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GOING PRIVATE: BUSINESS PRACTICES, LEGAL MECHANICS, JUDICIAL STANDARDS AND PROPOSALS FOR REFORM

LEWIS D. SOLOMON*

INTRODUCTION

During the late 1960's and early 1970's over 3,000 corporations went public for the first time.¹ Corporate executives sought to bring privately held companies to the securities market to obtain publicly traded paper as a means of increasing their wealth. One astute financial writer coined the term "super-currency"² to describe the stock resulting from this process.

However, amid the most severe recession since the Great Depression, public disillusionment with the nation's securities markets,³ an acceleration of the capital needs of American corporations,⁴ and a general crisis of confidence in American institutions and leadership, numerous corporations, including many of the same entities that so assiduously sought public shareholders only a few years ago, are searching to return to the status of privately held firms by using a variety of techniques. These going private transactions pose a potential for harm to minority shareholders. Consequently, these transactions raise several difficult fiduciary problems under federal and state law which require

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1. See Address by Commissioner A. Sommer, Jr., "Going Private": A Lesson in Corporate Responsibility, at the Notre Dame Law School, November, 1974, reprinted in [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,010 (1974) [hereinafter cited as Sommer Address].

2. See A. SMITH, SUPERMONEY 67-110 (1972). See also note 4 *infra*.

3. Solomon, *Institutional Investors: Stock Market Impact and Corporate Control*, 42 GEO. WASH. L. REV. 761, 768-70 (1974). See also Cole, *Institution Dollar Volume 69% of Big Board's Total*, N. Y. Times, Apr. 2, 1975, at 55, col. 2; Metz, *Market Place Investor Disenchantment Rising*, N. Y. Times, Mar. 13, 1975, at 58, col. 2; *Hearings on S-2787 and S-2842 Before the Subcommittee on Financial Markets of the Senate Committee on Finance*, 93rd Cong., 2d Sess., at 4 (1974); Sommer Address.

4. New York Stock Exchange, Inc., *The Capital Needs and Saving Potential Of The U. S. Economy, Projections Through 1985* (September, 1974); see Jones, *Business Capital Requirements 1974-1985*, FINANCIAL EXECUTIVE, Nov., 1974, at 22; Massaro, *Is The U. S. Facing a Capital Shortage?*, CONFERENCE BOARD RECORD, Jan., 1975, at 41. But see LEVINSON, CAPITAL, INFLATION AND THE MULTINATIONALS ch. VI (1971).

the expansion and interpretation of federal securities law as well as the more fundamental consideration of whether federal securities law should remain rooted in the concept of disclosure or should, instead, reach into substantive areas including the possibility of merit regulation. Underlying the entire controversy is the need for a reappraisal of the duties owed by controlling interests to minority public shareholders.

In an effort to protect the integrity and efficiency of securities markets, the Securities and Exchange Commission has undertaken an examination of the problems of going private.⁵ This study will explore the desirability of action and the limits of the SEC's power to act. However, while the Commission, corporations and shareholders are groping for practical guidelines which will balance the benefits accruing to majority shareholders and the detriments flowing to minority shareholders, the application of rules under federal or state laws will continue to rest on retrospective, ad hoc interpretations by the Securities and Exchange Commission and the courts.

After examining the reasons corporations have offered for going private and the business and legal mechanisms involved in connection therewith, this article will analyze the judicial response to such transactions. Although going private deals may, in the future, consistently be brought under the umbrella of rule 10b-5,⁶ most federal courts probably will not foreseeably apply rule 10b-5 to enforce standards of fairness unless accompanied by violations of the various disclosure obligations. Uncertainties also exist as to the fiduciary concepts evolving under state law.

To resolve the almost hopeless task of devising serviceable stan-

5. On September 9, 1974, the Securities and Exchange Commission announced a Public Fact-Finding Investigation in the Matter of Beneficial Ownership, Takeovers, and Acquisitions by Foreign and Domestic Persons. SEC Securities Act Release No. 5526, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,956, at 84,460 (Sept. 9, 1974); SEC Securities Act Release No. 5538, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,004, at 84,611 (Nov. 5, 1974). In connection with one of the specific inquiries of that proceeding, *i.e.*, relating to "going private," the SEC has stated, among other things, in its February 6, 1975, release that "the Commission has received a number of letters from shareholders expressing concern about the fairness of so-called 'going private' transactions, and from members of the investment community expressing concern about the impact of such transactions on the confidence of investors in the market place." SEC Securities Act Release No. 5567, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,104, at 85,091 (Feb. 6, 1975). In its Release of February 6, 1975, *supra*, the Securities and Exchange Commission announced that it has ordered a public investigatory and rulemaking proceeding, including public hearings, relating to so-called "going private" transactions by public companies and their affiliates. *Id.* at 85,089. *See also* text at 172-76.

6. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1974).

dards,⁷ and because traditional disclosure concepts are unsuitable to resolving the problem, it is recommended that the Securities and Exchange Commission promulgate regulations enabling the Commission to conduct an administrative hearing with respect to each corporation seeking to "go private" prior to the consummation of the proposed plan. After the Commission has reviewed the terms and conditions of each proposal, it would arrive at its own recommendations, which, if acceptable to the corporate management, would constitute the offer to be made to the public shareholders. This procedure would remove the sword of uncertainty and thus facilitate the planning of corporate transactions.

I. WHY CORPORATIONS GO PRIVATE

Corporations seek to go private for four principal reasons: (1) depressed price for the firm's stock, (2) cost savings, (3) freedom from disclosure and regulatory requirements, and (4) increased managerial flexibility. However, behind these rationalizations lies a critical variable: the extent of a company's future need for outside capital. If the business has no further need for external capital (*e.g.*, a service business such as advertising), a public vehicle may no longer constitute a necessity.⁸

First, insiders usually consider going private because the price of the company's stock is at an unsatisfactorily low level. Coupled with a

7. As Commissioner A. Sommer, Jr. has noted, "It is difficult to write precise rules that will clearly distinguish the transactions which should not be considered violative of the mandate the Commission is under from those which do violate that mandate and which undermine the confidence of the public in securities markets and corporate integrity." Sommer, *Further Thoughts on "Going Private,"* BNA SEC. REG. & L. REP. No. 294, at D-4 (Mar. 19, 1975).

8. See generally Pacey, *Going Private*, BARRON'S, Mar. 4, 1974, at 3; Letter of Anthony P. Grassi, Vice-President, Donaldson, Lufkin & Jenrette Securities Corporation, January 10, 1975; Prospectus Pursuant to Exchange Offer of Wells, Rich, Greene, Inc., Nov. 4, 1974, at 14 [hereinafter cited as Wells-Rich Prospectus]. Steven James Lee (Financial Consultant, BT Consultants, Bankers Trust Company), in *Going Private*, FINANCIAL EXECUTIVE, December, 1974, at 10, 14, sets forth a ten-fold test of the advantages of going private:

- 1) Is the money you spend on glossy annuals and interim reports significant by company standards?
- 2) Did principals of your company realize a substantial amount of cash through sale of their stock when you went public?
- 3) Do SEC requirements add heavy extra expense over and above customary financial reporting when you were private?
- 4) Did you go public more than three years ago?
- 5) Were all the claims on your original offering prospectus conservative?
- 6) Is your cash position strong?
- 7) Is your current stock quotation less than 60% of the issue price?
- 8) Would you run your company differently and more advantageously if it were private?
- 9) Have stock options that you gave key employees proved to be of little value to them?
- 10) Is less than 55% of your company in public hands?

market price deemed "inappropriate" by management, corporations with a small amount of outstanding shares ("float") encounter difficulty in generating institutional investor or broker-dealer interest. The result is a limited demand and trading market with respect to the stock.⁹ The stock is of little or no value for many of the purposes for which the corporation went public, including raising further equity or other capital, use as a vehicle for acquisitions, or management incentives.¹⁰ In particular, diminished security prices lessen the worth of a panoply of executive compensation devices—stock option, profit sharing and stock purchase plans. Executive morale, in the eyes of corporate officials, accordingly suffers as options are found worthless or stock purchased pursuant to an option plummets in value. Since a secondary offering of stock stands little chance of success, major shareholders are locked in holding shares with little liquidity. A laggard stock price may also have a more far reaching impact on corporate employees who feel that

9. J. F. Nethercutt, Chairman, Merle Norman Cosmetics, Inc. noted, "We don't feel that the financial world has put a proper value on our company, and that holders of our company's stock have been given unfair treatment." Wall St. J., Jan. 4, 1974, at 12, col. 4.

A company spokesman for Bourns, Inc., indicated that the corporation contemplated going private because Marlin E. Bourns, President, "was disappointed with the performance of the stock recently." Wall St. J., Sept. 24, 1974, at 22, col. 3; *see, e.g.*, Offer to Purchase, R. B. Jones Corp., Nov. 1, 1974, at 6 (disappointing price level and extremely limited public market); Offer to Purchase, Ad Press Ltd., Nov. 2, 1973, at 1 (stock market inadequately reflected the value of the firm); Offer to Purchase, Clinton E. Frank, Inc., Sept. 14, 1973, at 4 (unfavorable stock market reception and limited demand for stock); Wells-Rich Prospectus at 13-14 (low stock market price in comparison with book value, earnings, prospectus, and stock has been lightly traded); Wall St. J., Sept. 5, 1974, at 8, col. 2 ("Industry executives have long maintained that advertising agency stocks suffered from the public's misapprehension of their industry as one marked by extreme volatility. The prices of most agency stocks have been uniformly depressed for some time."); Exchange Offer, Inland Credit Corp., Oct. 4, 1974, at 4 ("depressed price for stock, and thus management was of the opinion . . . that the prospects of a substantial increase in the market price in the foreseeable future appear[ed] limited"); Proxy Statement of Barbara Lynn Stores, Inc., Oct. 8, 1974, at 11 (limited investor interest, light public trading, disappointing price level, and low price-earnings multiples for firms in the industry); Proxy Statement (draft) of The North Central Companies, Inc., Nov., 1974, at 9 (depressed market price and low trading volume). Metro-Goldwyn-Mayer, Inc., in contemplating going private indicated that the price of its shares did not reflect the corporation's earnings and its potential. Gottschalk, *MGM's '74 Tender and Exchange Offers for Stock, Debt Are Being Studied by SEC*, Wall St. J., Feb. 14, 1975, at 6, col. 3; Wall St. J., Oct. 1, 1974, at 4, col. 2.

10. In addition to management obtaining a sense of achievement and self-fulfillment and hopefully increasing investment liquidity, other reasons for going public include 1) securing funds for the corporation; 2) gaining prestige and improving business operations; 3) expanding through acquisitions involving the exchange of the publicly traded stock; 4) using stock with a public market or options to purchase such stock to attract and retain executives; 5) improving corporate net worth, thereby enabling the enterprise to borrow funds more advantageously as well as the possibility of raising funds through subsequent public issues. Schneider & Manko, *Going Public—Practice, Procedure and Consequences*, 15 VILL. L. REV. 283, 283-84 (1970).

they are working for an enterprise which is not properly managed. An employee may become disillusioned by observing his retirement benefits, if tied to the company's securities, evaporate as a result of a depressed stock market.¹¹ Furthermore, with the demoralization of securities markets, some corporations find that basic business judgments are affected by being public. Management spends more and more time worrying about earnings per share and price-earnings multiples.¹² In short, corporate executives may recognize and attempt to correct the original mistake of going public.¹³

Second, corporate officials have noted the cost savings inherent in reverting to a private status.¹⁴ The additional expenses of being a public corporation are significant: compliance with federal securities requirements¹⁵ (particularly the variety of reports that must be prepared and

11. *See, e.g.*, Wells-Rich Prospectus at 14 (Corporation, as a publicly held entity, had not gained the benefits of employee stock options and business acquisitions because of uncertain and disappointing stock prices. Stock options failed to provide employee incentives and stock no longer served as a means of acquiring other firms.). *See also* Freeman, *Going Private*, Wall St. J., Oct. 13, 1974, at 1, col. 6, in which Clinton Frank, President of Clinton E. Frank, Inc., noted that a low stock price no longer supported the firm's stock-option program.

12. *See, e.g.*, Wells-Rich Prospectus at 14 (as a private company, management would be less concerned regarding the immediate impact of costs or earnings and of earnings on the value of the stock); Offer to Purchase, Diversified Design Disciplines, Inc., Aug. 1, 1974, at 4 (the firm wished to shift its goals away from earnings per share, which factor, as a public corporation, impaired the company's ability to stimulate internal growth by using the full range of compensatory tools.). *See also* BUSINESS WEEK, June 30, 1975, at 30.

13. *See, e.g.*, Sam Higgins, President, Air Industries Corp., who stated that his company was "no longer a corporation suitable for widespread public investment." Freeman, *Going Private*, *supra* note 11.

14. *See, e.g.*, the Proxy Statement of Barbara Lynn Stores, Inc., Oct. 8, 1974, at 11, in which management estimated that expenses for American Stock Exchange and SEC fees, transfer agent fees, legal fees, and printing totalled approximately \$100,000 per year in 1972 and 1973. The North Central Companies, Inc., estimated it could save \$100,000 per year by going private. Freeman, *Going Private*, *supra* note 11. *See also* Lee, *Why Companies Want to Go Private*, N. Y. Times, Sept. 15, 1974, § 3, at 14, col. 1. However a significant and increasing body of regulatory requirements are imposed by other state and federal agencies. *See* Armstrong, "Going Private": *The Why and The How*, in *ACQUIRING PUBLICLY HELD SECURITIES: GOING PRIVATE AND TENDER OFFERS* 172 (R. Kirshberg ed. PLI 1974).

15. Under the Securities Exchange Act of 1934, if a corporation is large enough (\$1,000,000 in assets and at least 500 holders of an equity security) or if the stock is listed on a securities exchange, the corporation must make periodic disclosure of various types of information. Securities Exchange Act of 1934, 15 U.S.C. § 78I(g)(1),(m) (1970). Periodic reports must also be filed if an issuer has made a registered public offering under the Securities Act of 1933 and has at least 300 shareholders of record. *Id.* § 78o. In such corporations, proxies must be solicited in accordance with the SEC's proxy rules. *Id.* § 78n. Restrictions on the buying and selling of the corporation's shares are imposed on officers, directors and 10 percent shareholders. Liability may also be imposed on insiders for inadequate public disclosure, trading on inside information or tipping such information to others. *Id.* § 78p.

filed with the SEC); the attendant legal, accounting and public relations fees; and the printing and mailing costs in connection with the preparation and dissemination of proxy materials and interim and annual reports. Further, the cost of meeting the regulatory standards of national securities exchanges, particularly the disclosure rules, as well as transfer agent and registrar fees must also be taken into account. Once private, management time and corporate capital need no longer be diverted to dealing with public shareholders¹⁶ and the SEC.

Third, once a corporation attains public status, information must be publicly disclosed. Executives may feel uneasy about explaining their actions and disclosing previously confidential information. Revelations regarding compensation and benefit plans may be distasteful. Failure to observe the ever expanding scope of fiduciary duties under state and federal laws may subject corporate insiders to shareholder suits. Being private frees salaries and new business deals from public scrutiny.¹⁷

Fourth, executives contemplating going private point to increased managerial flexibility.¹⁸ The entrepreneurial minded officer may find it difficult to differentiate corporate and personal assets. Operating procedures in a private corporation (for example, placing relatives on the payroll) would be less restrictive. Private capital may also be easier to obtain.

Corporate executives are, of course, not oblivious to the fact that benefits also accrue to insiders. As the remaining shareholders they may, in effect, be buying assets at below book value and often at a

16. Tender Offer, Treasure Isle, Inc., Mar. 24, 1975, at 11, noted that valuable management time must be spent "attending to matters derived from its public status with only questionable benefits to the Company and its stockholders." See, e.g., Offer to Purchase, Merle Norman Cosmetics, Inc., Jan. 18, 1974, at 7; Offer to Purchase, Bourns, Inc., Oct. 25, 1974, at 7; Offer to Purchase, Presidents-First Lady Spa, Inc., Dec. 20, 1974, at 4-5; Proxy Statement (draft) of The North Central Companies, Inc., Oct. 1974, at 9-10; Exchange Offer, Inland Credit Corp., Oct. 4, 1974, at 4. See also Armstrong, "Going Private": *The Why and the How*, *supra* note 14, at 172, who notes that although the cost of compliance with obligations of a public corporation is "probably an over-rated rationale for a decision to eliminate public shareholders," it "can be a significant element for some companies," and a substantial cost exists in terms of managerial effort devoted to dealing with public shareholders.

17. The need to protect trade secrets from disclosure requirements probably constitutes an invalid reason, as the significant adverse consequences which may be envisioned rarely occur. Schneider & Manko, *Going Public—Practice, Procedure and Consequences*, *supra* note 10, at 284-85.

18. See, e.g., Wells-Rich Prospectus at 14 (Going private would afford greater flexibility and freedom in payment of cash and other remuneration as employee compensation. Other unspecified benefits would also accrue in relationships with the firm's employees and clients.). See also Paine, Webber, Jackson & Curtis, Inc., Considerations with Regard to a Public Company "Going Private" (Dec. 17, 1974).

fraction of the price at which the shares were sold to the public.¹⁹ Insiders may increase or re-establish complete ownership without cash outlay on their part. The fear of a take-over by a third party is removed, as is the danger of scrutiny of insiders' conduct by courts and

19. See Sommer Address. Selected data on cash tender offers by companies with an intent to go private indicates the following comparison between the tender offer price and the book value:

Issuer	Tender Offer Price as Percentage of Book Value
Ad Press, Ltd.	38%
Wally F. Findlay International Galleries, Inc.	76%
Clinton E. Frank, Inc.	25%
Institutional Investor Systems, Inc.	182%
McCaffrey and McCall, Inc.	100%
Merle Norman Cosmetics, Inc.	107%
Nardis of Dallas, Inc.	92%
Mr. Wiggs Department Stores, Inc.	66%
Henry I. Siegel & Co., Inc.	49%
Security Plastics, Inc.	133%
Imoco-Gateway Corp.	35%
Quorum Industries	50%
Combined Properties Corp.	84%
Diversified Design Disciplines, Inc.	123%
Federated Development Company	33%
Bourns, Inc.	73%

Paine, Webber, Jackson & Curtis, Inc., Considerations With Regard to a Public Company "Going Private"; Exhibit 1 (Certain Data on Recent Cash Tender Offers by Companies With an Intention to "Go Private") (Oct. 1, 1974).

The insiders, who controlled the corporation when it originally went public, benefit most by going private. For example, Wells, Rich, Greene, Inc. went public by selling common stock at \$17.50 per share. A secondary offering was priced at \$21.75 per share. Of these public funds, only \$696,000 went to the corporation with the remainder going directly to various controlling persons, including Mary Wells Lawrence, the founder and head of the agency, who received approximately \$3.5 million. The offer by the corporation in November, 1974, to exchange for each share of common stock held by the public \$3.00 in cash and \$8.00 in a subordinated debenture, would, if fully consummated, have increased the interests of Mary Wells Lawrence from seven to forty-three per cent. See Scheibla, *Private Affair*, BARRON'S, March 17, 1975, at 9. For other examples of going private transactions benefiting insiders, see Pacey, *Going Private*, *supra* note 8, at 3.

Insiders in Cornwall Equities, Ltd., for example, could liquidate the private corporation or take it public again at great profit to themselves upon restoration of the firm's profitability and a better market for new issues. BUSINESS WEEK, Nov. 30, 1974, at 32.

Corporate officials also assert that going private may assist management in coordinating its personal estate planning with corporate objectives. Paine, Webber, Jackson & Curtis, Inc., Considerations with Regard to a Public Company "Going Private" 2 (Dec. 17, 1974). However, if the shares of a publicly traded corporation are selling at a depressed price, stemming in large measure from the low price-earnings multiple accorded such shares, then the insiders may be better off, particularly where the market price is less than book value. In addition, for valuation for estate and gift tax purposes, the public market establishes an objective valuation figure.

An additional reason, although not offered, is the high tax bracket of corporate insiders and their desire that the company pay minimal or no dividends, subject to the requirements of the accumulated earnings tax. See, e.g., INT. REV. CODE of 1954, §§ 531-37. Public shareholders may pressure for declaration of dividends and for a regular dividend policy.

the Securities and Exchange Commission. The possibility also exists for a future reoffering of the shares to the public in a rising market at an increased price-earnings multiple.

However, in addition to the risk of possible action by the SEC and litigation on the part of shareholders, several disadvantages exist to going private. The company will face a cash drain, a need to finance the transaction through outside sources, or an exchange of corporate debt obligations.²⁰ In the future, access to the capital market may be blocked or severely restricted. If the company borrows funds to purchase the shares, its ratio of debt to equity may be significantly increased, thus reducing its debt capacity for expansion or other purposes. The multiple of earnings afforded by the public market place is eliminated as is the prospect of a heightened multiple in an improved stock market environment. The elimination of public shares, the "super-currency," probably renders expansion via the acquisition route more difficult.²¹

II. TECHNIQUES AND LEGAL MECHANICS OF GOING PRIVATE

Techniques for going private generally involve transactions by the issuer and take the form of purchases of stock from public shareholders for cash (tender offer) or an exchange offer for such shares. A combination of a tender offer and an exchange offer may be used. These procedures will reduce the number of shares held by the public and accordingly raise the percentage of ownership enjoyed by insiders. The public shareholders have, in theory, the ability to accept or refuse those corporate offers.²² For this reason, these techniques are considered "voluntary" devices. Independent of a tender offer or an exchange offer,

20. In addition to funding considerations, state corporate statutes place limitations on corporate repurchases of shares. *See, e.g.*, DEL. CODE ANN. tit. 8, § 160 (Supp. 1970) (funds may not be used for the repurchase of common shares when a corporation's capital is impaired or when the purchase would cause a capital impairment). *See also* Herwitz, *Installment Repurchase of Stock: Surplus Limitations*, 79 HARV. L. REV. 303 (1965); *Corporate Repurchases*, 8 REV. SEC. REG. 991, 992-93 (1975) (legal problems regarding consolidated surplus of parent and subsidiaries).

21. For a period of two years after the last purchase of shares pursuant to a plan to go private (or unless the shares so acquired are clearly earmarked and used in a relatively short time period for specific purposes or until the acquisition of entities in exchange for all stock so repurchased, whichever is sooner) any business acquisition or combination in which the corporation will be the acquired or acquiring party will be treated, for accounting purposes, as a purchase. SEC Accounting Series Release No. 146, 5 CCH FED. SEC. L. REP., at ¶ 72,168 (Aug. 24, 1973); SEC Accounting Series Release No. 146-A, 5 CCH FED. SEC. L. REP., at ¶ 72,168-A (Apr. 11, 1974).

22. *See also* text at 170-72.

or in conjunction therewith, a corporation may undertake a variety of "involuntary" (or cramdown) transactions, including short-form²³ or long-form merger,²⁴ reverse stock split²⁵ or a sale of assets followed by the liquidation of the enterprise.

A voluntary cash repurchase by a corporation may take one of two forms: market purchases²⁶ or a tender offer.²⁷ Corporations with the available funds have preferred to use the cash tender offer path in going private²⁸ because of a desire to consummate the transaction in a single step. The implementation of this technique requires consideration of federal regulation of tender offers,²⁹ particularly disclosure re-

23. Under a short-form merger statute, a parent corporation, owing a specified percentage of the outstanding shares of another corporation, may merge such other corporation into itself without the approval of the shareholders of either corporation. H. HENN, *THE LAW OF CORPORATIONS* § 346, at 715 (2d ed. 1970).

24. Under a long-form merger statute, the consolidation of a merger between two corporations requires the approval of the holders of a specified percentage, as prescribed by statute, of the outstanding shares of each corporation. *Id.* at 714-15.

25. A reverse stock split, or a split down, occurs when a number of shares are combined to form a smaller number of shares. There is no transfer from surplus to stated capital in a reverse stock split, however, there may be a change in the value per share. H. HENN, *LAW OF CORPORATIONS* § 330, at 673 (2d ed. 1970).

26. It is possible for corporate insiders to undertake, themselves, purchases at market or through a tender offer. However, in addition to the disclosure problems and regulation under the Williams Act, 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1970), amending 15 U.S.C. §§ 78m, 78n (1964), such individuals face a practical requirement—cash. A tender offer by principal shareholders as a means of going private has been attempted by a handful of corporations, including Air Industries Corporation and Nardis of Dallas, Inc. *See* Paine, Webber, Jackson & Curtis, Inc., Considerations With Regard to a Public Company "Going Private," Exhibit 1 (Certain Data on Recent Cash Tender Offers by Companies with an Intention to "Go Private") (Oct. 1, 1974). It is also possible for an employee pension plan or an employee stock ownership plan, in whole, or in part, to undertake the purchases. *See, e.g.*, Offer to Purchase, R. B. Jones Corp., Nov. 1, 1974. *See also* note 29 *infra* & accompanying text & note *infra*.

27. *See* Rule 10b-13 which, subject to certain exceptions, prohibits an issuer or other person who has made a tender or exchange offer from purchasing or arranging to purchase any equity security which is the subject of such offer otherwise than pursuant to the offer. SEC Rule 10b-13, 17 C.F.R. § 240.10b-13 (1975).

28. *See, e.g.*, Offer to Purchase, Treasure Isle, Inc., March 24, 1975; Offer to Purchase, Bourns, Inc., Oct. 25, 1974; Offer to Purchase, Ad Press, Ltd., Nov. 2, 1973; Offer to Purchase, Presidents-First Lady Spa, Inc., Dec. 20, 1974; Offer to Purchase, Diversified Design Disciplines, Inc., Aug. 1, 1974; Offer to Purchase, Clinton E. Frank, Inc., Sept. 14, 1973; Wall St. J., Apr. 11, 1975, at 2, col. 2. *See generally* Paine, Webber, Jackson & Curtis, Inc., Considerations with a Regard to a Public Company "Going Private," Exhibit 1 (Certain Data on Recent Cash Tender Offers by Companies with an Intention to "Go Private") (Oct. 1, 1974).

29. The Williams Act, 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1970), amending 15 U.S.C. §§ 78m, 78n (1964), requires extensive disclosures by both tender offerors (Section 14(d)), 15 U.S.C. § 78n(d)) and by persons purchasing a requisite percentage of the registered equity securities of an issuer (Section 13(d), 15 U.S.C. § 78m(d)), and regulates the terms by which tender offers may be made (Section 14(e), 15 U.S.C. § 78n(e)). A tender offer is also subject to substantive regulation (Section 14(d)(5) and (d)(6), 15 U.S.C. § 78n(d)(5), (d)(6)). Under Section 14(d), 15 U.S.C. § 78n(d),

quirements under section 14(e) of the Securities Exchange Act of 1934,³⁰ and rule 10b-5,³¹ as well as the limitations of rule 10b-6³² and

a person who, after consummation of an offer, would be the beneficial owner, directly or indirectly, of more than five per cent of such class, may make an offer, request or invitation for tenders for any class of any equity security registered under Section 12 of the Securities Exchange Act of 1934, 15 U.S.C. § 78k, only if such person has filed with the SEC, at the time of first making such offer, request or invitation a statement containing the information required by rule 14d-1 (as specified in Schedule 13 D).

30. 15 U.S.C. § 77a *et seq.* (1970). Under Section 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(e), it is unlawful for any person to make any untrue statement of a material fact, or omit any material fact, or engage in any fraudulent, deceptive or manipulative act or practice in connection with any tender offer or any solicitation of security holders in opposition to or in favor of any such offer, request or invitation for tenders. Section 14(e) requires that the alleged fraudulent conduct have occurred "in connection with" a tender offer or request or invitation for tenders. Section 14(e) contains, however, no purchaser-seller requirement. *Electronic Specialty Co. v. International Controls Co.*, 409 F.2d 937 (2d Cir. 1969). Of course, material information must be disclosed. *See Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54 (1972) (materiality defined as facts withheld "that a reasonable investor might have considered . . . important in the making of this decision"). *But see Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 362 (2d Cir. 1973) (facts a reasonable man would consider important to his decision to tender or not to tender); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973). *See also Broder v. Dane*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,875 (S.D.N.Y. Nov. 21, 1974) ("standard of materiality tending more toward a reasonable possibility than toward probability, thus requiring something more than mere possibility, but something less than probability"); *Kaufman v. Lawrence*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,908 (S.D.N.Y. Dec. 5, 1974), *aff'd per curiam*, Civil No. 74-2591 (2d Cir. Apr. 3, 1975).

A greater burden of disclosure, is imposed on tender offers made by the corporation or its insiders, than would reasonably be expected of a third party. *Broder v. Dane*, *supra* (failure to disclose prior repurchase from large shareholder at a higher price held inadequate).

Specific disclosure problem areas include asset values (*e.g.*, *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973)); intangible values (*e.g.*, *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971)); significant forecasts (*e.g.* *Beecher v. Able*, 374 F. Supp. 341 (S.D.N.Y. 1974)); SEC Securities Act Release No. 5362, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,211 (Feb. 2, 1973); *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); vague disclosure of plans (*e.g.*, *Texas Gulf, Inc. v. Canada Dev. Corp.*, 366 F. Supp. 374 (S.D. Tex. 1973)); related transaction (*Sonesta Int'l Hotels Corp. v. Wellington Associates*, 483 F.2d 247 (2d Cir. 1973)). For a discussion of the use of appraisals, see Comment, *The Use of Appraisals in SEC Documents*, 122 U. PA. L. REV. 138 (1973). For a list of specific disclosure items, see Beck, *Corporate Stock Repurchases and Going Private—Disclosure Requirements*, in *PLI, SIXTH ANNUAL INSTITUTE ON SECURITIES REGULATION* 374, 376-79 (A. Fleischer & L. Mundheim eds. 1974) (especially the effect of going private on the market for the securities and reporting requirements, the need to disclose further plans and proposals, how the total plan will be carried out, participation by insiders in the transaction, financing details, related transactions and plans). Disclosure in a tender offer should, among other things, point out that a public market for the corporation's stock may not exist, if a corporation purchases a sufficiently large percentage of the stock. *Wells-Rich Prospectus* at 16, indicating that *White, Weld & Co.* intended to make an over-the-counter market for untendered shares, if the corporation were delisted, stated:

The trading activity in such a market would depend upon a number of shares remaining in public hands and the number of holders. If substantially all of the

proposed rule 13e-2.³³ As an alternative to a cash transaction, an issuer

publicly held shares are exchanged, stockholders might encounter difficulty in obtaining prices they deem reasonable for their shares.

The tender offer should also disclose the possibility of deregistration and delisting, elimination of the remaining shareholders should a short-form or cash merger occur, and the possibility of a sale of significant assets. The value of the issuer, the method of arriving at such conclusion, and the relationship of the cash tender price to such value is of particular significance. *See generally* E. ARANOW & H. EINHORN, *TENDER OFFERS FOR CORPORATE CONTROL* (1973).

31. Since the tender offer involves the purchase or sale of a security, rule 10b-5 is applicable.

32. Rule 10b-6 provides, subject to specified exemptions, that for an issuer, "to bid for or purchase . . . any security which is the subject of distribution" shall constitute a "manipulative or deceptive device or contrivance." Thus, an issuer cannot purchase, directly or indirectly, any security which is the subject of such distribution, securities of the same class or series, or rights to acquire the securities being distributed. For example, if an issuer has outstanding publicly held warrants or securities convertible into the class to be purchased, such warrants or convertibles constitute a continuing offering and a "distribution" of such security for the purposes of rule 10b-6. *See* *Chris-Craft Indus., Inc. v. Bangor Punta Corp.*, 426 F.2d 569 (2d Cir. 1970); *Weiss & Leibowitz, Rule 10b-6 Revisited*, 39 GEO. WASH. L. REV. 474, 479-81 (1971); SEC Securities Act Release No. 8712, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,745 (Oct. 8, 1969). Exemption from rule 10b-6 in certain circumstances for purchases has been proposed for repurchases made in accordance with proposed rule 13e-2. SEC Securities Act Release No. 10,539, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,600 (Dec. 6, 1973) (Proposed Rule 10b-6(f) and (g)); *Lewis, Federal Securities Regulation of Issuer Repurchases, in ACQUIRING PUBLICLY HELD SECURITIES: GOING PRIVATE AND TENDER OFFERS* 147-50 (R. Kirshberg ed. PLI 1974). *See generally* 3 L. LOSS, *SECURITIES REGULATION* 1595-1604 (2d ed. 1961, Supp. 1969); 6 *id.* at 3765-77; E. WEISS, *REGISTRATION AND REGULATION OF BROKERS AND DEALERS* 112-13, 124-38 (1965); Wolfson, *Rule 10b-6: The Illusory Search for Certainty*, 25 STAN. L. REV. 809 (1973).

33. Proposed rule 13e-2, SEC Securities Act Release No. 10,539, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,600 (Dec. 6, 1973), proffered under section 13(c) of the Securities Exchange Act of 1934, 15 U.S.C. § 78m(e), grants the SEC the authority to define acts and practices in connection with corporate repurchases which are fraudulent, deceptive or manipulative and to prescribe means reasonably designed to prevent such acts. *See* SEC Securities Act Release No. 8930, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,837 (July 13, 1970); SEC Securities Act Release No. 10,539 *supra*. Proposed rule 13e-2 is patterned after *SEC v. Georgia-Pacific Corp.*, [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,680 (complaint) and ¶ 91,692 (May 24, 1966) (consent judgment) and *Genesco, Inc. Prospectus* (May 10, 1966), [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,354. Although not a *per se* exemptive rule, it purports to define certain acts as illegal without mandating that under all factual circumstances repurchases under the rule will be legal. The proposed rule provides that any repurchase of equity securities by a corporation whose securities are registered pursuant to section 12 of the Securities Exchange Act of 1934, 15 U.S.C. § 781, if not in compliance with the proposed rule, is a fraudulent, deceptive or manipulative act or practice. The rule is designed to prevent the use of certain trading techniques to gain maximum stock market impact. Interbroker competition might bid up the price as could purchases at the opening or closing of the trading day. Therefore, the issuer may only use one broker on any day and cannot purchase at the opening of trading or within one half hour prior to the close of the trading day. By establishing a volume limitation on repurchases, the rule seeks to prevent a corporation from dominating the market in its stock. Finally, by prohibiting an issuer from purchasing above established price levels, the rule prevents an issuer's purchases from creating an ever mounting price spiral. As well as open market purchases, the rule, subject to a variety of exemptions, will also control block purchases, privately negotiated

may structure an exchange offer using its own debt instruments or redeemable securities.³⁴ The issuer may also include a specific per share amount of cash in the exchange offer.³⁵

To conclude a going private transaction, the tender offer or exchange offer, which has reduced the number of shares in public hands, may be followed by (1) delisting and deregistration of the issuer's

(non-stock exchange) transactions not involving a broker or dealer, purchases by employee plans of the issuer, purchases by broker-dealer issuers, and purchases by control persons. The proposed rule does not require substantive disclosure, presumably because of the limited price impact. The Commission has also requested comment on the applicability of the disclosure concept to issuer repurchase programs and the content and manner of such disclosure, if suitable. See SEC Securities Act Release No. 10,539, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,600 (Dec. 6, 1973). The proposed rule 13e-2 has been used as a guideline by experienced securities practitioners. See Kerr, *Corporate Stock Repurchases-Substantive Trading Restrictions*, in SIXTH ANNUAL INSTITUTE ON SECURITIES REGULATION 11, 18 (PLI Handbook 1974). See also *id.* at 13-15 for a list of problems, questions, and comments relating to proposed rule 13e-2; Goodman, *Listed Securities Repurchases by Issuers: Federal Regulation*, in ACQUIRING PUBLICLY HELD SECURITIES: GOING PRIVATE AND TENDER OFFERS 136 (R. Kirshberg ed. PLI 1974).

An issuer solicited private transaction, not involving a broker or a dealer and not effected on a stock exchange, is free from the volume limitations but not the price requirement of proposed rule 13e-2. If an issuer does not solicit a transaction which is not effected on a stock exchange, it is free from the restrictions imposed by proposed rule 13e-2 and may repurchase shares at a mutually agreed price and in any amount. Malley, *Corporate Repurchases of Stock: Proposed Rule 13e-2 Revisited*, 29 BUS. LAW 879 (April, 1974). An issuer has an affirmative duty of full disclosure prior to initiating repurchases so as to comply with rule 10b-5. Kerr, *supra*, at 17-18, 25. But see Fleischer, Mundheim, & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Impact Information*, 121 U. PA. L. REV. 798, 840-47 (1973). See also *Frigitemp Corp. v. Financial Dynamics Fund, Inc.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,907 (S.D.N.Y. Dec. 6, 1974) (rule 10b-5 limited to inside corporate information). However, if the purchaser is the corporation or the insiders, does the market information become inside corporate information? For an indication that the SEC staff has accepted the concept of market information, see *SEC v. Sorg Printing Co.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,767, at 95,034. (S.D.N.Y. Aug. 21, 1974). The SEC and exchange or supervisory market authorities must also be notified. Johnston, *Repurchases of Securities*, 6 REV. SEC. REG. 926, 927 (1973). See generally Harrison, *Corporate Stock Repurchase Programs: SEC and Other Problems*, in PLI, SECOND ANNUAL INSTITUTE ON SECURITIES REGULATION 211 (A. Fleischer, Jr. & R. Mundheim eds. 1971).

34. See, e.g., Gottschalk, *MGM's '74 Tender and Exchange Offers For Stock Debt Are Being Studied By SEC*, Wall St. J., Feb. 14, 1975, at 6, col. 3; Pacey, *Going Private*, *supra* note 8, at 3 (American Financial Leasing & Services Co.); Scheibla, *Private Affair*, *supra* note 19, at 23; BUSINESS WEEK, Nov. 2, 1974, at 30 (proposal of Rapid-American Corp.); BUSINESS WEEK, Nov. 2, 1974, at 90; Wall St. J., Oct. 1, 1974, at 4, col. 3 (Metro-Goldwyn-Mayer, Inc., proposed an exchange of all the corporation's currently outstanding common shares for a new issue of callable participating voting Class B Common); Wall St. J., Nov. 26, 1974, at 2, col. 2; Wall St. J., Dec. 24, 1974, at 4, col. 4; Exchange Offer, Inland Credit Corp., Oct. 4, 1974 (subordinated debentures). If interest rates decline the debentures can be refunded. If the price of an issuer's stock increases, the corporation might attempt a public offering using the acquired shares and apply all or a portion of the proceeds to the retirement of the debentures. If interest rates rise, the debentures could be re-acquired at a discount. See also Abelson, *Up and Down Wall Street*, BARRON'S, Sept. 16, 1974, at 21.

35. See Wells-Rich Prospectus (cash and subordinated debentures).

stock³⁶ and/or (2) a short-form or long-form merger of the issuer and a new private corporation.³⁷ A request for delisting by a national securities exchange or supervisory market authority reduces investor interest in the stock which is thereby rendered more illiquid, placing more pressure on the remaining public shareholders to sell out. Deregistration with the SEC reduces corporate reporting obligations thereby decreasing the availability of publicly disclosed information. The response of the Securities and Exchange Commission to a request for deregistration, as part of a plan for going private, remains uncertain.³⁸

As part of a tender offer or an exchange offer, or independently thereof, a corporation may use a variety of involuntary techniques, including short-form merger, long-form merger, reverse stock split,

36. For the delisting requirements, see N.Y.S.E. Rules 499 & 500, 2 CCH N.Y.S.E. GUIDE ¶¶ 2499, 2500.

As a condition to listing new Metro-Goldwyn-Mayer, Inc. (MGM) shares to be issued pursuant to a stock split, MGM informed the New York Stock Exchange it would not make any tender or exchange offers for any of its capital stock in the foreseeable future. The New York Stock Exchange also required a supplemental listing agreement, which, among other things, provides that as long as MGM's common stock is listed, MGM, its officers or directors will not take any action with respect to capital stock if such reduction will result in fewer than 4,000 holders of 100 or more of MGM's common shares, or if it would result in fewer than two million publicly held shares of MGM common, or if the aggregate market value of the publicly held shares of MGM common stock would drop below 22 million dollars. Gottschalk, *supra* note 34, at 6, col. 4.

After delisting from a securities exchange, the issuer, if required to be registered under Section 12(g) of the Securities Exchange Act of 1934, 15 U.S.C. § 781(g), is automatically registered under Section 12(g) if, on termination of the listing, securities of the class are held of record by 300 or more persons. Rule 12g-2, 2 CCH FED. SEC. L. REP. ¶ 23,305. The issuer would request deregistration under Section 12(g)(4). As a Section 12(g) reporting company, the issuer may deregister in 90 days, or such shorter period as the SEC may determine, after certifying to the SEC that the number of record holders is less than 300. 15 U.S.C. § 781(g)(4). Under Section 15(d) of the Securities Act of 1934, an issuer who has filed a registration statement under the Securities Act of 1933 must continue to file periodic reports for the balance of its fiscal year in which it deregisters if, at the beginning of such period, there were more than 300 record holders of the registered security.

Although an issuer deregisters under Section 12(g), the corporation may remain subject to the periodic reporting and proxy solicitation requirements if it continues to have debt outstanding under a registered trust indenture. See *Corporate Repurchases*, 8 REV. SEC. REG. 991, 995 (Jan. 13, 1975).

37. These merger techniques also may be used as the sole means of going private.

38. The staff of the SEC has disapproved at least two transactions where issuers sought to reacquire shares in order to terminate registration under Section 12(g) of the Securities Exchange Act of 1934. However, one of these decisions was later reversed. House of Adler, Inc., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,515 (Sept. 30, 1971) (transaction disapproved on ground that depriving remaining shareholders of the protections accorded a reporting company under the Securities Exchange Act of 1934 raised questions under the anti-fraud provisions of the federal securities laws); First of Michigan Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,401 (Mar. 29, 1973), *rev'd*, ¶ 79,502 (Jul. 25, 1973). Among other factors, presumably, the Commission is using its power to condition exemptions under rule 10b-6(f) to prevent or discourage disfavored transactions. Kerr, *supra* note 33, at 16.

sale of assets and liquidation. In either a short-form or long-form merger under state law, the insider group first forms a new corporation and transfers its interest in the public corporation to the new corporation in exchange for all of the shares of such new corporation. Under a short-form merger statute, the new private corporation, the parent, having the specified percentage of share ownership in the subsidiary (in this case, the public corporation) requires the shareholders of the public company, without the approval of such holders, to exchange their stock for cash, or debt securities or redeemable stock of the private entity. Thereupon, such public shareholders cease to have an equity interest in the surviving private corporation which is wholly owned by the insiders.³⁹

In the event the insiders cannot employ the short-form merger statute, because the newly formed private corporation lacks the requisite percentage ownership, or state law does not provide for such a transaction, a long-form merger statute may be utilized, and shareholders may be given cash as consideration for their shares.⁴⁰ Although requiring the approval of the shareholders of the public corporation,⁴¹

39. See, e.g., DEL. CODE ANN. tit. 8, § 253 (1969); N.Y. BUS. CORP. LAW §§ 905, 907(c) (McKinney 1965); Note, *The Short Merger Statute*, 32 U. CHI. L. REV. 596 (1965). For an example of litigation involving a short-form merger see *Levine v. Biddle Sawyer Corp.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,816 (Ill. Oct. 7, 1974).

40. See, e.g., DEL. CODE ANN. tit. 8, § 251 (1970); N.Y. BUS. CORP. LAW § 903 (McKinney 1965). For use of cash, property rights or securities, see DEL. CODE ANN. tit. 8, § 252(b) (1969); N.Y. BUS. CORP. LAW § 902(a)(3) (McKinney 1965). For "cash out" mergers using a private corporation, see, e.g., *Cardwell, Cerro's Leadership Housing Is in Danger of Going Under, Filings With SEC Say*, Wall St. J., Apr. 9, 1975, at 8, col. 2; *Metz, Stockholder Opposes Going-Private Plan*, N.Y. Times, Apr. 12, 1975, at 34, col. 3; BUSINESS WEEK, Dec. 7, 1974, at 37; FORBES, Apr. 1, 1975, at 50; Wall St. J., May 5, 1975, at 11, col. 2; Wall St. J., Apr. 29, 1975, at 10, col. 1; Wall St. J., Mar. 4, 1975, at 17, col. 1; Wall St. J., Feb. 28, 1974, at 5, col. 1; Wall St. J., Jan. 30, 1974, at 4, col. 2 (public corporation owning 85 percent of another public corporation proposed merger using subordinated debentures of surviving public corporation). For an example of a litigated cash freeze-out merger involving minority shareholders in a private corporation, see *Bryan v. Brock & Blevins Co.*, 490 F.2d 563 (5th Cir. 1974) & text at 159-62. For examples involving minority shareholders in a public corporation, see *Grimes v. Donaldson, Lufkin & Jenrette, Inc.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,722 (N.D. Fla. Jul. 15, 1974). See also *University Capital Corp. v. Barbara Lynn Stores, Inc.*, Civ. No. 74-4460 (S.D.N.Y. Oct. 25, 1974) (The owners of 43 percent of the stock of Barbara Lynn Stores, Inc., a public corporation, transferred their stock to a newly created private corporation. A merger was sought between Barbara Lynn Stores, Inc., and the corporation, pursuant to which the public shareholders would receive cash and the owners of the 43 percent interest would own the new private corporation. Proxy Statement of Barbara Lynn Stores, Inc., Oct. 8, 1974); *Albright v. Bergendahl*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,997 (D. Utah Sept. 5, 1974); Wall St. J., Aug. 1, 1974, at 14, col. 6; Wall St. J., May 29, 1974, at 29, col. 3; Wall St. J., Jan. 30, 1974, at 4, col. 2.

41. See, e.g., DEL. CODE ANN. tit. 8, § 251 (Supp. 1970) (majority of outstanding

a long-form merger constitutes an involuntary transaction because of the dominant interest of the private corporation in the public entity. In addition to state law considerations, planning a merger transaction involves consideration of federal securities laws including regulation 14⁴² of the Securities Exchange Act of 1934 and rule 145.⁴³

Other involuntary modes of forcing out public shareholders include: (1) a reverse stock split and (2) a sale of assets and liquidation. A reverse stock split, with an extremely high exchange ratio (*e.g.*, one new share for each 500 owned) mandates that holders of fractional shares, after the split, exchange their new fractional shares for cash. A shareholder lacking a sufficient number of old shares to exchange for at least one new one will be barred from the public market.⁴⁴ A corporation may also go private by selling the assets, for cash, to the insiders (or a new corporation controlled by such shareholders), followed by a liquidation of the issuer so as to eliminate the public shareholders.⁴⁵

shares); N.Y. BUS. CORP. LAW § 903 (McKinney 1965) (two-thirds of all outstanding shares).

42. Deregistration, pursuant to Section 12(g)(4) of the Securities Exchange Act of 1934 removes compliance with proxy statement requirements under Regulation 14-A and information statement requirements under Regulation 14-C. *See* Beek, *Corporate Stock Repurchases and Going Private-Disclosure Requirements*, in PLI, SIXTH ANNUAL INSTITUTE ON SECURITIES REGULATION 380-81, 383 (A. Fleischer Jr. & L. Mundheim eds. 1974) (particularly whether short-form merger technique requires an information statement). *But see* *Scott v. Multi-Amp Corp.*, 386 F. Supp. 44 (D.N.J. 1974).

43. As a cash transaction does not involve the issuance of a security, registration will not be required under rule 145; however, the technique may be vulnerable under a "step" transaction doctrine. *See* Beek, *supra* note 42, at 381-82. Registration under rule 145 is required if the shareholders will receive debt or if redeemable securities will be required. SEC Securities Act Release No. 5316, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,075 (Oct. 6, 1972). If shareholder action is required in a cash or redeemable preferred stock merger, a proxy or information statement may be required. Possible exemptions from rule 145 include sections 3(a)(9) and (10) of the Securities Act of 1933. Since the issuer is publicly held, rules 146 and 147 will probably not be helpful in establishing an exemption.

44. A reverse split will be accomplished through an amendment to the corporation's articles of incorporation, which usually requires the approval of at least a majority of the shareholders of a corporation. *See, e.g.*, Sommer Address; Bender, *The Battle Over "Going Private"*, N.Y. Times, July 13, 1975, § 3, at 1, col. 3; Freeman, *supra* note 11, at 1, col. 6; Scheibla, *supra* note 19, at 9, 23 (proposal abandoned); Wall St. J., Sept. 9, 1974, at 16, col. 4. *But see* *Teschner v. Chicago Title & Trust Co.*, 59 Ill. 2d 452, 322 N.E.2d 54 (1974) (reverse stock split held constitutional under Illinois law).

45. A sale of assets and liquidation will ordinarily require the approval of a majority, and often two-thirds, of the shareholders of a corporation. For example, Rowlands, Inc., planned to sell a portion of its assets for cash to a new corporation owned primarily by insiders and liquidate. Wall St. J., Mar. 11, 1975, at 29, col. 1. It may be argued that the sale of assets to insiders constitutes an inequitable abuse of the statutory sale of assets procedure.

III. JUDICIAL RESOLUTION OF THE GOING PRIVATE PROBLEM

A shareholder who believes that a going private transaction is "improper," apart from violations pertaining to the legal mechanics, particularly disclosure, may seek relief under state law fiduciary concepts and rule 10b-5. However, there is a lack of clarity regarding the evolving state law fiduciary duties, as well as an unwillingness of many federal courts to hold that unfairness, in and of itself, states a claim for relief under rule 10b-5. By failing to provide guidelines to assess the traditional state law fiduciary duties to minority shareholders (a valid business purpose and price fairness), courts have placed businessmen and their counsel in a position of uncertainty in planning going private transactions.

A. *Fiduciary Duties Under State Law*

Under common law, a merger required the unanimous consent of all affected shareholders.⁴⁶ In response to the growing magnitude of corporations, the increase in the number of shareholders in such entities, and the possible nuisance value created by a recalcitrant minority, most state legislatures empowered a majority of two-thirds of each class

46. *Voeller v. Neilston Warehouse Co.*, 311 U.S. 531, 535 n.6 (1941); *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590 (1921); S.E.C. REPORT OF THE STUDY AND INVESTIGATION OF THE WORK ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEE pt. VII, at 557, 590 (1938); Gibson, *How Fixed Are Class Shareholder Rights?*, 23 LAW & CONTEMP. PROB. 283 (1958). However, the doctrine was rejected by a minority of courts which permitted, under common law, sale of assets by less than the unanimous consent of all the shareholders. *See, e.g.*, *Beidenkopf v. Des Moines Life Ins. Co.*, 160 Iowa 629, 142 N.W. 434 (1913); *Paterson v. Shattuck Arizona Copper Co.*, 186 Minn. 611, 244 N.W. 281 (1932).

For a theory that it is unconstitutional to allow termination of the shareholder's interest for cash, see Levy, *Rights of Dissenting Shareholders to Appraisal and Payment*, 15 CORNELL L.Q. 420, 427 (1930). *But see* *Coyne v. Park & Tilford Distillers Corp.*, 38 Del. Ch. 514, 154 A.2d 893 (Sup. Ct. 1959); *Willcox v. Stern*, 18 N.Y.2d 195, 219 N.E.2d 401, 273 N.Y.S.2d 38 (1966); *Beloff v. Consolidated Edison Co.*, 300 N.Y. 11, 87 N.E.2d 561, (1949), which all uphold the constitutionality of the short-form merger statutes. *See also* *Grimes v. Donaldson, Lufkin & Jenrette, Inc.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,722 (N.D. Fla. Jul. 15, 1974). A stockholder has no absolute right to his interest in the corporation and may be forced to surrender his shares for a fair cash price. *Teschner v. Chicago Title & Trust Co.*, 59 Ill. 2d 452, 322 N.E.2d 54, (1974), *rehearing denied* (Jan. 28, 1975). *But see* *Brudney & Chirelstein, Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 323-24 n.56 (1974); Note, *Elimination of Minority Share Interest by Merger: A Dissent*, 54 NW. U. L. REV. 629 (1959). *See also* *Goldberg v. Arrow Electronics, Inc.*, BNA SEC. REG. & L. REP. No. 311, at A-17 (July 16, 1975) (Docket No. 74-1530, petition for cert. filed June 5, 1975).

Underlying the controversy is the change from a vested theory of shareholder rights to a contract or social duty concept. *See* *Dodd, For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1156-61 (1932); Gibson, *How Fixed Are Class Shareholder Rights?*, 23 LAW & CONTEMP. PROB. 283 (1958).

of shareholders to approve a merger. This, in turn, opened the possibility for the victimization of the minority shareholders. To resolve the problem, most states adopted appraisal statutes permitting a shareholder the opportunity to dissent from certain specified corporate changes and, after an appraisal proceeding, to receive cash from the corporation in consideration for his shares.⁴⁷ In certain jurisdictions, the appraisal method, by statute, constitutes the exclusive remedy for a minority shareholder.⁴⁸ However, in the absence of express statutory language, courts have divided on the exclusiveness of the appraisal remedy.⁴⁹ In a jurisdiction where an appraisal is viewed as nonexclu-

47. Most states provide appraisal for a merger transaction, while a lesser number make appraisal available for the sale of all or substantially all of a corporation's assets. *See, e.g.*, DEL. CODE ANN. tit. 8, § 262 (1969); N.Y. BUS. CORP. LAW § 623 (McKinney 1965); W. CARY, CASES AND MATERIALS ON CORPORATIONS 1708 (4th ed. unabr. 1969); Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 262 (1962). *See also* Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952), *aff'g.* 33 Del. Ch. 20, 89 A.2d 862 (Del. Ch. 1952); Robb v. Eastgate Hotel, Inc., 347 Ill. App. 261, 106 N.E.2d 848 (1952); Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 123 N.E. 148 (1919). In Bryan v. Brock & Blevins Co., Inc., 490 F.2d 563 (5th Cir. 1974), the court, although not dealing with the question of exclusiveness of the appraisal remedy, by implication concluded in favor of non-exclusiveness. *Id.* at 568-69 n.3.

In Delaware, absent fraud or overreaching, the appraisal remedy is exclusive. *See* David J. Greene & Co. v. Schenley Indus., Inc., 281 A.2d 30 (Del. Ch. 1971). *See also* Marshel v. AFW Fabrics, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,219, at 98,134 (S.D.N.Y. June 25, 1975) stating that under New York law appraisal is the exclusive remedy, *citing* Willcox v. Stern, 18 N.Y.2d 195, 201-02, 219 N.E.2d 401, 404, 273 N.Y.S.2d 38, 43 (1966) & Beloff v. Consolidated Edison Co., 300 N.Y. 11, 87 N.E.2d 501 (1949). In reality, courts, even if espousing the concept that the appraisal remedy constitutes the exclusive relief, have devised various means of avoiding the doctrine of exclusiveness. Note, *Interplay of Rights of Stockholders Dissenting From Sale of Corporate Assets*, 58 COLUM. L. REV. 251, 254 (1958). The existence of a state appraisal remedy does not negate a federal claim under rule 10b-5. *See* Levine v. Biddle Sawyer Corp., 383 F. Supp. 618 (S.D.N.Y. 1974). For an outline of the disclosures required under rule 145 to shareholders who elect state appraisal rights, see Beek, *supra* note 42.

48. *See, e.g.*, CAL. CORP. CODE § 4123 (West 1955). *But see* MICH. COMP. LAWS ANN. § 450.1771 (West 1973), which provides that the appraisal remedy shall be non-exclusive.

This shift in legislative attitude, may stem in part from a repugnance against forcing a shareholder to surrender his equity interest unless the structural change serves a valid business purpose apart from the desire by the majority to enlarge its holding or eliminate the minority. Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189, 1200-05 (1964).

49. Compare Blumenthal v. Roosevelt Hotel, Inc., 202 Misc. 988, 115 N.Y.S.2d 52 (Sup. Ct. 1952) (in dismissing, for legal insufficiency, a complaint alleging that the purpose is to eliminate or "freeze out" scattered minority shareholders, the court observed that merely to seek to eliminate minority shareholders does not raise an issue of illegality.) with Matteson v. Ziebarth, 40 Wash. 2d 286, 242 P.2d 1025, 1033 (1952).

In a short-form merger, appraisal is apparently the exclusive remedy. *See, e.g.*, Stauffer v. Standard Brands, Inc., 41 Del. Ch. 7, 187 A.2d 78 (Sup. Ct. 1962); Beloff v. Consolidated Edison Co., 300 N.Y. 11, 87 N.E.2d 561 (1949).

sive, a dissident shareholder may, among other remedies, seek to enjoin a merger alleging a breach of fiduciary duties.

A shareholder probably has little to gain by invoking an appraisal statute where he holds shares traded on a securities exchange or in the over-the-counter market. After encountering a delay in payment, receiving no dividends during the proceeding, facing strict procedural requirements and substantial litigation costs, in the end, "he will be awarded the market price of the shares."⁵⁰ If the consideration offered as part of a freeze-out merger exceeds the market price, a dissenting shareholder is better off accepting the deal. In short, as appraisal does not serve as an effective remedy for the breach of fiduciary standards, some courts have imposed fiduciary obligations on majority shareholders.

The nature of the fiduciary duty⁵¹ owed by majority shareholders to minority shareholders, particularly with reference to the question of burden of proof, remains unclear. Traditionally, courts imposed upon controlling shareholders only a fiduciary obligation to the corporation or those acting on behalf of the corporation.⁵² The theory that a controlling shareholder occupies a position of trust received recognition by the United States Supreme Court in 1939.⁵³ The Court stated: "[A controlling shareholder] 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."⁵⁴ Even courts im-

50. Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 233 (1962). *But cf.* C. ISRAELS, CORPORATE PRACTICE § 14.06 (3d ed. 1974); Note, *Valuation of Dissenters' Stock Under Appraisal Statutes*, 79 HARV. L. REV. 1453 (1966). Some legislatures have made market price the sole test by permitting the elimination of appraisal if the stock trades in a public market. *See, e.g.*, DEL. CODE ANN. tit. 8, § 262k (Supp. 1970). For a recent example of a court using market value as an indicator of value, see *Scott v. Multi-Amp Corp.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,988, at 97,430 (D.N.J. 1974). For an analysis of the procedural difficulties encountered in the exercise of appraisal rights, see Kaplan, *Problems in the Acquisition of Shares of Dissenting Minorities*, 34 B.U.L. REV. 291 (1954).

51. Merely identifying a fiduciary duty does not describe it. *SEC v. Chenery Corp.*, 318 U.S. 80, 85-6 (1943) ("[T]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations?").

52. *See* 3 L. LOSS, SECURITIES REGULATION 1446 (1961).

53. *Pepper v. Litton*, 308 U.S. 295, 306 (1939).

54. *Id.* at 311; *Jones v. H. F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969). In *Jones*, controlling shareholders, owning 87 percent of a savings and loan association, swapped their shares for stock of a holding company which then went public creating liquidity for the majority's holdings, but not for the minority shareholders. The court held that the controlling shareholders are governed by a comprehensive rule of inherent fairness from the viewpoint of the corporation and those interested therein, including the minority shareholders.

posing a fiduciary duty on the majority toward minority shareholders, however, may require proof of bad faith or some type of fraud, thus eroding the "fairness" standard used in assessing such an obligation.⁵⁵

The burden of proving noncompliance with the required standard is usually imposed on the minority shareholders.⁵⁶ Several courts, however, have required the majority shareholders to prove that they acted in good faith towards the minority and that the transaction was inherently fair.⁵⁷

Recognizing that a majority shareholder owes a fiduciary duty to minority interests, two federal courts applying state law, in recent decisions involving freeze-out mergers, have attempted to develop more

55. See, e.g., *Allied Chemical & Dye Corp. v. Steel & Tube Co. of America*, 14 Del. Ch. 1, 120 A. 486 (Del. Ch. 1923); *Kavanaugh v. Kavanaugh Knitting Co.*, 226 N.Y. 185, 123 N.E. 148 (1919). A retrenchment from the fairness doctrine as a standard in interested merger transactions may be occurring in Delaware. In *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 93 A.2d 107 (1952), in establishing a fairness test, the court found the standard of business judgment or fraud inapplicable. Folk sums up recent Delaware law and the progeny of the *Sterling* rule as follows:

Thus, the effective vitality of the *Sterling* rule in "interested merger" transactions is in grave jeopardy. Perhaps, however, it is possible to synthesize the most recent decisions along the following lines. The "fairness" rule does not apply if the contest only concerns valuation, no matter how deeply the transaction is colored by conflict of interests. On the other hand, the fairness rule is applicable if an issue other than valuation is in dispute, such as seizure of a corporate opportunity, a drastic reduction in the earnings or book value of the stock of the acquired corporation, or something else which strongly offends the court. But even this may give too much life to the fairness rule, if the plaintiff must make an initial showing that the interested transaction constitutes actionable self-dealing. In any event, the attempted reconciliation is only a guess as to the final state of a very fluid subject. More significantly, it is a synthesis only at a verbal level, for it comes perilously close to concluding that for "interested merger" transactions the standard is no longer the proof of "full fairness" under "careful scrutiny by the courts," but simply a covert adoption of the "fraud" test, applicable heretofore only to "third party mergers."

E. FOLK, DELAWARE GENERAL CORPORATION LAW 336 (1972) (footnote omitted); see *David J. Greene & Co. v. Schenley Indus., Inc.*, 281 A.2d 30, 35 (Del. Ch. 1971); *Sinclair Oil v. Levien*, 280 A.2d 717 (Del. 1971); *Chasin v. Gluck*, 282 A.2d 188, 192 (Del. Ch. 1972).

56. Note, *Freezing Out Minority Shareholders*, 74 HARV. L. REV. 1630, 1638 (1961). The burden of proof is significant. In establishing bad faith, a minority shareholder may have to prove that the majority's prime, if not sole purpose, was to eliminate the minority or benefit at the expense of the minority. The burden of negating the legitimacy of business purpose is especially difficult. But in *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 298, 93 A.2d 107, 110 (1952), the defendant conceded that a majority shareholder in a parent-subsidary merger must "bear the burden of establishing its entire fairness." See also *David J. Greene & Co. v. Dunhill Int'l., Inc.*, 249 A.2d 427, 432 (Del. Ch. 1968); *Albright v. Bergendahl*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,997 (D. Utah, 1974), *petition to 10th Cir. for writ of mandamus denied*, Feb. 6, 1975, where court held that under rule 10b-5, the plaintiff did not have a duty to negate the legitimacy of corporate purpose.

57. See, e.g., *Pepper v. Litton*, 308 U.S. 295, 306 (1939); cf. *Vorenberg, Dissenter's Appraisal Rights*, 77 HARV. L. REV. 1189, 1212-13 (1964).

specific guidelines. In so doing, attention has been focused on two factors: (1) did the transaction have a redeeming business purpose and, (2) was the price fair. In *Bryan v. Brock & Blevins Co.*⁵⁸ the controlling shareholders of a private corporation, after unsuccessfully attempting to buy out a minority shareholder, transferred their shares to a newly created corporation, which was organized for the purpose of eliminating the minority shareholder. The majority merged the existing corporation with the new entity, giving the minority shareholder cash for his interest. The court found the merger to be a paper transaction without any business purpose other than to eliminate the minority shareholder.⁵⁹ Emphasizing the need for fairness in corporate transactions, the court quoted with approval the following language in the complaint: "Every plan of merger authorized by Georgia law . . . contains an implied condition that the parties to it will act in good faith and deal fairly with each other in adopting such plan."⁶⁰

58. 490 F.2d 563 (5th Cir. 1974) (decision under Georgia law). In holding that the minority has a right not to be subjected to inequitable treatment on the part of the majority shareholder, the court quoted at length from *Lebold v. Inland Steel Co.*, 125 F.2d 369 (7th Cir. 1941) and *Pepper v. Litton*, 308 U.S. 295 (1939). *Bryan v. Brock & Blevins Co., Inc.*, 490 F.2d at 569. The court, however, was not required to decide the standards to be used for a short-term merger. The Hon. Louis J. Lefkowitz, Attorney General of New York, obtained a preliminary injunction to prevent the freeze-out cash merger of Concord Fabrics, into AFW Fabrics, which Concord controls. Attorney General Lefkowitz alleged that the merger would be inherently fraudulent, contrary to rules of honesty, lack a legitimate business purpose, and would freeze-out minority shareholders. *People v. Concord Fabrics*, BNA SEC. REG. & L. REP. No. 307, at A-15 (Sup. Ct. N.Y. County, June 12, 1975); Metz, *Market Place*, N.Y. Times, April 8, 1975, at 50, col. 3; Wall St. J., April 11, 1975, at 2, col. 3. See also BNA SEC. REG. & L. REP. No. 309, at A-8 (July 2, 1975); Metz, *Market Place*, N.Y. Times, April 26, 1975, at 34, col. 4 (temporary restraining order issued to prevent freeze-out merger).

59. 490 F.2d at 570. The court did not discuss whether the claim that corporate policy allowed only active employees to remain as shareholders rose to the level of a valid business purpose. However, the court below viewed this alleged policy as a "scheme and contrivance" in violation of a fiduciary trust. 343 F. Supp. 1062, 1069 (N.D. Ga. 1972).

60. 490 F.2d at 571; see *United Funds, Inc. v. Carter Prods., Inc.*, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,288 (Baltimore City Cir. Ct. 1963). Here, a controlling shareholder caused the board of directors of a corporation to recommend to the shareholders an amendment to the certificate of incorporation authorizing the corporation to issue a new class of non-voting common stock. The New York Stock Exchange had advised the corporation, before the requisite corporate action had occurred, that the Exchange would take action to delist the corporation's common stock if the proposed amendment to create non-voting common stock became effective. The court found that the controlling shareholder breached his fiduciary duty to the minority shareholders by acting in a manner adverse to the interests of the minority shareholders and without a valid corporate purpose. Voting power could not be used for an ulterior purpose adverse to the interests of the corporation and its stockholders.

The court in *Bryan* left unclear whether it sought to enunciate a per se rule against the use of a new corporation to take advantage of a merger statute. See also *Berkowitz v. Power Mate Corp.*, BNA SEC. REG. & L. REP. No. 309, at A-8 (N.J. Super. Ct. May 8, 1975); *People v. Concord Fabrics*, BNA SEC. REG. & L. REP. No. 307, at A-15 (Sup. Ct.

In contrast, a freeze-out merger was held legal in *Grimes v. Donaldson, Lufkin & Jenrette, Inc.*,⁶¹ in part, because the transaction served a legitimate business purpose. The defendant corporation in the *Grimes* case acquired a 57% interest in a public corporation through two tender offers that the management of the latter entity supported. Thereafter, such shares were transferred to a wholly owned private subsidiary of the defendant corporation, with the intent to merge the public corporation into the private subsidiary with the 43% minority interest to be paid in cash. In denying the plaintiff's request to enjoin the merger, the court distinguished *Bryan*, finding three business reasons for the transaction: the public corporation and the private subsidiary were engaged in similar businesses, making a merger between the two operations a logical proposition; the continuation of a minority public interest would inhibit transactions between the public corporation and the subsidiary because of conflicts of interest flowing from the fact that both entities were engaged in the real estate business; and certain cost savings.⁶² After finding no support for the plaintiff's contention that any time a newly formed subsidiary is created for the purpose of facilitating a transaction the merger is per se illegal, the court concluded that "the public minority shareholders . . . will be given the fair value of their shares."⁶³ In short, under state law a freeze-out merger must meet the tests of business purpose and fairness.

N.Y. County, June 12, 1975); Metz, *Pressure Against Going Private*, N.Y. Times, July 29, 1975, at 36, col. 3; Wall St. J., June 13, 1975, at 19, col. 1.

61. [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,722 (N.D. Fla. 1974) (decision under Delaware law).

62. *Id.* at 96,390. The joint cost savings totalled more than 300,000 dollars per year. If cost savings constitutes a valid business purpose then practically any means of going private may be sustained. See text accompanying notes 14-16 *supra*.

63. *Grimes v. Donaldson, Lufkin & Jenrette, Inc.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,722, at 96,391 (N.D. Fla. Jul. 15, 1974). However, the court also indicated that a plaintiff might enjoin a freeze-out merger under Delaware law if there is evidence of fraud or overreaching. *Id.*; see text accompanying notes 51-57 *supra*; cf. *United Funds, Inc. v. Carter Prods., Inc.*, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,288 (Baltimore City Cir. Ct. 1963). Perhaps freeze-outs are legal, "if [as in *Grimes*] they represent the last step in the amalgamation of two previously unrelated business organizations." Kerr, *Tender Offers and Going Private—Ending Public Shareholding an Issue*, N.Y.L.J., Dec. 16, 1974, at 43, col. 2.

In analyzing freeze-out mergers under state law, a court may also give consideration to the manner of approval. If the action has been approved by shareholder vote and/or a majority of disinterested directors, a business purpose test may not be involved. *Corporate Purchases*, 8 REV. SEC. REG. 991, 996 (1975). See also *Puma v. Marriott*, 283 A.2d 693 (Del. Ch. 1971) (approval by a committee of disinterested directors places a transaction between the controlling shareholders and the corporation on the same basis as if approved by an independent third party); cf. *Fraud, Use of Inside Information, Discussed at ALI-ABA Conference*, BNA SEC. REG. & L. REP. No. 298, at A-12 to A-14 (April 16, 1975) (remarks of Kenneth J. Bialkin). However, in the *Grimes* case, although the directors of the public corporation were not affiliated with the defendant cor-

A dissatisfied shareholder might also challenge a freeze-out merger or a tender offer or exchange offer under state law by alleging a breach of other fiduciary duties including corporate opportunity,⁶⁴ a denial of equal opportunity for all shareholders,⁶⁵ or use of corporate funds to maintain or increase control.⁶⁶

B. Rule 10b-5 and the Fairness Doctrine

In championing the view of many public shareholders, Commissioner A. A. Sommer, Jr., has attacked going private transactions as a freeze-out⁶⁷ of minority shareholders which cannot be squared with

poration, some were employees of the public corporation. Because of the defendant corporation's majority ownership position, they were, in the final instance, under the control of the defendant corporation. Underpinning *Grimes* may also be the fact the price was negotiated with a major, financially sophisticated shareholder who was selling his stock.

For an analysis of the inadequacy of ratification by shareholders where the parent owns an amount of the subsidiary's stock required to approve the transaction, see Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 299-301 (1974). See also *United Funds Inc. v. Carter Prods., Inc.*, *supra*, where the controlling shareholders owned 50.38 percent of the stock, while two thirds constituted the requisite majority for effecting the charter amendment. The court stated:

The position in which they [minority stockholders] were placed was unfair to them; they had no effective freedom of volition. Under such circumstances, as in the question of the validity of a ratification of an alleged breach of trust, the vote of the minority stockholders who approved the amendment cannot be taken as an independent and legally binding act.

Id. at 94,293. *But cf.* *Porges v. Vadsco Sales Corp.*, 27 Del. Ch. 127, 32 A.2d 148 (Ch. 1943) (the court will give great weight to class vote by preferred shareholders in cases involving elimination of preferred stock dividend arrearages). See also *Sommer's Address* at 84,694 (concerning the "flimsiness" of the "safeguard" of disinterested directors because of the camaraderie of directors). See generally M. MACE, *DIRECTORS: MYTH AND REALITY* (1971).

64. See, e.g., *Perlman v. Feldman*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955). This contention could be based on the concept that a chance to go private again is a corporate asset.

65. See, e.g., *Jones v. H. F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); Note, 83 HARV. L. REV. 1904 (1970). See also *In re San Joaquin Light & Power Corp.*, 52 Cal. App. 2d 814, 127 P.2d 29 (4th Dist. 1942); *House of Adler, Inc.*, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,515 (Sept. 30, 1971) (the SEC may have objected here because the tender offer was not made available to all shareholders, thereby depriving them of the opportunity to sell before de-registration took place).

66. See, e.g., *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (1964); *Bennett v. Propp*, 41 Del. Ch. 14, 187 A.2d 405 (1962) (in making repurchases of shares to prevent a change in control, insiders have the burden of proof of showing reasonable grounds to believe that a change in control would harm the corporation). See also *United Funds, Inc. v. Carter Prods., Inc.*, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,288, at 94,281 (Baltimore City Cir. Ct. 1963).

67. A freeze-out is deemed to occur if a shareholder's interest in a public corporation is terminated by receipt of cash, or debt instruments or redeemable stock in a private corporation. The debt securities or redeemable stock may be viewed as a payment of cash at a future time. See also Note, *Freezing Out Minority Shareholders*, 74 HARV. L. REV. 1630 (1961). For freeze-out merger cases involving private corporations, see *Clarke v. Gold Dust Corp.*, 106 F.2d 598 (3d Cir. 1939), *cert. denied*, 309 U.S. 671 (1940)

the fiduciary responsibilities of majority shareowners to minority holders. Although state laws, as interpreted by federal and state courts, have in some instances fashioned theories which could meet the problem, Commissioner Sommer hoped that federal courts would be inclined to find in rule 10b-5 the basis for holding that such conduct, which is at the heart of going private, violates the federal securities laws.⁶⁸

The judicial expansion of rule 10b-5,⁶⁹ which Commissioner Sommer hopes for, is premised on the belief that the rule embodies a fairness concept.⁷⁰ Three decisions by the Second Circuit Court of Appeals, and several other recent cases dealing with the applicability of rule 10b-5 to freeze-out mergers and exchange offers as means of going private, evidence the split of judicial authority as to whether rule 10b-5 encompasses unfairness, apart from deception.

1. *Background.* In the Second Circuit Court of Appeals, unfairness alone will not state a claim for relief under rule 10b-5. In *Schoenbaum v. Firstbrook*,⁷¹ the court promulgated a two-fold test for violations under rule 10b-5. First, did the defendants, in inducing the transaction, exert a "controlling influence"⁷² over the corporation and was the transaction unfair to the corporation. Under this first standard certain acts of a defendant may constitute an "act, practice, or course

(redeemable preferred exchanged for non-redeemable preferred); *Matteson v. Ziebarth*, 40 Wash. 2d 286, 242 P.2d 1025 (1952) (redeemable preferred exchanged for common).

68. Sommer Address, *supra* note 1.

69. Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1975). For an analysis of the administrative history of rule 10b-5, see 1 A. BROMBERG, *SECURITIES LAW: FRAUD SEC RULE 10b-5*, § 2.2, at 22.6 (1970); Solomon & Wilke, *Securities Professionals and Rule 10b-5*, 43 *FORDHAM L. REV.* 505, 509 (1975).

70. See 3 A. BROMBERG, *supra* note 69, § 12.5, at 275-76. For a summary of corporate mismanagement cases, see 1 A. BROMBERG, *supra*, § 4.7, at 84.41-46. See also *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971).

71. 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969).

72. The SEC has defined control in 17 C.F.R. § 240.12b-2(f) (1975); see 2 L. LOSS, *SECURITIES REGULATION* 770, 778-79 (2d ed. 1961); Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 *HARV. L. REV.* 1007, 1034-35 (1973) (power to direct management decisions).

of business which operates . . . as a 'fraud.'"⁷³ Second, did the insiders deceive the corporation's shareholders. Thus, under *Schoenbaum* the manipulation of securities transactions, through either deception, non-disclosure or use of controlling influence, removes the requisite climate of fair dealing.⁷⁴

In *Popkin v. Bishop*,⁷⁵ the second circuit retreated from the *Schoenbaum* doctrine by holding that full disclosure to shareholders satisfies the federal interest even if a controlling influence is used to induce an unfair transaction. A disclosure requirement was sufficient because "armed with the information fully disclosed under compulsion of the federal proxy regulations and rule 10b-5 [the shareholders were] placed in a position to sue under state law to enjoin the merger as unfair."⁷⁶ As the duty to disclose constitutes the principal design of section 10(b), nondisclosure was viewed as the key issue.

Recently, in *Schlick v. Penn-Dixie Cement Corp.*,⁷⁷ after legitimately acquiring 53% of the common stock of another corporation, obtaining control of the board of directors of the corporation, and engaging in a course of conduct that manipulated and depressed the price of the other corporation's stock, the corporate defendant pro-

73. *Schoenbaum v. Firstbrook*, 405 F.2d 215, 219-20 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969); see Fleischer, *Federal Regulation of Internal Corporate Affairs*, 29 Bus. Law. 179 S-179 (Special Issue, March, 1974); Comment, *Schoenbaum v. Firstbrook: The "New Fraud" Expands Federal Corporation Law*, 55 VA. L. REV. 1103 (1969). See also *Shell v. Hensley*, 430 F.2d 819, 827 (5th Cir. 1970) (investment judgment may be impaired by deception or use of control so that "the determination of the corporation's choice of action in the transaction . . . is not made as a reasonable man would make it if possessed of all the material information known to the other party to the transaction").

74. See also *Herpich v. Wallace*, 430 F.2d 792, 806 (5th Cir. 1970); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967).

75. 464 F.2d 714 (2d Cir. 1972). The court assumed that the exchange ratio in question was unfair. The plaintiff conceded that the defendant made "full and fair disclosure" of its control position and of the terms of the transaction. See Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 HARV. L. REV. 1007, 1040 (1973). The outer limits of full disclosure are unclear, as is to whom disclosure must be made. The purpose of disclosure, therefore, may be placed in doubt.

76. 464 F.2d at 720 (2d Cir. 1972). The court stated that disclosure "has special relevance to merger transactions that, under state law, must be subjected to shareholder approval." *Id.* at 720. For a discussion of the infirmities of a state proceeding, including fraud or overreaching standard, see text at 158-62.

77. 507 F.2d 374 (2d Cir. 1974). No appraisal rights were involved in the merger litigated in *Schlick*. For an analysis of the impact of the appraisal remedy see Brodsky, *Rights of Minority in Merger*, N.Y.L.J., Dec. 12, 1974, at 1, col. 1. The decision is also significant because in the second circuit a cause of action exists for false or misleading proxy materials although the minority shareholders had no realistic means to affect the outcome. The decision will probably lead to more disclosure premised on the court's assumptions that disclosure might cause those in control to modify the terms of the transaction and the stock market would revalue the shares.

posed a merger whereby the 47% minority interest would receive stock in the corporate defendant. After finding that the reach of section 10(b) was broader than the type of misrepresentation or fraudulent practice usually associated with the purchase or sale of securities,⁷⁸ the court held that allegations as to the implementation of a scheme to defraud, which include market manipulation and a merger on preferential terms, stated a claim for relief under section 10(b). The requisite material omission or misstatements relate to the fairness of a merger proposal. Thus, in *Schlick*, where the element of deception was present, specifically, where prior misrepresentations affected the market-place, a result opposite from *Popkin* was reached.

2. *Decisions in Going Private Cases.* Whether rule 10b-5 may be used to attack unfairness, apart from questions of misrepresentation and non-disclosure, has constituted the main focus in three recent cases involving going private transactions. In two freeze-out merger cases involving publicly held corporations, the courts divided on the legality of similar factual situations. In *University Capital Corp. v. Barbara Lynn Stores, Inc.*,⁷⁹ the owners of 43% of the stock of Barbara Lynn

78. 507 F.2d at 379. See also *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10-11 (1971); *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967).

79. Civil No. 4460 (S.D.N.Y. Oct. 11, 1975) (consummation of merger enjoined to allow disclosure documents to be supplemented to correct deficiencies found by the court). But see *Tanzer Economic Associates, Inc. v. Haynie*, 388 F. Supp. 365 (S.D.N.Y. 1974) (favorable report need not be mentioned); *Denison Mines, Ltd. v. Fibreboard Corp.*, 388 F. Supp. 812 (D. Del. 1974) (without disclosure of basis for opinion reference to same may be misleading); *Scott v. Multi-Amp Corp.*, 386 F. Supp. 44 (D.N.J. 1974) (obtaining an independent appraisal not mandated). See also *Green v. Santa Fe Indus.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,085 (S.D.N.Y. 1975); *Marshall v. AFW Fabrics, Corp.*, [Current Binder] CCH FED. SEC. L. REP. ¶ 95,219 (S.D.N.Y. 1975); *Greenberg v. Institutional Investor Sys., Inc.*, [Current Binder] CCH FED. SEC. L. REP. ¶ 95,231 (S.D.N.Y. 1975); *Dreier v. Music Makers Group, Inc.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,406 (S.D.N.Y. 1974) (a plaintiff must allege non-disclosure to state a claim under rule 10b-5). In *Levine v. Biddle Sawyer Corp.*, 383 F. Supp. 618 (S.D.N.Y. 1974), plaintiffs objected to a short-form merger involving a private corporation owned 8 percent by the plaintiffs and 92 percent by the defendants. The plaintiffs alleged that the defendants transferred their stock to a newly created corporation and effected a short-form merger pursuant to which the plaintiffs received cash and the defendants all of the stock of the survivor corporation. Plaintiffs contended, among other things, that the defendants misrepresented the value of the private corporation and concealed financial information and certain other facts from a third party appraiser. The court held a claim was stated under rule 10b-5 as "misrepresentations and nondisclosures were made for the purpose of driving down the value made by the third party and thereby reducing the value of the plaintiff's shares." In citing *Popkin v. Bishop*, the court noted that where shareholder approval is not required, special concern will be given to the "impropriety of the conduct itself rather than on the 'failure to disclose' it because full and fair disclosure in a real sense will rarely occur." 464 F.2d at 719. The court also noted that the amended complaint also alleged use of the short-form merger for the sole purpose of eliminating the plaintiff's share interest.

Stores, Inc., a publicly held corporation, transferred their shares to Lynbar Corp., a private entity. The merger plan proposed to give \$4 per share in cash to the public shareholders owning 57% of Barbara Lynn or permit them to seek an appraisal. The insider group hoped to operate the surviving corporation as a private entity. Although the court noted that the creation of Lynbar and the proposed merger was for the purpose of enabling the insiders of Barbara Lynn to buy out the public stockholders of Barbara Lynn in order to return to the status of a private corporation, the court, adhering to the doctrine developed in *Popkin v. Bishop*, held: "Given full and adequate disclosure, the question of what is a fair price for the stock is not a question for the court to decide."⁸⁰

However, in *Albright v. Bergendahl*,⁸¹ which also involved a freeze-out merger of the shareholders of a public corporation, the court found that the transaction constituted a "' device, scheme or artifice to defraud'" or an "' act, practice or course of business which operates or would operate as a fraud or deceit'" on the public minority shareholders. The court concluded that the plaintiff did not have the burden of negating a legitimate corporate purpose. The court found no legitimate corporate purpose for the transaction in question because the proxy statement only indicated that the corporation was not a viable vehicle for the publicly held stock. Thus, under *Albright*, a plan to freeze-out minority shareholders, if lacking a plausible business purpose, constitutes a breach of fiduciary duty of the majority shareholders to the minority under rule 10b-5.⁸²

The sole tender offer or exchange offer case heard on the merits, to date, is *Kaufman v. Lawrence*,⁸³ which arose out of the efforts of Wells,

80. Civil No. 4460 (S.D.N.Y. Oct. 11, 1975). The litigation was settled, subject to court approval, by a 10 percent increase in the per share price to be paid to the public shareholders. Wall St. J., Nov. 12, 1974, at 38.

81. [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,997 (D.Utah Sept. 5, 1974) (memorandum decision). The court cited with approval the decisions in *Bryan v. Brock & Blevins Co.*, 343 F. Supp. 1062, 1068-70 (N.D. Ga. 1972), *aff'd on state law grounds*, 490 F.2d 563 (5th Cir. 1974). The district court found that the sole purpose and intent regarding the organization of the new corporation and the proposed merger was to eliminate the plaintiff. 343 F. Supp. at 1070. The proposed merger itself was a course of business which would operate as a fraud or deceit upon the plaintiff, in connection with the sale of his stock. To allow the defendant to select arbitrarily a time in which forcefully to exclude a minority's interest through unlawful means would not be condoned by the court. *But see* *Krafcisin v. LaSalle Madison Hotel Corp.*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,586 (N.D. Ill. June 19, 1972). *See generally* Note, *Recent Developments in the Law of Corporate Freeze-outs*, 14 B.C. IND. & COM. L. REV. 1252 (1973).

82. [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,997, at 97,453.

83. 386 F. Supp. 12 (S.D.N.Y. 1974), *aff'd per curiam*, 514 F.2d 283 (2d Cir. 1975). *See also* *Rapoport v. Merle Norman Cosmetics, Inc.*, Civil No. 74-248 (C.D.

Rich, Greene, Inc., an advertising agency previously listed on the New York Stock Exchange, to go private through an exchange offer of \$3 in cash and \$8 in principal amount of newly created and registered subordinated sinking fund debentures for each share of common stock held by the public. Insiders, holding 226,850 shares, agreed not to exchange their stock. In adhering to the second circuit view that a claim for relief under rule 10b-5 must involve deception plus unfairness, the court stated: "Whether the offer is fair or unfair or a good or bad transaction, however, does not raise a federal question."⁸⁴ Secondly, the court found the exchange offer a voluntary transaction as several alternatives existed for each shareholder: tender and sell the debentures at a discount; refuse to tender; or tender and hold the debentures. In short, a freeze-out did not exist. In addition, the court stated:

Nor does there appear to be any sizable group of shareholders opposed to the exchange proposal. Indeed, if such opposition does exist, defendants' plans to go "private" will be frustrated by a sizable number of shareholders refusing to tender their shares.⁸⁵

Cal., filed Jan. 30, 1974); Kreindler v. Cornwall Equities, Civil No. 74-5250 (S.D.N.Y., filed Dec. 2, 1974); Wall St. J., Jan. 31, 1974, at 18, col. 3; Wall St. J., Aug. 29, 1975, at 7, col. 6. In Broder v. Dane, 384 F. Supp. 1312 (S.D.N.Y. 1974), the court on a motion for a preliminary injunction, held certain omissions in an exchange offer material and enjoined consummation of the transaction until the corporation supplied the missing information.

84. 386 F. Supp. at 16, citing Lewis v. Siegel, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,992 (S.D.N.Y. May 18, 1973); Armour & Co. v. General Host Corp., 296 F. Supp. 470 (S.D.N.Y. 1969). The Kaufman court also stated at 17:

While Sections 10(b) and 14(e) must be read flexibly, and not technically or restrictively, see Superintendent of Life Insurance of the State of New York v. Bankers Life and Casualty Company, 404 U.S. 6, 92 S.Ct. 165, 30 L.Ed. 2d 128 (1971); accord, Drachman v. Harvey, 453 F.2d 722, 737 (2d Cir. 1972), there is nothing invalid *per se* in a corporate effort to free itself from federal regulations, provided the means and the methods used to effectuate that objective are allowable under the law. Nor has the federal securities law placed profit-making or shrewd business tactics designed to benefit insiders, without more, beyond the pale. Those laws in respect of their design and interpretive reach, as I understand them, including the provisions relied on here, are satisfied if a full and fair disclosure is made, so that the decision of the holders of WRG stock to accept or refuse the exchange offer can be said to have been freely based upon adequate information. See Popkin v. Bishop, 464 F.2d 714, 721 (2d Cir. 1972).

The preliminary injunction was also denied because the plaintiff and the class he represents have an adequate remedy at law since money damages will make them whole. *Id.* at 17. *But see* Broder v. Dane, 384 F. Supp. 1312 (S.D.N.Y. 1974), in which the court states, "it is wholly consonant with congressional intent to place a heavier burden of disclosure and *fair dealing* upon a corporation and its insiders who are acting in their own behalf than would be justified were this a case involving a contested tender offer." *Id.* at 1318 (emphasis added).

85. 386 F. Supp. at 17. This line of reasoning does not appear to answer a key contention raised by Commissioner Sommer, namely, if enough shareholders tender the market for the stock would evaporate or that in going public, a corporation makes

C. Summary of the Judicial Response to the Going Private Problem

In the absence of a material misstatement, omission or misrepresentation, a minority shareholder opposing a going private transaction currently faces⁸⁶ a difficult legal impediment to stating a claim for relief under rule 10b-5. State courts, however, increasingly, but not universally, are imposing a fiduciary duty on majority shareholders in their dealings with minority stockowners. However, uncertainties linger regarding the elements of the obligation and the burden of proof. Courts, if disposed to apply rule 10b-5 to corporate mismanagement cases, presumably would look to the same standards used by state courts under fiduciary principles: corporate purpose and price fairness.⁸⁷

The business purpose test rests on the premise that the appraisal remedy, by itself, does not assure fairness if shareholders exchange stock for cash. The test, therefore, focuses on fairness to the corporation. In reality, the majority shareholders will continue to run the business after the departure of the minority. Thus, the test imposes no real check on the conduct of the majority in its dealings with the minority, but instead represents a throwback to the traditional view which imposed a fiduciary obligation on controlling shareholders only toward the corporation or those acting on behalf of the entity.⁸⁸

an implied representation that the issuer will remain public and that the issuer or its affiliates will not interfere with the public market for the stock. Sommer Address, *supra* note 1; see *Jones v. H. F. Ahmanson*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); First of Michigan Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,401 (March 29, 1973); *United Funds v. Carter Prods., Inc.*, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,288 (Baltimore City Cir. Ct. 1963) (prospectus statement that an application for a listing on the New York Stock Exchange is pending implies a promise to maintain such a listing absent a business purpose for its discontinuance). *But see* *Grossman v. Cable Funding Corp.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,913 (D. Del. Dec. 16, 1974) (in response to a shareholder contention that the corporation was using the proceeds of a public offering for purposes other than stated in the prospectus, the court found no violations of § 11 or § 12(2) of the Securities Act of 1933 if the statements in the prospectus were true at the time when made, but the passage of time rendered the specified uses unwise). However, the funds, in any event, were used for corporate purposes. Firms going private may use funds for the benefit of insiders. See Brodsky, *Going Private*, N.Y.L.J., Feb. 5, 1975, at 1, col. 1.

86. A plaintiff would prefer to sue under rule 10b-5 so as to obtain certain procedural advantages, including nationwide service of process, broader discovery rules, more flexible venue requirements, and the ability to maintain a class action suit. See W. CARY, *CASES AND MATERIALS ON CORPORATIONS* 794-95 (4th ed. 1969).

87. Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 HARV. L. REV. 1007, 1033 n.111 (1973). See also *Albright v. Bergendahl*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,997 (D. Utah Sept. 5, 1974).

88. 3 L. LOSS, *SECURITIES REGULATION* 1446 (2d ed. 1961). Perhaps the strongest corporate purpose that also fulfills broader policy considerations involves going private through repurchase of shares by an Employee Stock Ownership Plan Trust (ESOP).

To overcome the conceptual problem inherent in the business purpose standard, courts applying state law generally examine the fairness of a transaction, particularly with reference to the consideration given minority shareholders. However, the enunciation of a fairness standard, subject to an ad hoc, retrospective interpretation by courts provides little assistance to a corporation or its counsel in planning a transaction. Few criteria exist to determine fairness because of the multitude of causal factors. This leads to a judgment based on evidence of value

See Solomon, Towards a Federal Policy on Work: Restructuring the Governance of Corporations, 43 GEO. WASH. L. REV.—(1975).

Through the ESOP financial technique, corporations enable their employees to acquire beneficial ownership of a corporation without taking anything out of their paychecks or inadequate or non-existent savings. The most important aspects of ESOP financing include a loan to an ESOP trust which qualifies as a tax-exempt employee stock bonus trust under Section 401(a) of the Internal Revenue Code of 1954. As presently used, the trust covers a major cross section of employees in the corporation and is controlled by a committee appointed by management which may include labor representatives. The committee invests the loan proceeds in the corporation by buying newly issued stock at its current market value. The trust gives its note to the lender. Pursuant to a guarantee of the note, the corporation makes annual payments into the trust in amounts sufficient to enable the trust to amortize its debt to the lender. The yearly payments made by the corporation to the trust are deductible by the corporation as payments to a qualified employee deferred compensation trust and are allocated proportionately among accounts of the employee participants in the trust. The employees thus acquire stock in increments over time at a price fixed when the block of stock was first purchased. When the loan is paid off, the beneficial ownership of the stock accrues to the employees. *See* Statement of Louis O. Kelso, General Counsel and Norman G. Kurland, General Counsel, Bangert & Co., *Hearings on S. 261 Before the Sub-Committee on Financial Markets of the Committee on Finance, United States Senate, 93rd Cong., 1st Sess. (1973)*. For an example of a repurchase transaction involving an Employee Share Ownership Plan *see* Offer to Purchase, R. B. Jones Corp., November 1, 1974. The repurchase is challenged in *Hurwitz v. R. B. Jones Corp.*, Civil No. 730 W-4 (W.D. Mo., filed Dec. 11, 1974) where plaintiffs allege, among other things, that because of the control position of the individual defendants, they have and will continue to benefit greatly from the establishment of the plan as they are among the highest paid employees and therefore have a significant interest in the trust, which they have caused to be implemented with company funds and are now in a position to exploit, enhance, and retain their control position in administering the trust and voting the shares held therein. Since the plan was discriminatory in the sense that certain officers and directors of the corporation acquired greater benefits under such plan, the effect of the acquisition of public shares was to reward these individuals with the purchased public stock. There is also an immediate realization of gain for the insiders who, as controlling persons of the corporation, effectuated the tender offer. *Wall St. J.*, Jan. 7, 1975, at 18, col. 3, indicated that of the 573,000 shares acquired by R. B. Jones Corp., pursuant to the Offer to Purchase, 100,000 were purchased by the company's employee trust. *See also Wall St. J.*, Mar. 25, 1975, at 14, col. 3. The Tax Reduction Act of 1975 provides that an 11% tax credit may be claimed for acquisitions and construction of specified property during the specified period, which includes the 10% tax credit and an amount equal to an extra 1%, if the corporation makes a qualified investment to an employee stock ownership plan. *INT. REV. CODE OF 1954, § 301(d)*. *See also Hyatt, Workers' Capitalism, Wall St. J.*, Apr. 29, 1975, at 44, col. 1; Thomas, *Explosive Esots*, *BARRON'S*, July 28, 1975, at 5; Thomas, *Mighty Kelso*, *BARRON'S*, July 21, 1975, at 3; *FORBES*, May 1, 1975, at 32; *Wall St. J.*, Mar. 25, 1975, at 14, col. 3; *Wall St. J.*, July 28, 1975, at 26, col. 3; *Wall St. J.*, July 28, 1975, at 13, col. 2.

after the transaction, an approach that assures a surface objectivity but little else.⁸⁹ Finally, courts lack expertise in solving the business and economic questions inherent in such a determination.⁹⁰

Despite the facile assertions contained in *Kaufman v. Lawrence*, going private through a tender offer or an exchange offer poses a potential for harm to minority shareholders.⁹¹ These transactions are, in

89. 3 A. BROMBERG, *supra* note 69, § 16.5, at 275-76. As Bromberg concludes: The price of such a flexible criterion as fairness includes high variability of results and large potential for dissatisfaction with them The problem becomes one of fair value or price, conspicuously difficult because of . . . [the] excess of influencing factors (particularly for publicly traded securities) The probable outcome is a reference to subsequent evidence of value, a hindsight approach that has little to recommend to it except a certain objectivity. Given the difficulties of reconstructing values any other way, it is naive to suppose that latter events will be ignored.

Id. SEC Securities Act Release No. 5567, *supra* note 5, at 85,091 states, "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." 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). See generally 3 FLETCHER, *CORPORATIONS* § 919 (1965); note 71 *supra*. Examples of unfairness in a state corporate law context include: a corporation which paid more than the market price for its shares (*e.g.*, *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)), or that in selling stock (or exchanging its shares in a merger) the corporation received too little (*e.g.*, *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 296-97, 93 A.2d 107 (Sup. Ct. 1952)).

90. One commentator has noted:

But "fairness" is an elusive standard. Where the statutory power exists, there is no clear and certain standard by which the chancellor can allow its exercise for some purposes and disallow its exercise for others. The quest for "fairness" also leads the chancellor into new fields where he is normally not expert. It places on him the heavy burden of solving complex economic problems in order to formulate a judgment as to soundness, and hence the fairness, of the proposed amendment.

Gibson, *How Fixed Are Class Shareholder Rights?*, 28 LAW & CONTEMP. PROB. 283, 296 (1958).

91. Apparently, the theory is that shareholders retain the option to hold the stock and participate equally with management. Although short-form freeze out mergers are legal under state law, they may be challenged under rule 10b-5. *Levine v. Biddle Sawyer*, 383 F. Supp. 618 (S.D.N.Y. 1974). Similarly, under a long-form merger statute, shareholder votes may be rendered ineffective if the insiders control the requisite percentage. The merger may be attacked on federal grounds. See *Schlick v. Penn-Dixie*, 567 F.2d 374 (2d Cir. 1974). For an attack on state law grounds, see *United Funds, Inc. v. Carter Prods., Inc.*, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,288, at 94,281 (Baltimore City Cir. Ct. 1963). It could be argued that no limitations should be placed on going private as it constitutes an additional reward to entrepreneurs. For a discussion of the relationship between entrepreneurial compensation and insider dealings, see H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 131-46 (1966). The concept of entrepreneurship may have some validity in going private situations since insiders usually have a substantial ownership position in the firms that attempt such transactions. However, the need to prevent overreaching and to preserve public confidence requisite for investors to place funds, especially in new ventures, seems paramount. For an argument that shareholders assumed the risk because of certain identifiable factors, see *N.Y. Times*, December 13, 1974, at 70, col. 3; 280 BNA SEC. REG. & L. REP.

fact, probably not voluntary and, thus, should be viewed under a more searching light. As Commissioner Sommer noted, "Is there not a clear conflict of interest when the shareholders are offered the empty choice of tendering or being forced out one way or another while the controlling shareholders reap benefits."⁹² No real choice exists—if a sufficient number of shareholders tender or exchange their shares, the remaining public shareholders face a market even more illiquid (and probably a lower price-earning multiple for their shares), stemming, in large measure from the small number of outstanding shares in public hands.⁹³ To the reduced float⁹⁴ must also be added the threat or the reality of delisting and deregistration of the shares. Although the expressed intention of a broker-dealer to continue to make a market in the firm's stock may seemingly counter this argument,⁹⁵ such assurance may prove ephemeral.⁹⁶ The notion that shareholders, in the exercise of their theoretical sovereignty, will reject management pro-

A-8 (Dec. 4, 1974). For the proposition that every consideration of equity argues for a categorical prohibition against the freeze-out, see Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 323 n.56 (1974). It is important, however, to note the trend towards a contract, not a vested rights theory of share ownership. See note 59 *supra*.

92. Sommer Address at 84,698. Sommer also put the shareholder's plight in picturesque language:

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

Id. at 84,696.

93. Hershman, *Going Private—or How to Squeeze Investors*, DUN'S REV., Jan., 1975, at 38.

94. An adequate float, that is, a sufficient number of shares in the hands of the public as opposed to the corporate insiders, permits a more orderly trading market in an issuer's security.

95. Wells-Rich Prospectus at 16, states that the corporation's investment banker indicated an intention to maintain an over-the-counter market in the common stock, if delisted from the New York Stock Exchange. The Wells, Rich, Greene, Inc., plan can be compared with the plan of Cornwall Equities, Ltd., which made no arrangements for an over-the-counter market for the company's stock. Anreder, *Up and Down Wall Street*, BARRON'S, Dec. 2, 1974, at 40, col. 2. After the exchange offer in Wells, Rich, Greene, Inc. approximately 1,200 out of 2,117 shareholders remained. Of the shares, 165,000 were tendered and only 465,463 were outstanding (including 265,052 held by insiders). Scheibla, *supra* note 19, at 24, col. 3. See also Brief for Defendants-Appellees, at 3, 8, Kaufman v. Lawrence, 514 F.2d 283 (2d Cir. 1975); Reply Brief for Plaintiff-Appellant at 6-7, Kaufman v. Lawrence, *supra*.

96. On a number of trading days since Wells, Rich, Greene, Inc., was traded on the over-the-counter market, no shares have been traded. Scheibla, *supra* note 19, at 22, col. 5. Trading in the common stock of Wells, Rich, Greene, Inc., was so light that none of the major newspapers carried the bid-asked quotes. Reply Brief for the Plaintiff-Appellant at 6-7, Kaufman v. Lawrence, 514 F.2d 283 (2d Cir. 1975).

posals also seems misplaced in light of shareholder attitudes toward securities and management's control of the disclosure machinery.⁹⁷ Thus, the search for legal standards and modes to prevent overreaching by the majority continues.

IV PROPOSALS FOR REFORM

The SEC has commenced a public investigatory and rule-making proceeding to ascertain facts, conditions, practices and other matters relating to going private transactions. The purpose of the proceeding is to develop a factual basis for determining "whether it is necessary or appropriate in the public interest or for the protection of investors for the Commission" to adopt rules under the Securities Exchange Act of 1934 on the basis of the proposed rules and/or to recommend further legislation to Congress.⁹⁸ To provide a framework for the hearings and the comments solicited by the SEC the Commission proposed two different rules to deal with going private transactions.

Proposed rule 13e-3A⁹⁹ would render unlawful certain purchases

97. On the motivation of shareholders, *cf.* Solomon, *supra* note 3, at 761, 763 (1974). *See also* Pacey, *supra* note 8, at 3, col. 1, which indicates that stockbrokers usually advised acceptance of corporate offers in going private transactions.

98. SEC Securities Act Release No. 5567, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,104, at 85,089 (Feb. 6, 1975).

When the Commission commenced its rule making, many corporations withdrew their disclosure documents involving going private transactions. *See* the decision, among others, of Cornwall Equities, Ltd., to halt repurchase of shares. Scheibla, *supra* note 19, at 9, cols. 1, 2. *See also* Kerr, *Tender Offers and Going Private-Ending Public Shareholding an Issue*, N.Y.L.J., Dec. 16, 1974, at 25, col. 3, regarding staff requirements in letter of comment on proxy or information statement filed under regulations 14A and 14C. From Nov. 14, 1974 to Feb. 6, 1975, the Commission refused to issue any comments on disclosure materials for corporations going private. After Feb. 6, 1975, the staff resumed making comments presumably on the basis that the Commission's members do not consider going private per se illegal, but as the rulemaking indicates, the Commission's position is far from clear. *See* comments in Scheibla, *supra*, note 19, at 9, col. 2, of Commissioner John R. Evans (who is reported as stating "any company going private now runs the usual risk that SEC staff comments will not hold up and that the transaction may be illegal, although the SEC does not consider going private illegal per se.") and former Chairman Ray Garrett, Jr. ("We are urging companies to consider the items in the proposed rulemaking. Some are attempting to comply with proposals for disclosure and for obtaining two appraisals of the offer. But they should consult their counsels and make their own determinations. I cannot tell them precisely what to do because we have not yet come up with our decision. We have found the problem too complex for quick action"). Commissioner Sommer has stated that letters of comment and grants of acceleration are "pouring out," at least in cases where the staff "does not have reason to think an investigation is merited." 294 BNA SEC. REG. & L. REP. No. 294, at D-2 (Mar. 19, 1975).

See generally Scheibla, *supra* note 19, at 9, col. 1; N.Y. Times, Feb. 7, 1975, at 39, col. 4; Bacon, *SEC Moving to Protect Minority Holders When Firms Buy Up Shares, "Go Private"*, Wall St. J., Feb. 5, 1975, at 12, col. 2.

99. SEC Securities Act Release No. 5567, *supra* note 5, at 85,091, 85,093; 2 CCH FED. SEC. L. REP. ¶ 23,704 (1975).

of an issuer's equity securities and certain proxy solicitations in connection therewith, unless the issuer or its affiliates complies with specific disclosure and substantive provisions. In addition to providing for a 20 day waiting period during which time certain transactions could not be affected, specified information¹⁰⁰ must be mailed to all holders of record and all known beneficial owners of the affected class of equity securities. The proposed rule also requires that the consideration offered constitute fair value as determined, in good faith, by both the issuer (or its affiliate) and a joint recommendation of two qualified independent persons. The consideration offered could not be less than the joint recommendation. A fair and adequate summary, among other things, of the reports, opinions and joint recommendation would be included in the information statement as well as a fair and adequate summary of any appraisal obtained by or for the issuer or its affiliate regarding the issuer, its material assets, or securities within the last two years.¹⁰¹ The proposed rule also includes certain substantive requirements including a "take-out" of the remaining security holders after deregistration.¹⁰²

This proposal appears deficient in two respects. First, disclosure is probably of limited utility in going private situations. The disclosure concept is premised on supplying an investor with sufficient information to make an investment decision, and serving as a glaring light of publicity which may prevent a fraudulent transaction by an unscrupulous management.¹⁰³ However, in reality, informed investment deci-

100. The requisite information would include: the source of funds for the transaction, the purposes of the transaction and the intentions with respect to the future conduct of business, background information regarding affiliates, an opinion of counsel respecting the legality of the transaction, certain financial information, recent acquisitions of securities, dividend and market price information, and a summary of an evaluation by two qualified independent persons of the consideration offered. 2 CCH FED. SEC. L. REP. ¶ 23,704, at 17,245-4 to -6 (1975).

101. *Id.* at 17,245-5, 17,245-6. The proposal would permit the appraisers to consider, among other factors, the value of the assets and the earning power of the issuer. *Id.* at 17,245-6.

102. *Id.* at 17,245-7. The provisions regulating the details of shareholder notification, withdrawal, pro rata acceptance, increase in consideration for tendered securities comport with standards of the Williams Act, Securities Exchange Act §§ 13(d), 14(d), 14(e), codified at 15 U.S.C. §§ 78m(4), 78n(d), 78n(e) (1970).

103. For background on disclosure concepts embodied in the Securities Act of 1933, see 1 L. LOSS, SECURITIES REGULATION 121-28 (2d ed. 1961); 4 L. LOSS, SECURITIES REGULATION 2270-75 (1969); SEC, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE 1933 AND 1934 ACTS (1969); Wheat, *The Philosophy and Policies of the SEC's Disclosure Policy Study*, in PLI FIRST ANNUAL INSTITUTE ON SECURITIES REGULATION 4 (1970); Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L. J. 311 (1974); Cary, *Corporate Standards and Legal Rules*, 50 CALIF. L. REV. 408, 410-11 (1962); Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959).

sions come about through a filtration process involving securities professionals.¹⁰⁴

In the current stock market, which is dominated by institutional investors,¹⁰⁵ security analysts, who would perform the filtration function, increasingly follow a limited range of securities held or of interest to institutions.¹⁰⁶ Corporations which have gone private or are

104. As Professor Homer Kripke has indicated:

The heart of my position is that the intelligent investor (unless he is himself a market professional) who tries to act in any informed way does so by getting at least part of his information second hand, filtered through professionals. The concept that a prospectus enables the investor to act in informed fashion without professional aid is a delusion

Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1165 (1970). Kripke sets forth his reasons in *id.* at 1167-70. See also Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631, 632-33 (1973).

"Analysts do, in fact, generate the recommendations that influence the great preponderance of investment decisions of institutions and of individuals." Parker, *A Professional's Thoughts—Needed Information*, 24 BUS. LAW. 63, 64 (1968). See generally Address by former chairman Bradford Cook, American Society of Corporate Secretaries, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,341. Commissioner Irving Pollack has noted, "There may be instances where disclosure is not enough." Scheibla, *supra* note 19, at 30, col. 3.

105. Solomon, *supra* note 3, at 768-72 (1974). See also Cole, *Institution Dollar Volume 69% of Big Board's Total*, N.Y. Times, April 2, 1975, at 55, col. 2.

106. See, e.g., Solomon, *supra* note 3, at 773-74. However, certain bank trust departments have diversified their holdings by placing funds into smaller corporations. *Id.* at 774. See also Metz, *Market Place: Investing in Small Companies*, N.Y. Times, Feb. 14, 1975, at 52, cols. 3, 4. Metz states:

Yet a recent study suggests that the biggest institutional investors—particularly the banks and the largest mutual fund organizations—are maintaining an interest in small promising companies and continue to support their shares.

. . . .

On the other hand, the study showed that the research departments of the various institutional investors and brokerage firms were indeed studying fewer companies than they had in the past.

Id. at 52, cols. 3, 4.

For an analysis of the impact of the Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001-1381 (1975), on institutional investing, particularly on the fiduciary standards (29 U.S.C. § 1104(a)(1)(B) states that fiduciaries must act "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims"), see Shakin, *Tough on Fiduciaries*, BARRON'S, Dec. 16, 1974, at 11, col. 1. Shakin states:

Moreover, the requirement of prudence in selecting securities for a pension fund portfolio may incline managers to pass up those of many smaller companies—or even larger ones—which do not possess the solid balance sheet of a Campbell Soup, for instance.

. . . .

. . . However, it appears that the need for investment caution will accelerate the tendency—which has been underway for some time—to shy away from smaller, unseasoned companies.

Id. at 11, col. 5; see Nassau, *Danger: Fiduciaries Warned to Perform as "Prudent Experts"*, N.Y.L.J., Sept. 23, 1974, at 25, col. 3. See also Steinberger, *Fiduciary Responsibilities in Employee Benefit Plans*, N.Y.L.J., Jan. 28, 1975, at 1, col. 3; cf. Note, *Fiduciary*

contemplating such transactions lack institutional sponsorship.¹⁰⁷ Prior to going private, the market for the securities of such corporations lacked liquidity.¹⁰⁸ To talk of a filtration process through disclosure in such a situation is simply to close one's eyes to reality.

The use of two independent, qualified persons to arrive at a joint recommendation attempts to overcome the fairness of price obstacle. The question turns on whether the process should be left to appraisers or should be handled as part of SEC administrative proceeding. Use of appraisals¹⁰⁹ involves a problem of professionalism, particularly defining who is qualified.¹¹⁰ The reports, moreover, probably would lack uni-

duciary Standards and the Prudent Man Rule under the Employment Retirement Income Security Act of 1974, 88 HARV. L. REV. 960 (1975).

107. Metz, *Market Place: Investing in Small Companies*, N.Y. Times, Feb. 14, 1975, at 52, col. 3.

108. See, e.g., Wells-Rich Prospectus at 4 (stock lightly traded); Proxy Statement of Barbara Lynn Stores, Inc., Oct. 8, 1974, at 11 (limited investor interest and light public trading); Offer to Purchase of Diversified Design Disciplines, Inc., Aug. 1, 1974, at 4 (lack of demand for stock); Proxy Statement (draft) of The North Central Companies, Inc., Oct. 1974, at 9 (low trading volume); Offer to Purchase of R. B. Jones Corp., Nov. 1, 1974, at 6 (extremely limited public market). One corporate executive expressed the dilemma as follows:

"We were neither fish nor fowl when we were public," Mr. [John] Sherman [controller, Nardis of Dallas, Inc.] says. "We never had a large enough float (of outstanding stock) to entice some large firms to take an interest in us. We tried making acquisitions, but we found being public was a disadvantage because most of the firms we talked to were private themselves and didn't want to get involved with disclosure."

Freeman, *Going Private*, Wall St. J., Oct. 18, 1974, at 21, col. 3.

Usually firms seeking to go private evidenced four factors: they went public in 1969; have under 500,000 shares in public hands; one family, the employees, or a combination of a family and the employees own many shares; and the firm itself has the cash or the ability to borrow the necessary funds. Pacey, *supra* note 8, at 3, col. 1.

A liquid market exists when transactions in the stock of an issuer can take place without the price of a security experiencing sudden, sharp fluctuations in the absence of material information on a volume deemed "light." An illiquid market is characterized by such price swings. See Solomon, *Institutional Investors: Stock Market Impact and Corporate Control*, 42 GEO. WASH. L. REV. 761, 776-77 (1974). See also Elia, *Heard on the Street*, Wall St. J., Jan. 8, 1975, at 31, col. 3.

109. See generally the problems of projections, *Beecher v. Able*, 374 F. Supp. 341 (S.D.N.Y. 1974); SEC Securities Act Release No. 5362, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,211 (Feb. 2, 1973); Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1200 (1970); Mann, *Prospectuses: Unreadable or Just Unread?—A Proposal to Reexamine Policies Against Permitting Projections*, 40 GEO. WASH. L. REV. 222 (1971); Schneider, *Financial Nits, Grits, and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254, 274-83 (1972); Comment, *Fearless Forecasts: Corporate Liability for Earnings Forecasts that Miss the Mark*, 16 B.C. IND. & COM. L. REV. 115 (1974). For the Commission's traditional policy against disclosure of asset appraisals in proxy statements, see *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1291-94 (2d Cir. 1973). For SEC proposals to implement SEC's statements on projections see SEC Securities Act Release No. 5581, 300 BNA SEC. REG. & L. REP. H-1 (April 30, 1975). See also Belair, *Forecast Rules Offered by SEC*, N.Y. Times, April 29, 1975, at 43, col. 4; Wall St. J., April 29, 1975, at 2, col. 3.

110. See Comment, *The Use of Appraisals in SEC Documents*, *supra* note 30, at 138, 151 (suggesting that an appraiser must hold a senior designation of a recognized ap-

formity as accepted appraisal methods do not exist.¹¹¹ The absence of a single set of accepted appraisal principles deprives the Commission of a standard against which to test the accuracy and honesty of figures furnished by different appraisers using different methods. The lack of uniformity could be overcome either by the SEC or the appraisal profession, more rigorously prescribing approved methods of appraisal. Also, under the proposed rule, the selection of and the payment for the appraiser remains in the hands of the issuer or its affiliates.¹¹² Finally, even in the face of two appraisals, a shareholder could mount a challenge to the transaction which would again be subjected to a retrospective interpretation by the Commission or the courts.

In addition to all or some of the disclosure and tender offer requirements contained in Proposed rule 13e-3A, Proposed rule 13e-3B¹¹³ would apply to certain specified consequences that would or are intended to occur. Proposed rule 13e-3B would require that the terms of a transaction, including any consideration to be paid to any affected security holder, be fair, and in the case of a transaction by an issuer, that a valid business purpose exist for the transaction. Apparently, before clearing the appropriate disclosure documents, the Commission would make a determination regarding business purpose and fairness. In addition to the unsoundness of a business purpose test¹¹⁴ and the inapplicability of the disclosure concept,¹¹⁵ the proposal is notably imprecise.

CONCLUSION

It is recommended that the Securities and Exchange Commission enact regulations¹¹⁶ vesting the Commission, in the situations and un-

praisal society). See also [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,104, at 85,093, (Feb. 6, 1975) where the SEC raises the questions dealing with the qualifications, methods of selection, and standards of independence for persons making the evaluations. The requirement of a joint appraisal may destroy the independence of each appraiser.

111. Comment, *The Use of Appraisals in SEC Documents*, supra note 30, at 138, 152-53 (suggests that professional appraisal societies be encouraged to develop a single set of accepted appraisal principles).

112. Metz, *Stockholder Opposes Going-Private Plan*, N.Y. Times, April 12, 1975, at 34, col. 3 (appraiser selected because he asked for lowest fee).

113. SEC Securities Act Release No. 5573, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,104, at 85,093 (Feb. 6, 1975). See also Investment Company Act. § 17(b), 15 U.S.C. § 80a-17(b) (1970), for a comparison in regards to the fairness requirement.

114. See text at 168.

115. See text at 173.

116. The Commission appears to possess the power to promulgate this proposed rule on the basis of Sections 2 and 10(b) of the Securities Exchange Act of 1934. The

der the terms and conditions set forth below, with the authority to make determinations regarding an issuer's proposal to go private. An issuer or an affiliate thereof seeking to engage in certain transactions¹¹⁷ would notify the SEC and each record holder and beneficial owner known to such issuer or affiliate. The notice would briefly describe the proposed transaction, its impact on the affected class of shareholders and the type and amount of consideration to be given to the holders of the affected equity securities. A shareholder could then, within a short period of time (10 to 20 days), file a statement with the Commission regarding the fairness of the consideration. Whether or not any such objections were filed by shareholders, the staff of the Commission would proceed to hold an administrative hearing regarding the fairness of the consideration offered. The burden of proving fairness would be placed on an issuer or an affiliate. After the hearing, the staff would prepare a report containing its independent evaluation on the "fairness" question and making a recommendation regarding the terms and conditions of the consideration to be offered. If the issuer or its affiliate disapproved of the staff's recommendation, the issuer or its

legislative history of both sections is exceedingly scanty. H.R. REP. NO. 1838, 73d Cong., 2d Sess. 32-33 (1934), states, regarding Section 10(b), "it is made unlawful to use or employ any such device or continuance 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'" (emphasis added). See also 5 A. S. JACOBS, *THE IMPACT OF RULE 10b-5* § 35.01 (1974). On the purpose of Section 2 see *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235 (2d Cir. 1943). See also BNA SEC. REG. & L. REP. A-1, at A-2 (Sept. 10, 1975) (authority exists under Section 13(e) of the Securities Exchange Act of 1934). But see Letter from Sullivan and Cromwell to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, March 14, 1975. See generally Loomis, *The Securities Exchange Act of 1934 and the Investment Advisors Act of 1940*, 28 GEO. WASH. L. REV. 214 (1959); Tracy & MacChesney, *The Securities Exchange Act 1934*, 32 MICH. L. REV. 1025 (1934). For a summary of the unsuccessful challenges to the constitutionality of rule 10b-5, see A. JACOBS, *THE IMPACT OF RULE 10b-5* § 12 (1974). For a layman's analysis of the problem regarding the SEC's powers, see BUSINESS WEEK, Feb. 24, 1975, at 104 ("The commission should stop sucking its thumb and clamp down hard on going private").

117. These transactions, including purchase, cash tender offer, exchange offer, merger, sale of assets, and reverse stock split, are those which (1) compel a security holder of the issuer to terminate his equity interest in an issuer; (2) substantially reduce the amount of any class of an issuer's outstanding equity prior to the transaction and held beneficially by persons other than the issuer; and (3) cause (i) a class of equity securities of an issuer to be subject to delisting from a national securities exchange, (ii) a class of equity securities to be eligible for termination of registration (Section 12(g)(4) of the Securities Exchange Act of 1934), (iii) an issuer to be eligible for suspension of reporting obligations (Section 15(d) of the Securities Exchange Act of 1934), and (iv) a class of the issuer's equity securities authorized to be quoted in an inter-dealer quotation system of a national securities association to cease to be authorized. Compare this category of transactions with the type of transactions covered under Proposed Rules 13e-3A and 13e-3B, 2 CCH FED. SEC. L. REP. ¶¶ 23,704, 23,705 (1975).

affiliate could drop the proposed transaction.¹¹⁸ A dissatisfied shareholder who had previously filed an objection to the original proposal could seek a review of the staff's recommendation by the entire Commission,¹¹⁹ thus laying the basis for judicial review. In the absence of a veto by the issuer or its affiliate or a further challenge by a dissatisfied shareholder, the staff's recommendation would be disseminated, on a specified form, to the shareholders who could then accept or reject the proposal. The Commission would also retain the right to later enjoin a transaction, even upon the terms and conditions specified by it, should material facts later develop.

This method affords several advantages. It would offer a prospective judgment by the staff of the Securities and Exchange Commission based on the business, financial and economic expertise¹²⁰ of an independent body, applying, hopefully, more uniform standards. The opportunity for later second guessing in future judicial or administrative proceedings, especially if a corporation prospers, is eliminated. The costs for the participants would probably be lower in the administrative hearing as opposed to retrospective judicial proceedings.

At least three objections exist to the outlined procedure: money and manpower, time¹²¹ and lack of standards.¹²² As to the first point,

118. In such a case, an issuer or its affiliate would be required to wait a specified period before resubmitting a "going private" proposal.

119. *Kixmiller v. SEC*, 492 F.2d 641 (D.C. Cir. 1974) (court declined to review because only a staff report rather than a Commission order was involved).

120. The SEC, as an administrative agency, assists federal courts in the field of corporate reorganization. Under Chapter X of the Bankruptcy Act of 1938, 11 U.S.C. §§ 572, 608 (1970), the SEC at the request of or with the approval of the court, acts as a participant in the proceedings thereunder in order to provide, for the court and investors, independent, expert assistance on materials arising in such proceedings and to prepare, for the benefit of the courts and investors, formal advisory reports on the plans of reorganization submitted to it by the court in such proceedings. See 10 SEC ANN. REP. 141-52 (1944); 6 W. COLLIER, *BANKRUPTCY* ¶ 7.01, at 1154-55 (14th ed. 1972); Frank, *Epithetical Jurisprudence and the Work of the Securities and Exchange Commission in the Administration of Chapter X of the Bankruptcy Act*, 18 N.Y.U.L.Q. REV. 317 (1941); Gerdes, *Recent Developments in Corporate Reorganization Under the Bankruptcy Act*, 26 VA. L. REV. 999, 1010-13 (1940). The Investment Company Act of 1940 § 17(a), 15 U.S.C. § 80a-17(a) (1970), prohibits certain transactions, for example, the purchase or sale of securities or other properties, between a registered investment company and certain affiliated persons. The Securities and Exchange Commission, pursuant to the Investment Company Act § 17(b), 15 U.S.C. § 80a-17(b), may exempt such a transaction by an order after a hearing, if the evidence, among other items, establishes that "the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned." Investment Company Act § 17(b)(1), 15 U.S.C. § 80a-17(b)(1) (1970).

121. See, e.g., Bacon, *The Regulators: Federal Commissions Are Masters of Delay on Cases Before Them*, Wall St. J., Oct. 15, 1974, at 1, col. 1.

any corporations desirous of engaging in a specified transaction would be required to pay the expenses (salaries of staff and support personnel, other experts, administrative overhead, out of pocket costs) incurred by the Commission in conducting an administrative hearing and preparing a report.¹²³ Regarding the delay often encountered in Federal regulatory inquiries, the Commission would be required to formulate its report within a specified, but brief, time period. Finally, over a period of time standards would develop regarding the fairness of the type and amount of consideration.¹²⁴ As to the question of valuation, the guidelines remain to be charted, but perhaps all that can be expected is an educated, but more consistent, guess.¹²⁵

122. On substantive administrative discretion and case-to-case method of adjudication, see Reich, *The New Property*, 73 YALE L.J. 733, 749-50, 782-83 (1964). See also J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS 15 (1971).

123. But see Solomon & Wilke, *Securities Professionals and Rule 10b-5*, 43 FORDHAM L. REV. 505, 545 (1975) (proposal for industry-wide funding).

124. In formulating standards regarding price fairness, the Commission faces a multitude of possibilities regarding valuation—market price, historic market prices, asset appraisal, book value, capitalization of earnings, plans and prospects for the corporation and/or industry. Consideration should also be given to the following: post-transactional benefits, including the rewards to be received by the insiders, and the potential for future enhancement in value and cost savings. SEC Securities Act Release No. 11,231, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,104 (Feb. 6, 1975); see Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974). One commentator has suggested the granting of warrants to shareholders so that they may continue to participate, even though they no longer own an equity interest, if the corporation, within a specified time period, goes public again, or merges so as to become public again. See Note, *Going Private*, 84 YALE L.J. 903, 929-30 (1975). The former public shareholders might also share in the liquidation or sale of the corporation if effectuated within a specified time period.

For an analysis of capitalization rates, adjustments to past earnings and base periods in corporate reorganization proceedings under the Bankruptcy Act, see generally Gardner, *The SEC and Valuation under Chapter X*, 91 U. PA. L. REV. 440, 441, 449-50, 454-56 (1943). For another approach to the definition of fairness, see Latty, *Fairness—The Focal Point in Preferred Stock Arrearage Elimination*, 29 VA. L. REV. 1 (1942).

125. Jerome N. Frank (former SEC Commissioner and later Judge on the Second Circuit Court of Appeals) noted:

A conclusion as to value is, in last analysis, an expression of judgment. The "facts", in such cases, are not rigid, inert, purely "objective" data. Even in the most exact sciences, a fact usually involves an interpretation, an hypothesis or theory. As I have said elsewhere, "Of course, there is no such thing as mere pure observation or description. Looking and reporting are always selective and purposive." "A 'fact' is a synthesis. A . . . description is . . . interpretative." "The arts of the lawyer and the judge involve daily dealing with uncertainties, contingencies, imponderables, unpredictable. Were that not true, life would be simple for clients, judges, lawyers . . ."

Frank, *Epithetical Jurisprudence and the Work of the Securities and Exchange Commission in the Administration of Chapter X of the Bankruptcy Act*, 18 N.Y.U.L. Q. REV. 317, 338-39 (1941) (footnotes omitted). Bromberg has characterized the process as the "metaphysics of value." 1 A. BROMBERG, *supra* note 69, § 6.3(900), at 122.16.

