Notes

Going Private

In January 1973, the Dow Jones Industrial Average, the traditional index of stock market performance, broke 1000 for the first time. By the end of 1974, it had collapsed beneath 600, and has only recently climbed higher. Since in most cases the collapse has not been the result of reduced corporate earnings, stocks are now selling at far lower price/earnings ratios and multiples of book value than at any time in the recent past.

In an effort to capitalize on this collapse in the value of their stock, many publicly held corporations—especially those that first went public during the bull market era of the late 1960's—have attempted to reacquire from investors all the publicly held common stock in their firms. This procedure leaves only that group of insiders who direct the corporate reacquisition programs (usually the very ones who took the companies public originally) as the surviving shareholders in a now privately held enterprise. Such a program of share reacquisition is known as "going private."

1. A chart plotting the course of the Dow Jones Industrial Average over the last 12 years can be found in the N.Y. Times, Dec. 7, 1974, at 39, col. 5. Other indexes tell a similar story. The unweighted average of common stocks on the New York Stock Exchange, for example, had lost 69 percent of its value from 1968 to the summer of 1974, BARRON'S, Aug. 26, 1974, at 11, and the value of total stock holdings of individuals (including private trust funds) had declined from $914.3 billion at year end 1972 to $565.3 billion on June 30, 1974, id. at 1.

2. The Dow Jones Industrials, for example, are now selling at their lowest price/earnings ratio since World War II. See BUSINESS WEEK, Dec. 21, 1974, at 105 (chart of price/earnings ratios since 1945).

3. From 1967 to 1972, some 3,000 corporations filed registration statements with the SEC for the first time. Sommer "Going Private": A Lesson in Corporate Responsibility, BNA SEC. REG. & L. REP., No. 278, at D-1 (Nov. 20, 1974).

4. On the causal link between current securities market conditions and going private, see, e.g., Knapp, Going Private—Wall Street's Latest, O-T-2 MARKET CHRONICLE, MAR. 7, 1974, at 1, col. 1.


As used in this Note, "going private" will refer only to transactions whose ultimate goal is the return of a corporation to a privately held status. Thus programs of share repurchase
Companies going private have one broad objective in mind: the elimination of sufficient numbers of shareholders to enable the corporation to remove its shares from registration with the Securities and Exchange Commission (SEC) under § 12 of the Securities Exchange Act, and also to achieve the lesser benefits of de-listing from the exchange on which they are traded. De-registration can be effected by reducing the total number of shareholders in a publicly held corporation to below 300. It enables a corporation, among other advantages, to avoid sending to its shareholders proxy statements and annual reports disclosing information required by the SEC, and it relieves insiders from being subject to such provisions as § 16(b) of the Exchange Act.

Rarely before have companies, however unhappy they were with their role as publicly held enterprises, been afforded the opportunity to buy their way back to private status at such a modest cost. As a result, going private has become, of late, a popular course of corporate action. Nevertheless, going private raises numerous legal prob-
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lems, particularly of insider fiduciary obligations and self-dealing, which cannot be resolved by a simple recourse to precedent. This Note attempts to analyze these problems, to suggest standards for judicial review of minority challenges to going private, and to outline certain means by which corporate counsel can reduce the possibility of litigation in future going private efforts.11

I. Motives and Mechanics of Going Private

A. Insider Motives

The advantages of going private which accrue to a corporation's inside shareholders alone are patently clear, both to business writers and to dissident shareholders. Thus Merle Norman Cosmetics, Wells, Rich, Greene, Inc., and Barbara Lynn Stores, as well as their directors and controlling shareholders, have all been sued in connection with their attempts to go private,12 while such journals as Business Week have editorialized against some efforts to go private.13 Running through all the criticism is a common argument that insiders who sold a portion of their equity interest when their company went public in the 1960's are now buying that interest back, through the use of the corporate mechanism, for a fraction of the earlier price, and that to do so is grossly unfair to the public, upon whom the shares were foisted at inflated values, and from whom they are now being repurchased at bargain prices.14

11. In analyzing these issues, the Note concentrates on the going private efforts of four corporations—Barbara Lynn Stores, Inc., Federated Development Company, Merle Norman Cosmetics, Inc., and Wells, Rich, Greene, Inc.—which represent a broad cross-section of recent going private transactions.

These four companies were chosen because they are typical of current going private efforts. Barbara Lynn operates a chain of discount stores. Federated Development invests in real estate. Merle Norman retails, through its own outlets, a well known line of cosmetics. Wells, Rich, Greene is the 13th largest advertising company in the United States.


13. BUSINESS WEEK, Nov. 2, 1974, at 11. The editorial singled out Wells, Rich, quoting one analyst as saying "Wells, Rich management in effect sold their stock short by going public, and now they're covering by going private—with the stockholders' money."Id.

14. When Merle Norman, for example, first went public in 1969, the family of J.B. Nethercutt sold 400,000 shares to the public at $25 per share. Two years later, the Neth-
More generally, insider profits in going private can be contrasted with the price, including any premiums above market price, offered public shareholders for the surrender of their stock. Any increase in a company's value that results from its having gone private, as well as the potential for higher values in the future should business prosper, accrue only to those who are still stockholders—the insiders themselves. Although some of that profit is passed on to public shareholders in the premium above market price they are offered for their shares, insiders can still receive a disproportionate amount of any actual or anticipated gains arising from going private whenever they alone can determine the terms offered to the public shareholders. In this sense, going private can present corporate insiders with an opportunity to enrich themselves at the direct expense of the investing public, and it is this potential abuse which must be circumscribed if going private is to pass judicial scrutiny.

B. Corporate Motives

If insider motive in going private is clear, the benefits to a corporation itself are not. Although insiders anxious to justify their action have not hesitated to suggest advantages which would accrue to their corporations from going private, only a few of the alleged advantages are genuine.

One purported justification, from the perspective of benefit to the corporation, is that going private is simply traditional corporate share repurchasing writ large. Such a rationale ignores the effect on a corporation of its change from public to private status. The usual justifications for limited share repurchasing include its functional equivalence to a dividend (but with capital gains treatment for the shareholder), its leverage effect, its positive effect on earnings per share (by reducing the number of shares outstanding), and the conviction by management that the stock represents a good investment.15

Because going private is directed to only one segment of a corporate family sold 220,000 shares at $17 per share. The company itself offered to the public a total of only 120,000 shares in 1969, for which it obtained $25 per share. Were the corporation's recent tender offer for its own stock wholly successful, it would have bought back those 740,000 shares in the hands of the public at a cost of $13 per share, plus expenses, Merle Norman Circular, supra note 11, at 1. The Nethercutt family would have become the company's sole stockholders once again, and the combined wealth of Merle Norman and the Nethercutt family would have increased by the net difference between the sale and repurchase prices.

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tion's shareholders (the investing public), it cannot be treated as an alternative method to dividends for making a pro rata distribution of assets—as could a more limited repurchase offer in which all shareholders could participate without dilution of control. Leverage has advantages to a corporation when used judiciously, because of the structure of federal corporate income tax, but has definite limits beyond which it becomes a burden to a corporation's financial structure—and going private would presumably often exceed those limits. A reduction in the number of outstanding shares might bolster an otherwise sagging earnings per share figure, but that number has no financial relevance beyond its appeal to the shareholding public in their investment decisions. Since it is the elimination of the public from share ownership which going private seeks, such techniques of maintaining public interest in a stock are no longer meaningful. Finally, because going private means the elimination of any market for a company's securities, it cannot be justified as a good investment in the same manner in which more limited repurchasing could, because following a going private transaction there would no longer exist a marketplace in which the corporation's stock could be resold as its market value rose.17

Perhaps sensing that the corporate rationale for going private must be different from that of limited share repurchasing, defenders of going private frequently suggest another possible benefit to the corporation: the anticipated savings of a corporation's cost of SEC registration and compliance, which can easily amount to $100,000 per year.18 This savings is not without its own costs, however. First, the purchase price of reacquiring the shares held by the public will often amount to millions of dollars, making the amount saved a very poor yield on such a large investment.19 Second, sizable legal, accounting and brokerage expenses are incurred by going private.20 Third, the intangible benefits to the corporation foregone by reverting to a private status are significant. They include protections against insider trading and the increased disclosure required of a corporation with securities registered under § 12 of the Exchange Act, both of which serve to protect a publicly held corporation and its shareholders from

17. This point is reexamined in more depth in note 132 infra.
19. Merle Norman, for example, estimated the purchase price for all its publicly held stock at about $10,000,000. Merle Norman Circular, supra note 11, at 15.
20. Thus Wells, Rich has predicted that these costs will reach some $900,000 for its proposed tender offer. Wells, Rich Prospectus, supra note 6, at 11. But see Barbara Lynn Statement, supra note 10, at 5 (estimated expenses of going private via merger, $100,000).
insider abuse.\textsuperscript{21} Going private, then, can rarely be justified as a money-saving device, despite the efforts of some corporations to do so.\textsuperscript{22}

A more persuasive argument, and one made by several enterprises, relates to the reasons why many of these companies went public in the first place. Traditionally, of course, a firm goes public in order to raise needed equity capital to finance the growth of its business. In the case of many businesses now going private, however, particularly those service companies which had little need to raise capital for the purchase of tangible assets, the original decision to go public was made not necessarily to raise funds for expansion but to take advantage of the "new issues" market from 1967 to 1969.\textsuperscript{23} By going public, these companies hoped to use the highly optimistic market valuation of their stock both in the acquisition of other firms and in the retention of key employees through stock option programs made more lucrative by the new higher value of the companies' stock. The companies have found instead that, though their earnings have gone up, the price/earnings ratio of their stock has collapsed with the drop of the stock market;\textsuperscript{24} with that collapse the anticipated uses of a publicly traded stock have vanished.\textsuperscript{25}

By going private, corporations using their stock for stock option and acquisition programs will no longer be tied to a market-determined valuation of their stock. Instead of granting stock options whose value fluctuates with the vagaries of the stock market, corporations could, for example, grant options based on their stocks' book value.\textsuperscript{26} In many cases, book value is above the market price for a company's stock, and the net effect of buying back all publicly held shares is to increase book value still further.\textsuperscript{27} Additionally, book value tends to be a rela-

\begin{itemize}
  \item \textsuperscript{21} See note 9 supra.
  \item \textsuperscript{22} See, e.g., Barbara Lynn Statement, supra note 10 at 4 (the cost of remaining a publicly held corporation is listed as a significant factor in the decision to go private); Lee, supra note 5, at 14 (Globe Security Systems).
  \item \textsuperscript{23} See, e.g., Pacey, supra note 5, at 3 (chart); Wells, Rich Prospectus, supra note 6, at 14: "Unlike corporations with substantial capital requirements, the Company does not need a public market for its Common Stock for the purpose of raising capital."
  \item \textsuperscript{24} See note 2 supra.
  \item \textsuperscript{25} Prompting... [corporations] to go private was the fact that the low prices of their securities made stock options of scant value in attracting and keeping good employees, and were definitely no aid in acquisitions or mergers. Pacey, supra note 5, at 3. See Wells, Rich Prospectus, supra note 6, at 14: The Company's Board of Directors has come to the conclusion that a public market for the Common Stock is no longer providing the benefits to the Company which had originally been anticipated. In particular, because of the often uncertain and disappointing prices of the Common Stock, stock options have failed to provide employee incentives needed by the Company, and at recent prices the Common Stock no longer serves as an effective means of acquiring other agencies.
  \item \textsuperscript{26} See, e.g., Wells, Rich Prospectus, supra note 6, at 14 (corporation intends to restructure its stock option plan around the stock's book value).
  \item \textsuperscript{27} See, e.g., id. at 15; Federated Circular, supra note 11, at 6. Book value rises, of course, only when the purchase price paid by the corporation is lower than the stock's
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tively stable figure, and for most companies advances steadily with the years. Both these factors make it a figure more attractive to the corporation and the optionees for stock option valuation purposes than a highly volatile market price. Similarly, a company wishing to use its stock in mergers or acquisitions would not be stymied by a depressed stock market price, but could instead reach, through private negotiation, any valuation for its stock satisfactory to all parties in the transaction.\textsuperscript{28}

We are left, then, with but one reasonable corporate justification for going private: the upward revaluation of a company's own securities for use in various corporate transactions. Whether this motive evidences a corporate purpose adequate to justify the use of coercive devices in going private will be discussed later.\textsuperscript{29} One should remember, however, that this use of the securities markets to boost the value at which a company's shares can be employed for corporate transactions is no different from the motive behind many public offerings in the 1960's.

C. The Mechanics of Going Private

The techniques used in recent attempts to go private fall into two basic categories: “one-step” acquisitions of publicly held shares, typically through a merger; and “two-step” acquisitions, which usually involve a tender offer followed, if necessary, by one of several “mop-up” devices.\textsuperscript{30}

The simpler of the two methods, but the less common,\textsuperscript{31} is the “one-step” merger. Barbara Lynn Stores, for example, is seeking to go private by merging into Lynbar Corp., which owns 44 percent of Barbara Lynn's stock.\textsuperscript{32} Lynbar in turn is owned in its entirety by a group of officers and directors of Barbara Lynn. In accordance with the terms of the proposed merger, as determined by the common directors of Barbara Lynn and Lynbar, Barbara Lynn shareholders, other than

initial book value. Thus Merle Norman's going private effort, in which stock with an initial book value of about $6 was repurchased for $13, had a depressant effect on the untendered shares' book value. Merle Norman Circular, supra note 11, at 8.

28. Along with these advantages come certain ancillary benefits, including, of course, the savings in SEC registration fees discussed above, freedom from the threat of subsequent takeover attempts (a small benefit in most cases, since insiders usually own an outright majority of the stock), and the increased managerial flexibility that comes with the more informal manner in which privately held companies can be run. These benefits alone, however, could hardly justify the huge expenditures involved in going private.

29. See pp. 922-24 infra.


Lynbar, will receive cash, and Lynbar, as the surviving corporation, will change its name to Barbara Lynn Stores. Under Delaware law, a merger must be approved for each of the merging corporations by a majority of that corporation’s voting stock, but since Lynbar controls 44 percent of Barbara Lynn’s stock, approval is practically a foregone conclusion.

More common in going private efforts than a simple merger is a two-step method beginning with a tender offer by a corporation to its public shareholders, followed by a mop-up of any remaining publicly held shares. Tender offers, of course, require no approval by shareholders as a group. Instead, their success is dependent upon the decision of individual shareholders, and to overcome shareholder inertia companies have regularly fixed the tender price above, and sometimes as much as double, that obtainable in the market immediately before the tender offer was announced.

Such a tender offer by itself will rarely be entirely successful. Even if the offer made by the company were to prove irresistible to any rational shareholder, every corporation has its share of irrational investors who would never willingly abandon their investment, as well as a certain number of shareholders of record who have apparently disappeared, leaving no forwarding address. Should a tender offer prove largely but not sufficiently successful, a management eager to revert to a wholly private status has two options available. If the remaining public shareholders all have small holdings, the company can use a reverse stock split, issuing one new share, for example, in exchange for every 500 old ones. This results in all shareholders with less than 500 shares, or multiples thereof, holding a fractional share of stock. Because a corporation can usually unilaterally buy out frac-

33. One firm, however, Clinton E. Frank, did call a shareholders’ meeting to approve its tender offer, Pacey, supra note 5, at 3.
34. See, e.g., the Offer by Nardis of Dallas, Pacey, supra note 5, at 3; Merle Norman Circular, supra note 11, at 1, 11.

Tender offers have usually been for cash, but Wells, Rich, for one, has offered to pay public shareholders $3 in cash and an $8 principal amount subordinate debenture with 10 percent return for each share tendered. Wells, Rich Prospectus, supra note 6, at 1. In commenting on this offer, one observer wrote that “what the company is proposing, in essence, is that shareholders lend it the money to help buy back the stock.” Abelson, Up and Down Wall St., BARRON’S, Sept. 16, 1974, at 21.

Other companies have turned to more traditional sources for the money to effect tender offers, such as cash reserves, banks (Federated Circular, supra note 11, at 9) and, of course, the inside shareholders. Apparently, however, it is generally difficult to use borrowed funds to go private, because of Regulations T and U of the Federal Reserve Board, Special Report, supra note 5, at 4.

It should be remembered that most states restrict share repurchase to an amount smaller than a corporation’s surplus account (see, e.g. DEL. CODE ANN. tit. 8, § 160 (Supp. 1970)). In order to create that surplus account, Wells, Rich for example, merged a wholly owned subsidiary back into itself. Wells, Rich Prospectus, supra note 6, at 5.
tional shares, and even in some states do so in disregard of the impairment of capital rules. reverse stock splits can be an effective means of removing any remaining minority interests following a going private tender offer.

A second mop-up technique following a largely successful tender offer is for the majority shareholders to “freeze out” the remaining public shareholders through a merger. If the tender offer has left a substantial minority, then the merger would follow the same pattern as that outlined above in connection with Barbara Lynn Stores. If, however, as a result of the company’s tender offer the inside shareholders control almost all of the outstanding stock, then they can take advantage of the short-form merger statutes in effect in many states. Short-form mergers also proceed by the inside shareholders’ setting up a new corporation as the parent of the one going private and merging the latter into the former, but they do not require shareholder approval, and the right to freeze out the minority is more clearly established than in the case of long-form mergers.

II. Going Private: Problems from a Static View

In a recent speech, SEC Commissioner A.A. Sommer, Jr., lashed out at the development of going private, stating:

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

37. For the use of a reverse split following a tender offer by a third party, see Teschner v. Chicago Title & Trust Co., Civil No. 46159 (Ill. Sept. 27, 1974). See generally Kerr, supra note 5, at 25.
38. “Freeze-out” has been defined:
In its broadest sense, it might be taken to describe any action by those in control of the corporation which results in the termination of a stockholder’s interest in the enterprise. The term has come to imply a purpose to force a liquidation or sale of the stockholder’s shares, not incident to some other wholesome business goal.

39. See, e.g., Del. Code Ann. tit. 8, § 253 (Supp. 1970) (requires that the parent corporation control 90 percent of the subsidiary’s stock); N.Y. Bus. Corp. Law § 905(a) (McKinney 1963) (sets the degree of control at 95 percent).
40. See statutes cited in note 39 supra.
41. See note 82 infra. In addition to merger and tender offers as techniques for going private, a number of less important methods exist. One, open market purchase of stock, would be severely restricted by SEC Proposed Rule 13e-2, SEC Release No. 34-10539, [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,600 (Dec. 6, 1973), from which tender offers for a corporation’s own shares are specifically exempted. Rule 13(e)-2(6)(9). Another, the sale of a corporation’s assets in conjunction with a plan of liquidation, is discussed at pp. 914-15 infra.
42. Sommer, supra note 3, at D-2.
Most financial commentators have reached similar conclusions, and aggrieved minority shareholders have brought suit against many going private efforts, usually alleging violations of federal securities laws as well as a breach by the corporation’s insiders of their fiduciary duties to the public shareholders.

It is unquestionable, however, that share repurchasing by a corporation is intra vires. If commentators believe that going private ought to be held unlawful, they must look beyond the simple act of share repurchasing to find a reason.

Federal securities regulation strikes many as the most immediate avenue of attack. Commissioner Sommer himself stated, “I would hope that the Commission will deal aggressively and firmly with this problem and identify clearly the wrongs which I think are inherent in these practices.” Yet, outside of the promulgation of new rules, federal securities regulation is ill-equipped to reach the problems of substantive fairness raised by going private. It is true that tender offers are directly regulated under the Securities Exchange Act, and that share repurchases generally, like any securities sale, are covered by the antifraud provisions of the Exchange Act. But the antifraud provisions of the securities laws, particularly Rule 10b-5, have been construed to reach only those wrongs which contain at their heart misrepresentation or nondisclosure of material facts, rather than substantive unfairness alone. A tender offer or proxy statement which frankly

43. See generally sources cited in notes 4, 5 & 13 supra.
44. See, e.g., Merle Norman Complaint, supra note 12, at 8; Barbara Lynn Complaint, supra note 12, at 8.
45. Sommer, supra note 3, at D-4, D-5.
46. The SEC has the power under § 13e of the Securities Exchange Act, 15 U.S.C. § 78m(e) (1970), for example, to issue rules concerning corporate share repurchases. The SEC has recently proposed two alternative rules covering going private on which hearings will be held in April 1975. One proposal would require independent appraisal of the value of a corporation’s stock, while the other would simply require the demonstration of a valid corporate purpose. SEC Securities Act Release No. 5567 (Feb. 6, 1975).
47. See, e.g., Rule 10b-13, 17 C.F.R. § 240.10b-13 (1974) (prohibits the purchase by a tender offeror of the stock for which he has made his offer at any terms other than those contained in the tender offer; and § 14(e) of the Exchange Act, 15 U.S.C. § 78n(e) (1970), which prohibits fraud and misrepresentations in connection with tender offers). On the regulation of tender offers generally, see E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 64-152 (1973).
49. 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.... In the context of such transactions, if federal
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discloses any wrongs being done minority shareholders avoids a cause of action under present securities law, yet does not protect minority shareholders from the wrongs disclosed.

Two recent cases involving going private efforts illumine the limitations of federal securities regulation. In *Broder v. Dane*, the court required that a corporation attempting to go private simply amend its offering circular to reveal material facts about the value which insiders had attached to the stock when trading among themselves, but the court did not consider the substantive fairness of the offer. In *Kaufman v. Lawrence*, which involved the going private efforts of Wells, Rich, the court found no material misrepresentation or omission and denied the requested relief. It disavowed any policing of substantive fairness: "Whether the offer is fair or unfair or a good or a bad transaction . . . does not raise a federal question."

Yet, even if federal securities regulation cannot, in its present form, reach the problems of fairness raised by going private, traditional doctrines of substantive corporate law can.

A. Going Private and the Fiduciary Obligations of Insiders

Going private will raise significant issues under corporate common law to the extent that insiders can use corporate mechanisms unilaterally to slice the corporate pie into portions which satisfy their

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.


52. Id. at 97,082. The court went on: While Sections 10(b) and 14(e) must be read flexibly, and not technically or restrictively, . . . there 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.

Id. (emphasis added) [citations omitted]. But see Bryan v. Brock & Blevins Co., 343 F. Supp. 1062 (N.D. Ga. 1972); (Rule 10b-5 prohibits any manipulative act which would violate majority stockholders' fiduciary duty to the minority); Note, *Recent Developments in the Law of Corporate Freeze-Outs*, 14 B.C. Ind. & Com. L. Rev. 1252 (1975). Bryan, however, was affirmed on state law grounds only, the Court of Appeals expressly "pretermitting" the issue of the applicability of Rule 10b-5. Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir.), cert. denied, 95 S. Ct. 77 (1974).
appetite alone. Thus, insiders directing a going private effort through a one-step merger usually have enough control both to propose the merger terms and to assure shareholder approval. The use of mop-up techniques following a partially successful tender offer creates almost identical problems, because again insiders can both dictate the terms of a freeze-out and assure its acceptance by the necessary majority.

This power of coercion will often conflict with insiders' fiduciary duties to public shareholders. An insider's fiduciary duty prevents him from exercising corporate powers, no matter how absolute on the surface they are, if the effect is simply to enrich himself at the expense of the minority. Thus, in the well-known case of Condec Corp. v. Lunkenheimer Co., a Delaware court held that stock issued as part of a program which had for its primary purpose the defeat of a takeover bid by another corporation and the perpetuation of management's control, was cancellable as a breach of defendant management's fiduciary obligations to minority shareholders, even though the program complied with the letter of Delaware law. Similarly, in two cases which can be viewed as primitive efforts to go private, Lebold v. Inland Steel Co. and Zahn v. Transamerica Corp., insiders were found liable for having used dissolution proceedings solely for the purpose of eliminating minority shareholders from the profits to be made, in the former case, from the continuation of a going concern.

53. [The majority shareholder] cannot violate rules of fair play by doing indirectly what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis.

Pepper v. Litton, 308 U.S. 295, 311 (1939) (emphasis added). See generally Southern Pac. Co. v. Bogert, 250 U.S. 483, 487-88 (1919) ("the majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers and directors"); Mansfield Hardwood Lumber Co. v. Johnson, 263 F.2d 748 (5th Cir.) (petition for rehearing denied, 268 F.2d 317 (5th Cir.) cert. denied, 361 U.S. 885 (1959); Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947); H. Henn, CORPORATIONS 319-21, 457-82 (2d ed. 1970). Apparently, Illinois is a principal exception. Note, supra note 52, at 1272 n.128.

54. 125 F.2d 369 (7th Cir. 1941), modified on denial of rehearing, 136 F.2d 876 (7th Cir.), cert. denied, 320 U.S. 787 (1943). For cases similar to Lebold see Allaun v. Consolidated Oil Co., 16 Del. Ch. 318, 147 A. 237 (Ch. 1929) (dictum); Theis v. Spokane Falls Gaslight Co., 34 Wash. 23, 74 P. 1004 (1904); Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 123 N.E. 148 (1919). See Vorenberg, supra note 38, at 1194; Note, supra note 52, at 1254.


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and in the latter, from the liquidation of an undervalued asset.\(^{59}\)

In all these cases, courts have found a variety of corporate acts, regular in form, to constitute a violation of insiders' fiduciary duties to their minority shareholders when the act in question enriches insiders or is otherwise unfair to the minority, and when no valid corporate purpose for the act can be shown.

This same principle is presumably applicable to going private transactions. However, although share repurchases in general must presumably meet this test,\(^{60}\) courts have been surprisingly willing to find a valid corporate purpose when a voluntary sale to the corporation was involved.\(^{61}\) Courts might well extend this indulgence to going private transactions if they believe that public shareholders have voluntarily surrendered their shares. Conversely, if courts believe that public shareholders have been forcibly removed from equity participation in a corporation, they can be expected to scrutinize a going private transaction closely to test the validity of the corporation's purpose in removing them.

We must therefore examine two related issues: the degree of coercion present in going private transactions and the extent to which a valid corporate purpose can be demonstrated. Tender offers—viewed by themselves and without the prospect of a subsequent mop-up—\(^{62}\)

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59. Leaf tobacco worth on the market some 300 percent more than book value. 162 F.2d at 39.

Though primitive, the technique of using otherwise valid corporate transactions to seize the liquidation value of a corporation for its insiders, held unlawful in Zahn, is apparently not yet dead—or so the Federated Development Company's offering circular for its going private tender offer would seem to imply.

Federated, a New York business trust with large real estate investments, is in the process of liquidating its real estate properties. Federated Circular, supra note 11, at 9-10. At the time of its tender offer, for $5.00 net per share, the company's tangible book value was $14.62 per share. Id. at 6. Additionally, a recent preliminary valuation analysis by an independent appraiser indicated that the company was carrying some property at too low a figure on its books, and that book value would be increased by the new valuation by some $3.00 per share. Id. at 10. Moreover, a completely successful tender offer would increase tangible book value still another $6.50, bringing the total tangible book value to some $24 per share. Id. at 6.

In the fall of 1973, Federated was the target of a tender offer by SMR Holding Corp., which obtained approximately 58 percent of Federated's common stock. At that time, Federated intended to adopt a Plan of Complete Liquidation, but was blocked from doing so by SMR. Id. at 8. Following the going private tender offer, however, Federated will apparently "once again consider the advisability of a partial or complete liquidation," and "SMR (following a successful tender offer, the sole stockholder) has indicated to the Company that if such a proposal were to be made... it would... consider the matter anew." Id. Were such a plan adopted, SMR would presumably receive something close to the revised tangible book value of the company ($24 per share)—as contrasted with the public shareholders, who would have received $5 for each of their shares.

60. See Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405 (Sup. Ct. 1963); Potter v. Sanitary Co. of Am., 22 Del. Ch. 110, 194 A. 87 (Ch. 1937).


62. The first stage of the two-step acquisition—the tender offer—would hardly be worth discussing if it were no more than a necessary first step in a two-step acquisition. However, although the possibility of a subsequent mop-up is mentioned in most of the
are the most likely of common going private techniques to be categorized as voluntary. But their claim to such a categorization is far from automatic; we will therefore examine them first, below. In both one-step mergers and the mop-up stage of two-step acquisitions, insiders clearly have coercive power both to set the terms under which public shareholders are bought out and to assure their acceptance. Because of this common characteristic, we will then examine the one-step merger and the mop-up stage of two-step acquisitions together under the general rubric of freeze-out devices. This leaves the issue of corporate purpose. Because it is common to both tender offers and freeze-outs, a discussion of that issue will be postponed until after an examination of the coercive aspects of those two techniques.

B. Tender Offers and the Destruction of Public Markets

Commissioner Sommer, in his recent speech attacking going private efforts in general,\(^6\) singled out tender offers as devices which, though apparently free from coercive qualities, in fact offered no meaningful choice to minority shareholders. He reasoned that by refusing to sell his stock a shareholder would likely find “the liquidity of his investment—the ability to sell readily at a price reasonably proximate to the last sale—reduced, perhaps completely destroyed.”\(^0\) Similarly, shareholders attacking Merle Norman’s going private tender offer alleged that the effect of such an offer was unilaterally to destroy the existing public market in Merle Norman securities, which destruction was claimed to be a breach of defendant’s fiduciary duties.\(^5\)

Commissioner Sommer and these dissident shareholders were unquestionably correct in claiming that a tender offer, if successful, will result in the complete disappearance of a market in which shares can be disposed.\(^6\) Even a partially successful repurchase program, while

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\(^6\) The Merle Norman Circular itself admits that:
If a significant number of shares are purchased pursuant to this Offer, it is unlikely that any meaningful trading market will exist with regard to the remaining publicly held Shares.

Merle Norman Circular, supra note 11, at 9.
not wholly eliminating trading in the company's securities, can have an adverse influence on market prices. By reducing a stock's "float,"\(^7\) such a program can enable a company to effect a de-listing from the national exchange on which its shares are traded.\(^8\) Although the outstanding public stock probably could be traded on the over-the-counter markets,\(^9\) and its book value increased by such a repurchase program, most analysts believe that a stock with a small float and no listing on a national exchange will have a more volatile price and command generally a lower price/earnings ratio than it did before de-listing.\(^7\) For these reasons, shareholders are usually advised by their stockbrokers to accept a tender offer made by a company going private,\(^7\) and therefore even a "voluntary" tender offer carries with it coercive elements. Specifically, a shareholder refusing to sell may find himself with stock value at still less by the market than it was before the tender offer, if the market values it at all.

Courts have, on several occasions, taken notice of the importance to a stockholder of a public market in his securities.\(^7\) In United Funds v. Carter Products, Inc.,\(^7\) a court held that a prospectus issued by the defendant corporation upon the public offer of its securities, containing the usual representation that it would endeavor to obtain listing for its stock on the New York Stock Exchange, carried with it an implied promise under § 90 of the Restatement (Second) of Contracts that the corporation

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\(^7\) Id. See note 7 supra.

\(^8\) See Pacey, supra note 5, at 3: "So Security Plastics may be on its way to private ownership. At any rate, Amex delisting is certain, but management is 'not upset' at this."

The New York Stock Exchange's standards for de-listing are summarized at note 7, supra.

\(^9\) There is a large difference, however, between the market liquidity of shares traded on the O-T-C market on an occasional and haphazard basis, and that of the same stock traded on the O-T-C market when a major brokerage house has taken on the role of market maker. See p. 918 infra.

\(^1\) Merle Norman Circular, supra note 11, at 9; Hershman, supra note 5, at 38.

\(^2\) In a securities law context, see Sonesta Int'l Hotels Corp. v. Wallington Associates, 483 F.2d 247, 253-54, (2d Cir. 1973) (duty to disclose in tender offer prospectus potential adverse effects of offer on public market in stock); Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 81 Cal. Rptr. 592, 460 P.2d 464 (1969). In Ahmanson the Supreme Court of California held that the majority shareholders of a privately held savings and loan association violated their fiduciary duties to the minority by forming a holding company with their portion of the association stock and then creating a public market for the securities of that holding company, which market precluded the possibility of developing a market in the savings and loan association's shares:

[D]efendants chose a course of action in which they used their control of the Association to obtain an advantage not made available to all stockholders. They did so without regard to the resulting detriment to the minority stockholders and in the absence of any compelling business purpose.

1 Cal. 3d at 114, 81 Cal. Rptr. at 604, 460 P.2d at 476.

The corporation here violated that implied promise, on which minority shareholders had relied in purchasing their stock, because the corporate action—the declaration of a stock dividend in nonvoting rather than voting stock—had been undertaken for the sole purpose of causing de-listing and thereby perpetuating the control of the company's majority shareholder. The court placed its holding on a second ground as well: The majority shareholder, who had arranged for the issuance of nonvoting common, had violated his fiduciary duty to the minority, again because the issuance of nonvoting shares would destroy the public market in the corporation's securities for his own personal gain, while serving no valid corporate purpose.

These two grounds of the Carter Products holding have been applied in analyzing going private transactions. An attempt to go private, the argument runs, by definition threatens the public market in a corporation's securities. To a shareholder deciding whether to sell or hold his stock in an ostensibly voluntary tender offer, that threat can act as a coercive factor, limiting his apparent freedom of choice and effectively requiring him to sell.

Whether shareholders actually feel this somewhat subtle threat to their stock's public market is uncertain. Nonetheless, to the extent the argument is correct and going private tender offers do contain an element of coercion perceptible to investors, any alleged coercion can still be reduced to a minimum by corporate action. The corporation, by making suitable financial arrangements, can have the dealer-manager of the tender offer guarantee to make an over-the-counter market for all untendered shares. While a reduced float would probably

74. Id. at 94,283-85. In reaching this conclusion, the court pointed out that "N.Y.S.E. listing is generally regarded as a material advantage for the company and its stockholders." Id.

75. Id. at 94,285-86.

76. Id. at 94,289. Under N.Y.S.E. rules, no corporation with a class of nonvoting common stock will be listed. Id. at 94,284. Apparently the majority shareholder intended to diversify his investments by selling the nonvoting shares he was to receive as his dividend, without diluting his voting control in the company. Id. at 94,289-90.

77. Id. at 94,292-93.

78. See, Sommer, supra note 3, at D-4; Kerr, supra note 5.

79. Wells, Rich, for one, induced its dealer-manager, White, Weld & Co., to do so. Wells, Rich Prospectus, supra note 6, at 16. At the trial, an officer of White, Weld testified that a market could be made with as few as 50,000 shares outstanding. Kaufman v. Lawrence, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,903 at 97,091 (S.D.N.Y. Dec. 5, 1974). Admittedly, such a guarantee would raise the cost of going private to a corporation, thus providing another reason for arguing that going private cannot be justified as a money-saving device. The cost of guaranteeing a continued public market should be as much an inescapable cost of going private as is the cost of SEC registration one of the prices that must be paid when going public.
have some adverse effect on market price, the total amount of coercion exerted on a public shareholder would be greatly reduced were he to know that a prominent brokerage firm had guaranteed to make a market in all untendered stock. With such a guarantee, an investor would not have to fear that he could not sell his stock later should he wish to. His only risk would be a somewhat lower market price as a result of a reduced float—that is, as a result of the offer's persuasiveness to others. Presumably, in the minds of some this lower immediate value would be more than compensated by anticipated future gains, and they would refuse to sell regardless of the impact of a reduced float.80

C. Freeze-outs

If the existence and extent of coercion in tender offers is not immediately apparent, it is surely evident in one-step mergers and the second stage of two-step going private transactions. Whether the technique employed is a traditional long-form merger, a statutory parent-subsidiary (short-form or freezer-out merger)81 or a reverse stock split, the effect is the same: Insiders both determine what will be given public shareholders and provide any necessary shareholder ratification of the plan. Moreover, all three techniques have received explicit judicial blessing for use in the freezing out of minority interests from a going concern.82

Yet it would be wrong to conclude that freeze-out devices are no more than a judicially approved form of absolute majority tyranny.

Most corporations going private, however, have not made the effort which Wells, Rich did to guarantee a public market. The offering circular for Cornwall Equities, Ltd's (formerly Franklin Stores Corp.) tender offer, for example, states that “the company has made no arrangement to provide for an over the counter market in the company's stock.” Abelson, Up & Down Wall Street, BARRON'S, Dec. 2, 1974, at 39-40.

The effectiveness of a guarantee to make a public market in removing from shareholders' minds a fear of coercion is perhaps indicated by the response to the Wells, Rich exchange offer, in which such a guarantee was made. The exchange offer, despite proffering to public shareholders a cash and debenture package with a market value approximately 70 percent higher than the stock’s pre-announcement price, concluded with 43 percent of the company's stock still in the hands of the public. Wall St. J., Jan. 7, 1975, at 18, col. 3.

80. The effectiveness of a guarantee to make a public market in removing from shareholders' minds a fear of coercion is perhaps indicated by the response to the Wells, Rich exchange offer, in which such a guarantee was made. The exchange offer, despite proffering to public shareholders a cash and debenture package with a market value approximately 70 percent higher than the stock’s pre-announcement price, concluded with 43 percent of the company's stock still in the hands of the public. Wall St. J., Jan. 7, 1975, at 18, col. 3.
They frequently serve a useful policy goal: "to provide needed [corporate] flexibility and to remove what was [at common law] a power of veto held by a dissenting minority." Even their leading critic, Professor Vorenberg, concedes that in some circumstances freeze-out devices can serve a valid corporate purpose. On the other hand, it can be argued that the power to freeze out, like the statutory power to dissolve a corporation through majority vote, is not absolute, but may be exercised only for a valid corporate purpose and in the absence of fraud or overreaching. Vorenberg has convincingly demonstrated that many cases apparently blessing freeze-outs without qualification do, in fact, involve the use of a freeze-out to effect a valid corporate purpose, and concludes that corporate freeze-outs should be limited to situations in which such a corporate purpose can be demonstrated.

Admittedly, most recent Delaware cases suggest that the courts of that jurisdiction have overcome the hostility with which Vorenberg claims courts view freeze-outs, and would apparently have minorities settle for appraisal rights in nearly every situation, but in at least one case a Delaware Court has held that a short-form merger, lawful in form, cannot be used as a scheme to reach unlawful ends.

In a recent case decided under Georgia law, Bryan v. Brock & Blevins Co., the Fifth Circuit held that the power to effect a freeze-out merger is in fact qualified by a requirement of valid business purpose, in the absence of which the merger will be enjoined as a breach of the majority shareholders' fiduciary duties to the minority. In affirming the district court on the issue of substantive corporate law, the court wrote that:

Where a corporation is unable, because of well recognized contract law, to eliminate a minority stockholder by simply adopting a by-law or voting to purchase his stock, its majority stockholders

83. Teschner v. Chicago Title & Trust Co., Civil No. 46159 (Ill. Sept. 27, 1974). See Vorenberg, supra note 38, at 1198.
84. Vorenberg, supra note 38, at 1198, 1204.
85. Thus the freeze-out merger approved in Matteson v. Ziebarth, 40 Wash. 2d 286, 242 P.2d 1025 (1952), according to Vorenberg, was not the unilateral appropriation of a going concern by a majority, but instead served a useful business goal in permitting an advantageous sale of this financially distressed corporation to be consummated over the attempted veto of an obstinate minority shareholder. Vorenberg, supra note 38, at 1196-98.
86. Vorenberg, supra note 38, at 1204.
87. Id. at 1194. See Stauffer v. Standard Brands, Inc., 41 Del. Ch. 7, 9, 187 A.2d 78, 80 (Sup. Ct. 1962); David J. Greene & Co. v. Schenley Industries, Inc., 281 A.2d 30, 36 (Del. Ch. 1971). Presumably, however, appraisal would not be a reasonable remedy were more than present value at stake. See pp. 924-29 infra.
89. Id.
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cannot accomplish the same purpose by setting up a second corporation wholly owned by them whose sole purpose is to enable it to take advantage of the merger statutes which, when utilized by two existing corporations, may, as a part of the merger procedure result in the elimination of a dissenter.\footnote{91}

The court cited only two other cases in its opinion: \textit{Lebold v. Inland Steel Co.}\footnote{92} and \textit{Pepper v. Litton}.\footnote{93} Although the court simply described its holding as based on general principles of equity and corporate law,\footnote{94} the cases cited drive home the point that \textit{Bryan} in fact held that the use by a majority of a merger statute for no valid corporate purpose,\footnote{95} and with the effect of freezing out the minority, is a breach of the majority's fiduciary duty to the minority.

\textit{Bryan} is particularly important in a discussion of going private because it, unlike most cases analyzing freeze-outs, involves an attempt by one segment of a corporation's equity ownership to remove another from a going concern, rather than the acquisition of one company by another.\footnote{96} The use of freeze-outs in going private transactions must be analyzed separately from their use as part of traditional take-over attempts and structural reorganizations. As Vorenberg points out,\footnote{97} a parent can often avoid business difficulties and generate economies of operation by merging a subsidiary into it, and the purchaser of the vast majority of a company's stock, acquired through a tender offer, for example, can gain needed managerial or structural flexibility by forcing out remaining public shareholders. These justifications for the use of freeze-outs do not apply automatically to going private transactions, however, because the same corporate purposes in freezing out shareholders do not exist when there is no operating subsidiary whose activities are being consolidated with those of an active parent. Thus those cases which apparently give unqualified ap-

\footnote{91. 490 F.2d at 569.}
\footnote{92. 125 F.2d 369 (7th Cir. 1941). See note 56, supra.}
\footnote{93. 308 U.S. 295 (1939); see note 53, supra.}
\footnote{94. 490 F.2d at 571.}
\footnote{95. For the importance of corporate purpose to the holding of \textit{Bryan}, see Grimes v. Donaldson, Lufkin & Jenrette, Inc., [Current Binder] CCH Fed. Sec. L. Rep. \textcircled{94772} (N.D. Fla. July 15, 1974) (distinguished \textit{Bryan} primarily because it found a clear business purpose to the freeze-out, \textit{id.} at 96,389).}
\footnote{96. Another exception is Matteson v. Ziebarth, 40 Wash. 2d 286, 242 P.2d 1025 (1952) (approved the use of a freeze-out merger in a situation similar to \textit{Bryan} but where the freeze-out was necessary to insure the economic survival of an ailing corporation). See note 85, supra.}
\footnote{97. Vorenberg, supra note 38, at 1198-99. For a classic example of the troubles caused by a failure to observe corporate niceties in a contract between a parent and a subsidiary, when the latter has a few public shareholders still outstanding, see Levien v. Sinclair Oil Corp., 261 A.2d 911 (Del. Ch. 1969), aff'd in part and rev'd in part, 280 A.2d 717 (Del. Sup. Ct. 1971), on remand, 300 A.2d 28 (Del. Ch. 1972), after trial as to damages, 314 A.2d 216 (Del. Ch. 1973). Final judgment against Sinclair was for over $5,600,000. \textit{Id.} at 223.}

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proval to freeze-out devices deserve critical re-examination before they are considered dispositive of going private cases.88

D. Going Private and Corporate Purpose

If the interpretation of Bryan offered above is correct, and if Bryan is generally followed by other courts,99 then freeze-out mergers used to go private could be enjoined in the absence of a demonstrated valid corporate purpose.100 So, too, tender offers alone, to the extent that they are coercive, would be subject to a similar equitable limitation.101 The use of coercive devices in going private—or, to be more realistic, the availability of going private as a course of corporate action at all (because some coercion will always be present)—will therefore depend on the meaning of the phrase “valid corporate purpose.” It remains to give some content to that phrase, and then measure current going private efforts by it.

Although generalizations here are difficult, two negative ones can be made. First, it is clear that a simple recitation of corporate purpose will not protect a corporate defendant from the holding of such cases as Bryan; for in Bryan itself the defendants unsuccessfully claimed a corporate policy of only allowing active employees to remain as shareholders.102 As one court has put it, in some circumstances where a corporate purpose is claimed for a transaction which enables insiders to preserve control, “it has been held to be a mockery to suggest that the ‘control’ effect of . . . [the transaction] is merely incidental to its primary business objective.”103 Second, as discussed

88. Kerr, supra note 5, is incorrect, however, in maintaining that the distinction is simply between mergers of previously unrelated enterprises and freeze-outs within one company. The distinction is between freeze-outs with a valid corporate purpose and those without. It is true, of course, that mergers between previously unrelated companies can demonstrate that purpose more easily than can freeze-outs in conjunction with going private.

99. It should be remembered that, since most litigation involving going private will have a federal securities law component, those other courts will in all likelihood be federal courts exercising pendent jurisdiction.

100. On the burden of proof involved in such a demonstration, compare Vorenberg, supra note 38, at 1217, with Note, supra note 52.

101. This conclusion is apparently shared by Commissioner Sommer, who, despite the heated rhetoric of much of his speech, finally concluded that:

There are circumstances when business considerations (and I would not include among these avoiding the cost and bother of SEC compliance and shareholder servicing) may be sufficiently compelling to justify visiting upon public shareholders diminished liquidity, less protection from the federal securities laws, or even compelling that they give up their investment, but I would suggest that should only be done after the most searching inquiry into the purported purpose and a sensitive balancing of the interests of the shareholders.

Sommer, supra note 3, at D-4.

102. 490 F.2d at 565.

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above, the mere savings of SEC registration costs, if that savings is offered as the corporate purpose, should not generally be considered an adequate corporate justification for going private. An exception, of course, might be a company with extremely small earnings and an ability to go private at minimal cost.

It was suggested above that the most plausible corporate motive which can be attached to going private is a desire to revalue upwards the price at which a company’s securities can be used in various corporate transactions. Yet even this motive alone should not serve to justify the allocation to insiders of the power to slice the corporate pie as they might please. At a first level, insiders abusing this power might seek to cloak their acts in the language of corporate authority, but exercise it solely for their own interests. Because the insiders directing a going private effort stand to make large gains at the expense of minority shareholders by the upward revaluation of a company's shares, and because the use of coercive devices ensures that, while a shareholder’s decision to invest was voluntary, his decision to disinvest is not, a court must make sure that it is the corporation itself, rather than the inside shareholders, that has a valid interest in effecting such a revaluation.

More important, an expectation of corporate profit alone is not enough. Because only those remaining as shareholders after a going private transaction would share in any accretions to corporate wealth that would result, the possibility of “corporate” gain cannot by itself evidence a sufficiently valid corporate purpose to justify the removal of public shareholders. An opportunity for corporate profit as a result of a readjustment in securities values by the elimination of public shareholders would accrue only to those still left as shareholders: the insiders who dictated the terms under which the public shareholders were removed.

Although potential corporate profit cannot justify the allocation to insiders of the power to use coercion, there are nevertheless occasions in which going private should be permitted. Those occasions, admittedly rare, would be times at which a corporation could demonstrate a compelling corporate need to revalue its shares, for example, in or-

104. See pp. 907-08 supra.
105. See pp. 908-09 supra. Another possible motive which could be advanced, less likely to appeal to courts or the SEC, is a desire to escape what management feels are the adverse effects of SEC disclosure requirements. Thus Wells, Rich has argued that, owing to the nature of the advertising industry, it cannot engage in fruitful merger negotiations if it must announce those discussions at an embryonic stage. Wells, Rich Prospectus, supra note 6, at 14.

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order to continue functioning as a viable economic entity, and an inability to achieve the same result through less drastic means.

Wells, Rich, for one, has striven to cast its effort in such a mold, by claiming that it can neither expand through merger nor hold on to key employees through stock options as long as its stock is publicly held and minimally valued.\(^\text{106}\) Apparently creative advertising talent is notoriously fickle, and can only be induced to remain with one agency through a strong stock option program. Whether Wells, Rich has thus demonstrated a compelling corporate need, and whether less drastic alternatives exist, are, of course, questions of fact, but surely one can say that in the absence of even an effort to demonstrate a need to go private—and few companies have made such an effort—the use of coercive devices ought to be enjoined. Interpreting "valid corporate purpose" to require the demonstration of a compelling corporate need is, admittedly, a high standard, but one necessary if insiders are to be permitted the power to coerce public shareholders out of equity participation.\(^\text{107}\)

III. Going Private: Problems from a Dynamic View

Until this point, going private has been examined from a static perspective. Yet going private is largely a response to certain stock market phenomena, which have frequently shifted with time. The possibility of a future bull market, however gloomy the market's present prospects, cannot be forgotten, and the implication of dynamic stock market trends for going private must therefore be considered. The possibility of future bull markets, and with them, probable waves of corporations going public, presents an opportunity for insider profiteering which goes beyond the potential abuse of coercive powers considered so far. This opportunity is best approached by an examination of equitable limitations other than those previously discussed on insiders' power to exclude a minority. For brevity, and because of its importance, Delaware law will be emphasized in the following analysis.\(^\text{108}\)


107. Need, of course, is not an absolute concept. To the extent that coercion is minimal, as in a tender offer in which a subsequent public market in untendered shares is guaranteed, and in which all possibility of future freeze-outs is foreworn, the standard suggested here could be construed generously toward the corporation without doing violence to its logic.

108. Because it is a rare occasion on which the conscience of a Delaware Chancellor plumbs deeper than that of fellow jurists in the remaining states, the objections to going private presented herein should be construed as the minimum of which equity is capable.
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A. Freeze-outs and Self-dealing: The Misappropriation of Corporate Assets

Generally, a Delaware "interested merger"—that is, one between companies with common majority control and common directors—must meet the requirements laid down in *Sterling v. Mayflower Hotel Corp.* Insiders, "[s]ince they stand on both sides of the transaction, . . . bear the burden of establishing its entire fairness, and it must pass the test of careful scrutiny by the courts." Despite the further application of this approach in some important cases, Professor Folk is correct in suggesting that in the future "the Sterling rule will receive only lip service." Folk's conclusion is based on two recent decisions. In the first, *David J. Greene & Co. v. Schenley Industries, Inc.*, the court, confronted with a classic interested merger situation, agreed that the *Sterling* rule was applicable, yet went on to conclude that "the parties are merely in dispute as to value, for which an appraisal should be adequate." The second case cited by Folk, although not a merger transaction, provides a further gloss on *Schenley* by explaining more specifically when the fairness doctrine of *Sterling* will be employed by the courts:

In the application of the intrinsic fairness rule the mere fact that interlocking directors are involved in an intercorporate transaction does not of itself cause the higher burden of proof called for under such rule to shift to the party sought to be charged with accountability. In other words, self-dealing on the part of a dominant fiduciary must first be established in order for the intrinsic fairness rule to be successfully invoked.

110. 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952).
111. 33 Del. Ch. at 298, 93 A.2d at 110.
113. Folk, supra note 109, at 334-35.
114. 281 A.2d 30 (Del. Ch. 1971).
115. Id. at 32.
116. Id. at 33.
117. 282 A.2d 188 (Del. Ch. 1971).
118. Id. at 192. See David J. Greene & Co. v. Schenley Indus. Inc., 281 A.2d 30, 33 (Del. Ch. 1971) (appraisal remedy is exclusive unless "minority stockholders are being deprived of clear rights or otherwise so taken advantage of by those charged with a fiduciary duty towards them as to constitute a form of constructive fraud, or the like"). Constructive fraud is an amorphous concept, with definitions ranging from simple conflict of interest, see, e.g., Seagrave Corp. v. Mount, 212 F.2d 389, 397 (6th Cir. 1954), to "unfairness... of such character... as to impel the conclusion that it emanates from acts of bad faith, or reckless indifference to the rights of others interested," Porges v. Vadisco Sales Corp., 27 Del. Ch. 127, 133, 32 A.2d 148, 151 (Del. Ch. 1943).
If Folk is correct in believing that Delaware courts will require evidence of self-dealing before applying the intrinsic fairness rule to an interested merger, and if a dispute must concern something more than quantifiable value before a remedy other than appraisal will be granted, then, unless these two conditions can be satisfied, freeze-outs in conjunction with going private will be subject only to the constraints of the valid corporate purpose test outlined above. It is the contention of this section that self-dealing can be found in going private transactions, and that the right of appraisal is an inadequate remedy. As a result, an additional equitable limitation to going private should be imposed.

Presumably, the definition of self-dealing which will be employed by Delaware courts in considering interested mergers in the context of going private transactions will be similar to that enunciated by the Delaware Supreme Court in Sinclair Oil Corp. v. Levien. There the court held that, in the context of parentsubsidiary relations,

When applied to a going private transaction, then, self-dealing would mean the appropriation by the inside shareholders of something from the corporation—some corporate asset—"to the exclusion of, and detriment to, the minority stockholders of the subsidiary."

The most frequent examples in the case law of sales or misappropriations of corporate assets involve the sale or purchase of control in a corporation and the seizure by insiders or a parent corporation of a business opportunity presented to a company. But to call going private the acquisition of control by insiders would be to ignore the realities of most such efforts; insiders usually can effect a going private attempt precisely because they have substantial control of their company from the start. Nor does going private usually involve a seizure

119. Appraisal, of course, has long been recognized as a wholly inadequate remedy. See, e.g., Vorenberg, supra note 38. Its use in curbing any abuses in going private is therefore not considered in this Note.
121. Id. at 720.
122. See, e.g., Perlman v. Feldman, 219 F.2d 173 (2d Cir. 1955).
124. For a table of proportionate interests held by insiders in a representative group of companies going private, see Pacey, supra note 5, at 3.
of a corporate business opportunity in the traditional sense, for there is rarely a tangible enterprise or physical asset which will be taken from the corporation by its insiders.\textsuperscript{125}

In recent years, however, corporate assets have been more broadly defined. Confidential information about a corporation's finances, for example, has been treated as a corporate asset.\textsuperscript{126} Moreover, on at least two occasions, courts have held that the threatened destruction of an existing public market in a corporation's securities\textsuperscript{127} or the appropriation of a potential market in such securities\textsuperscript{128} would constitute the seizure by corporate insiders of a corporate asset. In the latter case, \textit{Jones v. Ahmanson},\textsuperscript{129} the court wrote:

The remaining stockholders would thus be deprived of the opportunity to realize a profit from those intangible characteristics that attach to publicly marketed stock and enhance its value above book value. Receipt of an appraised value reflecting book value and earnings alone could not compensate the minority shareholders for the loss of the potential.\textsuperscript{130}

It is perhaps inconceivable to most insiders that they would ever wish to go public again, but that conviction is probably no more than a reflection of the times. If the same companies now going private go public again during another bull market, however many years in the future that might be, they will effect a boost in the value of their shareholders' holdings similar to that enjoyed in the bull market of the 1960's, but this time the minority holders frozen out in the bear market of 1974 will not be among the shareholders reaping those benefits.\textsuperscript{131}

In a fashion similar to that of the insiders in \textit{Jones}, then, insiders taking a corporation private are appropriating a real, but indeterminate, corporate asset to the exclusion and detriment of minority shareholders: the profit to be made by taking the same company

\textsuperscript{125} See, e.g., Guth v. Loft, 23 Del. Ch. 255, 5 A.2d 503 (Ch. 1939) (insider acquisition of shares of Pepsi-Cola Co.; opportunity arose through corporate contacts).
\textsuperscript{129} \textit{Jones v. H.F. Ahmanson & Co.}, 1 Cal. 3d 93, 81 Cal. Rptr. 592, 460 P.2d 464 (1969) (discussed at note 83A, supra).
\textsuperscript{130} Id.
\textsuperscript{131} While it is true that the tender or freeze-out price offered to minority shareholders by corporations now going private is generally above that presently obtainable in the market, the price is still usually a fraction of the original public offering price. See Pacey, supra note 5, at 3 (chart).
public again a few years in the future.\textsuperscript{132} Insiders should thus be viewed as engaging in self-dealing under the \textit{Levien} definition,\textsuperscript{133} and therefore the use of freeze-out mergers must pass \textit{Sterling}'s intrinsic fairness test.\textsuperscript{134}

Additionally, because the benefits of going public in the future are real, but its specific value is unmeasurable at present, more than a dispute as to quantifiable valuation is involved, and appraisal would therefore be an inadequate remedy. Courts should therefore seriously consider enjoining from the start any freeze-out merger that appropriates for insiders alone the potential profits to be made by future public offerings. There are devices, however, to be discussed in section C below, which corporations could employ in future going private transactions to avoid or limit this misappropriation.

\textbf{B. Tender Offers}

Tender offers, as seen above, present subtler problems than do freeze-out mergers. They can, for example, be coercive, but the degree of that coercive quality will depend on the circumstances in which they are used. Tender offers used in conjunction with the threat of subsequent freeze-out devices have little of the free choice element left to them.\textsuperscript{135} In fact, the only real choice remaining to the minority shareholder is one of time: Does he prefer his check from the corporation now, or sometime in the future, following a freeze-out merger and a possible appeal to his appraisal rights? In such a context, going private tender offers have the same coercive qualities as do freeze-out mergers themselves, and could be enjoined as merely the first stage in a bifurcated freeze-out process which misappropriates to insiders a corporate asset.

If, however, case law or representations in a tender offer's prospectus make clear that freeze-out devices could not or would not be employed as part of a corporation's efforts to go private, then judicial handling of tender offers becomes more complex. No court will be eager to take from minority shareholders confronted with a bleak future for their investments over the next few years an opportunity to

\textsuperscript{132} In this sense, then, corporations going private are correct in stating that share repurchase is a "good investment." \textit{Id.} at 3. The attractiveness of the investment, however, does not lie in the possibility of a simple sale at some later point—for after deregistration, such sales would be greatly restricted—but in the making of a new public offering. Unconsciously, then, corporate insiders touting going private as a canny investment for their corporation must be looking ahead to some future public offering.

\textsuperscript{133} \textit{See p. 926 supra.}
\textsuperscript{134} \textit{See p. 925 supra.}
\textsuperscript{135} \textit{See note 62 supra.}
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sell out, should they desire to, at a price considerably better than that obtainable in the market place.

A tender offer, then, stripped of the possibility of any subsequent freeze-out, loses much—but not all—of its coercive quality, and possibly confers a benefit on minority shareholders. It nonetheless is as susceptible as is a freeze-out merger to the theory outlined above, that inside shareholders are appropriating a corporate asset, of real but indeterminate value, in their ability to profit in a later public offering, at the expense of minority shareholders. None of the tender offers considered in this Note has attempted to fix a value for this corporate asset, much less pay the minority for it—nor could any of them do so, because this asset is by its nature of an indeterminate present value. Simply because some portion of the minority is willing, today, to accept that potential loss in order to salvage something of its investment does not mean that a court should be blind to the misappropriation of a corporate asset even a voluntary tender offer would entail—especially when, as will be seen below, that misappropriation can be curbed without seriously restricting the availability of going private to corporations evidencing a valid corporate purpose.

C. Warrants

Neither freeze-outs nor tender offers need have the effect of misappropriating for corporate insiders a real but intangible corporate asset—the ability to go public in the future—should insiders repudiate the benefits of any self-dealing. All that would be required would be for a corporation going private to offer its minority shareholders warrants in addition to cash for their present holdings. These warrants would enable their owner to repurchase his stock at the price for which he sold out, in the event that the corporation should choose

136. Remaining, of course, is the relatively small coercive nature of the reduced float of the stock's public market—assuming, of course, that a public market in untendered shares is guaranteed.

137. A warrant is “a contract entitling the owner to purchase (at a prescribed price or prices for a fixed period) a security, generally the residual common stock, of the enterprise.” V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE 248 (1972). Warrants are securities under the express language of § 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) (1970), and can be traded, usually over the counter, like any other security. A more difficult question is whether such warrants would have to be registered. Registration is not necessary unless the warrant is “offered or disposed of for value.” R. JENNINGS & H. MARSH, SECURITIES REGULATION 472 (3rd ed. 1972). Whether such a distribution to public shareholders in a going private transaction would be “for value” is unclear.

Warrants are rarely issued in the ordinary course of corporate finance except in conjunction with senior securities. V. BRUDNEY & M. CHIRELSTEIN, supra. They are often used in corporate reorganizations, however, where they serve a purpose similar to the one they would serve if employed in going private transactions; they enable stockholders who would otherwise be frozen out completely to continue to have a beneficial interest in long term future growth of the enterprise. H. GUTHMANN & H. DOUGALL, supra note 15, at 653-55.
to go public again at some point in the future. The warrants need not be valid indefinitely, but should have a reasonable life span: Ten years would seem a satisfactory compromise figure.

The effect of these warrants, of course, would be to remove from corporate insiders the potential profits to be made by a continued series of public offerings followed by going private transactions, and to redistribute that profit among all those removed, whether voluntarily or by force, from equity participation in the corporation during a major bear market. If corporate insiders are sincere in their protestations that they will never again offer their securities to the public, the issuance of warrants should be of little consequence, and an excellent demonstration of good faith. If, on the other hand, the tune of these insiders should change with the growth of a new bull market, then those warrants will have served a useful purpose in preventing the abuse of one segment of a company’s stockholders by the other through the medium of a bear market. Courts, no longer confronted with the possibility of the misappropriation of a corporate asset, could then concentrate instead on the static problems, discussed above, of fiduciary obligations and corporate purpose.

Conclusion

Born of the bear market of 1974, going private is a technique which seeks to utilize market condition to eliminate public shareholders at an advantageous price and return a company to a privately held status. From a static perspective, the advantages to a corporation of reverting to private ownership are not clear, while the advantages to the company’s controlling shareholders are obvious. This combination creates a serious risk that going private transactions will be used ostensibly for a corporation’s benefit, but in reality for insider profit. Much opportunity thus exists for insiders to use corporate mechanisms to take advantage of public shareholders through going private efforts, and courts should therefore examine going private attempts closely for signs of failure by corporate insiders to maintain their fiduciary obligations to the minority. Because going private does enrich insiders, a company seeking to eliminate minority shareholders should not be permitted to employ coercion, absent a valid corporate purpose. Though guaranteeing a market in a corporation’s remaining public securities is one way to minimize the problem in the context of tender offers, it is difficult to conclude that any of the going private efforts or techniques examined here is or can be absolutely free
from coercion. "Valid corporate purpose," in the context of going private, should mean a compelling corporate need to revert to a privately held status in order to function as a viable business entity. To date, few corporations going private could meet such a test, and few have even attempted to do so.

A dynamic view of going private reveals the issue of insider self-dealing through the misappropriation of a corporate asset—the ability to go public, at a profit, when the stock market finally reverses itself. Insiders are correct when they state that going private represents a good investment; that investment value, however, does not derive from the public marketplace, which by definition does not deal in privately held companies, but from the possibility of returning to that marketplace at a figure considerably higher than the value at which the company withdrew. Going public and going private can thus be used together to take advantage of changing market conditions, permitting a company repeatedly to first suck in the public's money, and then squeeze out the public's equity participation. Yet, in contrast to fiduciary issues, the misappropriation of the ability to go public again can be easily removed from going private transactions, through the issuance of warrants, if corporate insiders are willing to do so. To date, however, no corporation has squarely faced this issue.

The very nature of going private raises serious problems under substantive corporate law, which must be resolved before any going private effort can be permitted. Few, perhaps none, of the recent spate of going private transactions have succeeded in resolving, or in many cases even addressing, the problems raised by their action.