Going Private: Who Shall Provide the Remedies?

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INTRODUCTION

The phenomenon of "going private," by which publicly owned companies return to private ownership, is one of the consequences of the recent depressed market for equity securities. The poor market has caused substantial reductions in price/earnings ratios for shares of stock generally, and in some cases has resulted in sales of shares at prices far below book value. Since lower share prices necessarily result in less capital for the publicly owned corporation, compliance with the Securities and Exchange Commission's requirements governing public corporations now often appears to be a proportionately greater burden for these corporations to bear in order to maintain public financing. Accordingly, majority shareholders of several corporations have taken measures designed to concentrate ownership of the corporation in a sufficiently small number of hands to allow them to "go private" and thus delist the corporation with the SEC.

There are several devices available to majority shareholders who wish to rid the corporation of its minority interests. Some of

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1 For many smaller public corporations the recent extended period of poor market conditions has meant that they could expect relatively little increased capital through public financing. Many of these corporations, after reconsidering the benefits and burdens of public ownership, have decided that their interests can be better served by going private. The resultant trend to go private has been much noted and discussed. See, e.g., Borden, Going Private—Old Tort, New Tort or No Tort?, 49 N.Y.U. L. Rev. 987 (1974) [hereinafter cited as Borden]; Brudney, A Note on "Going Private," 61 Va. L. Rev. 1019 (1975) [hereinafter cited as Brudney]; Note, Going Private: An Analysis of Federal and State Remedies, 44 Fordham L. Rev. 796 (1976); Note, Going Private, 84 Yale L.J. 903 (1975) [hereinafter cited as Yale Note].

2 The market factors influencing corporations to go private have been reported and analyzed in the financial media. See, e.g., Lee, Why Companies Want to Go Private, N.Y. Times, Sept. 15, 1974, § 3 (Business and Finance), at 14, col. 3. See generally Yale Note, supra note 1, at 903 & nn.1-5.

3 The cost of being a public corporation, including auditing and legal fees, shareholder relations, annual meetings, transfer agents, and stock certificates, has been estimated at between $75,000 and $200,000 annually for the average corporation listed on the American Stock Exchange. A major portion of these costs would be eliminated by going private. Borden, supra note 1, at 1007.


5 Details of the various types of going private transactions which have been used are provided in Borden, supra note 1, at 990-1002. See also 3 A. Bromberg, Securities Law § 4.7, at 400.2 (Supp. 1975); 2 J. Flom, M. Lipton & E. Steinberger, Takeovers and
the principal means used, either alone or in combination, are cash tender offers for minority shares, made either by the corporation or the majority shareholders; cash mergers; reverse stock splits; and offers by the corporation to exchange debentures for minority shares. Probably the most common device is a two-step procedure involving a tender offer to acquire control, followed by a cash merger to eliminate, or freeze out, the nontendering minority. Fre-

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TAKEOUTS—TENDER OFFERS AND GOING PRIVATE 9-17 (1976) [hereinafter cited as TAKEOVERS AND TAKEOUTS].

4 A tender offer may be defined as "a written offer to purchase within a specified period of time a quantity of corporate securities for cash or other securities, usually securities of the offeror, at a stated price or exchange ratio." Kerr, Going Private: Adopting a Corporate Purpose Standard, 3 SEC. REG. L.J. 33, 34 (1975). Tender offers have become the most commonly used method of acquiring control of public corporations. Id. For a detailed description of the tender offer process, see E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL (1973).

7 Holders of the majority interest in a corporation may cause the corporation to tender for its own shares or, alternatively, may transfer their interests to a newly formed corporation in return for all of the new corporation’s stock, and then cause the new corporation to tender for the minority shares of the first corporation.

8 In a cash merger, the minority shareholders of the transferor corporation receive cash for their shares. It is more customary for shareholders of the acquired corporation to receive stock or other securities in the surviving corporation. See TAKEOVERS AND TAKEOUTS, supra note 5, at 10. For an excellent analysis of the types of mergers used in freeze-outs generally, see Greene, Corporate Freeze-out Mergers: A Proposed Analysis, 28 STAN. L. REV. 487 (1976) [hereinafter cited as Greene]. There, the author postulates that there are three distinct types of freeze-out mergers, each of which involves different policy considerations and hence calls for a different type of analysis. The first two types involve combinations of two ongoing businesses. Greene concludes that these should normally be allowed. Id. at 508-12. The third type, that commonly found in going private transactions, involves the use of a shell corporation as an intermediary created solely for the purpose of freezing out minority shareholders. Greene concludes that the policy considerations favoring corporate flexibility do not require that the majority be entitled to eject the minority at will, and thus this type of freeze-out merger should be banned. Id. at 518-19.

9 The reverse stock split is one of the more ingenious devices used to freeze-out minority interests. The freeze-out is made possible because many states allow corporations to eliminate fractional shares of stock by cash payment. See, e.g., DEL. CODE tit. 8, § 155 (1974); N.Y. Bus. CORP. LAW § 509(b) (McKinney 1983). Thus, where the majority interest is concentrated in blocks substantially larger than the blocks held by the minority shareholders, the corporation may reclassify its shares into fractions small enough so that the largest minority shareholder will have only a fraction of a full share and hence may be cashed out. See, e.g., Teschner v. Chicago Title & Trust Co., 59 Ill. 2d 452, 322 N.E.2d 54 (1974), appeal dismissed, 422 U.S. 1002 (1975) (1 for 600 split).

10 See Kaufmann v. Lawrence, 386 F. Supp. 12 (S.D.N.Y. 1974), aff’d per curiam, 514 F.2d 283 (2d Cir. 1975) (offer to exchange $3 cash and $8 principal amount of 10% subordinated sinking fund debentures per share).

11 See, e.g., Tanzer Economic Assocs. v. Universal Food Specialties, Inc., 87 Misc. 2d 167, 383 N.Y.S.2d 472 (Sup. Ct. N.Y. County 1976). While most freeze-out cases have involved the use of a cash merger to eliminate minority interests, whether the freeze-out device is a reverse stock split, exchange of definite term debentures, or even the more primitive technique of a sale of corporate assets followed by dissolution, the same general considerations
quently, a new corporation is created solely for this purpose.\textsuperscript{12} If control of a sufficiently large number of shares has been gained by the tender offer, the corporation may be able to effect a merger pursuant to a short-form merger statute;\textsuperscript{13} if not, the corporation must utilize the long-form merger procedure.\textsuperscript{14}

Typically, decisions as to whether a public corporation should go private, how much compensation should be paid to the minority for their shares, and how and when the transaction should be effectuated are made exclusively by a control group comprised of the corporation's largest shareholders. This control group, now seeking the return of the corporation to private ownership and thus to their own exclusive control, may well be the very same group which took the corporation public a relatively short time before, perhaps by selling its shares at a price several times higher than that to be offered the frozen-out minority for their shares.\textsuperscript{15} Frequently, there

\footnotesize{apply. For an illustration of a freeze-out accomplished by the sale of corporate assets followed by dissolution, see Lebold v. Inland Steel Co., 125 F.2d 369 (7th Cir. 1941), cert. denied, 316 U.S. 675 (1942).

\textsuperscript{12} See, e.g., Bryan v. Brock & Blevins Inc., 490 F.2d 563 (5th Cir.), cert. denied, 419 U.S. 844 (1974). The usual procedure involves a transfer by the majority of their shares in the corporation to a new corporation created solely for the purpose of the merger in return for all of the new corporation's shares. The majority then votes for a merger of the two corporations, with provisions for the minority shareholders to receive cash for their shares, subject to state law appraisal rights.

\textsuperscript{13} Short-form merger statutes generally provide that if a sufficient number of shares, usually 90% or 95%, is held by the majority, approval of the merger by shareholder vote is not necessary. See, e.g., Del. Code tit. 8, § 253 (1974) (90%); N.Y. Bus. Corp. Law § 905(a) (McKinney Supp. 1976) (95%). If the required total is reached, the insiders may simply form a new corporation which can be merged with the public corporation pursuant to a simple resolution by the board of directors. No stockholders' meeting is necessary and no SEC filings are required. At present, some 38 states have some type of short form merger statute. See Green v. Santa Fe Indus., Inc., 533 F.2d 1283, 1289 n.1 (2d Cir.) (Moore, J., dissenting), cert. granted, 97 S. Ct. 54 (1976) (No. 75-1753).

\textsuperscript{14} Long-form mergers are those which are carried out according to the general state merger statute. While shareholder approval is required, most modern merger statutes, in the interest of corporate flexibility, have provided that such approval may be obtained even in the face of a substantial dissenting minority. The Delaware merger statute, for example, provides that a merger may be accomplished upon the affirmative vote of a majority of the shareholders. Del. Code tit. 8, § 251(c) (1974). Cf. N.Y. Bus. Corp. Law § 903(a)(2) (McKinney 1963) (two-thirds vote required for approval). Long-form mergers are slightly more favorable to the minority than short-form mergers due to their notice requirements through which the minority may be afforded an additional remedy, \textit{viz.}, an injunction.

\textsuperscript{15} See, e.g., Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir.), remanded for determination of mootness, 97 S. Ct. 228 (1976), \textit{discussed in notes 76-90} and accompanying text infra; Kaufmann v. Lawrence, 386 F. Supp. 12 (S.D.N.Y. 1974), \textit{aff'd per curiam}, 514 F.2d 283 (2d Cir. 1975). In \textit{Kaufmann}, Wells, Rich, Greene, Inc., an advertising agency, went public in 1968 by selling 409,000 of its shares at $17.50 per share. By 1974 the price of the stock had fallen to $5.50 per share, and the company's management decided to take the
are other aspects of going private which the minority shareholders find objectionable. Often there is no valid business purpose for the change.\textsuperscript{16} Further, the going private device may be financed with corporate assets.\textsuperscript{17} The board of directors of the corporation going private may be completely controlled by insiders, with the freeze-out victims having no voice and no real chance to affect the outcome.\textsuperscript{18} The merger used to squeeze out the minority sometimes involves only the public corporation and a "shell" intermediary created solely for the purpose, rather than another ongoing business.\textsuperscript{19} Finally, the appraisers who value the minority shares are usually selected and retained by the controlling interests and may be of questionable independence.\textsuperscript{20}

While the benefits of going private that accrue to the majority shareholders and insiders of a public corporation are usually readily apparent and tangible,\textsuperscript{21} any benefits to the corporation's minority interests\textsuperscript{22} or to the corporation itself\textsuperscript{23} are often much more difficult
corporation private by means of an exchange of cash and debentures worth about $9 per share for the minority shares.

\textsuperscript{16} The existence of a proper business purpose has been viewed by many as perhaps the single most important determinant of whether a corporation should be allowed to freeze-out its minority shareholders. See, e.g., Albright v. Bergendahl, 391 F. Supp. 754 (D. Utah 1974) (mem.). The business purpose test was suggested by the SEC in a proposed regulation designed to curb abuses by majority shareholders in such situations. See Proposed Rule 13e-3B, SEC Exchange Act Release No. 11,231 (Feb. 6, 1975), as appearing in \textsuperscript{2}FED. SEC. L. REP. (CCH) \textsuperscript{2}23,704-05. The proposed rule is discussed in notes 73-75 and accompanying text infra.

\textsuperscript{17} See, e.g., Marshel v. AFW Fabric Corp., 533 F.2d 1277, 1279 (2d Cir.), remanded for determination of mootness, 97 S. Ct. 228 (1976).

\textsuperscript{18} While it is invariably the case that the insiders seeking to take the corporation private will have control of a sufficient number of shares to ensure the success of the venture, it is not necessarily true that the freeze-out victims will have no voice and no opportunity to affect the outcome. See, e.g., Schulwolf v. Cerro Corp., 86 Misc. 2d 292, 292, 380 N.Y.S.2d 957 (Sup. Ct. N.Y. County 1976), where the insiders agreed to vote its shares for the merger only if a majority of the minority public shareholders did so and if a business reason for the merger was advanced.

\textsuperscript{19} See note 12 supra. See also Greene, supra note 8, at 495-96, 519.

\textsuperscript{20} See, e.g., People v. Concord Fabrics, Inc., 83 Misc. 2d 120, 121, 371 N.Y.S.2d 550, 551 (Sup. Ct. N.Y. County), aff'd per curiam, 50 App. Div. 2d 787, 377 N.Y.S.2d 84 (1st Dep't 1975).

\textsuperscript{21} It is obvious that when a corporation buys back recently issued shares for a price substantially less than the issue price the corporation realizes a profit. It is also obvious that the benefits of this profit will accrue only to those who are still shareholders in the corporation. Further, it is the majority shareholders and insiders who are relieved of the burden of SEC registration liability. See Yale Note, supra note 1, at 905-06. See generally Brudney, supra note 1.

\textsuperscript{22} The only benefit to minority shareholders who are frozen out by a corporation going private is the premium over present market value which they may receive for their stock. See note 15 supra. However, this potential benefit is often precluded by the fact that the majority, who are in complete control of the going private mechanism, will usually choose a time when
to discern. Further, inasmuch as the control group will often have such complete control of the going private mechanism that they can entirely disregard the interests of the minority, the process can easily be abused. There is, therefore, a need for an effective means of controlling these transactions. Before any effective regulation of the going private process can be provided, it is necessary to determine how these transactions should be regulated and who should do the regulating.

The alternative sources of regulatory power over going private transactions are the corporation laws of the individual states and the federal securities laws as enforced by either the federal courts or the SEC. Proponents of state regulation maintain that since corporations are creatures of the state, internal corporate activities such as those involved in going private should be regulated by the state. Advocates of a federal theory of regulation have premised their arguments on the assumption that the only state law remedy readily available in this type of transaction is the often inadequate exercise of appraisal rights by the minority. Recently, the Court of Appeals for the Second Circuit adopted a federal theory of regulation, allowing relief to shareholders frozen out in going private transactions.

The most obvious advantage to the corporation is saving the cost of compliance with SEC registration requirements. It should be noted, however, that such savings represent a small return on the substantial investment involved in most going private transactions. Moreover, any savings must be balanced against the corporation's loss of the protection from insider abuse provided by the securities laws. See Brudney, supra note 1, at 1032-33; Yale Note, supra note 1, at 966-08.

In what has become a widely quoted speech, former SEC Commissioner A.A. Sommer, Jr. severely attacked the "fad of 'going private,'" noting:

What is happening is, in my estimation, serious, unfair, and sometimes disgraceful,
a perversion of the whole process of public financing, and a course that inevitably
is going to make the individual shareholder even more hostile to American corpo-
rate mores and the securities markets than he already is.


See, e.g., Borden, 'Going Private' Fad: Infatuation Unlikely to Disappear Soon, 174 N.Y.L.J. 114, Dec. 15, 1975, at 40, col. 4. See also notes 68, 71 infra.

See Second Sommer Address, supra note 24, at D-3. See also notes 28-37 and accompa-
nying text infra.
transactions on the ground that these transactions, even if in accord with applicable state statutes, violated the antifraud provisions of the federal securities laws. These decisions mark the most expansive readings of the antifraud provisions to date. The purpose of this Note is twofold: First, to determine whether the expansion of the federal securities laws in this area is justified; and second, to examine the remedies available under state law to shareholders who have been frozen out in a going private transaction. Since the existence of effective state law remedies has a direct bearing on whether federal intervention is justified in the area of going private, this Note will first present an overview of the state law remedies made available by those few courts which have considered the problem.

**AVAILABILITY OF REMEDIES UNDER STATE LAW**

Most states provide by statute that shareholders who dissent from fundamental corporate transactions such as mergers have a right to have the corporation purchase their shares at their appraised value. While this remedy works reasonably well in situations wherein the shareholder has the option of continuing his investment in the merged enterprise or demanding appraisal, there are several reasons why an appraisal proceeding may provide inadequate protection for a shareholder's investments in freeze-out situations. It has been argued, for example, that appraisal will often give the shareholder less than his stock is worth to him, that only a shareholder should have the right to decide when his stock should be sold, and that a shareholder may well have other ties to the corporation which should not be undermined by the elimination of his stock interest. Moreover, forced appraisal may result in unde-

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27 Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir.), remanded for determination of mootness, 97 S. Ct. 228 (1976); Green v. Santa Fe Indus., Inc., 533 F.2d 1283 (2d Cir.), cert. granted, 97 S. Ct. 54 (1976) (No. 75-1753).
29 Even if the minority shareholder is allowed to continue his investment, he may meet with substantial difficulties. See Manning, The Shareholders' Appraisal Remedy: An Essay for Frank Coker, 72 Yale L.J. 223 (1962).
30 See generally Vorenberg, Exclusiveness of the Dissenting Stockholder's Appraisal Right, 77 Harv. L. Rev. 1189, 1200-05 (1964) [hereinafter cited as Vorenberg]. Professor Vorenberg argues that while the minority shareholder's interests are not absolute, "only where there is a plausible business purpose of the corporation beyond the majority's desire to enlarge their own stockholdings or to eliminate a minority stockholder should the minority holder be required to choose between what is available to him as a result of the action
sirable tax consequences for the frozen-out shareholder.\textsuperscript{31} Finally, since the object of an appraisal proceeding is to give those shareholders who dissent from a basic corporate transaction the opportunity to avoid the consequences of the transaction, rather than undo it or to exert any control over its terms, the appraisal remedy is ill suited to provide any measure of substantive fairness for those shareholders unjustly frozen out.\textsuperscript{32} In a typical going private case, for example, the corporation's control group will often have far more extensive information about the company's present finances and future prospects than the minority shareholders, and thus may be in a position to induce the appraisal-triggering device at a time when the minority forced to seek appraisal can neither demonstrate, nor perhaps even determine, that the corporation is worth more than its past record and current share value suggests.\textsuperscript{33}

A threshold question to be answered by a shareholder faced with a freeze-out device which triggers his appraisal rights is whether existence of the appraisal remedy forecloses all other forms

\textsuperscript{31} See Vorenberg, supra note 30, at 1203-04, where the author observes that a stockholder who is forced to take cash for his shares may have capital gains tax payable on any appreciation in the value of his shares. This consequence might have been avoided had there been a merger, by giving the shareholder stock in the reorganized enterprise. This situation is unlikely to occur in most going private transactions, however, since these usually take place when the stock is selling at depressed prices, and thus capital gains are unlikely. See Brudney, supra note 1, at 1024 n.20.

\textsuperscript{32} See Brudney & Chirelstein, \emph{Fair Shares in Corporate Mergers and Takeovers}, 88 HARV. L. REV. 297, 304-07 (1974).

\textsuperscript{33} See Vorenberg, supra note 30, at 1201-03. \textit{But see} Endicott Johnson Corp. v. Bade, 37 N.Y.2d 585, 338 N.E.2d 614, 376 N.Y.S.2d 103 (1975), where shareholders who had dissented from a proposed merger sought appraisal of their shares. The New York Court of Appeals noted that the three factors usually considered in an appraisal are net asset value, market value, and investment value. The court stated that it did not necessarily follow that all three should influence the result of the appraisal in every proceeding. After examining the facts before it, the court held that the only proper measure of true value in \textit{Endicott Johnson} was the investment value, and that the market value, which was only slightly more than half of the investment value, should be ignored altogether. The flexible approach utilized by the court in this case goes a good distance towards meeting at least some of the arguments against the appraisal remedy.
of relief. Although some appraisal statutes indicate that the remedy is intended to be exclusive, many are silent on the subject, and some provide express exceptions to the remedy's exclusiveness. It has been noted that if the appraisal remedy were held to be exclusive in freeze-out situations, the result would be analogous to an eminent domain proceeding whereby the majority interests could, simply by their approval of an appraisal-triggering device, impose a forced liquidation on the minority.

Although the older decisions based on state law indicate some unwillingness to extend other legal and equitable remedies to shareholders with appraisal rights, recent freeze-out cases evidence a more liberal attitude with respect to these remedies. For example, in Bryan v. Brock & Blevins Inc. the Court of Appeals for the Fifth Circuit granted equitable relief in the form of an injunction to shareholders who were the intended victims of such a freeze-out.

At issue in Bryan was whether a Georgia merger statute that granted appraisal rights to dissenting shareholders could properly be used solely for the purpose of freezing out the minority shareholders. The plaintiff, Bryan, had owned 15 percent of the shares of Brock & Blevins, a closely held Georgia corporation. Bryan had been a vice president of the company, but had resigned that position because of management problems. After his resignation, the remaining shareholders sought to acquire all Bryan's shares for themselves. After unsuccessful cash offers, the majority group attempted to utilize a freeze-out merger with a shell intermediary corporation to eliminate Bryan's interests in Brock & Blevins. Bryan petitioned the federal district court for an injunction preventing the proposed merger, alleging that it violated both the federal securities laws and the conditions of good faith and fair dealing which were implicit in the Georgia merger statute. The district court granted the injunc-

31 E.g., CAL. CORP. CODE § 4123 (West 1955); CONN. GEN. STAT. ANN. § 33-373(f) (West 1960).
32 E.g., DEL. CODE tit. 8, § 262 (1974); IND. CODE ANN. § 23-1-5-7 (Burns 1972).
33 E.g., N.Y. BUS. CORP. LAW § 623(k) (McKinney Supp. 1976); N.C. GEN. STAT. § 55-113(b) (1975).
37 343 F. Supp. at 1063-66; 490 F.2d at 571.
tion, holding, *inter alia*, that the merger scheme violated section 10(b) of the Securities Exchange Act of 1934.42

On appeal, the Fifth Circuit found it unnecessary to decide whether the merger violated the federal securities laws, and instead affirmed the decision solely on the basis of the pendent state claim.13 The court held that absent a valid business purpose, mergers which have the effect of freezing out minority shareholders breach the majority's fiduciary duty to the minority, and should be enjoined pursuant to general principles of state corporation law.44 In its opinion the *Bryan* court noted that in situations where the majority interests could not legally eliminate the minority shareholders directly, simple equity required that they not be allowed to do so indirectly by such means as a "sham" merger transaction.45 Although *Bryan* involved a closely held corporation, and hence was not a going private case, the *Bryan* court's willingness to grant injunctive relief where majority shareholders breach their fiduciary duties by freezing out the minority shareholders without a business purpose was quickly adopted by other courts and subsequently applied to publicly held corporations.46

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42 343 F. Supp. at 1070. See 15 U.S.C. § 78j (1970). The district court found that "[t]he proposed merger itself was a course of business which would operate as a fraud or deceit upon Bryan, in connection with the sale of his stock." 343 F. Supp. at 1070.

13 490 F.2d at 571.

44 Id. The court of appeals apparently adopted the plaintiff's contention that the valid business purpose requirement was implicit in the Georgia merger statute. The court indicated that it took a dim view of such transactions:

> We think that the case so clearly establishes the right of the plaintiff to the relief granted by the trial court under general principles of corporation law, which we have discussed above, that we permit a determination as to whether the trial court correctly related the misuse of the Georgia statute to the Securities Exchange law, and approve the decision on the basis of general equity and state law grounds.

Id.

45 Id. at 570-71. The court noted that a majority shareholder cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements.


46 E.g., Albright v. Bergendahl, 391 F. Supp. 754 (D. Utah 1974)(mem.), wherein a federal district court, relying principally on *Bryan*, enjoined a going private cash merger as both a violation of rule 10b-5 and a breach of the majority's fiduciary duties under state law. The merger plan, which was developed for the purpose of eliminating public ownership, called for the use of a shell intermediary. The court held that going private was not, in and of itself, a valid business purpose which would justify eliminating minority interests. Id. at 756-57. The
One question unanswered by the Bryan decision is just what constitutes a business purpose properly sufficient to justify freezing out minority shareholders. While subsequent cases which have found a business purpose to exist have set forth a number of reasons for this decision, it would appear from an analysis of those cases
that in each of them the freeze-out transaction represented what was to be the final step in combining two ongoing and previously unrelated businesses.\(^4\) It should be noted that none of the courts were prepared to hold that the frozen-out shareholder's only proper relief was through an appraisal proceeding, even though appraisal was available. Moreover, each court indicated that in a proper case, injunctive relief would be available.\(^5\)

A theory entirely different from breach of fiduciary duty by the majority was utilized to support the grant of injunctive relief in *People v. Concord Fabrics, Inc.*\(^6\) There, the court utilized the anti-fraud provisions of New York State's blue sky laws\(^7\) to grant a temporary injunction sought by the state attorney general against a going private freeze-out merger. The court found that the absence of scienter, one of the classical elements of common law fraud, was not a defense to the action\(^8\) since the statute affords the attorney general broad powers to investigate securities transactions and to separate business reasons for the merger, including greater economy from centralization, avoidance of duplication, diversity of products, greater ease in financing, elimination of conflicts of interest problems, and avoidance of the cost of being public. *Id.* at 182, 383 N.Y.S.2d at 483.

\(^{19}\) In each of the cases cited in note 48 *supra*, the contested mergers represented what was to be the final step in a program of corporate amalgamation. In each, the corporation which eventually assumed control of the target corporation had begun its program of acquisition as an unrelated concern, independent of the controlling interests of the acquired corporation. It is submitted that the real reason for the denial of injunctive relief in these cases is that "the elimination of a remaining minority interest as the final step in the amalgamation of two previously unrelated businesses is a proper purpose." Kerr, *Going Private: Adopting a Corporate Purpose Standard*, 3 SEC. REG. L.J. 33, 61 (1975). It is still an open question whether there is a legitimate corporate purpose sufficient to justify going private freeze-outs where the only corporations involved are the target corporation and a shell corporation, created by the target corporation's insiders.


\(^{21}\) 83 Misc. 2d 120, 371 N.Y.S.2d 550 (Sup. Ct. N.Y. County), *aff'd per curiam*, 50 App. Div. 2d 787, 377 N.Y.S.2d 84 (1st Dep't 1975). The merger at issue in *Concord* was the same one later enjoined by the Second Circuit in *Marshel v. AFW Fabric Corp.*, 533 F.2d 1277 (2d Cir.), *remanded for determination of mootness*, 97 S. Ct. 228 (1976), discussed in notes 76-90 and accompanying text *infra*.

\(^{22}\) N.Y. GEN. BUS. LAW §§ 352 to 359-h (McKinney 1968 & Supp. 1976). The court noted that § 352 empowers the New York Attorney General to conduct investigations into "fraudulent practices" in securities transactions, and § 353 empowers him to bring an action to enjoin such practices. 83 Misc. 2d at 123-24, 371 N.Y.S.2d at 553-54.

\(^{23}\) 83 Misc. at 124, 371 N.Y.S.2d at 554. It has long been the rule in New York that the protection afforded by the state blue sky laws is more extensive than that afforded by a cause of action in common law fraud. See, *e.g.*, *People v. Federated Radio Corp.*, 244 N.Y. 33, 154 N.E. 655 (1926).
enjoin them where necessary to facilitate his inquiries. Although the substantive questions regarding legality of the merger were not at issue in the case, the court nevertheless expressed its distaste for the type of transaction involved. Interestingly, Concord may be the first time a court has applied state blue sky laws to a going private transaction. Although Concord was instituted by the attorney general and was not a minority shareholder's action, it is submitted that it is indicative of judicial willingness to intervene in freeze-out situations.

While injunctive relief has been the remedy most often sought in going private cases by minority shareholders not content with appraisal, it is not necessarily the only relief available. In Jutkowitz v. Bourns, a California case, the plaintiff was a minority shareholder in Bourns, Inc., a corporation controlled by the Bourns family. When the Bourns family sought to return the corporation entirely to its own control by means of a freeze-out merger with a shell intermediary, the plaintiff sued to enjoin the transaction, alleging that the terms were unfair and the merger lacked a business purpose. The court dismissed the claims as to the unfair price, finding that appraisal was a sufficient remedy for these complaints. More importantly, the court implied that the plaintiff had a right to retain his interest in the corporation if he so wished, and that a corporation seeking to go private must make some provision for those minority shareholders who wish to continue their investment. To effectuate this principle, the Jutkowitz court created a novel remedy: rather than enjoin the merger outright, the court conditioned it on the surviving corporation placing a sufficient number of shares

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54 83 Misc. 2d at 125, 371 N.Y.S.2d at 554.
55 The court observed:
   What is disquietingly evident here is the fact that a group of insiders who are directing the reacquisition program, even controlling the appraisal of the stock are the very ones who made the company public originally, and will be the surviving shareholders in the proposed privately-held enterprise. Adding to the odium of the scheme is that fact that no real corporate purpose has been demonstrated and that the credit of a now public corporation will be used to finance a merger for the benefit of a private group.
Id.
57 No. CA 000268, slip op. at 4. The court noted:
   Money now may well satisfy some or most minority shareholders, but others may have differing investment goals, tax problems, a belief in the ability of Bourns' management to make them rich, or even a sentimental attachment to the stock which leads them to have a different judgment as to the desirability of selling out.
Id.
in escrow to cover the demands of those shareholders who desired to continue their investment. Those shareholders who chose not to retain their shares were left with the choice of either accepting the cash offer or exercising their appraisal rights.58

Jutkowitz and the other cases discussed herein illustrate the potential availability of state remedies other than appraisal, and indicate that state laws are flexible enough to provide injunctive or other relief in proper cases. By imposing a business purpose requirement on going private transactions, courts applying state law can accomplish a balancing of interests between the minority and majority shareholders. While the state cases are few, and it may not be assumed that all states have adequate remedies to protect victims of improper going private transactions, neither should the assumption be made that appraisal is the sole remedy available under state law and that state law protections are necessarily inadequate. It is in the light of the trend towards expansion of state law remedies that the case for extension of the federal securities laws into this area must be reviewed.

**FEDERAL REMEDIES**

Those going private cases which have been brought in federal courts have all alleged violations of either the antifraud provisions of section 10(b)59 or the proxy rules of section 14(e)60 of the Securities and Exchange Act of 1934. Until recently, it was generally believed that claims arising under those sections and based upon corporate transactions such as mergers could be sustained only where it could be shown that there had been inadequate disclosure.61 In the wake

58 For a discussion of Jutkowitz, see Note, The Second Circuit Adopts a Business Purpose Test for Going Private: Marshel v. AFW Fabric Corp. and Green v. Santa Fe Industries, Inc., 64 CALIF. L. REV. 1184, 1203-05 (1976). It has been argued that the decision in Jutkowitz gives the minority interests too much control and substitutes a rule of "minority tyranny" for the "private condemnation" argument advanced by the Jutkowitz plaintiffs. See Takeovers and Takeouts, supra note 5, at 25. For a discussion of the possible effects of recent changes in the California corporation laws on the Jutkowitz holding, see Small, Corporate Combinations Under the New California General Corporation Law, 23 U.C.L.A.L. REV. 1190, 1218 n.137 (1976).


61 The leading case in this area was Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972), wherein the Second Circuit concluded that "where it appears from the record that full and fair disclosure was made . . . we think that a Rule 10b-5 action for injunctive relief must fail." Id. at 720 n.17. Hence, the only remedy for the plaintiff who alleged unfairness in the
of the growing trend towards going private, however, more expansive readings of the federal securities laws were urged so that the interests of the investing public might be better protected. Former SEC Commissioner A.A. Sommer framed the problem as follows:

"Going private" presents somewhat directly and dramatically the problems which are at the cutting edge in the development of federal securities law. To what extent should the expansion of federal securities law be fostered? Should the expansion of its concepts be limited to areas in which state corporation law is not operative? Should it be confined simply to disclosure or should the powers accorded the Commission be read to sanction extension into more substantive rule-making? Where state law provides inadequate protection for shareholders, particularly minority shareholders, should federal law be interpreted broadly to supply safeguards lacking in state law?

It is noteworthy that one of the cornerstones in the argument made by Commissioner Sommer and others in favor of federal regulation of going private transactions is the presumed lack of adequate state law remedies. This presumption is apparently based on the notion that the sole state law remedy available to shareholders in freeze-out situations is appraisal. While this may more nearly have been the case at the time this assumption was made, the analysis made herein of recent court decisions construing state law shows that state courts are not necessarily bound by the terms of the merger agreement set by a controlling stockholder was in state court. Popkin was generally followed by the lower federal courts. See, e.g., Marshel v. AFW Fabric Corp., 398 F. Supp. 734 (S.D.N.Y. 1975), rev'd, 533 F.2d 1277 (2d Cir.), remanded for determination of mootness, 97 S. Ct. 228 (1976); Kaufmann v. Lawrence, 386 F. Supp. 12 (S.D.N.Y. 1974), aff'd per curiam, 514 F.2d 283 (2d Cir. 1975). But see Albright v. Bergendahl, 391 F. Supp. 754 (D. Utah 1974)(mem.); Bryan v. Brock & Blevins Inc., 343 F. Supp. 1062 (N.D. Ga. 1972), aff'd on other grounds, 490 F.2d 563 (5th Cir.), cert. denied, 419 U.S. 844 (1974). An excellent discussion of the Popkin case and its progeny is provided in Borden, supra note 1, at 1032-36.

See Sommer Address, supra note 24; Second Sommer Address, supra note 24. Former SEC Commissioner Sommer is perhaps the chief protagonist of federal intervention in going private transactions.

Second Sommer Address, supra note 24, at D-3.

See id.


See Sommer Address, supra note 24, at 84,696. See also Marshel v. AFW Fabric Corp., 398 F. Supp. 734 (S.D.N.Y. 1975), rev'd, 533 F.2d 1277, remanded for determination of mootness, 97 S. Ct. 228 (1976), wherein the district court stated that "[w]here a merger is to be accomplished in accordance with statutory proceedings, as here, appraisal is the only remedy available to dissenting shareholders." Id. at 739 (footnotes omitted).
praisal remedy. In fact, in view of the potentially wide range of relief against corporations available under state law, state courts would appear to be the forum better suited to provide these remedies.

It seems ironic that when the federal courts finally did intervene in going-private transactions, they adopted a state law theory of liability, *viz.*, breach of fiduciary duty, and equated it with fraud under rule 10b-5 in order to justify federal jurisdiction. If the sympathetic outlook toward minority shareholders and the innovative approach to remedies shown in some recent state court decisions continue, it would seem more economical and logical to leave these theories of liability and remedies to state courts.

Without the benefit of such hindsight, however, Commissioner Sommer urged that a liberal reading be given the securities laws both to assure the SEC the power to impose substantive requirements on corporations seeking to go private, and to provide federal courts a broader scope of review over such transactions. In an effort

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67 See notes 28-58 and accompanying text supra. See generally 3 A. Bromberg, Securities Law § 4.7(B), at 400.2 (1975 Supp.).

68 As a matter of policy, the Supreme Court has directed that ordinarily, federal courts should leave regulation of internal corporate activity to the states: Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation. Cort v. Ash, 422 U.S. 66, 84 (1975). Similar sentiments are expressed in Green v. Santa Fe Indus., Inc., 533 F.2d 1283, 1304 (2d Cir.) (Moore, J., dissenting), cert. granted, 97 S. Ct. 54 (1976)(No. 75-1753). See note 71 infra.

69 Rule 10b-5, which has perhaps become the single most important element in the SEC's fraud prevention scheme, 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 a national securities exchange,

(1) to employ any device, scheme or artifice to defraud,
(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

70 See notes 39-58 and accompanying text supra.

71 Since corporations are creations of the state, it is logical to allow the state to provide a comprehensive scheme for regulating corporate activities. If the states do, in fact, provide effective regulation, it seems unnecessary and wasteful to equate state law theories with federal theories to create still more overlapping regulatory power. See note 68 supra.

72 Second Sommer Address, supra note 24, at D-3.
to provide more substance-oriented regulation, the SEC proposed two alternative rules directly aimed at the practice of going private.  

Although these rules initially generated some favorable comments from investors, the reaction of the organized bar has been generally negative, and difficult questions have been raised regarding both the wisdom of intervention by the SEC in the internal affairs of corporations and the Commission's authority to so intervene. Probably as a result of such criticism, the proposals have apparently been abandoned. 

The development of new SEC rules regarding going private transactions may have become irrelevant, however, in view of two recent holdings by the Court of Appeals for the Second Circuit. In *Marshel v. AFW Fabric Corp.* and *Green v. Santa Fe Industries, Inc.*, the Second Circuit expanded the scope of rule 10b-5 to include regulation of these transactions, holding that mergers effectuated by corporations as part of attempts to go private are in viola-

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75 The American Bar Association's opinion letter on the proposed rules concludes: "The Commission should not attempt to meet "going private" problems by promulgating broad new substantive rules. The difficulty in identifying those circumstances in which unfairness becomes fraud alone suggests that the effort be abandoned. Equally important, detailed substantive rules would begin Federal regulation of internal corporate affairs of a type which should occur, if at all, only as a result of Congressional investigation and explicit statutory authority."


tion of rule 10b-5 absent a valid business purpose for the transaction.

Marshel, which was decided first, presented the more compelling facts to justify federal intervention. Prior to 1968, Concord Fabrics was a closely held corporation owned entirely by the Weinstein family. In that year, the company offered for sale to the public 300,000 of its shares at a price of $15 per share. During the following year, the Weinsteins sold an additional 200,000 shares to the public at $20 per share. The stock rose in price for a time, eventually reaching a high of $25, but by the end of 1974 had plunged in value to only $1 per share. Corporate earnings also fluctuated considerably, reaching record highs in fiscal 1968-1969, but suffering severe losses in fiscal 1971-1972. From that time until the merger, however, the corporation met with moderate success. The Weinsteins, who still retained 68 percent ownership of Concord, then decided to return the corporation to their exclusive control.78

To accomplish their objective and regain complete control of Concord, the Weinsteins formed a new corporation, AFW Fabric Corp., to which they transferred all their Concord shares in return for all of AFW's stock. A merger between AFW and Concord was then proposed, under the terms of which the public shareholders of Concord were to receive $3 in cash for each share of Concord stock.79 The Weinsteins arrived at the $3 per share figure based on an appraisal conducted by an investment banker of questionable independence.80 The shareholders were to be paid out of the assets of Concord.81 The proxy statement issued in conjunction with the shareholders' meeting at which the merger decision was to be made stated straightforwardly that the purpose of the merger was to make Concord a private company again so that the Weinsteins could determine all company policies by themselves without any public scrutiny.82

76 533 F.2d at 1278-79.
77 Id. at 1279.
78 The appraiser was the son of one of Concord's directors. Although this fact was not stated in the Second Circuit's opinion, it had been brought out in related litigation. See People v. Concord Fabrics, Inc., 83 Misc. 2d 120, 121, 371 N.Y.S.2d 550, 551 (Sup. Ct. N.Y. County), aff'd per curiam, 50 App. Div. 2d 787, 377 N.Y.S.2d 84 (1st Dep't 1975).
79 The share repurchase was to be financed through bank loans to AFW Corp., which would become the obligations of Concord after the merger. 533 F.2d at 1279. The court found this to be important since it represented an attempt by the majority stockholders to use corporate funds for personal benefit. Id. at 1282. It has been argued, however, that it is immaterial whether the money used by the corporation to finance going private is provided by the majority shareholders or by the corporation since this factor would make no difference to the minority. See Brodsky, Going Private (III), 175 N.Y.L.J. 67, April 7, 1976, at 2, col. 2.
80 The court quoted the recital of purpose included in the proxy statement:
The minority shareholders of Concord sued in federal district court to enjoin the merger as violative of both state law and the federal securities laws on the ground that the merger constituted a scheme to defraud the plaintiffs into selling their Concord shares for inadequate consideration. The district court rejected the federal claim, relying primarily on Popkin v. Bishop for the proposition that if there has been full disclosure in connection with such corporate transactions, as there had been in the instant case, there is no remedy available under the federal securities laws. The court noted that the sole remedy available in situations of this type was the exercise of appraisal rights under state law.

The Second Circuit reversed the district court’s decision and enjoined the merger. The court declared that when controlling stockholders and directors of a publicly-held corporation cause it to expend corporate funds to force elimination of minority stockholders’ equity participation for reasons not benefiting the corporation but rather serving only the interests of the controlling stockholders such conduct will be enjoined pursuant to Section 10(b) and Rule 10b-5.

The court stated that the 10b-5 remedy exists regardless of the presence or absence of state remedies, and therefore made no finding as to whether the merger was valid under state law. A concurring opinion found it difficult to reconcile the majority’s holding with the Popkin case, however, and maintained instead that the injunction should be granted because the proposed merger constituted a breach of fiduciary duty under state law.

The purpose of the proposed merger of AFW into the Company is to return the Company to the status of a privately-held corporation owned by the Weinstein family. Upon consummation of the merger, the Weinsteins will be the sole stockholders and directors of the Company, and will thus be able to determine all policies of the Company, such as salaries for themselves and others, dividends and business activities, without public scrutiny and solely with regard to their own interests.

533 F.2d at 1279.
398 F. Supp. at 739.
464 F.2d 714 (2d Cir. 1972), discussed in note 61 supra.
Id. at 739.
Id. at 738. On the appraisal question, the Second Circuit noted simply that “[w]e do not regard the existence of the state appraisal remedy as negating the appellants’ rights under federal law.” Id. at 1281.
Id.
Id. at 1280-81.
Id. at 1282 (Smith, J., concurring). Judge Smith observed that the “full, even brazen”
Less than a week after *Marshel* was decided, the Second Circuit utilized its decision in that case as a stepping stone to perhaps the most expansive reading of rule 10b-5 to date. In *Green v. Santa Fe Industries, Inc.*, the court held that a freeze-out of minority shareholders by a majority attempting to go private through the use of a short-form merger is a violation of rule 10b-5 absent a proper business purpose. This is a rather remarkable holding in view of the fact that a major purpose of short-form merger statutes, enacted in 38 states, is to enable a parent company holding the specified number of shares to freeze-out the minority stockholders of a corporation without their approval.

In *Green*, the defendant, Santa Fe Industries Corp., owned all the capital stock of Santa Fe Natural Resources, Inc. [Resources], which in turn owned approximately 95 percent of the voting shares of Kirby Lumber Corporation, a Delaware corporation. Pursuant to a merger plan, Resources caused Forest Products, Inc. [FPI] to incorporate in Delaware, and then transferred its Kirby shares to FPI in return for all of FPI's shares. Shortly thereafter, FPI's board of directors, which was identical to the board of Resources, adopted a resolution to merge FPI and Kirby. Under the terms of the merger, the minority shareholders of Kirby were to receive $150 cash per share for their stock.

The plaintiff, a minority shareholder of Kirby, brought suit in
federal district court, alleging two separate violations of rule 10b-5. He contended, first, that a merger consummated for the benefit of the majority, and without any justifiable business purpose, is a fraud on minority shareholders. The plaintiff also argued that the compensation offered the plaintiffs for their shares was so grossly inadequate as to constitute fraud in and of itself. 97

The district court rejected the shareholders' claims, finding the merger to be in compliance with the Delaware Corporation Law which does not require that a merger be effected for a business reason. 98 The court noted:

The primary objective of Rule 10b-5 is to impose a duty of disclosure upon a corporation and its controlling persons. That objective is to be achieved in conjunction with the state corporate law. This Court does not regard Rule 10b-5 as an omnibus federal corporation law having such broad reach as to modify the notice requirements of the Delaware merger statute, or prevent Delaware, in its legislative wisdom, from providing a means by which a majority can exclude a minority from the corporation's future affairs, so long as due process is satisfied, as it is here, by the appraisal procedures. 99

Interestingly, the district court found implicit support for its holding—that rule 10b-5 does not reach such a transaction—in the fact that the SEC had apparently thought it necessary to propose specific new rules to regulate such conduct under section 13(e) of the 1934 Act. 100 The court also rejected the claim of fraudulent under-valuation, noting that appraisal is an adequate remedy where there has been full disclosure and the dispute is simply as to the fair value of the minority shares. 101

The Second Circuit reversed, 102 holding that "a complaint alleges a claim under Rule 10b-5 when it charges, in connection with a Delaware short-form merger, that the majority has committed a breach of its fiduciary duty to deal fairly with minority shareholders by effecting the merger without any justifiable business purpose." 103
The opinion found that such a breach of fiduciary duty was equivalent to fraud under subdivisions (1) and (3) of rule 10b-5, and that the presence or absence of full disclosure, dealt with in subdivision (2) of the rule, was inapplicable in the case at bar.\(^\text{104}\) Relying on *Popkin v. Bishop\(^\text{105}\)* for the proposition that "[w]here Rule 10b-5 properly extends, it will be applied regardless of any cause of action that may exist under state law,"\(^\text{106}\) the court also held that compliance with applicable state laws in effectuating the merger was not a defense.\(^\text{107}\)

In a vehement dissent, Judge Moore stated that the effect of the decision would be "to override and nullify not only the corporate laws of Delaware with respect to short-form corporate mergers, but also, in effect, comparable laws in an additional thirty-seven states."\(^\text{108}\) Judge Moore argued that the *Green* holding was an unwarranted extension of federal securities laws into internal corpo-

\(^{104}\) *Id.* at 1286-87. The court noted that while subdivision 2 of the rule deals exclusively with misrepresentation and nondisclosure, there are two other subdivisions of the rule which are not so limited. The majority adopted a broad reading of the federal securities laws, declaring:

> As with other laws Rule 10b-5 must be interpreted and applied so as to accomplish the purpose for which it was intended. That this requires a generous reading is too obvious for comment. Since the time to which the memory of man runneth not to the contrary the human animal has been full of cunning and guile. Many of the schemes and artifices have been so sophisticated as almost to defy belief. But the ordinary run of those willing and able to take unfair advantage of others are mere apprentices in the art when compared with the manipulations thought up by those connected in one way or another with transactions in securities.

*Id.* at 1287. This preface to the court's holding drew sharp criticism from Judge Moore because of what he characterized as the suggestive words used to characterize the transaction. *Id.* at 1299-1300 (Moore, J., dissenting). Later, in *Tanzer Economic Assocs., Inc. v. Universal Food Specialties, Inc.*, 87 Misc. 2d 167, 383 N.Y.S.2d 472 (Sup. Ct. N.Y. County 1976), Justice Greenfield also cited with disapproval this use of language by the court in *Green*, noting that:

> Skill in choosing appropriate semantic labels may foreshadow the outcome. The claim of "freeze-out" by a predatory majority using their power as insiders to mulct corporate funds and to overreach in order to unjustly enrich themselves tends to lead a sympathetic court to look indulgently upon extra-statutory remedies.

*Id.* at 175, 383 N.Y.S.2d at 478-79 (footnote omitted).

\(^{105}\) 464 F.2d 714 (2d Cir. 1972), discussed in note 61 supra.

\(^{106}\) 533 F.2d at 1286, quoting *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972). The conceptual difficulty presented by this statement, of course, is that the quotation from *Popkin* is directed toward conduct which violated both federal and state law, whereas the transaction in *Green* was specifically sanctioned by state law. Thus, the *Green* holding does not add a federal remedy to those provided by state law, but rather has the effect of nullifying state laws. This problem is discussed in *Brodsky, State Going-Private Laws—Dead or Alive?*, 175 N.Y.L.J. 39, Feb. 27, 1976, at 14, col. 2.

\(^{107}\) 533 F.2d at 1286.

\(^{108}\) *Id.* at 1299 (Moore, J., dissenting) (footnote omitted).
rate affairs, an area traditionally reserved to the states. The dissent stated that "[u]nder the law, breach of fiduciary duty and commission of fraud are wholly different from one another," and that "the essence of fraud is deliberate deception or concealment which is calculated to deprive the victim of some right or to obtain, by deceptive means, an impermissible advantage over him." The Green decision is far more difficult to justify than is Marshel. In Marshel, "the odium of the scheme," to quote the New York court's characterization of the AFW-Concord merger, was so great as to compel the Second Circuit to find a theory affording relief to the shareholders. Indeed, the New York court had enjoined the merger, a fact noted, although apparently not relied on by the Second Circuit. Green, on the other hand, involved a fairly typical short-form merger. Not only was the transaction in issue in complete technical compliance with applicable state law, but also the facts were not compelling and there was apparently no fraud involved, at least in the traditional sense. It has been suggested that the court may have been influenced to intervene because of the wide discrepancy in the valuation of the minority shares. It is submitted, however, that appraisal is an adequate remedy for undervaluation, and certainly could have been utilized to ensure that the frozen-out shareholders were adequately compensated for their interest. On the whole, the facts in Green do not seem to justify a radical extension of rule 10b-5. Judge Moore argued: "Corporations are creatures of the State. They are created under State law; they are empowered by State statute; and they are regulated by the legislative mandates of the State which has sanctioned their existence." Id. at 1304. Compare id. with Cort v. Ash, 422 U.S. 66, 84 (1975), discussed in note 68 supra. Judge Moore charged that the majority's use of the term "fraud" was no more than a smokescreen for its intervention in internal corporate affairs, and accused it of "putting a torch to the teachings of Erie." 533 F.2d at 1307.

533 F.2d at 1280 n.3.

See TAKEOVERS AND TAKEOUTS, supra note 5, at 53. The court itself noted specifically that it was not holding that a claim of substantial undervaluation alone would support a 10b-5 claim. 533 F.2d at 1291. However, the fact that the court listed "additional elements" would seem to indicate that the undervaluation factor formed part of the basis for its decision.

533 F.2d at 1301 (footnote omitted). Judge Moore's requirements of calculated deception or concealment appear to be in line with the Supreme Court's interpretation of rule 10b-5 handed down a short time later in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). For a discussion of the Hochfelder case, see notes 127-30 and accompanying text infra.

One commentator has commented on the surprise Green generated by noting:
The decisions rendered by the Second Circuit in both *Marshel* and *Green* do not appear consistent with the recent holdings by the Supreme Court in the securities area. The trend of these decisions seems to lie in the direction of curbing further expansions of the federal securities laws and limiting federal regulation of corporate activity. Both *Marshel* and *Green* relied in large part on the Supreme Court's direction in *Superintendent of Insurance v. Bankers Life and Casualty Co.* that "Section 10(b) must be read flexibly, not technically or restrictively." In spite of that language, however, decisions by the Court subsequent to *Bankers Life* have evidenced considerable caution in expanding the federal remedies available against corporations. During the past two years the Court has handed down three major decisions concerning rule 10b-5 which show a general trend toward constricting the scope of remedies available under the rule.

In *Blue Chip Stamps v. Manor Drug Stores, Inc.* the Court considered whether potential purchasers of stock should be granted standing to maintain an action under rule 10b-5. The Court held that the Birnbaum rule, limiting the class of plaintiffs in 10b-5 actions to actual purchasers and sellers, was well founded both by virtue of longstanding judicial and legislative acceptance and by policy considerations, and should not be expanded or discarded absent the most compelling circumstances, which were not present in that case. Writing for the majority, Justice Rehnquist noted that section 10(b) of the Exchange Act does not expressly provide for civil remedies, and further that there exists no legislative history indicating that Congress had even considered the problem of civil

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[It is fair to say that before *Green*, the vast majority of corporate lawyers would have concluded that the short-form merger as accomplished in *Green* was proper, that there was no violation of Rule 10b-5 and that the shareholders' remedy was either to accept cash offered by the company or to be appraised out. *Brodsky, State Going-Private Laws—Dead or Alive?*, 175 N.Y.L.J. 39, Feb. 27, 1976, at 14, col. 3. A fine capsule history of the Second Circuit's decisions in 10b-5 cases leading up to and including *Green* and *Marshel* is provided in *Greene*, supra note 8, at 497-99 n.37.


16 Id. at 12. This direction was quoted in both the opinion and the concurrence in *Green*. 533 F.2d at 1290, 1296-97. It is noteworthy that *Bankers Life* was authored by Justice Douglas, himself a former SEC Commissioner, and hence more likely to indulge broad interpretation of the federal securities laws. The fact that Justice Douglas is no longer on the Court may perhaps indicate that rule 10b-5 will henceforth be interpreted more narrowly.


19 421 U.S. at 755.
remedies prior to passage of the Act. Characterizing private actions under rule 10b-5 as "a judicial oak which has grown from little more than a legislative acorn," the Court reaffirmed the Birnbaum limitations, reversing the circuit court's decision and halting expansion of rule 10b-5, at least on that front.

Perhaps even more indicative of the current thought of at least some members of the Court with respect to further expansions of rule 10b-5 is the concurring opinion in Blue Chip Stamps which is directed more toward the basic policy questions involved. Justice Powell, joined by Justices Stewart and Marshall, after noting that it was not feasible to extend rule 10b-5 to embrace offers to sell, stated:

We are entitled to assume that the Congress, in enacting 10(b) and in subsequently declining to extend it, took into account these and similar considerations. The courts already have inferred a private cause of action that was not authorized by the legislation. In doing this, however, it was unnecessary to rewrite the precise language of § 10(b) and Rule 10b-5. This is exactly what respondents—joined, surprisingly, by the SEC—sought in this case. If such a far-reaching change is to be made, with unpredictable consequences for the process of raising capital so necessary to our economic well-being, it is a matter for the Congress, not the courts.

A restrictive approach to rule 10b-5 was again adopted by the Court in Ernst & Ernst v. Hochfelder, a highly significant decision rendered shortly after Marshall and Green. In Hochfelder, the Court held that a claim under rule 10b-5 cannot be maintained absent some element of scienter and that section 10(b) does not impose liability for negligent conduct alone. It should be noted that this position is somewhat parallel to that urged by Judge Moore in his dissenting opinion in Green. Nonetheless, it remains an open
question at this time whether Hochfelder will be construed as requiring reversal of Green. In both Marshel and Green, full disclosure was conceded, and full disclosure seems somewhat inconsistent with an intent to defraud. It would seem that a strong case could be built, therefore, to the effect that going private cases can no longer be reviewed by federal courts, at least in those instances where there has been such full disclosure. Finally, while the Hochfelder Court did not decide whether the scienter requirement extends to suits seeking injunctive relief, it has since been held that scienter is necessary in such cases as well.

In another recent securities decision, TSC Industries, Inc. v. Northway, Inc., the Supreme Court constricted the definition of materiality as used in the SEC's proxy rules. The change was intended, at least in part, to prevent unduly burdensome regulation of corporations, along with the concomitant chilling effect on corporate activity. This decision requires a shareholder alleging a material omission in a proxy statement to show a "substantial likelihood" that a shareholder would find the omitted material important in deciding how to vote, rather than simply that the shareholder might have found it important.

Not only do Marshel and Green appear inconsistent with the tenor of these recent Supreme Court decisions, but by extending the limits on rule 10b-5 actions they create several problematic policy questions. The American Bar Association Committee on Federal Regulation of Securities of the Section of Corporation, Banking and Business Law noted a parallel problem concerning the SEC's pro-

130 The Supreme Court has granted certiorari to determine this precise question. Santa Fe Indus., Inc. v. Green, 97 S. Ct. 54 (1976) (No. 75-1753).

131 See Brodsky, Rule 10b-5 Liability: The 'Ernst' Decision, 175 N.Y.L.J. 77, Apr. 21, 1976, at 2, col. 3. The equation made by the Second Circuit in Marshel and Green between fraud and breach of fiduciary duty would seem to be difficult to sustain in the wake of Hochfelder. The breach of fiduciary duty theory of liability has a liberal requirement regarding the state of mind of the person charged with the duty, and probably relatively few of those guilty of breaching a fiduciary duty would have satisfied the scienter requirement of Hochfelder. See id.


posed going private rules. In a letter to the SEC commenting on the rules, the committee inquired as to the limits of the fairness requirement in these transactions, and observed that:

Having embarked upon an attempt to require “fairness” in this one type of corporate transaction, how could the Commission refrain from similar action in other areas?

If the evidence adduced during the Commission’s investigatory hearing leads it to conclude that a federal fairness standard is necessary, the Commission should meet the issue head-on by recommending legislation to Congress.

Similar considerations would seem to apply when, as in Green and Marshel, rule 10b-5 is expanded into those areas of substantive corporate law heretofore reserved to the states.

Closely related to the problem of defining new limits for rule 10b-5 once it is extended to reach internal corporate matters is the sensitive policy question of federalizing state corporation laws. At least one highly regarded commentator has advocated that some types of minimum federal standard be established for regulating substantive corporate matters. While the Green and Marshel decisions might be viewed by some as a positive first step in this direction, the better view would seem to be that if such federalization of state corporation laws is to occur, the proper way is by statute and not through progressively more elastic interpretations of rule 10b-5.

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135 For a discussion of the proposed rules, see notes 73-75 and accompanying text supra.
136 Letter from the American Bar Association, Committee on Federal Regulation of Securities of the Section of Corporation, Banking and Business Law to George A. Fitzsimmons, Secretary, SEC, reprinted in TAKEOVERS AND TAKEOUTS, supra note 5, at 113, 123. Similar concerns were expressed in Brodsky, State Going-Private Laws—Dead or Alive?, 175 N.Y.L.J. 39, Feb. 27, 1976, at 14, col. 3.
137 See Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 YALE L.J. 663, 705 (1974). Professor Cary argues that the corporation laws of the individual states reflect an absurd “race for the bottom, with Delaware in the lead,” as a result of state legislative policies designed more to attract incorporations and thereby increase tax revenues than promote public confidence in corporate management.
139 See also Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 YALE L.J. 663, 699-700 (1974), wherein Professor Cary expresses similar sentiments. Similarly, Professor Borden maintains that such an extension of the federal securities laws would create problems parallel to those finally resolved when Erie R.R. v. Tompkins, 304 U.S. 64 (1939), brought almost 100 years of federal common law development tumbling down. Borden, supra note 1, at 1038-39.
GOING PRIVATE

CONCLUSION

Transactions involving a company which is going private have caused much concern, not only as to how these transactions should be regulated, but also as to who should do the regulating. At stake are the competing interests of a state in governing the internal activities of entities created by state law and of the federal government in protecting shareholders through the federal securities laws.

Initially, demands for extension of the federal securities laws to provide protection for potential freeze-out victims of going private transactions were predicated upon the absence of any effective state law remedy which could deal with the problem. The assumption was that the only remedy available under state law was the often inadequate exercise of appraisal rights. Recent decisions involving the application of state laws to this type of transaction, however, have shown that this is not necessarily true. Shareholders who have brought actions predicated on state law generally have not seen their requests for injunctive relief rejected summarily, but rather have achieved careful review of the substance of the transactions, and often have been the beneficiaries of equitable and legal relief previously thought not to be available. In some cases, the courts have been resourceful and innovative in fashioning entirely new remedies. The effect of these decisions is to make further extensions of the federal securities laws into these areas involving corporate management more difficult to justify, since the need for such an extension was predicated on the absence of adequate state law remedies.

Even if it is assumed, however, that state law remedies are inadequate, it is difficult to see how existing federal securities laws can be stretched, within reason, to provide either federal courts or the SEC with the authority to review the substance of these transactions. The securities laws have always been interpreted to impose only disclosure requirements, and, barring only the most exigent circumstances, should be so applied. The going private cases do not appear to present such circumstances.

Lawrence W. Thomas