The Developing Law of Corporate Freeze-outs and Going Private

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At common law, any fundamental corporate change, such as a merger or the sale of corporate assets, required the unanimous consent of shareholders. In effect, each shareholder held a veto power which could restrain the majority’s ability to act. In contrast, under present statutory corporation law, a specified percentage of shareholder votes can effect such changes over the objections of other shareholders, and the objecting shareholders may or may not be entitled to “dissenter’s” or “appraisal” rights. By voting in favor of a corporate change which results in the elimination of some shareholders, majority shareholders can force the termination of minority shareholder interest. Such transactions are referred to as “freeze-outs,” which are defined as the exercise of corporate control by majority or inside shareholders to eliminate minority or outside shareholders, to reduce their relative voting power to insignificance, or to otherwise deprive them of rights and privileges.

Inside shareholders of several publicly-held corporations have recently attempted to utilize corporate acts to eliminate public stock ownership, a process referred to as “going-private.” There are two

1. In Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 595-96 (1921), the Supreme Court stated the rule as follows:
   
   It is, of course, a general rule of law that, in the absence of special authority so to do, the owners of a majority of the stock of a corporation have not the power to authorize the directors to sell all of the property of the company and thereby abandon the enterprise for which it was organized.

   The rule . . . rests upon the principle that exercise of such power would defeat the implied contract among the stockholders to pursue the purpose for which [the corporation] was chartered.


4. 2 F. O’Neal, Close Corporation § 8.07 at 43 (2d ed. 1971).

5. The two techniques most commonly used in going private are the tender offer addressed to public shareholders, which is frequently followed by a merger to eliminate non-tendering stockholders (“two-step” going private), and a merger into a corporation holding the insiders’ stock, pursuant to which the public shareholders receive cash or debt (the “one-step” going private). Less frequently used is a reverse stock split with the public shareholders receiving cash for their fractional shares. Borden, Going Private — Old Tort, New Tort or No Tort?, 49 N.Y.U. L. Rev. 987, 987-88 (1974) [hereinafter cited as Going Private — Old Tort, New Tort or No Tort?].
goals which may be sought by going private. The first is the elimination of all public shareholders. The other is avoiding the reporting and filing requirements imposed upon public corporations by the Securities Exchange Act of 1934 (the 1934 Act). Hence, any transaction which results in freeing a corporation from these statutory requirements is properly labelled a going private transaction.

Since going private involves the elimination of some or all public stockholders and the continuation of a corporation's business, it is analogous to a corporate freeze-out. Corporate freeze-outs most often occur in close corporations, whereas going private by definition can only occur in public corporations. Accordingly, going private can be classified either as a subclass of freeze-outs or as the publicly-held corporation counterpart of the close corporation freeze-out.

Minority or public shareholders have challenged the validity of going private freeze-outs so frequently that one commentator has described litigation as the last step of going private. In state courts, these shareholders have claimed that by engineering such transactions the majority shareholders have breached their fiduciary duties to the corporation and to the minority. In federal courts, they have claimed that such transactions are violative of federal securities laws. In the past, freeze-out transactions have been attacked as violative of section 10(b) of the 1934 Act and rule 10b-5 because of false or misleading statements, or omissions in tender offer or proxy

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8. Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1970) provides:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
   (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.
Rule 10b-5, 17 C.F.R. § 240.10b-5 (1975) provides:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
   (a) to employ any device, scheme or artifice to defraud,
   (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
materials. Now, however, some litigants are alleging that going private or freeze-out transactions are inherently violative of section 10(b) and rule 10b-5.

The purpose of this article is to examine the scope of present laws affecting going private and freeze-out transactions by reviewing state and federal judicial responses to freeze-out challenges, and to analyze the possibilities of extending federal securities laws, either judicially or administratively, to substantively regulate freeze-outs. Although this article primarily focuses on those freeze-outs which effectuate going private, freeze-outs in close corporations are also considered.

**PRESENT LAW**

**State Law**

State corporation statutes have been aptly labelled a “race for the bottom” insofar as shareholder protection is concerned. State courts, however, have not been reluctant to inject equity into the statutes. Proponents of freeze-outs have relied upon the leading case of *Matteson v. Ziebarth* as support for the proposition that freeze-out mergers are now permissible under statutory corporation law. In *Matteson*, the Washington Supreme Court upheld a merger designed to eliminate a stockholder who was blocking a proposed sale to a purchaser who would buy only if it could acquire all the outstanding stock. Professor Vorenberg, however, has suggested that this case was, in fact, decided in accordance with an analogous common law exception allowing sale of a profitless company because there was a pressing business need for the sale.

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11. Few courts have made a distinction between close corporation freeze-outs and private transactions although the underlying policy considerations differ. *Going Private — Old Tort, New Tort or No Tort?, supra* note 5, at 1017-18.

> [W]hen, from any cause, the business of a corporation, not charged with duties to the public, has proved so unprofitable that there is no reasonable prospect of conducting the business in the future without loss, or when the corporation has not, and cannot obtain, the money necessary to pay its debts and to continue the business for which it was organized, even though it may not be insolvent in the commercial sense, the owners of a majority of the capital stock, in their judgment
In determining whether fiduciary duties run from majority to minority stockholders, the minority rule, that such duties exist, is replacing the majority rule, that they do not.\textsuperscript{15} Moreover, as the cases discussed below indicate, the standards against which these duties are being measured are becoming more stringent and the courts are looking beneath the surfaces of transactions to evaluate underlying motives. The cases reviewed first involve public corporations that are going or have gone private and illustrate the courts' tendency to shift from an actual fraud analysis to one which focuses upon a valid business purpose.

The Supreme Court of Illinois recently held in \textit{Teschner v. Chicago Title & Trust Co.}\textsuperscript{16} that the corporate purpose of reducing corporate expenses and simplifying and facilitating procedures justified a freeze-out by a 600 to one reverse stock split. In that case, Lincoln National Corporation (Lincoln) had acquired 99.6 percent of the outstanding stock of Chicago Title and Trust Company (Chicago Title) through a Chicago Title common stock for Lincoln preferred exchange offer, and 0.28 percent through purchase. Proceeding in accordance with Illinois corporation law, Lincoln effectuated a reverse stock split that converted all minority stock to fractional shares which Lincoln proposed to purchase for cash. Teschner, a Chicago Title minority stockholder, claimed that eliminating her as a stockholder was a breach of Lincoln's fiduciary duty toward her and violated her equal protection and due process rights. The supreme court affirmed the trial court judgment for defendants, but left open the question of whether a different result would follow in other circumstances:

We do not say that under all circumstances minority shareholders will be denied relief when the majority has proceeded under the provisions of the [Illinois Business Corporation] Act, but we do not consider that the plaintiff here has shown grounds for the relief she seeks.

\ldots The plaintiff's complaint made no claim of fraud or deceptive conduct by the defendants. It did not charge that the exchange

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\textsuperscript{15} See F. O'NEAL \& J. DERWIN, \textsc{Expulsion or Oppression of Business Associates} 138-39 (1961).
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offer was unfair or that the price later offered for the shares was inadequate.\textsuperscript{17}

It has been suggested that Illinois still adheres to the actual fraud standard of fiduciary duty between majority and minority stockholders.\textsuperscript{18} Teschner, however, implies the court's willingness to reconsider the question if a plaintiff alleges deceptive conduct, unfair dealing or inadequate price. Although the court did not explicitly hold that a valid business purpose is a prerequisite to a valid freeze-out, it did consider the existence of such a business purpose, and the lack of an improper purpose, in reaching its decision. More significantly, the facts indicate that Lincoln did, in fact, act in good faith.\textsuperscript{19}

In contrast with Teschner, in which an acquisition preceded the going private transaction, the next two cases involve going private transactions in which no acquisitions by outside interests were involved. A New Jersey court granted a preliminary injunction halting a going private merger in Berkowitz \textit{v.} Power/Mate Corp.\textsuperscript{20} The controlling shareholders of Power/Mate Corporation (Power/Mate) organized General American Industries, Inc. (General), transferred their Power/Mate shares to General and, as directors of Power/Mate and General, entered into a cash merger agreement. The court found that the proposed merger was in full technical compliance with state statutory law and did not violate any SEC rules,\textsuperscript{21} but that those

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\item \textsuperscript{17} \textit{Id.} at 457, 322 N.E.2d at 57.
\item \textsuperscript{18} Comment, \textit{Recent Developments in the Law of Corporate Freeze-Outs}, 14 B.C. IND. & Com. L. Rev. 1252, 1272 n.128 (1973) [hereinafter cited as \textit{Recent Developments in Corporate Freeze-Outs}].
\item \textsuperscript{19} The exchange offer had been addressed to all shareholders. When Lincoln failed to acquire all the Chicago Title shares pursuant to the exchange offer and the market for Chicago Title stock disappeared, it apparently offered to purchase all remaining outstanding stock. This remaining stock was held by 50 stockholders who accepted the purchase offer, by 44 "lost" stockholders and small estates, and by plaintiff, the only dissenting stockholder. The fact that so many stockholders accepted the exchange or purchase offer provides strong support for the conclusion that Lincoln had acted fairly toward the minority shareholders in its acquisition of Chicago Title, 59 Ill. 2d 452, 322 N.E.2d 54.
\item \textsuperscript{20} 135 N.J. Super. 36, 342 A.2d 566 (1975).
\item \textsuperscript{21} The court was referring only to the proxy rules of section 14(a) of the 1934 Act, 15 U.S.C. \textsection 78n(a) (1970), the requirements of which had been met by Power/Mate's board sending Power/Mate shareholders notice of a special meeting, together with a proxy statement which included the following information: the Power/Mate and General officers and directors were identical; the 71.5 percent of Power/Mate owned by General would be voted in favor of the merger and therefore the merger would be approved; under state law shareholders would have no legal right to dissent; the Power/Mate board believed the terms of the proposed merger were fair and equitable although the merger price was advantageous to the former majority stockholders; the merger price was based upon the report of an independent financial consultant; the objective of the merger was to eliminate the publicly-held interest in Power/Mate; and the Power/Mate board believed the public shareholders would benefit
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conclusions did not preclude it from considering whether the merger would satisfy equitable requirements of good faith and fair treatment:

At a minimum [the controlling shareholders'] conduct is subject to a searching inquiry to determine whether it conforms to accepted concepts of fairness and equity.22

In *People v. Concord Fabrics, Inc.*,23 the majority shareholders of Concord Fabrics, Inc. had planned a two-step going private procedure, but abandoned the tender offer when public shareholders filed suit and proceeded to the proposed merger. Acting pursuant to New York's Blue Sky Law,24 the New York attorney general brought suit to enjoin the merger. In granting a preliminary injunction the court refused to follow *Blumenthal v. Roosevelt Hotel, Inc.*,25 an earlier freeze-out case in which the court had held that dissenting shareholders would be limited to their appraisal rights where only bad faith was shown. The court noted that since *Blumenthal* had been decided, the concept of the majority shareholder fiduciary duty to the minority had been expanded by New York courts. The court noted:

[T]here appears to have been a balancing of the equities between whether dissenting shareholders must be relegated to actions at law or obtain relief in equity, depending on the peculiar circumstances and exigencies of a given situation.26

The courts in *Berkowitz* and *Concord Fabric* enjoined going private mergers because they questioned the "fairness" of the mergers. However, the courts were speaking of different types of "fairness."

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22. *Id.* at 45, 342 A.2d at 574. The court indicated that one focus of that searching inquiry would be the $100,000 year-end bonus each of the two controlling stockholders had received from Power/Mate three months before the merger was proposed. Since those bonuses significantly reduced Power/Mate earnings, they might have affected the market price for Power/Mate stock which had been tied into the merger terms. The court accorded little weight to the appraiser's report because his conclusion regarding the fairness of the merger price was based largely upon a comparison with terms of other freeze-out or going private transactions, and not on prices determined in arms-length transactions.

23. 3 BLUE SKY L. REP. ¶71,220 (N.Y. Sup. Ct., N.Y. County, June 12, 1975). The transaction at issue in *Concord Fabrics* was also challenged in a federal district court, *Marshel v. AFW Fabric Corp.*, 398 F.Supp. 734 (S.D.N.Y. 1975), in which the federal court refused to enjoin the merger. See text accompanying notes 72 and 74 infra.


In *Berkowitz* the court was referring to the fairness of the merger price, whereas in *Concord Fabric* the court was referring to the fairness of forcing the minority shareholders out of the corporation. The courts also differed in their evaluations of the necessity for a valid corporate purpose. The court in *Concord Fabric* considered the lack of a corporate purpose as an additional factor warranting an injunction. The court in *Berkowitz*, however, found it unnecessary to rule that the absence of a corporate purpose would invalidate a merger, and enjoined the merger solely on the issue of fairness.

The foregoing cases reflect state court concern for the minority shareholder in a public corporation. The following cases show that this concern becomes more pronounced when the minority shareholder before the court holds stock in a close corporation.

The decision of the Supreme Court of California in *Jones v. H.F. Ahmanson & Co.*[^27] has been hailed as a leading case upholding minority shareholder rights.[^28] In *Ahmanson*, a minority shareholder of a closely-held savings and loan association complained of the actions of former majority shareholders who had transferred their savings and loan stock (which constituted 85 percent of the outstanding stock) to a new corporation and had created a market for the new corporation’s shares, thereby profiting from the trading in the new corporation stock and foreclosing the possibility of a public market for the savings and loan stock. The parent corporation attempted to eliminate the minority interest in the savings and loan association by a tender offer, by a refusal to declare dividends and, finally, by an exchange offer.

The court summarily rejected defendants’ argument that they owed no fiduciary obligation to the minority absent reliance on inside information, appropriation of corporate assets or fraud. The court stated:

> Majority shareholders, either singly or acting in concert to accomplish a joint purpose, have a fiduciary responsibility to the minority . . . to use their ability to control the corporation in a fair, just, and equitable manner. Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority.^[29^]

[^27]: 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).


[^29]: 29. *Jones v. H. F. Ahmanson & Co.*, 1 Cal. 3d 93, 108, 460 P.2d 464, 471, 81 Cal. Rptr. 592, 599 (1969); accord, *Thompson v. Hambrick*, 508 S.W.2d 949, 952-54 (Tex. Civ. App. 1974), whether majority stockholders of close corporation, who had refused offer to purchase all corporate stock at $45 per share and who later secretly agreed to sell their stock at $55 per share to same offerors breached fiduciary duty to minority stockholders, raised factual issue precluding summary judgment. See also *Grognet v. Fox Valley Trucking Service*, 45
The comprehensive rule of good faith and inherent fairness to the minority in any transaction where control of the corporation is material properly governs controlling shareholders in this state.\(^3\)

The court concluded that proof that defendants had used their majority power to create a market benefiting only themselves, to the detriment of the minority, would establish a prima facie case of breach of fiduciary duty, rebuttable at trial only by evidence of good faith or compelling business purpose. Accordingly, the court remanded the case for trial.

Last year the Supreme Judicial Court of Massachusetts adopted an even stricter standard for shareholders in close corporations by imposing an equal opportunity rule in *Donahue v. Rodd Electrotype Co. of New England, Inc.*\(^3\) When minority shareholders of a close corporation learned that the corporation had redeemed shares of the former majority shareholder, they offered their shares to the corporation on the same terms. When the corporation refused, the minority shareholders sued, alleging that this conduct constituted a breach of fiduciary duty. The trial judge, applying a standard of good faith and inherent fairness, dismissed the case on the merits. On appeal the court reaffirmed this standard as the rule for shareholders of public corporations, but adopted a more stringent test for close corporations. It stated:

> Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another . . . . "utmost good faith and loyalty."\(^3\)

These cases demonstrate that state courts are aware that majority shareholders can abuse their control power in transactions which adversely affect a relatively helpless minority. In order to protect minority shareholders, the courts have not permitted majority shareholders to abusively exercise their power. The courts are increasing the restrictions limiting the use of majority shareholder's controlling power and requiring that the majority deal fairly with minority shareholders. A rule of good faith and inherent fairness is

\(^{30}\) Wis. 2d 235, 241, 172 N.W.2d 812, 816 (1969), majority stockholder of corporation cannot take position that his self-interest is superior to that of minority stockholder.

\(^{31}\) 1 Cal. 3d 93, 112, 460 P.2d 464, 474, 81 Cal. Rptr. 592, 602 (1969).

\(^{32}\) 328 N.E.2d 505 (Mass. 1975).

\(^{3}\) Id. at 515.
supplanting the former rule that actual fraud was necessary before a court would hold that majority shareholders had abused their powers.

Majority shareholders are deemed to owe a fiduciary duty to minority shareholders in transactions which affect corporate control. The standard against which conduct of majority shareholders is measured varies among states. The standards applied are best visualized as points along a continuum. At one end is an actual fraud standard: controlling shareholders will be deemed to have abused their power only if they actually intend to fraudulently injure minority shareholders. At the other end is the Massachusetts equal opportunity standard: majority shareholders will be held to have abused their control power whenever they withhold from the minority any potential benefit they may enjoy. At some point on the continuum lies the standard of good faith and inherent fairness.

When applying the relevant standard to a particular transaction, the courts weigh many factors, including the size of the corporation, the type of transaction at issue, the terms of the transaction and the purpose for the transaction. The courts tend to scrutinize freeze-outs more carefully in close corporation cases and apply a more stringent standard of fairness. This differentiation is sound because there are more opportunities for abuse in close corporations and because such abuse may have a greater impact upon shareholders in close corporations. Current cases indicate that the courts tend to permit freeze-outs for valid business purposes if the terms of the transaction are fair.33

Although there is disagreement as to whether state courts are adequately enforcing rights of minority shareholders,34 those who would extend rule 10b-5 to create and enforce a federal fiduciary duty must frame their question in terms of providing an additional, complementary remedy. Arthur Fleischer, Jr., a former Executive Assistant to the SEC Chairman, has declared himself against such unlimited expansion of rule 10b-5 because:

[It would involve the federal courts in working out federal rules to govern every aspect of corporate behavior that involves securities. This would be unfortunate. It is clear that federal law should not cover every breach of duty associated with a securities transaction. Thus, a repurchase by a company of its own stock at

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fair market value, but for an improper purpose, should be ex-
ccluded.\textsuperscript{35}

\textit{Federal Law}

In November, 1974, SEC Commissioner A.A. Sommer, Jr. con-
demned going private as "serious, unfair, and sometimes disgrace-
ful, a perversion of the whole process of public financing."\textsuperscript{36}

In the opinion of Commissioner Sommer, stock liquidity is of
primary importance to the public investor. Such liquidity depends
in part on there being enough stock in public hands to assure a
reasonably active market. When public shareholders are faced with
an issuer tender offer, Commissioner Sommer contends, they have
little real choice; either they tender their shares and lose future
growth, or they retain their shares (assuming the tender offer is not
followed by a cash merger) and lose the liquidity of their investment
and federal protection. If the going private transaction takes the
form of a cash merger, either as a follow-up to a tender offer or as a
one-step going private transaction, or a reverse stock split, the pub-
lic shareholders have no choice. Commissioner Sommer recognized
that some corporate freeze-outs are justified.\textsuperscript{37} He argues that the
presence or absence of a compelling corporate business purpose
should be determinative and that proof of such a purpose should be
a condition precedent to going private. While he gave no hint as to
what purposes he would consider sufficiently compelling, he clearly
specified some which are not: repurchasing the corporation's stock
as an investment because the market price is less than book value;
avoiding the costs incident to listing on a national securities ex-
change or registration with the SEC; avoiding the costs of maintain-
ing required records and sending required disclosures; and avoiding
the threat of litigation concomitant to federal securities laws.\textsuperscript{38}

What Commissioner Sommer finds inherently unethical about
going private is that the going private price, even if it is above the
current market price, is significantly less than the initial public
offering price, and that the value of the inside shareholders' stock
is exponentially increased without any additional investment by
them. Moreover, in his view going private is not only unethical, but
also unlawful under concepts of common law fiduciary duty and

\textsuperscript{35} Fleischer, "Federal Corporation Law": An Assessment, 78 Harv. L. Rev. 1146, 1166
(1965) [hereinafter cited as Federal Corporation Law].

\textsuperscript{36} Sommer, Going Private: A Lesson in Corporate Responsibility, [1974-75 Transfer

\textsuperscript{37} Sommer, Further Thoughts on "Going Private," BNA Sec. Reg. L. Rep. 294, D-1
(March 19, 1975) [hereinafter cited as Sommer II].

\textsuperscript{38} Sommer I, supra note 36, at 84,695-96.
federal securities laws. He accordingly encourages federal courts to find going private transactions violative of rule 10b-5 by broadly interpreting the rule.

The federal courts, however, have not been consistent in their approaches to cases involving corporate freeze-outs or other conflict of interest transactions. Prior to the recognition of implied private causes of action under the federal securities laws, the courts acquired jurisdiction over cases involving intracorporate fiduciary duties on the basis of diversity or under federal laws other than securities laws. After federal courts had implied a private cause of action under rule 10b-5 and relaxed the purchaser-seller standing rule of Birnbaum v. Newport Steel Corp., plaintiffs began alleging that directors and majority stockholders had violated section 10(b) and rule 10b-5 in conflict of interest transactions. Most of these cases involved issuance of corporate shares to insiders for inadequate consideration or mergers with control persons on terms unfair to minority stockholders. In each case, false representations or nondisclosure to some or all directors or to other stockholders was also alleged. Where, however, full and fair disclosure had been made to all stockholders regarding conflict of interest transactions, federal courts have reached opposite conclusions. The Second Circuit deemed a claim under rule 10b-5 for injunctive relief precluded by full disclosure since such disclosure satisfied the requirements of the

39. Commissioner Sommer's view that going private violates present federal securities laws echoes a 1971 SEC ruling, House of Adler, Inc., [1971-72 Transfer Binder] CCH Fed. Sec. L. Rep. §78,515 (1971). Adler planned a stock repurchase plan to reduce the number of its shareholders to less than 300, through a tender offer directed to those shareholders who owned less than 150 shares. The Commission staff reply indicated the proposed tender offer might violate the anti-fraud provisions of the 1934 Act since a successful tender offer would result in deregistration under section 12(g) of the 1934 Act and would deprive remaining shareholders of the protection afforded shareholders of registered issuers.

40. Sommer I, supra note 36, at 84,698; Sommer II, supra note 37, at D-3.

41. E.g., Pepper v. Litton, 308 U.S. 295 (1939), holding that bankruptcy court properly disallowed claim of a controlling stockholder of bankrupt corporation who had reduced his alleged salary claim to judgment against corporation because underlying claim did not represent an "honest debt" of the bankrupt corporation; Lebold v. Inland S.S. Co., 82 F.2d 351 (7th Cir. 1936), denial of injunction prohibiting dissolution of West Virginia corporation by parent corporation affirmed because plaintiff failed to establish proof of actual fraud; suit dismissed without prejudice since future actions of parent might justify equitable relief.


44. 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).

rule. In contrast, the District Court of Colorado indicated that although full disclosure had been made, an intrinsically unfair transaction would violate rule 10b-5.47

There are two lines of federal cases involving freeze-outs under rule 10b-5. The first interprets the function of section 10(b) and rule 10b-5 as insuring complete disclosure; hence, an alleged lack of corporate purpose or low valuation is irrelevant to a section 10(b) and rule 10b-5 claim. In the second line of cases the courts treat nondisclosure as only one facet of a section 10(b) and rule 10b-5 violation and require a showing of fairness or a valid corporate business purpose as a prerequisite to a freeze-out.

The first case requiring a valid business purpose for a freeze-out merger was *Bryan v. Brock & Blevins Co.*48 Bryan was a minority shareholder in Brock & Blevins Co., Inc. (Brock & Blevins) who resigned as an officer and director on October 17, 1970 as a result of a company management problem. Beginning October 14, 1970, the other stockholders attempted to purchase Bryan's stock through a series of overtures which culminated in a November 18, 1971 meeting. At this meeting, an ultimatum was given to Bryan: if he refused to sell his shares, "fundamental corporate changes [in the form of a merger with a new corporation] would be necessary in order to acquire [his] stock."49 When Bryan refused to sell, the other stockholders formed a new corporate shell, Power Erectors, Inc. (Power Erectors), and exchanged their Brock & Blevins stock for Power Erector stock. The Power Erector Board of Directors recommended to its shareholders that Brock & Blevins be merged into Power Erectors under a plan of merger resulting in the cancellation of the Brock & Blevins stock owned by Power Erectors and in a cash payment to Bryan. Bryan, who had been notified of a special meeting of Brock & Blevins shareholders, brought suit to have the proposed merger enjoined, alleging that the proposed merger was a scheme to defraud him of his status as a shareholder in an existing corporation, and was therefore violative of section 10(b) and rule 10b-5.

The defendants asserted that the proposed merger was permissible under Georgia corporation law,50 and that the long-standing

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48. 343 F.Supp. 1062 (N.D. Ga. 1972), aff'd on other grounds, 490 F.2d 563 (5th Cir. 1974). The court found additional section 10(b) and rule 10b-5 violations in defendants' failure to disclose the probable expansion of the corporation by the acquisition of another business and by going public.
49. Id. at 1065.
company policy of Brock & Blevins to have only active employees as shareholders was a valid business purpose supporting the proposed merger. The district court found that no such company policy existed. The court characterized the assertion of the company policy as a scheme and contrivance in violation of the majority shareholders' and directors' fiduciary duty to Bryan as a minority shareholder.

Accordingly, the court enjoined the proposed merger because of the following violations of section 10(b) and rule 10b-5: defendants had deliberately withheld material information; Power Erectors had been formed with the arbitrary restriction that only active shareholders of Brock & Blevins could obtain Power Erectors stock; and the proposed merger itself would have operated as a fraud upon Bryan since it was planned for the sole purpose of eliminating Bryan and not for any valid business purpose.

shareholders receive cash instead of shares of the surviving corporation. § 22-1202 provides that a shareholder who dissents from a merger plan is entitled to receive the fair value of his shares and is not entitled to any other rights he might have had as a shareholder "except where the corporation by fraud has induced the shareholder to enforce his dissenter's rights."

51. The court based its finding on the following facts: Judge Painter, an Assistant Secretary and Director of Brock & Blevins, who had never been an active employee, attempted to purchase Bryan's stock; neither Bryan nor Power Erectors, the then-majority shareholder of Brock & Blevins, had been active employees of Brock & Blevins; Bryan was unaware of such a policy; and there was considerable evidence that Brock & Blevins might go public in the near future. The court failed to reconcile its finding that Judge Painter individually had attempted to purchase Bryan's stock with its earlier finding that Judge Painter had represented himself as acting for the other stockholders. Bryan v. Brock & Blevins Co., 343 F. Supp. 1062, 1064 (N.D. Ga. 1972). Moreover, the finding that Bryan had never been an employee of Brock & Blevins conflicts with the court's earlier finding that Bryan had been employed by Brock & Blevins for 15 years. Id. at 1064.

52. On appeal, the Fifth Circuit focused only upon the pendent jurisdiction issue of whether Georgia corporation law permitted the proposed merger. The district court opinion does not indicate that plaintiff joined a state law claim to his federal claim. However, since the Fifth Circuit found that the federal claim presented a serious and material question, it took the position that the district court had pendent jurisdiction over "[a]ny equitable cause of action that would lie under the same proof and the same findings" and approved the district court decision "on the basis of general equity and state law grounds." 490 F.2d at 571 (emphasis added). The court accepted the trial court finding that the sole purpose of the proposed merger was the elimination of Bryan as a minority stockholder and interpreted this finding as an implicit construction of Georgia corporation law. Although no Georgia court had so construed the statute, the court read a limitation into the statute, finding that it had been intended only to allow the merger of two viable pre-existing corporations, but that a merger into a newly-formed corporation would be fraudulent and therefore excepted from operation of the statute. In so holding, the court stated that by utilizing the merger statute to eliminate a troublesome minority, defendants would be doing indirectly something they could not do directly. Relying upon the equitable principle that the majority shareholder has a fiduciary duty to the minority which prohibits the majority from using its powers for its personal advantage, the court held that the proposed merger was a violation of the Brock & Blevins majority shareholders' duties under general principles of equity and state corporation law.
In Albright v. Bergendahl,\(^3\) the District Court of Utah applied a corporate purpose test and the reasoning of the district court in Bryan to a going private suit. In Albright, the majority shareholders of International Service Industries, Inc. (International) had caused the formation of Body Contours, Inc. (Body Contours) and the merger of International into Body Contours pursuant to a plan whereby the International inside majority received the capital stock of Body Contours and the International public minority received cash. The court held that the merger was a device, scheme or artifice to defraud, or an act, practice or course of business which operated as a fraud or deceit upon the International public minority in violation of rule 10b-5, and that the conduct of the International majority constituted a breach of their fiduciary duties to the minority.\(^4\) In so holding, the court determined that defendants' purpose for the merger, "the belief of the [International] Board of Directors that [the corporation was] not a viable vehicle for the publicly held stock,"\(^5\) was not a legitimate corporate purpose. Accordingly, the merger was voided.

The corporate purpose test was applied by the District Court for the Northern District of Florida to validate the proposed merger challenged in Grimes v. Donaldson, Lufkin & Jenrette, Inc.\(^6\) In that case, the management of Meridian Investing and Development Corporation (Meridian) had sought an investor which would make a substantial investment in Meridian by purchasing its stock. The management found such an investor in Donaldson, Lufkin & Jenrette, Inc. (DLJ) which acquired an aggregate of 57 percent of the outstanding Meridian stock through two separate public tender offers.\(^7\) The court found that DLJ's acquisition of Meridian stock was originally intended as an investment. When the market price for Meridian failed to rise, DLJ's management deemed it desirable to make the corporation's investment in Meridian more permanent and proposed a merger between Meridian and a new second-tier


\(^{4}\) The opinion fails to state whether the breach of fiduciary duty was premised upon federal or state law.


\(^{6}\) 392 F. Supp. 1393 (N.D. Fla. 1974).

\(^{7}\) At the time of the first tender offer, the management of DLJ did not wish to have the Meridian financial statements consolidated into DLJ financials which would have been necessary if DLJ acquired more than 50 percent of the outstanding Meridian stock. Accordingly, the first tender offer was limited to less than 50 percent of the outstanding Meridian stock. Several months later, the opposition to Meridian and DLJ consolidated financials had decreased and DLJ made a second tender offer through which it acquired the remainder of its 57 percent of the outstanding Meridian stock. 392 F. Supp at 1397-99.
subsidiary of DLJ. Under the proposed merger plan, the minority Meridian shareholders would receive cash for their Meridian stock. A minority shareholder of Meridian filed suit to enjoin the proposed merger on the basis of the decision in *Bryan*.

The court distinguished *Bryan* from the present case because the merger proposed in *Bryan* was a "paper transaction without any real effect on the business involved other than to get rid of the sole minority shareholder." In contrast, the managements of DLJ and Meridian had valid business reasons for the proposed merger. Since both corporations were engaged in similar businesses, merging their operations was not only logical, but there was justified concern over potential claims of conflict of interest as long as some Meridian stock was held by a public minority. Additionally, the merger would reduce annual operating expenses and could be effected by merging Meridian directly into an existing subsidiary of DLJ, with the same ultimate effect upon the Meridian public shareholders. Therefore, the proposed merger was more than a paper transaction and passed the legitimate business purpose test followed in *Bryan*. In response to plaintiff's contention that a minority could never be eliminated through merger, the court found that:

> [T]he [state] legislature has determined that a stockholder has no absolute right to his interest in the corporation and may be forced to surrender his shares for a fair cash price.  

While recognizing that the Meridian minority stockholders could not be subjected to inequitable conduct by the majority stockholder, the court found no evidence of fraud or over-reaching on the part of DLJ and, further, determined that the price offered to the minority shareholders was fair and equitable.

Other courts have held that going private does not raise a federal question under the 1934 Act if full disclosure has been made. The most publicized going private transaction, and one condemned by SEC Commissioner Sommer, involved the exchange offer of Wells, Rich, Greene, Inc. (WRG). As a result of two public offerings, the public had invested more than $14 million in WRG, most of which went directly to its officers, directors and employees. In November, 1974, WRG extended an offer to purchase all the publicly-held

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58. *Id.* at 1402.
shares in exchange for cash and ten-year debentures. A public shareholder sought to have the exchange offer enjoined and withdrawn and to have all tendered shares returned, alleging *inter alia* that the exchange was an attempt to squeeze out the public at an unfair price.63

In denying plaintiff’s motion for a preliminary injunction, the court recognized that the going private issue is “undeniably serious and troublesome,” but that:

[T]here is nothing invalid *per se* in a corporate effort to free itself from federal regulations, provided the means and the methods used to effectuate that objective are allowable under the law. Nor has the federal securities law placed profit-making or shrewd business tactics designed to benefit insiders, without more, beyond the pale. Those laws in respect of their design and interpretative reach, as I understand them, including [section 10(b) and 14(e)] relied on here, are satisfied if a full and fair disclosure is made, so that the decision of the holders of WRG stock to accept or refuse the exchange offer can be said to have been freely based upon adequate information.64

The court stated that even if this interpretation of the scope of the 1934 Act was incorrect, plaintiff’s remedy at law would be adequate.65

The court in *Kaufmann*, relied upon the Second Circuit’s decision in *Popkin v. Bishop*66 in holding that the requirements of section 10(b) and rule 10b-5 are met in freeze-out cases when full disclosure to shareholders has been made. *Popkin* arose out of the proposed merger of Bell Intercontinental Corporation (Bell) and two of its subsidiaries into The Equity Corporation (Equity), the major stockholder of Bell. A Bell shareholder alleged a violation of rule 10b-5 in that the proposed exchange ratios were unfair to the merging corporations and their minority shareholders and the officers and directors of Bell had breached their fiduciary duties by proposing those ratios. The Second Circuit affirmed the district court’s dismissal of the complaint. In so doing, the court began with the assumption that plaintiff was correct in contending the exchange ratios were unfair. The court found the complaint deficient in that

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64. *Id.* at 17.
65. The court also noted that plaintiff apparently stood alone in his opposition to the proposed exchange and that if sizeable opposition to the exchange proposal did in fact exist, WRG’s plan to go private would fail. Significant opposition to the exchange proposal did exist. After the exchange offer, 43 percent of WRG’s outstanding stock remained in public hands. *Wall St. J.*, Jan. 7, 1975, at 18, col. 3.
66. 464 F.2d 714 (2d Cir. 1972).
it contained no allegation of any misrepresentation or nondisclosure of a material fact by defendants. The court disagreed with plaintiff's argument that,

"Rule 10b-5 is more than a disclosure provision" and that the Rule affords minority shareholders protection against overreaching by majority shareholders and directors "[w]hether the facts remain hidden from the minority or are ultimately revealed . . . ."67

Judge Feinberg distinguished Schoenbaum v. Firstbrook,68 in which the Second Circuit had introduced the rule 10b-5 concept now known as "new fraud."69 In Schoenbaum, the court held that the controlling shareholder and the board of directors had violated rule 10b-5 by issuing stock to the controlling shareholder at an inadequate price and by withholding material information from the minority shareholders. Although Judge Hays' opinion in Schoenbaum had "suggested that the alleged improper self-dealing itself constituted a violation,"70 in Popkin Judge Feinberg found that the non-disclosure by the controlling stockholder and the board of directors had been an essential element of the rule 10b-5 violation. He stated:

[O]ur emphasis on improper self-dealing did not eliminate non-disclosure as a key issue in Rule 10b-5 cases. Section 10(b) of the Exchange Act and Rule 10b-5 are designed principally to impose a duty to disclose and inform rather than to become enmeshed in passing judgments on information elicited. [citations omitted] This design has special relevance to merger transactions that, under state law, must be subjected to shareholder approval. In the context of such transactions, if federal law ensures that shareholder approval is fairly sought and freely given, the principal federal interest is at an end. Underlying questions of the wisdom of such transactions or even their fairness become tangential at best to federal regulation.71

It is this rationale which has been consistently applied by judges in the Southern District of New York in refusing to enjoin a pro-

67. Id. at 718.
69. In Schoenbaum, the court reversed the summary judgment for defendants in a derivative suit wherein the plaintiff alleged that the corporation's controlling shareholder, Aquitane Company of Canada, Ltd. (Aquitane), had exercised its controlling influence over the corporation's board of directors in order to cause the corporation to issue to it a substantial amount of treasury stock at a price which Aquitane knew to be grossly inadequate. The court held that the complaint stated a triable claim under section 10(b) and rule 10b-5 because if the plaintiff's allegations were true, (a) Aquitane had engaged in an act, practice or course of business which had operated as a fraud or deceit within the meaning of rule 10b-5(3), and (b) Aquitane and the directors had deceived the other shareholders of the corporation.
71. Id.
posed merger or tender offer, particularly since they deem money damages an adequate remedy if plaintiffs prove their claims.72 When frozen shareholders have sought money damages, however, their complaints have been dismissed for failure to state a claim upon which relief could be granted.73 In those cases in which plaintiffs have alleged mergers to be fraudulent for lack of a corporate business purpose, the courts have stated that the presence or absence of a business purpose was irrelevant to the alleged violations of section 10(b) and rule 10b-5.74

In two going private cases, 

Dreier v. The Music Makers Group, Inc.75 and Greenberg v. Institutional Investor Systems, Inc.76 minority shareholders presented novel arguments. In 

Dreier, the plaintiff alleged that the defendants had failed to make full and accurate disclosure in a 1967 prospectus and registration statement in which

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Plaintiffs rely on decisions in other circuits holding mergers which eliminate public shareholders without a corporate business purpose violative of Rule 10b-5. [footnote omitted] The cases in this circuit and in this district, however, are to the contrary.


In addition, in 

Green the court concluded that SEC Proposed Rule 13e-3B which would make any going private transaction initiated by an issuer unlawful unless there was a valid business purpose for the transaction, evidenced the SEC’s:

own estimate of the reach and the limitations of existing regulations in dealing with “going private” transactions . . .

. . . .

Implicit in the Commission’s expressed intent to enact these or similar rules is the conclusion . . . that existing rules, including Rule 10b-5, do not reach the sort of acts complained of.

Green v. Santa Fe Indus., Inc., 391 F. Supp. 849, 854 (S.D.N.Y. 1975). In the same case, the court refused to read a valid business purpose requirement into the Delaware short-form merger statute based on rule 10b-5, in contrast with the Bryan court’s interpretation of the Georgia merger statute.


The Music Makers Group, Inc. (Music Makers) shares had been offered. The alleged nondisclosure was defendants' intention to go private six years later by merging Music Makers into a then non-existent corporation. Plaintiff attempted to telescope the registration and subsequent merger into a scheme to defraud. Because of the novelty of plaintiff's claim regarding the 1967 prospectus and registration statement, and the problems of proving the claim, the court refused to dismiss the claim. Instead, the court directed plaintiff to file a more detailed amended complaint.

Dreier's argument was modeled on the successful argument in United Funds, Inc. v. Carter Products, Inc. 71 The corporate defendant in United Funds proposed to issue a new class of non-voting common stock. Issuance of such stock would have resulted in delisting by the New York Stock Exchange (NYSE). Plaintiffs sought an injunction prohibiting the issuance of the new class of stock, alleging that they had relied on a statement in the offering prospectus that application would be made for listing the common stock of the corporation on the NYSE; that the common stock had been and continued to be so listed; that they would be injured if the common stock were delisted; and that the only purpose for the proposed issuance of non-voting common stock was to preserve the controlling stockholder's control of the corporation while he utilized the non-voting common stock in his estate planning. The court granted the injunction because the prospectus statement was an implied promise to obtain and continue NYSE listing. Pursuant to section 90 of the Restatement of Contracts, 78 the defendant corporation was obligated to continue the listing, absent a proper corporate purpose, and no such corporate purpose had been shown. 79

A similar argument was raised but rejected in Greenberg. Plaintiff argued that since the corporation's stock had been registered with the SEC when defendants initiated an allegedly fraudulent going private freeze-out which resulted in deregistration, she should not be deprived of the protection shareholders receive under the SEC proxy rules. The court foreclosed plaintiff's claim of detrimental reliance. Since the stock had not been registered when she purchased it, she could not claim that her purchase "was induced in

78. Restatement of Contracts § 90 (1932) provides:
A promise which the promisor should reasonably expect to induce action or forbearance of a definite and substantial character on the part of the promisee and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise.
79. In addition, the court held that the controlling shareholder's attempt to have the new class of stock issued was a breach of his fiduciary duty to the minority shareholders.
part by the expectation that she would enjoy the protections that accompany registration."\textsuperscript{80}

On the whole, district court judges have not encouraged minority shareholders to bring their going private complaints to federal courts. In most cases, the courts have refused to consider whether or not a particular transaction is fair or whether a valid corporate purpose for the transaction exists. These courts have relied upon the premise that the function of rule 10b-5 is to force insiders and issuers to accurately disclose all details of a going private transaction. If full disclosure has been made, these courts have ruled that no securities law question was presented. If such disclosure has not been made, the courts have temporarily enjoined the transaction until an omission or misstatement is corrected, and the correction has reached minority shareholders. Once this has been done, however, the courts have found that the requirements of rule 10b-5 are satisfied and that the transaction can proceed.

Three district court judges have interpreted rule 10b-5 differently. In \textit{Bryan}, the district court considered whether a valid corporate purpose for the freeze-out merger at issue existed and found no such purpose. The court then concluded that the freeze-out merger itself operated as a fraud under rule 10b-5. This conclusion can be interpreted in two ways. First, it can be viewed as dictum. Since the court found the traditional type of rule 10b-5 nondisclosure violation, that violation alone was sufficient to support its judgment for the plaintiff. Secondly, it can be and has been considered the essence of the \textit{Bryan} decision. In holding that a going private transaction was a fraud under rule 10b-5, the \textit{Albright} court merely stated that it found the reasoning of the court in \textit{Bryan} persuasive.\textsuperscript{81} In measuring the freeze-out merger at issue in \textit{Grimes} against a valid business purpose standard, the court there simply distinguished \textit{Bryan} on the facts and found it inapplicable.\textsuperscript{82} In fact, \textit{Bryan} has been interpreted as creating a federal fiduciary law under rule 10b-5.\textsuperscript{83}

If this second interpretation is correct, the court's opinion is deficient in that it contains no analysis whatsoever supporting the creation of a federal fiduciary duty. In support of its conclusion that the freeze-out merger was a fraud under rule 10b-5, the court stated the familiar rule that federal securities laws should be interpreted liber-


\textsuperscript{83} See Recent Developments in Corporate Freeze-Outs, supra note 18, at 1270.
ally to effectuate their remedial purposes. However, the court failed to explain why this liberal construction makes a freeze-out an artifice to defraud. Its conclusion that a freeze-out is violative of rule 10b-5 was wholly unsupported. Supportive reasoning may not be necessary where a court is following clear precedent. Where, however, a court is making new law, a well-reasoned opinion is expected, particularly where the law created is federal common law impinging upon existing state law.

Since *Erie R.R. v. Tompkins*, there has been no general federal common law. Federal courts have, however, found that federal common law does exist in a few areas. Such federal common law has not been created casually in those areas in which state law has traditionally governed because of the presumption in favor of applying state law. This presumption is overcome if a federal statute clearly evidences a congressional interest in having a particular issue resolved by federal law. Evidence of such interest must be found by analyzing the intended scope of a statute and considering whether it was intended to pre-empt state law, or by determining that the need for uniformity mandates creation of such federal law.

State law has traditionally governed intracorporate matters. Therefore, the presumption in favor of state law must be overridden before a federal fiduciary law can be created under rule 10b-5. The 1934 Act was not intended to pre-empt state law in matters of all internal corporate affairs dealing with securities. Accordingly, the creation of a federal fiduciary law can only be justified by a compelling need for a uniform law of fiduciary duty. Such a need may be necessary in formulating remedies for the breach of duties imposed by federal law, or when the inconvenience to the federal government arising from fifty diverse rules outweighs the inconvenience to individuals of being governed by two different sources of law. The need for a uniform fiduciary rule in cases arising under the implied private cause of action of rule 10b-5 can not be supported by inconvenience to the federal government. Although the private cause of action under rule 10b-5 has been judicially implied from the purposes of the 1934 Act, the courts have not found it necessary to create a complete body of law to enforce this cause of action.

84. 304 U.S. 64 (1938).
87. Id. at 1090-93.
Whether the lower federal courts can or should create a federal fiduciary law is debatable. But the court which does must reason through the need for such a law.

The view of those courts which refuse to become entangled in issues of substantive fairness is the better view. By attempting to fit a federal fiduciary law within the parameters of rule 10b-5, those courts which rule on fairness are attempting to turn the rule into a procrustean bed.

**FUTURE LAW**

*Judicial Expansion of Rule 10b-5*

None of the courts which have concluded that a corporate freeze-out constitutes a rule 10b-5 violation have analyzed the nature of "fraud" under the rule. Such an analysis can be made by reviewing analogous statutory and case law.

In construing language in the Investment Advisers Act of 1940 which is similar to the language of rule 10b-5 in *SEC v. Capital Gains Research Bureau,* the Supreme Court considered whether the terms "fraud and deceit" were used in their technical sense, requiring intent to injure as an element of the offense. In concluding that Congress intended the Investment Advisers Act to be construed flexibly to effectuate its remedial purposes, the Court held that fraud under the Act did not require proof of intent to injure. The Court also considered the common law differences between fraud at law and fraud in equity. While fraud at law is primarily a tort, constrained by stringent requirements, fraud in equity is:

> [A] conveniently comprehensive word for the expression of a lapse from the high standard of conscientiousness that it exacted from any party occupying a certain contractual or fiduciary relation towards another party.

The 1934 Act is not a direct analogue of the Investment Advisers Act of 1940. The latter is a comprehensive substantive law regulating investment advisers, whereas the former regulates corporate insiders only insofar as securities transactions are involved and does

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91. 15 U.S.C. § 80b-6 (1970), provides in relevant part that:

*It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentalities of interstate commerce, directly or indirectly —

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;  
(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client . . . .


93. Id. at 193, quoting H. HANBURY, MODERN EQUITY 643 (8th ed. 1962).
not pre-empt complementary state laws. Nevertheless, the rule of Capital Gains Research Bureau, that federal securities laws should be construed flexibly because they are remedial, is applicable to the 1934 Act and, in particular, to rule 10b-5.

One of the classes of fraud cognizable in equity is fraud presumed from the circumstances and condition of the parties. This class includes transactions presumptively invalid between persons in a fiduciary relationship. If federal courts hold that a fiduciary relationship exists between controlling shareholders and minority shareholders as a matter of federal fiduciary law, then there is a basis for holding that allegations of a freeze-out state a prima facie claim under rule 10b-5, even if full disclosure has been made.

However, this view ignores the referent and enabling language of section 10(b), which speaks only of “manipulative or deceptive” devices. The clear case is one of nondisclosure, in which the prohibition against deceptive devices provides a ground for finding a rule 10b-5 violation. When full disclosure has been made, however, there is no deception and only manipulation can provide a basis for finding a violation of the section and the rule. “Manipulative devices” are not defined in section 10(b) of the 1934 Act. The terms of section 2(3) of the 1934 Act refer to manipulation and control of prices; sections 9 and 15(c) of the 1934 Act refer to manipulation of security prices on exchange and over-the-counter markets, respectively. While the “manipulative devices” proscribed by rule 10b-5 are not limited by sections 9 and 15(c), particularly insofar as those sections require intent, it seems reasonably clear that congres-

96. 3 Pomeroy, Equity Jurisprudence § 874 at 424, § 958d at 815-16 (5th ed. 1941).
97. Bromberg suggests that a violation of rule 10b-5 would be easy to plead in a freeze-out merger and recommends as the central allegation:

The defendants engaged in a course of business which operated as a fraud on the minority shareholders by using the defendants' control over the company to have it merge with 2d company on terms that were grossly inadequate for the minority shareholders of the company, thereby causing them damage.

98. 15 U.S.C. § 78b(3) (1970) provides in part:

Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities . . .
101. 2 Bromberg, supra note 97, at §§ 8.4 (410) at 204.41, and (457) at 204.91 (Supp. 70-2, 1970); id. § 8.4 (505) at 204.106 (Supp. 71, 1971).
sional attention focused only on manipulation of prices. The Senate Report on the 1934 Act stated:

Subsection 10(b) authorizes the Commission by rules and regulations to prohibit or regulate the use of any other manipulative or deceptive practices which it finds detrimental to the interest of the investor.\footnote{102} The counter-argument is that since the deception prohibited by section 10(b) and rule 10b-5 is not limited to deception involving the value of the security,\footnote{103} neither should manipulation be limited to mean price manipulation.

Most cases decided to date, however, have not found a corporate freeze-out violative of section 10(b) or rule 10b-5.\footnote{104} These cases are consistent with the view that the section and rule are primarily disclosure provisions\footnote{105} and that the manipulative devices prescribed by section 10(b) refer to manipulations of price and not to the use of majority power to "manipulate" the position of the minority stockholder. Even the cases decided under the "new fraud" doctrine center on allegations of inadequate consideration flowing to the corporation.\footnote{106}

The federal courts' reluctance to litigate "fairness" is consonant with the view that the 1934 Act is primarily a disclosure statute,\footnote{107} "ill-equipped to reach the problems of substantive fairness raised by going private,\footnote{108} and that "the SEC should not pass upon the merits of specific securities transactions.\footnote{109} The issue of substantive fairness is really an issue of breach of fiduciary duty.\footnote{110}

\begin{footnotes}
\item[102] S. Rep. No. 792, 73d Cong., 2d Sess. 18 (1934) (emphasis added). The author of \textit{Recent Developments in Corporate Freeze-Outs}, supra note 18, interprets this language as support for his conclusion that a freeze-out is a 10b-5 violation. \textit{Id}. at 1271.
\item[105] E.g., W. Painter, \textit{Federal Regulation of Insider Trading} 332 (1968).
\item[107] 1 L. Loss, \textit{Securities Regulation} 21 (2d ed. 1961):
"Then too, there is the recurrent theme throughout these statutes of disclosure, again disclosure, and still more disclosure. Substantive regulation has its limits. But "The truth shall make you free."
\end{footnotes}
mentator has noted that "[i]t is one thing for federal courts to enforce recognized, state-created fiduciary duties but quite another for them to create new fiduciary duties."

The crucial question, therefore, is whether such a federal fiduciary law will be created under section 10(b) and rule 10b-5. Despite Commissioner Sommer's praise of the federal courts' "resourceful applications of rule 10b-5," judicial creation of such a law in the near future is unlikely. In Blue Chip Stamps v. Manor Drug Stores, the Supreme Court stated that the judicially implied private cause of action under rule 10b-5 must be delimited "one way or another unless and until Congress addresses the question." Professor Loss sees this decision as "opening up for reargument all past decisions on the reach of 10b-5." Without doubt, the lower federal courts will heed the warning and retrench. Accordingly, the interpretation of rule 10b-5 which excludes consideration of the substantive terms of corporate freeze-outs may become the majority rule.

SEC Release 5567 and Proposed Rules

Because the judiciary may refrain from using existing federal securities laws to regulate going private, the SEC is considering whether it should do so. In early 1975, the SEC issued alternative proposed rules pursuant to section 13(e) of the 1934 Act covering going private transactions and initiated a public fact-finding investigation for the purpose of determining whether the Commission should adopt going private rules or recommend legislation to protect minority shareholders. Questions regarding the adequacy of state remedies and the concern expressed by shareholders and the investment community regarding the fairness and impact of going private transactions led the SEC to propose rules which include substantive provisions.

111. Going Private — Old Tort, New Tort or No Tort?, supra note 5, at 1037.
112. Sommer II, supra note 37, at D-2.
113. 95 S.Ct. 1919 (1975).
114. Id. at 1932 (emphasis added).
116. 15 U.S.C. § 78m(e) (1970). Under section 13(e), it is unlawful for a registered issuer:
[T]o purchase any equity security issued by it if such purchase is in contravention of such rules and regulations as the Commission, in the public interest or for the protection of investors, may adopt (A) to define acts and practices which are fraudulent, deceptive, or manipulative, and (B) to prescribe means reasonably designed to prevent such acts and practices.
Under the proposed rules it would be unlawful for an issuer or its affiliates to engage in certain transactions, including repurchases of the issuer's shares, except in compliance with the detailed provisions of the proposed rules. Proposed Rule 13e-3A would regulate certain issuer repurchases, tender and exchange offers, and solicitations of proxies, consents or authorizations in connection with: a merger, consolidation or similar business combination; the sale of substantially all issuer assets to an affiliate; or a reverse stock split involving the purchase of fractional shares.\(^\text{118}\) These transactions would be regulated by the proposed rule only if they could result in delisting by a national securities exchange, deregistration pursuant to section 12(g)(4) of the 1934 Act, suspension of reporting obligations pursuant to section 15(d) of the 1934 Act, or termination of NASDAQ authorization.\(^\text{119}\) Proposed Rule 13e-3B would regulate those purchases of the issuer's stock by the issuer or its affiliates: which are intended to compel a shareholder to terminate his status as a shareholder or to reduce the amount of the issuer's outstanding stock not held by affiliates by 25 percent or more; or which could result in delisting by a national securities exchange, deregistration under section 12(g) of the 1934 Act, suspension of reporting under section 15(d) of the 1934 Act or termination of NASDAQ authorization.\(^\text{120}\)

The substantive provisions of Proposed Rule 13e-3A include a requirement that the consideration for shares constitute "fair value," as determined by the offeror in good faith, but not less than the value recommended jointly by two qualified independent appraisers.\(^\text{121}\) In addition, if the transaction involves a cash tender offer or exchange offer, tendering shareholders must be able to withdraw deposited shares any time prior to acceptance; shares deposited within the first 20 days must be accepted pro-rata; any increase in consideration must apply to all shares accepted; and all shares purchased within the 60-day period following the tender offer will be deemed purchased pursuant to the tender offer. If the transaction results in freeing the issuer from the reporting requirements of sections 12 or 15(d) of the 1934 Act, the offeror must so notify nontendering shareholders and allow them an additional 20 days to tender their shares as part of the same offer.\(^\text{122}\) Alternatively, the


\(^\text{120}\) Subsection (b) of Proposed Rule 13e-3B, 2 CCH FED. SEC. L. REP. ¶23,705, at 17.245-9. Proposed Rule 13e-3B is hereinafter referred to as Proposed Rule 13e-3B.

\(^\text{121}\) Subsection (c)(2) of Proposed Rule 13e-3A, supra note 118, at 17,245-6.

\(^\text{122}\) Subsection (c)(3) of Proposed Rule 13e-3A, supra note 118, at 17,245-7.
terms of Proposed Rule 13e-3B would require that all terms of a transaction, including consideration, be fair, and that if the transaction is initiated by the issuer, it have a “valid business purpose” therefor.123

Section 13(e) of the 1934 Act confers rule-making power upon the SEC to regulate issuer repurchases, but that power is limited to defining and preventing fraudulent, deceptive or manipulative acts and practices,124 and to imposing disclosure requirements.125 Rule 13e-1, the only rule adopted pursuant to section 13(e), prohibits undisclosed issuer purchases during a take-over attempt.126 A second rule, proposed in 1973 and not yet enacted, would regulate issuer repurchases in detail by defining as a fraudulent, deceptive or manipulative act any repurchase not in accordance with the limitations imposed by the proposed rule.127 This proposed rule has been criticized as being beyond the scope of the rule-making power granted in section 13(e).128

The rules proposed under section 13(e) to limit going private transactions129 are vulnerable to the same criticism. Two commentators, writing prior to announcement of the proposed rules, have taken opposite positions regarding the scope of the Commission’s rule-making power under section 13(e). Professor Kerr asserted that the SEC could substantively regulate going private through section 13(e) rules. He suggested that the SEC could use its rule-making power under section 13(e) in the same expansive manner in which it has used its rule-making power under section 10(b).130 Professor Borden, however, questioned whether the Commission could or should create a substantive rule of fairness under section 13(e) and anticipated a vigorous debate on the issue.131 As he expected, the

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123. Subsection (a) of Proposed Rule 13e-3B, supra note 120.


129. Proposed Rules 13e-3A and 13e-3B, supra notes 118 and 120.


131. Going Private — Old Tort, New Tort or No Tort?, supra note 5, at 1036 n.220. Professor Borden also considers the consequences of the federal adoption of a per se prohibition of corporate freeze-outs by positing hypotheticals which illustrate the myriad variables involved in freeze-outs, such as percentage of control, relative approval or disapproval by outside or minority shareholders, full disclosure and fair price, and permutations of these variables. Id. at 1038-39.
authority of the Commission to include substantive requirements in the proposed rules has been questioned, although not unanimously, by securities law experts.\textsuperscript{132}

An obvious analogy exists between the proposed going private rules and certain provisions of the Williams Act.\textsuperscript{133} This analogy supports a conclusion that the substantive provisions of the proposed rules are beyond the scope of the Commission's rule-making power under section 13(e). Congress, not the Commission, imposed substantive limitations on tender offers through the Williams Act. Similarly, any substantive provisions regulating going private transactions should originate in Congress.

**CONCLUSION**

The equities involved in going private and freeze-out transactions are being considered by state courts. These courts have found particular transactions unfair to minority shareholders by measuring the transaction at issue against a variety of increasingly stringent standards of fairness. Although some authorities find state court efforts inadequate, state law remedies are available to minority shareholders who seek them. Therefore, existing federal securities laws, and rule 10b-5 in particular, should not be applied by federal courts to test the fairness of going private or freeze-out transactions, nor should new rules be promulgated by the SEC to substantively regulate these transactions, in the absence of a clear congressional mandate or a compelling need for a uniform substantive federal law.

\textbf{ANNE JENTRY}

\textsuperscript{132} The comments received by the Commission regarding the proposed rules have been divided. Generally, investors favor the proposed rules while members of the securities bar and the investment community do not. \textit{Investor Comments Favor SEC "Going Private" Proposals; Bar Opposes Them}, BNA SEC. REM. L. REP. 318A-I (Sept. 10, 1975).

\textsuperscript{133} \textit{Pub. L. No. 90-439, 82 Stat. 454 (July 29, 1968); amended by Pub. L. No. 91-567 (Dec. 22, 1970). Section 13(d) of the 1934 Act requires certain disclosures after acquisition of more than five percent of the outstanding shares of a registered security, 15 U.S.C. \$ 78m(d) (1970). Proposed Rule 13e-3B, \textit{supra} note 120, would require certain disclosures if the acquisition of more than 25 percent of the publicly-held shares of a registered security is planned. Section 14(d)(1) of the 1934 Act requires that a tender offeror file a statement with the SEC, 15 U.S.C. \$ 78n(d) (1970). Proposed Rules 13e-3A and 13e-3B, \textit{supra} notes 118 and 120, would require that an issuer or its affiliates file a statement with the SEC. Section 14(d)(5), (6) and (7) contain tender offer withdrawal, pro rata acceptance and increased consideration provisions similar to those contained in Proposed Rules 13e-3A and 13e-3B, \textit{supra} notes 118 and 120.