

CORPORATE FINANCE: SEEKING A LEGAL BASIS FOR THE VALID CORPORATE PURPOSE TEST IN GOING PRIVATE MERGERS

INTRODUCTION

The continuing phenomenon of going private¹ mergers in response to downward swings in stock market prices² has been the source of much comment,³ criticism⁴ and litigation.⁵ Until recently, it was thought that such mergers, which have the effect of eliminating the interest of minority shareholders, could be successfully challenged under federal securities laws. Where such mergers were effected without a valid corporate purpose, violations of federal securities regulations were found in a number of cases.⁶ However, in the landmark decision of *Santa Fe Industries, Inc. v. Green*,⁷ the United States Supreme Court sharply limited the thrust of lower court decisions by eliminating federal securities laws as a basis for application of the "valid corporate purpose"

1. Going private is the term used to describe financial transactions by public companies attempting to reduce or eliminate the number of minority stockholders and thus return to the status of privately held corporations. These transactions may take the form of tender offers, asset sales, mergers and reverse stock splits. See *Going Private and Singer v. Magnavox*, 28 CORPORATION J. 75 (Dec. 1977).

2. Brudney, *A Note on "Going Private"*, 61 VA. L. REV. 1019, 1019-21 (1975). The author traces the movement of stock prices as they relate to the number of going private transactions taking place at the same time.

3. See generally Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U.L. REV. 987 (1974); Brudney, *A Note on "Going Private"*, 61 VA. L. REV. 1019 (1975); Greene, *Corporate Freeze-Out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487 (1976); Kerr, *Going Private: Adopting a Corporate Purpose Standard*, 3 SEC. REG. L.J. 33 (1975). See also Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189 (1964).

4. See, e.g., Rosenfeld, *An Essay in Support of the Second Circuit's Decisions in Marshal v. AFW Fabric Corp. and Green v. Santa Fe Industries*, 5 HOFSTRA L. REV. 111 (1976); Address by former SEC Commissioner A. Sommer, Jr., "Going Private": A Lesson in Corporate Responsibility, at Notre Dame Law School (November 1974), reprinted in FED. SEC. L. REP. (CCH) ¶ 80,010 (1974).

5. See, e.g., *Green v. Santa Fe Industries, Inc.*, 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977); *Marshal v. AFW Fabric Corp.*, 533 F.2d 1277 (2d Cir. 1976), *vacated as moot*, 429 U.S. 881 (1976); *Bryan v. Brock & Blevins Co.*, 490 F.2d 563 (5th Cir. 1974); *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972); *Albright v. Bergendahl*, 391 F. Supp. 754 (D. Utah 1974); *Grimes v. Donaldson, Lufkin & Jenrette, Inc.*, 392 F. Supp. 1393 (N.D. Fla. 1974), *aff'd without opinion*, 521 F.2d 812 (5th Cir. 1975); *Singer v. Magnavox Co.*, 367 A.2d 1349 (Del. Ch. 1976), *rev'd in part*, 380 A.2d 969 (Del. 1977); *Berkowitz v. Power/Mate Corp.*, 135 N.J. Super. 36, 342 A.2d 566 (1975).

6. See notes 35-80 and accompanying text *infra*.

7. 430 U.S. 462 (1977).

test to going private mergers.⁸

The Supreme Court's ruling in *Santa Fe* has forced the reconsideration of the whole area of law dealing with going private. Among the questions raised by the decision are: whether there is a need to control going private transactions;⁹ if there is such a need, what test or standards should be used to balance the rights of minority shareholders against those of the majority;¹⁰ and what statutory or case law basis, federal or state, may be utilized to enforce a test governing the validity of going private transactions?¹¹

In attempting to answer these questions, this article will first look at the financial facts and applicable laws which have facilitated the going private transactions, and then consider the response of the federal courts to minority shareholder litigation testing these transactions under Securities and Exchange Commission ("SEC") Rule 10b-5.¹² In light of this background, the Supreme Court's decision in *Santa Fe*, as well as the subsequent response of the Delaware Supreme Court in *Singer v. Magnavox Co.*¹³ will be discussed.

THE GOING PRIVATE MERGER

The continuous upward movement of stock prices during the 1960's and the subsequent downturn in the 1970's produced corresponding trends of going public transactions in the 1960's and going private transactions in the 1970's.¹⁴ As stock market prices rose, corporation owners moved into the securities marketplace to convert part of their equity holdings into publicly held shares of stock.¹⁵

During the subsequent downturn in stock prices, corporations returned to the market place, but this time to reacquire the publicly held shares of their own stock. This reacquisition of stock, or going private transaction, has taken several forms.¹⁶ The most

8. *Id.* at 479. See notes 81-102 and accompanying text *infra*.

9. For a discussion of the problems associated with going private transactions, see notes 14-34 and accompanying text *infra*.

10. For a discussion of the standards used to test going private mergers, see notes 37-48 and accompanying text *infra*.

11. For a discussion of the legal basis for the valid corporate purpose test, see notes 103-144 and accompanying text *infra*.

12. 17 C.F.R. §240.10b-5 (1976).

13. 380 A.2d 969 (Del. 1977).

14. See Brudney, *A Note on "Going Private,"* 61 VA. L. REV. 1019, 1019-21 (1975).

15. *Id.*

16. Besides a merger, other forms of going private transactions may include the use of a tender offer for minority shares of stock. See notes 170-172 and accompanying text *infra*. Another method of going private is a reverse stock split. In this transaction, the company trades one share of new stock for multiple shares of old

often litigated method of reacquiring publicly held stock is a forced merger of the publicly held company into a closely held shell corporation controlled by the majority shareholders.¹⁷ This going private merger has typically included in its merger agreement a provision for cashing out minority shareholders.¹⁸ In most states, the only statutory remedy available to those minority shareholders dissatisfied with the transaction is to seek a court appraisal of the fair market value of the stock.¹⁹ Consequently, such transactions are often called freeze-out mergers, since the majority, by use of its voting power, forces a merger which freezes out the minority.²⁰

It is also possible in most states to effect such freeze-outs by the use of short-form merger statutes. These statutes typically provide that a corporation owning ninety percent of another corporation may consummate a merger between the two without a vote of the shareholders.²¹

stock (for example, one share of new stock for 600 shares of old stock). To prevent fractional shares of new stock from being issued, the company pays cash for any amount of old stock which does not reach the number required to be traded in for the new stock. To freeze-out minority shareholders, the majority simply prescribes the number of old shares required to be traded in for a new share at such a high ratio that no minority shareholder can obtain a new share and thus must be cashed out. See Jacobs, *How Santa Fe Affects 10b-5's Proscriptions Against Corporate Mismanagement*, 6 SEC. REG. L.J. 3, 22 (1978); *Going Private and Singer v. Magnavox*, 28 CORPORATION J. 75 (Dec. 1977).

17. See, e.g., *Green v. Santa Fe Industries, Inc.*, 533 F.2d 1283, 1288 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977); *Marshel v. AFW Fabric Corp.* 533 F.2d 1277, 1279 (2d Cir. 1976), *vacated as moot*, 429 U.S. 881 (1976). *Bryan v. Brock & Blevins Co.*, 490 F.2d 563, 567 (5th Cir. 1974); *Singer v. Magnavox Co.*, 380 A.2d 969, 971 (Del. 1977).

18. See, e.g., cases cited in note 17 *supra*.

19. See notes 116-128 and accompanying text *infra*.

20. See Greene, *Corporate Freeze-Out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487, 489 (1976).

21. Short-form merger statutes do not require the approval of the shareholders of either of the corporations involved and usually limit the rights of dissenting shareholders to the remedy of appraisal in the courts. These types of mergers are available in 38 states with varying percentages of ownership required of the parent corporation. *Green v. Santa Fe Industries, Inc.*, 533 F.2d 1283, 1299 n.1 (2d Cir. 1976) (Moore, J., dissenting). In *Green*, for example, the court dealt with the Delaware short-form merger statute which read, in part, as follows:

§253. Merger of parent corporation and subsidiary or subsidiaries.

(a) In any case in which at least 90% of the outstanding shares of each class of the stock of a corporation or corporations is owned by another corporation and 1 of the corporations is a corporation of this State . . . the corporation having such stock ownership may either merge the other corporation or corporations into itself and assume all of its or their obligations, or merge itself or itself and 1 or more of such other corporations, into 1 of the other corporations by executing, acknowledging and filing, in accordance with §103 of this title, a certificate of such ownership and merger setting forth a copy of the resolution of its board of directors to so merge and the date of the adoption; provided, however, that in case the parent corporation shall not own all the outstanding stock of all the subsidiary corporations, parties to a merger as aforesaid, the resolution of the board of directors of the parent corporation shall state the terms and conditions of the merger,

A number of reasons for the desirability of the going private merger stem from the advantages private corporations have over those publicly held.²² One of these advantages is the inapplicability of disclosure and registration requirements of the Securities Exchange Act of 1934 (and the accompanying costs of compliance) enjoyed by private corporations.²³ A second advantage is the greater managerial flexibility available to those corporate managers who do not have to report to a large group of public stockholders.²⁴ In addition, there is the obvious advantage that the depressed price of the stock creates an opportunity for profit for the corporation and its remaining stockholders.²⁵ Further, the depressed price of the stock may itself provide a reason for the going private merger, since the low stock price may hinder the implementation of future financing plans,²⁶ or defeat the purpose of stock option plans for employees.²⁷ These considerations, singly or in conjunction, often make the going private merger quite beneficial for the corporation.

In contrast, a more critical attitude towards the reasoning be-

including the securities, cash, property, or rights to be issued, paid, delivered or granted by the surviving corporation upon surrender of each share of the subsidiary corporation or corporations not owned by the parent corporation.

...
 (d) In the event all of the stock of a subsidiary Delaware corporation party to a merger effected under this section is not owned by the parent corporation immediately prior to the merger, the stockholders of the subsidiary Delaware corporation party to the merger shall have appraisal rights and the surviving corporation shall comply with paragraph (2) of subsection (b) of §262 of this title. Thereafter, the surviving corporation and the stockholders shall have such rights and duties and shall follow the procedures set forth in subsections (c) to (j), inclusive, of §262 of this title.

DEL. CODE ANN. tit. 8, §253 (1974 & Supp. 1977).

NEB. REV. STAT. §21-2074 (Reissue 1977) is unique in that it is the only short-form merger statute which permits less than 90% ownership by the parent corporation prior to effecting the merger. *Green v. Santa Fe Industries, Inc.*, 533 F.2d 1283, 1299 n.1 (2d Cir. 1976) (Moore, J., dissenting).

22. See *Going Private and Singer v. Magnavox*, 28 CORPORATION J. 75, 75 (Dec. 1977).

23. See 15 U.S.C. §78-1(g)(1) (1976).

24. See Comment, *Going Private and Rule 10b-5: The Green and Marshel Decisions*, 47 MISS. L.J. 981, 985 (1976).

25. See *Going Private and Singer v. Magnavox*, 28 CORPORATION J. 75, 75 (1977).

26. The stock's depressed price forces any future offering of new stock to be made at that same low price. The company is, therefore, unable to raise money in a stock offering without selling a greater proportion of the company's equity than it would otherwise sell if the price per share were higher. See Note, *Going Private* 84 YALE L.J. 903, 908-09 (1975).

27. Companies using stock option plans to compensate executives find their plans to be not nearly so attractive, as might be expected, when the price of the stock is low. For a further discussion, see *id.*

hind these so called freeze-out mergers has also been taken. Questions concerning the propriety of the majority shareholders determining the price and timing of forced minority sales, along with questions concerning the fairness of buying the minority interests with corporate assets, have generated a negative attitude towards such transactions among some commentators²⁸ and courts.²⁹ A former SEC Commissioner has summarized this skepticism by stating:

Apart from whether [the going private merger is] legal or illegal, it is offensive that a corporation, and often inside selling shareholders, can, when the public is euphoric about the state of the market and grabbing up stock of newly public companies as quickly as they possibly can, reap the benefits of that kind of a market particularly, and then, when the public confidence in the market has sagged to historically low levels (now the lowest since 1929), take advantage of that situation to retrieve the stock at a very low price using the corporation's own assets. I think that's bad. I think it's bad for investor confidence. I felt it was bad for investor confidence when I was on the commission, and I still feel the same way.³⁰

The financial community has also recognized the problems inherent in going private mergers.³¹ One leading financial publication has stated:

However one looks at it "going private" is most often a no-win situation for public shareholders. For the buy-out price is almost always a small fraction of what the investor paid for the stock The investors have a choice of taking what is offered or holding a stock that is no longer readily marketable. And the insiders have formidable legal devices available to fight investors who refuse the com-

28. See, e.g., Levine, *The Proposed SEC Going Private Rules, Proceedings of ABA National Institute on Corporate Takeovers: The Unfriendly Tender Offer and the Minority Stockholder Freezeout*, 32 BUS. LAW 1509, 1509 (1977); Rosenfeld, *An Essay in Support of the Second Circuit's Decisions in Marshel v. AFW Fabric Corp. and Green v. Santa Fe Industries*, 5 HOFSTRA L. REV. 111 (1976); Sommer, *Background and Policy Considerations, Proceedings of ABA National Institute on Corporate Takeovers: The Unfriendly Tender Offer and the Minority Stockholder Freezeout*, 32 BUS. LAW 1513, 1514 (1976).

29. See, e.g., *Green v. Santa Fe Industries, Inc.*, 533 F.2d 1283, 1295 (2d Cir. 1976) (Mansfield, J., concurring), *rev'd*, 430 U.S. 462 (1977); *Marshel v. AFW Fabric Corp.*, 533 F.2d 1277, 1279-81 (2d Cir. 1976), *vacated as moot*, 429 U.S. 881 (1976).

30. Sommer, *Background and Policy Considerations, Proceedings of ABA National Institute on Corporate Takeovers: The Unfriendly Tender Offer and the Minority Stockholder Freezeout*, 32 BUS. LAW. 1513, 1514 (1977).

31. *Green v. Santa Fe Industries, Inc.*, 533 F.2d 1283, 1295 (2d Cir. 1976) (Mansfield, J., concurring), *rev'd*, 430 U.S. 462 (1977).

pany's offer.³²

Since corporate financial transactions often involve large amounts of money, the courts have been called upon to resolve the various disputes and to balance the conflicting rights and interests of minority and majority stockholders in going private transactions. A review of the major cases follows with attention centering on attempts to limit and control the freeze-out mergers by use of the federal securities statutes and regulations. The specific provisions involved are Section 10(b) of the Securities Exchange Act of 1934,³³ and its progeny, Rule 10b-5 of the Securities and Exchange Commission Regulations.³⁴

RULE 10b-5 AND THE VALID CORPORATE PURPOSE DOCTRINE

Section 10(b) was intended to protect public shareholders from fraudulent practices or manipulative devices used in connection with the sale or purchase of securities.³⁵ To accomplish this purpose, section 10(b) implements a philosophy of full disclosure of all relevant facts so that buyers and sellers may make their pricing decisions on a rational basis.³⁶

The initial case considering the applicability of section 10(b) and rule 10b-5 thereunder to a going private merger was *Bryan v.*

32. *Id.* (quoting *Dun's Review*, January 1975, at 37).

33. 15 U.S.C. §78j (1976). This section reads in part:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange. . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

34. 17 C.F.R. §240.10b-5 (1976). The rule states:

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.

Id.

35. *Santa Fe Industries v. Green*, 430 U.S. 462, 475-76 (1977).

36. *Id.* at 477-78.

*Brock & Blevins Co.*³⁷ In that case, the United States District Court for the Northern District of Georgia was presented with an attempt by the majority shareholders to eliminate as a stockholder a former long time employee, manager and board member.³⁸ The plan the majority attempted to use involved merging the original corporation, Brock & Blevins Company, into a shell corporation, Power Erectors, Inc., owned and controlled by the majority.³⁹ The court invoked rule 10b-5 by characterizing the creation of the shell corporation as a "device, scheme, or artifice to defraud Bryan of his stock."⁴⁰ The court invalidated the scheme since the sole purpose of the merger was the elimination of a minority shareholder.⁴¹

The Fifth Circuit Court of Appeals affirmed the district court ruling,⁴² but declined to reach the issue of whether the facts in *Bryan* constituted a violation of rule 10b-5.⁴³ The appellate court invalidated the plan by finding that it involved no valid corporate purpose.⁴⁴ However, the basis for the application of this valid corporate purpose test was found in state law and general equity, rather than rule 10b-5.⁴⁵ The court went on to describe the valid corporate purpose test in the following terms:

[T]he trial court found the absence of a "business purpose" for the proposed merger of Brock & Blevins into Power Erectors. In the absence of such business purpose Power Erectors was purely a sham party created to circumvent the rule of law that prohibits a majority of stockholders of a corporation, absent any charter provision as to the contrary, to force the minority interests to surrender

37. 343 F. Supp. 1062 (N.D. Ga. 1972), *aff'd on other grounds*, 490 F.2d 563 (5th Cir. 1974).

38. *Id.* at 1064.

39. *Id.* at 1065.

40. *Id.* at 1070.

41. *Id.*

42. *Bryan v. Brock & Blevins Co.*, 490 F.2d 563, 571 (5th Cir. 1974).

43. *Id.* at 571.

44. *Id.* at 570.

45. *Id.* at 571. The *Bryan* court cited *Lebold v. Inland Steel Co.*, 125 F.2d 369 (7th Cir. 1941) as authority for its conclusion that state law and general equity provided a basis for the invalidation of the freeze-out merger by application of the valid corporate purpose test. 490 F.2d at 569. In *Lebold* the parent company attempted to eliminate minority shareholders by purchasing the assets of the subsidiary corporation and dissolving its legal structure. Holding the scheme invalid, the court stated:

Whether we stamp the happenings as dissolution or with some other name, equity looks to the essential character and result to determine whether there has been faithlessness and fraud upon the part of the fiduciary. However proper a plan may be legally, a majority stockholder cannot, under its color, appropriate a business belonging to a corporation to the detriment of the minority stockholder.

125 F.2d at 373.

their stock holdings. Implicit in this holding was a construction of the Georgia statute that comports with equity in good conscience. Such construction would read out of the statute a situation where there was no pre-existing corporation to be merged, but instead where such corporation was created solely for the purpose of accomplishing an illegal result.⁴⁶

Both the *Bryan* district court ruling based on rule 10b-5, and the *Bryan* circuit court decision, relying on state law and general equity, spawned a great deal of comment⁴⁷ and were cited as precedents in several later decisions.⁴⁸

Two years later, the Second Circuit's decisions in *Marshel v. AFW Fabric Corp.*⁴⁹ and *Green v. Santa Fe Industries, Inc.*⁵⁰ adopted and extended the approach of the district court in *Bryan* by stating that going private was, in the absence of a valid corporate purpose, a violation of rule 10b-5.⁵¹

The facts of the *Marshel* case present a clear example of the most objectionable features of freeze-out mergers.⁵² In *Marshel*,

46. *Bryan v. Brock & Blevins Co., Inc.*, 490 F.2d 563, 570 (5th Cir. 1974).

47. See generally Borden, *Going Private - Old Tort, New Tort or No Tort?*, 49 N.Y.U.L. REV. 987 (1974); Greene, *Corporate Freeze-Out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487 (1976); Comment, *Recent Developments in the Law of Corporate Freeze-Outs*, 14 B.C. INDUS. & COM. L. REV. 1252 (1973).

48. For example, in *Albright v. Bergendahl*, 391 F. Supp. 754 (D. Utah 1974), the court relied on both *Bryan* decisions to find a breach of the fiduciary duty of the majority to the minority stockholders. *Id.* at 756. The court agreed with the district court's reasoning in *Bryan*, and specifically found that the merger of International Services Industries, Inc. into Body Contour, Inc. constituted a "device, scheme or artifice to defraud" the minority shareholders, as prohibited by rule 10b-5. *Id.* The court rejected the defendant's stated purpose for the merger, that International Service Industries was not a viable vehicle for publicly held stock, as not constituting a "legitimate corporate purpose." *Id.* at 755-57. Consequently, the court invalidated the merger as "an indirect attempt to accomplish what could not be directly accomplished lawfully." *Id.* at 756-57.

During the same year, a federal district court in Florida followed the *Bryan* courts' conclusions of law but distinguished the case before it on its facts. *Grimes v. Donaldson, Lufkin & Jenrette, Inc.*, 392 F. Supp. 1393 (N.D. Fla. 1974). In *Grimes*, the court ruled that the attempted merger of a local real estate investment firm into the real estate subsidiary of a national investment firm which owned a majority of the local company's stock was justified by valid corporate purposes. *Id.* at 1399-1402. The court specifically decided that projected cost savings of \$300,000 annually, and the possibility that shareholder's conflict of interest claims would impede joint action between the parent and subsidiary were legitimate business reasons warranting validation of the merger. *Id.* at 1402.

49. 533 F.2d 1277 (2d Cir. 1976), *vacated as moot*, 429 U.S. 881 (1976).

50. 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977).

51. 533 F.2d at 1280-81 and 533 F.2d at 1290, respectively. *Green* and *Marshel* were decided by separate judicial panels of the Second Circuit. The *Marshel* panel consisted of Circuit Judges Smith, Hays and Meskill. 533 F.2d at 1277. The *Green* panel included Circuit Judges Medina, Moore and Mansfield. 533 F.2d at 1285.

52. *People v. Concord Fabrics, Inc.*, 83 Misc. 2d 120, 125, 371 N.Y.S.2d 550, 554 (Sup. Ct. 1975), *rev'd*, 50 A.D.2d 787, 377 N.Y.S.2d. 84 (1975). This case resulted from

the Weinstein family had made a public offer of 300,000 shares of Concord Fabrics, Inc. ("Concord"), a textile fabric manufacturer owned by the family, for \$15 per share in 1968.⁵³ In 1969 the family sold 200,000 additional shares at a price of \$10 per share.⁵⁴ Total proceeds to the family from the two offerings equaled \$7,800,000.⁵⁵ In 1975, after a dramatic downturn in the price of the stock, the Weinstein family attempted to return to private ownership of Concord by issuing a tender offer for the purchase of Concord stock at \$3 per share.⁵⁶ This tender offer was abandoned in the face of a stockholder suit seeking to enjoin its implementation.⁵⁷ A companion merger plan, however, was pursued with complete assurance of success, since the Weinstein family had retained ownership of sixty-eight percent of the Concord stock.⁵⁸ A stockholder action was brought in response to the second plan to prevent the freeze-out merger. The trial court refused to enjoin completion of the merger,⁵⁹ but, on appeal, the Second Circuit reversed, finding that the merger violated rule 10b-5.⁶⁰

The Second Circuit in *Marshel* rejected the defendant's contention that the merger was legal under the circumstances because the corporation had complied with all provisions of the New York statutes concerning corporate mergers.⁶¹ Included in the defendant's argument was a concession that no underlying business purpose existed for the transaction. However, the defendants contended that such a business purpose was irrelevant since the statutory requirements had been satisfied.⁶² The court characterized the actions of the Weinstein family as a "scheme to defraud their corporation and the minority shareholders to whom they owe fiduciary obligations."⁶³ The panel then declared these actions to be in violation of rule 10b-5.⁶⁴ The court relied on its earlier ruling

the New York Attorney General's attempt to enjoin the Concord merger. For a discussion of *Concord Fabrics*, see notes 123-128 and accompanying text *infra*.

53. *Marshel v. AFW Fabric Corp.*, 533 F.2d 1277, 1278 (2d Cir. 1976), *vacated as moot*, 429 U.S. 881 (1976).

54. *Id.*

55. *Id.* at 1278-79.

56. *Id.* at 1279.

57. *Id.*

58. *Id.* at 1279.

59. *Id.* at 1282.

60. *Id.* at 1280-81.

61. *Id.* The applicable statutes authorizing corporate mergers were N.Y. BUS. CORP. LAW §§901-911 (McKinney 1968 & Supp. 1978-1979).

62. 533 F.2d at 1280.

63. *Id.* at 1282.

64. *Id.* at 1280. The court stated:

What this purported "merger" amounts to is a scheme by the appellees, having previously taken advantage of public financing, to appropriate for

in *Popkin v. Bishop*⁶⁵ to justify the application of rule 10b-5 "regardless of any cause of action that may exist under state law."⁶⁶

The companion case of *Green v. Santa Fe Industries, Inc.*⁶⁷ arose when the parent company, Santa Fe Industries, holder of ninety-five percent of the shares of Kirby Lumber Company, formed a shell corporation and attempted to complete a statutory short-form merger between Kirby and the shell corporation.⁶⁸ According to the plaintiffs, minority shareholders of Kirby, the real value of each share of Kirby stock was \$772.⁶⁹ The short-form merger statement sent to shareholders, however, offered a payment of only \$150 for each minority held share of Kirby stock.⁷⁰ The parent company, Santa Fe Industries, justified its low offering price by relying on the advice of investment bankers Morgan Stanley and Co. Basing its report on the low market price of the stock, Morgan Stanley and Co. had valued the price of each share at \$125.⁷¹ Without reaching a determination as to the true value of the stock, the Second Circuit reversed that part of the lower court's order dismissing the action as to Santa Fe Industries.⁷² Judge Medina's majority opinion stated: "We hold 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."⁷³

In a concurring opinion, Judge Mansfield observed that the merger was a "'manipulative or deceptive device' or contrivance

their personal benefit the entire stock ownership of Concord at a price determined by them and paid out of the corporate treasury at a cost of over \$1,600,000. Such conduct is proscribed by the language of Section 10(b) and Rule 10b-5.

Id. at 1280-81.

65. 464 F.2d 714 (2d Cir. 1972).

66. *Marshel v. AFW Fabric Corp.*, 533 F.2d 1277, 1281 (2d Cir. 1976), *vacated as moot*, 429 U.S. 881 (1976) (quoting *Popkin v. Bishop*, 464 F.2d 714, 718 (2d Cir. 1972)).

67. 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977).

68. *Id.* at 1286-87.

69. *Id.* at 1288.

70. *Id.*

71. *Id.*

72. *Id.* at 1291. The court, however, affirmed that part of the district court order dismissing the action as to co-defendant's Morgan Stanley & Co. The court stated that

absent any claim that Morgan Stanley & Co. was in any way involved in planning or effectuating the merger, or that it shared in the alleged profiteering and faithless conduct of the majority shareholders, appellants' summary allegations that the company participated in fraudulently undervaluing the minority shares fails to state a claim under Rule 10b-5.

Id. at 1293-94.

73. *Id.* at 1291.

which operates as a fraud on public stockholders of the type intended to be proscribed by Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder."⁷⁴

The major significance of the *Green* decision was its characterization of a merger without a justifiable business purpose as a breach of the fiduciary duty owed by the majority to the minority shareholders. This breach of fiduciary duty was then held to constitute a violation of Rule 10b-5 and Section 10(b) of the Securities Exchange Act.⁷⁵

Perhaps the harshest criticism of the *Green* decision came in Judge Moore's impassioned dissent. He argued that the majority had misread section 10(b) and rule 10b-5⁷⁶ and had, in fact, created federal common law.⁷⁷ Judge Moore viewed the statute and regulation as antifraud in nature, and maintained that the majority's decision went far beyond protection against deliberate deception, which he viewed as the gravamen of fraudulent activity.⁷⁸

In contrast, at least one commentator has rejected the view reflected in the dissent.⁷⁹ The legislative history, case law interpretation, and the avowed purposes of the federal securities laws have been read as compelling the protection of "investors who are being forced to surrender their stock at unfair prices . . . not withstanding even the most revealing corporate disclosures."⁸⁰

SANTA FE INDUSTRIES, INC. V. GREEN

The issues which divided the Second Circuit in the *Green* decision came before the United States Supreme Court in *Santa Fe Industries, Inc. v. Green*.⁸¹ As in the Second Circuit's decision, the main controversy centered on the applicability of rule 10b-5 as a basis for invalidating a freeze-out merger.⁸²

74. *Id.* at 1294 (Mansfield, J., concurring).

75. *Id.* at 1291.

76. *Id.* at 1299-1300. (Moore, J., dissenting). Judge Moore stated:

The majority's conjury in holding that this case presents a violation of Section 10(b) of the Securities and Exchange Act and Rule 10b-5 promulgated thereunder is totally without factual anchor, and I cannot refrain at the outset from objecting to the frailty of their factual foundation, which is truly of the character of bricks without straw and an omission that warrants immediate correction.

Id. at 1300. (Moore, J., dissenting).

77. *Id.* at 1307 (Moore, J., dissenting).

78. *Id.* at 1301 (Moore, J., dissenting).

79. Rosenfeld, *An Essay in Support of the Second Circuit's Decisions in Marshel v. AFW Fabric Corp. and Green v. Santa Fe Industries*, 5 HOFSTRA L. REV. 111 (1976).

80. *Id.* at 136.

81. 430 U.S. 462 (1977).

82. *Id.* at 464-65.

The Court, in discussing the operative words of rule 10b-5, "fraud" and "manipulative device," specifically rejected the Second Circuit's construction of the term fraud as including the breach of the majority stockholders' fiduciary duties toward the minority.⁸³ Furthermore, the Court excluded freeze-out mergers from the category of manipulative devices, noting that manipulation was " 'virtually a term of art when used in connection with securities markets.' "⁸⁴ The Court observed that the term manipulation in this context was intended by Congress to include "the full range of ingenious devices that might be used to manipulate securities prices."⁸⁵ The breach of a fiduciary duty of majority shareholders to the minority was, in the Court's opinion, corporate mismanagement rather than a device used to manipulate stock prices and, therefore, not within the intended meaning of the term manipulative device.⁸⁶

Part IV of the opinion, in which Mr. Justice Blackmun and Mr. Justice Stevens refused to join,⁸⁷ reasoned that an alleged breach of corporate fiduciary duty should not be within the ambit of federal securities regulation in any case.⁸⁸ The majority observed that the fundamental purpose of the Securities Exchange Act was to implement a philosophy of full disclosure, and that fairness was only a tangential concern which the Court would be reluctant to vindicate.⁸⁹ The same section of the opinion went on to identify the type of shareholder suit in question as one traditionally relegated to the state courts.⁹⁰ The majority, therefore, refused to "federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."⁹¹

The significance of the Supreme Court's decision in *Santa Fe* would seem to go beyond its specific definition of fraud and manipulation. The case limits the application of rule 10b-5 to implementing the philosophy of full and fair disclosure,⁹² which in turn places the burden of determining the fairness of a given transaction on the states. In this regard the Court stated: " 'Corporations are

83. *Id.* at 472-74.

84. *Id.* at 476-77.

85. *Id.* at 477.

86. *Id.*

87. *Id.* at 480.

88. *Id.* at 477-80.

89. *Id.* at 477-78.

90. *Id.* at 478 (citing *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977) and *Cort v. Ash*, 422 U.S. 66 (1975)).

91. *Id.* at 479.

92. *Id.* at 477-78.

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.' ”⁹³

The separate opinions of Mr. Justice Blackmun and Mr. Justice Stevens concurred with the majority's definition of fraud and manipulative devices, but refused to join in Part IV of the majority opinion⁹⁴ which effectively eliminated rule 10b-5 as a remedy for “the wide variety of corporate [mis]conduct traditionally left to state regulation.”⁹⁵ In very brief concurring opinions, both Justices referred to, *inter alia*, Mr. Justice Blackmun's dissent in *Blue Chip Stamps v. Manor Drug Stores*⁹⁶ to support their arguments.⁹⁷ In *Blue Chip Stamps*, Mr. Justice Douglas and Mr. Justice Brennan joined Mr. Justice Blackmun in condemning the majority decision which limited the types of plaintiffs having standing to pursue remedies under section 10(b) and rule 10b-5.⁹⁸ In that case, the dissenters argued that Congress could not have intended a “broad ranging antifraud provision, such as section 10(b)” to be limited by artificial “mechanical overtones.”⁹⁹ According to Mr. Justice Blackmun, the majority decision in *Blue Chip Stamps* exhibited a “preternatural solicitousness for corporate well-being and a seeming callousness toward the investing public quite out of keeping . . . with our own traditions and the intent of the securities laws.”¹⁰⁰

93. *Id.* at 479 (quoting *Cort v. Ash*, 422 U.S. 66, 84 (1975)).

94. *Id.* at 480-81. (Blackmun, J., concurring in part and Stevens, J., concurring in part).

95. *Id.* at 478.

96. 421 U.S. 723, 761 (1975) (Blackmun, J., dissenting).

97. 430 U.S. at 480. (Blackmun, J., concurring in part and Stevens, J., concurring in part).

98. 421 U.S. at 770. (Blackmun, J., dissenting). In *Blue Chip Stamps*, the plaintiffs were offerees of stock distributed in compliance with a consent decree entered in an earlier antitrust action. *Id.* at 725-26. They contended that the prospectus prepared pursuant to this offering “was materially misleading in its overly pessimistic appraisal of Blue Chip's status and future prospects.” *Id.* at 726. The plaintiff-offerees further alleged that in reliance on this “false and misleading prospectus” they failed to purchase the offered stock and therefore sustained compensatory and exemplary damages. *Id.* at 727. The majority opinion held that only sellers or purchasers of the securities in question had standing to sue under rule 10b-5. *Id.* at 754-55.

99. *Id.* (Blackmun, J., dissenting).

100. *Id.* at 762. (Blackmun, J., dissenting). Mr. Justice Blackmun cited the following cases as support for the proposition that the purpose of federal securities laws is to provide broad protection for the investing public through full and fair disclosure: *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971); *SEC v. National Sec.*,

The Eighth Circuit's reading of the *Santa Fe* decision is especially relevant with regard to the status of the valid corporate purpose doctrine after the Supreme Court's ruling. In *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*,¹⁰¹ Judge Ross stated:

In *Santa Fe Industries, Inc. v. Green*, . . . the Supreme Court stated that § 10(b) and Rule 10b-5 should not be extended to cover a cause of action which has been traditionally relegated to state law. The Court emphasized that requirements of state corporation law, such as the existence of a "valid corporate purpose" or the elimination of the minority interest in a short form merger, should not be transposed on a § 10(b) and Rule 10b-5 action because of the danger of vexatious litigation and the potential for interference with state corporate law.¹⁰²

This interpretation of the *Santa Fe* opinion would seem to foreclose the availability of section 10(b) and rule 10b-5 as a basis for controlling going private transactions.

CONTROLLING FREEZE-OUT MERGERS THROUGH STATE CORPORATE LAW

If the impact of the *Santa Fe* case was not to destroy the valid corporate purpose test, but rather to pass the responsibility for its implementation on to the state courts, the question becomes what basis, if any, in state statutes or case law may be used to justify the application of this doctrine. The Supreme Court seemed to assume that a basis for the application of the valid corporate purpose test already existed and suggested in a footnote that fiduciary standards imposed under state law could be utilized for this purpose.¹⁰³ Ironically, in support of this assumption, the Court cited the Fifth Circuit decision of *Bryan v. Brock & Blevins Co.*¹⁰⁴ No state court decision applying state fiduciary standards was cited by the *Santa Fe* court,¹⁰⁵ and the citation to *Bryan* is more perplexing than helpful since the *Bryan* court also did not cite any state statute or court decision as authority for application of the valid corporate purpose test.¹⁰⁶ As noted earlier, the Fifth Circuit decision

Inc., 393 U.S. 453, 463 (1969); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963).

101. 562 F.2d 1040 (8th Cir. 1977).

102. *Id.* at 1052.

103. 430 U.S. at 479 n.16.

104. 490 F.2d 563 (5th Cir. 1974). See notes 42-46 and accompanying text *supra*.

105. See 430 U.S. at 479 n.16.

106. See *Bryan v. Brock & Blevins Co., Inc.*, 490 F.2d 563, 570-71 (5th Cir. 1974).

relied on general principles of state law and equity.¹⁰⁷ Thus, the Supreme Court's assumption that the valid corporate purpose test could be used by state courts could not be supported by the case law cited in the opinion.

Not only does it appear that little support existed in state law for the valid corporate purpose test, but at the time of the *Santa Fe* decision precedent existed for sustaining going private mergers at the state level. This is best illustrated by the often cited Delaware case of *Stauffer v. Standard Brands, Inc.*¹⁰⁸ Where the statutory requirements for a short-form merger were met,¹⁰⁹ the *Stauffer* court held that the dissenting shareholders were entitled only to the statutorily prescribed appraisal remedy,¹¹⁰ and ordinarily could not rely on the courts to enjoin such a short-form merger.¹¹¹

The Delaware courts have espoused at least two closely related principles which would seem to prevent the application of the valid corporate purpose test through state law.¹¹² The first principle is the doctrine of independent legal significance.¹¹³ Under this doctrine, "a result prohibited by action attempted under one section of the law may be entirely permissible when accomplished through the authorization of another."¹¹⁴ Thus, a corporate transaction which requires, for example, shareholder approval under one section of the state statutes could be valid without such approval under another section. The courts, therefore, would not interfere with the transaction where it was attempted under the second statute.¹¹⁵

The second principle is the sole remedy of stock appraisal for minority shareholders dissatisfied with the merger transaction.¹¹⁶ By invoking the statutorily authorized remedy of appraisal, the Delaware courts have justified their reluctance to create a judicial

107. *Id.* at 571. See note 45 and accompanying text *supra*.

108. 41 Del. Ch. 7, 187 A.2d 78 (1962).

109. See note 21 *supra* for an explanation of a short form merger.

110. DEL. CODE ANN. tit. 8, §253(d) (Supp. 1977). The text of this statute appears at note 21 *supra*.

111. *Stauffer v. Standard Brands, Inc.*, 41 Del. Ch. 7, —, 187 A.2d 78, 80 (1962).

112. See Arshnt, *Minority Stockholder Freezeouts Under Delaware Law*, 32 BUS. LAW. 1495, 1497 (1977). Arshnt identifies a number of pillars of Delaware law which would seem to indicate a "deferential attitude . . . toward mergers, even where the merger is intended to eliminate a minority stock interest." *Id.* at 1498-99.

113. *Id.* at 1497.

114. *Singer v. Magnavox Co.*, 367 A.2d 1349, 1354 (Del. Ch. 1976), *rev'd*, 380 A.2d 969 (Del. 1977).

115. See, e.g., *Stauffer v. Standard Brands*, 41 Del. Ch. 7, 187 A.2d 78 (1962).

116. The remedy of appraisal consists of an independent judgment by the courts of the value of the minority held stock. The action is initiated by the complaining stockholders bringing suit in the state courts. *Stauffer v. Standard Brands, Inc.*, 41 Del. Ch. 7, —, 187 A.2d 78, 80 (1962).

remedy for minority shareholder complaints with respect to statutory short-form mergers.¹¹⁷

Both of these principles, which sharply limit the legal actions available to minority shareholders who dissent from a short-form merger, have been applied by the Delaware courts despite allegations that such a transaction was fraudulent,¹¹⁸ oppressive,¹¹⁹ or effected in the absence of a valid corporate purpose.¹²⁰ The rationale for this approach was articulated in *Bruce v. E.L. Bruce Co.*,¹²¹ wherein the court stated:

[A]bsent fraud or a showing that the terms of a proposed merger are so unfair as to shock the conscience of the court it is the policy of the courts of Delaware to permit contracting corporations to take advantage of statutory devices for corporate consolidation furnished by legislative act The reasons for a merger or the business necessity behind it are not matters for judicial determination¹²²

In New York, a similar doctrine evolved and was recently stated in the case of *People v. Concord Fabrics, Inc.*¹²³ This suit arose from the same merger challenged in *Marshall v. AFW Fabric Corp.*,¹²⁴ but was prosecuted by the state attorney general under New York corporate laws.¹²⁵ The lower court granted an injunction preventing completion of the merger, basing its decision partially on the fiduciary duty owed by the majority shareholders to the minority, which, according to the court, was established in part

117. See *Singer v. Magnavox Co.*, 367 A.2d 1349, 1362 (Del. Ch. 1976), *rev'd in part*, 380 A.2d 969 (Del. 1977).

118. *Stauffer v. Standard Brands, Inc.*, 41 Del. Ch. 7, —, 187 A.2d 78, 80 (1962). The *Stauffer* court rejected the plaintiff minority shareholder's claim that the alleged undervaluation of the stock constituted constructive fraud. The decision held that since the only issue was the value of the stock the plaintiffs were relegated to the statutory remedy of appraisal. *Id.* at —, 187 A.2d at 80.

119. *Id.* at —, 187 A.2d at 80. The plaintiff minority shareholder's assertion that the statutory short-form merger was oppressive was rejected by the court as a justification sufficient to warrant setting aside the merger. *Id.* at —, 187 A.2d at 80.

120. *Singer v. Magnavox Co.*, 367 A.2d 1349, 1358 (Del. Ch. 1976), *rev'd in part*, 380 A.2d 969 (Del. 1977).

121. 40 Del. Ch. 80, 174 A.2d 29 (1961).

122. *Id.* at —, 174 A.2d at 30.

123. 83 Misc. 2d 120, 371 N.Y.S.2d 550 (Sup. Ct. 1975), *rev'd*, 50 A.D.2d 787, 377 N.Y.S.2d 84 (1975).

124. 533 F.2d 1277 (2d Cir. 1976), *vacated as moot*, 429 U.S. 881 (1976). See notes 52-66 and accompanying text *supra*.

125. *People v. Concord Fabrics, Inc.*, 83 Misc. 2d 120, —, 371 N.Y.S.2d 550, 553 (Sup. Ct. 1975), *rev'd*, 50 A.D.2d 787, 377 N.Y.S.2d 84 (1975). Under the Martin Act, New York's Blue Sky Law, the Attorney General is given broad powers to enjoin activities which he believes to be fraudulent. N.Y. GEN. BUS. LAW §353 (McKinney 1968).

on principles of general equity.¹²⁶ However, on appeal the injunction was vacated.¹²⁷ The per curiam opinion of the appellate division in *Concord Fabrics* observed that the lower court ruling did "violence to statutory and case law" and stated that the merger was authorized by the New York Business Corporation Law which "specifically provides for procedures to effectuate mergers and also affords remedies to minority holders."¹²⁸ The New York court, it would seem, followed the Delaware approach in refusing to vindicate the rights of the shareholders objecting to the short-form merger where the prescribed procedure was followed and the statutory remedy of appraisal was available. The valid corporate purpose doctrine, therefore, was not available under the approach of the Delaware and New York courts as a means of preventing the statutorily effected freeze-out merger.

SINGER V. MAGNAVOX CO.

A lower court decision that deserves detailed examination, since it set forth the basic tenets of Delaware state law with regard to corporate freeze-out mergers, is *Singer v. Magnavox Co.*¹²⁹ There the Delaware Chancery Court dismissed a minority shareholder's petition for an injunction to halt a merger between a subsidiary of North American Phillips Corporation and Magnavox.¹³⁰ The action arose when North American Phillips Corporation, through a subsidiary, attempted to take over Magnavox Corporation.¹³¹ Dissenting Magnavox shareholders charged that the

126. 83 Misc. 2d at —, 371 N.Y.S.2d at 554 (Sup. Ct. 1975), *rev'd*, 50 A.D.2d 787, 377 N.Y.S.2d 84 (1975).

127. 50 A.D.2d 787, —, 377 N.Y.S.2d 84, 87 (1975).

128. *Id.* at —, 377 N.Y.S.2d at 86. See N.Y. BUS. CORP. LAW § 910 (McKinney 1963) which provides that a shareholder dissenting from a statutory short-form merger shall have the right to receive payment of the fair value of his shares of stock in the corporation which does not survive the merger.

129. 367 A.2d 1349 (Del. Ch. 1976), *rev'd in part*, 380 A.2d 969 (Del. 1977).

130. *Id.* at 1351.

131. *Id.* A tender offer for Magnavox's outstanding stock was at first resisted by the Magnavox Board of Directors, but later approved after North American guaranteed employment for all of Magnavox's management and raised the offering price for the stock from eight to nine dollars per share. *Id.* at 1352. The tender offer was successful in acquiring 84% of the outstanding stock of Magnavox. *Id.* at 1352. North American Phillips Corporation had formed a wholly owned subsidiary, North American Development, as a vehicle for effecting the tender offer. *Id.* at 1351-52. Development then formed another wholly owned subsidiary, T.M.C. Development Corporation, to facilitate a merger under Delaware Law. *Id.* at 1352. The large majority of stock owned by North American assured the success of the merger. Provisions of the merger agreement called for the payment in cash of nine dollars per share to the minority shareholders, the same amount as had been paid during the tender offer. *Id.* Two dissenting shareholders, Lewis and Molly Singer, sought to nullify the transaction in the Delaware courts. *Id.* at 1351.

merger lacked a valid corporate purpose, that the proxy statement was false and misleading (thereby violating Delaware's Blue Sky Law), and that North American had violated the fiduciary duty of majority shareholders by recommending approval of the merger at an inadequate price.¹³²

The suit was dismissed by the trial court for failure to state a cause of action.¹³³ The trial court found that "a merger designed primarily to eliminate minority shareholders was not an improper use" of the merger statutes.¹³⁴ The dissenting shareholder's second contention, that there was a violation of Delaware Blue Sky Laws by the use of false and misleading statements in the proxy statement, was dismissed for lack of causation. The decision held that the merger would have been completed with or without the proxy statement and, therefore, the plaintiffs were not actually injured by any misleading statements in the proxy material.¹³⁵ Finally, the plaintiffs' charge of a breach of fiduciary duty was dismissed by the lower court. Relying on *Stauffer*, the lower court ruled that this portion of the complaint reduced itself to a charge of unfair pricing and that the proper remedy for such a charge was the statutory remedy of appraisal.¹³⁶

In what may be termed a dramatic turn around, the Delaware Supreme Court reversed in part the chancery court ruling.¹³⁷ By combining the first and third contentions of the plaintiffs' complaint and concentrating not on the allegation of fraud but on the breach of fiduciary duty by the majority shareholders, the court held that the complaint should not have been dismissed.¹³⁸ The supreme court stated:

After review of the cases, the Trial Court concluded that to the extent the complaint charges that the merger was fraudulent because it did not serve a business purpose of Magnavox, it fails to state a claim upon which relief may be granted. Our analysis leads to a different result, not on the basis of fraud but on application of the law governing corporate fiduciaries.¹³⁹

The court noted that the fiduciary duty of majority shareholders to minority shareholders was affirmatively established in Delaware

132. *Id.* at 1353.

133. *Id.* at 1362.

134. *Id.* at 1356.

135. *Id.* at 1361.

136. *Id.* at 1361-62. For a discussion of the *Stauffer* case, see notes 108-119 and accompanying text *supra*.

137. *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977).

138. *Id.* at 975.

139. *Id.*

law.¹⁴⁰ This fiduciary duty, the court held, was breached where the merger was effected for the sole purpose of freezing out the minority shareholders.¹⁴¹

The *Singer* approach of invalidating a freeze-out merger based on state fiduciary standards, seems to fit the pattern suggested by the Supreme Court in the *Santa Fe* case. In *Santa Fe*, as previously mentioned, the Supreme Court suggested the utilization of state fiduciary standards as a basis for the valid corporate purpose test.¹⁴² The *Singer* court held that a merger effected for the sole purpose of freezing out minority shareholder interests constituted a violation of the majority shareholders' fiduciary duty to minority shareholders.¹⁴³ Thus, the question of what basis may be used to enforce the valid corporate purpose test was answered by the *Singer* court's use of the fiduciary duty of majority shareholders.¹⁴⁴ It is ironic to note that the state of Delaware, which the Supreme Court in *Santa Fe* suggested did not have a valid corporate purpose test,¹⁴⁵ was actually the first state court after the *Santa Fe* decision to utilize corporate fiduciary standards to vindicate the rights of minority shareholders in a freeze-out merger.

The *Singer* decision also established that a merger could be

140. *Id.* at 976 (citing *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 93 A.2d 107 (1952)).

141. *Id.* at 980.

142. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 479 n.16 (1977).

143. *Singer v. Magnavox Co.*, 380 A.2d 969, 980 (Del. 1977).

144. Although the valid corporate purpose test was never expressly adopted in the opinion, the court designated the sole purpose of freezing out minority shareholders to be a violation of the fiduciary duties owed by the majority to the minority. *Id.* at 980.

The preliminary *Singer* opinion, printed at 422 SEC. REG. & L. REP. (BNA) E-6 (Oct. 5, 1977), used the following language: "By analogy, if not *a fortiori*, use of corporate power to *eliminate* the minority is a violation of [fiduciary] duty if done without a valid business purpose." *Id.* However, the later version of the opinion, substituted the language "solely to eliminate the minority" instead of "without a valid business purpose." 380 A.2d at 980. It is not clear whether this change of language is a retreat from the valid corporate purpose test. See Note, *Going Private—The Need for a Valid Business Purpose in Delaware: Singer v. Magnavox Co.*, 10 CONN. L. REV. 511, 517 n.36 (1978).

The *Singer* decision may be interpreted as applying the valid corporate purpose test but as avoiding a precise definition of the standard. The court did not wish to discuss the various questions concerning the valid corporate purpose test which were raised in the opinion. 380 A.2d at 976. Thus the holding is simply couched in terms of one purpose, the elimination of minority shareholders, which it designates as an invalid purpose. *Id.* at 980. Thus, some commentators have read the *Singer* case as effectively adopting the valid corporate purpose test as the standard by which the validity of freeze-out mergers will be determined. See Note, *Going Private—The Need for a Valid Business Purpose in Delaware: Singer v. Magnavox*, 10 CONN. L. REV. 511, 517 (1978); *Going Private and Singer v. Magnavox*, 28 CORPORATION J. 75, 78 (Dec. 1977).

145. See *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 479 n.16 (1977).

invalidated even though its sole purpose was not to freeze out minority shareholders. The court held that the merger would violate the majority's fiduciary duty to the minority if, under all the circumstances, it was unfair to the minority shareholders. The court stated:

This is not to say, however, that merely because the Court finds that a cash-out merger was not made for the sole purpose of freezing out minority stockholders, all relief must be denied to the minority stockholders in a §251 merger. On the contrary, the fiduciary obligation of the majority to the minority stockholders remains and proof of a purpose, other than such freeze-out, without more, will not necessarily discharge it. In such case the Court will scrutinize the circumstances for compliance with the . . . rule of "entire fairness" and, if it finds a violation thereof, will grant such relief as equity may require.¹⁴⁶

The *Singer* court had to sidestep several previous holdings in order to avoid the obstacles of independent legal significance and the statutory remedy of appraisal.¹⁴⁷ Specifically, the court attacked directly the idea that compliance with the statutory merger requirements made the defendant's transaction legal per se:

[T]here is both statutory authorization for the Magnavox merger and compliance with the procedural requirements. But, contrary to defendants' contention, it does not necessarily follow that the merger is legally unassailable. We say this because, (a) plaintiffs invoke the fiduciary duty rule which allegedly binds defendants; and (b) Delaware case law clearly teaches that even complete compliance with the mandate of a statute does not, in every case, make the action valid in law.¹⁴⁸

The court then stated that "inequitable action does not become permissible simply because it is legally possible."¹⁴⁹ Thus, the doctrine of independent legal significance was outweighed, in the court's view, by the gravity of the broad responsibilities of fiduci-

146. *Singer v. Magnavox Co.*, 380 A.2d 969, 980 (Del. 1977). The *Singer* court relied on the decision in *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 93 A.2d 107 (1952), as establishing the entire fairness test. In *Sterling* the court was asked to enjoin the merger of a subsidiary hotel corporation into the Hilton Hotel chain on the basis that the terms of the merger were unfair. *Id.* at —, 93 A.2d at 108-09. The court held that the parent corporation, Hilton Hotels, had the burden of establishing the entire fairness since it stood on both sides of transaction. *Id.* at —, 93 A.2d at 109-10. The court, after considering the plaintiffs' objections to the merger, found that it was neither fraudulent nor unfair. *Id.* at —, 93 A.2d at 117.

147. See notes 114-117 and accompanying text *supra*.

148. *Singer v. Magnavox Co.*, 380 A.2d 969, 975 (Del. 1977).

149. *Id.* (quoting *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971)).

ary duty.¹⁵⁰

Furthermore, Judge Duffy, speaking for the *Singer* majority, rejected the argument in favor of a single remedy of appraisal for dissenting shareholders.¹⁵¹ The court stated that "in our view, defendants cannot meet their fiduciary obligations to plaintiffs simply by relegating them to a statutory appraisal proceeding."¹⁵² In the final analysis, the *Singer* court adopted the valid corporate purpose rule as a test of whether the majority had breached its fiduciary duty.¹⁵³ The *Singer* court held that

a Delaware Court will not be indifferent to the purpose of a merger when a freeze-out of the minority stockholders on a cash-out basis is alleged to be its sole purpose. In such a situation, if it is alleged that the purpose is improper because of the fiduciary obligation owed to the minority, the Court is duty-bound to closely examine that allegation even when all of the relevant statutory formalities have been satisfied.¹⁵⁴

THE IMPLICATIONS OF *SINGER*

A subsequent decision by the Delaware Supreme Court, also written by Judge Duffy, sheds some light on the scope and application of the *Singer* holding. In *Tanzer v. Internatinal General Industries, Inc.*,¹⁵⁵ the court was asked to enjoin a merger between two subsidiaries of International General Industries, Inc. ("IGI") on the basis that the sole purpose was to serve the interests of the parent corporation.¹⁵⁶ The trial court had found that the principle reason for the merger was to facilitate long-term debt financing by IGI, which, it concluded, was a "legitimate and present and compelling business reason for the merger."¹⁵⁷ The Delaware Supreme Court used the test established in *Singer*, but declared that a parent corporation, in its role as a majority shareholder, was not bound to disregard its own interest in favor of those of minority shareholders.¹⁵⁸ Rather, the court declared that it was a fundamental right of shareholders to vote in their own interest.¹⁵⁹ The *Tanzer* court stated that "[a]s a stockholder, [the parent corpora-

150. *Id.*

151. *Id.* For a discussion of the statutory remedy of appraisal, see notes 116-117 and accompanying text *supra*.

152. 380 A.2d at 977.

153. See note 144 *supra* and authorities cited therein.

154. *Singer v. Magnavox Co.*, 380 A.2d 969, 979 (Del. 1977).

155. 379 A.2d 1121 (Del. 1977).

156. *Id.* at 1122.

157. *Id.* at 1124.

158. *Id.*

159. *Id.* at 1123.

tion] need not sacrifice its own interest in dealing with a subsidiary; but that interest must not be suspect as a subterfuge, the real purpose of which is to rid itself of unwanted minority shareholders in the subsidiary."¹⁶⁰

From this it is possible to conclude that the parent company's own corporate purpose, if that purpose is not to reap benefit at the expense of the minority, may satisfy the test established by the Delaware Supreme Court in *Singer* and *Tanzer*. Clarification of what constituted a valid corporate purpose was provided by the court's approval of the lower court ruling that facilitation of long-term debt financing was a "bona fide purpose."¹⁶¹

Another recent case interpreting the *Singer* decision is *Young v. Valhi, Inc.*¹⁶² In that case, the Delaware Chancery Court issued a permanent injunction against a proposed merger between the parent, Contran Corporation, and one of its subsidiaries, Valhi, Inc.¹⁶³ Valhi and the other respondents claimed two business purposes for the merger: elimination of conflicts of interest between parent and subsidiary, and the ability to use a consolidated tax return for the two companies if merged.¹⁶⁴ However, the court ruled that the tax advantages could be achieved by other methods¹⁶⁵ and that the claimed conflicts of interest were only minimal and did not constitute the real reason for the merger.¹⁶⁶

The court noted, with regard to the entire fairness of the merger in issue, that "[w]here the parties basically differ . . . is as to the cash proposed to be paid to the minority stockholders of Valhi."¹⁶⁷ It was further held that "the basic purpose behind the merger now before the court is effecutation of a long standing decision on the part of Contran to eliminate the minority shares of Valhi by whatever means as might be found to be workable."¹⁶⁸ Thus, in the *Valhi* case, the court looked behind the stated purposes of the merger, thereby making the *Singer* doctrine a more meaningful test.¹⁶⁹

160. *Id.* at 1124.

161. *Id.* at 1124-25.

162. 382 A.2d 1372 (Del. Ch. 1978).

163. *Id.* at 1379.

164. *Id.* at 1376.

165. *Id.* at 1377. The court noted that the tax advantages could be achieved by merging Contran into Valhi rather than Valhi into Contran. Under this alternative the minority shareholders of Valhi could not claim that the merger was unfair, since their interests would not be frozen-out. *Id.*

166. *Id.* at 1377-78.

167. *Id.* at 1377.

168. *Id.* at 1378.

169. In another recent decision the Third Circuit Court of Appeals ruled that the transfer of control of a private law school to a nonprofit college satisfied the *Singer*

A question left open by the *Singer* decision is its applicability to other financial transactions. In *American Medicorp, Inc. v. Humana, Inc.*,¹⁷⁰ the Delaware Chancery Court addressed the applicability of *Singer* to an unfriendly takeover tender offer.¹⁷¹ The court stated that "[t]he case of *Singer v. Magnavox* . . . involving an entirely different factual setting is not applicable to the facts in this case."¹⁷²

Finally, the significance of *Singer* may be partially measured by the extent to which it is followed in other jurisdictions. At least one state court, however, has specifically rejected *Singer* as a basis for judging corporate mergers. In *Gabhart v. Gabhart*,¹⁷³ the Indiana Supreme Court stated:

The case before us is similar to the case of *Singer v. Magnavox Co.* In that case, the Supreme Court of Delaware . . . relied upon agency principles of fiduciary duty to hold that a corporate merger is subject to judicial scrutiny concerning its 'entire fairness' to minority shareholders. We see no need to go that far in deciding the question before us. Under the Delaware view, it appears that every proposed merger would be subject to having its bona fides determined by judicial review. We do not believe the judiciary should intrude into corporate management to that extent.¹⁷⁴

The Indiana Supreme Court did, however, hold that a merger proceeding attempted without a valid purpose could be challenged by dissenting shareholders as a defacto dissolution under Indiana law.¹⁷⁵ Viewed as a dissolution, dissenting shareholders would not be limited to appraisal proceedings, as under the merger provisions, but could subject the transaction to all of the principles of equity.¹⁷⁶ Thus, while rejecting the specific approach of the *Singer*

tests when such a transfer was made for the purpose of meeting American Bar Association accreditation requirements. *Plechner v. Widener College, Inc.*, 569 F.2d 1250 (3d Cir. 1977). Further, the court intimated that charitable corporations would not be held to the same high standards as for-profit corporations. *Id.* at 1259-60.

170. 381 A.2d 571 (Del. Ch. 1977).

171. An unfriendly takeover tender offer is an attempt to purchase controlling shares of a corporation without approval of its board of directors.

172. *Id.* at 576. The court did not offer any analysis as to what facts distinguished the two cases. In contrast to the *American Medicorp* holding, another recent decision extended the *Singer* doctrine to short-form mergers. *Kemp v. Angel*, 381 A.2d 241 (Del. Ch. 1977).

173. — Ind. —, 370 N.E.2d 345 (1977).

174. *Id.* at —, 370 N.E.2d at 356.

175. *Id.* at —, 370 N.E.2d at 355-56. The Indiana Supreme Court defined a valid purpose as "a purpose intended to advance a corporate interest." *Id.* at —, 370 N.E.2d at 356.

176. *Id.* at —, 370 N.E.2d at 355-56.

court, the *Gabhart* court did adopt a variation of the valid corporate purpose test.

CONCLUSION

Many issues have been left for discussion by the recent decisions in the area of corporate law concerned with "going private" transactions. The valid corporate purpose test seems to have emerged as an appropriate measure for balancing the rights of the majority against those of the minority shareholders. The United States Supreme Court decision in *Santa Fe* eliminated federal securities laws, and specifically rule 10b-5, as the basis in law for the valid corporate purpose test, and thus shifted the forum for litigation to the state courts. The Delaware Supreme Court in *Singer* accepted the responsibility for determining the validity of going private mergers as part of the state's regulation and enforcement of corporate duties.

Among the most controversial of the issues still to be decided will be the provision of judicial guidelines for the balancing of majority and minority shareholders' interests through the valid corporate purpose test. Basically, this will require judicial definition of what is and what is not a valid corporate purpose for mergers involving controlling shareholders and minority interests. The cases of *Tanzer v. International General Industries, Inc.*¹⁷⁷ and *Young v. Valhi, Inc.*¹⁷⁸ have already initiated this definitional process and have emphasized that the weight to be given to the stated purposes of the merger, where an ulterior motive of eliminating the minority shareholders may also be present, is a major concern.

The impact of the *Singer* doctrine in controlling abuses of the going private process is ultimately dependent upon whether it is followed by the courts of other states.¹⁷⁹ But even in its present

177. 379 A.2d 1121 (Del. 1977). For a discussion of *Tanzer*, see notes 155-161 and accompanying text *supra*.

178. 382 A.2d 1372 (Del. Ch. 1978). For a discussion of *Young*, see notes 162-169 and accompanying text *supra*.

179. An impact of the recent decisions dealing with freeze-out mergers has been to increase the cost and difficulty of effecting these transactions. See *Going Private and Singer v. Magnavox*, 28 CORPORATION J. 75, 79 (Dec. 1977). An expert in the area has recently stated that the court decisions have had a "chilling effect" on going private transactions. Wall St. J., Sept. 14, 1978, at 38 (statement of Steven J. Lee, Financial Consultant for Bankers Trust Co.).

A technique to avoid the problems of "going private" has recently been developed by Oppenheimer & Co. ("Oppenheimer"). Under this plan, Oppenheimer approaches the management and key stockholders of the target corporation offering to purchase the operating assets of the company and to give long-term contracts to the management. The proceeds of the sale of the assets may be used to either dissolve the corporation and pay off the stockholders, or, more commonly, to purchase

status, the *Singer* decision provides a new basis for vindication of minority shareholder rights.

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tax-exempt bonds. The corporation thus becomes a shell holding company whose earnings are simply the proceeds of the bonds. In many cases, Oppenheimer has found that the stockholders actually receive a greater return after taxes than when the company had its own operating assets. Further, objections of minority stockholders are limited to voting against the sale of assets as provided for in state laws and the corporation's charter and the remedies provided thereunder. The decisions in *Singer* and its progeny would seem to have no effect on this technique since there is no merger involved. See Wall St. J., Sept. 14, 1978, at 38, col. 2.

