Sale of Corporate Control; Going Private

MARTIN LIPTON: Sale of control with a premium, without affording minority shareholders equal opportunity to participate in the premium, and going private change the focus from regulation of corporate management achieved through disclosure requirements to actual substantive regulation achieved not through disclosure but through direct prohibition of the type of transaction in question. To set the stage for the discussion of the application of the Federal securities laws to these two points, I'll quote from two recent cases—*Schlick* v. *Penn-Dixie Cement Corp.*,[1] an October 1974, second circuit case, and *Cort* v. *Ash*,[2] one of the cases that I think ought to be added to the trilogy that Milton Kroll mentioned before. In *Schlick* v. *Penn-Dixie Cement Corp.*, we had a situation where the holder of control of a corporation was merging the corporation to achieve 100 percent ownership and the plaintiff-shareholder was alleging that the terms of the merger were unfair. In discussing the applicability of rule 10b-5 the court said:

> It is well to put at rest . . . a contention first authoritatively set forth in *Birnbaum* v. *Newport Steel Corp.*, . . . that § 10(b) "was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs. . . ." Here, appellees tell us, all that appellant is complaining about is "corporate mismanagement," and as such is in the wrong forum. As long ago as *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393, 397 (2d Cir. 1967), this *Birnbaum* proposition was no longer the law of this circuit as 10b-5 was there construed to include "*all* fraudulent schemes in connection with the purchase or sale of securities, whether . . . a garden variety type of fraud, or . . . a unique form of deception.

The court then goes on to discuss *Schoenbaum* v. *Firstbrook*,[3] and *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*[4] to conclude that the mere fact that the transaction involves corporate mismanagement does not exclude such transaction from the scope of rule 10b-5.

On the other hand, in *Cort* v. *Ash*, decided this June, the Supreme Court said:

> 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

1. 507 F.2d 374 (2d Cir. 1974).
2. 422 U.S. 66 (1975).
3. 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).
4. 404 U.S. 6 (1971).

HeinOnline -- 31 Bus. Law. 1689 1975-1976

> respect to stockholders, state law will govern the internal affairs of the corporation.

Marylin Bender, in a July article in *The New York Times*, posed the issue very succinctly:

> When a public company goes private—that is, eliminates its outside stockholders by one of several means such as merger, reverse stock splits or buying back shares, who should regulate the substance of the transaction? Should it be the Federal Government, through the Securities and Exchange Commission which watches over the relationship between investors and management at public companies? Or should it be the states, which traditionally set the rules for the internal conduct of corporations?

Sale of control at a premium and going private pose the frontier questions as to the expansion of the federal securities laws and particularly rule 10b-5 to include regulation of corporate management. As with all frontier questions, much depends on how the policy issues are presented and phrased. It is not difficult to answer yes to the question: In the absence of an effective state law remedy, should the federal securities laws be interpreted to provide a remedy for minority public shareholders who have been treated unfairly by the controlling insiders? This is a loaded question. It is much more difficult to answer yes when the question is broadened to encompass more than just fairness to minority stockholders. The issue in both the sale of control and going private situations might be more properly stated as: In light of the absence of an effective state law remedy, should the federal securities laws either proscribe on a *per se* basis, or delegate to the SEC the substantive power to approve or disapprove, transactions which, while they could be and they sometimes are unfair to minority stockholders, nevertheless are types of transactions which have traditionally been highly productive in the overall economic sense and generally result in better management and expansion of the businesses involved? If, as is true in both the sale of control and going private situations, there are effective state law remedies, then the answer is even easier.

Analysis of the cases, the recent SEC proposals and the law review literature with respect to sale of control and going private yields four principal points, in my opinion. First, these transactions do indeed excite extreme shareholder and press reaction. Second, some of these transactions do involve overreaching of the type that must be remedied in order to maintain confidence in the public securities market. However, neither type of transaction is so inherently unfair or different from other corporate conflict transactions that it should be singled out for special *per se* proscription. Third, and here I think Professor Cary will speak more to the point, state law has been much maligned. State law is still a vital force in regulating these trans-

HeinOnline -- 31 Bus. Law. 1690 1975-1976

actions. Recently, in the *Concord Fabrics*[5] case and in the *Power/Mate*[6] case, the state courts have shown that they can be innovative and adept at providing state law remedies where the insiders have in going private situations been unfair and overreached the majority. *Jones* v. *H. F. Ahmanson & Co.,*[7] which was mentioned before, is evidence of the ability of the state courts to reach the sale of control at a premium in a situation that goes beyond the classic receipt of a premium by an insider who sells his control block. Fourth, the federal courts have generally rejected a *per se* federal securities law approach in both of these areas. However, the federal courts have been quick to apply the traditional fraud and disclosure remedies in cases of blatant overreaching. *Gould* v. *American Hawaiian Steamship Co.,*[8] which Allan Kramer mentioned a moment ago, is just such a case. There, nondisclosure in a proxy statement was the means used by the court to reach a sale of control at a premium situation and in effect provide equal opportunity for the public shareholders through the medium of holding the insiders who sold at the premium and the directors who represented them liable for damages to the minority shareholders in an amount which effectively spread the premium among the minority.

Prior to June of 1975, the trend of the decisions in the federal courts was such that I would have prophesized that before 1980 rule 10b-5 would be expanded to cover both types of transactions. However, in light of the June Supreme Court decisions and the recognition of the renewed vitality of state law, I think that the judicial expansion of rule 10b-5 will be much slowed and the forum may well shift now to Congress and the state legislatures. Proposals such as the minimum federal standards proposal advanced by Professor Cary will be receiving special attention. With that by the way of general background, I would like to turn to cases to illustrate the juxtaposition of federal and state law in the two areas.

With respect to sale of control,[9] the general rule under state law is that sale of a controlling interest in a corporation at a premium, without more, is not a breach of duty to the minority shareholders who do not share in the premium.

There are several exceptions to this general state law rule where, for example, sale of control involves (i) the sale of an office or of a corporate asset—*e.g., Perlman* v. *Feldman,*[10] in which control carried the ability to

5. Marshel v. AFW Fabric Corp., [Current Binder] CCH Fed. Sec. L. Rep. ¶ 95,219 (S.D.N.Y. 1975).

6. Berkowitz v. Power/Mate Corp., Doc. No. C-3043-74 (N.J. Super. Ct. May 8, 1975).

7. 460 P.2d 464 (Cal. 1969).

8. 362 F. Supp. 771 (D. Del. 1973).

9. For general background in this area, see Cary, Corporations, (4th Ed. 1969) note at p. 827, and Andrews, *The Stockholder's Right to Equal Opportunity in the Sales of Shares,* 78 Harv. L. Rev. 505 (1965).

10. 219 F.2d 173 (2d Cir. 1955).

HeinOnline -- 31 Bus. Law. 1691 1975-1976

allocate steel in a tight market, or *Rosenfeld* v. *Black,*[11] involving sale of an investment adviser (although *Essex Universal Corp.* v. *Yates*[12] held that the resignation of an officer accompanying the sale of his control block was not a breach of fiduciary duty), (ii) looting or mismanagement, or (iii) a breach of duty to the minority—*e.g., Jones* v. *H. F. Ahmanson & Co.,* in which control shareholders created a holding company which they took public leaving the minority locked into a subsidiary with no public market for their shares.

Sale of a controlling interest at a premium is also not *per se* unlawful under rule 10b-5.[13] In *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.,*[14] liability was imposed upon the defendant for denying plaintiff a fair opportunity to compete for control, and damages occasioned thereby were measured by the premium that would have attached to the stock had control been achieved by the plaintiff. On remand from the court of appeals, the district court proceeded to cast substantial doubt on the ability to sell a control block at a premium.[15] Confronted with the district court's non-adherence to its original instructions, on appeal from the remand opinion the second circuit reiterated its position that damages must be based on the possible control premium that would have attached to a controlling interest. Furthermore, it contradicted the district court by intimating that a person who has a control block but is not in active control may sell the block at a premium. There is an implication in this last opinion, however, that where a person is in actual control, there may be a duty to provide equality of opportunity for all shareholders to participate in any premium.[16] An interesting twist to this issue which has already surfaced in at least one case is whether or not the sale of a controlling interest *without* obtaining a premium violates rule 10b-5. *Most* v. *Alleghany Corp.*[17] held that failure to obtain a premium might be a waste of corporate assets but was not fraud.

However, to the extent "deception" is involved in a sale of control situation there may be a rule 10b-5 violation. *Drachman* v. *Harvey*[18] held that deception in connection with the sale of control at a premium combined with redemption of debentures of the company, with the aid of a control seller who remained on the company's board of directors, which was allegedly designed to solidify control, constituted a rule 10b-5 violation, reversing, on

---

11. 445 F.2d 1337 (2d Cir. 1971).

12. 305 F.2d 572 (2d Cir. 1962).

13. *See, e.g.,* Haberman v. Murchison, 468 F.2d 1305 (2d Cir. 1972); Ferraioli v. Cantor, 281 F. Supp. 354 (S.D.N.Y. 1968).

14. 480 F.2d 341, 375-76 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973).

15. Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 384 F. Supp. 507, 517-520 (S.D.N.Y. 1974).

16. [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,058, at 97,704-05 (2d Cir. 1975).

17. [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,583, at 98,667 (S.D.N.Y. 1970).

18. 453 F.2d 722, 736 (2d Cir. 1972) (en banc).

HeinOnline -- 31 Bus. Law. 1692 1975-1976

the basis of *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, an earlier holding in the same case that there was no violation since plaintiffs were neither purchasers nor sellers of securities and that alleged misconduct was corporate mismanagement not covered by rule 10b-5.

A number of cases have held that the sale of control as part of a scheme to defraud violates rule 10b-5. Under this line of cases, the sale of control at a premium, an activity which would not itself be actionable under rule 10b-5, becomes actionable because it can be linked within one "scheme" to another activity which is a 10b-5 violation. *Northway, Inc.* v. *TSC Industries, Inc.*,[19] while holding the *evidence* was insufficient to support a 10b-5 claim, ruled that an allegation of a negligent transfer of control which aided and abetted the purchaser in acquiring the remaining shares for a "fraudulently low consideration" set forth a cause of action under the Rule. In *Herpich* v. *Wallace*[20] a complaint alleging a scheme to defraud a corporation, involving a sale of control at a premium, a subsequent merger of the controlled corporation and the use of its funds for non-corporate purposes, was held to state a derivative claim under rule 10b-5. Also, *Harman* v. *Willbern*[21] suggested that a rule 10b-5 claim is appropriate where the sale of control and subsequent looting of the corporation might be viewed as part of one scheme.[22]

This "one scheme" rationale could support 10b-5 derivative actions in a variety of circumstances where, as part of an overall scheme, there has been a sale of control at a premium and subsequently or prior thereto the *corporation* has either purchased or sold securities. For example, if sale of control of a corporation at a premium were followed by the looting of the corporation's assets by the new control person, any sales or purchases of securities by the corporation which occurred as part of the looting could be viewed as part of the overall scheme of gaining control. Thus, looting cases which were decided on traditional state breach of fiduciary obligation grounds could now be brought as violations of rule 10b-5.

Cort v. *Ash*, previously mentioned, may portend the Supreme Court's in-

---

19. 361 F. Supp. 108, 118 (N.D. Ill. 1973), *aff'd in part and rev'd in part on other grounds*, 512 F.2d 324 (7th Cir. 1975), *cert. granted*, 44 U.S.L.W. 3180 (U.S. Oct. 6, 1975).

20. 430 F.2d 792 (5th Cir. 1970).

21. 374 F. Supp. 1149 (D. Kan. 1974).

22. Additional "one scheme" cases include *Dasho* v. *Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), *cert. denied sub nom. Bard* v. *Dasho*, 389 U.S. 977 (1967), which held that the corporation has an action to recover a control premium where the defendants proposed merging the purchaser of control into the corporation at an unfair exchange rate and thus cause the corporation to pay for the control premium, and *Boggess* v. *Hogan*, 328 F. Supp. 1048, 1052-53 (N.D. Ill. 1971), involving the situation where a tenderor for Corporation A's stock bought stock of Corporation B at a premium from the management of Corporation A to induce management's support of the tender offer, in which, although plaintiff stockholders were not actual sellers, the court viewed them as such due to the radical change in the character of the corporation whose stock they held.

HeinOnline -- 31 Bus. Law. 1693 1975-1976

creased reluctance to entertain suits claiming a breach of state law fiduciary obligations brought in the guise of a violation of federal law. Nevertheless, *Cort* v. *Ash* might be distinguished from cases which involve securities transactions. To allow a derivative suit on the facts in *Cort* would be tantamount to encouraging the institution of derivative suits by disgruntled stockholders for management's violations of any federal statute. Any federal law might then be a potential source for a garden variety breach of fiduciary obligation action otherwise falling within the jurisdiction of the state courts. Because the federal statutes generally are not directed at, nor intended to reach, internal corporate mismanagement, it is inappropriate to employ them as tools to reach non-federal interests. The securities laws, however, fall into a different category. They are clearly directed at securities transactions—indisputably an area of legitimate federal concern. Of necessity, corporations are constantly engaged in securities transactions of various kinds. These securities dealings are inextricably bound up with the management of the corporation and cannot be isolated as a separate genus. Thus the problem is posed: if one regulates securities, one inevitably regulates internal corporate management to some extent. As there is no workable technique to split the areas of regulation neatly down the middle, the effective enforcement of federal securities regulations will necessarily impinge upon the traditional state regulation of internal corporate management. Although the precise holding of *Cort* has no direct application in the area of securities regulation, its philosophy is, nevertheless, significant. For the true problem in the securities cases, including those involving the sale of control at a premium, is the point at which the federal interest in regulating securities transactions becomes only tangential to a plaintiff's interest in reaching internal corporate mismanagement. If anything, *Cort* indicates that the connection between the securities law violation and the act which really forms the basis of the plaintiff's complaint must be somewhat more direct to survive judicial scrutiny in the Federal courts.[23]

The failure to make adequate disclosure in proxy materials of the circumstances surrounding the receipt of a control premium may require that the premium be shared with the other stockholders. In *Gould* v. *American Hawaiian Steamship Co.*, certain shareholders who were either directors or had agents on the board, although not in control of the corporation, had the power to block the merger. They took advantage of this position to extract a premium for their shares in the target company. Although the premium was disclosed and by itself was permissible, the court ruled that failure

23. *See also Bangor Punta Operations, Inc.* v. *Bangor & Aroostook R.R.*, 417 U.S. 703 (1974), in which the Supreme Court reversed (5 to 4) the first circuit and reaffirmed the *Home Fire* rule that the purchaser of all of the shares of a corporation cannot bring a derivative action for wrongs committed by his vendor, even when the injured corporation is a "public interest" corporation such as a railroad and the wrongs were violations of the federal antitrust and securities laws.

HeinOnline -- 31 Bus. Law. 1694 1975-1976

adequately to disclose in the proxy materials the reason why the acquiring company was paying the premium prevented the other stockholders from fully evaluating the premium. Thus, those receiving the premium were required to share it with the other stockholders. And as in *Schlick* v. *Penn-Dixie Cement Corp.,* even where the controlling shareholders have the votes to effect a transaction absent any support from the minority, a violation of section 14(a) may entail liability for damages in a purportedly unfair merger.[24] It should also be noted that in *Chris-Craft* the Piper family was held to have violated section 14(e) for failing to disclose that they would receive a substantial premium from Bangor-Punta in the event that Bangor-Punta was successful in its bid to acquire control of Piper.[25]

Moving from sale of control to the issue of going private, two recent cases, *Popkin* v. *Bishop*[26] and *Kaufmann* v. *Lawrence*[27] hold that whether or not a going private transaction is fair does not raise a federal question; the only question under section 14(e) and rule 10b-5 is "Has full disclosure been made?"[28] However, Commissioner Sommer, Jr. has suggested[29] that sections 10(b) and 13(e) be read broadly to give the SEC the power to impose duties upon controlling shareholders, such as an obligation that the transaction be fair to the minority, that are substantive and closely resemble requirements that have traditionally been the subject of state law, following the philosophy of *Schoenbaum* v. *Firstbrook,*[30] rather than that of *Popkin* v. *Bishop.*

The SEC, in response to the trend of court decisions, has proposed in Securities Act Release No. 5567 (Feb. 6, 1975), rules 13e-3A and 13e-3B, which contain substantive limitations on, and disclosure requirements with respect to, a variety of transactions, including short form mergers, reverse splits and cash or exchange offers, having the effect of "going private."

Concord Fabrics is a classic example of the going private phenomenon. Prior to 1968 Concord was a private company. In the new issue markets of 1968–69 Concord sold 300,000 shares in a public offering at $15 per share and then the controlling family sold 200,000 shares in a public offering at $20 per share. In 1969 Concord was listed on the American Stock Exchange. Concord stock reached a high of $25 per share in 1969 and declined to $1 in 1974. The decline in market price paralleled a decline

24. *See also* Laurenzano v. Einbender, 264 F. Supp. 356 (E.D.N.Y. 1966). *But see* Barnett v. Anaconda Co., 238 F. Supp. 766 (S.D.N.Y. 1965).

25. Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 365-366 (2d Cir. 1973).

26. 464 F.2d 714 (2d Cir. 1972).

27. 386 F. Supp. 12 (S.D.N.Y. 1974), *aff'd,* No. 74-2591 (2d Cir., April 3, 1975).

28. *See also* Greenberg v. Institutional Investors Systems, Inc., [Current Binder] CCH Fed. Sec. L. Rep. ¶ 95,231 (S.D.N.Y. 1975), and cases cited therein.

29. *"Going Private": A Lesson in Corporate Responsibility,* [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 80,010 (1974), and *Further Thoughts on "Going Private,"* 294 B.N.A. Sec. Reg. L. Rep. D-1 (Mar. 19, 1975).

30. 405 F.2d 215 (2d Cir. 1968).

HeinOnline -- 31 Bus. Law. 1695 1975-1976

in earnings and discontinuance of dividends. With the stock at $1 per share, Concord decided to go private at $3 per share. The $3 valuation was based on the opinion of an investment banker who had had prior dealings with Concord and who was related to a director of Concord. The controlling family transferred its 68 percent of the Concord stock to a private corporation and then Concord entered into a cash merger agreement with the private corporation. Concord made arrangements to borrow the funds to pay the cash merger price. Under the applicable New York Business Corporation Law, 66⅔ percent of the stock could authorize the cash merger, and shareholders objecting to the cash merger price would have statutory appraisal rights.

Thus, *Concord Fabrics* presented all of the unappealing aspects of going private. The corporation was going private within six years of a secondary public offering and listing on a stock exchange. The going public price was substantially greater than book value, while the going private price was substantially less than book value. The going private price was 85 percent below the secondary public offering price. The corporate assets were being used to finance the cash merger. The board of directors which authorized the transaction was controlled by the insiders who would own 100 percent of the corporation after the merger. The investment banker who had opined on the going private price was of questionable independence. There was no business purpose for going private other than the elimination of public ownership. The public shareholders had no voice in determining the transaction—the 68 percent controlling interest would authorize the merger no matter what percentage of the public shares objected. And, finally, the insiders did not have the 95 percent ownership necessary for a short-form merger in New York and the going private transaction was structured with a "shell" intermediary corporation in order to take advantage of the New York long-form cash merger statute.

However, Concord did make full and complete disclosure in the proxy statement for the shareholders meeting called to authorize the cash merger. Indeed, the Concord proxy statement is a classic model of full disclosure in a going private situation. Rejecting *Bryan* v. *Brock & Blevins Co.*[31] and *Albright* v. *Bergendahl,*[32] the two cases that have held going private transactions to be subject to rule 10b-5, Judge MacMahon followed the second circuit principle expressed in *Popkin* v. *Bishop* that rule 10b-5 is limited to disclosure and does not reach the question of the fairness of corporate transactions. Judge MacMahon's opinion states:

> Plaintiffs' claims that there has been a Rule 10b-5 violation because of the unfair and inadequate price to be paid for the Concord shares and the absence of a bona fide corporate purpose for the merger are

31. 343 F. Supp. 1062 (N.D. Ga. 1972), *aff'd*, 490 F.2d 563 (5th Cir. 1974).
32. 391 F. Supp. 754 (D. Utah 1974).

HeinOnline -- 31 Bus. Law. 1696 1975-1976

patently without merit. Rule 10b-5 simply does not encompass these alleged wrongs.

Although plaintiffs do allege a myriad of misrepresentations and nondisclosures in connection with the proposed merger, thus lumping their claims within the ambit of rule 10b-5, we find little factual substance to these allegations. The thrust of plaintiffs' allegations of nondisclosure is that defendants did not disclose the illegality of their actions, *i.e.*, that the merger had no valid business purpose, that the price to be paid for the Concord shares is inadequate, that the [controlling insiders] are benefitting themselves to the detriment of the public shareholders, and that what is described as a merger is no more than a fraudulent scheme.

The proxy statement, we find, is not misleading. Nor does it fail to disclose any material information. . . . [All it] appears to omit is plaintiffs' legal conclusion that the merger is illegal. We see no indication, at least at this juncture of the litigation, that the conclusion is well founded.

The validity of the second circuit position in *Popkin* v. *Bishop* is supported by the Supreme Court position in *Cort* v. *Ash* 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."

Judge MacMahon also dealt decisively with the state corporation law issue—whether a long-form cash merger can be used by the original controlling insiders to go private. In what is believed to be the first opinion directly on this point (*David J. Greene & Co.* v. *Schenley Industries, Inc.*[33] sustained a long-form merger freeze-out which followed a third party tender offer acquisition of a controlling, but not sufficient, interest to permit a short-form merger) Judge MacMahon said:

We find plaintiffs' contention that they are entitled to a preliminary injunction for violations of state law equally without merit. Where a merger is to be accomplished in accordance with statutory proceedings, as here, appraisal is the only remedy available to dissenting shareholders.

" 'In short, the merged corporation's shareholder has only one real right; to have the value of his holding protected, and that protection is given him by his right to an appraisal. . . . He has no right to stay in the picture, to go along into the merger, or to share in its future benefits. . . .'

"The remedy of an appraisal and payment for one's shares affords fair and just compensation to dissenting stockholders while allowing

33. 281 A.2d 30 (Del. Ch. 1971).

> the overwhelming majority to proceed with the merger." [Citing *Willcox* v. *Stern,* 18 N.Y.2d 195, 201-02 (1966), involving a short-form merger.]

In another recent going private case, *Green* v. *Santa Fe Industries, Inc.,*[34] a short-form going private merger was sustained. Santa Fe owned 95 percent of Kirby, a Delaware corporation. Santa Fe formed a new Delaware shell and transferred the 95 percent to the shell. The shell then effected a Delaware short-form merger of Kirby paying the minority $150 cash per share. The next day the minority shareholders were sent a comprehensive information statement detailing the short-form merger and the related Delaware appraisal procedures, a statement of Kirby's income, appraisals of the value of Kirby's stock and assets and a history of the dealings between Santa Fe and Kirby. A Morgan Stanley appraisal of $125 per share based on audited financials for the last fiscal year, unaudited financials for the most recent stub period, Kirby's five-year profit forecast and appraisals of Kirby's assets was appended to the information statement along with the opinions of the asset appraisers.

The Court held: (1) rule 10b-5 does not supersede state short-form merger statutes; rule 10b-5 does not proscribe all freeze-outs; rule 10b-5 does not require that there be a valid business purpose—other than elimination of the minority—for a short-form merger; (2) rule 10b-5 does not require notice of a short-form merger *before* it is consummated; (3) "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"; (4) The investment banking opinion, appraisals and history of prior purchases of Kirby stock by Santa Fe satisfied the disclosure requirements, accordingly adequacy or fairness of the merger terms are not at issue under rule 10b-5; and (5) The proposal of the SEC to adopt specific going private rules under section 13(e) of the Securities Exchange Act supports the proposition that if full and fair disclosure is made, transactions eliminating minority interests are beyond the purview of rule 10b-5.

Less than two weeks prior to Judge MacMahon's *Concord Fabrics* decision, Justice Markowitz in the New York State Supreme Court granted a temporary injunction to the New York Attorney General in an action under the New York Martin Act to prevent Concord from going private. The Attorney General's basic theory appears to be that a freeze-out of public stockholders is *per se* a fraudulent scheme within the Martin Act. Judge Markowitz did not reach any of the substantive questions: "The sole issue

34. [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,085 (S.D.N.Y. 1975).

HeinOnline -- 31 Bus. Law. 1698 1975-1976

here is whether the State has an interest in investigating and seeking to have vitiated a proposed merger or freeze-out of minority stockholders under its police power, where proper grounds exist." However, Judge Markowitz did not refrain from reflecting his attitude toward the transaction:

> It would thus appear that under the broad powers afforded the Attorney General, under Article 23A of the General Business Law, the security transactions such as are involved in this proceeding are proper targets for his scrutiny despite the fact that full disclosure of the aims of the [controlling insiders] have been articulated. 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 the 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.

The *Concord Fabrics* cases, when considered together with proposed rules 13e-3A and 13e-3B and the other recent cases such as *Bryan* v. *Brock & Blevins, Grimes* v. *Donaldson, Lufkin & Jenrette, Inc.*,[35] *Kaufmann* v. *Lawrence* and *Green* v. *Santa Fe Industries, Inc.*, provide a road map for going private. While based on Judge MacMahon's opinion in *Concord Fabrics* it is possible to argue that all that is necessary is full disclosure and compliance with the applicable state law merger and appraisal procedures, it would be foolhardy not to recognize that going private has generated intense opposition and public concern. Indeed, in the *Power/Mate* case, on facts strikingly similar to *Concord Fabrics* but with the added factors of no statutory appraisal rights and significant insider self-dealing to depress earnings, it was held that the insider had to demonstrate fairness in a going private transaction. The court in *Power/Mate* also indicated an inclination to adopt the business purpose test.

Accordingly, going private transactions should be structured within the following guidelines. First, the going private price should be determined in a manner designed to achieve objective fairness. It is suggested that a committee of independent directors aided by the opinion of an independent investment banker will go a long way toward satisfying this requirement. Second, if there are sophisticated holders of a substantial part of the public interest, direct negotiation of the going private price with one or more of such holders is desirable. Third, the public shareholders should be accorded appraisal rights. This can be accomplished either by structuring the transaction so that statutory appraisal rights are available or by voluntarily

35. [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,722 (N.D. Fla. 1974).

HeinOnline -- 31 Bus. Law. 1699 1975-1976

providing appraisal rights. Fourth, except where the short-form merger procedure is applicable, the public shareholders should be accorded the right to vote on the transaction. This can be accomplished by providing that the insiders will vote their shares for the transaction only if approved by a plurality of the public shares. Fifth, it is not necessary to dream up business reasons other than the desire to go private. If there are other reasons so much the better, but they are not essential. Sixth, it is generally simpler and more direct to go private in one step through the long-form cash or debt merger rather than the two-step tender offer followed by a short-form merger route. The long-form merger procedure has the advantage of according statutory appraisal rights to all shareholders at the time the decision to go private is made and to eliminate the "shake-down" aspect of the going private tender offer which coerces shareholders to tender for fear of being left with no real public market and perhaps no information about the company.[36] Finally, absent cogent business purposes, management which does not have a significant ownership interest should not attempt to use the corporate assets to go private.

It is not necessary that all of these guidelines be followed in each going private transaction. In addition to full disclosure, the key element is a means of assuring that the going private price is fair. The particular facts of each going private situation and the current interpretation of the applicable state corporation law will dictate how many of these guidelines should be followed. It appears that, with the possible exception of the business reason requirement, even the most restrictive state would not interfere with a going private transaction that followed all of these guidelines.

In both the sale of control and going private situations, I think that while the present state of the federal law is such that one can fairly readily opine that rule 10b-5 does not apply on a substantive basis, it, of course, does apply in the disclosure context. In the going private context the SEC has proposed substantive rules. Proposed rules 13e-3(A) and 13e-3(B) would substantively regulate going private transactions. The future will tell whether the SEC will seek to expand its jurisdiction into substantive regulations. I, for one, hope not. In the meantime, it should be recognized that both kinds of transactions are indeed at the frontier. When you are at the frontier, you build a stockade. The wise counsellor in each situation will make sure that, in addition to the disclosure obligations having been met, the transaction is structured to meet the burden of establishing fair and reasonable consideration of the interests of the minority shareholders. I find that it is a rare sale of control at a premium transaction that cannot be structured or restructured so as to meet most of the equal opportunity objectives. In the going private situation, the proposed SEC rules and a Delaware case that I

36. *See* Borden, *Going Private—Old Tort, New Tort, or No Tort?*, 49 N.Y.U. L. Rev. 987 (1974).

HeinOnline -- 31 Bus. Law. 1700 1975-1976

am most fond of—*Puma* v. *Marriott*,[37]—provide excellent road maps for how to deal with the conflicts inherent in these transactions. Counsel who handled the transaction which gave rise to *Puma* v. *Marriott* recognized the conflict problem and the possibility of litigation from the inception. To meet the problem they utilized an independent committee of the board of directors which was advised by independent investment counsel, independent lawyers retained by the committee and an independent appraiser. The proper structuring of a transaction in contemplation of the inherent conflict goes a long way toward satisfying the public and the courts that the transaction should not be subject to *per se* proscription.

MR. BIALKIN: Thank you for that very comprehensive survey, Marty. When you are on the frontier you build a stockade—I hadn't heard it referred to that way. I wonder sometimes whether the stockade is to keep the Indians out or to keep everyone else in. Time will tell.

The tradition of activism of the SEC for many of us stems from the chairmanship of Bill Cary, commencing in 1960. The Special Study of the Securities Markets, conceived under Chairman Cary, and conducted under the direction of Milton Cohen, published in 1963, is commonly regarded as the major seminal review of the fundamental assumptions of the securities laws and the source of most of the reforms since then. Since leaving the Commission, Bill Cary has not been idle. He remains ever active and it is always a privilege to hear him speak on any subject.

---

37. 363 F. Supp. 750 (D. Del. 1973).

HeinOnline -- 31 Bus. Law. 1701 1975-1976