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To Our Clients:

Going Private

The Supreme Court decision in Santa Fe Industries, Inc. v. Green on March 23 sustains the state short form merger statutes and removes the cloud on going private transactions that had been created by the Second Circuit's holding that in the absence of a valid corporate purpose such transactions were a per se violation of Rule 10b-5. In addition, the Supreme Court reemphasized that Rule 10b-5 is not intended to create a federal corporation law by providing a remedy for corporate mismanagement. Rule 10b-5 applies only where there is manipulation or a disclosure violation -- it does not deal with the mere fairness of a corporate transaction. Fairness is a matter of state corporation law.

The following is an edited version of the Supreme Court decision:

> In 1936 Santa Fe acquired control of 60% of the stock of Kirby, a Delaware corporation. Through a series of purchases over the succeeding years, Santa Fe increased its control of Kirby's stock to 95%; the purchase prices during the period 1968-1973 ranged from $65 to $92.50 per share. In 1974, wishing to acquire 100% ownership of Kirby, Santa Fe availed itself of the short form merger provision of the Delaware Corporation Law which permits a parent corporation owning at least 90% of the stock of a subsidiary to merge with that subsidiary, upon approval by the parent's board of directors, and to make payment in cash for the shares of the minority stockholders. The statute does not require the consent of, or advance notice to, the minority stockholders. However, notice of the merger must be given within 10 days after its effective date, and any stockholder who is dissatisfied with the terms of the merger may seek appraisel under the Delaware Corporation Law.
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> Santa Fe obtained independent appraisals of the physical assets of Kirby -- land, timber, buildings, and machinery -- and of Kirby's oil, gas, and mineral interests. These appraisals, together with other financial information, were submitted to the investment banking firm of Morgan Stanley which was retained to appraise the fair market value of Kirby stock. Kirby's

physical assets were appraised at $320 million (amounting to $640 for each of the 500,000 shares); Kirby's stock was valued by Morgan Stanley at $125 per share. Under the terms of the merger, Minority stockholders were offered $150 per share.

The provisions of the short-form merger statute were fully complied with. The minority stockholders of Kirby were notified the day after the merger became effective and were advised of their right to obtain an appraisal in Delaware court if dissatisfied with the offer of $150 per share. They also received an information statement containing in addition to the relevant financial data about Kirby, the appraisals of the value of Kirby's assets and the Morgan Stanley appraisal concluding that the fair market value of the stock was $125 per share.

Plaintiffs, minority stockholders of Kirby, objected to the terms of the merger, but did not pursue their Delaware appraisal remedy. Instead, they brought an action in federal court on behalf of Kirby and other minority stockholders, seeking to set aside the merger or to recover what they claimed to be the fair value of their shares -- at least $772.

The District Court dismissed the complaint for failure to state a claim upon which relief could be granted, 391 F. Supp. 849 (S.D.N.Y. 1975). The District Court viewed the complaint as resting on two distinct grounds. First, Rule 10b-5 was assertedly violated because the merger was for the sole purpose of eliminating the minority from Kirby, therefore lacking any justifiable business purpose, and because the merger was undertaken without prior notice to the minority shareholders. Second, the low valuation placed on the shares was itself said to be a fraud actionable under Rule 10b-5. In rejecting the first ground for recovery, the District Court reasoned that Delaware law required neither a business purpose for a short-form merger nor prior notice to the minority shareholders who the statute contemplated would be removed from the company, and that Rule 10b-5 did not override these provisions of state corporate law by independently placing a duty on the majority not to merge without prior notice and without a justifiable business purpose.

As for the claim that actionable fraud inhered in the allegedly gross undervaluation of the minority shares, the District Court observed that plaintiffs valued their shares at a minimum of $772 per share, "basing this figure on the pro rata value of Kirby's physical assets." Accepting this valuation for purposes of the motion to dismiss, the District Court further noted that, as revealed by the complaint, the physical asset appraisal, along with other information relevant to Morgan Stanley's valuation of the shares, had been included with the Information Statement sent to respondents within the time required by state law. It thought that if "full and fair disclosure is made, transactions eliminating minority interests are beyond the purview of Rule 10b-5," and concluded that "the complaint fail[ed] to allege an omission, misstatement or fraudulent course of conduct that would have impeded a shareholder's judgment of the value of the offer." The complaint therefore failed to state a claim and was dismissed.

A divided Court of Appeals for the Second Circuit reversed, 533 F.2d 1283 (1976). It first agreed that there was a double aspect to the case: first, the claim that gross undervaluation of the minority stock itself violated Rule 10b-5; and second, that "without any misrepresentation or failure to disclose relevant facts, the merger constituted a violation of Rule 10b-5" because it was accomplished without any corporate purpose and without prior notice to the minority stockholders. As to the first aspect of the case, the Court of Appeals did not disturb the District Court's conclusion that the complaint did not allege a material misrepresentation or nondisclosure with respect to the value of the stock; and the court declined to rule that a claim of gross undervaluation itself would suffice to make out a Rule 10b-5 case. With respect to the second aspect of the case, however, the court fundamentally disagreed with the District Court as to the reach and coverage of Rule 10b-5. The Court of Appeals' view was that, although the Rule plainly reached material misrepresentations and nondisclosures in connection with the purchase or sale of securities, neither misrepresentation nor nondisclosure was a necessary element of a Rule 10b-5 action; the rule reached "breaches of fiduciary duty by a majority against

minority shareholders without any charge of misrepresentation or lack of disclosure." The Court of Appeals went on to hold that the complaint taken as a whole stated a cause of action under the Rule:

> "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. The minority shareholders are given no prior notice of the merger, thus having no opportunity to apply for injunctive relief, and the proposed price to be paid is substantially lower than the appraised value reflected in the Information Statement."

> "Whether full disclosure has been made is not the crucial inquiry since it is the merger and the undervaluation which constituted the fraud, and not whether or not the majority determines to lay bare their real motives. If there is no valid purpose for the merger, then even the most brazen disclosure of that fact to the minority shareholders in no way mitigates the fraudulent conduct."

The Court of Appeals' approach to the interpretation of Rule 10b-5 is inconsistent with that taken by the Court last Term in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

Ernst & Ernst makes clear that in deciding whether a complaint states a cause of action for "fraud" under Rule 10b-5, "we turn first to the language of §10(b), for '[t]he starting point in every case involving construction of a statute is the language itself.'" Id., at 197, quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (Powell, J. concurring). In holding that a cause of action under Rule 10b-5 does not lie for mere negligence, the Court began with the principle that "[a]scertainment of congressional intent with respect to the standard of liability created by a particular section of the [1933 and 1934] Acts must . . . rest primarily on the language of § 10(b) -- "[t]he words 'manipulative

or deceptive' used in conjunction with 'device or contrivance.'" Id., at 197. The same language and the same principle apply to this case.

To the extent that the Court of Appeals would rely on the use of the term "fraud" in Rule 10b-5 to bring within the ambit of the Rule all breaches of fiduciary duty in connection with a securities transaction, its interpretation would, like the interpretation rejected by the Court in Ernst & Ernst, "add a gloss to the operative language of the statute quite different from its commonly accepted meaning." Id., at 199. But as the Court there held, the language of the statute must control the interpretation of the Rule:

> "Rule 10b-5 was adopted pursuant to authority granted the [Securities Exchange] Commission under § 10(b). The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is '"the power to adopt regulations to carry into effect the will of Congress as expressed by the statute."' . . . [The scope of the Rule] cannot exceed the power granted the Commission by Congress under § 10(b)." Id., at 212-214 (citations omitted).

The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception. Nor have we been cited to any evidence in the legislative history that would support a departure from the language of the statute. "When a statute speaks so specifically in terms of manipulation and deception, . . . and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute . . . ." Id., at 214 (footnote omitted). Thus the claim of fraud and fiduciary breach in this complaint states a cause of action under any part of Rule 10b-5 only if the conduct alleged can be fairly viewed as "manipulative or deceptive" within the meaning of the statute.

It is our judgment that the transaction, if carried out as alleged in the complaint, was neither deceptive nor manipulative and therefore did not violate either § 10(b) of the Act or Rule 10b-5.

As we have indicated, the case comes to us on the premise that the complaint failed to allege a material misrepresentation or material failure to disclose. The finding of the District Court, undisturbed by the Court of Appeals, was that there was no "omission" or "misstatment" in the Information Statement accompanying the notice of merger. On the basis of the information provided, minority shareholders could either accept the price offered or reject it and seek an appraisal in the Delaware Court of Chancery. Their choice was fairly presented, and they were furnished with all relevant information on which to base their decision.

We therefore find inapposite the cases relied upon by the Court of Appeals, in which the breaches of fiduciary duty held violative of Rule 10b-5 included some element of deception. Those cases forcefully reflect the principle that "[s]ection 10(b) must be read flexibly, not technically and restrictively" and that the statute provides a cause of action for any plaintiff who "suffer[s] an injury as a result of deceptive practices touching its sale [or purchase] of securities. . . ." Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6. 12-13 (1971). But the cases do not support the proposition, adopted by the Court of Appeals below and urged by respondents here, that a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure, violates the statute and the Rule.

It is also readily apparent that the conduct alleged in the complaint was not "manipulative" within the meaning of the statute. Manipulation is "virtually a term of art when used in connection with securities markets." Ernst & Ernst, 425 U.S. at 199. The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artifically affecting market activity. See, e.g., § 9 of the 1934 Act, 15 U.S.C. § 78(i) (prohibiting specific manipulative practices); Ernst & Ernst, 425 U.S. at 195, 199 n.21. 205; Piper v. Chris-Craft Industries, Inc., 45 U.S.L.W. 4182, 4193 (1977). No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices. But we do not think it would have chosen this "term of art" if it had meant to bring within the scope of § 10(b) instances of corporate mismanagement such as this, in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary.

The language of the statute is, we think, "sufficiently clear in its context" to be dispositive here, Ernst & Ernst, 425 U.S. at 201; but even if it were not, there are additional considerations that weigh heavily against permitting a cause of action under Rule 10b-5 for the breach of corporate fiduciary duty alleged in this complaint. Congress did not expressly provide a private cause of action for violations of § 10(b). Although we have recognized an implied cause of action under that section in some circumstances. Superintendent of Insurance v. Bankers Life & Cas. Co., supra, at 13 n.9, we have also recognized that a private cause of action under the antifraud provisions of the Securities Exchange Act should not be implied where it is "unnecessary to ensure the fulfillment of Congress' purposes" in adopting the Act. Piper v. Chris-Craft Industries, 45 U.S.L.W., at 4193. Cf. J.I. Case Co. v. Borak, 377 U.S. 426, 431-433 (1964). As we noted earlier p. 13, supra, the Court repeatedly has described the "fundamental purpose" of the Act as implementing a "philosophy of full disclosure"; once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute. Cf. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 381-385 (1970). As in Cort v. Ash, 422 U.S. 78, 80 (1975), we are reluctant to recognize a cause of action here to serve what is "at best a subsidiary purpose" of the federal legislation.

A second factor in determining whether Congress intended to create a federal cause of action in these circumstances is "whether 'the cause of action [is] one traditionally relegated to state law . . . .'" Piper v. Chris-Craft Industries, 45 U.S.L.W., at 4192, quoting Cort v. Ash, 422 U.S., at 78. The Delaware Legislature has supplied minority shareholders with a cause of action in the Delaware Court of Chancery to recover the fair value of shares allegedly undevalued in a short-form merger. Of course, the existence of a particular state law remedy is not dispositive of the question whether Congress meant to provide a similar federal remedy, but as in Piper and Cort, we conclude that "it is entirely appropriate in this instance to relegate respondent and others in his situation to whatever remedy is created by state law." 422 U.S., at 45 U.S.L.W., at 4193.

The reasoning behind a holding that the complaint in this case alleged fraud under Rule 10b-5 could not be easily contained. It is difficult to imagine how a court could distinguish, for purposes of Rule 10b-5 fraud, between a majority stockholder's use of a short-form merger to eliminate the minority at an unfair price and the use of some other device, such as a long-form merger, tender offer, or liquidation, to achieve the same result; or indeed how a court could distinguish the alleged abuses in these going private transactions from other types of fiduciary self-dealing involving transactions in securities. The result would be to bring within the Rule a wide variety of corporate conduct traditionally left to state regulation. In addition to posing a "danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975), this extension of the federal securities laws would overlap and quite possibly interfere with state corporate law. Federal courts applying a "federal fiduciary principle" under Rule 10b-5 could be expected to depart from state fiduciary standards at least to the extent necessary to ensure uniformity within the federal system. Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden. As the Court stated in Cort v. Ash, supra, "Corporations are creatures of 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." 422 U.S., at 84 (emphasis added).

We thus adhere to the position that "Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement." Superintendent of Insurance v. Bankers Life & Cas. Co., 404 U.S. at 12. There may well be a need for uniform federal fiduciary standards to govern mergers such as that challenged in this complaint. But those standards should not be supplied by judicial extension of § 10(b) and Rule 10b-5 to "cover the corporate universe."

M. Lipton