Going Private: An Examination of Going Private Transactions Using the Business Purpose Standard

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Expansion and contraction, like all movements affecting nations, institutions, individuals and corporations, creates turbulence and discomfort in varying degrees of intensity, and almost inevitably, dislocations. Those affected, the threatened and the dispossessed, often turn to the courts as a last resort to protect their positions and to attempt to stave off the ultimate change.¹

In the 1970’s one type of corporate change of increasing significance has been the return of public corporations to private status.² This “going private”³ phenomenon has brought an increasing number of minority shareholders to the courts in an attempt to prevent the destruction of their equity interest in corporations.⁴ In spite of the conformity of such transactions with state statutory procedures, a number of state and federal courts⁵ have

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⁴ For a discussion of reasons for mergers and the present trend toward their increased use, see V. Brudney & M. Charlesten, CASES AND MATERIALS ON CORPORATE FINANCE 487-96 (1972).
⁶ See, e.g., Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir.), vacated and remanded for a determination of mootness, 429 U.S. 881 (1976); Lebold v. Inland Steel Co., 125 F.2d 369 (7th Cir. 1941).
expressed a willingness to examine the substance of going private transactions wherein minority shareholders are eliminated.\(^7\) Controversy continues, however, over what protection the eliminated minority shareholder should be granted.\(^8\) Traditionally, the exclusive remedy available to minority shareholders has been appraisal of their stock pursuant to state dissenters' appraisal statutes. Because of the inadequacy of these statutes, some courts have used concepts of fiduciary duty to protect minority interests, granting both injunctive and monetary relief.\(^9\) This fiduciary duty requires the majority shareholders to treat minority shareholders fairly in all corporate transactions. Alleged breaches of this duty have been raised in both state and federal courts. At the state level, minority shareholders have alleged a violation of common law fiduciary obligations when the majority shareholders or the corporation itself had engaged in corporate transactions which resulted in detriment to the minority. At the federal level, minority shareholders have attempted to imply a similar breach of fiduciary duty within section 10(b) and rule 10b-5\(^{10}\) when the corporate transaction had no legitimate corporate purpose. While the Supreme Court has cast doubt on the applicability of the business purpose requirement in the area of federal securities law, in the last four years this business purpose requirement has been used increasingly by state courts as a standard with which to examine going private transactions in light of common law fiduciary obligations.\(^{11}\) This Comment discusses the methods used in going private, federal and state attempts to apply the business purpose test to such transactions, the legitimacy of various proposed business purposes, and the imposition of the burden of proof in challenges to such transactions.


\(^{8}\) Some courts have emphasized a general obligation of loyalty and good faith owed by corporate officers and directors to the corporation; other courts assume that directors' decisions should be overturned only in exceptional cases. Compare Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964) (directors must show good faith in authorizing purchase of shares), with Cumberland Publishing Co. v. Adams, 432 S.W.2d 808 (Ky. 1968) (courts will not interfere with management of majority unless there is actual fraud or such a wasting of corporate property as amounts to fraud).

\(^{9}\) See Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir.), cert. denied, 419 U.S. 844 (1974) (injunctive relief); Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 81 Cal. Rptr. 592 (1969) (monetary relief). In contrast, however, the court in Jutkowitz v. Bourns, Inc., No. CA-000268 (Cal. Super. Ct., L.A. Co., Nov. 19, 1975), fashioned a remedy which satisfied neither party. The court conditioned completion of the merger on the deposit in escrow of stock of the surviving corporation sufficient to cover the demands of those shareholders who desired to retain their interest in the corporation. Thus, the shareholders had the opportunity to retain their corporate interest or to resort to an appraisal of their corporate interest. Comment, The Second Circuit Adopts a Business Purpose Test for Going Private: Marshel v. AFW Fabric Corp. and Green v. Santa Fe Indus., Inc., 64 CALIF. L. REV. 1184, 1203-04 (1976).


I. METHODS OF GOING PRIVATE

Formerly, under most state corporate codes, minority shareholders had such rights as mandatory cumulative voting and required shareholder approval of certain corporate decisions. Since World War II, however, a significant number of states have severely reduced such statutory protection for minority shareholders, enabling controlling shareholders to eliminate minority shareholders with impunity. Such elimination has been accomplished through both voluntary and involuntary means. In an involuntary or compulsory transaction, the public shareholders may be compelled to terminate their equity holdings. This mandatory type of transaction, commonly known as a freeze-out of the public shareholders, includes mergers, sales of assets, and reverse stock splits. In a voluntary transaction, on the other hand, the shareholder is given the choice of “cashing in” his equity interest or remaining with the corporation. These volitional transactions include the cash tender offer or any number of possible exchange offers either for debt or nonvoting equity interests.

The return of a public corporation to private status typically involves the use of both involuntary and voluntary transactions. In most going private transactions the first step involves a control group gaining dominance over the corporation; the second step involves the subsequent elimination of the remaining minority interest. The dominance or voluntary stage is usually accomplished by either an open market purchase of the corporation’s stock by the corporation itself or by the control group, an exchange offer of some form of nonvoting, callable preferred stock or debt for the outstanding voting common stock, or a cash tender offer by the control group or the corporation for the outstanding stock of the corporation. The elimination or

12. See 1 MODEL BUS. CORP. ACT ANN. § 33 (2d ed. 1971). Cumulative voting was originally devised to protect minorities by providing a method of voting which assured minorities representation on the board of directors roughly proportionate to the minority’s size.

13. The Model Business Corporation Act as originally drafted provided that each share of stock carried the right to vote on a proposed plan of merger or consolidation whether or not the stock was entitled to vote under the articles of incorporation. A 1962 amendment eliminated this provision on the ground that shareholders who had waived the right to vote on all other fundamental issues deserved no inalienable right to vote on mergers or consolidations. The 1969 amendment, however, requires that notice be given to a shareholder of record whether or not entitled to vote and that the notice state the purpose of the meeting. 2 MODEL BUS. CORP. ACT ANN. § 73, ¶ 2, Comment (2d ed. 1971).


15. In most jurisdictions the only recourse was the dissenting shareholder’s appraisal rights. See generally Vorenberg, supra note 3.

16. For case examples of different going private techniques, see Moore, supra note 3, at 324-27.

17. A freeze-out describes any action by those in control of the corporation which results in the termination of a stockholder’s interest in the enterprise. See Vorenberg, supra note 3, at 1192; Note, Freezing Out Minority Shareholders, 74 HARV. L. REV. 1630 (1961).

18. See notes 58-65 infra and accompanying text.

19. See notes 38-43 infra and accompanying text.

20. See notes 44-57 infra and accompanying text.

21. See notes 25-36 infra and accompanying text.

22. For a general discussion of methods of going private, see Solomon, supra note 3, at 148-55.
involuntary stage is then accomplished either by a sale of the operating assets by the corporation or by a merger of the acquired corporation with a second corporation wholly owned by the control group, thus resulting in an exchange of the minority's equity interest in the acquired corporation for securities of the acquiring corporation, or cash, or both. Elimination may also be accomplished with a technique known as the reverse stock split followed by a cash payoff of remaining fractional shares.23

A. Voluntary Transactions

If the control group already has sufficient voting power to obtain the necessary shareholder vote for a sale of assets, merger, or reverse stock split, the attainment of dominance is unnecessary. Where this is not the case tender and exchange offers are common techniques for acquiring a significant percentage of the outstanding shares.24 Corporate capital structure and available cash, however, necessarily place limitations on which methods may be used.

Tender and Exchange Offers. A predominant method employed to gain control of a corporation is for the corporation25 to make a tender offer26 to its public shareholders for the purchase of all or substantially all of the outstanding shares.27 The corporation offers to purchase at a specified price, normally using cash or a combination of cash, debentures, and preferred stock28 as consideration.29 The tender offer can usually be accomplished with a minimum amount of interference from dissenting minority shareholders, as a shareholder vote is not required to approve such action and under no state corporate statutes are dissenters' appraisal rights available in such circumstances.30 While a tender offer is considered a voluntary transaction,

25. In many instances the controlling shareholder will begin by purchasing shares in the market and follow by causing the corporation to make a formal tender offer for all or part of the remaining shares. SEC Rule 10b-13, 17 C.F.R. § 240.10b-13 (1977), however, prohibits, subject to certain exceptions, an issuer or other person who has made a tender or exchange offer from purchasing or arranging to purchase any equity security which is the subject of such offer otherwise than pursuant to the offer.
26. A tender offer may be defined as a public offer to purchase shares of stock for cash or cash and other securities. Comment, The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934, 86 HARV. L. REV. 1250, 1251 (1973). This definition has undergone significant expansion under the federal securities laws. Id. at 1260-70.
27. See, e.g., Kaufmann v. Lawrence, 386 F. Supp. 12, 13-15 (S.D.N.Y. 1974); Broder v. Dane, 384 F. Supp. 1312, 1315-16 (S.D.N.Y. 1974). A variation to have an "employee share ownership trust," perhaps newly formed as a vehicle for compensating shareholder-employees and other key employees, make the purchases of the publicly held shares. Such a trust is usually financed by corporate contributions and by loans.
28. Occasionally, redeemable preferred stock may be used, thus permitting the corporation to eliminate the holders by calling in the stock for redemption.
29. The consideration specified usually represents a premium over the current market price of the securities sought. A survey published in 1967 reported the median price offered was 16% over the market price of the desired shares two days before the offer. Hayes & Taussig, Tactics of Cash Takeover Bids, 45 HARV. BUS. REV., Mar.-Apr. 1967, at 135, 140.
30. See 2 MODEL BUS. CORP. ACT ANN. § 80 (2d ed. 1971). The right of appraisal is generally only available in mergers and consolidations. In some states appraisal rights are given
when many shareholders tender their shares the tender offeree is faced with the prospect of reduced liquidity and partial deprivation of the protection of the federal securities laws, thus making the transaction in practical terms resemble an involuntary transaction. Tender offers by issuers have been subject only to limited, indirect federal regulation. The Williams Act, for instance, specifically exempted from some of its provisions offers by issuers for their own securities. The SEC, however, in the wake of the Supreme Court decision in *Santa Fe Industries, Inc. v. Green*, has proposed a rule regulating going private transactions and has introduced a separate proposal on issuer tender and exchange offers.

Since "every corporation has its share of irrational investors who would never willingly abandon their shares," a tender or exchange offer is normally only the first step in a going private transaction. The minority is seldom totally eliminated without the second or involuntary step.

### B. Involuntary Transactions

#### Sales of Assets and Dissolution

Once control is acquired, one method of eliminating the remaining minority interest is for the majority shareholders of the corporation to sell all or part of its business or assets. The sale is for substantial transfers of assets and in a few others for certain amendments to the articles of incorporation. See Vorenberg, *supra* note 3, at 1189.

It has been suggested that the tender offeree faces the prospect that, if many shareholders tender their shares, the market for his stock may be "reduced to glacial activity and the liquidity of the Mojave Desert." Address by A.A. Sommer, Jr., *supra* note 2, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) 80,010, at 84,696.

With the exception of SEC Rule 10b-13, 17 C.F.R. § 240.10b-13 (1977), which prohibits short tendering during any offer, issuer tender offers are regulated only by the existence of antifraud remedies.

The Williams Act had as its primary thrust the traditional protection of investors by requiring full disclosure of the terms, conditions, and financing of the tender offer, as well as the identity and pertinent background information regarding the offeror.


The new proposal will require:

1. that the offer remain open for at least 15 business days after publication;
2. offers to be made to all holders of the class of subject securities except odd lots of fewer than 100 shares;
3. securities deposited could be withdrawn at any time until 10 days after the offer is first published and if they are not accepted for payment, after 40 business days from the date of the original offer;


Early attempts to squeeze-out minority shareholders usually involved a sale of assets. Lebold v. Inland Steel Co., 125 F.2d 369 (7th Cir. 1941), provides an example of such an attempt. A shipping company was dissolved and its assets purchased by a steel company under common control. The minority shareholders brought suit to recover damages claimed to have been incurred by reason of the alleged fraudulent acts of dissolving the shipping company, buying its assets, and appropriating its business. The plaintiff’s theory was that the defendant utilized its dominant position as majority stockholder to force the steamship company out of a prosperous going business, bringing about its dissolution, and taking over its property and business to the detriment of the minority shareholders. The court, applying a fiduciary duty standard, found for the plaintiffs, allowing as damages the difference between what plaintiffs had received from the sale of the physical assets and the value of the stock as stock in a going prosperous concern continuing in business.
usually made to a "shell" corporation owned and organized by the majority shareholders. The old corporation is then liquidated with the minority shareholders receiving cash, stock, or debentures for their equity interest in the old corporation.\(^4\) At common law, in the absence of a provision in the corporate charter so authorizing, the sale of all the assets of a solvent corporation required unanimous shareholder consent.\(^5\) Today, however, almost all states permit corporations to sell their assets without unanimous shareholder approval.\(^6\) The statutory trend has been to reduce the shareholder vote required for approval of such action. Many modern statutes permit a sale upon approval by a simple majority of the shares entitled to vote.\(^7\) While the trend has consistently been to reduce the percentage approval required for a sale, numerous jurisdictions have conferred appraisal rights upon dissenters whenever a corporation sells all or substantially all of the corporate assets.\(^8\)

The Reverse Stock Split. The reverse stock split is a compulsory method of eliminating the minority in going private transactions in jurisdictions that either permit or require a corporation to redeem outstanding fractional shares.\(^9\) The essence of a reverse stock split is the amendment of the corporate statutes of most jurisdictions contain four provisions which can be combined by issuers to freeze out minority shareholders through a reverse stock split and repurchase of fractional shares: (1) a corporation may amend its articles of incorporation to increase or decrease the authorized number of shares, or to reclassify or cancel all or part of its shares; (2) a corporation may issue fractional shares, or the board of directors may in lieu thereof pay in

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39. In the absence of a statute so providing, shareholders in the old corporation cannot be compelled to accept securities in the new corporation in exchange for their shares except when the shares have an established market value making them readily convertible and thus equivalent to cash. F. O'NEAL, supra note 3, § 5.17.

40. See Traer v. Lucas Prospecting Co., 124 Iowa 107, 99 N.W. 290 (1904) (although state law at that time did not contain a statutory provision on sale of all assets, the court held that a prosperous corporation could dispose of all its assets over the objection of a minority shareholder where its charter authorized the sale of all assets); City of St. Louis v. St. Louis Gaslight Co., 70 Mo. 69 (1879) (charter provision allowing directors to sell all corporate assets without unanimous shareholder approval was valid).

41. The unanimous shareholder approval rule was relaxed to permit the directors or majority shareholders of an insolvent corporation to approve the sale of all its assets. Butler v. New Keystone Copper Co., 10 Del. Ch. 371, 93 A. 380 (1915); Skinner v. Smith, 134 N.Y. 240, 31 N.E. 911, 10 N.Y.S. 81 (1892); see Note, Disposition of Corporate Assets, 43 N.C.L. REV. 957, 958 (1965).

42. The reasoning behind this rule was that each shareholder had a contractual right to have the corporation continue during its existence to seek to accomplish the purposes for which it was created. As a disposition of all corporate assets tended to frustrate the achievement of corporate objectives, such a transaction had to be approved by all the shareholders. See Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1921); Note, Privilege of Majority Shareholders to Dissolve the Corporation or to Sell All or Substantially All of Its Assets Over the Protests of the Minority, 94 U. Pa. L. Rev. 412 (1946).

43. Appraisal statutes authorize a shareholder who dissents from certain corporate transactions to demand that the corporation purchase his shares at their appraised value. See generally Latin, Minority and Dissenting Shareholders' Rights in Fundamental Changes, 23 LAW & CONTEMP. PROB. 307 (1958).

44. A reverse stock split occurs when a number of shares are combined to form a smaller number of shares. H. HENN, LAW OF CORPORATIONS § 330, at 673 (2d ed. 1970). For a discussion of reverse stock splits, see F. O'NEAL, supra note 3, § 5.32; Dykstra, The Reverse Stock Split—That Other Means of Going Private, 53 CHI.-KENT L. REV. 1 (1976); LAWSON, Reverse Stock Split: The Fiduciary's Obligations Under State Law, 63 CALIF. L. REV. 1226 (1975). The corporate statutes of most jurisdictions contain four provisions which can be combined by issuers to freeze out minority shareholders through a reverse stock split and repurchase of fractional shares: (1) a corporation may amend its articles of incorporation to increase or decrease the authorized number of shares, or to reclassify or cancel all or part of its shares; (2) a corporation may issue fractional shares, or the board of directors may in lieu thereof pay in
corporate charter to allow for the consolidation of the number of shares authorized and outstanding. While most jurisdictions authorize the issuance of fractional share certificates, many state statutes provide two alternatives to the issuance of fractional shares. One alternative is the issuance of scrip or warrants; the other is the payment of cash in lieu of fractional shares. The reverse stock split has distinct advantages and disadvantages over the other involuntary methods. The advantages include certainty as to the number of remaining shareholders, finality in the elimination of minority shareholders, cost savings, unavailability of dissenters' appraisal rights, and insulation from litigation. The principal disadvantage is that such a transaction requires amendment of the corporate charter. An additional disadvantage is that the reverse stock split requires the preparing and filing of proxy materials.

Occasionally fractional shares are outlawed, either by state statute or by the articles of incorporation. This forces fractional shareholders to purchase cash the fair value of fractional shares, in the same transaction that triggered the fractional share interest; (3) a corporation may purchase or otherwise acquire its own shares for the purpose of eliminating fractional shares that are outstanding and that were not liquidated as part of the triggering transaction; and (4) a corporation may issue scrip in lieu of fractional shares subject to the condition that the shares for which scrip is exchangeable may be sold by the corporation and the proceeds thereof distributed to the holder of scrip. Id. at 1228.

45. See 2 MODEL BUS. CORP. ACT ANN. § 59 (2d ed. 1971) (approval by a majority of outstanding shares entitled to vote and a majority of the outstanding shares of each class entitled to vote); TEX. BUS. CORP. ACT ANN. art. 4.02 (Vernon Supp. 1978) (approval by two-thirds of outstanding shares entitled to vote and two-thirds of shares in each class entitled to vote).

46. Fractional share interests are typically vested with the same substantive rights given to full equity shares for purposes of voting, dividend declarations, and participation in the distribution of assets at dissolution, but these rights are exercisable only in proportion to the fractional interest. See, e.g., 1 MODEL BUS. CORP. ACT ANN. § 24 (2d ed. 1971).

47. While scrip and warrants preserve a shareholder's proprietary interest in the corporation, they confer no substantive shareholder rights. Scrip and warrant holders are generally denied rights in voting, dividends, and liquidation participation unless otherwise provided by the issuing corporation in the articles of incorporation. Id.

48. The alternatives were provided because of the administrative inconvenience of computing dividends and votes on fractional shares. Lawson, supra note 44, at 1229-30.

49. See Dykstra, supra note 44, at 7-13.

50. In a tender or exchange offer, there is usually the need to "mop-up" the lingering minority. Lawson, supra note 44, at 7.

51. Securities to be offered in a merger or consolidation generally must be registered under the Securities Act of 1933 by the terms of SEC Rule 145, 17 C.F.R. § 230.145 (1977), requiring a registration statement. SEC Rule 145(a)(1), 17 C.F.R. § 230.145(a)(1) (1977), specifically excludes a reverse stock split from this requirement. The cost of a tender or exchange offer is normally higher because it usually involves the current market price plus a sweetener. Dykstra, supra note 44, at 8.

52. Dissenters' statutory rights of appraisal generally do not apply to reverse stock splits. Vorenberg, supra note 3, at 1189.

53. There have been few reported cases involving the propriety of reverse stock splits. See, e.g., Teschner v. Chicago Title & Trust Co., 59 Ill. 2d 452, 322 N.E.2d 54 (1974), appeal dismissed, 422 U.S. 1002 (1975); Clark v. Pattern Analysis & Recognition Corp., 87 Misc. 2d 385, 384 N.Y.S.2d 660 (Sup. Ct. 1976). A strong case can be made that preferred shareholders should be entitled to vote separately as a class on the proposal since most state statutes require a separate class vote where there is going to be an increase or decrease in the number of authorized shares of the class. See, e.g., DEL. CODE tit. 8, § 242(c)(2) (1975); TEX. BUS. CORP. ACT ANN. art. 4.03(B)(1) (Vernon Supp. 1978).


other fractional interests to aggregate full shares. If the minority shareholder fails to acquire a full share, however, he is forced to accept cash for his interest in the enterprise, and is thereby eliminated.\(^5\)

**Squeeze-out Mergers.** A squeeze-out merger is another involuntary method of eliminating the minority.\(^5\) This involves the merger of two corporations, one having a controlling interest in the other. For example, corporation \(S\), a subsidiary of corporation \(P\), is merged into corporation \(P\). Corporation \(P\) is usually either the parent of \(S\) or has been created by the controlling shareholders of \(S\) for the sole purpose of squeezing the minority shareholders out of \(S\). In either case, when the merger is consummated the minority shareholders of \(S\) are eliminated by \(P\)'s exchanging the minority shareholders' stock in \(S\) for either cash, debentures, or both.

Two statutory forms of merger can be utilized in eliminating the minority, the long form merger and the short form merger. For the long form merger, approval is required from the board of directors of each corporation and the holders of a majority of a specified portion of each company's shares.\(^5\) As an alternative to the long form merger, most states now have short form merger statutes\(^6\) which permit a parent corporation to merge a ninety or ninety-five percent subsidiary into itself, solely on the approval of the parent's board of directors, and without a shareholder vote at either the parent or subsidiary level.\(^3\) Many state short form merger procedures provide for no prior notice to the minority shareholders.\(^4\) Thus, the shareholder

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\(^5\) There have been two reported cases involving reverse stock splits. See Teschner v. Chicago Title & Trust Co., 59 Ill. 2d 452, 322 N.E.2d 54 (1974), appeal dismissed, 422 U.S. 1002 (1975); Clark v. Pattern Analysis & Recognition Corp., 87 Misc. 2d 385, 384 N.Y.S.2d 600 (Sup. Ct. 1976).


\(^5\) At common law, an equity interest could not be altered, and thus no merger effected without the unanimous consent of all shareholders. See Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1921) (an exception to the general rule was when the corporation was so unprofitable that there was no reasonable prospect of conducting a business without a loss); Kremer v. Public Drug Co., 41 S.D. 365, 170 N.W. 571 (1919) (majority shareholders attempted to sell assets of corporation to new corporation wholly owned by majority shareholders). See also E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 331 (1972); Gibson, *How Fixed Are Class Shareholder Rights?*, 23 LAW & CONTEMP. PROB. 283 (1938).

\(^6\) See MODEL BUS. CORP. ACT ANN. § 75 (2d ed. 1971).


\(^6\) See, e.g., N.Y. BUS. CORP. LAW § 905 (McKinney 1963).

\(^6\) The short form merger originated in New York to remedy a situation which had contributed to the collapse of some utility companies during the depression. To facilitate a simplification of holding and operating company relationships, the New York Legislature enacted the short form merger to circumvent blocking or delaying tactics employed by small but belligerent minority interests. Similar procedures were made available to all corporations and as the effectiveness of the short form merger became apparent, numerous state legislatures adopted short form merger statutes. Comment, supra note 58, at 602. The legislative rationale for the short form merger has been the promotion of operating efficiencies, the prevention of delaying tactics of minority interests, and that both companies benefit from eliminating "the difficulty and expense of insuring that continuing intercompany transactions and allocations of overhead and other shared expense will always be handled on a 'fair' arm's length basis." Id. at 602-03.

\(^6\) See 2 MODEL BUS. CORP. ACT ANN. § 75 (2d ed. 1971).
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is merely entitled to dissent and seek appraisal rights or accept the terms offered in exchange for his equity.\textsuperscript{65}

C. Effect of Going Private on Minority Interests

In contrast to the advantages going private confers upon corporations and majority shareholders, such transactions can be detrimental to minority interests. Hardships to the eliminated minority shareholder include the loss of statutorily created appraisal rights,\textsuperscript{66} the forced recognition of a taxable gain or loss,\textsuperscript{67} loss of the corporation's valuable business prospects,\textsuperscript{68} and a loss of special relationships a minority shareholder might have with the corporation, such as his status as an employee or creditor. Even when dissenters' appraisal rights are available, a shareholder has little to gain by invoking the appraisal statute if his shares are traded on a securities exchange or an over-the-counter market and he is offered consideration in excess of the market price. Should the eliminated minority invoke his appraisal rights, he encounters not only a delay in subsequent payment with no dividend payments during the proceeding, but additionally faces strict procedural requirements at trial and stands to incur substantial litigation costs. The result is usually an award of the market price of his shares, with no consideration for the actual going-concern value of his stock. Since the timing of the going private transaction is within the control of the issuer or majority shareholder, the transaction can be conveniently compared to a private condemnation. The transaction additionally may occur during a period of depressed market prices, causing the minority an unanticipated loss. Depending on the type of transaction involved, prior notice and disclosure may not be required. In individual cases the detrimental effects are unlimited.

In some early cases the courts protected the minority shareholders' interests on the basis of a fiduciary duty owed the minority by the majority.\textsuperscript{69}


\textsuperscript{66} The right to appraisal is generally only given for consolidations and mergers. See 2 Model Bus. Corp. Act Ann. § 81 (2d ed. 1971); Manning, The Shareholder's Appraisal Remedy: An Essay for Frank Coker, 72 Yale L.J. 223, 262-65 (1962); Vorenberg, supra note 3, at 1189.

\textsuperscript{67} In Delaware, for example, when a parent and subsidiary corporation merge, the board is required by statute to pass a resolution stating "[T]he terms and conditions of the merger, including the securities, cash, property, or rights to be issued, paid, delivered or granted by the surviving corporation upon surrender of each share of the subsidiary corporation or corporations not owned by the parent corporation." Del. Code tit. 8, § 253(a) (1975). This effective "cashing in" could create an unexpected gain or loss from the transaction which might adversely affect the shareholder's taxable income.

\textsuperscript{68} It is difficult to compensate the eliminated shareholder for the corporation's improved business prospects. This difficulty arises because at the time of appraisal the evidence of improvement in business prospects is often more intuitive than tangible. Further, appraisers generally rely on conservative valuation formulas. Such valuations fail to reflect the special appeal the company or industry might have in the market, a factor ordinarily considered when the stock is sold through an underwriter. The majority may further complicate the procedure by choosing a time for appraisal when the stock value is most difficult to assess. Vorenberg, supra note 3, at 1202-03. See also Note, Valuation of Dissenters' Stock Under Appraisal Statutes, 79 Harv. L. Rev. 1453 (1966).

\textsuperscript{69} See Theis v. Spokane Falls Gaslight Co., 34 Wash. 23, 74 P. 1004 (1904). The court considered whether the statute in question conferred an absolute right on a two-thirds majority.
Many recent state and federal decisions have attempted to apply this fiduciary duty to minority shareholders in transactions in which majority control was material. These courts have applied the "legitimate business purpose" standard in determining whether the majority shareholders or the directors of the corporation have fulfilled their fiduciary obligations in going private transactions. Both federal and state courts have required the showing of a legitimate business purpose for a corporation to go private. The federal courts attempted to apply the business purpose requirement through section 10(b) and rule 10b-5; the state courts began applying the business purpose requirement under common law fiduciary duty standards.

II. LEGITIMATE BUSINESS PURPOSE: FEDERAL AND STATE LITIGATION INVOLVING GOING PRIVATE TRANSACTIONS

A. Federal Law

The Securities Exchange Commission has consistently been concerned with the going private phenomenon because of its effect upon the public market. Consequently, the Commission proposed alternative rules 13e-3A and 13e-3B in 1974. The first rule would impose requirements of disclosure and fairness on companies or their affiliates that engage in transactions which might result in or be a part of a plan to go private. The second rule would not only require the terms of the transaction to be fair, but also require that a valid business purpose exist for engaging in the transaction.

of a prosperous corporation to dissolve and pay the minority for their interest in cash, when the clear intent was to reorganize and pursue the business with the minority eliminated. The court, in finding no cause for dissolution except elimination of the minority, enjoined the transaction. The court focused on the inequity of allowing the majority to have that kind of power over the minority. See also Lebold v. Inland Steel Co., 125 F.2d 369, 372 (7th Cir.), cert. denied, 316 U.S. 675 (1941), which relied more specifically on fiduciary duty. That case also involved the dissolution of a prosperous corporation. The court held that the freeze-out was unfair despite adherence to legal form. The court was dissatisfied with appraisal as the exclusive economic protection and presented a wide-ranging discussion of equitable principles.

75. See Address by A.A. Sommer, Jr., supra note 2. The SEC views going private more in terms of loss of SEC jurisdiction rather than in terms of elimination of minority shareholders. 4 A. Bromberg, supra note 3, § 4.7, at 400.15. This can be seen from the proposed SEC definitions of going private:
        [A]ny transaction or series of transactions engaged in by an issuer or its affiliate, which would, if successful, permit the issuer to cease filing reports under the Exchange Act . . . .
    or
        [A]ny transaction by an issuer or its affiliate which might directly or indirectly result in the issuer being able to cease filing reports under the Exchange Act or which might result in a significant impairment in the liquidity of the trading market in its equity securities.

With the proposed rules as background, the Second Circuit read a similar business purpose requirement into rule 10b-5 in two 1976 decisions. Marshel v. AFW Fabric Corp. involved a corporation which had gone public in 1968 with public offerings of fifteen dollars a share, increased to twenty dollars a share in 1969. After the stock price dropped to one dollar a share in 1974, the owners of sixty-eight percent of the voting shares decided to return the corporation to private status. This was to have been accomplished by a long form merger of the public corporation with a shell corporation created solely for the purpose of taking the public corporation private. The merger would have eliminated the minority shareholders, thereby reducing the number of shareholders to the point where the corporation could go private. In response to an action brought by the minority shareholders to enjoin the merger, the Second Circuit held that the majority shareholders had breached a fiduciary duty owed to both the corporation and the minority shareholders. The breach consisted of devising a scheme to defraud the minority shareholders, as the proposed merger was without a valid corporate purpose. This use of a fraudulent scheme allowed the court to enjoin the merger under section 10(b) and rule 10b-5, which prohibits any act, practice, or course of business which operates or would operate as a fraud in connection with the purchase or sale of any security.

Shortly thereafter, the Second Circuit decided Green v. Santa Fe Industries, Inc., which again concerned the application of rule 10b-5 to going private transactions. Pursuant to the state short form merger procedure, Kirby, a ninety-five percent subsidiary of Santa Fe, was to be merged with a holding company created solely to return Kirby to private status. In response to the challenge that no valid ground for applying rule 10b-5 had been raised the Second Circuit held that a claim is properly stated under rule among business considerations the goal of “avoiding the cost and bother of SEC compliance and Shareholder servicing.” A.A. Sommer, Jr., supra note 2, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,010, at 84,699. One state court has recently made reference to proposed rule 13e-3[B] in finding that a freeze-out merger had no valid business purpose. A preliminary injunction was granted, with questions raised as to the fairness of the transaction. Berkowitz v. Power Mate Corp., 135 N.J. Super. 36, 342 A.2d 566, 571 (Ch. 1975).


81. The price determined by the controlling shareholders was to be paid out of the corporate treasury at a cost of $1,600,000. The controlling shareholders interest increased from 68% to 100% without any additional investment on their part. The assets, however, decreased by the $1,600,000 paid for the shares. 533 F.2d at 1280 n.4.

82. Section 10b-5 states:
   (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.


84. The court stated:
   When controlling shareholders of a publicly held corporation use corporate funds
10b-5 "when it charges, in connection with a Delaware short form merger statute, that the majority has breached its fiduciary duty to deal fairly with minority shareholders by effecting the merger without any justifiable business purpose." In both *Marshel* and *Sante Fe* the majority shareholders had fully disclosed their intentions to squeeze out the minority shareholders. The Second Circuit recognized a difference between the classical application of rule 10b-5 to cases involving misrepresentation and non-disclosure and the application of rule 10b-5 to cases such as *Sante Fe* involving breach of fiduciary duty. The court, therefore, restricted the Popkin v. Bishop requirement of misrepresentation, non-disclosure allegation to the classical 10b-5 cases. In cases involving breach of fiduciary duty, however, the court adopted a "justifiable business purpose" requirement.

In an effort to resolve the reach and coverage of section 10(b) and rule 10b-5 which had thus developed, the Supreme Court reviewed the Second Circuit's opinion in *Green v. Santa Fe Industries, Inc.* The Court, however, refused to adopt the Second Circuit's justifiable business purpose doctrine. It, instead, held that in an action in which a majority shareholder's alleged breach of fiduciary duty by effecting a short form merger is challenged under section 10(b) or rule 10b-5, the claim must contain an allegation of material misrepresentation or a material failure to disclose; lack of a justifiable business purpose would not suffice to invoke section 10(b) or rule 10b-5. This interpretation limited the application of section 10(b) to situations involving manipulation or deception. While the Court expressed no view as to the SEC's authority to promulgate rules covering going private transactions under other sections of the Act, it eliminated section 10(b) and rule 10b-5 as a weapon for the eliminated shareholder, at least where no material misrepresentation or omission had occurred.

Although there has been much discussion of the business purpose requirement by both the SEC and the federal courts, there does not appear to be a place for the requirement under federal securities law in the near future unless the transaction otherwise involves misrepresentation or nondisclosure of the purpose regarding a going private transaction. The Supreme Court stated it was "reluctant to recognize a cause of action ... to serve what is 'at best a subsidiary purpose' of the federal legislation." 430 U.S. at 478.

Court, however, did indicate that Congress had quite possibly viewed such action as "one traditionally relegated to state law," thus suggesting state forums as the proper place for eliminated minority shareholders to raise such claims.

B. State Law

While some state courts have refused to scrutinize going private transactions beyond testing whether the minority had been treated fairly, other courts have begun to examine these transactions in terms of whether there was a legitimate business purpose for the transaction. The business purpose requirement has been adopted in at least five jurisdictions as a standard for testing whether there has been a breach of the majority shareholders' fiduciary obligation to minority shareholders.92 A majority shareholder's common law fiduciary duty prevents him from exercising corporate powers if the effect is simply to enrich himself at the expense of the minority, regardless of how absolute those powers appear to be.93 Both New York and Delaware stand out because of the frequency of their application of the business purpose test to determine whether this fiduciary duty has been met. In New York the business purpose requirement was adopted in a proceeding brought under New York's blue sky law in which a breach of the fiduciary relationship between controlling and minority shareholders was at issue.94 The business purpose standard has since been applied by New York courts three times.95 In each case the business purpose requirement was applied to test whether there had been a breach of the fiduciary duty owed by the majority shareholders to the minority.96 In application, the business purpose

91. 430 U.S. at 478.
93. In 1939 Justice Douglas set forth the standard of conduct by a fiduciary:
"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."
96. In Tanzer Economic Assocs. Profit Sharing Plan v. Universal Food Specialties, Inc., 87 Misc. 2d 167, 383 N.Y.S.2d 472, 482 (Sup. Ct. 1976), the court explained the rationale for applying a business purpose standard:
What, then, is the business purpose of the merger, and why must it be demonstrated? The why is readily answerable. Meticulous compliance with statutory
standard was considered separately from the issues of fraud, self dealing, and fairness of the price.\footnote{77}

The Delaware courts have also applied the business purpose requirement as a part of the fiduciary duty those in control owe to the minority in the exercise of corporate powers.\footnote{78} In \textit{Singer v. Magnavox Co.}, the Delaware Supreme Court used the business purpose requirement as the first step in examining a possible breach of a fiduciary duty to the minority.\footnote{79} After the court had satisfied itself that a proper business purpose was in fact present, the transaction was then scrutinized under the \textit{Sterling v. Mayflower Hotel Corp.}\footnote{80} rule of "entire fairness." Two Delaware cases since \textit{Singer} have applied the business purpose standard in the same manner.\footnote{101}

\section*{III. LEGITIMATE BUSINESS PURPOSES: A DEFINITION}

While state courts have begun to adopt the business purpose requirement, specificity has been lacking regarding a definition of the standard. The confusion concerning what constitutes a legitimate business purpose is aptly pointed out by Justice Duffy in his majority opinion in \textit{Singer v. Magnavox Co.:}

Any inquiry into the business purpose of a merger immediately leads to such questions as: ‘Whose purpose?’ or ‘Whose business?’ Is it that of

\begin{itemize}
  \item requirements can still be the device for unfair dealing, human ingenuity being what it is. If the takeover represents nothing more than a naked grab for power, with no further justification, that, in and of itself, may be one of the telltale signs of overreaching. That overreaching may be fraud, in its original common law sense of deception and concealment, or it may be some other species of chicanery. The presence of a legitimate corporate business purpose, over and above the self-interest of the investors, tends to negate the ‘raiding’ or the ‘milking’ which might justify the courts’ equitable intervention.
\end{itemize}
the corporation whose shares are (or were) held by the minority? If so it may well be that the business purpose of that company... is advanced by the merger. . . . On the other hand, if the corporation in which the complainants held shares ‘vanishes’ in the merger, inquiry as to purpose may be unrealistic if not academic. And if the business purpose of the parent (or dominant) corporation should be examined... minority shareholders of the subsidiary (or controlled corporation) may have undue difficulty in raising and maintaining the issue. 102

Many arguments have been presented as to what business purposes are legitimate business purposes. 103 Authorities have argued for the categorization of numerous business purposes as legitimate; this portion of the Comment discusses the major business purposes that have been presented.

Danger of Financial Collapse. In Matteson v. Ziebarth104 the Washington Supreme Court became one of the first courts to apply the business purpose standard to a going private transaction. The court adopted the proposition that a freeze-out of minority shareholders motivated by a valid business reason is a legitimate equitable corporate transaction that does not involve a breach of the controlling shareholders’ fiduciary duties.105 A legitimate business purpose was found to exist when insiders resorted to a freeze-out of a minority shareholder when the corporation was on the brink of insolvency. The proposed merger and subsequent sale were virtually “the only salvation for the hardpressed Ziebarth Corporation”106 because it was near financial collapse.

The danger of financial collapse argument was also upheld in Polin v. Conductron,107 in which a merger between an electronics firm and a major aircraft manufacturer was permitted. The electronics firm, in dire financial condition, would have gone into bankruptcy had it failed to merge with the aircraft manufacturer. Danger of financial collapse is a particularly persuasive business purpose and should be accepted in cases where the court is convinced that one of the corporations is, in fact, in perilous financial condition. Careful scrutiny, however, should be applied to ensure that the financial records are not contrived to create the appearance of poor financial health; such a deception could easily be created in a parent-subsidiary relationship.

Shareholders as Employees. In two separate going private transactions the defendant corporation contended that the business purpose for the transac-
tion was the elimination of shareholders who were no longer employees. In both transactions company policy required all shareholders to be employees with a substantial interest in stock ownership and management responsibility. Thus, when status as an employee was terminated, the equity owner was required to sell his interest to the corporation. In both cases, however, the court disbelieved the defendants' contention. In Bryan v. Brock & Blevins Co., the case that re instituted the use of the business purpose requirement as a device for examining going private transactions, the majority shareholders sought to freeze out a single minority shareholder who had resigned from management in a close corporation. When the minority shareholder refused to sell his interest to the controlling shareholders the majority arranged a short form merger of the old corporation into a newly formed corporation. The Fifth Circuit Court of Appeals held that Georgia law prohibited the elimination of the minority through a merger when there was no corporate purpose for the merger. The court rejected the defendant's argument that a valid business purpose had been demonstrated in the maintenance of "a long-standing company policy of . . . having only active shareholders as shareholders."

This same argument was subsequently raised in New York in application to a reverse stock split. In Clark v. Pattern Analysis & Recognition Corp. the controlling shareholders adopted a reverse stock split consolidating the one million authorized shares into 250 shares. The plan disallowed fractional shares, requiring their purchase by the corporation. Conceding that the sole reason for the reverse stock split was the elimination of the plaintiffs as shareholders, the defendants attempted to justify the plan by stating that all remaining shareholders would be employees having a substantial interest with respect to both stock ownership and management responsibility. As in Bryan, the court refused to accept the validity of the business purpose. A long-standing corporate policy that all outstanding stock be held by the corporate employees should be accepted by the courts only when the corporation can show a legitimate business purpose for the policy.

Elimination of Conflicts of Interest. The parent-subsidiary relationship necessarily creates conflicts of interest concerning the allocation of business opportunities and expenses. There is always the possibility that the minority interest in the subsidiary will be treated unfairly. This danger arises from the difficulty and expense of ensuring that intercompany transactions and allocations of overhead and other shared expenses, as well as business and investment opportunities, will always be handled on an arm's length basis.

110. Bryan had consistently refused to sell because he considered the price offered too low.
111. Id.
112. Id.
113. Id.

was premised on this conflict of interest problem. The parent corporation’s principal stockholder, in defense of the proposed merger, argued that the merger would eliminate possible conflicts of interest. The court accepted the parent’s desire to eliminate potential claims of conflicts of interest as a proper business purpose for the proposed merger.

In *Schulwolf v. Cerro Corp.*, a New York supreme court was also presented with elimination of conflicts of interest as the business purpose behind a parent corporation’s merger with its forty-five percent subsidiary. The minority shareholders of the subsidiary were to receive preferred stock in the merged corporation in exchange for their common stock. Injunctive relief was requested because the aggrieved minority shareholders were going to receive a lesser benefit from the merger than the controlling shareholders. One valid corporate purpose presented by the defendant corporation for the merger was the desire to “combine [to allow] . . . inter-company transactions . . . presently restricted because of possible conflicts of interest . . . .” The court refused to enjoin the proposed merger, accepting this as a valid corporate purpose for the transaction.

The elimination of possible conflicts of interest as a valid business purpose was subsequently affirmed by another New York supreme court in *Tanzer Economic Associates Profit Sharing Plan v. Universal Food Specialties, Inc.* In *Tanzer* the court refused to enjoin a proposed merger between a parent corporation food processor, canner, and distributor and its

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115. It is questionable whether a business purpose need be presented by both the parent and subsidiary in a parent-subsidiary merger. The Delaware Supreme Court noted, but failed to resolve, the issue in *Singer v. Magnavox Co.*, 380 A.2d 969, 980 n.11 (Del. 1977). In *Grimes*, however, the court scrutinized both the parent and subsidiary concerning their conflicts of interest contention. This writer contends that no legitimate business purpose need be shown by either the surviving corporation or the corporation which merged with the entity which eliminated the minority since the question is only whether the original corporation in which the minority owned an interest breached its fiduciary obligations.

116. The parent corporation contested that there were two kinds of possible conflict of interest problems. First, any allocation of business opportunity between the parent and the subsidiary could be questioned depending on whether it was profitable or not. Secondly, the allocation of managerial personnel and the price to be charged for their services would present conflict of interest problems. 392 F. Supp. at 1399.

117. The court concluded that both the parent and the subsidiary had valid business reasons for the merger: (1) both engaged in similar businesses; (2) joint ventures and business dealings between the corporations would be inhibited by potential claims of conflict of interest by either the parent or subsidiary shareholders; (3) the merger promised extensive savings in the day-to-day operations of two corporations. Id. at 1402.

118. 86 Misc. 2d 292, 380 N.Y.S.2d 957 (Sup. Ct. 1976). This was the first New York state court to apply the business purpose standard after adoption in *People v. Concord Fabrics*, 83 Misc. 2d 120, 371 N.Y.S.2d 550 (Sup. Ct.), aff'd, 50 App. Div. 2d 787, 377 N.Y.S.2d 84 (1975) (a merger was enjoined in a proceeding brought by the attorney general under the state blue sky law).


120. 380 N.Y.S.2d at 962.

121. The other corporate purposes presented and accepted were: (1) to consolidate for financial reporting and tax purposes; and (2) to combine management and resources of two businesses engaged in related businesses. Id. at 962.

A ninety-two percent subsidiary, a food manufacturer. Pursuant to the merger, the minority was to be cashed out at a price sixty-five percent above market price. Of the numerous business purposes presented by the defendant, two of the most significant were the prevention of potential claims of conflicts of interest and the elimination of the possibility of charges of overreaching or unfairness inherent in a public corporation. The court found these purposes acceptable. An additional component of the conflicts of interest problem has been the elimination of the possibility of derivative suits. While the hidden costs of preventing conflicts of interest are substantial, the major impetus to act cautiously in intercompany transactions is the possibility of minority shareholder derivative suits.

Although the conflicts of interest problem should be recognized as a valid business purpose, the courts should examine the transactions closely to determine whether conflicts of interest do in fact exist. In Young v. Valhi, Inc. for example, a Delaware court of chancery considered whether there had actually been conflicts of interest. The court determined that past conflicts of interest had been minimal and rejected as contrived a blanket contention that the merger would prevent future conflicts of interest. Along these lines, for a court to accept the elimination of conflicts of interest as a valid business purpose it should also be persuaded that elimination of the minority was necessary to obtain the business purpose. It should be very difficult to eliminate the minority in a subsidiary when the parent is publicly held and the minority is not given a chance to remain as shareholders in the parent. In determining whether the conflicts of interest argument should be accepted, the courts necessarily must examine the business of both the parent and the subsidiary. While the parent is more apt to overreach in dealing with the subsidiary, the subsidiary must also have a business purpose for eliminating the minority.

Operating Efficiencies. Eliminating the costs of maintaining two separate companies has been accepted as a legitimate business purpose. This

123. The merger was between Libby, McNeil & Libby and Universal Food Specialties, a wholly owned subsidiary of Nestle Alimentana, S.A., 383 N.Y.S.2d at 474.
124. The business purposes presented were: (1) improved management and corporate planning since greater resources would be available; (2) existing management in two corporations would be mutually available; (3) savings would result from economies in centralized procurement of raw materials; (4) marketing economy in joint distribution, warehousing, and advertising; (5) duplication of departments and personnel could be avoided; (6) a greater diversity of products would result in the evening out of cyclical demand; (7) stronger financial position with fewer problems in outside financing and more efficient cash flow; (8) potential claims of conflicts of interest would be prevented; (9) without public shareholders controlling corporation would not be subject to charges of overreaching or unfairness to the minority; (10) all time, expense, and energy incurred in connection with stock transfers, dividends, proxy notices, annual reports, SEC compliance, and attendant legal problems would be eliminated. Id. at 483.
125. Id.
127. Schulwolf v. Cerro Corp., 86 Misc. 2d 292, 380 N.Y.S.2d 957 (Sup. Ct. 1976), involved a merger where the minority shareholders in the subsidiary were allowed to remain as shareholders. The court noted that the transaction was not a freeze-out, but still applied the business purpose requirement to the merger.
129. See Brudney, supra note 3, at 1037; Vorenberg, supra note 3, at 1199-1200.
purpose was accepted in *Grimes v. Donaldson, Lufkin & Jenrette, Inc.*\textsuperscript{130} in which the court found that there promised to be joint savings in excess of $300,000 per year by going private.\textsuperscript{131} This equalled approximately thirty-four cents for each publicly held share, a substantial savings. Another of the business purposes accepted in *Tanzler Economic Associates Profit Sharing Plan v. Universal Food Specialties, Inc.*\textsuperscript{132} was the desire to effect savings which would result from eliminating duplicated functions, economies in centralized procurement of raw materials, marketing economy in joint distribution, warehousing, and advertising, and better tax planning. A third case involving the business purpose of operating efficiency was *Techner v. Chicago Title & Trust Co.*\textsuperscript{133} The Illinois Supreme Court refused to enjoin a reverse stock split\textsuperscript{134} that would have eliminated the minority shareholders. The proposed transaction was the final step in an acquisition and was found to be legitimate, as it resulted in a reduction of corporate expenses and a simplification of corporate procedures.\textsuperscript{135}

*Schulwolf v. Cerro Corp.*\textsuperscript{136} and *Cole v. Schlenley Industries, Inc.*\textsuperscript{137} also involved a business purpose of operating efficiencies. *Schulwolf* involved a consolidation for financial reporting and tax reporting and a combination of management and resources in related businesses,\textsuperscript{138} while *Schlenley* involved a simplification of the corporate structure. Both mergers were permitted, and the business purposes were accepted as justification for going private.

While creating operating efficiencies appears to be a valid business purpose justifying going private, actual savings must be determined. Further, it must be certain that the savings could not be achieved by an alternate method less destructive of minority interests. In *Young v. Valhi*, for example, a Delaware court of chancery refused to accept tax savings as a

\textsuperscript{130} 392 F. Supp. 1393 (N.D. Fla.), aff'd, 521 F.2d 812 (5th Cir. 1975).
\textsuperscript{131} The savings were to occur due to a reduction in salaries and legal and accounting expenses, as well as savings in franchise taxes, stock transfer fees, public relations expenses, directors' fees and the use of tax losses. 392 F. Supp. at 1400.
\textsuperscript{132} 87 Misc. 2d 167, 383 N.Y.S.2d 472 (Sup. Ct. 1976).
\textsuperscript{133} 392 F. Supp. at 1397.
\textsuperscript{134} In *Teschner*, Lincoln National Corporation, the majority shareholder of Chicago Title, made an exchange offer to the shareholders of Chicago Title, offering one share of Lincoln preferred for each share of Chicago Title common stock. Through this and a subsequent cash tender offer Lincoln gained control of 99.9% of Chicago Title. In order to simplify its corporate activities and reduce expenses Lincoln amended Chicago Title's articles of incorporation to authorize a reverse stock split which prohibited the issuance of fractional shares and required the purchase by Chicago Title of all outstanding fractional share interests. A shareholder eliminated in the reverse stock split brought the action seeking restoration of her status as a shareholder and declaration that the meeting held to amend Chicago's articles of incorporation was illegal and invalid as a breach of fiduciary duty and a deprivation of property without due process of law. 322 N.E.2d at 55-56.
\textsuperscript{135} The court, however, did not specifically adopt a business purpose requirement, but said that the plaintiff had not alleged or shown any improper purpose on the part of the defendants. *Id.* at 58.
\textsuperscript{136} 86 Misc. 2d 292, 380 N.Y.S.2d 957 (Sup. Ct. 1976).
\textsuperscript{138} See *Schenley* involved a merger between Schenley and its 88% parent corporation, Glen Alden. Schenley's minority shareholders were to receive cash and Glen Alden debentures. The merger was scrutinized under the Securities Exchange Act, not state corporate law.
legitimate business purpose since the savings could have been achieved by other means less damaging to minority interests. Courts, additionally, should be certain that the estimated savings the remaining corporation would experience in merging are realistic, not inflated, and should consider whether the costs of eliminating the minority outweigh the foreseeable monetary savings through greater operating efficiencies.

Prudent Management. One commentator has concluded that the most significant motivation for a corporation to go private is "the fundamental incompatibility in many enterprises between prudent management and the constraints imposed by public ownership." As to the functioning of a corporation, prudent management is generally concerned with long term corporate growth and stability. The mere fact that a corporation is public, on the other hand, creates enormous pressures to perform for the short run. As the short term pressures often prove to be the most compelling, the result is "payment of higher income taxes, hasty introduction of new products, ill-conceived entry into new markets, impulsive acquisitions of other businesses, retention of unsatisfactory customers in lieu of recognizing bad receivables, deterioration of research, products, and services, and a host of other imprudent actions." Although difficult to quantify, a strong argument can be made for the position that the desire to eliminate this pressure constitutes a valid business purpose. If management in a publicly held corporation must increase profits for the short run, the necessary result is hasty, ill-conceived decisions.

Public status has the additional disadvantage of inhibiting corporate involvement in many activities which otherwise might increase corporate profitability. This results because of the rigid disclosure requirements placed on a public corporation and the uncertainty of the effect of the public disclosure of such information. A public corporation, for example, might be less inclined to expend sums to entertain clients because this would have to be made public. The private corporation, on the other hand, could entertain clients, thus increasing corporate profits without the corresponding burden of making such information public. In all such circumstances involving the claimed business purpose of prudent management the court must be persuaded that actual monetary savings would result because of a change in management objectives.

Cost of Disclosure and Deregistration Savings. One obvious advantage
of going private is the corresponding corporate savings which can result. A corresponding expense in this regard is the diversion of management time and attention from the business affairs of the enterprise to potentially wasteful concerns such as shareholder relations, auditing, and legal matters. An additional cost common to the public corporation is the expense of preparing reports and various other filings with the SEC. Thus, deregulation obviates the necessity of preparing reports and filings and eliminates the costs of servicing the public shareholders.

Another contended "cost" peculiar to the public corporation is that the disclosure requirements, which compel public corporations to divulge more than they otherwise would, result in extensive liability for all concerned. This argument was raised in *Jutkowitz v. Bourns, Inc.*, in which the defendants contended that the going private transaction was instituted for the legitimate business end of removing the possible liability to the public shareholders for noncompliance with disclosure requirements. The court, however, refused to accept this as a sufficient business purpose for the proposed transaction.

Corporations raise the complaint concerning disclosure requirements that, pursuant thereto, they are occasionally required to disclose business secrets. In *Kaufman v. Lawrence*, for example, the defendant corporation stated that it had decided to go private because previous negotiations for the acquisition of another company were subject to SEC disclosure requirements. This prospect proved more burdensome than the acquisition was worth.

Although achieving a savings from deregulation and elimination of the costs of disclosure have been persistently argued as valid business purposes, no court has accepted these arguments without more substantial supplemental business purposes for the going private transaction. Notably, the elimination of the "time, expense and energy incurred in connection with stock transfers, dividends, proxy notices, annual reports, SEC compliance and the attendant legal problems" was accepted as a legitimate business purpose in *Tanzer Economic Associates Profit Sharing Plan v. Universal*.
The extent to which *Tanzer* is authority for acceptance of this business purpose as the sole factor, however, is uncertain as it was but one of ten business purposes presented. The court did not disclose whether it would accept this as a valid business purpose if presented without the other substantiating business purposes for the going private transaction.

Courts should accept the avoidance of costs associated with compliance with SEC regulations as a valid business purpose. The major reason corporations go public is to gain access to the stock market. Public status affords the corporation a means of obtaining financing at a more favorable price. Before a corporation goes public it balances the risks of liability and the costs of servicing shareholders against the value of being able to raise capital at a favorable price through the stock market. When access to the public market is eliminated because of stock market conditions, retaining public status can no longer be justified financially. Rather than continue to incur the costs and liabilities inherent in public status, public corporations should be allowed to go private. An additional factor to consider, however, is the anticipated savings in eliminating the cost of servicing shareholders weighed against the expense of going private. The corporation must bear both the cost of repurchasing the shares and considerable legal, accounting, and brokerage expenses. The savings might mean a very poor yield on such a large investment. In particular situations, however, there could be real savings, especially in the case of a small public corporation.

*Drop in Market Price.* Another rationale used in some going private transactions has been that the stock is merely a bargain, a rationale similar to that applied to "legitimate issuer repurchase programs." A limited share repurchasing plan can be justified on grounds that it is the functional equivalent of a dividend, it creates a leverage effect, it has a positive effect on earnings per share, and it is motivated by the conviction of management that the stock represents a good investment. Such justifications, however, fail to recognize the distinction between a limited share repurchase, in which the shareholders voluntarily surrender their shares, and a total share repurchase which involuntarily eliminates the minority. To the totally eliminated minority the repurchase is not an alternative to dividends. While the reduction in shares will increase earnings per share, thereby resulting in a higher market price, the eliminated shareholders will not share in this, as their equity interest in the corporation is involuntarily extinguished. Since the repurchase necessarily benefits only the controlling shareholders, discussion of repurchase rationales should be accordingly qualified as they would seem to constitute a flagrant breach of the fiduciary duty owed to the minority, and thus should not be accepted as a valid business purpose.

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152. See note 124 supra.
Increasing Value of Stock. ¹⁵⁵ Many corporations wish to go private because the advantages previously foreseen in public status have failed to materialize. Many corporations thought the market of the late 1960's would increase the value of their stock considerably. This would have enabled them to acquire other firms and retain key employees through stock option programs made more profitable by the higher value of the company's stock. Instead, while earnings went up, their price/earnings ratio collapsed with the stock market.¹⁵⁶ By going private, however, this problem could be circumvented. The stock used for stock option and acquisition programs of a private corporation, unlike a public corporation, could be tied to book value rather than the public market of the business. As book value is often above market price, the net effect is that of a buy back.¹⁵⁷ The nature of book value, stable but increasing in value over the years, makes it more attractive than market price, which is often highly volatile, to both the corporation and the stock optionee.

While no case has arisen in which the defendant corporation contended that the business purpose for the going private transaction was to increase the value of the stock for a stock option plan, the court in Condec Corp. v. Lunkenheimer Co.¹⁵⁸ implied that this would be a valid business purpose. The court stated that the going private transaction "was not connected with a stock option plan or other proper purpose."¹⁵⁹ Increasing the value of its stock is rarely argued by corporations as a valid business purpose for going private since acquisitions of other corporations through exchange offers usually take the company back into the public realm. Thus, a corporation should not be allowed to go private to increase its stock value for acquisitions through exchange offers, since one set of minority shareholders would simply be substituted with a new set when the first acquisition was made. In addition, privately held stock is not necessarily worth more; it is merely subject to fewer variables.¹⁶⁰

Long Term Debt Financing. Recently another business purpose was ac-

¹⁵⁵. See Brudney, supra note 3, at 1035; Comment, supra note 103, at 1443; Note, supra note 36, at 908.
¹⁵⁶. With the stock market drop, the anticipated uses of a publicly traded stock vanished. "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, More Firms Are Turning Their Back on Wall Street, Barron's, Mar. 4, 1974, at 3; see Prospectus Pursuant to Exchange Offer of Wells, Rich, Greene, Inc., Nov. 4, 1974, at 14, cited in Moore, supra note 3, at 324:

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.

¹⁵⁸. Book value rises, of course, only when the purchase price paid by the corporation is lower than the stock's initial book value.
¹⁵⁹. 43 Del. Ch. 353, 230 A.2d 769 (1967).
¹⁶⁰. 230 A.2d at 777.
cepted by the Delaware Supreme Court. In Tanzer v. International General Industries, Inc. an eighty-one percent subsidiary of International General was merged into a newly created, wholly owned International General subsidiary. The business purpose presented and accepted was that the merger would facilitate long term debt financing by International General. This business purpose was also accepted in Tanzer Economic Associates Profit Sharing Plan v. Universal Food Specialties, Inc. The availability of long term debt financing should be accepted as a valid business purpose for a going private transaction if the defendant can substantiate that the corporation is both in need of long term debt financing and that the financing cannot be obtained economically while still public.

IV. APPLICATION OF THE LEGITIMATE BUSINESS PURPOSE STANDARD

The threshold question is whether a business purpose is to be required for both voluntary and involuntary transactions. In the voluntary context, since tender offers are subject to individual shareholder approval, it would appear unnecessary to require the corporation to present a legitimate business purpose for the transaction. Factors exist, however, requiring the application of the business purpose standard to voluntary transactions. In such volitional transactions the dissenting shareholders have no statutorily afforded appraisal rights. If the minority shareholder is offered an unsatisfactory price for his interest in the corporation, he is forced to choose between accepting the unsatisfactory price or the futility of remaining a shareholder in a corporation subject to stagnant liquidity and deprivation of rights under federal securities law.

161. The notion that privately held stock is worth more for acquisition and stock option programs is, however, far from self-evident. In the 1960's there was no indication that private corporations sold at higher multiples than publicly held corporations. Likewise, there is no reason why non-marketable stock constitutes a more useful currency to stimulate employees than do options to buy marketable stock. Brudney, supra note 3, at 1035 n.60.

162. 379 A.2d 1121 (Del. 1977). The Delaware Supreme Court had only adopted the business purpose standard a month earlier in Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977), where the court adopted the business purpose requirement, but failed to delineate what would be acceptable business purposes for the elimination of the minority shareholders.

163. 379 A.2d 1121 (Del. 1977).

164. In answering this question the rationales behind adoption of the business purpose requirement in going private transactions should be considered. First, in Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir.), cert. denied, 419 U.S. 844 (1974), the Fifth Circuit implicitly recognized that the right of appraisal could no longer be relied on as an exclusive remedy. In an abrupt departure from precedents which relied on appraisal as an exclusive remedy and those requiring a showing of substantive fairness, the court did not even consider the possibility that appraisal could protect the minority's interest. Second, courts felt compelled to protect minority shareholders when controlling shareholders and corporations used state statutory procedures to eliminate minority interests inconsistent with the rationale for adopting the procedure, the facilitation of "business transactions." See Beloff v. Consolidated Edison Co., 300 N.Y. 11, 20-21, 87 N.E.2d 561, 565 (1949). See also note 96 supra.

165. See note 30 supra.

166. A company whose number of record shareholders is reduced to less than 300, and whose stock is not listed on a national exchange, may be deregistered under the Securities Exchange Act 90 days after the company certifies the reduction in the number of shareholders to the SEC. Securities Exchange Act of 1934, § 12(g)(2)(H)(4), 15 U.S.C. § 78l(g)(2)(H)(4) (1976). Proxy requirements and insider reporting and trading restraints become inapplicable after the 90-day period has elapsed. Periodic reports under § 13(a) of the 1934 Act would no longer be required after the end of the fiscal year in which the company deregisters. Securities Exchange Act of 1934, § 15d, 15 U.S.C. § 78o(d) (1976). See also note 31 supra.
In the context of involuntary transactions, an equally appealing argument can be asserted for requiring a legitimate business purpose for the transaction. Reverse stock splits should be subject to the business purpose requirement since dissenters’ appraisal rights are unavailable. The eliminated minority shareholder, therefore, has no method for receiving the fair value for his shares. When the minority interest is eliminated by a sale of the corporate assets, the corporation should also have a legitimate business purpose for the transaction. At common law the minority was protected, as unanimous shareholder approval was required for a sale of the assets. This requirement was gradually eroded, however, because of the injustice which could result if there were even one shareholder with a small interest who refused to go along with a sale. The relaxation of the unanimous shareholder approval requirement has led to the need for another test to insure that the minority can still be adequately protected. Thus, when the sale of assets is used simply to eliminate the minority, the business purpose requirement should be used to enjoin the transaction.

Courts which apply the business purpose requirement merely because dissenters’ appraisal rights are inadequate should accept a less compelling business purpose if the transaction is inherently “fair” to the minority interests; the shareholders receive a fair price and fair treatment at the hands of the acquiring corporation. Certainly cash-out mergers and similar transactions of close corporations should require a stricter business purpose than publicly held corporations. In a close corporation there is no public market, creating the added difficulty of finding a fair price for the interest of the eliminated. As a practical matter, the close corporation investor is not generally a market-oriented investor, but rather is interested in and should not be deprived of the opportunity of deriving the benefits of his long term investment.

The business purpose requirement has typically arisen in suits for injunctive relief prior to the consummation of the corporate transaction. For

167. See note 52 supra.
168. In re Timmis aptly points out the evils present and the rationale for the change in the requirement that all shareholders approve a sale of assets:
(1) The injustice to the bulk of the stockholders from want of power in a corporation to sell its business or an essential part thereof to another corporation organized for the purpose, frequently from its own membership, on terms deemed advantageous by the holders of a large majority of the stock. (2) The injustice to minority stockholders of requiring them to abandon, change, or limit their business if the majority should have the power to direct such a sale. An incidental evil was the power of a dissenting stockholder to compel the majority to buy him out on his own terms in order to secure unanimous consent with no one left to question the transaction.
200 N.Y. 177, 181, 93 N.E. 522, 523 (1910).
169. The term “close corporation” has various definitions. See 1 F. O’Neal, Close Corporations § 1.02 (2d ed. 1971).
170. The different treatment accorded the minority shareholders in Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir.), cert. denied, 419 U.S. 844 (1974), and Grimes v. Donaldson, Luftkin & Jenrette, Inc., 392 F. Supp. 1393 (N.D. Fla.), aff’d, 521 F.2d 812 (5th Cir. 1975), contrast the courts’ inclination to preserve a minority shareholder’s interest in a closely held corporation. The freeze-out of a minority shareholder of a close corporation was enjoined in Bryan. In Grimes, however, the court distinguished Bryan on this very point, allowing a merger between a privately held parent corporation and its publicly held subsidiary.
171. For a discussion of three variations of the freeze-out merger, see Greene, supra note 3, at 491-96.
example, all four New York cases applied the business purpose requirement only when the state attorney general or minority shareholders sought to enjoin a corporate transaction which had not yet been effectuated.\footnote{Clark v. Pattern Analysis & Recognition Corp., 87 Misc. 2d 385, 384 N.Y.S.2d 660 (Sup. Ct. 1976); Tanzer Economic Assocs. Profit Sharing Plan v. Universal Food Specialties, 87 Misc. 2d 383, 384 N.Y.S.2d 472 (Sup. Ct. 1976); Schulwolf v. Cerro Corp., 87 Misc. 2d 267, 380 N.Y.S.2d 957 (Sup. Ct. 1976); People v. Concord Fabrics, Inc., 83 Misc. 2d 267, 380 N.Y.S.2d 957 (Sup. Ct. 1976).}

It could be contended, therefore, that the business purpose requirement should arise only when a party is seeking injunctive relief. The rationale would be that equity should tip the scales against the defendant corporation and preserve the status quo pending a hearing on "fairness," a hearing that would take time. To prevent the issuance of an injunction the defendant corporation would merely be required to present a legitimate business purpose. The plaintiffs would then be relegated to their remedy at law, damages, for any injury suffered. None of the New York cases, however, expressly gave the business purpose requirement such a limited application. The New York courts have merely stated that the business purpose requirement is part of the fiduciary duty standard, along with the issues of fraud, self-dealing, and unfairness.\footnote{See note 97 supra.}

Since the question whether there has been a breach of a fiduciary duty has not been limited to suits for injunctive relief, the courts should not so limit the business purpose standard.

The application of the business purpose requirement in Singer v. Magnavox Co.\footnote{367 A.2d 1349 (Del. Ch. 1976).} gives added weight to a broad application of the business purpose requirement. The Singer litigation concerned a merger which had occurred two years earlier. The minority shareholders sought nullification of the merger. The court of chancery, however, dismissed for failure to state a claim upon which relief could be granted.\footnote{See note 99 supra.}

The Delaware Supreme Court reversed, holding that the defendant corporation must show both a legitimate business purpose for the merger and compliance with the "entire fairness" rule.\footnote{See Kutik v. Taylor, 80 Misc. 2d 839, 364 N.Y.S.2d 387, 390 (Sup. Ct. 1975).} A limited application of the business purpose requirement to only injunctive suits would be grossly unfair to litigants who were unable to reach the courts prior to the consummation of the corporate transaction. This is especially prevalent in the short form merger area. While notice prior to the merger is required in some states, others require no notice or notice after the transaction has taken effect.

Another complex question in this context is where the burden of proof should lie in this type of proceeding. Traditionally the plaintiff was burdened with the duty of negating the existence of a legitimate business purpose. The trend, however, is to place the burden upon the defendant corporation or control persons. In New York, transactions involving interested mergers have been subject to "careful judicial scrutiny" which shifts the burden to the fiduciary to prove the fairness of the transaction.\footnote{See Chetrob, Inc. v. Barrett, 293 N.Y. 442, 57 N.E.2d 825, 834 (1944).}
ested mergers have been subject to "close scrutiny" to establish the "intrinsic fairness" of the merger, with an analogous shift of the burden of proof. These shifts have also been applied when the business purpose test was involved. In only one of the going private cases recently decided was the burden of proof placed upon the plaintiff. In Tanzer Economic Associates Profit Sharing Plan v. Universal Food Specialties, Inc. a New York supreme court stated that the plaintiff had the burden of negating the existence of a legitimate business purpose for the merger. In each of the remaining cases the burden of proof was shifted to the defendant corporation either explicitly or impliedly.

V. CONCLUSION

The expanding permissiveness of state corporate codes has required state judiciaries to examine going private transactions using fiduciary duty standards, both because of the inadequacy of dissenters' appraisal rights and the inappropriate use of state statutory procedures. While the courts have begun to apply the business purpose requirement, they have failed to define what constitutes a valid business purpose. While case law will eventually define the standard, the interim will be a period of confusion and misinterpretation. In order to alleviate this problem, courts should not be hesitant to delineate valid business purposes and the rationale behind their validity.


181. The court stated: "Plaintiff... has, in this application for injunctive relief, the burden of showing that there is no legitimate business purpose which could be served by this merger."

182. In Albright v. Bergendahl, 391 F. Supp. 754 (D. Utah 1974), the court stated that the plaintiff does not have the duty of negating a legitimate corporate purpose. In Green v. Santa Fe Indus., Inc., 533 F.2d 1283 (2d Cir. 1976), the Second Circuit stated:

However, where a short-form merger involving use of a dummy corporation appears to be used for no purpose other than to squeeze out minority public shareholders, as is alleged in this case, the burden is upon the corporate insiders to demonstrate the existence of a legitimate compelling corporate purpose.

Id. at 1299.

183. Impliedly, the burden of proof has been placed on the defendant because the court has ruled against the defendant corporation because it either failed to present a legitimate business purpose or because it failed to present a compelling business purpose. In People v. Concord Fabrics, Inc., 83 Misc. 2d 120, 371 N.Y.S.2d 550 (Sup. Ct.), aff'd, 50 App. Div. 2077, 377 N.Y.S.2d 84 (1975), the court stated in discussion of their reasoning that no real corporate purpose had been demonstrated, implying that the defendant corporation had to demonstrate a business purpose for the merger. In Clark v. Pattern Analysis & Recognition Corp., 87 Misc. 2d 385, 384 N.Y.S.2d 660 (Sup. Ct. 1976), the court stated:

Where there is an allegation of fraud, illegality or bad faith, coupled with a tenuous showing of legitimate corporate business purpose, fairness requires that a minority shareholder be afforded an opportunity to fully contest the actions of the majority before he is deprived of his property. Where a strong and compelling corporate business purpose is shown, however, the courts should not interfere at the mere whim of a dissident shareholder.

384 N.Y.S.2d at 664-65.