-for-share interested mergers.[96] Courts can only identify this coerciveness and determine the entire fairness of the merger by reviewing such nonprice factors as the timing of the merger in relation to the general condition of the stock market, any evidence of self-dealing, and the tax consequences to the minority shareholders.[97] On the other hand, economic justifications for freezeout mergers may outweigh the unfairness and thus should also enter into the court's determination.

The entire fairness standard, therefore, calls for a broad balancing test in which the above nonprice factors, the adequacy of consideration, and the economic justifications for the merger are considered.[98] In light of the unique and varied situations in which freezeout mergers arise, a broad balancing test would enable courts to consider the fairness of each merger individually without declaring all freezeout mergers per se unfair. The entire fairness standard as such is indeterminate, but necessarily so, because the competing interests vary with each particular freezeout merger.[99]

In contrast to this suggestion of a broad balancing test for all types of

92. *See* David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 433 (Del. Ch. 1968); *cf.* Francis I. duPont & Co. v. Universal City Studios, Inc., 312 A.2d 344, 348 (Del. Ch. 1973), *aff'd*, 334 A.2d 216 (Del. 1975) (appraisal must be based upon historical rather than prospective earnings).

93. Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 305, 93 A.2d 107, 113 (Sup. Ct. 1952); *cf.* Del. Code Ann. tit. 8, § 262(h) (Supp. 1977) (liquidity value—the amount a shareholder would receive if the company is liquidated and its assets sold—is one factor, but not the sole factor, in appraising dissenting shareholders' stock).

94. *See* notes 66-68 *supra* and accompanying text.

95. 379 A.2d at 1125.

96. *See* note 7 *supra* and accompanying text.

97. *See* notes 29-35 *supra* and accompanying text.

98. Ratification of the merger by a majority of the disinterested shareholders is another factor which might be considered in determining fairness. Of course, shareholder ratification is not always an accurate determinant in light of the management's control over the proxy machinery. *See Fair Shares, supra* note 16, at 300. In addition, the minority shareholders are usually unable to influence the terms of the merger agreement and are therefore left with either accepting or rejecting the merger. Thus, a vote to accept is not necessarily an indication of the minority's complete satisfaction with the terms of the merger agreement. *Id.* At present, the effect of disinterested shareholder ratification is still unclear in Delaware. *Compare* Bastian v. Bourns, Inc., 256 A.2d 680, 682 (Del. Ch. 1969), *aff'd*, 278 A.2d 467 (Del. 1970) *with* David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 432 (Del. Ch. 1968).

99. Similarly, the standard of loyalty that people who control corporate property owe to the shareholders is "measured by no fixed scale." Guth v. Loft, Inc., 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (Sup. Ct. 1939). The proposed SEC rule also appears to require a balancing approach; it enumerates the factors to be considered but provides no definite standard for determining fairness. *See* note 57 *supra*.

freezeout mergers, Professors Brudney and Chirelstein propose in a recent article that freezeout mergers be classified into three categories with different standards of fairness applying to each.[100] They classify freezeout mergers as follows: shell corporation or going private mergers,[101] two-step mergers in which an unrelated acquiring corporation first gains stock control in the acquired corporation through a tender offer and then eliminates the remaining stockholders by way of a freezeout merger,[102] and mergers between long-held affiliates.[103] Brudney and Chirelstein conclude that shell corporation mergers should always be prohibited, and that two-step mergers should always be allowed. Only in the case of mergers between long-held affiliates should a balancing test be applied whereby the common-law fiduciary duty of the majority is measured by the fairness standard.[104]

Their conclusion that two-step mergers are per se lawful is based on the theory that these mergers are equivalent to ordinary asset acquisitions by unrelated companies.[105] This analogy is inaccurate in several respects. First, in an ordinary asset acquisition, the minority shareholders of the selling company retain their equity interest after the transaction. Second, unlike an ordinary asset acquisition, freezeout mergers are interested transactions in which the acquiring company is able to set unilaterally the terms of the merger agreement. The potential for self-dealing which this creates is absent in ordinary asset acquisitions because the transacting companies are by definition unrelated. To prevent such self-dealing, Brudney and Chirelstein suggest that the price paid in the merger to the minority shareholders be the same as the price offered on the initial tender.[106] They claim that this will ensure a fair price for the minority shareholders being cashed out. This solution to the self-dealing problem is inadequate, however, for it assumes that the cash price offered on the initial tender will represent a fair price from which to measure the fairness of the consideration offered in the subsequent freezeout merger. Tender offers themselves, however, are coercive and often do not represent an accurate measure of true stock value. The fact that the shareholders are dispersed, uninformed, and often concerned about the possibility of later being cashed out causes the tender offer price to be lower than true stock value.[107] Although Brudney and Chirelstein recognize this problem, they offer no solution and, as a result, the potential for self-dealing remains. The third problem with the analogy is that it ignores the adverse tax consequences to the minority shareholders who are forced to receive cash and to recognize taxable gain or loss on the transaction.[108] These tax consequences

100. Brudney & Chirelstein, *supra* note 17, at 1354.

101. *Id.* at 1365.

102. *Id.* at 1359.

103. *Id.* at 1370.

104. *Id.* at 1359.

105. *Id.* at 1360.

106. *Id.* at 1361.

107. *See* Nathan & Maloney, *State Tender Offer Statutes: An Analysis of the Practical and Policy Considerations,* 23 N.Y.L. Sch. L. Rev. 647, 679 (1978). Brudney and Chirelstein also liken the initial tender to a conventional majority vote of the shareholders. Brudney & Chirelstein, *supra* note 17, at 1360. The coerciveness and unfairness of the initial tender, as described above, shows the inaccuracy of this analogy.

108. *See* notes 33-35 *supra* and accompanying text.

are absent in ordinary asset acquisitions in which the shareholders of the transacting companies retain their equity interests. Because two-step and long-held-affiliate mergers present, for common reasons, equal potential for unfairness, it is suggested that the fairness standard be applied to both. For this same reason, both types of mergers are discussed here under the single rubric of parent-subsidiary mergers.

Although both *Singer* and *Tanzer* involved parent-subsidiary mergers, the principles enunciated therein are equally applicable to shell corporation mergers. In fact, *Singer*'s and *Tanzer*'s disapproval of a merger, the sole purpose of which is the elimination of minority shareholders, would appear to invalidate all shell corporation mergers because, in one sense, their only purpose is the elimination of minority shareholders. Brudney and Chirelstein also argue for a per se rule invalidating all shell corporation mergers.[109] This rule is not justified, however, because shell corporation mergers may in some cases have valid economic justifications.[110] Consider, for example, a public company of 300 shareholders, one of whom owns a one-third interest in the company and is uncooperative in solving the company's problems. Although the company may be in serious financial trouble, the recalcitrant shareholder is able to block any solutions with the vote of his one-third interest. By freezing him out of the company, the other 299 shareholders would be able to eliminate not only the problems which he creates for the company but also the costs of SEC disclosures.[111] Therefore, rather than making rigid distinctions between shell corporation and parent-subsidiary mergers, it is more appropriate to recognize various merger purposes, which may or may not outweigh the accompanying unfairness. Thus, the balancing approach of the entire fairness standard seems to provide a workable test for court approval of all classes of freezeout mergers and at the same time avoids the mechanical approach of Brudney and Chirelstein's per se rule.

B. *The Valid Purpose Requirement*

In addition to the fiduciary duty to be fair to minority shareholders when freezing them out, *Singer* and *Tanzer* held that this duty would not be met if the majority did not have some valid purpose for the freezeout merger. Because the court did not fully explain the new purpose requirement, its scope and future implications are still uncertain. Moreover, the requirement at present suffers from two weaknesses. First, the precedent upon which the court relied does not provide substantial support for establishing the requirement. Second, the requirement adds little to the fairness standard and only confuses the real issue in freezeout mergers—whether their economic justifications outweigh the unfairness to the minority shareholders.

In adding the business purpose requirement to the entire fairness standard, the *Singer* court relied primarily on *Guth v. Loft, Inc.*[112] The *Singer* court borrowed language from the *Guth* opinion describing the fiduciary duty owed by directors[113] and applied this same duty to the majority shareholders in the

109. Brudney & Chirelstein, *supra* note 17, at 1359.
110. *See* notes 21-28 *supra* and accompanying text.
111. *See* notes 22-23 *supra* and accompanying text.
112. 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939).
113. The court in *Singer* borrowed the following language from *Guth:* "While technically not

freezeout context.[114] The requirement that the majority shareholders meet the same standards of loyalty and care as directors is based on the reasoning that, by assuming control of the corporation in voting for the merger, the shareholders are in effect taking the position of directors in forming corporate policy.[115] This analogy is not completely applicable to freezeout mergers. Although the director is never permitted to injure the corporation to which he owes his duty, the majority shareholders should in some situations be relieved of their duty not to injure the minority when their actions actually benefit the corporation.[116] The synergistic gain discussed above is a specific example of such a benefit. This element of corporate benefit is in direct contrast to *Guth*, in which a president had acquired a corporate opportunity using corporate funds—a clear example of injury to the company. Thus, the action by a director which works harm to the corporation is not directly analogous to mergers, which are "encouraged and favored" for the benefits they confer upon the corporations involved.[117]

The *Singer* court found an additional precedent for the business purpose rule in a statement in *Bennett v. Breuil Petroleum Corp.*,[118] that "action by majority stockholders having as its primary purpose the 'freezing out' of a minority interest is actionable without regard to the fairness of the price."[119] This statement was taken out of context, however, because *Bennett* did not involve a freezeout. Instead, the plaintiff, a minority shareholder, complained that the majority shareholders had issued new stock for an inadequate price and that his interest in the company would be diluted if he did not buy a pro rata share of the issuance.[120] Moreover, the court in *Bennett* did not rest its

trustees, [corporate directors] stand in a fiduciary relation to the corporation and its stockholders. A public policy . . . has established a rule that demands of a corporate officer or director . . . the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it . . . ." *Id.* at 270, 5 A.2d at 510; *see* Pepper v. Litton, 308 U.S. 295, 311 (1939).

114. "[T]he spirit of the definition [of the directors' fiduciary duty to the shareholders] is equally applicable to a majority stockholder in any context in which the law imposes a fiduciary duty on that stockholder for the benefit of minority stockholders." Singer v. Magnavox Co., 380 A.2d at 977; *accord,* Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947) (majority's redemption of minority's shares at a low price prior to liquidation of the company was a breach of the majority shareholders' fiduciary duty).

115. *See* Lebold v. Inland Steel Co., 125 F.2d 369, 372 (7th Cir. 1941), *cert. denied,* 316 U.S. 675 (1942) (vote of every director and every majority shareholder must be cast in favor of the corporation's interests). *See generally* Allied Chem. & Dye Corp. v. Steel & Tube Co., 14 Del. Ch. 1, 120 A. 486 (Ch. 1923).

116. Again, using a broad balancing test rather than a per se rule would bring situations like this to light.

117. MacFarlane v. North Am. Cement Corp., 16 Del. Ch. 172, 178, 157 A. 396, 398 (Ch. 1928).

118. 34 Del. Ch. 6, 99 A.2d 236 (Ch. 1953).

119. 380 A.2d at 979 (quoting Bennett v. Breuil Petroleum Corp., 34 Del. Ch. at 12, 99 A.2d at 239).

120. *Bennett,* therefore, involved the right not to purchase as opposed to the right not to sell in freezeout mergers: "[P]laintiff has the right not to purchase as well as the right to purchase. But his right not to purchase is seriously impaired if the stock is worth substantially more than its

decision on the language quoted by *Singer*, but rather it required the minority shareholder to prove constructive fraud, a standard significantly different from a valid purpose requirement.[121] Therefore, the above language from *Bennett* should not be applied to freezeout mergers and, in any event, does not appear to justify the valid purpose requirement enunciated in *Singer*.

In addition to the weakness of precedent for the valid purpose test, the test itself is unsatisfactory because it is confusing and adds little to the fairness standard. Although *Tanzer* attempted to answer the question of whose purpose by stating that a valid purpose would include one that directly benefits only the parent company,[122] it left unclear whether a valid economic purpose on the shareholder level, rather than the corporate level, would satisfy the requirement. Ironically, the *Singer* court, which established the test, recognized this confusion when it said: "Any inquiry into the business purpose of a merger immediately leads to such questions as: 'Whose purpose?' or 'Whose business?' "[123] In general, a distinction between a corporate purpose and a shareholder purpose for freezeout mergers makes little sense because in either case a valid economic reason for the merger may exist. A conflict of interest between shareholders in a close corporation offers one example of a bona fide shareholder purpose. If a minority shareholder in that corporation proved to be uncooperative, thereby creating a risk of deadlock, the other shareholders would have a valid economic reason to freeze him out by way of a shell corporation merger.[124] If the valid purpose requirement enunciated in *Singer* and *Tanzer* prevented such a merger because the purpose originates on the shareholder level,[125] the result would be unjust and arbitrary.

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issuing price." 34 Del. Ch. at 14, 99 A.2d at 240. This represents a further distinction between *Singer* and *Bennett* in that the right not to purchase gives the shareholder the right to refrain from doing something that would work hardship to him if he were financially unable to exercise the right. The right not to sell, on the other hand, protects a right which is independent of the shareholder's financial status because he can always sell his shares without substantial economic harm.

121. Although constructive fraud is a vague gauge of fiduciary obligation, it apparently requires some kind of bad faith on the part of the majority. *See id.* at 13-14, 99 A.2d at 240.

122. 379 A.2d at 1125.

123. 380 A.2d at 976. The same confusion occurs in corporate tax law where the business purpose test is applied to corporate reorganizations. *See* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders § 14.51 (3d ed. 1971). *Compare* Gregory v. Helvering, 293 U.S. 465 (1935) *with* Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir.), *cert. denied*, 419 U.S. 844 (1974).

124. This example is based on the facts of Matteson v. Ziebarth, 40 Wash. 2d 286, 242 P.2d 1025 (1952), in which a minority shareholder tried to block a proposed sale of the corporation's stock that was economically beneficial to the company and its stockholders. The majority eliminated him by way of a shell corporation freezeout merger. When the minority shareholder sued to enjoin the merger, the court upheld the merger on the ground that the appraisal statute, absent proof of actual fraud on the part of the majority, was exclusive. The holding has been interpreted, however, as being based on a valid business purpose in the elimination of a troublemaking shareholder, rather than on the exclusive nature of the appraisal statute. Vorenberg, *supra* note 5, at 1196.

125. One commentator has suggested that mergers should be prohibited if their purposes originate on the shareholder level. *See* Borden, *Some Comments on Singer v. Magnavox*, N.Y.L.J., Oct. 4, 1977, at 3, col. 2. Although *Tanzer* affirmed *Singer*'s purpose requirement, the

An additional problem with the valid purpose requirement is its tendency to direct a court's attention solely to the purpose of a merger and away from the majority's purpose for paying cash rather than stock to the minority shareholders.[126] Thus, courts may fail to recognize an unfair merger in which corporate planners fabricate nonexistent purposes to disguise the fact that their sole motivation is the elimination of the minority shareholders.[127] The entire fairness standard, however, promotes a broader analysis of all aspects of the merger and prevents overemphasis on the business purposes suggested by the majority shareholders.[128]

CONCLUSION

Singer and *Tanzer* are significant because they increase the needed state protection for minority shareholders in freezeout mergers. Although they establish both the entire fairness and the valid purpose tests, the latter is confusing and unnecessary and should be abolished.[129] It is more appropriate to make the merger's purpose just one of the factors to be considered in determining the entire fairness of the merger. Unfortunately, the Supreme Court of Delaware has not clarified the entire fairness standard by enumerating the relevant factors to be considered and thus has left Delaware law governing freezeout mergers in a state of ambiguity. If a broad balancing test is adopted, which enables courts to weigh both the economic justifications and the potential unfairness of freezeout mergers on a case-by-case basis, the Delaware decisions in *Singer* and *Tanzer* will have started an important trend toward adequate state protection for minority shareholders in these mergers.

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court altered its language on the ground that a "business purpose" test was ambiguous and stated a result rather than a right or duty. 379 A.2d at 1123. The court therefore used the term "bona fide purpose" instead of "business purpose." *Id.* at 1124. Although the Supreme Court of Delaware offered no explanation, it is possible that when it modified the "business purpose" language to "bona fide purpose" in *Tanzer,* it was indicating that the purpose can also occur on the shareholder level.

126. Although a merger may have an economic justification, this does not mean that payment of cash rather than stock is justified. *See* note 20 *supra* and accompanying text.

127. *See* Folk, *Holdings by State Court Grounded in Prior Law,* N.Y.L.J., Dec. 19, 1977, at 41, col. 3.

128. The bona fide purpose requirement of *Tanzer* could therefore be encompassed within the fairness standard. This approach was advocated by a concurring opinion in *Singer*: "To determine whether that burden has been met under *Sterling,* I think the Court must scrutinize the business purpose, or economic necessity, desirability and feasibility involved, evidence of self-serving, manipulation, or overreaching, and all other relevant factors of intrinsic fairness or unfairness. Upon finding a breach of the fiduciary duty owed, the Court must then grant such relief as the circumstances require, by injunction, appraisal, damages, or other available equitable relief . . . ." 380 A.2d at 982 (McNeilly, J., concurring).

129. A further reason for abolishing the business purpose test is that it creates the anomalous situation of prohibiting mergers designed solely to eliminate the minority when it is recognized that shareholders no longer have a vested right to continued participation in the company. *See* note 2 *supra* and accompanying text.