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RULE 13e-3 AND THE GOING PRIVATE DILEMMA: THE SEC'S QUEST FOR A SUBSTANTIVE FAIRNESS DOCTRINE

The act of a public corporation "going private"¹ often evokes a question of fairness and fiduciary responsibility² to minority shareholders. In response to the marked increase in going private transactions the Securities and Exchange Commission (SEC) recently promulgated rule 13e-3³ and related Schedule 13e-3⁴ to prevent fraudulent or unfair transactions on the part of majority shareholders in their dealings with minority shareholders.

Although rule 13e-3 does not impose an explicit substantive fairness standard on going private transactions, the rule prescribes such rigid disclosure requirements regarding the effects, purposes, and fairness of

1. "Going private" refers to the act of transforming a publicly held corporation—one whose stock is bought and sold at an exchange or over the counter—into one which is no longer listed or available to the public for purchase. Pursuant to § 12(g) of the Securities Exchange Act of 1934, 15 U.S.C. § 78l(g) (1976), most issuers having outstanding equity security held by 500 or more persons must register the security with the SEC and are thereby subject to the periodic reporting requirements imposed by §§ 13 and 15(d) of the 1934 Act, 15 U.S.C. §§ 78m, 78o(d) (1976 & Supp. 1978). For an in depth analysis of the going private concept, see 4 A. BROMBERG, SECURITIES LAW: FRAUD (New Matter) § 4.7 (Supp. 1977); F. O'NEAL, "SQUEEZE-OUTS" OF MINORITY SHAREHOLDERS § 5.32 (1975); F. O'NEAL & J. DERWIN, EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES § 4.01-.12 (1961); Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987 (1974); Brudney, *A Note on "Going Private"* 61 VA. L. REV. 1019 (1975); Greene, *Corporate Freeze-out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487 (1976); Keit, *Going Private: Adopting a Corporate Purpose Standard*, 3 SEC. REG. L.J. 33 (1975); Moore, *Going Private: Techniques and Problems of Eliminating the Public Shareholder*, 1 J. CORP. L. 321 (1976); Solomon, *Going Private: Business Practices, Legal Mechanics, Judicial Standards and Proposals for Reform*, 25 BUFFALO L. REV. 141 (1975); Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189 (1964); Note, "Going Private"—*The Insider's Fiduciary Duty and Rule 10b-5: Is Fairness Requisite?*, 28 BAYLOR L. REV. 565 (1976); Note, *Federal Regulation of the Going Private Phenomenon*, 6 CUM. L. REV. 141 (1975); Comment, *SEC Proposed "Going Private" Rule*, 4 DEL. J. CORP. L. 184 (1978); Comment, *Protection of Minority Shareholders From Freeze-outs Through Merger*, 22 WAYNE L. REV. 1421 (1976).

A going private transaction is either a one step or two step acquisition. A one step transaction may be a long form or short form merger, tender offer, reverse stock split, dissolution, or open market purchase. See notes 14-24 *infra* and accompanying text. The first step of a two step acquisition may be accomplished by a negotiated purchase from a control group, a purchase on the open market, or a tender offer. The second step may be accomplished by a short form or long form merger.

2. 44 Fed. Reg. 46,736 (1979).

3. Rule 13e-3, Going Private Transactions by Certain Issuers or Their Affiliates, 17 C.F.R. § 240.13e-3 (1980).

4. Schedule 13E-3, 17 C.F.R. § 240.13e-100 (1980).

the transaction that a fairness objective is clearly implicit in its provisions. The Commission's implicit fairness objective has prompted commentators to contend that the Commission's preoccupation with the fairness of going private transactions is beyond the mandate that Congress granted in the Securities Exchange Act of 1934.⁵ Rule 13e-3 has thus provoked vigorous debate regarding the propriety of SEC investigation into the substantive fairness of going private transactions and, indeed, SEC substantive rulemaking authority in general.

This Note will trace the development of rule 13e-3 and study its extensive disclosure provisions to determine whether a substantive fairness rationale lies therein. To understand these issues, however, it is necessary to understand the going private phenomenon and why the SEC enacted rule 13e-3. Finally, this Note will conclude with a consideration of whether the SEC does indeed have a substantive fairness authority within the context of rule 13e-3.

I. THE GOING PRIVATE PHENOMENON

Going private describes the various techniques that a publicly held corporation employs to return to private status by reacquisition of publicly held stock,⁶ thereby excluding public shareholders from further

5. 15 U.S.C. § 78 (1976).

6. For example, majority shareholders may initiate an asset sale or a corporate dissolution proceeding and then sell their assets to a "shell" corporation. *See, e.g., LeBold v. Inland Steel Co.*, 125 F.2d 369 (7th Cir.), *cert. denied*, 316 U.S. 675 (1941), *modified on rehearing*, 136 F.2d 876 (7th Cir. 1943). At common law, in the absence of a provision in the corporate charter the sale of all the assets of a solvent corporation required unanimous consent. *See, e.g., Traer v. Lucas Prospecting Co.*, 124 Iowa 107, 112, 99 N.W. 290, 292 (1904); *City of St. Louis v. St. Louis Gaslight Co.*, 70 Mo. 69 (1879). *But see Butler v. New Keystone Copper Co.*, 10 Del. Ch. 371, 377, 93 A. 380, 382-83 (1915); *Skinner v. Smith*, 134 N.Y. 240, 31 N.E. 911, 10 N.Y.S. 81 (1892); Note, *Disposition of Corporate Assets*, 43 N.C. L. REV. 957, 958 (1965). Today, however, almost all states permit corporations to sell their assets without unanimous shareholder approval. *See generally* 2 MODEL BUS. CORP. ACT ANN. § 79 (2d ed. 1971); TEXAS BUS. CORP. ACT ANN. art. 5.10 (Vernon Supp. 1978).

Corporate insiders may also make a tender offer to purchase all outstanding shares. *See, e.g., Kaufmann v. Lawrence*, 386 F. Supp. 12, 13-15 (S.D.N.Y. 1974), *aff'd per curiam*, 514 F.2d 283 (2d Cir. 1975); *Broder v. Dane*, 384 F. Supp. 1312, 1315-16 (S.D.N.Y. 1974). *See also* SEC Securities Exchange Act Release No. 5567, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,104, at 85,090 (Feb. 6, 1975); *Borden, supra* note 1, at 1003-06; *Brudney, supra* note 1, at 910-11; *Kerr, supra* note 1, at 34.

If a substantial number of stockholders refuse to accept the tender offer, insiders may utilize various "mop up" techniques. *See* Securities Exchange Act Release, *supra*, at 85,091; *Borden, supra* note 1, at 999-1000; *Kerr, supra* note 1, at 44-45; Note, *Going Private*, 84 YALE L.J. 903, 910-

participation in the enterprise.⁷ Before a corporation implements a going private transaction, minority shareholders generally may choose between selling their shares⁸ or retaining their status as shareholders in the private firm.⁹ This choice, however, is not a true option because the liquidity of a private security in the trading market is greatly impaired.¹⁰ Moreover, remaining shareholders in a private corporation

11 (1975). *See generally* Note, *Federal Regulation of the Going Private Phenomenon*, 6 CUM. L. REV. 141, 160 & n.115 (1975).

The corporation can employ a reverse stock split, so the smaller security holders retain only a fraction of the whole share. The corporation may then purchase those shares for cash. *See, e.g.*, DEL. CODE ANN. tit. 8, § 155 (1974); N.Y. BUS. CORP. LAW § 513 (McKinney 1963). *See also* *Teschner v. Chicago Title & Trust Co.*, 59 Ill. 2d 452, 322 N.E.2d 54 (1974), *appeal dismissed*, 422 U.S. 1002 (1975); *Clark v. Pattern Analysis & Recognition Corp.*, 87 Misc. 2d 385, 384 N.Y.S.2d 660 (Sup. Ct. 1976); Securities Exchange Act Release, *supra*, at 85,090-91; H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS 673 (2d ed. 1970); Borden, *supra* note 1, at 994-97, 999-1000; Dykstra, *The Reverse Stock Split—That Other Means of Going Private*, 53 CHI.-KENT L. REV. 1 (1976); Kerr, *supra* note 1, at 44-45; Lawson, *Reverse Stock Splits: The Fiduciary's Obligations Under State Law*, 63 CALIF. L. REV. 1226 (1975); Note, *Federal Regulation of the Going Private Phenomenon*, *supra*, at 146-51; Note, *Going Private*, *supra*, at 910-11.

Majority shareholders also may employ a merger to "freeze out" minority shareholders. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 251-52 (Supp. 1978); N.Y. BUS. CORP. LAW § 903 (McKinney Supp. 1979). *See generally* Kessler, *Elimination of Minority Interests by Cash Merger: Two Recent Cases*, 30 BUS. LAW. 699 (1975); Vorenberg, *supra* note 1, at 1192-93.

Insiders may merge by transferring their shares in the "target" corporation to a "shell" corporation. *See, e.g.*, *Greenberg v. Institutional Inv. Sys., Inc.*, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,231 (S.D.N.Y. 1975) (publicly owned corporation eliminated all minority shareholders by means of tender offer followed by merger); *Grimes v. Donaldson, Lufkin & Jenrette, Inc.*, 392 F. Supp. 1393 (N.D. Fla. 1974), *aff'd*, 521 F.2d 812 (5th Cir. 1975) (tender offer followed by merger of publicly held corporation into subsidiary of target corporation's principal shareholder).

For a thorough review of all available going private techniques, see F. O'NEAL & J. DERWIN, *EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES* §§ 4.01-.14, at 61-98 (1961); Borden, *supra* note 1, at 989-1000; Kerr, *supra* note 1, at 44-45.

7. *See* note 1 *supra*. Going private transactions cause a reduction or elimination of public holdings in the corporation's stock. *See* T. ARMSTRONG, "GOING PRIVATE" THE WHY AND THE HOW, IN *ACQUIRING PUBLICLY HELD SECURITIES: GOING PRIVATE AND TENDER OFFERS* 171 (PLI 1974).

8. The offer to purchase is generally only the first step in a going private transaction. *See* note 1 *supra*. Because "every corporation has its share of irrational investors who would never willingly abandon their investment," Note, *Going Private*, *supra* note 6, at 910, the minority is seldom totally eliminated without the second involuntary step, the force-out. *See, e.g.*, *Greenberg v. Institutional Inv. Sys., Inc.*, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,231 (S.D.N.Y. 1975).

9. *See, e.g., id.*

10. *See* 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, at 84,696.

lose much of the protection provided by federal securities laws.¹¹

In its incipency the going private phenomenon took place in an economic climate of great optimism and enthusiastic speculative interest.¹² The United States economy began to plunge into recession in 1974,¹³ however, and the market dropped catastrophically. The trend toward registration with the SEC subsided, and stocks began selling at far lower price-earning multiples.¹⁴ As a result of this economic downturn, corporate managers began to decide that their best investment was to reacquire their own securities from public shareholders, thereby becoming stockholders in a new, privately held enterprise.¹⁵

A number of reasons exist for going private. The 1934 Act requires registration of securities by companies that either have securities listed on a national securities exchange,¹⁶ or assets in excess of \$1,000,000 and at least five hundred shareholders.¹⁷ Private status avoids¹⁸ the necessity of complying with the restrictive and financially burdensome network of Exchange Act provisions that would otherwise regulate the corporation's affairs.¹⁹ Thus, it is not surprising that many public com-

11. House of Adler, Inc., [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,515, at 81,114 (SEC Staff Letter Sept. 30, 1971).

12. In fiscal year 1950, 496 companies filed registration statements; 112 were by companies that previously had not filed a registration statement. In fiscal year 1961, 1830 companies filed registration statements; 958 were first filings. In fiscal year 1962, 2307 companies filed registration statements; 1377 were first filings. 1 REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess. (1963). The fact that 3000 companies filed registration statements for the first time in the period between 1967 and 1972 illustrates the increasing trend of going public until 1974. See Address of A.A. Sommer, Jr., *supra* note 10. A rocky stock market was largely responsible for the going private phenomenon. The bull market of the late sixties and early seventies prompted many corporations to go public. See generally Sommer, *SEC Now Set For Next Going Private Wave*, Legal Times of Washington, Sept. 3, 1979, at 19, col. 1.

13. Hooper, *Market Comment*, FORBES, Jan. 15, 1975, at 55.

14. See generally 33 SEC STATISTICAL BULLETIN 35 (May 15, 1974).

15. See Freeman, *Going Private: Corporate Insiders Move to Eliminate Outside Shareholders*, Wall St. J., Oct. 18, 1974, at 1, col. 6. See also Hershman, *Going Private—Or How to Squeeze Investors*, Dun's Rev., Jan. 1975, at 37.

16. Securities Exchange Act of 1934, § 12(a), 15 U.S.C. § 781(a) (1976 & Supp. 1978).

17. Securities Exchange Act of 1934, § 12(g)(1)(B), 15 U.S.C. § 781(g)(1)(B) (1976).

18. Securities Exchange Act of 1934, § 12(g)(4), 15 U.S.C. § 781(g)(1)(B) (1976). See [1978] 2 NYSE GUIDE (CCH) ¶¶ 2499.20, 2500; [1972] 2 AM. STOCK EX. GUIDE (CCH) ¶ 10,051.

19. Section 13 of the 1934 Act requires certain periodic reports to be sent to the SEC to keep information in the initial report current. Securities Exchange Act, § 13(a), 15 U.S.C. § 78m(a) (1976 & Supp. 1978). Section 14, and Regulation 14A which implements it, govern the solicitation of proxies by registered companies. Securities Exchange Act of 1934, § 14, 15 U.S.C. § 78n (1976); SEC Reg. 14A, 17 C.F.R. § 240.14a-1 (1980). Section 16(a) requires officers, directors, and ten percent stockholders of registered companies to report trading in the company's stock. Securities

panies have seized the opportunity to go private and preclude "those zealous cops at the SEC" from entering into their corporate affairs.²⁰ Going private not only frees the corporation from the expense of complying with federal securities laws, but also allows the company to regain confidentiality of corporate information.²¹ The increasing incidence of going private transactions has drawn blunt criticism,²² and a growing number of dissenting shareholders are challenging their management's efforts to go private.²³

These challenges, as well as the promulgation of rule 13e-3, have led to heated controversy regarding the propriety of going private. Critics of the SEC's position argue that the minority shareholder has no absolute right to continue participation in an enterprise that seeks to go private.²⁴ Proponents of the SEC, on the other hand, claim that corpo-

Exchange Act of 1934, § 16(a), 15 U.S.C. § 78p(a) (1976). Section 16(b) provides for the recapture by the company of short swing profits made in the stock of that company by corporate insiders. Securities Exchange Act of 1934, § 16(b), 15 U.S.C. § 78p(b) (1976).

20. Guzzardi, *Those Zealous Cops on the Securities Beat*, FORTUNE, Dec. 1974, at 144.

21. *E.g.*, Kaufmann v. Lawrence, 386 F. Supp. 12, 14 (S.D.N.Y. 1974), *aff'd per curiam*, 514 F.2d 283 (2d Cir. 1975). See Hershman, *supra* note 15.

22. See note 1 *supra*. One commentator stated: "It seems to me to be nothing less than scandalous, and a species of downright fraud, for small corporations to go public at higher prices, and then buy back substantial quantities of their stock at lower prices . . ." (quoted in Address by A.A. Sommer, Jr., Further Thoughts on "Going Private," Second Annual Securities Seminar of the Detroit Institute for Continuing Legal Education, 294 SEC. REG. & L. REP. (BNA) D-1 (March 19, 1975, from unidentified source). See also Borden, *supra* note 1, at 1014; Kerr, *Tender Offers and Going Private—Ending Public Shareholding in Issue*, 172 N.Y.L.J., Dec. 16, 1974, at 25, col. 3; Note, *Going Private: An Analysis of Federal and State Remedies*, 44 FORDHAM L. REV. 796, 796 n.5; Note, *Going Private*, *supra* note 6, at 928.

23. *E.g.*, Kaufmann v. Lawrence, 386 F. Supp. 12 (S.D.N.Y. 1974), *aff'd per curiam*, 514 F.2d 283 (2d Cir. 1975); University Capital Corp. v. Barbara Lynn Stores, Inc., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,949 (S.D.N.Y. 1975); Berkowitz v. Power/Mate Corp., 135 N.J. Super. 36, 342 A.2d 566 (1975).

24. *E.g.*, Krafscis v. LaSalle Madison Hotel Co., [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,586 (N.D. Ill. 1972) (minority shareholders do not have right to continue their participation in the corporation when the majority of controlling interests in 90% of the outstanding shares voted to dissolve the corporation). See Coyne v. Park & Tilford Distillers Corp., 37 Del. Ch. 558, 146 A.2d 785 (1958), *aff'd*, 38 Del. Ch. 514, 154 A.2d 893 (Super. Ct. 1959); Wilcox v. Stern, 18 N.Y.2d 195, 202, 219 N.E.2d 401, 404, 273 N.Y.S.2d 38, 43 (1966); Beloff v. Consolidated Edison Co., 300 N.Y. 11, 19, 87 N.E.2d 561, 564-65 (1949); Anderson v. International Minerals & Chem. Corp., 295 N.Y. 343, 350, 67 N.E.2d 573, 576-77 (1946). *But see* Brudney, *supra* note 1, at 1029-30.

Minority interests of less than 10% in Delaware and New Jersey, and less than 5% in New York, constitute evidence that the legislative intent was to authorize the elimination of such minority shareholders without giving them any recourse other than their right of appraisal. See, *e.g.*, CONN. GEN. STAT. ANN. § 33-373(f) (1960); DEL. CODE ANN. tit. 8, § 262 (1975); N.J. STAT. ANN. § 14A: 11-2 (Supp. 1975); N.Y. BUS. CORP. LAW § 623(k) (McKinney Supp. 1975).

rations owe a fiduciary duty to minority shareholders to act in good faith in all of their transactions.²⁵ This duty, if fulfilled, could effectively preclude many going private transactions. The conceptual tension between these two propositions underlies the failure of prior attempts to successfully address the going private dilemma.

II. ATTEMPTS TO REDRESS GOING PRIVATE ABUSES PRIOR TO THE ENACTMENT OF RULE 13e-3

To understand the traditional parameters of the federal securities regulation scheme is to appreciate the inadequacy of prior attempts to redress the problems that accompany many going private transactions. Full and fair disclosure is the foundation²⁶ of the federal securities regulation scheme.²⁷

The rationale for the emphasis on disclosure rests upon two purposes: First, to provide investors with sufficient information to enable them to reach intelligent and volitional investment decisions,²⁸ and second, to deter fraudulent, deceptive, or manipulative practices by publicizing various material aspects of corporate transactions.²⁹ Although Congress did not grant a substantive fairness authority in either the 1933 or 1934 Act, Congress did intend to achieve a higher standard of conduct and to eliminate the vestiges of *caveat emptor* within the securities industry.³⁰

Although disclosure is effective in policing securities trading that is conducted at arms length,³¹ going private transactions raise problems between majority and minority shareholders that the 1933 and 1934 Acts did not anticipate or sufficiently address.³² Disclosure is effective in determining fraudulent or deceptive conduct because it prevents concealment of material information. The problems that arise from many going private transactions are generally not fraud or deception,

25. See Brudney, *supra* note 1, at 1031-39; Gibson, *How Fixed Are Class Shareholder Rights?*, 23 LAW & CONTEMP. PROB. 283, 298-99 (1958).

26. See note 236 *infra* and accompanying text.

27. 15 U.S.C. § 78 (1976).

28. See note 29 *infra*.

29. See *Cant v. A.G. Becker & Co.*, 374 F. Supp. 36, 45 (N.D. Ill. 1974). See also *SEC Summary of Disclosure Policy Study Report* [1963-1972 Special Studies Transfer Binder], FED. SEC. L. REP. (CCH) ¶ 74,601, at 65,241.

30. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

31. 1 A. BROMBERG, *SECURITIES LAW: FRAUD* § 4.7, at 88.95 (1974).

32. See notes 30-31 *supra* and accompanying text.

but simple coercion. Because one of the parties is generally in a position of control and has the ability to unilaterally dictate the terms of the transaction, there is potential for abuse of minority shareholders. Disclosure neither negates the unconcealed coercive conduct that is characteristic of many going private transactions, nor does it balance the inequitable distribution of power between parties to the transaction.

Prior to an express SEC response to the going private problem, many state and federal courts recognized this gap in the federal securities scheme and fashioned a number of judicial remedies. These remedies ranged from the implementation of judicially created fairness standards³³ to federal court attempts to find a fairness test implicit in section 10(b) of the 1934 Act³⁴ and in rule 10b-5.³⁵ None of these judicial remedies totally solved the going private dilemma.

A. *State Remedies*

The United States Supreme Court recently reiterated that state law traditionally governs the duties owed by majority shareholders toward minority shareholders.³⁶ Because a majority of going private techniques are powers that state charters expressly grant to a corporation,³⁷ these techniques are “internal affairs,”³⁸ and are thus regulated by state law.

State courts and legislatures, however, have not adequately regulated going private transactions.³⁹ Most states have practiced the “hands off” philosophy of going private activity. These states authorize procedures

33. In a number of early cases, courts protected minority shareholders' interests on the basis of a perceived fiduciary duty to minority shareholders by the majority. *See, e.g.,* *Thisis v. Spokane Falls Gas Light Co.*, 34 Wash. 23, 31-34, 74 P. 1004, 1006-07 (1904). *See also* *LeBold v. Inland Steel Co.*, 125 F.2d 369, 372 (7th Cir.), *cert. denied*, 316 U.S. 675 (1941), *modified on rehearing*, 136 F.2d 876 (1943).

34. 15 U.S.C. § 78j(b) (1976).

35. 17 C.F.R. § 240.10b-5 (1980). *See* note 73 *infra*.

36. *See* *Cort v. Ash*, 422 U.S. 66 (1975).

37. *See, e.g.,* DEL. CODE ANN. tit. 8, § 160 (1974 & Supp. 1978) (permitting a corporation to purchase its own stock); *id.* §§ 251-53 (permitting corporate mergers); *id.* §§ 151-55 (providing procedures that may be used to implement a reverse stock split).

38. *Cort v. Ash*, 422 U.S. 66, 84 (1975).

39. *See* 42 Fed. Reg. 60,090, 60,091-92 (1977). *See* Note, *Federal “Going Private” Standards: A New Direction for the Second Circuit?*, 45 FORDHAM L. REV. 427, 442-44 (1976); Note, *Going Private: An Analysis of Federal and State Remedies*, 44 FORDHAM L. REV. 796, 807-15 (1976); Note, *SEC Rulemaking Authority and the Protection of Investors: A Comment on the Proposed “Going Private” Rules*, 51 IND. L.J. 433, 436-38 (1976).

that a corporation may use to carry out its purpose,⁴⁰ and protect minority stockholders only secondarily.⁴¹ States have rarely attempted to regulate the substantive terms of going private transactions. Thus, state courts traditionally tend to strictly construe their corporate laws. If an action is technically permissible under the statute, it is likely to be upheld irrespective of the effect or fairness of that action.⁴²

The strongest traditional safeguard available to minority stockholders is the state statutory right of appraisal.⁴³ In theory, appraisal rights prevent or redress unfair management practices by allowing valuation of shares by a disinterested court; in actuality, appraisal may be cumbersome, expensive, and ineffective.⁴⁴ One commentator has characterized appraisal as "a remedy of desperation."⁴⁵ The opportunity for a true evaluation of a stock's worth depends upon the presence of a market for the security.⁴⁶ When an active market for a stock exists, the courts tend to award the dissenter the market price on grounds that it represents fair value.⁴⁷ Because the opportunity for a profitable issuer repurchase due to low market prices generally motivates the decision to go private, appraisal is not an indicator of fair value to the minority shareholder. Moreover, the delay, uncertainty, and expense often will

40. See note 37 *supra*.

41. See, e.g., DEL. CODE ANN. tit. 8, § 262 (1974 & Supp. 1978) (providing for shareholder's appraisal suit in event of dissatisfaction with terms of short form merger).

42. For instance, to implement a merger and simultaneously deny minority shareholders their statutory right of appraisal, a corporation need only sell its assets to another corporation, dissolve the original corporation, and resume its regular business activities. See *Orzeck v. Englehart*, 41 Del. Ch. 223, 192 A.2d 36, *aff'd*, 41 Del. Ch. 361, 195 A.2d 375 (Super. Ct. 1963). Technically, if the transaction is a merger, the dissenting shareholder possesses an appraisal right. If the transaction is a sale of assets, however, the dissenting shareholder does not have appraisal rights. Although this tactic properly may be characterized as a sham, it is nonetheless legal.

43. See generally Vorenberg, *Exclusiveness of the Dissenting Shareholder's Appraisal Right*, 77 HARV. L. REV. 1189 (1964).

44. See 42 Fed. Reg. 60,090, 60,091 (1977).

45. See Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CALIF. L. REV. 1, 85 (1969).

46. See Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 231-32 (1962).

47. See Comment, "Going Private": *Establishing Federal Standards for the Forced Elimination of Public Investors*, 1975 U. ILL. L.F. 638: "In the case of a publicly held corporation, depressed market prices may be determinative of fair price, with the result that minority shareholders may be forced out of the corporation for a 'fair' price that is less than the asset value of their holdings." *Id.* at 656-57. See, e.g., *Gallois v. West End Chem. Co.*, 185 Cal. App. 2d 765, 8 Cal. Rptr. 596 (1960); *David J. Greene & Co. v. Schenley Indus., Inc.*, 281 A.2d 30 (Del. Ch. 1971); *Jones v. Healy*, 185 Misc. 400, 55 N.Y.S.2d 349 (1945), *aff'd*, 270 A.D. 895, 62 N.Y.S.2d 605 (1946). See also *Tome Land & Improvement Co. v. Silva*, 83 N.M. 549, 494 P.2d 962 (1972).

dissuade a minority shareholder from seeking the appraisal remedy.⁴⁸ In addition, state courts' strict construction restricts the remedies of dissenting shareholders to appraisal as the shareholder's exclusive remedy in the absence of fraud or gross unfairness.⁴⁹

State courts, however, increasingly have imposed a fiduciary duty upon majority shareholders relative to their dealings with minority shareholders.⁵⁰ A number of recent cases suggest that state courts are

48. See Manning, *The Shareholder's Appraisal Remedy: An Essay For Frank Coker*, 72 YALE L.J. 223, 226-30 (1962); Vorenberg, *Exclusiveness of the Dissenting Shareholder's Appraisal Right*, 77 HARV. L. REV. 1189, 1192-93 (1964).

49. A fairness standard is often not enforced by courts due to the "exclusiveness" of appraisal rights. See, e.g., MASS. GEN. LAWS ANN. ch. 156B, §§ 76, 86-98 (1979 & Supp. 1980); 2 MODEL BUS. CORP. ACT ANN. 2d § 81 (1971); see generally *McGhee v. General Fin. Corp.*, 84 F. Supp. 24 (W.D. Va. 1949); *David J. Greene & Co. v. Schenley Indus., Inc.*, 281 A.2d 30 (Del. Ch. 1971); *Stauffer v. Standard Brands, Inc.*, 41 Del. Ch. 7, 187 A.2d 78 (Super. Ct. 1962); *Bruce v. E.L. Bruce Co.*, 40 Del. Ch. 80, 174 A.2d 29 (Ch. 1961); *Morris v. Columbia Apartments Corp.*, 323 Ill. App. 292, 55 N.E.2d 401 (1944); *Geiger v. American Seeding Mach. Co.*, 124 Ohio St. 222, 177 N.E. 594 (1931) (dictum). See also Vorenberg, *supra* note 48, at 1195-99.

50. The states of California, Delaware, Georgia, New Jersey, New York, and Wisconsin have attempted to shield minority shareholders from unfair going private transactions:

California: Under CAL. CORP. CODE § 1312(b) (Deering Supp. 1977), a shareholder who is frozen out by a short form merger or reorganization, when the same parties are in control of both corporations, can attack the validity of the transaction.

Delaware: See note 53 *infra*.

Georgia: The Fifth Circuit Court of Appeals, in the case of *Bryan v. Brock & Blevins Co.*, 490 F.2d 563 (5th Cir. 1974), held that a going private transaction violated Georgia corporate law because a corporation cannot do by merger what it could not otherwise legally do. In disallowing the squeeze-out of a minority shareholder, the court quoted *LeBold v. Inland Steel Co.*, 125 F.2d 369, 373 (7th Cir. 1941): "Whether we stamp the happenings as dissolution or with some other name, equity looks to the essential character and result to determine whether there has been faithfulness and fraud upon the part of the fiduciary." 490 F.2d at 569.

New Jersey: In *Berkowitz v. Power/Mate Corp.*, 135 N.J. Super. 36, 342 A.2d 566 (Ch. Div. 1975), the court struck down a proposed merger because such a transaction involved self-dealing by the directors and therefore might be a breach of fiduciary duty.

New York: In *People v. Concord Fabrics, Inc.*, 83 Misc. 2d 120, 371 N.Y.S.2d 550 (Sup. Ct. 1975), *aff'd mem.*, 50 A.D. 2d 787, 377 N.Y.S.2d 84 (1976), the court struck down a squeeze-out undertaken for the purpose of eliminating public shareholders because the scheme violated state blue sky laws.

Wisconsin: See WIS. STAT. § 551, reprinted in [1980] 3 BLUE SKY L. REP. (CCH) ¶ 64,101. This regulation bears substantial similarity to the SEC's proposed rules 13e-3A and 13e-3B, insofar as the Wisconsin statute requires both fairness and independent appraisals. Wisconsin is the only state thus far to enact a specific regulation to deal with going private transactions. See notes 67-69 *infra* and accompanying text.

Compare *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (1964) (directors must show good faith) with *Cumberland Publishing Co. v. Adams Real Estate Corp.*, 432 S.W.2d 808 (Ky. 1968) (courts will not interfere with management of majority unless there is actual fraud). See generally Comment, *Going Private: An Examination of Going Private Transactions Using the Business Purpose Standard*, 32 Sw. L.J. 641, 653 (1978).

beginning to take a more flexible approach toward the regulation of going private transactions.⁵¹ These courts impose a fairness standard on going private transactions by scrutinizing them for a legitimate business purpose to determine whether the majority shareholders have upheld their fiduciary duty⁵² to the minority.⁵³

In spite of the state court trend of imposing a fairness standard on majority shareholders in going private transactions, the criteria for the fairness standard remain unclear. To date, state courts have not con-

51. See, e.g., cases cited in note 50 *supra*.

52. See *Bryan v. Brock & Blevins Co.*, 490 F.2d 563 (5th Cir.), *cert. denied*, 419 U.S. 844 (1974); *Jutkowitz v. Bourns, Inc.*, No. 000268 (Calif. Super. Ct., L.A. Co. Nov. 19, 1975), *cited in Comment, The Second Circuit Adopts a Business Purpose Test For Going Private: Marshell v. AFW Fabric Corp. and Green v. Santa Fe Indus., Inc.*, 64 CALIF. L. REV. 1184, 1203 (1976); *Singer v. Magnavox*, 380 A.2d 969 (Del. 1977); *Clark v. Pattern Analysis & Recognition Corp.*, 87 Misc. 2d 385, 384 N.Y.S.2d 660 (Sup. Ct. 1976). See also *Gabhart v. Gabhart*, 545 F.2d 877 (7th Cir. 1977).

53. Consistent with general corporation law principles, a majority shareholder may not enrich himself at the expense of minority shareholders. See H. HENN, *CORPORATIONS* 319-21, 457-82 (2d ed. 1970). In *Pepper v. Litton*, 308 U.S. 295 (1939), the Supreme Court set forth the standard of conduct expected of a fiduciary:

[The majority shareholder] cannot violate rules of fair play by doing indirectly . . . what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis*.

Id. at 311.

The Delaware courts first adopted the business purpose requirement as a part of the fiduciary duty of those in control to minority shareholders, in *Singer v. Magnavox*, 380 A.2d 969 (Del. 1977). In *Singer* the Delaware Supreme Court used the business purpose requirement as the first step in examining a possible breach of fiduciary duty to the minority.

The Delaware Supreme Court recognized that the dominant corporation, as a majority shareholder standing on both sides of a merger transaction, has the "burden of establishing its entire fairness" to the minority shareholders, sufficiently to "pass the test of careful scrutiny by the courts." 380 A.2d at 976, *quoting* *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 298, 93 A.2d 107, 109-10 (1952).

See also *Tanzer v. International Gen. Indus., Inc.*, 379 A.2d 1121 (Del. 1977); *Young v. Valhi, Inc.*, No. 5430 (Del. Ch. Feb. 22, 1978).

The business purpose requirement also was adopted in a proceeding brought under New York's blue sky law in which a breach of the fiduciary relationship between controlling and minority shareholders was at issue. *People v. Concord Fabrics, Inc.*, 83 Misc. 2d 120, 371 N.Y.S.2d 550, *aff'd*, 50 A.D.2d 787, 377 N.Y.S.2d 84 (1975). Cf. *Marshell v. AFW Fabric Corp.*, 533 F.2d 1277 (2d Cir. 1976) (same merger involved). The business purpose test has since been applied in New York courts numerous times. See generally *Clark v. Pattern Analysis & Recognition Corp.*, 87 Misc. 2d 385, 384 N.Y.S.2d 660 (Sup. Ct. 1976); *Tanzer Economic Assocs. Profit Sharing Plan v. Universal Food Specialties, Inc.*, 87 Misc. 2d 167, 383 N.Y.S.2d 472 (Sup. Ct. 1976); *Schulwolf v. Cerro Corp.*, 86 Misc. 2d 292, 380 N.Y.S.2d 957 (Sup. Ct. 1976).

structed a universally accepted fairness standard.⁵⁴ State courts offer a wide variety of definitions for "legitimate business purpose."⁵⁵ Insiders offer the following justifications for going private: Danger of financial collapse,⁵⁶ elimination of shareholders who are no longer employees,⁵⁷ elimination of conflicts of interest,⁵⁸ operating efficiency,⁵⁹ prudent

54. However, an increasingly accepted approach toward a fairness standard was articulated in *Tanzer Economic Assocs. Profit Sharing Plan v. Universal Food Specialties, Inc.*, 87 Misc. 2d 167, 383 N.Y.S.2d 472 (Sup. Ct. 1976):

[W]e must conclude that there is no basis for equitable intervention . . . unless (1) fraud or illegality clearly be shown, or (2) there has been concealment or non-disclosure of material facts, or (3) that the merger is merely a device to deal inequitably with the minority and has no valid business purpose, or (4) that there has been a breach of fiduciary responsibility.

Id. at 176, 383 N.Y.S.2d at 479.

55. See, e.g., *Grimes v. Donaldson, Lufkin & Jenrette, Inc.*, 392 F. Supp. 1393 (N.D. Fla. 1974); *Tanzer Economic Assocs. Profit Sharing Plan v. Universal Food Specialties, Inc.*, 87 Misc. 2d 167, 383 N.Y.S.2d 472 (Sup. Ct. 1976); *Schulwolf v. Cerro Corp.*, 86 Misc. 2d 292, 380 N.Y.S. 2d 957 (Sup. Ct. 1976). See generally *Greene, Corporate Freeze-Out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487 (1976); *Solomon, Going Private: Business Practices, Legal Mechanics, Judicial Standards, and Proposals for Reform*, 25 BUFFALO L. REV. 141 (1975); *Comment, Protection of Minority Shareholders From Freeze-outs Through Merger*, 22 WAYNE L. REV. 1421 (1976); *Note, Going Private*, 84 YALE L.J. 903 (1975).

56. The case perhaps most representative in utilizing danger of financial collapse as a business purpose for going private is *Matteson v. Ziebarth*, 40 Wash. 2d 286, 242 P.2d 1025 (1952) (en banc). The Washington Supreme Court in *Matteson* held that a freezeout of a minority shareholder motivated by valid fears of financial difficulty is a legitimate corporate transaction. The court deemed that a legitimate business purpose existed when insiders resorted to a freeze-out of a minority shareholder when the corporation was on the brink of insolvency, with the proposed merger the "only salvation" from bankruptcy. *Id.* at 295, 242 P.2d at 1034. See *Polin v. Conduction Corp.*, 552 F.2d 797 (8th Cir.), cert. denied, 434 U.S. 857 (1977) (danger of financial collapse an acceptable and persuasive business purpose, subject to strict scrutiny of corporate records to prevent deception). See also *Vorenberg, Exclusiveness of the Dissenting Shareholders' Appraisal Right*, 77 HARV. L. REV. 1189, 1195-97 (1964).

57. The leading case in this area is *Bryan v. Brock & Blevins Co.*, 490 F.2d 563 (5th Cir.), cert. denied, 419 U.S. 844 (1974), which suggested that elimination of shareholders who are no longer employees of the enterprise is a proper business purpose. Majority shareholders sought to freeze-out a single minority shareholder who had resigned from management in a close corporation after he had refused to sell his interest to controlling shareholders. The majority attempted a short form merger of the old corporation into a newly formed corporation. The Fifth Circuit Court of Appeals held that Georgia law prohibited the elimination of the minority through merger when there was no corporate purpose for doing so. 490 F.2d at 565. *Accord*, *Clark v. Pattern Analysis & Recognition Corp.*, 87 Misc. 2d 385, 384 N.Y.S.2d 660 (Sup. Ct. 1976).

58. The parent-subsidiary relationship creates conflicts of interest because of the difficulty and expense of assuring that intercompany transactions will always be handled on an arm's length basis. See *Grimes v. Donaldson, Lufkin & Jenrette, Inc.*, 392 F. Supp. 1393 (N.D. Fla.), *aff'd*, 521 F.2d 812 (5th Cir. 1975), noted in *Kessler, Elimination of Minority Interests By Cash Merger: Two Recent Cases*, 30 BUS. LAW. 699, 702-04 (1975). In *Grimes*, a parent-subsidiary merger was premised on this conflict of interest problem. The court accepted the parent company's desire to eliminate potential claims of conflict of interest as a proper purpose for going private. 392 F.

management,⁶⁰ cost of disclosure and deregistration savings,⁶¹ drop in

Supp. at 1402. *Accord*, *Schulwolf v. Cerro Corp.*, 86 Misc. 2d 292, 380 N.Y.S.2d 957 (Sup. Ct. 1976). It is interesting to note that *Schulwolf* was the first New York state court decision to apply the business purpose standard after its adoption in *People v. Concord Fabrics, Inc.*, 83 Misc. 2d 120, 371 N.Y.S.2d 550 (Sup. Ct.), *aff'd mem.*, 50 A.D. 2d 787, 377 N.Y.S.2d 84 (1975). Prior to *Concord Fabrics* and *Schulwolf*, appraisal and payment was the exclusive remedy available to dissenting shareholders in a merger under New York law. *See Endicott Johnson Corp. v. Bade*, 37 N.Y.2d 585, 338 N.E.2d 614, 376 N.Y.S.2d 103 (1975).

Although the elimination of conflicts of interest is generally a valid business purpose, it is not per se valid. In *Young v. Valhi, Inc.*, No. 5430 (Del. Ch. Feb. 22, 1978), a Delaware Court of Chancery considered whether there actually had been conflicts of interest. The court held past conflicts of interest to have been minimal and rejected out of hand the contention that a merger would prevent future conflicts of interest. The lesson of *Young* is that courts must examine the business of both parent and subsidiary to determine whether a conflict of interest argument should be accepted.

59. Eliminating the costs of maintaining two separate companies is a legitimate business purpose. *Cf. Grimes v. Donaldson, Lufkin & Jenrette, Inc.*, 392 F. Supp. 1393 (N.D. Fla.), *aff'd*, 521 F.2d 812 (5th Cir. 1975) (going private transaction approved that promised joint savings in excess of \$300,000 per year); *Teschner v. Chicago Title & Trust Co.*, 59 Ill. 2d 452, 322 N.E.2d 54 (1974), *appeal dismissed*, 422 U.S. 1002 (1975) (reverse stock split eliminating minority shareholders liquidated because it resulted in a reduction of corporate expenses and a simplification of corporate procedures); *Tanzer Economic Assocs. Profit Sharing Plan v. Universal Food Specialties, Inc.*, 87 Misc. 2d 167, 383 N.Y.S.2d 472 (Sup. Ct. 1976) (desire to effect savings that would result from eliminating duplicated functions, economies in centralized procurement of raw materials, marketing economy in joint distribution, warehousing, and advertising, deemed valid business purpose). *See also Schulwolf v. Cerro Corp.*, 86 Misc. 2d 292, 380 N.Y.S.2d 957 (Sup. Ct. 1976); *Cole v. Schenley Indus., Inc.*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,765 (S.D.N.Y. 1976).

60. Many observers have noted "the fundamental incompatibility" between prudent management and the constraints imposed by public ownership. *See Borden, supra* note 1, at 1006-08; *Brudney, supra* note 1, at 1034-35. This incompatibility is a significant motivation for going private. Although prudent management must be concerned with long term growth and stability, a corporation's public status creates substantial pressure to provide a short term return for investors. *Borden, supra* note 1, at 1007. When a corporation claims the business purpose of prudent management, the court must find that an actual monetary savings would result because of a change in management objectives.

61. Monetary savings that generally result from going private are a major factor in the popularity of going private. Public corporations have a duty to provide shareholders with meetings, annual reports, and communications. The cost of these services is substantial. *See Borden, supra* note 1, at 1007. Moreover, the expense in diversion of time and attention from regular business affairs is often prohibitive. Therefore, deregulation avoids the time and cost of servicing public shareholders, as well as the SEC.

Another cost of a public corporation is the extensive potential liability for SEC disclosure requirements, which compel public corporations to divulge more information than they otherwise would. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). *See also Note, The Liability of Outside Directors Under Rule 10b-5*, 49 N.Y.U. L. REV. 551, 556-59 (1974). In *Jutkowitz v. Bourns, Inc.*, No. 000268 (Calif. Super. Ct., L.A. Co. Nov. 19, 1975), *cited in Comment, supra* note 52, defendants contended that the going private transaction was instituted for the legitimate business purpose of removing the possible

market price,⁶² increasing value of stock,⁶³ and long term debt financing.⁶⁴

The virtually unlimited number of reasons that justify a going private transaction make the development of objective criteria to ascertain their fairness an onerous task. This failure to develop objective criteria has forced state courts to consider only "evidence of value *after* the transaction, which may not adequately protect minority shareholders."⁶⁵ Moreover, because state courts as a rule lack the requisite ex-

liability to public shareholders for noncompliance with disclosure provisions. The court in *Texas Gulf* refused to accept the *Jutkowitz* argument as a sufficient purpose for the proposed transaction. 401 F.2d at 835. The *Jutkowitz* rationale that cost of disclosure is not a valid business purpose for going private was reiterated by Commissioner Sommer in his strong statement that the goal of "avoiding the cost and bother of SEC compliance and shareholder servicing" is not a proper goal. Address of A.A. Sommer, Jr., *supra* note 10, at 84,699. Cf. *Kaufmann v. Lawrence*, 386 F. Supp. 12 (S.D.N.Y. 1974) (corporation's complaint that compliance with SEC disclosure requirements compelled divulgence of business secrets not sufficient to justify going private).

Notwithstanding persistent corporate arguments, the general rule is that costs of disclosure and savings from deregulation are not valid reasons to justify going private, unless there are substantive supplemental purposes for the going private transaction. *But see* *Tanzer Economic Assocs. Profit Sharing Plan v. Universal Food Specialties, Inc.*, 87 Misc. 2d 167, 383 N.Y.S.2d 472 (Sup. Ct. 1976), in which the elimination of time, expense, and energy incurred in connection with providing SEC and shareholder services pertaining to the corporation's public status was a legitimate business purpose for going private. It is not clear whether *Tanzer* is authority for the proposition that saving money alone justifies going private because in that case, monetary savings was one of ten business purposes presented. *Id.* at 483.

62. See generally H. GUTHMAN & H. DOUGALL, *CORPORATE FINANCIAL POLICY* 622-25 (4th ed. 1962); Moskowitz, *Corporate Stock Repurchase Under the Securities Exchange Act of 1934*, 51 NEB. L. REV. 193, 193-95 (1971); Comment, *Protection of Minority Shareholders From Freezeouts Through Merger*, 22 WAYNE L. REV. 1421, 1443 (1976); Note, *Going Private*, *supra* note 6, at 906-07.

63. Very few cases involve corporations that hold out the increasing value of corporate stock as a purpose for going private. See, e.g., *Condec Corp. v. Lunkenheimer Co.*, 43 Del. Ch. 353, 230 A.2d 769 (1967) (implied that it would be a proper business purpose).

64. This argument was accepted only recently as a proper business purpose. In *Tanzer v. International Gen. Indus., Inc.*, 379 A.2d 1121 (Del. 1977), an 81% subsidiary of International General was merged into a newly created, wholly owned subsidiary. The business purpose presented and accepted was that the merger would facilitate long term debt financing by International General. *Accord*, *Tanzer Economic Assocs. Profit Sharing Plan v. Universal Food Specialties, Inc.*, 87 Misc. 2d 167, 383 N.Y.S.2d 472 (Sup. Ct. 1976).

65. Solomon, *Going Private: Business Practices, Legal Mechanics, Judicial Standards and Proposals For Reform*, 25 BUFFALO L. REV. 141, 170 (1975). See 4 A. BROMBERG, *SECURITIES LAW: FRAUD, SEC RULE 10B-5 § 12.5*, at 275-76. See also SEC Securities Act Release No. 5567, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,104, at 85,091 (Feb. 6, 1975) ("Under many state statutes, however, questions have been raised as to whether the procedures involved and the tests of fairness developed adequately protect minority security holders.").

Examples of unfairness in the state law realm include: *Mathes v. Cheff*, 41 Del. Ch. 166, 190 A.2d 524 (Ch. 1963), *rev'd on other grounds*, 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1964); *Ster-*

pertise to solve delicate business and economic questions, divergence in judicial opinion is understandable.⁶⁶

In contrast to the case-by-case basis upon which state courts have generally addressed going private problems, Wisconsin has adopted an innovative regulatory scheme by enacting the first specific regulations to deal with going private transactions.⁶⁷ The Wisconsin regulations set forth a substantive fairness standard, which creates a presumption of fairness if three objective criteria are met.⁶⁸ The advantage of the Wisconsin regulations is that they protect the reasonable expectations of the minority shareholder while simultaneously preserving the corpo-

ling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952). See generally 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 919 (rev. 1975). See also R. BAKER & W. CARY, CASES AND MATERIALS ON CORPORATIONS 1551-54 (3d ed. 1959); Walter, *Fairness in State Court Recapitalization Plans: A Disappearing Doctrine*, 29 B.U. L. REV. 453 (1949).

66. See Gibson, *How Fixed Are Class Shareholder Rights?*, 23 LAW & CONTEMP. PROB. 283 (1958). See generally Solomon, *supra* note 55, at 144.

67. See 13 WIS. ADM. CODE § 6.05 (1977). The regulations prohibit a corporation from repurchasing its own stock if the corporation will no longer be subject to state or federal registration requirements. *Id.* § 6.05(2). The regulations also provide procedural requirements. *Id.* § 6.05(1)(b). In addition, the regulations prohibit repurchase if the terms are unfair. *Id.* § 6.05(1)(a).

68. The terms of the transaction shall be presumed to be fair if:

1. The compensation is no less than that independently recommended by 2 qualified, independent appraisers after reasonable investigation considering all relevant factors, and the issuer's board of directors states that such compensation is fair to security holders and was determined in good faith;
2. The latest public offering of the securities occurred more than ten years prior to the transaction, or the compensation is greater than the public offering price; and
3. More than 50% of the securities held by persons not affiliated with the issuer approve the transaction; provided, however, the absence of one or more of the above conditions shall create no presumption as to the fairness or unfairness of the term of the transaction

13 WIS. ADM. CODE §§ 605 (1)(a)(1)-(3) (1977).

The rationale for the condition that either the last public offering of the securities occur more than ten years prior to the transaction, or that the compensation be greater than the former offering price, is that a shareholder should possess a reasonable expectation that once a company taps public equity markets, it will remain in the market long enough to give the investor a fair chance to benefit from an investment, or if the company does withdraw from the market, investors will be properly compensated. An investor should be able to expect at least a minimal degree of permanence or, in the alternative, compensation in the event of a freeze-out.

The rationale for the condition that at least 50% of the unaffiliated shareholders approve the transaction is that a shareholder should have some control over his investment even though he may not be able to control corporate affairs. Because insiders control the timing, the value of the shares, and even the form of payment, they are perceived as managing not only the corporation, but also the minority's investment. The 50% rule thus provides minority shareholders with a degree of leverage against corporate insiders.

ration's right to go private.⁶⁹

Because the various jurisdictions have worked independently and inconsistently, development of a universal fairness standard at the state level has proceeded very slowly. Although Wisconsin has developed a detailed framework for regulation of going private transactions, it is the only state to have enacted such a comprehensive regulatory scheme. Thus, the situation has heightened the need for uniform federal regulation of going private.

B. *Federal Remedies*

Because the federal securities regulatory scheme provides for the protection of investors through disclosure,⁷⁰ attempts by federal courts to fashion a substantive fairness test have not been fruitful. Yet, because traditional disclosure provisions have inadequately redressed the problems of going private,⁷¹ a number of federal courts have continued to search the federal securities laws for an implicit substantive fairness test.

Commentators have suggested that federal courts utilize section 10(b)⁷² of the 1934 Act and rule 10b-5⁷³ to deal with corporate freeze-

69. The three objective criteria of the substantive fairness standard contained in the Wisconsin regulation actually serve to protect the right of the corporation to go private, even though they limit this right. Although the three conditions impose cumbersome restrictions on corporate planning, they do provide clear and predictable guidelines for the company that seeks to go private.

70. See, e.g., 15 U.S.C. §§ 78m, 78o, 78p, 78r (1976). See also Note, *Corporate Repurchases Under the Federal Securities Laws*, 66 COLUM. L. REV. 1292, 1296 (1966).

71. One commentator has argued that "it would be best to adhere to established disclosure rules and to rely upon the shareholder's innate suspicion that things are going well if the insiders propose to go private." Borden, *supra* note 1, at 1029.

72. 15 U.S.C. § 78j(b) (1976):

It shall be unlawful for any person, directly or indirectly . . . (b) To use or employ, in connection with the purchase or sale of any security . . . 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.

Id. See 1 A. BROMBERG, *SECURITIES LAW* § 2.2, at 331 (1974).

73. 17 C.F.R. § 240.10b-5 (1980):

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.

outs.⁷⁴ The fairness standard never materialized as a bona fide rule of law, however, because the federal courts subsequently split over the propriety of basing a fairness standard on rule 10b-5. Consequently, dissenting minority shareholders found a significant reluctance to look beyond the issue of mere compliance with SEC disclosure requirements.⁷⁵

Section 10(b) of the 1934 Act is the "catch-all" provision of the securities regulatory scheme.⁷⁶ If conduct is neither manipulative⁷⁷ nor

74. For an analysis of rule 10b-5 and its role in the substantive fairness debate, see Dyer, *An Essay on Federalism in Private Actions Under Rule 10b-5*, 1976 UTAH L. REV. 7; *Recent Developments in Securities Law: Cause of Action Under Rule 10b-5*, 26 BUFFALO L. REV. 503, 562 (1977); Note, "Going Private"—*The Insiders' Fiduciary Duty and Rule 10b-5: Is Fairness Required?*, 28 BAYLOR L. REV. 565 (1976); Note, *Federal "Going Private" Standards: A New Direction For the Second Circuit?*, 45 FORDHAM L. REV. 427 (1976); Note, *The Encroachment of Rule 10b-5 on State Corporation Law*, 29 ME. L. REV. 218 (1977). See generally Address of A.A. Sommer, Jr., *supra* note 10, at 80,010. See also *Clarke v. Golddust Corp.*, 106 F.2d 598 (3d Cir. 1939), *cert. denied*, 309 U.S. 671 (1940); *Matteson v. Ziebarth*, 40 Wash. 2d 286, 242 P.2d 1025 (1952); Note, *Freezing Out Minority Shareholders*, 74 HARV. L. REV. 1630 (1961).

75. See, e.g., *University Capital Corp. v. Barbara Lynn Stores, Inc.*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,949 (S.D.N.Y. 1975); *Kaufmann v. Lawrence*, 386 F. Supp. 12 (S.D.N.Y. 1974), *aff'd per curiam*, 514 F.2d 283 (2d Cir. 1975); *Berkowitz v. Power/Mate Corp.*, 135 N.J. Super. 36, 342 A.2d 566 (Ch. 1975). *But see* *People v. Concord Fabrics, Inc.*, 83 misc. 2d 210, 371 N.Y.S.2d 550 (Sup. Ct. 1975), *aff'd mem.*, 50 A.D. 787, 377 N.Y.S.2d 84 (1976).

76. See 15 U.S.C. § 78j(b) (1976). "Of course, subsection (c) [§ 9(c) of H.R. 7852, which became § 10(b)] is a catch-all clause to prevent manipulative devices." *Hearings on H.R. 7852 & H.R. 8720 Before the House Comm. on Interstate & Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934) (testimony of Thomas G. Corcoran).

77. The verb "manipulate" means to manage artfully or shrewdly, especially in an unfair way. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1376 (1971). See *Banoff, Fraud Without Deceit: Marshel v. AFW Fabrics Corp. and Green v. Santa Fe Industries, Inc.*, 17 SANTA CLARA L. REV. 1, 24 n.86 (1977) (quoting Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883, 905-06 (1976)):

[W]ith a little ingenuity and receptiveness, [manipulative] might have an elastic definition which would permit its application to other situations either (a) where the form of the transaction is artificially constructed (as for example in de facto mergers) or (b) the transaction is essentially a sham or where there is no valid business purpose or (c) by virtue of coercive actions the minority shareholders could be said to be acting at the will of another, in the sense that the puppet is manipulated by his master.

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Supreme Court implied that the term "manipulative" "is and was virtually a term of art when used in connection with the securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Id.* at 199. Thus, manipulation as described in *Ernst & Ernst* means non-verbal deceit. Cases involving alleged market manipulation under rule 10b-5 have adopted a similar definition. See *United States v. Charnay*, 537 F.2d 341, 352 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 378 (2d Cir. 1974); *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 792 (2d Cir. 1969); *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 546 (2d Cir. 1967). See also *Rosenfeld, An Essay in Support of the Second Circuit's Decisions in Marshel v. AFW Fabric Corp. and*

deceptive,⁷⁸ however, it is not prohibited under the language of section 10(b)⁷⁹ or rule 10b-5.⁸⁰ Notwithstanding the language and construction

Green v. Santa Fe Industries, 5 HOFSTRA L. REV. 111, 131 (1976). For a discussion of the meaning of the term "manipulative" in the context of § 10(b), see generally Banoff, *supra*, at 23-24.

78. Deception first became a requirement of rule 10b-5 in *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir.), *aff'ing*, 230 F. Supp. 235 (S.D.N.Y. 1964). See generally Banoff, *supra* note 77. The Supreme Court has stated that, absent a showing of a material misrepresentation or nondisclosure, there is no "deception" within the meaning of § 10(b). See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 474-76 (1977).

79. See notes 137-41 *infra* and accompanying text.

80. It is axiomatic that the rule cannot be broader than its enabling statute, and § 10(b) does not extend to mere breaches of fiduciary duty. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976).

The second clause of rule 10b-5 is limited to material misstatements and omissions. If any provision of rule 10b-5 is to support a substantive fairness test, it must be derived from either the first ("to employ any device, scheme, or artifice to defraud") or third ("to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person") clauses. Although the term "fraud" as used in clause (c) could mean "equitable fraud" (i.e., a freeze-out), the consensus is that clause (b) deals with verbal deceit, and clauses (a) and (c) deter deceptive conduct, (i.e., market manipulation or silent deception). See *Cochran v. Channing Corp.*, 211 F. Supp. 239, 243 (S.D.N.Y. 1962) (undisclosed scheme held actionable because clauses (a) and (c) of rule 10b-5, unlike clause (b), do not require any form or statement). Cf. *United States v. Charnay*, 537 F.2d 341, 350 (9th Cir. 1976) ("clauses (a) and (c) . . . are not aimed at failures to disclose. Rather they are flat prohibitions of deceitful practices and market manipulations").

The legislative history of rule 10b-5 suggests that it was taken almost verbatim from § 17(a) of the 1933 Act, 15 U.S.C. § 77q (1976), and that it was intended to provide defrauded sellers with the same protections given buyers under § 17(a). It is reasonable to infer that Congress did not intend to give broader meaning to the term "fraud" in rule 10b-5 than in a closely related section. See Securities Act Release No. 3230 (May 21, 1942). Neither the House nor the Senate reports on the 1933 Act explain the meaning of § 17(a). See S. REP. NO. 47, 73d Cong., 1st Sess. (1933); H.R. REP. NO. 85, 73rd Cong., 1st Sess. (1933). House Committee hearings on an earlier version of § 17(a), § 13, however, are helpful in ascertaining the meaning of the term "fraud," and establish that it does not mean "equitable fraud." Section 13 was intended to deter "fraud by way of misrepresentation through the mails. . . . It had to do with the communication of false information . . ." *Hearings on H.R. 4314 Before the House Comm. on Interstate & Foreign Commerce*, 73d Cong., 1st Sess. 11 (1933). Moreover, the legislative history of § 13 indicates that it "does not attempt to regulate the internal operations of the corporation . . ." *Id.* at 116 (testimony of draftsman Ollie M. Butler). Thus, "fraud," for purposes of § 17(a), and accordingly § 10(b), connotes deception, not "equitable fraud."

The phrase "any scheme or artifice to defraud," which appears in rule 10b-5, was construed by the Supreme Court in *Fasulo v. United States*, 272 U.S. 620 (1926). In *Fasulo* the Court considered whether blackmail letters fall within the meaning of that phrase, and held that coercion, however morally objectionable, was not "fraud" absent a showing of trickery or deceit. See also *Hammerschmidt v. United States*, 265 U.S. 182, 188 (1924) (advocating violation of Selective Service Act is not fraud because it does not involve "deceit, craft, or trickery"); *Epstein v. United States*, 174 F.2d 754, 765 (6th Cir. 1949) ("Actual fraud has been defined as intentional fraud, consisting in deception intentionally practiced to induce another to part with property or to surrender some legal right, and which accomplishes the end designed."). *Accord*, *Post v. United*

of section 10(b) and rule 10b-5, a number of federal courts have attempted to stretch these provisions to apply to all intentional breaches of fiduciary duty, including going private transactions.⁸¹ A split of judicial opinion ensued over whether rule 10b-5 may be utilized to prevent going private transactions that are not deceptive, but merely coercive in nature.⁸² The divergent viewpoints stemmed from a fundamental dispute over the propriety of expanding the scope of section 10(b) beyond the traditional parameters of disclosure to embody a substantive fairness standard not on the face of the statute, or within the legislative history.⁸³ In light of this division,⁸⁴ rule 10b-5 failed to

States, 407 F.2d 319, 329 (D.C. Cir. 1968), *cert. denied*, 393 U.S. 1092 (1969); *Shushan v. United States*, 117 F.2d 110, 115 (5th Cir.), *cert. denied*, 313 U.S. 574 (1941).

81. *E.g.*, *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977) (holding that rule 10b-5 prohibits all intentional breaches of fiduciary duty, whether or not the conduct which constitutes the breach is disclosed). *Accord*, *Bailey v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976); *Seigal v. Merrick*, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,467 (S.D.N.Y. 1976). *But see, e.g.*, *Marsh v. Armada Corp.*, 533 F.2d 978, 985-86 (6th Cir. 1976), *cert. denied*, 430 U.S. 954 (1977) (court refused to read *Green* so broadly as to include all intentional breaches of fiduciary duty).

82. *See* Address by A.A. Sommer, Jr., *supra* note 10, at 84,695, in which Commissioner Sommer aptly described why coercion in itself is a vice that the federal securities regulation scheme must recognize:

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

For a discussion of the limits of rule 10b-5, see Bradford, *Rule 10b-5: The Search For a Limiting Doctrine*, 19 BUFFALO L. REV. 205 (1970); Bromberg, *Are There Limits to Rule 10b-5?*, 29 BUS. LAW. 167 (Spec. Issue March 1974); Jacobs, *Birnbaum in Flux: Significant 10b-5 Developments*, 2 SEC. REG. L.J. 305 (1975).

83. *See* note 74 *supra*. The legislative history of the securities statutes uncovers no legislative intent to prohibit "unfair" practices that are disclosed. Although the purpose of the Act is admittedly "to prevent inequitable and unfair practices on such exchanges and markets," and "to insure the maintenance of fair and honest markets," 15 U.S.C. § 78b (1976), it is clear that fairness in this context refers to market manipulation, rather than intracorporate disputes. The legislative purpose of the Act to prevent "inequitable and unfair practices" is consistent with the language of § 10(b), which limits its effect to manipulative and deceptive devices. In short, neither the Act's purpose nor § 10(b) supports the prohibition against all breaches of fiduciary duty. *See* H.R. REP. NO. 1383, 73d Cong., 2d Sess. 10 (1934); S. REP. NO. 1455, 73d Cong., 2d Sess. 81 (1934). There is no substantive proof of a congressional intent to enforce fiduciary obligations under the 1934 Act beyond requiring disclosure. *See also* H.R. REP. NO. 1383, 73d Cong., 2d Sess. 5 (1934) (making clear that the fiduciary duty owed between shareholders is a duty to disclose).

84. *Albright v. Bergendahl*, 391 F. Supp. 754, 756 (D. Utah 1974), represents the SEC position. In *Albright* a merge-out of minority shareholders was held to constitute "a device or artifice to defraud" or "an act, practice or course of business which operates or would operate as a fraud or

emerge as the bearer of a fairness standard.

The SEC proposed rules 13e-3A⁸⁵ and 13e-3B⁸⁶ as the first step toward a comprehensive solution to the going private dilemma. Rule 13e-3A would have imposed requirements of both disclosure and fairness of parties initiating a going private transaction, whereas rule 13e-3B would have required not only fairness with respect to the terms of the transaction, but also a "valid business purpose."⁸⁷ These proposed rules prompted the Second Circuit Court of Appeals to construe rule 10b-5 as analogous to the "valid business purpose" test of rule 13e-3B, in *Marshel v. AFW Fabric Corp.*,⁸⁸ and *Green v. Santa Fe Industries*,

deceit' upon the minority shareholders. . . ." *Id.* See Howard Weinberger [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,052, at 84,898 (SEC staff letter Nov. 7, 1974) (implying SEC approval of the *Albright* holding). See generally Banoff, *supra* note 77, at 3-10.

The Second Circuit adopted the opposing viewpoint in *Kaufmann v. Lawrence*, 386 F. Supp. 12, 17 (S.D.N.Y. 1974), *aff'd per curiam*, 514 F.2d 283 (2d Cir. 1975). In *Kaufmann* the court held that the requirements of the securities laws regarding going private are satisfied as long as full and fair disclosure has been made. Two questions, in the court's view, should be asked: 1) Do minority shareholders have a true choice? and 2) Is the market price of a public corporation's stock necessarily a fair valuation of its worth? See Note, *Federal Regulation of the Going Private Phenomenon*, 6 CUM. L. REV. 141, 193 (1975). See generally *Herpich v. Wallace*, 430 F.2d 792, 806 (5th Cir. 1970); *Kahan v. Rosenstiel*, 424 F.2d 161, 173 (3d Cir.), *cert. denied*, 398 U.S. 950 (1970).

The *Kaufmann* rationale that minority shareholders need only be fully apprised of the implications of their decision is generally given in response to the view that corporate insiders acted improperly in going private. Defendant's Memorandum at 18, and Defendant's Reply Memorandum at 5, *Kaufmann v. Lawrence*, 386 F. Supp. 12 (S.D.N.Y. 1974). *Accord*, *University Capital Corp. v. Barbara Lynn Stores, Inc.*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,949 (S.D.N.Y. 1975). See generally *Brudney & Chirelstein, Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974); *Vorenberg, supra* note 48, at 1189. See also *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 383 (2d Cir. 1974) ("[T]he equities call for protection of the minority shareholder when he is the most helpless, as when neither disinterested director nor disinterested shareholder voting exists as a safeguard"); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967) (minority shareholder "cashed out" by a short form merger held a "forced seller" with standing to sue under rule 10b-5).

85. Proposed rule 13e-3A, SEC Securities Exchange Act Release No. 11231, 40 Fed. Reg. 7947, 7950 (1975). See notes 97 and 99 *infra* and accompanying text.

86. Proposed rule 13e-3B, SEC Securities Exchange Act Release No. 11231, 40 Fed. Reg. 7947, 7952 (1975).

87. Commissioner Sommer said specifically that he would not include among business considerations the objective of "avoiding the cost and bother of SEC compliance and shareholder servicing." Address of A.A. Sommer, Jr., *supra* note 10, at 84,699. In *Berkowitz v. Power/Mate Corp.*, 135 N.J. Super. 36, 44, 342 A.2d 566, 571 (Ch. 1975), a case arising shortly after promulgation of the proposed rules, the court referred to proposed rule 13e-3B in finding that a freeze-out merger had no valid business purpose. Although proposed rule 13e-3B did not have the force of law, a preliminary injunction was granted, with questions raised as to the fairness of the transaction. *Id.*

88. 398 F. Supp. 734 (S.D.N.Y. 1975), *rev'd as to rule 10b-5 but not as to state law*, 533 F.2d 1277 (2d Cir.), *cert. granted, judgment vacated, and remanded for consideration of question of moot-*

*Inc.*⁸⁹

The United States Supreme Court refused to uphold the Second Circuit's position in *Santa Fe Industries, Inc. v. Green*.⁹⁰ *Santa Fe* firmly

ness, 429 U.S. 881 (1976), *order denying injunctive relief vacated on grounds of mootness, remanded to district court on question of damages*, 552 F.2d 471 (2d Cir.), *motion to dismiss on basis of Green v. Santa Fe Indus. Inc. granted*, 441 F. Supp. 299 (S.D.N.Y. 1977). In *Marshel* a corporation had gone public in 1968 with public offerings of fifteen dollars per share. When the stock price dropped to one dollar per share in 1974, the owner of 68% of the voting shares decided to go private by a long form merger of the public corporation with a shell corporation created solely for the purpose of going private. 533 F.2d at 1279. In an action brought by minority shareholders to enjoin the merger, the Second Circuit held that the majority shareholder had breached a fiduciary duty owed to both the corporation and the minority shareholders. *Id.* at 1282. Because there was no valid business purpose for the merger, the court concluded that the majority shareholder had defrauded the minority shareholders in violation of rule 10b-5, which prohibits any act which operates as a fraud in connection with the purchase or sale of any security. *Id.* at 1281. To support its holding, the court cited *Schoenbaum Ins. v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969), and *Drachman v. Harvey*, 453 F.2d 722, 736-38 (2d Cir. 1972) (rehearing en banc). *Id.*

For an in depth analysis of the *Marshel* case as well as the use of rule 10b-5 to regulate fairness in going private, see Banoff, *supra* note 77, at 1; Rosenfeld, *An Essay in Support of the Second Circuit's Decisions in Marshel v. AFW Fabric Corp. and Green v. Santa Fe Industries*, 5 HOFSTRA L. REV. 111 (1976); Note, *The Second Circuit Adopts a Business Purpose Test For Going Private: Marshel v. AFW Fabric Corp. and Green v. Santa Fe Industries, Inc.*, 64 CALIF. L. REV. 1184 (1976); Comment, *Going Private and Rule 10b-5: The Green and Marshel Decisions*, 47 MISS. L.J. 981 (1976); 10 GA. L. REV. 1059 (1976); 64 GEO. L.J. 1381 (1976); 89 HARV. L. REV. 1917 (1976); 9 IND. L. REV. 1033 (1976); 55 N.C. L. REV. 333 (1977); 45 U.M.K.C. L. REV. 297 (1976).

89. 533 F.2d 1283 (2d Cir.), *rehearing en banc denied*, 533 F.2d 1309 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977), *noted in* 31 Sw. L.J. 739 (1977). In *Green* majority shareholders attempted to merge Kirby, a 95% subsidiary of Santa Fe, with a holding company pursuant to a state short form merger procedure, solely for the purpose of returning Kirby to private status. Contrary to the claim of initiators of the going private transaction that no valid ground for applying rule 10b-5 had been raised, the Second Circuit ruled that a claim is properly stated under rule 10b-5 "when it charges . . . 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." 533 F.2d at 1291. The Second Circuit upheld the minority shareholders' argument that the short form merger violated rule 10b-5 and was a "flagrant self-deal" in which the majority stockholders breached a fiduciary duty to the minority by cashing them out at an unfair price without prior notice or consent. *Id.* at 1285, 1288, 1291.

The Second Circuit took pains to recognize the distinction between the traditional application of rule 10b-5 to misrepresentation and nondisclosure situations and the application of rule 10b-5 to situations involving a breach of fiduciary duty. *Id.* at 1289-90. *Green* thus adopted the valid business purpose test for cases involving breach of fiduciary duty.

90. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), *noted in* 4 A. BROMBERG, SECURITIES LAW: FRAUD (New Matter) § 4.7, at 400.20-23 (Supp. 1977). See notes 74 and 88 *supra*. The plaintiffs in *Santa Fe* alleged that the only purpose for the merger was to eliminate minority shareholders, and that the valuation placed on the shares in the cash exchange was fraud, thus actionable under rule 10b-5. Contrary to the finding of the Second Circuit, the Supreme Court held that unless a material, intentional misrepresentation or nondisclosure is proven, a mere breach of fiduciary duty will not support a rule 10b-5 violation. The Court followed the precedent

limited the scope of SEC authority to substantively regulate corporate activity under section 10(b). Justice White emphasized that, because the SEC only had authority to adopt regulations to carry out express congressional intent,⁹¹ the Commission had no power to make rules that exceeded the scope of section 10(b). Thus, the language “manipulative or deceptive device” could not be used to stretch section 10(b) to reach mere breaches of fiduciary duty “in which the essence of the complaint is that shareholders were treated unfairly.”⁹²

The Supreme Court in *Santa Fe* thus created a conspicuous gap in the federal securities regulation of going private transactions.⁹³ The *Santa Fe* Court opined that this area was one that Congress intended to be left to the states.⁹⁴ The regulatory void left by *Santa Fe* created a

established in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), by strictly construing the language of § 10(b) and finding “no indication that Congress meant to prohibit any conduct not involving manipulation or deception.” 430 U.S. at 473. The Court then defined “deceptive” and “manipulative,” a discussion which has proven to be of great value in construing those terms in the context of rule 13e-3. *Id.* at 474-77. *See generally* note 77 *supra*.

91. 430 U.S. at 472 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976)).

92. 430 U.S. at 477. *See id.* at 479-80 (quoting Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 700 (1974)). The Supreme Court’s disagreement with the Second Circuit was in part derived from the former’s reluctance to recognize a cause of action “to serve what is ‘at best a subsidiary purpose’ of the federal legislation.” 430 U.S. at 478.

93. The *Santa Fe* case is but a sampling of the Supreme Court’s “strict constructionist” philosophy regarding rule 10b-5. For another example, see *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). In *Blue Chip Stamps*, the Supreme Court refused to extend the protection of § 10(b) and rule 10b-5 to persons who rejected a private stock offering. Because the statute refers to deception or manipulation in connection with the purchase or sale of securities, the Court reasoned that only actual purchasers or sellers enjoy the protection of § 10(b) and rule 10b-5. *Id.* at 731.

94. *See* 430 U.S. at 478. The Court was obviously concerned with the effect its decision would have on state regulation of corporations:

Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden. As the Court stated in *Cort v. Ash*, *supra*: ‘Corporations are creatures of the state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.’

430 U.S. at 479 (emphasis in original).

The Court articulated this states rights argument as a policy consideration to justify a restrictive reading of the scope of rule 10b-5. The creation of federal fiduciary principles, the Court stated, could “overlap and quite possibly interfere with state corporate law.” *Id.*

For an analysis of the Supreme Court’s decision in *Green*, see Jacobs, *How Santa Fe Affects 10b-5’s Proscriptions Against Corporate Mismanagement*, 6 SEC. REG. L.J. 3 (1978); Newton, *The Limits of Liability: Recent Judicial Restrictions on Rule 10b-5*, 6 FLA. ST. U.L. REV. 63, 97 (1978); 9 TEX. TECH. L. REV. 211 (1977); 29 U. FLA. L. REV. 761 (1977).

climate of urgency among proponents of SEC power to regulate going private transactions, which served as a catalyst for the further development and eventual enactment of rule 13e-3.⁹⁵

III. THE EVOLUTION OF RULE 13E-3

Because federal and state courts were unable to deal with the going private dilemma, the SEC began rulemaking proceedings in 1975 to ascertain facts, conditions, and practices of going private. To provide a framework for the hearings and comments and to determine whether to adopt rules under section 13(e), the Commission proposed two alternative rules:⁹⁶ 13e-3A⁹⁷ and 13e-3B.⁹⁸

The proposed rules offered two alternative formulations for regulating the substantive fairness of a going private transaction. Rule 13e-3A prescribed objective requirements for a going private transaction, and rejected federal inquiry into the motive for the transaction, providing only that the offered consideration "constitute fair value."⁹⁹ Rule 13e-3B was much broader. In addition to disclosure, it required that the terms of the transaction, including the consideration, be fair.¹⁰⁰ Rule 13e-3B went a step further, however, by requiring that the going private transaction be consistent with a "valid business purpose."¹⁰¹

Not unexpectedly, these proposals, especially rule 13e-3B, drew heavy criticism from many quarters of the legal and business communities.¹⁰² The Supreme Court, in *Santa Fe Industries, Inc. v. Green*,¹⁰³

95. The SEC, however, in promulgating rule 13e-3, "specifically affirmed" its view that it did have authority to regulate going private transactions. SEC Securities Exchange Act Release No. 6100, 44 Fed. Reg. 46,736, 46,738 (1979).

96. See SEC Securities Act Release No. 5567, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,104, at 85,089 (1975). See generally Bacon, *SEC Moving to Protect Minority Holders When Firms Buy Shares, "Go Private,"* Wall St. J., Feb. 5, 1975, at 12, col. 2; Scheibla, *Private Affair*, BARRON'S, March 17, 1975, at 9, col. 1; New York Times, Feb. 7, 1975, at 39, col. 4.

97. SEC Securities Exchange Act Release No. 5567, 40 Fed. Reg. 7947, 7950 (1975).

98. SEC Securities Exchange Act Release No. 5567, 40 Fed. Reg. 7947, 7952 (1975).

99. The proposed rule required two independent appraisers to determine fair value. SEC Proposed Rule 13e-3A(c)(2), 40 Fed. Reg. 7947, 7951 (1975).

100. See SEC Proposed Rule 13e-3B(a)(2), 40 Fed. Reg. 7947, 7952 (1975).

101. *Id.* The Release that accompanied the proposals stated that the rationale for the broad language of proposed rule 13e-3B was to give the SEC "sufficient flexibility to deal with any type of transaction." 40 Fed. Reg. 7947, 7950 (1975).

102. The SEC received 83 letters of comment in response to its proposals. 42 Fed. Reg. 60,090, 60,092 (1977). A summary of the comment letters appears in [1975] SEC REG. & L. REP. (BNA) No. 318, A-1 to A-6. See also Mulvihill, *Securities Release Analysis*, CORPORATE COUNSEL'S ANN. 1027 (1975).

103. 430 U.S. 462 (1977), *rev'g* 533 F.2d 1283 (2d Cir. 1976), *noted in* 4 A. BROMBERG, SECURITIES LAW: FRAUD (New Matter) § 4.7 (Supp. 1977).

added to the debate. Although the Court in *Santa Fe* considered rule 10b-5 rather than section 13(e) of the Exchange Act, the majority addressed itself directly to the issue of SEC substantive rulemaking power. The Court held that minority shareholders do not state a cause of action under rule 10b-5 absent proof of deceptive or manipulative conduct.¹⁰⁴

In response to this position, the SEC publicly took the position that the Supreme Court's holding was narrow, restricted to rule 10b-5 disputes, and without bearing on section 13(e). The Commission further contended that section 13(e), unlike section 10(b), was part of legislation that Congress intended to "close the gaps" in the federal securities laws.¹⁰⁵ Thus, the rulemaking power under section 13(e) extended beyond section 10(b).¹⁰⁶

Shortly after *Santa Fe*, the SEC refined its position, issuing proposed rule 13e-3¹⁰⁷ in 1977. This proposal stated that it would be unlawful for an issuer to engage in a going private transaction unless the transaction was "fair" to minority shareholders.¹⁰⁸ Although the "valid business purpose" language, which was part of proposed rule 13e-3, was omitted from the 1977 version, the Rule's "fairness" requirement suggested the same extent of SEC intrusion in the corporate decisionmaking process. To critics of SEC substantive fairness authority, the 1977 proposal was no improvement over the two 1975 proposals.¹⁰⁹ Proposed rule 13e-3B required that the consideration paid in the going private transaction be fair.¹¹⁰ Under the 1977 version of rule 13e-3 the

104. See 430 U.S. at 463.

105. See S. REP. NO. 550, 90th Cong., 1st Sess. 4 (1967).

106. See 42 Fed. Reg. 60,090, 60,094 (1977). While section 10(b) speaks in terms of "manipulative or deceptive," section 13(e) refers to "fraudulent, deceptive, or manipulative." "The specific language of and the rulemaking authority conferred by Section 13(e) which was part of legislation intended by Congress to close a gap in the Federal securities laws, is in sharp contrast to that of Section 10(b) which is directed at the purchase or sale of any security." *Id.* at 60,094 (footnote omitted). See also S. REP. NO. 560, 90th Cong., 1st Sess. 4 (1967).

107. Proposed Rule 13e-3, SEC Securities Exchange Act Release No. 5884, 42 Fed. Reg. 60,090 (1977).

108. See Proposed Rule 13e-3(b)(i), (2)(i), (2)(iii)(A)-(J), 42 Fed. Reg. at 60,101.

109. See generally Note, *SEC Rulemaking Authority and the Protection of Investors: A Comment on the Proposed "Going Private" Rules*, 51 IND. L. J. 433 (1976).

110. See SEC Proposed Rule 13e-3B, SEC Securities Exchange Act Release No. 5567, *supra* note 96, at 85,092.

transaction itself had to be fair.¹¹¹

In August of 1979, the SEC finally enacted rule 13e-3.¹¹² Like its precursors, the Rule requires the issuer to file information with the Commission. The proposed fairness requirements, however, were omitted from the final version of rule 13e-3. Instead, the adopted Rule requires extensive disclosures regarding the fairness of the going private transaction. For example, the issuer must state whether it reasonably believes that the transaction is fair or unfair to minority shareholders.¹¹³ A mere statement that the issuer has no reasonable belief as to the fairness of the transaction is insufficient.¹¹⁴

The issuer must also disclose the grounds for its reasonable belief in the fairness of the transaction,¹¹⁵ including a discussion of the various criteria that form the basis for that belief. Boilerplate statements concerning the management's belief in the fairness of the going private transaction are no longer sufficient.¹¹⁶

Rule 13e-3 mandates expanded disclosure of the "purpose(s), alternatives, reasons, and effects" of the going private transaction.¹¹⁷ The Rule also requires a description of both the benefits and detriments of the transaction to the issuer as well as affiliates and minority shareholders.¹¹⁸ The Rule requires disclosure of any report, opinion, appraisal or negotiation report received from an outside party relative to the going private transaction,¹¹⁹ and therefore broadens the information avail-

111. Of the numerous factors listed in the 1977 proposal as indicia of the general fairness of the going private transaction, only one went to the question of fair consideration. SEC Proposed Rule 13e-3(b)(2)(iii)(A)-(J), *supra* note 108. This extension of the SEC role in evaluating going private transactions was a major factor in the subsequent assertion by state courts that going private transactions have to be characterized by "entire fairness." The Delaware Supreme Court was the first court to act in this fashion. See *Singer v. Magnavox*, 380 A.2d 969 (Del. 1977). For an analysis of the *Magnavox* fairness approach, see Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978); McBride, *Delaware Corporate Law: Judicial Scrutiny of Mergers—The Aftermath of Singer v. The Magnavox Company*, 33 BUS. LAW. 2231 (1978); 66 CALIF. L. REV. 118 (1978); 10 CONN. L. REV. 511 (1978); 57 N.C. L. REV. 163 (1978); 47 U. CINN. L. REV. 164 (1978); 31 VAND. L. REV. 183 (1978).

112. SEC Rule 13e-3, SEC Securities Act Release No. 6100, 17 C.F.R. § 240.13e-3 (1980).

113. See SEC Schedule 13E-3(H) Item 8, SEC Securities Act Release No. 6100, 44 Fed. Reg. 46,736, 46,745 (1979).

114. *Id.* See also SEC Schedule 13E-3(H) Item 7(d)(1), *supra* note 113, at 46,745: "Conclusory statements will not be considered sufficient disclosure . . ."

115. See SEC Schedule 13E-3(H) Item 7, *supra* note 113, at 46,745.

116. *Id.*

117. See SEC Schedule 13E-3(H) Item 7, *supra* note 113, at 46,745.

118. *Id.*

119. See SEC Schedule 13E-3(H) Item 9, 17 C.F.R. § 240.13e-100 (1980). In addition, Item 9

able to minority shareholders.¹²⁰

The issuer must disclose any plans to merge, reorganize, sell assets or employ any other material change after the going private transaction.¹²¹ Moreover, officers or directors who plan to vote to sell their stock after a rule 13e-3 transaction, must disclose such plans.¹²² Finally, rule 13e-3 requires disclosure of the source and total amount of funds for the going private transaction,¹²³ an estimation of the expected expenses, and a summary of any loan agreement, as well as plans or arrangements to finance or repay loans.¹²⁴

IV. SEC POWER TO REGULATE SUBSTANTIVE FAIRNESS

The basis of the so-called going private debate is whether the SEC has authority not only to require disclosure of material aspects of secur-

requires the issuer to disclose whether it has received any report, opinion, or appraisal or negotiation report from an outside party which is materially related to the rule 13e-3 transaction. *Id.* at (a). This includes any report relating to the fairness of the transaction. *Id.* If a report is received, it must be made available to shareholders for inspection and copying. *Id.* at (c). In addition, disclosures are required about the identity, *id.* at (b)(1), method of selection, *id.* at (b)(3), qualifications, *id.* at (b)(2), and material relationships between the issuer and the outside party. *Id.* at (b)(4).

Rule 13e-3(e)(2)(A), (B), 17 C.F.R. § 240.13e-3 (1980), requires the issuer to respond to these items in a prominent place on the disclosure document:

(ii) Set forth on the outside front cover page in capital letters printed in bold face roman type at least as large as ten point modern type and at least two points leaded, the statement in paragraph . . . (A) . . . if the Rule 13e-3 transaction does not involve a prospectus, or the statement in paragraph . . . (B) . . . if the Rule 13e-3 transaction does involve a prospectus

(A) THIS TRANSACTION HAS NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE FAIRNESS OR MERITS OF SUCH TRANSACTION NOR UPON THE ACCURACY OF (sic) ADEQUACY OF THE INFORMATION CONTAINED IN THIS DOCUMENT. ANY REPRESENTATION TO THE CONTRARY IS UNLAWFUL.

(B) NEITHER THIS TRANSACTION NOR THESE SECURITIES HAVE BEEN APPROVED OR DISAPPROVED (sic) BY THE SECURITIES AND EXCHANGE COMMISSION. THE COMMISSION HAS NOT PASSED UPON THE FAIRNESS OR MERITS OF THIS TRANSACTION NOR UPON THE ACCURACY OR ADEQUACY OF THE INFORMATION CONTAINED IN THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS UNLAWFUL.

Id.

120. See SEC Schedule 13E-3(H) Item 9, 17 C.F.R. § 240.13e-100 (1980).

121. See SEC Schedule 13E-3(H) Item 5, 17 C.F.R. § 240.13e-100 (1980). The issuer must describe such plans in detail. *Id.* See SEC Rule 13e-3(g)(1)(ii)(A), 17 C.F.R. § 240.13e-3 (1980).

122. See SEC Rule 13e-3(g)(1)(ii)(B), 17 C.F.R. § 240.13e-3 (1980). See also SEC Schedule 13E-3(H) Item 5 (a)(b), 17 C.F.R. § 240.13e-100 (1980).

123. See SEC Schedule 13E-3(H) Item 6(a), 17 C.F.R. § 240.13e-100 (1980).

124. *Id.* at 6(b).

ities transactions, but also to regulate their substantive fairness as well.¹²⁵ This controversy persists despite the form of the test—the “valid business purpose” of proposed rule 13e-3B,¹²⁶ the “fairness” standard of the 1977 proposal,¹²⁷ or the extensive fairness oriented disclosure provisions of the adopted rule.¹²⁸

The centerpiece of the going private debate is section 13(e) of the 1934 Act.¹²⁹ Its legislative history clearly restricts SEC power to adopt fairness standards in the regulation of securities transactions. Congressional debate on section 13(e) indicates an intent not only to grant authority to enact disclosure requirements, but also to deny the SEC power to regulate the fairness of securities transactions.¹³⁰ The language of the original bill in the Senate inferred a broad rulemaking power vested in the SEC. The original bill granted the SEC power “necessary or appropriate in the public interest *or* for the protection of investors *or* in order to prevent such acts as are fraudulent, deceptive,

125. See notes 129-46 *infra* and accompanying text.

126. SEC Proposed Rule 13e-3B, SEC Securities Exchange Act Release No. 5567, 40 Fed. Reg. 7947, 7952 (1975) (codified at 17 C.F.R. § 240.13e-3 (1980)):

(a) it shall be *unlawful*, as a fraudulent, deceptive, or manipulative act or practice, for any issuer . . . to enter into a [going private transaction] . . . unless:

(1) if such transaction . . . has a valid business purpose . . . ;

(2) the terms of such transaction, including any consideration to be paid to any security holder, are fair.

Id. (emphasis added).

127. See SEC Proposed Rule 13e-3, SEC Securities Exchange Act Release No. 5884, 42 Fed. Reg. 60,090 (1977). Representative examples of the substantive fairness requirements in the 1977 proposal are: “*It shall be a fraudulent, deceptive or manipulative act or practice . . . for an issuer . . . to purchase . . . any such security if such Rule 13e-3 transaction is unfair . . .*” *Id.* at 60,101 (emphasis added). The 1977 Proposal also spelled out conditions that bear on the question of fairness. *Id.*

128. See SEC Rule 13e-3, 17 C.F.R. § 240.13e-3 (1980). The adopted rule omits the outright prohibitions of unfairness that were included in the proposals, see notes 126 and 127 *supra*, but requires instead that the issuer state whether he “reasonably believes” that the rule 13e-3 transaction is fair to unaffiliated security holders. See notes 113-15 *supra* and accompanying text.

129. Securities Exchange Act of 1934, § 13(e), 15 U.S.C. § 78m(e) (1976). Section 13(e) empowers the SEC to enact rules and regulations with respect to going private “to define acts or practices which are fraudulent, deceptive, or manipulative, and . . . to prescribe means reasonably designed to prevent such acts and practices.”

Section 13(e) is a part of the 1968 Williams Act Amendments. See Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454, amending 15 U.S.C. § 78m (1970). The Williams Act, 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1976), was enacted to protect investors by the traditional full disclosure of terms, conditions, and financing, as well as the identification of background information regarding the offeror.

130. See generally Note, *SEC Rulemaking Authority and the Protection of Investors: A Comment on the Proposed “Going Private” Rules*, 51 IND. L.J. 433 (1976).

or manipulative.”¹³¹ The fear that the bill would enable the SEC to interfere in the traditional areas of state regulation, especially fairness,¹³² resulted in the present, more restrictive form. Congress thus empowered the SEC to adopt rules “in the public interest or for the protection of investors, . . . (A) to define acts and practices which are fraudulent, deceptive, or manipulative, and (B) to prescribe means reasonably designed to prevent such acts and practices.”¹³³ The House expressly stated that this change in the wording of section 13(e) was made so as not to convey the “improbable interpretation” that the Commission could issue rules not “designed solely to prevent acts and practices which are fraudulent, deceptive, or manipulative.”¹³⁴

Because the legislative history of section 13(e) indicates congressional intent to withhold substantive fairness authority from the SEC,¹³⁵ proponents of SEC fairness authority have relied upon (1) generalized notions of a “national public interest in the regulation of going

131. S. REP. NO. 550, 90th Cong., 1st Sess. 14 (1967):

(e)(1) It shall be unlawful for an issuer to purchase any equity which it has issued 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, or in order to prevent such acts and practices as are fraudulent, deceptive, or manipulative.

Id. Note the use of the disjunctive which spells out a broad, vague grant of power to the SEC. To give the SEC power to prescribe rules as are “necessary or appropriate” or for “protection of investors” is tantamount to a blank check of authority.

132. See Letter from the Ass’n of the Bar of the City of New York to the House Comm. on Interstate and Foreign Commerce, June 28, 1968, *Hearings on S. 510 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate & Foreign Commerce*, 90th Cong., 1st Sess. 13, 73-74 (1968) (“In our view, this proposal represents an unnecessary and unwarranted departure from the concepts of investor protection which the Federal regulatory power has been traditionally designed to provide”). Former SEC Chairman Manuel F. Cohen countered this objection to potentially broad SEC authority. *Id.* at 15 (testimony of Manuel F. Cohen).

133. Securities Exchange Act of 1934, § 13(e)(1), 15 U.S.C. 78m(e)(1) (1976). See note 129 *supra*.

134. The Williams Act Amendments, see note 129 *supra*, were explained on the House floor by Rep. Moss: “The original language might be interpreted, although not so intended, as giving the Commission a broader basis for prescription of rules unassociated with this purpose.” 114 CONG. REC. 21484 (1968). See *id.* at 21954 (1968) (remarks of Sen. Bennett).

135. The SEC, on the other hand, believes that an examination of the Exchange Act and its legislative history indicates a legislative intent to grant the Commission power to regulate fairness in the going private context. Section 2 of the Act, 15 U.S.C. 78b (1976), which sets forth the rationale for the Commission’s regulatory power, states that transactions in securities are effected with a “national public interest” that makes it necessary to provide for the regulation and control of such transactions. This includes “transactions by officers, directors, and principal security holders . . . to impose requirements necessary to make such regulation and control reasonably complete and effective in order to . . . insure the maintenance of fair and honest markets . . .” *Id.*

private transactions,"¹³⁶ and (2) a stated, albeit vague, legislative intent that section 13(e) "fill the gaps" in the federal securities regulation scheme. Indeed, the keystone of the securities law decisions that broadly construed the Commission's rulemaking power¹³⁷ has been an express congressional mandate that the SEC adopt rules "in the public interest or for the protection of investors."¹³⁸

The SEC also attempts to support its "specifically affirmed"¹³⁹ substantive fairness authority by the penumbra doctrine, which states that the Commission's power to regulate fairness is derived from not one, but a combination of six different Exchange Act provisions.¹⁴⁰

The argument that the SEC rulemaking authority exists on the basis of a penumbra pales, however, against the clarity of the legislative history of section 13(e).¹⁴¹ The House Report on section 13(e) categorically clarified that such rules and regulations may be adopted only to define and prohibit fraudulent, deceptive or manipulative acts.¹⁴²

Proponents of SEC rulemaking authority further attempt to justify substantive fairness power by conceding the validity of section 13(e)-3's restrictive legislative history. Focusing their efforts on the phrase "fraudulent, deceptive, or manipulative," they claim that any going private transaction that lacks a valid business purpose constitutes a manipulative transaction. This approach, rather than expanding the scope of section 13(e), argues that the coercion, which is inherent in a going private transaction, falls within the meaning of that phrase.

In response, critics of the Commission contend that to attempt to define coercive, and typically unconcealed going private conduct as "fraudulent, deceptive, or manipulative" would violate the restrictive congressional intent of section 13(e).¹⁴³ Moreover, to define as fraudu-

136. Securities Exchange Act of 1934, § 2, 15 U.S.C. § 78b (1976): "Transactions in securities . . . are affected with a national public interest which makes it necessary to provide for regulations and control of such transactions and of practices and matters related thereto . . ." *Id.*

137. *See* Superintendent of Ins. v. Banker's Life & Cas. Co., 404 U.S. 6, 12-13 (1971); Eason v. General Motors Acceptance Corp., 490 F.2d 654, 659 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

138. Securities Exchange Act of 1934, § 13(e)(1), 15 U.S.C. § 78m(e)(1) (1976).

139. 44 Fed. Reg. 46,736, 46,736 (1979).

140. Securities Exchange Act of 1934, §§ 13(e), 14(e), 14(a), 14(c), 10(b), & 3(b), 15 U.S.C. §§ 78m(e), 78n(e), 78n(a), 78n(c), 78j(b), & 78c(b) (1976).

141. *See* notes 131-34 *supra* and accompanying text.

142. *See* notes 128-34 *supra* and accompanying text.

143. The Subcommittee Report explained that the amendment was made:

To clarify the intent . . . that the rules to be adopted by the Commission covering the

lent or deceptive any going private transaction that lacks a valid business purpose would contradict case law.¹⁴⁴ Given the fact that federal securities laws specifically provide for deregulation of companies¹⁴⁵ and delisting of shares¹⁴⁶ without regard to corporate purpose, it is improbable that Congress would intend to empower the SEC to utilize its anti-fraud authority as a pretext for the regulation of fairness.

Thus, the legislative history of section 13(e) provides no basis for an expansive interpretation, but indicates that Congress actually narrowed the language of section 13(e). For this reason, neither the statutory language nor the legislative history supports the SEC's attempt to construct a broad substantive fairness standard from section 13(e), as the proposed rules have done.

Because the SEC omitted the controversial substantive fairness provisions¹⁴⁷ of the proposals when it promulgated the final version of rule 13e-3, a number of commentators took the position that the Commission punted on the issue of SEC authority to regulate the fairness of going private transactions, rendering the question moot. Closer scrutiny of the disclosure scheme reveals, however, that the Commission did not concede the issue of substantive fairness. Although the drafters confined themselves to disclosure requirements, the extensiveness of the SEC provisions and their preoccupation with the fairness and purpose of the going private transaction, prompts the inquiry: Are not the extensive disclosure provisions of rule 13e-3 tantamount to a substantive fairness standard?

On its face the disclosure scheme of rule 13e-3 strongly suggests the presence of a substantive fairness rationale. Conspicuous similarities

purchase by an issuer of its own securities were related *solely* (A) to define acts and practices which are fraudulent, deceptive, or manipulative, and (B) to prescribe means reasonably designed to prevent such acts and practices

H.R. REP. NO. 1711, 90th Cong., 2d Sess. 6-7 (1968) (emphasis added). The House Report goes on to state why the original language of section 13(e) was changed:

The amendment . . . was made . . . following consideration of the original language of the subsection which was in the disjunctive and lent itself to the possible although improbable interpretation that the Commission had authority to issue rules or regulations . . . quite apart from whether designed solely to prevent [fraud]. . . . The revised language makes it clear that such rules and regulations may be adopted only for these purposes.

Id. at 7.

144. See Note, *supra* note 130, at 433.

145. 15 U.S.C. § 78s(g)(4) (1976); see, e.g., Note, *supra* note 130, at 446 n.65.

146. See Note, *supra* note 130, at 446 n.65.

147. See notes 107-11 and 127 *supra* and accompanying text.

exist between the express substantive fairness requirements of the proposals and the probing disclosure provisions of the adopted rule.¹⁴⁸ For instance, even though the SEC omitted the proposed requirement that the Commission pass on the fairness of a going private transaction,¹⁴⁹ the adopted rule requires that the issuer disclose whether there is a reasonable belief that a particular transaction is fair or unfair to minority shareholders.¹⁵⁰ These two requirements are virtually indistinguishable particularly because the criteria for determining the issuer's "reasonable belief" of fairness under the adopted rule (i.e., approval of minority shareholders,¹⁵¹ current market prices,¹⁵² net book value,¹⁵³ going concern value,¹⁵⁴ liquidation value,¹⁵⁵ previous purchases,¹⁵⁶ and reports, opinions, and appraisals¹⁵⁷) are identical to the factors that the SEC would have utilized to ascertain the substantive fairness of a going private transaction under the proposed rules.¹⁵⁸

Ostensibly, the focal point of the adopted rule represents a shift from a requirement of objective fairness to one of reasonable belief. Actually, no such shift has occurred. Although the SEC could determine that the transaction itself is unfair under the proposals,¹⁵⁹ under adopted rule 13e-3 the Commission may charge either that the issuer misstated, or that he did not disclose his reasonable belief in the fairness of the going private transaction.¹⁶⁰ Under either standard the issuer is in violation of rule 13e-3 on fairness grounds.¹⁶¹ Therefore, adopted rule 13e-3 is the functional equivalent of the express substan-

148. See notes 121-22 *supra*.

149. *Id.*

150. *Id.* See SEC Schedule 13E-3(H) Item 8(a), 17 C.F.R. § 240.13e-100 (1980).

151. *Id.* at (8)(b)(1), (c).

152. *Id.* at (8)(b)(1)(i).

153. *Id.* at (8)(b)(1)(iii).

154. *Id.* at (8)(b)(1)(iv).

155. *Id.* at (8)(b)(1)(v).

156. *Id.* at (8)(b)(1)(vi).

157. *Id.* at (8)(b)(1)(vii).

158. See SEC Schedule 13E-3(H) Item 8(b), *supra* note 113, at 46,745.

159. See SEC Proposed Rule 13e-3(b)(1)(i), Securities Exchange Act Release No. 5884, 42 Fed. Reg. 60,090, 60,101 (1977). See also notes 126-27 *supra*.

160. See note 127 *supra*.

161. The adopted version of rule 13e-3 further closes up any potential loopholes from the avoidance of fairness analysis by forbidding any statement that the issuer has no reasonable belief as to the fairness of the transaction. See notes 113, 114, 133 *supra*. Moreover, mere conclusory statements regarding the issuers' belief as to fairness are no longer sufficient.

tive fairness standards contained in the proposals, and achieves a substantially similar objective.

If rule 13e-3, as finally adopted, does in fact regulate the fairness of going private transactions in the same way as the proposed rules, the next question is: Does the SEC have the statutory authority to regulate substantive fairness within the context of its disclosure power?

The SEC must possess greater discretion within the parameters of its statutory powers to confront the problem of going private. Although the legislative history of section 13(e) and the 1934 Act do not support the SEC's desire to stretch the statutory language to include a broad fairness standard, the SEC should be allowed to breathe within the limitations of its power. Congress implemented both the 1934 Act and the Williams Act amendments prior to the advent of the going private phenomenon. Thus Congress could not have designed the amendments to address going private abuses. As a result, these problems have fallen between state and federal regulatory schemes, with no forum to fill the jurisdictional void. Given the necessity for a suitable regulatory body to assume jurisdiction over the going private phenomenon, the consistent failure of state remedies and traditional SEC disclosure principles, rule 13e-3 as enacted is not only proper, but also necessary for effective securities regulation.

V. CONCLUSION

Because the fairness standard of adopted rule 13e-3 emanates from the full complement of disclosure provisions that make up the Rule, it does not overstep the limitations that the restrictive legislative history of section 13(e) impose on it. Thus rule 13e-3 requirements are within the parameters of the SEC's statutory mandate. Moreover, its disclosure provisions are infused with general equitable principles to enable them to fill the gaps of the federal statutory scheme in a way that mere disclosure provisions cannot. To fill these gaps, an element of discretion is essential.

Granting the SEC discretion to pursue a fairness objective within the context of its disclosure authority allows the Commission to require information that is material to the problem. The coercive nature of the typical going private transaction raises questions that disclosure of standard information will not answer. To remedy coercion in cases where deception and concealment are not in issue, disclosure in sensitive areas of fairness is essential. The concept of disclosure is, as one

commentator has said, “axiomatic,”¹⁶² but in the going private realm, it is of little value unless the SEC has the power to require disclosure in the right areas. Thus, rule 13e-3 aggressively employs disclosure principles to their optimum effectiveness.

Randal J. Brotherhood

162. See Note, *Federal Regulation of the Going Private Phenomenon*, 6 CUM. L. REV. 141, 179 (1975).