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COMMENTS

REGULATION OF LEVERAGED BUYOUTS TO PROTECT THE PUBLIC SHAREHOLDER AND ENHANCE THE CORPORATE IMAGE

Regulation of securities transactions is most often considered in the context of corporations making stock offerings to the public. A corporation is said to “go public” when it offers its shares for trade to the general public, rather than to a relatively few private investors. The corporation, in such a transaction, becomes classified as a public corporation. On the other hand, a corporation is said to “go private” when it removes its publicly-traded shares from the control of the general public and thereby ceases to be a publicly reporting and trading company under the federal securities laws. Essentially, the public corporation abandons the marketplace and becomes classified as a private corporation, with its shares being closely-held.

“Going private” transactions have been a subject of vast attention and debate since 1974. The leveraged buyout, a particular type of “going private” transaction, recently has attracted widespread concern and debate


2. The technique often implemented in a leveraged buyout transaction involves a merger or a sale of the original company’s assets to a shell corporation, in which only the control group consisting of the management and certain other investors retain equity ownership in the corporation. In either technique, the outside shareholders are eliminated from the company and receive only cash consideration for their stock ownership. A.B.A. Comm. on Corporate Laws, Guidelines on Going Private, 37 BUS. LAW. 313, 317 (1981). A significant amount of the purchase price is borrowed by the control group, which pledges (leverages) the purchased assets to secure repayment of the loan.

As an example of the merger technique, the transaction
over its fairness to the public shareholder. With increasing frequency, *The Wall Street Journal* and *The New York Times* are reporting on leveraged buyout developments and merger experts expect this torrid pace of buyout activity to continue.

starts with the formation by the control group of the original company of a new shell corporation for the sole purpose of acquiring the control group's shares in the original company. In exchange for these shares, the control group receives shares in the shell corporation. Thus, the control group becomes the sole owner of the shell corporation which, in turn, becomes the "parent" of the original company. The original company is then merged into the shell (whose name is usually changed to that of the original company). Under the terms of the merger, the outsiders receive cash or securities redeemable for cash.

Id. at 316 (footnote omitted); Coleman v. Taub, 638 F.2d 628, 633 (3d Cir. 1981) (describing the mechanics of a "going private" transaction). See, e.g., Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir.), cert. denied, 419 U.S. 844 (1974). For an example of the sale of assets technique, which involves a sale for cash of substantially all the assets of a public company to a shell corporation, followed by a dissolution of the public company, see A.B.A. Comm. on Corporate Laws, *supra*, at 316 n.11 (citing as an illustration Eisenberg v. Central Zone Property Corp., 306 N.Y. 58, 115 N.E.2d 652 (1953)).

3. See B. Longstreth, Management Buyouts: Are Public Shareholders Getting A Fair Deal? (Oct. 6, 1983) (remarks to the Int'l Bar Ass'n, published by the Securities and Exchange Comm'n). As a commissioner with the Securities and Exchange Commission at the time of his speech, Bevis Longstreth concluded that "[w]e see with increasing frequency the spectacle of a conflicted management surrounding itself with procedural shields to defend a deal widely believed to be substantively unfair to shareholders. Such behavior is threatening to tarnish the image of our corporate community—to give corporate fiduciaries a bad name." *Id.* at 17. See also *Why Leveraged Buyouts Are Getting So Hot*, Bus. Wk., June 27, 1983, at 86 (stating that some people see the leveraged buyout as an insider's technique for taking advantage of outside shareholders who do not know the value of their stock). Some institutional investors, however, have expressed reluctance to participate in leveraged buyouts. Williams, *Leveraged Buyouts Are Encountering More Resistance From Lenders, Investors*, Wall St. J., July 25, 1984, at 18, col. 1. For example, Gary Wendt, executive vice president for financial operations at General Electric Company's Stamford, Connecticut-based General Electric Credit Corporation unit, stated: "We have to watch ourselves so that we don't chase rainbows, and we have to avoid buyout promoters trying to unload old businesses they no longer want." *Id.*

The public debate over the fairness of leveraged buyouts is expected to continue. Congressional hearings will be occurring throughout 1985 to consider generally the ramifications of mergers and takeovers. Among the specific topics to be discussed are shareholders' rights in leveraged buyout transactions and the impact of the dramatic increase in debt appearing on the balance sheets of companies that have gone private through the use of leveraged buyouts. See Vise, *Merger Experts See Torrid Pace Continuing in '85*, Wash. Post, Jan. 13, 1985, at F8, col. 1.

4. See, e.g., Wall St. J., Feb. 23, 1984, at 10, col. 2 (Dr. Pepper Co., a publicly-owned soft drink concern, proposed to its shareholders a $516 million buyout transaction which eventually settled at a purchase price of $650 million); Thomas, *A Free Ride for Management Insiders*, N.Y. Times, Jan. 22, 1984, § 3, at 2, col. 2 (expressing that few readers of the financial pages could have missed hearing about the leveraged buyout game). See also Waters, *Banking on the Entrepreneur: The Leveraged Buyout Boom*, Inc., Sept. 1983, at 46 (stating that the leveraged buyout "has become a phenomenon, a device whose popularity is attested to by everything short of buttons and bumper stickers").

5. W.T. Grimm & Company, a Chicago-based merger broker that tracks corporate ac-
In a typical leveraged buyout, a group of investors joins with the top management of a company to buy out the public shareholders and gain full ownership of the company. A management-investor purchasing group uses the company's assets and stock as collateral to secure long and medium term loans, which in turn finance the buyout—hence the name "leveraged buyout." The money may be borrowed from a bank, a venture capital company, or a group of investors. The purchasing group, comprised of the corporation's management, either in part or in whole, together with selected investors are able to purchase a company with a comparatively small personal financial investment. For management, a leveraged buyout offers the opportunity to own a piece of the company it is currently managing and thereby an opportunity to control the company's destiny. For selected investors, however, a leveraged buyout offers the opportunity to take calculated risks on prospective companies with strong established cash flows and acquisitions, indicated that 1983 buyout sales of public companies "going private", most of which involved leveraged buyouts, totalled $7.1 billion, up tenfold from $636 million in 1979. Smith, Shareholder Risks in Leveraged Buyouts Ride on Fear of Bankruptcy-Law Filings, Wall St. J., July 25, 1984, at 10, col. 1. W.T. Grimm & Company further asserted that in the first three months of 1984, total buyout sales reached $3.5 billion. Leonard Shaykin of Adler & Shaykin, a partnership formed in 1983 to arrange leveraged buyouts, has predicted that the number of leveraged buyouts will eventually approach 50% of all corporate acquisitions. Waters, supra note 4, at 47. William Brian Little, a partner in the leveraged buyout firm of Forstmann Little & Company stated that the environment for leveraged buyouts in 1985 is good because of the sluggish stock market and drop in interest rates, creating a climate congenial to the technique. Vise, supra note 3, at col. 3.


7. See, e.g., Scott, supra note 5, at 19, col. 2, wherein Bulent Gultekin, an associate finance professor at the Wharton School, is quoted, stating that in a leveraged buyout for $100 "you can borrow $99 of that and put up $1 of your own money. . . . You end up owning the company—by using other people's money."
8. See id., wherein representatives of two major companies, involved in leveraged buyout transactions, expressed their desire to control their company's future. Dean Meadors, spokesman for Mary Kay Cosmetics, states that being a private company gives "the freedom to make long-term strategic decisions." Robert D. Haas, president of Levi Strauss & Co., says that private ownership of a company provides a "way to ensure that the company continues to respect and implement its corporate values and traditions." Id.
developed markets. In turn, the acquired company usually becomes highly indebted or leveraged, displaying a dramatic increase in debt on its balance sheet. Ultimately, the debt is repaid with money raised by the company's operations or by a subsequent sale of its assets.

The proliferation and operation of the leveraged buyout have spawned questions concerning its fairness to public shareholders. A leveraged buyout creates two groups of shareholders. The first, the control group, consists of top management. The other, the outside shareholder group, consists of the public shareholders who are not members of the management-investor purchasing group and thereby lack participation in the direct control of the company. Each group is treated differently. The control group may re-


10. Debt-to-equity ratios, which are calculated by dividing the total liabilities of a corporation by its total equities, have been as high as 12-to-1 for the leveraged buyout. L. Lederman, R. Citron & R. Macris, supra note 9, at 284. Compare this figure to a typical public company's financing that rarely exceeds a debt-to-equity ratio of three-to-one. Id. at 291. For example, a public company with $100 million of debt and $900 million of equity undergoing a leveraged buyout transaction is transformed by that transaction into "a private company with $900 million of debt and $100 million of capital." Rohatyn, On a Buyout Binge and a Takeover Tear, Wall St. J., May 18, 1984, at 26, col. 4. As an example of a 1985 highly leveraged deal, Levi Strauss & Co. would be required to spend $150 million in interest for each of five years—about 40% of operating profits. Scott, supra note 5, at col. 2. Corporate assets, however, are generally intended to "provide a base for innovation, expansion, modernization and diversification." Thomas, supra note 4, at cols. 2-3.


12. See, e.g., B. Longstreth, supra note 3, at 1 (discussing the leveraged buyout of one company, Stokely Van-Camp, Inc.). The outside shareholders of Stokely were offered a buyout price of $55 per share based on the financial judgment of an investment banking firm. Management presented and recommended the price to the shareholders as "fair and attractive." When outside companies heard of this transaction, however, they offered higher prices than that of management. One company, Pillsbury, made a cash tender offer of $62 per share and a few weeks later, another company, Quaker Oats, surpassed Pillsbury with a successful bid of $77 per share. Notably, the Quaker Oats offer could not be blocked by the Stokely management group because it controlled only 22% of the outstanding stock, an insufficient amount to control the terms of the buyout. If, however, the management group had controlled a majority of the outstanding shares, then the Stokely shareholders may not have been so fortunate as to receive $77 per share—a 40% increase—because the management would have a control block, enabling it to control the outcome of the buyout. Id.

Longstreth cited another example of a buyout in which the minority shareholders were powerless. In a particular company (unnamed), the minority acted upon the news of a low price buyout proposal by the majority management shareholders by attempting to attract a higher bid from a third-party. They were unsuccessful, however, because the management majority was unwilling to sell out to outside parties. Id. at 2.

13. In the "going private" merger cases that are discussed in this Comment, the term "minority group" depicts this outside group of shareholders. In the discussion of leveraged buyouts, however, "outside shareholder group" or "outside shareholders" is used instead of minority group because the outside shareholder group may conceivably hold a majority of the
receive preferential treatment since it voluntarily retains an equity interest in the company, while the outside shareholder group may receive disadvantageous treatment because it involuntarily loses participation in the future profits of the company. The effective arms-length bargaining that accompanies most intercorporate transactions is often absent from this transaction. Indeed, the control group enjoys the opportunity to buy back and thereby take the acquired company private at a bargain price because the stock prices of the target companies are often “far below the value of their assets.” Moreover, the control group does not share with the outside group the opportunity to be the “sole owners of a cash machine.” Because the usual corporate conduct of focusing on the best interests of all shareholders is not readily applicable to the leveraged buyout transaction, such a transaction “present[s] the danger that the control group will, consciously or unconsciously, treat itself more favorably” than the outside shareholder group. These benefits and opportunities are not generally available to the company’s public shareholders. It is not surprising, then, that some outside group shareholders have become disgruntled and have voiced their disapproval of proposed leveraged buyouts.

Because of the relative novelty of the leveraged buyout transaction, neither state case law nor the federal securities laws have sufficiently developed to regulate adequately the fairness of this business phenomenon. Therefore, existing case law and securities laws that relate to this type of transaction will be examined and an analogy will be drawn to the leveraged buyout. Primarily, the relevant law is in the area of “going private” merger transactions with its attendant “fiduciary duty of fair dealing and fair price,” outstanding shares. Further, in this discussion, “control group” may be used interchangeably with management-investor purchasing group.

14. A.B.A. Comm. on Corporate Laws, supra note 2, at 318. In a nonleveraged buyout transaction, for example, where all the shareholders may receive continued equity in the corporation on a pro rata basis, then no disparate treatment among the shareholders seemingly exists. Id.
15. Id.
16. Williams, supra note 5, at 18, col. 2; Scott, supra note 5, at 19, col. 2.
19. See, e.g., Complaint at 3, Hennesey v. North American Royalties, Inc., Civ. No. 83-4233 (E.D. La. filed Aug. 23, 1983), wherein an outside shareholder, Hennesey, averred that the offered price in this buyout is woefully inadequate and unfair, does not represent the full value of the shares of NAR, is manipulative of the market price of the shares of NAR, represents an attempt by the majority shareholders of NAR to “freeze out” the minority stockholders of NAR, does not benefit NAR in any way, and operates as a fraud on the minority stockholders of NAR.
"disclosure," and "business purpose" standards. The federal securities laws regulate disclosure in "going private" transactions and state case law regulates matters of fiduciary duty, including fair dealing, fair price, and business purpose. Because the state of Delaware is widely considered to be the harbinger of trends in corporate law, Delaware law will be examined in determining the appropriate degree of fairness and business purpose to be applied to leveraged buyouts.

This Comment will address whether the public shareholder is treated fairly in the leveraged buyout transaction. It will first examine the relevant Delaware case law and federal securities laws that pertain to this type of transaction. Furthermore, it will discuss fairness between the control group and the outside shareholder group in terms of arranging deals and setting prices. The Comment will also explore the need for the Securities

20. Although the concepts addressed in this Comment may also apply to "going private" transactions in a general sense, this Comment singularly discusses the leveraged buyout as the transaction most in need of specialized treatment because self-dealing becomes a primary concern in this type of transaction.

21. See, e.g., Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983), deciding the rights of cashed-out shareholders in a merger context, which is expected to extend to the other states. See L. Lederman, R. Citron & R. Macris, supra note 9, at 300 ("We believe that the key thrust of Weinberger, appraisal as the remedy to the exclusion of damages or recission [sic] . . . will find its way into all the cases where mergers are challenged.").

In the same vein, Delaware is recognized for its extensive body of fiduciary law. See, e.g., Kaplan, Fiduciary Responsibility in the Management of the Corporation, 31 BUS. LAW. 883, 889 (1976). He stated that

[a] large portion of all corporate litigation is conducted in Delaware because of the disproportionate number of publicly held corporations chartered there. Not even the populous financial centers of New York, Illinois and California have given rise to a body of fiduciary law as extensive as that which Delaware has accumulated.

Id. Adoption of Delaware's fiduciary duty provisions by other states is commonplace. See, e.g., Dower v. Mosser Indus., 648 F.2d 183, 189 (3d Cir. 1981) (example of a federal court sitting in Pennsylvania looking to Delaware case law for guidance in determining a standard for fundamental fairness in a merger transaction).

It is relevant to note, however, that

[t]he State of Delaware has a long history as the domicile of nationally known corporations, and has traditionally provided a favorable climate for corporations. The official attitude of the Legislature and administrative officers of Delaware has consistently been one of sympathetic understanding of the problems of the corporate organization.


22. This Comment will confine its discussion to buyouts of public companies or their subsidiaries or divisions by a management-investor group. The result is the elimination of the public shareholders' interest in the companies. When a publicly-held company goes private in this type of transaction it will in most instances be subject to the requirements of the Securities and Exchange Commission's Rule 13e-3, 17 C.F.R. § 240.13e-3 (1985), to be discussed infra.

23. See infra notes 32-202 and accompanying text.
Regulation of Leveraged Buyouts and Exchange Commission (SEC or Commission) to require a proper business purpose before control groups may implement this type of transaction. Finally, this Comment will suggest that the public shareholder in a leveraged buyout transaction is dealing from a disadvantaged position within the corporation in which he holds a financial interest. Because of the inequality between the control group and the outside group and the conflicts of interest inherent in this transaction, the outside shareholder remains ever vulnerable to unfair treatment. Therefore, this Comment will conclude with a proposal calling for a review of "entire fairness" in the leveraged buyout transaction consisting of a scrutiny of three elements: fair dealing (which includes full disclosure), fair price, and a valid business purpose. This proposal is intended to increase the protection afforded the public shareholder, confronted with the leveraged buyout transaction, and concomitantly to enhance the image of the American corporation.

I. DELAWARE CASE LAW AND FEDERAL SECURITIES LAWS ADDRESSING THE LEVERAGED BUYOUT TRANSACTION

Although the federal courts have occasionally addressed the issue of general fiduciary duty between the controlling shareholder and the outside shareholder, they have firmly based their opinions in state common law principles.\(^2\) Those federal cases that are not firmly grounded in state common law principles nonetheless have looked to state law for guidance, and where state precedents have not been directly on point, they have speculated a given result.\(^2\) In situations where complaints against the implementation of "going private" merger transactions have been brought into federal courts, the complaints routinely have been examined both at the federal level, via the federal securities laws, and at the state level under case law, discussing the general fiduciary duty of fairness standards.\(^2\) Whatever the source of

\(24.\) See, e.g., Coleman v. Taub, 638 F.2d 628 (3d Cir. 1981) (applying Delaware state law and finding that it did not permit a merger without a valid business purpose); Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir.), cert. denied, 419 U.S. 844 (1974) (looking to Georgia state law and finding that it did not authorize a merger without a valid business purpose). However, the continued validity of the Coleman decision may be in doubt as a result of Delaware's Weinberger decision, 457 A.2d 701, 715 (Del. 1983), holding that a valid business purpose would no longer be required when implementing a merger transaction in Delaware. See infra notes 151-55.

\(25.\) See, e.g., Schein v. Chasen, 478 F.2d 817 (2d Cir. 1973) (wherein the New York federal court speculated that New York state courts would look to Florida law to find a rule for its decision and then decided that Florida courts would likely impose liability upon a certain corporation's tippees).

\(26.\) See, e.g., Santa Fe Indus. v. Green, 430 U.S. 462 (1977); Susman v. Lincoln American Corp., 578 F. Supp. 1041 (N.D. Ill. 1984) (minority shareholders challenging mandatory cash-out merger under Securities and Exchange Act § 10(b) and rule 10b-5 thereunder for alleged
the holding, however, the tenor of federal decisions is unmistakable in up-
holding the importance of requiring a general fiduciary duty of fair dealing
by those in control of a corporation. Therefore, until federal case law ex-
plicitly sets independent standards for a general fiduciary duty of fair deal-
ing, state law continues to control this issue. For this reason, this
Comment will consider relevant Delaware case law.

A. Extending Delaware's General Fiduciary Duty of Fair Dealing and
Fair Price and Delaware's Business Purpose Element to "Going
Private" Transactions

The Delaware courts have struggled with establishing an appropriate stan-
dard of "entire fairness" in the context of a "going private" merger transac-
tion because they have been uncertain as to whether the standard should
include some or all of the following elements: fair dealing, fair price, disclo-
sure, and business purpose. Whether to include a "valid business purpose"
in the group of elements has been a subject of particular uncertainty. Ac-

27. Several Supreme Court decisions evidence the judicial intent to establish federal fidu-
uciary standards for those in control of a corporation. See Southern Pacific Co. v. Bogert, 250
U.S. 483, 487 (1919) (wherein the Supreme Court stated that “[t]he rule of corporation law
and of equity invoked is well settled and has been often applied.”). The Court further stated
that “[t]he majority has the right to control; but when it does so, it occupies a fiduciary rela-
tion toward the minority, as much so as the corporation itself or its officers and directors.” Id.
at 487-88; see also Pepper v. Litton, 308 U.S. 295 (1939) (where the Supreme Court upheld the
denial of a bankruptcy claim of a controlling shareholder who violated his fiduciary duty to the
other shareholders). The Court stated that

[a] director is a fiduciary. . . . So is a dominant or controlling stockholder or group
of stockholders. . . . Their dealings with the corporation are subjected to rigorous
scrutiny and where any of their contracts or engagements with the corporation is
challenged the burden is on the director or stockholder not only to prove good faith
of the transaction but also to show its inherent fairness from the viewpoint of the
corporation and those interested therein.

Id. at 306 (citations omitted). Cf. E.I. du Pont de Nemours & Co. v. Collins, 432 U.S. 46
(1977) (where the Court recognized the intent of Congress to extend fiduciary standards to
mergers of investment companies under the Investment Company Act of 1940); SEC v. Capital
Gains Research Bureau, 375 U.S. 180, 194 (1963) (recognizing the intent of Congress to ex-
tend fiduciary standards to investment advisers under the Investment Advisers Act of 1940).
For other federal cases addressing the "fairness to minority shareholders," see Speed v. Trans-
america Corp., 235 F.2d 369 (3d Cir. 1956); Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir.
1947). (recognizing that directors of a corporation are required to treat fairly each class of
stock and holding that the directors violated a duty owed to the minority shareholders when
they caused the corporation to call a convertible participating preferred security, such that
only the majority shareholder could realize the large appreciation in value of the inventory).

28. For a general discussion of the regulation of corporate management, see Symposium—
An In-Depth Analysis of the Federal and State Roles in Regulating Corporate Management, 31
cordingly, the business purpose element needs to be examined closely and independently of the other elements even though it emerges in many of the same cases that discuss the other three elements. Therefore, this Comment will first examine those cases in the context of fiduciary duty of fair dealing and fair price to establish an "entire fairness" standard. The same cases will then be reexamined in a separate section to establish a business purpose element that might be included in the "entire fairness" standard.

1. The Evolution of Delaware’s Fiduciary Duty of Fairness in Corporate Transactions

Under Delaware case law, corporate officers and directors owe a general fiduciary duty of honesty, good faith, and diligence29 to their corporation and its outside shareholders. These fiduciary duty principles have been construed by the courts to prevent the control group from manipulating the corporate machinery so as to injure the outside shareholder group.30 Repeatedly, these traditional fiduciary duty principles have appeared in Delaware cases not involving “going private” transactions.31 Three such cases are discussed below and demonstrate corporate transactions that directly affect the interests of outside shareholders but are permissible so long as the transaction does not violate Delaware's attendant fiduciary duty principles of honesty, good faith, and diligence. Application of these principles to relations between the control group and the outside shareholder group is justified to prevent the control group from manipulating the corporate machinery and injuring the outside shareholder group.

In 1923, the Delaware Court of Chancery addressed the standard of fiduciary care owed by the majority shareholders to the minority shareholders in Allied Chemical & Dye Corp. v. Steel & Tube Co. of America.32 The court considered whether the majority shareholders' sale of the corporate assets was permissible merely because it complied with Delaware statutory requirements for a sale of assets and determined that it was not. The control group of Steel & Tube Company entered into negotiations to sell to Youngstown Sheet & Tube Company all its property, assets, and goodwill. The control group was dominated by holders of the preferred stock, who stood to benefit

29. See generally Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939); infra notes 38-43 and accompanying text.
30. Rothschild, Going Private, Singer, and Rule 13e-3, 7 SEC. REG. L.J. 195, 200 (1979) (examining Delaware corporation law and finding that its fiduciary duties have been specifically construed to prevent injury to minority shareholders through management’s manipulation of corporate machinery).
31. See infra notes 32-50 and accompanying text.
32. 14 Del. Ch. 1, 120 A. 486 (1923).
most by the proposed sale. Also, the majority shareholders, who voted for the sale, would receive a greater return on their common shares than the minority shareholders, who voted against the proposed sale. A corporate minority shareholder attacked the transaction on the grounds that, although legal, the sale was unfair to the minority shareholder group because of its inequitable terms. The court acknowledged that the relevant statute appeared to give the majority shareholders the exclusive right to sell the assets, but warned that this right could be exercised only upon terms and conditions that considered the best interests of the corporation. These terms included such considerations as the price to be paid, the terms of credit, if any, and the manner of payment. The court indicated that it would look beyond the mere statutory requirements for a sale of corporate assets and would require the control group to exercise its fiduciary duty of fair dealing, by considering the best interests of the corporation.

The concern for fiduciary duty principles underlying the Allied Chemical case was again addressed in Guth v. Loft, Inc. In Guth, the Delaware Supreme Court held that a corporate officer in a candy and beverage manufacturing company who had earned profits from his interest in the affairs of a competing business had breached his fiduciary duty. The corporate officer owed to the candy and beverage company a duty of loyalty and good faith. He breached this duty by organizing another company, with money belonging to the original company, to manufacture a competing, similar beverage syrup. The court stated that a corporate officer could engage in competitive independent businesses only if he did not violate any moral or legal duty arising out of the fiduciary relationship that existed between himself and the corporation of which he was an officer. The court stated that the requirement of undivided loyalty to the corporation demands that "there shall be no conflict between duty and self-interest," and that officers and directors

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33. Id. at 7-8, 120 A. at 489.
34. Id. at 11-12, 120 A. at 491.
35. Id.
36. Id.; see Allaun v. Consolidated Oil Co., 16 Del. Ch. 318, 147 A. 257 (1929) (applying identical Delaware fiduciary principles in a similar case involving the sale of corporate assets by the majority).
37. Allied, 14 Del. Ch. at 18-19, 120 A. at 494.
38. 5 A.2d 503 (Del. 1939).
39. Id. at 511.
40. Id. at 507.
41. Id. at 514.
42. Id. at 510. The Guth court based the corporate officers' fiduciary duty on long established public policy. The court stated that

[p]ublic policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corpo-
must exercise their utmost good faith in fulfilling their fiduciary duty to the
corporation and its public shareholders. Guth established the principle
that neither management nor directors may shirk their general fiduciary
duty and use their corporate power solely for their individual advantage if to
do so would be detrimental to their public shareholders.

In 1952, minority shareholders of a hotel corporation brought an action to
enjoin an unwanted merger of their corporation into the parent corporation
on the grounds that the merger was a breach by the parent corporation of its
general fiduciary duty. The Delaware Court of Chancery, in Sterling v.
Mayflower Hotel Corp., considered whether the transaction was a breach of
fiduciary duty owed to the minority shareholders by the parent corporation
and found that it was not. The minority shareholders of Mayflower Hotel
Corporation asserted that the merger plan was both fraudulent and unfair to
them because the plan was not approved by a quorum of disinterested direc-
tors at the meeting of the Mayflower board. The court reasoned, however,
that the transaction was neither fraudulent nor unfair to the minority be-
cause each shareholder received equity in the merged corporation on a
share-for-share basis. In affirming the order of the Court of Chancery, the
Delaware Supreme Court nonetheless recognized the unflinching fiduciary
duty of fair dealing required of the dominant parent corporation, standing as
controlling shareholder on both sides of the merger transaction. It there-
fore placed the burden on the controlling shareholder to clearly and unques-
tionably demonstrate the “entire fairness” of the merger transaction, taking
into consideration all pertinent factors. It thus became established Dela-
ware law that controlling or majority shareholders owe to the minority
shareholders of that corporation a fiduciary obligation of “entire fairness” in

rate officer or director, peremptorily and inexorably, the most scrupulous observance
of his duty, not only affirmatively to protect the interests of the corporation commit-
ted to his charge, but also to refrain from doing anything that would work injury to
the corporation, or to deprive it of profit or advantage which his skill and ability
might properly bring to it, or to enable it to make in the reasonable and lawful exer-
cise of its powers.

Id.

43. Id. at 511. Cf. Pepper v. Litton, 308 U.S. at 311 (stating that a corporate officer with a
fiduciary duty could not use his power for personal gains and to the detriment of the corpora-
tion’s creditors and shareholders, no matter how absolute that power may be and no matter
how scrupulously he satisfies technical requirements).

44. 33 Del. Ch. 20, 89 A.2d 862 (1952).

45. Id. at 24-25, 89 A.2d at 864-65.

46. Id. at 23, 89 A.2d at 864.


48. Id. Although the court did not expand on the components of “entire fairness,” it
emphasized a standard, which was developed in the Singer trilogy and Weinberger. See infra
notes 53-104.
dealing with the minority shareholders' property interests during a corporate merger transaction.\(^49\)

These cases permit corporate transactions directly affecting the property interests of the corporation's minority shareholders, unless the transactions violate Delaware's attendant fiduciary duty standards. They echo the traditional concern for breaches of the control group's fiduciary duty of fair dealing to the corporation and its outside shareholder group. Although none of these cases involved a "going private" transaction, it was against the backdrop of these cases that \textit{Singer v. Magnavox Co.}\(^50\) and its progeny were considered by the Delaware Supreme Court. Through the case law following \textit{Singer} and successive cases considering the issue of "going private" in the context of a merger transaction, the Delaware courts have established a standard of "entire fairness" that is currently considered in leveraged buyouts.\(^51\)


\textit{Singer v. Magnavox Co.} is the first of four important Delaware cases examining the fiduciary duty principles involved in a "going private" merger transaction. As previously stated, a "going private" transaction occurs when a corporation removes its publicly-traded shares from the market and ceases to file public company reports under the federal securities laws. The most important consideration in \textit{Singer} was the fiduciary obligation owed by majority shareholders, who had control of the corporation, to the minority shareholders. The minority shareholders of Magnavox were subjected to a long-form cash merger\(^52\) orchestrated by the majority. The majority had previously acquired 84.1\% of the shares of Magnavox following a tender

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\textsuperscript{49} 33 Del. Ch. at 298, 93 A.2d at 109-10. See Bennett v. Breuil Petroleum Corp., 34 Del. Ch. 6, 99 A.2d 236 (1953) (recognizing minority shareholder's fiduciary rights in statutorily authorized issuance of stock transaction that was allegedly done to impair the minority shareholder's interest and to oust him from the corporation upon the management's own terms).


\textsuperscript{51} L. Lederman, R. Citron & R. Macris, \textit{supra} note 9, at 299.

\textsuperscript{52} The long-form merger is the absorption of one company by another. The latter retains its own name and identity and acquires the liabilities, assets, franchises, and powers of the former. The absorbed company ceases to exist as a separate business entity and the companies become united in interest. 15 W. Fletcher, \textit{Cyclopedia of the Law of Private Corporations} \textsection 7041 (rev. perm. ed. 1983). See, e.g., Havender v. Federal United Corp., 23 Del. Ch. 104, 2 A.2d 143 (1938) (where two corporations, each with its distinct body of shareholders, desired to combine their liabilities and assets and thereafter had their two corporations operated and managed as one). A second form of merger, the "short-form" merger is discussed \textit{infra} at note 76.
offer,\textsuperscript{53} thereby assuring passage of the subsequently proposed long-form cash merger. In the Court of Chancery, the minority charged that the buyout was fraudulent because the majority had failed to articulate a valid business purpose for seeking the shares.\textsuperscript{54} Also, the minority shareholders contended that the offered buyout price of nine dollars per share was grossly inadequate,\textsuperscript{55} thereby enabling the controlling shareholders of Magnavox to attain easily sole ownership. Further, the minority alleged that the majority had breached its fiduciary duty to the minority by recommending approval of the merger at a cash price per share that it knew to be grossly inadequate and by ignoring the minority's desire to retain its equity interest in Magnavox. Conversely, the majority acknowledged its fiduciary duty to the minority, but contended that the duty did not require a business purpose in order to implement a cash-out merger.\textsuperscript{56} The Court of Chancery granted the majority shareholders' motion to dismiss and held that the merger was not fraudulent merely because it was orchestrated solely to eliminate the Magnavox minority shareholders. The court further stated that those shareholders dissatisfied with the cash-out price could seek an appraisal remedy.\textsuperscript{57}

The Delaware Supreme Court reversed.\textsuperscript{58} Focusing on the fiduciary responsibility of fairness owed by majority shareholders to the minority shareholders, the court stated that it would "not be indifferent" to a proposed cash-out merger of the minority without a business purpose.\textsuperscript{59} It held that a proposed merger, which would effectively eliminate the minority, needed a legitimate, asserted business purpose.\textsuperscript{60} The question of what constituted a legitimate business purpose was left undecided.\textsuperscript{61} Additionally, the pro-

\textsuperscript{53} Singer v. Magnavox Co., 380 A.2d 969, 971 (Del. 1977).


\textsuperscript{55} 367 A.2d at 1353.

\textsuperscript{56} Id.

\textsuperscript{57} Id. at 1362. The dissatisfied shareholder's appraisal remedy is a statutory creation enabling shareholders to seek valuation of their equity shares by independent expert opinion rather than current market figures. The purpose of these statutes is to protect the dissenting shareholder's property rights from possibly adverse transactions by majority shareholders. 12B W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5906.1 (rev. perm. ed. 1983).

\textsuperscript{58} Singer, 380 A.2d at 980.

\textsuperscript{59} Singer, 380 A.2d at 979. But see Stauffer v. Standard Brands, Inc., 41 Del. Ch. 7, 187 A.2d 78 (1962) (standing for proposition that the purpose of a merger or the absence thereof is irrelevant for judicial purposes).

\textsuperscript{60} Singer, 380 A.2d at 978-79. See Rothschild, supra note 30, at 207 n.30 (stating that the Delaware Supreme Court's "rejection of the defendant's appraisal argument served to focus attention on one aspect of going private transactions that is often overlooked, namely, the stockholder's right in the form of his investment and not merely its value") (citing Singer, 380 A.2d at 977-78).

\textsuperscript{61} Singer, 380 A.2d at 980 n.11. For a thorough discussion of Delaware's business pur-
posed merger would have to meet the standard of "entire fairness," originally articulated in *Sterling*, which comprises a showing of fairness by the majority shareholders and an establishment of a business purpose for the transaction other than the elimination of the minority shareholders. The *Singer* court categorically stated that fiduciary principles of Delaware law apply to mergers and that redress is available to cashed-out minority shareholders under state law, even though the transaction may be accompanied by complete disclosure. Thus, *Singer* specifically extended the controlling shareholders' general fiduciary duty of "honesty, loyalty, good faith and fairness" (including fair price) to the "going private" aspect of a long-form merger transaction.

In a second Delaware "going private" merger case, *Tanzer v. International General Industries*, the Delaware Supreme Court considered the question left unanswered in *Singer*, that is, whether a long-form merger made primarily to advance the business purpose of the majority shareholders violated the fiduciary duty owed to the minority shareholders. The court found that the fiduciary duty owed to the minority shareholders by the majority was not violated in instances where the merger was initiated to advance a *bona fide* purpose of the majority. *Tanzer* involved a merger between two subsidiaries of a common parent corporation in which shareholders holding a 19% interest in one of the subsidiaries were bought out for cash. The uncontested purpose of the merger was the desire of the parent corporation to merge its majority-owned subsidiary into the parent corporation so that the assets of the subsidiary would be available to facilitate long-term debt financing by the parent corporation. The bought-out minority sought to enjoin the merger, alleging that the sole purpose of the merger was to serve only the interests of the majority shareholders. The majority argued, however, that

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62. *Id.* at 976. *See Bastian v. Bourns, Inc.*, 256 A.2d 680, 681 (Del. Ch. 1969), *aff'd*, 278 A.2d 467 (Del. 1971) (recognizing that an individual controlling both corporations in a merger transaction owed a fiduciary duty to the minority shareholders requiring treatment in an "entirely fair manner"); *David J. Greene & Co. v. Dunhill Int'l, Inc.*, 249 A.2d 427, 431 (Del. Ch. 1968) (restricting parent corporation from taking unfair advantage in a merger of its subsidiary and utilizing an inherent fairness test to examine the conduct of the parent).


67. *Id.* at 1124.
no violation of fiduciary duty occurred because the merger was completed for a valid business purpose. Delaware's Court of Chancery accepted the majority's purpose as nonviolative of the minority shareholders' fiduciary rights. The court, therefore, denied the minority's application for a preliminary injunction.

The Delaware Supreme Court affirmed. The court noted that among the general rights of a corporate shareholder is a right to vote in his or her own interest. This right, however, is limited by any fiduciary duty owed to other shareholders. Therefore, the court reasoned that a parent corporation owning a majority of its subsidiary's stock had a right to consider a merger for its own corporate purpose, subject, however, to its fiduciary duty of fair dealing owed to the minority. This corporate purpose could not include ridding the corporation of unwanted shareholders, expressly prohibited by the Singer decision. In this context, the court made clear that the majority shareholder, in dealing with a subsidiary, must not hide its true objective of ridding itself of unwanted minority shareholders in the subsidiary. Moreover, the majority "must be prepared to show that it has met" a standard of "entire fairness" to the minority as imposed by both Singer and Sterling, which consists of fair dealing, fair price and a valid business purpose. Extending this language to the Tanzer situation, the court found a valid purpose for the merger, overriding the minority's desire to retain its equity interest in the subsidiary corporation.

Thus, after Singer and Tanzer, the law of fiduciary duty, in the "going private" merger context, required the majority shareholders to meet a standard of "entire fairness" in all aspects of the transaction. Although, as was

68. Id.
69. Id. at 1122.
70. Id. at 1125.
71. Id. at 1123.
72. Id. at 1124. See Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 29 Del. Ch. 610, 622, 53 A.2d 441, 447 (1947) (a shareholder of a corporation may liberally vote his shares according to whim or caprice, so long as he does not violate any duty to other shareholders); Heil v. Standard Gas & Elec. Co., 17 Del. Ch. 214, 151 A. 303, 304 (1930) (shareholders have a right to vote for personal profit motives, so long as no advantage is obtained at the expense of other shareholders); Allied Chem. & Dye Corp. v. Steel & Tube Co. of Am., 14 Del. Ch. 1, 16-17, 120 A. 486, 493 (1923) (subject to the fairness rule, majority shareholders have a right to dispose of assets of profitable business over objection of minority shareholders).
73. Tanzer, 379 A.2d at 1124.
74. Id. The standard of "entire fairness" to the minority calls for a demonstration of fairness by the majority and the establishment of a business purpose for the transaction that is something other than the elimination of the minority shareholders. See supra note 62 and accompanying text.
75. Id. at 1125.
demonstrated in Tanzer, the Delaware Supreme Court would permit a merger that benefitted the majority shareholders and resulted in the cash-out of minority shareholders, such transactions would be carefully scrutinized. However, Singer and Tanzer addressed the fiduciary duty issue only in the context of long-form mergers, leaving open the question of whether the same principles applied to short-form mergers.\textsuperscript{6}

The Delaware Supreme Court considered the applicability of Singer and Tanzer to short-form mergers in yet another "going private" merger case, Roland International Corp. v. Najjar.\textsuperscript{7} In Roland, the majority shareholders attempted a cash buyout of the minority shareholders through use of a short-form merger.\textsuperscript{8} A minority shareholder of Roland International Corporation brought a class action against the corporation for money damages that allegedly occurred from a breach of fiduciary duty owed to the minority shareholder.\textsuperscript{9} The majority, owning 97.6\% of the outstanding shares of the Roland Corporation, conceded in the Court of Chancery that the sole purpose of implementing the merger was to eliminate the minority from further equity participation so that the majority shareholders could gain full ownership of the corporation.\textsuperscript{10} The Court of Chancery denied the majority's motion to dismiss this action because it found that Singer supported the minority's proposition that the principles of fiduciary duty applied in a short-form merger.\textsuperscript{11} The majority shareholders appealed.

The Delaware Supreme Court asserted that the primary focus of Singer and Tanzer was the enforcement of a corporate fiduciary duty. In extending these fiduciary principles owed by the majority shareholders to the minority shareholders in a short-form merger, the court affirmed the decision of the lower court. The court stated that the majority shareholders of a corporation owe a fiduciary duty of fair dealing and fair price to the minority be-

\textsuperscript{6} A short-form merger is one in which the parent corporation owns substantially all of the shares (e.g., 90\% ownership required) of the subsidiary corporation and is therefore given a means of eliminating the minority shareholders' interest in the corporation upon approval of the parent corporation's board of directors and without the approval of the shareholders of either corporation. The result is a merger that is less expensive and time consuming than the normal long-form merger, \emph{supra} note 52. \textit{15 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS} § 7046.1 (rev. perm. ed. 1983). \textit{See, e.g., REVISED MODEL BUSINESS CORP. ACT} § 11.04 (1984) which authorizes the merger of a 90\% owned subsidiary into the parent corporation without a vote of the shareholders. A shareholder vote is required, however, in a long-form merger. \textit{See supra} note 52.

\textsuperscript{7} 407 A.2d 1032 (Del. 1979), overruled by Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

\textsuperscript{8} \textit{See supra} note 76.

\textsuperscript{9} Najjar v. Roland Int'l Corp., 387 A.2d 709 (Del. Ch. 1978).

\textsuperscript{10} \textit{Id}.

\textsuperscript{11} \textit{Id.} at 711-13.
cause the majority has the power to control the destiny and property of the corporation.\textsuperscript{82} The court declared that the fiduciary duty owed by the majority shareholders would not be diminished merely because it held a majority of the corporation's shares.\textsuperscript{83}

The majority argued that its actions did not ignore its fiduciary duty to the minority. Because of the high percentage of stock it owned, the majority claimed that the short-form merger, created specifically to ease mergers for high-percentage owners, presumed a proper business purpose.\textsuperscript{84} Of equal importance, the majority contended, was the minority's right to seek the remedy of appraisal if it was dissatisfied with the offered price per share.\textsuperscript{85}

The court rejected both of these arguments and reaffirmed that a fiduciary duty arises from long-standing principles of equity, independent of the type of merger involved. In rejecting the appraisal remedy as inadequate, the court noted that the timing of the cash-out merger remained entirely within the control of the majority, and that the majority had the power to arrange the cash-out merger at a time when the state of the market and the elements of appraisal were most favorable to it.\textsuperscript{86} Therefore, the court concluded that the short-cut afforded the majority by the short-form merger could not be used to "short-circuit" the fiduciary duty it owed to the minority.\textsuperscript{87}

\textit{Weinberger v. UOP, Inc.}\textsuperscript{88} is the final of the four Delaware merger cases setting standards of fiduciary care for the "going private" transaction. The court's decision in this case overruled the holdings of \textit{Singer, Tanzer,} and \textit{Roland,} thus marking a return to the pre-\textit{Singer} policy of not requiring a business purpose for the transaction and relegating the complaining share-

\textsuperscript{82} \textit{Roland,} 407 A.2d at 1035.
\textsuperscript{83} \textit{Id.} at 1036. In addressing the short-form merger, the court stated that: [W]e find nothing magic about a 90% ownership of outstanding shares which would eliminate the fiduciary duty owed by the majority to the minority. The duty existed in \textit{Singer,} when the parent corporation owned about 84% of the target corporation's stock. Clearly, the same rule would have applied if the parent had held 89% of the shares. \ldots In fact, the need to recognize and enforce such equitable principles is probably greater when the size of the minority is smaller.
\textit{Id.}

\textsuperscript{84} \textit{Id.} at 1035-36. The majority shareholders contended that the Delaware short-form merger statute simplified the steps necessary to effect a short-form merger from those required to effect a long-form merger, in order to give the parent corporation some control as to the timing of the merger and some certainty as to its fruition. \textit{Id.} The majority conceded, however, that a "proper purpose [for the merger] would not be conclusively presumed if the majority had attained 90% ownership by illegal or fraudulent means." \textit{Id.} at 1036 n.7.

\textsuperscript{85} \textit{Id.} at 1035.
\textsuperscript{86} \textit{Id.} at 1034.

\textsuperscript{87} \textit{Id.} at 1036. See generally \textit{Brudney \\& Chirelstein, A Restatement of Corporate Freezeouts,} 87 \textit{Yale L.J.} 1354 (1978) for a pragmatic approach that would set the standard of review of fiduciary duties according to the type of merger involved.

\textsuperscript{88} 457 A.2d 701 (Del. 1983).
holders to appraisal remedy, unless that remedy is rendered inadequate.\textsuperscript{89} In this controlling case, the majority shareholders of a corporate subsidiary cashed-out the minority shareholders. The parent majority owned 50.5\% of the outstanding shares and the minority owned the remainder. The minority attacked the validity of the transaction because a feasibility study prepared by two of the subsidiary's directors, who were also directors of the parent corporation, recommended an offering price per share that was higher than the price publicly offered to the minority.\textsuperscript{90} The feasibility study had been made concerning the possible acquisition of UOP's 49.5\% outstanding shares from the minority. The study concluded that the price of $24 per share was a good investment for the parent majority. However, only $21 per share was offered to the minority.\textsuperscript{91} The higher price suggested by the feasibility study was not disclosed to the subsidiary's outside directors nor to its minority shareholders prior to their vote of approval for the merger.\textsuperscript{92} In deciding the case, the Court of Chancery reexamined the issue of fiduciary duty of fairness owed to the cashed-out minority by the majority.

Following the principles set forth in the Singer trilogy, the Delaware lower court placed the burden on the management group to establish the transaction's "entire fairness" to the minority stockholders, sufficient to pass close scrutiny by the courts.\textsuperscript{93} The "entire fairness" test included four factors for the court to consider: a) the fiduciary duties of the subsidiary company's directors in approving the "going private" merger transaction; b) the adequacy of the price paid to the cashed-out minority shareholders; c) the adequacy and accuracy of information disclosure by the subsidiary or majority shareholders to the minority shareholders; and d) the purpose of the "going private" merger transaction.\textsuperscript{94} Applying these factors to the Weinberger facts, the Court of Chancery found that the subsidiary's board of directors did not breach their fiduciary duty to the minority shareholders in approving the "going private" merger transaction, and that there was no failure by the subsidiary or majority shareholders to disclose pertinent information to the minority shareholders. Moreover, the Court of Chancery found that there was a proper purpose for the "going private" merger transaction and that the price offered to the minority shareholders was fair.\textsuperscript{95}

The Delaware Supreme Court reversed and remanded, requiring manage-

\textsuperscript{89} Id. at 715.
\textsuperscript{90} Id. at 707.
\textsuperscript{91} Id.
\textsuperscript{92} Id.
\textsuperscript{94} 426 A.2d at 1345-56.
\textsuperscript{95} Id.
Regulation of Leveraged Buyouts

The court stated, however, that the burden may shift to the minority shareholders to prove “specific acts of fraud, misrepresentation, or other items of misconduct” when alleging unfairness by the majority shareholders. If the minority shareholders are unable to prove any fraud or misconduct by the majority shareholders, then the minority shareholders would be relegated to an appraisal proceeding as their sole means of remedy. Recission or damages would no longer be available remedies, unless the minority shareholders could demonstrate a situation where appraisal is rendered inadequate relief.

In its examination of fairness of the transaction, the court stated that fairness consists of two elements: fair dealing and fair price. The court turned first to fair dealing. It examined the manner in which the “going private” merger transaction was initiated, structured, and disclosed to the outside directors and minority shareholders. It observed that the merger was entirely initiated and structured without the benefit of independent, arms-length negotiations, which could have helped in assuring a certain degree of fairness to the minority shareholders. Moreover, material information used to determine a fair price for the shares was not disclosed to the outside directors and minority shareholders. Given these facts, the court stated that the merger transaction did not satisfy any reasonable concept of fair dealing. Thus, the transaction violated the first element of the court’s fairness examination.

Next, the court turned to fair price. Citing Tri-Continental Corp. v. Battye, the court noted that fair price should require a consideration of “all relevant factors” pertaining to the value of a company. It was at this stage in the court’s analysis that it recommended appraisal proceeding as the

96. Weinberger, 457 A.2d at 703.
97. Id. at 715.
98. Id. at 711-12.
99. Id. at 712.
100. 31 Del. Ch. 523, 526, 74 A.2d 71, 72 (1950) (“The basic concept of value under the appraisal statute is that the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern.”).
101. Weinberger, 457 A.2d at 713. The court looked to the 1981 amendment to section 262 of the Delaware Code that called for the court to consider “all relevant factors.” Id. The court stated that pursuant to DEL. CODE ANN. tit. 8, § 262(h) (1981) the Court of Chancery: shall appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger, together with a fair rate of interest, if any, to be paid upon the amount determined to be the fair value. In determining such fair value, the Court shall take into account all relevant factors . . . .

Id. (emphasis added by the Weinberger court). The court then interpreted the legislative intent of this section of the Delaware Code to allow full compensation to shareholders for whatever
The basic remedy available to cashed-out shareholders.\textsuperscript{102} The court acknowledged, however, that the appraisal remedy may be inadequate in cases involving fraud, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching. Turning to the feasibility study, which indicated that an offering price of up to $24 per share would be reasonable, the court determined that the actual offered price of $21 per share could not be held fair to the minority shareholders.\textsuperscript{103} Thus, the transaction failed to meet the second element of the court’s fairness test and the case was therefore remanded to the Court of Chancery for further proceedings.\textsuperscript{104}

In the above four cases, the courts applied the fiduciary duty of fair dealing and fair price to the “going private” merger transaction. Difficulties arise, however, when considering whether to require inclusion of a business purpose element in the test of “entire fairness” of “going private” mergers. The Delaware courts have been ambivalent on this issue. Thus, the development of the business purpose element, as one consideration of the “entire fairness” test, must be reviewed to determine its status in the fairness analysis of leveraged buyouts. The Singer trilogy and Weinberger cases will be reexamined from this perspective. However, another case, Rabkin v. Philip A. Hunt Corp.,\textsuperscript{105} will be examined first to illustrate Delaware’s most recent position on Weinberger’s appraisal remedy.

\textbf{a. Rabkin Enables Delaware’s Supreme Court to Reconsider Weinberger’s Appraisal Remedy}

On September 23, 1985, the Delaware Supreme Court examined, for the first time since its decision in Weinberger, the exclusivity of the appraisal remedy in buyout merger transactions.\textsuperscript{106} In Rabkin v. Philip A. Hunt Corp., the court broadened the scope of Weinberger to consider allowing traditional remedies beyond appraisal proceedings for shareholders alleging procedural unfair dealing that has a “reasonable bearing on substantial is-

\begin{itemize}
  \item Their loss may be, “subject only to the narrow limitation that one cannot take speculative effects of the merger into account.” \textit{Id.} at 714.
  \item The then existing valuation procedures were apparently very structured and mechanistic. \textit{See} Weinberger, 457 A.2d at 712 (“‘Delaware block’ or weighted average method was employed wherein the elements of value, i.e., assets, market price, earnings, etc., were assigned a particular weight and the resulting amounts added to determine the value per share.”) (citing \textit{In re} General Realty & Utilities Corp., 29 Del. Ch. 480, 497-98, 52 A.2d 6, 14-15 (1947)).
  \item Weinberger, 457 A.2d at 715; \textit{see} David J. Greene & Co. v. Schenley Indus., 281 A.2d 30 (Del. Ch. 1971) and Stauffer v. Standard Brands, Inc., 41 Del. Ch. 7, 187 A.2d 78 (1962) (mandating a shareholder’s recourse to the basic remedy of appraisal).
  \item Weinberger, 457 A.2d at 714.
  \item \textit{Id.} at 715.
  \item 498 A.2d 1099 (Del. 1985).
  \item \textit{Id.}
\end{itemize}
sues affecting the price being offered" per share. The court reversed the lower court's motion to dismiss, acknowledging that the alleged facts support a claim of unfair dealing, and stating that in the context of Weinberger's "entire fairness" standard, such a claim deserves a more considered analysis on remand.

Rabkin involved a merger in July, 1984 between the Philip A. Hunt Corporation ("Hunt") and the Olin Corporation ("Olin"). Olin had acquired 63.4% of Hunt's common stock on March 1, 1983 at $25 per share pursuant to a stock purchase agreement. The agreement stated that Olin would pay $25 per share for Hunt's remaining common stock, acquired before March 1, 1984. Olin did not buy any additional stock before March 1, 1984. It did, however, offer to buy Hunt's remaining common stock for $20 per share on March 23, 1984, after its obligation to pay $25 per share had elapsed. From the trial record, it is clear that Olin had always intended to own 100% of Hunt. In pursuance of its goal, Olin's senior management had its $20 per share offer endorsed by an investment bank as representing a fair offer. The proposal was subsequently approved by Olin's Finance Committee, and thereafter, Olin alerted Hunt to the committee's approval of the merger. In response, Hunt's board of directors obtained its own fairness opinion from an investment banking firm, which found that, while $20 per share was financially fair, the range of fair values was between $19 and $25 per share. When Hunt's board of directors notified Olin that $20 per share was a fair price but not a generous price, Olin refused to raise its bid. Nonetheless, Hunt's board unanimously recommended approval of the merger to its shareholders at $20 per share and issued a proxy statement in June, 1984. Because the proxy statement noted Olin's intention to vote its 64% interest in favor of the merger proposal, the merger's passage was inevitable.

Hunt's minority shareholders challenged the Olin-Hunt merger in Delaware's Court of Chancery. They charged that the $20 price per share was grossly inadequate because the majority shareholders breached their fiduci-

107. Id. at 1100.
108. Id. at 1107-08.
109. Id. at 1100-01.
110. Id. at 1101-02.
111. Id. at 1101. "Several Olin interoffice memoranda referred to the eventual merger of the two companies. One document, dated September 16, 1983, sent by Peter A. Danna to Johnstone, then a director of both Olin and Hunt, spoke of Olin's long-term strategy which would be relevant 'when the rest of Hunt is acquired.'" Id.
112. Id. at 1102-03.
113. Id. at 1103.
114. Id.
ary duty of "entire fairness" by unfairly manipulating the timing of the merger to avoid having to pay $25 per share for Hunt's remaining common stock. The majority shareholders responded by claiming that the minority shareholders' argument goes to the issue of fair price, which under *Weinberger* is remedied by an appraisal remedy. The minority shareholders countered by arguing that appraisal is inadequate in their case, and alleging that procedural unfairness entitles them to broader relief than appraisal proceeding. The Delaware Court of Chancery granted the majority shareholders' motion to dismiss, however, because absent claims of fraud or deception, the minority shareholders are relegated to an appraisal proceeding as their sole remedy. The minority shareholders appealed.

Although the Delaware Supreme Court did not reach the merits of the minority shareholders' claims, it questioned whether the lower court properly dismissed the minority's claims on the ground that absent fraud or deception, *Weinberger* mandates their sole remedy to be appraisal. The court reversed the motion to dismiss and remanded the case to the Court of Chancery to hear the minority’s claim of procedural unfairness. The court noted that *Weinberger* does not necessarily make appraisal a shareholder's sole remedy nor does *Weinberger*’s mandate of fair dealing turn solely on issues of deception. Rather, *Weinberger* mandates a review of a transaction's fair dealing that includes procedural fairness by embracing "questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the


116. 498 A.2d at 1103-04. The minority shareholders contended that appraisal is inadequate because "(1) the alleged wrongdoers are not parties to an appraisal proceeding, and thus are not personally accountable for their actions; (2) if such misconduct is proven, then the corporation should not have to bear the financial burden which only falls upon it in an appraisal award; and (3) overreaching and unfair dealing are not addressed by an appraisal." Id. at 1104.

117. *Id.* at 1103.

118. *Id.* at 1104. The Court of Chancery reasoned that: "[w]here . . . there are no allegations of nondisclosures or misrepresentations, *Weinberger* mandates that plaintiffs' entire fairness claims be determined in an appraisal proceeding." *Rabkin*, 480 A.2d at 660.

119. 498 A.2d at 1104.

120. *Id.* at 1107-08. "At the very least the facts alleged import a form of overreaching, and in the context of entire fairness they deserve more considered analysis than can be accorded them on a motion to dismiss." *Id.* at 1107.

121. *Id.* at 1104-05. The court stated that "the trial court's narrow interpretation of *Weinberger* would render meaningless our extensive discussion of fair dealing found in that opinion." *Id.* at 1104.
directors and the stockholders were obtained.” Nonetheless, a mere allegation of unfair dealing cannot survive a motion to dismiss, the court stated, without some claim of “specific acts of fraud, misrepresentation, or other items of misconduct.”

The court pointed out that the minority shareholders were not only arguing fair price, an issue that the appraisal remedy could resolve, but they were alleging manipulative conduct by the majority shareholders, who timed the merger to deprive the minority shareholders of $25 per share. Acknowledging that Olin had no legal obligation to effect the merger before March 1, 1984 and pay $25 per share, the court stated that inequitable conduct will not be guarded simply because it is not illegal. Therefore, the Court of Chancery was summoned to reexamine the Olin-Hunt merger with a focus on both fair price and fair dealing as mandated in Weinberger.

3. Delaware’s Business Purpose Element in the “Going Private” Merger Context

The requirement that the controlling shareholder group must state a valid business purpose in a “going private” merger transaction is closely linked to the requirement that the controlling shareholder group satisfy its fiduciary duty of fairness to the outside shareholder group. Whether to include the business purpose element in the mix of factors that weigh into the “entire fairness” test of “going private” mergers has been a matter of considerable debate. Delaware case law originally did not require management to prove a business purpose when initiating a “going private” merger. This policy, however, was reversed with Singer, which required proof of a business purpose. Then, the Delaware Supreme Court announced its decision in Weinberger, which not only relegated complaining shareholders to appraisal remedy in most situations, but overruled Singer’s business purpose element. This marked a return to the pre-Singer policy that no business purpose need be stated in a “going private” merger transaction.

In 1962, the Delaware Supreme Court in Stauffer v. Standard Brands,

122. Id. at 1104 (quoting Weinberger, 457 A.2d at 711).
123. 498 A.2d at 1105 (quoting Weinberger, 457 A.2d at 703).
124. 498 A.2d at 1105-06.
125. Id. at 1106-07; see also Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985); Giuricich v. Emtrol Corp., 449 A.2d 232, 239 (Del. 1982); Schnell v. Chris-Craft Indus., 285 A.2d 437, 439 (Del. 1971).
126. 498 A.2d at 1107.
127. See generally A.B.A. Comm. on Corporate Laws, supra note 2; 15 W. Fletcher, Cyclopedia of the Law of Private Corporations § 7160.5 (rev. perm. ed. 1983) (citing cases that have held that cash mergers must meet two tests under state law: a “fairness” test and a “business purpose” test).
considered and rejected the necessity of the control group to state a valid business purpose before implementing a short-form merger. In *Stauf-fer*, a minority shareholder in a subsidiary corporation sued to set aside a short-form merger with the parent corporation, which owned more than 90% of the subsidiary's stock. The minority shareholder claimed that the cash offer of $105 per share was inadequate and the transaction lacked a business purpose and, therefore, constituted constructive fraud by the control group. Delaware's Court of Chancery upheld the short-form merger. The court stated that whenever minority shareholders primarily allege an undervaluation of shares in a short-form merger, valuation appraisal is their only remedy. On appeal, the Delaware Supreme Court dismissed the claim of fraud and limited the issue in the case solely to the value of the cashed-out shares. It initially stated that the "very purpose" of a short-form merger is to give the parent corporation "a means of eliminating the minority shareholders' interest in the enterprise." Therefore, in the absence of fraud, where the only dispute is as to the value of the minority's share, the court stated that such a transaction did not require the proffering party to state a business purpose. The court, therefore, ruled that an appraisal proceeding was the dissatisfied shareholder's exclusive medium of relief.

A decade and a half later, the Delaware Supreme Court overruled *Stauffer* and expanded the "entire fairness" test of *Sterling* to include a "valid business purpose" when implementing a long-form merger. In *Singer v. Magnavox Co.*, the minority shareholders challenged the Magnavox Company's long-form merger on the grounds that it was not motivated by a valid business purpose. The minority contended that the sole purpose of the merger was to enable the majority to obtain complete ownership of Magnavox. The court stated that a merger with no purpose other than the elimination of minority shareholders from the company, regardless of the amount of cash paid them, would be a breach of the majority sharehold-

131. *Id.* at 316.
134. *Id.*
135. 380 A.2d 969, 972 (Del. 1977). *See supra* notes 50-64 and accompanying text.
136. 380 A.2d at 978.
ers' fiduciary duty of "entire fairness" and was therefore wrong. The court rejected the majority shareholders' argument, which relied principally on Stauffer, that fiduciary obligation was unnecessary because the minority shareholders had an appraisal remedy available and because business purpose was irrelevant for judicial purposes. This fiduciary obligation, the court asserted, would not be discharged simply because the minority shareholders had an appraisal remedy available. Rather, the court suggested that the majority shareholders' "purpose" in implementing a "going private" merger should be a specific element to be weighed in determining its fairness to the minority shareholders. Finally, the Singer court stated that an improper purpose should preclude the majority shareholders from exercising their voting control so as to implement the merger.

In another long-form merger, Tanzer v. International General Industries, the Delaware Supreme Court went further than Singer. In Tanzer, the parent corporation desired to merge its majority-owned subsidiary into the parent corporation so that the assets of the subsidiary would be available to facilitate long-term financing by the parent corporation. The court held this purpose valid. Acknowledging that the majority shareholders of a corporation had a right to control the future of the corporation and that it was not necessarily wrong for the majority shareholders to consider their private interests in merging out the minority shareholders, the court nonetheless limited this control by applying the Singer requirement of a valid business purpose. The court specifically required that the purpose of the merger be "bona fide," meaning that it be something more than a mere subterfuge to eliminate the minority shareholders. The Tanzer court thereby reaffirmed the test of "entire fairness" as imposed by both Singer and Sterling by including a business purpose element.

137. Id. at 980. The court stated:

[W]hile we agree with the conclusion of the Court of Chancery that this merger was not fraudulent merely because it was accomplished without any purpose other than elimination of the minority stockholders, we conclude that, for that reason, it was violative of the fiduciary duty owed by the majority to the minority stockholders.

Id.

138. Id. at 978. The Delaware Supreme Court found Stauffer inapplicable to Singer because Stauffer was not a cash merger "whose sole purpose was to eliminate minority stockholders." Rothschild, supra note 30, at 206.

139. Singer, 380 A.2d at 977.

140. Id. at 978-80.

141. Id.

142. 379 A.2d 1121 (Del. 1977). See supra notes 65-76 and accompanying text.

143. 379 A.2d at 1124-25.

144. Id. at 1124.

145. Id.

146. Id. ("[I]n any event, a bona fide purpose notwithstanding, IGI must be prepared to
In *Roland International Corp. v. Najjar*, the Delaware Supreme Court continued its expansion of the "entire fairness" test of *Singer* and *Sterling* to include short-form mergers. The court applied the rule of *Singer* and *Tanzer*, which required the majority shareholders to demonstrate a valid "corporate purpose" for implementing the cash-out merger. In *Roland*, the majority shareholders admitted that the sole purpose of the merger was to eliminate the minority shareholders from the Roland International Corporation. As a result, the court held that a merger effected for no other reason than to exclude public shareholders from future participation in the company would give rise to a claim of breach of fiduciary duty.

In 1983, the Delaware Supreme Court again changed its position. In *Weinberger v. UOP, Inc.*, the court overruled the business purpose requirement as established in the trilogy of *Singer, Tanzer*, and *Roland*, thereby stripping one of the essential ingredients from the test of "entire fairness." The *Weinberger* court returned to the *Stauffer* rule and held, consistent with that decision, that majority shareholders are not required to demonstrate a valid business purpose when effecting corporate mergers. Further, the court stated its desire to return to the principle holding that a dissenting shareholder in a cash-out merger is limited to an appraisal remedy of his shares. In so holding, the court noted that the requirement of a business purpose was new to Delaware law governing corporate mergers and that *Singer* and its progeny were a departure from *Stauffer* and prior case law. The court stated its belief that Delaware's expanded appraisal remedy available to shareholders would give adequate protection and fairness. Therefore, requiring a business purpose, the court stated, would no longer be necessary to show that it has met its duty, imposed by *Singer* and *Sterling v. Mayflower Hotel Corp.* . . . of "entire fairness" to the minority." (citation omitted)).

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147. 407 A.2d 1032 (Del. 1979). *See supra* notes 77-87 and accompanying text.
149. *Id.* at 1033, 1037.
150. *Id.* at 1036.
152. *Id.* at 715.
153. *Id.* The *Weinberger* court stated that

[i]n view of the fairness test which has long been applicable to parent-subsidiary mergers, *Sterling v. Mayflower Hotel Corp.* . . . the expanded appraisal remedy now available to shareholders, and the broad discretion of the Chancellor to fashion such relief as the facts of a given case may dictate, we do not believe that any additional meaningful protection is afforded minority shareholders by the business purpose requirement . . . .

*Id.* (citation omitted).

154. *Id.* The *Weinberger* court stated that it would return to the principles of *Stauffer v. Standard Brands, Inc.*, which implicitly denied the necessity of stating a valid business purpose before implementing a merger. *Id.* *See supra* notes 128-34 and accompanying text.
of any force or effect in Delaware.¹⁵⁵

As the preceding cases demonstrate, the Delaware courts have extended the requirement of a fiduciary duty of fair dealing and fair price to the “going private” transaction. The requirement of a valid business purpose, however, has been excised from the “entire fairness” test. Although the trilogy of Singer, Tanzer, and Roland concluded that even compliance with the letter of Delaware’s merger statutes should not insulate the control group’s actions from scrutiny as to the purpose of a cash-out merger, the Delaware Supreme Court has concluded that the other remedies available to minority shareholders make the business purpose test unnecessary.

The Singer trilogy established two principles of law to be included in the mix of elements constituting the “entire fairness” test for “going private” mergers. First, the control group was said to owe a general fiduciary duty of fair dealing and fair price to the minority shareholders in its exercise over the corporate powers and property. Second, the courts were summoned to examine the business purpose underlying corporate transactions that allegedly violate the general fiduciary duty of fair dealing owed to minority shareholders. A violation of either of these principles, the Singer trilogy concluded, would allow the court to grant equitable relief as needed.¹⁵⁶ The Weinberger court, however, adopted only the first of these principles to include in its “entire fairness” test. Moreover, the Weinberger court effectively consigned the minority to an appraisal proceeding in which to defend its right to corporate participation.¹⁵⁷ These differences in the “entire fairness” tests and their impact on outside shareholders involved in a leveraged buyout transaction will be discussed in subsequent sections of this Comment.

B. Federal Regulation of “Going Private” Transactions

In 1974, A. A. Sommer, Jr., then a commissioner of the SEC, delivered the initial federal response to the “going private” phenomenon.¹⁵⁸ He raised several policy concerns and focused on the duty that management owed to the minority shareholders. Sommer stated that the obligation of fiduciary duty by officers and directors requires that they be “fair” and not deprive the shareholders of their investment if the shareholders choose to retain their shares. He urged that corporations engaged in “going private” transactions should be required to show a “compelling business purpose” so as to ensure

¹⁵⁵. Weinberger, 457 A.2d at 715.
¹⁵⁶. Singer, 380 A.2d at 980.
¹⁵⁷. See Weinberger, 457 A.2d at 714; Coleman v. Taub, 638 F.2d 628, 635 (3d Cir. 1981).
¹⁵⁸. See A. Sommer, supra note 1, at D-1.
¹⁵⁹. Id. See supra note 1 and accompanying text.
fairness to public shareholders,¹⁶⁰ regardless of whether they received an adequate price for their shares in the "going private" transaction.¹⁶¹ Sommer concluded that a breach of fiduciary duty could be sustained only after a "sensitive balancing" of the public shareholders' interests and the corporation's purported business purpose.¹⁶²

Following Sommer's statements, the Commission addressed the fairness concern in 1975¹⁶³ and again in 1977,¹⁶⁴ by issuing for public comment, notices of proposed rule 13e-3 under section 13(e) of the Securities Exchange Act of 1934 (Proposed Rule 13e-3).¹⁶⁵ These proposed rules would have given the SEC the power to judge the substantive and procedural fairness of a "going private" transaction and to prohibit those transactions it deemed to be "unfair" to the outside shareholders.¹⁶⁶ In effect, the rules were intended to protect the interests of minority shareholders in "going private" transactions.

The 1975 proposed rule 13e-3 initially suggested a definition for a "going private" transaction,¹⁶⁷ because none existed under the federal securities laws at that time. Then the SEC proffered two versions of the rule that

¹⁶⁰. Id. According to Sommer, "when a corporation chooses to tap public sources of money, it makes a commitment that, absent the most compelling business justification, management and those in control will do nothing to interfere with the liquidity of the public investment or the protection afforded the public by the federal securities laws." Id. at D-4.

¹⁶¹. Id.

¹⁶². Id.


> It shall be unlawful for an issuer . . . to purchase any equity security issued by it if such purchase is in contravention of such rules and regulations as the Commission, in the public interest or for the protection of investors, may adopt (A) to define acts and practices which are fraudulent, deceptive, or manipulative, and (B) to prescribe means reasonably designed to prevent such acts and practices.

Id. See supra notes 163-64 and accompanying text.


¹⁶⁷. One suggestion was to define the transaction as that "which would, if successful, permit the issuer to cease filing reports under the Exchange Act." See 1975 Proposed Rule 13e-3, supra note 163, 40 Fed Reg. at 7948. Another suggestion called it a transaction by an issuer "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." Id.
would govern the "going private" transaction. The 1975 proposed rule 13e-3A would have made a company's purchase of its own securities unlawful unless it complied with specific substantive and procedural disclosure requirements. Additionally, this version of the rule would have required that the consideration offered to the minority shareholders "constitute fair value . . . as determined in good faith" by the company, and that it "shall be no lower than [the consideration] recommended jointly by two qualified independent persons." The second version of the rule, 13e-3B, included similar disclosure requirements to those set forth in proposed rule 13e-3A. Rule 13e-3B, however, required that a company buying out its minority shareholders demonstrate that a valid business purpose existed for the transaction.

The 1977 proposed rule 13e-3 provided numerous disclosure and antifraud provisions to regulate "going private" transactions. In addition to numerous disclosure requirements, the proposed rule stated that any such transaction found to be unfair would be considered a fraudulent, deceptive, or manipulative act, prohibited by section 13(e) of the Securities Exchange Act. Moreover, the 1977 proposed rule 13e-3 would have authorized the courts to consider all relevant factors surrounding a "going private" transaction to ensure fairness and minority shareholder protection. Further, the proposed rule would have combined the uniformity of a federal fairness stan-

168. *Id.* at 7949, where the Commission stated the requisite information for proposed rule 13e-3A. It would include, among other things:

the source of funds for the transaction, the purposes of the transaction and intentions with respect to the future conduct of the business, background information regarding affiliates, an opinion of counsel respecting the legality of the transaction, certain financial information, recent acquisitions of securities, dividend and market price information, and a summary of an evaluation by two qualified independent persons of the consideration to be offered to the security holders of the affected class of securities who are not affiliates of the issuer.

*Id.* See *id.* at 7951 (1975 Proposed Rule 13e-3A(c)(1)-xx).

169. See 1975 Proposed Rule 13e-3A(c)(2), which states:

(2) The consideration for the equity securities to be purchased shall constitute fair value to the security holders of such class of the issuer who are not affiliates as determined in good faith by the issuer or its affiliate, and shall be no lower than that recommended jointly by two qualified independent persons. Such persons, in recommending the consideration, shall consider, among other factors, the value of the assets and earning power of the issuer.

40 Fed. Reg. at 7951.

170. See 1975 Proposed Rule 13e-3B(a)(1), which states that certain transactions are unlawful unless: "(1) if such transaction is entered into by the issuer, such issuer has a valid business purpose for doing so . . . ."


standard with an in-depth scrutiny of substantive fairness not provided by current disclosure laws.174 However, in the midst of an avalanche of critical comments from the corporate community questioning the Commission's statutory authority to impose such substantive fairness standards, the Commission retreated from its proposed assertion of substantive regulation to judge the fairness of "going private" transactions.175

The Commission's 1977 proposed rule 13e-3 may have been influenced by the United States Supreme Court's opinion in Santa Fe Industries v. Green,176 determining whether the federal securities laws provide a remedy for breach of fiduciary duty by officers, directors, and majority shareholders in connection with a "going private" transaction.177 The Supreme Court's decision effectively removed the issue of fiduciary duty of fairness in the context of a "going private" transaction from the jurisdiction of section 10(b) of the Securities and Exchange Act. The Supreme Court noted, however, that the Commission's authority to initiate other rules for "going private" transactions was unaffected by the Court's decision that "going private" cases are unactionable under section 10(b) of the Securities and Exchange Act.178

In this short-form merger, Santa Fe Industries owned more than 90% of the outstanding stock of a subsidiary, Kirby Lumber Corporation, and desired to acquire 100% ownership of that corporation.179 The control group of Santa Fe Industries used a Delaware short-form merger statute, permitting payment of cash to the subsidiary's minority shareholders for their shares and restricting these shareholders to an appraisal action in state court if they expressed dissatisfaction with the price they received.180 The control group disclosed all material information relative to the value of the subsi-


[m]ost of the commentators were opposed to the requirement in the 1977 proposals that a Rule 13e-3 transaction must be both substantively and procedurally fair to unaffiliated security holders. A number of these commentators expressed the view that the Commission does not have the authority to adopt such a requirement. . . .

The Commission believes that the question of regulation of the fairness of going private transactions should be deferred until there is an opportunity to determine the efficacy of the provisions of Rule 13e-3.

177. Id. at 464-65.
178. Id. at 473 n.12.
179. Id. at 465.
180. Id. at 465-66.
ary's stock. Nevertheless, the dissatisfied shareholders brought suit in federal district court contesting the fairness of the "going private" merger.

The minority shareholders alleged that the merger was a manipulative or deceptive practice and sought remedy under section 10(b) of the Securities Exchange Act and the Commission's rule 10b-5. They alleged that rule 10b-5 was breached because the offered price of $150 per share was grossly inadequate, the merger had no valid business purpose, and the sole purpose of the merger was the elimination of the minority shareholders. The District Court for the Southern District of New York dismissed the complaint for failure to state a claim upon which relief could be granted. On appeal, the United States Court of Appeals for the Second Circuit reversed, reasoning that rule 10b-5 reached breaches of fiduciary duty despite the majority shareholders' full disclosure of material information to the minority shareholders.

181. Id. at 466.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

Compare the language of § 10(b) which includes the terms "manipulative" and "deceptive" with the language of § 13(e), see supra note 165, which includes the terms "fraudulent," "manipulative," and "deceptive." The additional term in § 13(e) "was part of legislation intended by Congress to close a gap in the federal securities laws, and thus the Commission is promulgating its [going private] rules under that section." SEC Proposes Rule on "Going Private," SEC REG. & L. REP. (BNA) No. 429, at A-6 (Nov. 23, 1977).

184. 17 C.F.R. § 240.10b-5 (1985). SEC rule 10b-5 provides in relevant part:

It shall be unlawful for any person . . .

(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.

Id.

185. 391 F. Supp. at 852, 855-56. The district court stated that rule 10b-5 requires only full disclosure. The court reasoned that if the majority discloses that its purpose is to eliminate minority shareholder interests in the corporation, then the transaction is "beyond the purview of Rule 10b-5." Id. at 854.
shareholders. 186

The Supreme Court reversed. 187 The Court reasoned that the federal securities laws were designed to protect investors by requiring full and honest disclosure of material facts so that investors could make informed investment decisions. 188 The Court found that the control group implementing the merger had indeed disclosed all material information relative to the value of the subsidiary's stock and therefore did not breach their corporate fiduciary duty in violation of rule 10b-5. 189 Moreover, the Court refused to override or interfere with established state policies concerning this area of corporate regulation and, accordingly, relegated the dissatisfied shareholders' claim to state law for relief. 190 The Court held unequivocally that “going private” transactions, even if unfair, could not be attacked under rule 10b-5 or other federal securities laws absent allegations of nondisclosure or misrepresentation of material facts, or manipulation that involved nondisclosure. As a result of the Green decision, “going private” transactions appeared to be solely a matter of state law.

In 1979, the SEC issued another notice of proposed rule 13e-3 in an attempt to extend the federal securities laws to remedy the claims of “unfairness” stemming from “going private” transactions. 191 The 1979 proposed rule 13e-3, however, did not include the earlier controversial substantive fairness provisions, which would have prohibited transactions that were “unfair” to outside shareholders. 192 The Commission adopted this version of rule 13e-3. 193 Ordinarily, when a company “goes private,” it will be subject

186. Green v. Santa Fe Indus., 533 F.2d 1283, 1287 (2d Cir. 1976).
188. Id. at 477-78.
189. Id. at 474.
190. Id. at 478. The Court stated:
The Delaware Legislature has supplied minority shareholders with a cause of action in the Delaware Court of Chancery to recover the fair value of shares allegedly undervalued in a short form merger. . . . Of course, the existence of a particular state-law remedy is not dispositive of the question whether Congress meant to provide a similar federal remedy, but . . . we conclude that “it is entirely appropriate in this instance to relegate respondent and others in his situation to whatever remedy is created by state law.”

Id. (quoting Cort v. Ash, 422 U.S. 66, 84 (1975); Piper v. Chris-Craft Indus., 430 U.S. 1, 41 (1977)).

Notably, the Supreme Court's narrow interpretation of relief available under the federal securities laws for breaches of fiduciary duty “may have actually been a causative element” of the Singer decision and its progeny. Rothschild, supra note 30, at 199.
192. See supra note 175 and accompanying text.
193. See 17 C.F.R. § 240.13e-3 (1985). In adopting the 1979 version of rule 13e-3, the Commission felt that state court decisions such as Singer v. Magnavox, 380 A.2d 969 (Del.
Regulation of Leveraged Buyouts

to the requirements of this adopted rule, which merely requires disclosure and prohibits fraud or untrue statements.

In conjunction with rule 13e-3, the Commission adopted schedule 13E-3 as a detailed disclosure form for “going private” transactions that fall within the scope of the rule. The disclosures are intended to reveal specific information that the Commission believes is needed by investors in corporations that are engaging in “going private” transactions. Among the matters to be disclosed by such corporations are whether ratification by a majority of the outside shareholders is required, whether a fairness opinion of the transaction was rendered, and whether the outside directors approve the transaction. The most significant item of schedule 13E-3 is the requirement that the control group attest to the fairness of the transaction. Item 8 requires the control group to formally state on the record whether it “reasonably believes” that the rule 13e-3 transaction is “fair or unfair” to the outside shareholders, and to discuss the basis for that belief.

In sum, even with the adoption of rule 13e-3, the federal securities laws do not require that a proposed leveraged buyout or any “going private” transaction must, in fact, be “fair.” Green specifically stated that section 10(b) of the Securities and Exchange Act and the Commission’s rule 10b-5 were not meant to cover allegations of corporate mismanagement in which the com-

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1977) and Tanzer v. Int’l. General Indus., 379 A.2d 1121 (Del. 1977), which were effective law at that time, provided adequate protection to outside shareholders from control persons acting unfairly when taking a company private. See Securities Exchange Commission No. 34-16075, supra note 175, 44 Fed. Reg. at 46,736.

194. See generally supra note 193; see also A.B.A. Comm. on Corporate Laws, supra note 2, at 325, explaining the applicability of this rule:

This rule applies when, as a result of the proposed transaction, the number of shareholders of record would drop below 300, when the company would lose its listing on any of the ten national securities exchanges, or when it would become ineligible for quotation by NASDAQ. The mere “reasonable likelihood” that any of these results would occur is enough to invoke the rule.


197. Item 8(c) of Schedule 13E-3 reads: “(c) State whether the transaction is structured so that approval of at least a majority of unaffiliated security holders is required.” Id.

198. Item 8(d) of Schedule 13E-3 reads: “(d) State whether a majority of directors who are not employees of the issuer has retained an unaffiliated representative to act solely on behalf of unaffiliated security holders for the purposes of negotiating the terms of the Rule 13e-3 transaction and/or preparing a report concerning the fairness of such transaction.” Id.

199. Item 8(e) of Schedule 13E-3 reads: “(e) State whether the Rule 13e-3 transaction was approved by a majority of the directors of the issuer who are not employees of the issuer.” Id.

200. Items 8(a) and (b) of Schedule 13E-3 pertain to disclosure of the fairness of the transaction and read: “(a) State whether the issuer or affiliate filing this schedule reasonably believes that the Rule 13e-3 transaction is fair or unfair to unaffiliated security holders. . . . (b) Discuss in reasonable detail the material factors upon which the belief stated in Item 8(a) is based . . . .” Id.
plaint avers that the outside shareholders were not treated fairly by a fiduciary. It further stated that in the absence of deficiencies in disclosure, outside shareholders contesting the "fairness" of the transaction would be relegated to state courts for relief. In the same vein, the Commission's rule 13e-3 and attendant schedule 13E-3 require merely that the control group make disclosures and state its reasonable belief regarding whether the leveraged buyout or any "going private" transaction is fair or unfair to the outside shareholders. Therefore, outside shareholders who have complaints concerning the transaction, other than those associated with disclosure, are forced to seek redress in state court, where they and especially those shareholders involved in a leveraged buyout may well receive an inadequate remedy.

II. THE LEVERAGED BUYOUT TRANSACTION

In most situations, neither the federal securities laws through rule 13e-3 disclosure requirements nor Delaware court decisions advocating appraisal remedies are adequate vehicles to redress outside shareholder grievances stemming from the leveraged buyout transaction. In examining such transactions, both federal and state forums fail to consider the best interests of outside shareholders. This Comment strives to focus attention on this troublesome situation of outside shareholders by calling for an upgraded standard of "entire fairness" for the leveraged buyout transaction. This standard will include a discussion of fair dealing (which includes full disclosure), fair price, and a valid business purpose, other than one designed solely to eliminate the outside shareholders. Initially, a discussion of the unique characteristics of this type of transaction will reveal the need for its specialized treatment. In fact, in 1979 the SEC sensed the need for special focus on the leveraged buyout and issued an interpretative release containing elements the Commission deemed unfair to outside shareholders.

201. Green, 430 U.S. at 477.


In the leveraged buyout transaction, management's inherent status as both buyer and seller of the corporation leads to conflict of interest and potential inequity. While management can benefit substantially from this type of transaction, management owes a fiduciary duty of fairness to its public shareholders. As required by general fiduciary principles under state law, management should act as a prudent seller of the corporation and seek the highest price for its public shareholders. Simultaneously, however, management may act as a prudent purchaser of the corporation and seek the lowest possible price to enhance its own financial position. By purchasing at a low price, management's debt and risk are minimized. As a result of its dual role, by acting on both sides of the same transaction, management places itself in a self-dealing transaction.

Beyond this, the leveraged buyout is unusual in that it provides a means by which management can assume ownership and control of a corporation with a relatively small personal investment. This is possible because the assets and funds of the acquired corporation are used to finance the buyout.

At the same time, the control group will often be motivated by the opportunity to buy the company at a bargain price, because its listed stock price and future earnings power may be undervalued by the market and management. The control group can also realize the tax benefits of high leverage. Moreover, the control group will no longer be required to comply with burdensome SEC disclosure requirements with which public companies must comply under the federal securities laws. Further, the managing segment of the purchasing group is given an opportunity to rekindle its “en-

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15567, 16 SEC Doc. No. 1094 (Feb. 27, 1979) (where Commission orders for administrative proceedings show the SEC's readiness to proceed against control groups implementing leveraged buyouts without adherence to some standard of fairness).

204. Self-dealing is present when the majority shareholders of a corporation cause it to act in a manner whereby the majority shareholders receive something from the corporation to the detriment and exclusion of the minority shareholders. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

205. See B. Longstreth, supra note 3, at 2, 16.

206. See, e.g., Brody, supra note 17, at 15, col. 1 (listing low price as a primary motivating factor of the Empire, Inc. buyout).

207. L. Lederman, R. Citron & R. Macris, supra note 9, at 286. These benefits include "deductibility of interest payments and tax-free return of capital to investors in the form of ultimate repayment of principal." Id.

208. See B. Longstreth, supra note 3, at 3. In a leveraged buyout, the acquired company becomes a private company, effectively removing itself from the disclosure reporting required of public companies under the federal securities laws. See also Williams, supra note 5, at 18, cols. 1-2. "Sometimes the motive for going private is mainly management's desire to avoid the record-keeping, shareholder meetings and other tedious hassles associated with being a public company.


entrepreneurial spirit" and take greater business risks, without the fear of "inquisitive shareholders and Wall Street analysts." Finally, when the market improves for investing, the purchasing group can consider returning the company to public ownership, thereby realizing a large profit.

Another significant and unique characteristic of the leveraged buyout is the purchasing group's use of the company's assets as collateral for the large loans needed to buy out the company's outstanding shares. Despite management's allegation that the company is experiencing business losses and needs a buyout to ameliorate the situation, it is probable that the assets of the company have sufficient value to serve as collateral needed by the control group to implement the buyout. It is equally probable that the company has a steady cash flow that will enable it to satisfy the potentially large loan payments it incurs in securing financing for the transaction. From any point of view, the control group enjoys an array of advantages from leveraged buyout transactions.

Conversely, the leveraged buyout is fraught with disadvantages for the selling company's outside shareholder group, which is afforded none of the opportunities of the control group. For instance, the outside shareholder group receives only cash in the transaction and is excluded from all future equity participation. This group's expectation of participation in the future profits of the company or increases in stock value is extinguished.

209. See, e.g., Waters, supra note 4, at 47 (explaining management's opportunity to completely control the company as one of the primary reasons for the increase in leveraged buyout transactions).

210. Scott, supra note 5, at 19, col. 2 ("That kind of scrutiny—especially when a company is struggling—can pressure management into short-term strategies just to pacify this constituency.").

211. See, e.g., Waters, supra note 4, at 48, 53. Gibson Greeting Cards, Inc. engaged in a leveraged buyout transaction in January of 1982 for $81 million, well under book value. All but $1 million of it was financed by bank loans and real estate leasebacks. In May of 1983, Gibson went public, its $81 million investment skyrocketed into stock worth an estimated $280 million. See Bus. Wk., supra note 3 (explaining that the significant increase in the value of the Gibson shares was due primarily to the below book value purchase, the economy's continued strengthening, and the drop in interest rates from their mid-1982 highs); see also Scott, supra note 5, at 20, col. 3, wherein Richard W. Madresh, senior vice-president at Security Pacific Business Credit, which has financed some $800 million in leveraged buyouts, explains that an "investment banker says we'll take the company private, run it more efficiently, more profitably, then take it public again and make a killing in the market."

212. For example, assume a leveraged buyout of a company goes for $100,000. The purchasing group may put up $10,000 of its own money and borrow the remaining $90,000 against the assets of the company. It then uses its cash flow from earnings and operations to repay the debt. Thus, the purchasing group ends up owning the company by using other people's money.

213. See, e.g., B. Longstreth, supra note 3, at 1 (reviewing the effects of leveraged buyouts).

214. See A.B.A. Comm. on Corporate Laws, supra note 2, at 318.
Although the disparate treatment between these two groups is difficult to calculate in terms of dollars, there exists, nonetheless, unequal treatment. Clearly, the control group establishes the terms of the transaction. Thus, from a public policy perspective, leveraged buyouts present the danger that the public shareholder will become hostile toward American corporate mores and the securities markets. This is important because the public’s attitude toward the markets has a significant impact on the state of the economy.\(^{215}\) Consequently, this type of transaction, which continues to be reported regularly in the *The Wall Street Journal* and *The New York Times*, needs specialized regulation consistent with the underlying philosophy of the federal securities laws—investor protection and preservation of the integrity of the financial markets.\(^{216}\) Such specialized regulation does not currently exist. This Comment will present a framework for such regulation for the leveraged buyout within the context of the principles of fair dealing (which includes full disclosure), fair price, and a valid business purpose, which may also be applicable to other "going private" transactions.

The control group of a public corporation initiating a leveraged buyout should not be permitted to force unfairly the shareholders of the outside group to take cash for their interest, while the control group retains the assets and goodwill of the corporation. Accordingly, the initiation of a leveraged buyout transaction should raise a prima facie cause of action for breach of fiduciary responsibility and thereby place the burden on management to show "entire fairness," despite the control group’s compliance with state merger or appraisal statutes. Adequate protection for the disadvantaged shareholder, therefore, should require the control group to demonstrate the "entire fairness" of the transaction and should allow the outside shareholders a full range of equitable remedies beyond mere appraisal. The


Securities markets in the United States are, in contemplation of law and in fact, public markets. They are public both in the sense that large numbers of people are directly or indirectly involved in owning and trading securities, and in the broader sense that the performance of securities markets affects the general economy and well-being in important ways. The former sense was recently expressed, for example, by the president of the New York Stock Exchange as follows: “The sole purpose of a modern marketplace is to provide the public with an efficient and dependable mechanism through which securities can be bought and sold.” The latter sense is expressed by section 2 of the Exchange Act, which succinctly states various reasons why securities markets are “affected with a national public interest.”


\(^{216}\) Cf. *id.*
analysis of "entire fairness" should consist of a scrutiny of three elements: fair dealing (which includes full disclosure), fair price, and a valid business purpose.\textsuperscript{217} Only through an analysis consisting of these three elements can the outside shareholder in a leveraged buyout be reasonably assured that he is being treated with "entire fairness."

The first element, fair dealing, should encompass the duty to conduct the leveraged buyout in a manner that protects the interests of all the shareholders.\textsuperscript{218} It should also include the manner in which the buyout transaction is structured, timed, negotiated, and disclosed to the voting directors and shareholders, as well as the manner in which the approval of the directors and shareholders is sought.\textsuperscript{219} The second element, fair price, should encompass a consideration of "all relevant factors" affecting the value of a company.\textsuperscript{220} The final element, business purpose, should force an inquiry into whether the control group has initiated the transaction to benefit the acquired company or rather to benefit only the control group in terms of future profit growth.\textsuperscript{221} A valid business purpose for a leveraged buyout transaction should be one that benefits the corporation and all its shareholders equitably but not necessarily identically.

To date, neither established case law nor any SEC ruling has specifically addressed the unique characteristics of the leveraged buyout transaction, or formulated an adequate method of assuring "entire fairness" for the outside shareholders. While courts have applied settled law in the relative area of "going private" transactions to leveraged buyouts, the application of law has failed to give outside shareholders adequate assurance of an "entirely fair" deal. The satisfaction of three elements, including fair dealing (which includes full disclosure), fair price, and a valid business purpose can reasonably give this assurance to the outside shareholder group. Relying on the discussion of each of these elements set forth above in the context of Delaware case law and the federal securities laws, this Comment will propose a substantive "entire fairness" standard to be applied to leveraged buyouts.

217. See Nathan & Shapiro, \textit{Legal Standard of Fairness of Merger Terms Under Delaware Law}, 2 Del. J. Corp. Law 44 (1977); see also A.B.A. Comm. on Corporate Laws, \textit{supra} note 2, at 318 (recognizing in its discussion of "going private" transaction the distinctions between the terms: fairness, business purpose, disclosure, shareholder voting, and expert opinion).

218. Weinberger, 457 A.2d at 710-11.

219. Id.

220. Id. at 713. These factors include, among other things, the terms of the financing and the determination of the offered price. \textit{See infra} notes 308-14 and accompanying text.

221. A.B.A. Comm. on Corporate Laws, \textit{supra} note 2, at 322.
III. DELAWARE CASE LAW AND FEDERAL SECURITIES LAWS: INADEQUATE SAFEGUARDS FOR THE DISADVANTAGED SHAREHOLDER

A. Fair Dealing

The leveraged buyout creates potential for "self-dealing" by management. Therefore, an examination of a proposed leveraged buyout should emerge that will ensure the control group's adherence to its fiduciary duty of fair dealing: to "disclose" conflicts of interest; to act primarily for the benefit of the corporation and all its shareholders; and to act honestly and in good faith. In this examination, the outside shareholders should possess additional interests in their shares, apart from the obvious monetary concern for market value.222 The range of the additional interests can traditionally be classified as either extreme, liberal, or moderate. The extreme position holds that the outside shareholders have no additional interests in the corporation other than the value of their shares and provides appraisal as their sole remedy in a buyout.223 The liberal position, on the other hand, holds that the outside shareholders have a vested right to corporate participation that goes beyond share value.224 Finally, the moderate position rejects both the extreme and liberal views and holds that the outside shareholders have some degree of additional interest beyond share value, but may be relieved of their right to future corporate participation if the transaction is fair and its purpose "serves the corporate good."225 This Comment adopts the moderate

222. See generally Borden, supra note 1 (examining the various degrees of interests that shareholders may possess in their equity investment).
223. See Coleman v. Taub, 638 F.2d 628, 634 (3d Cir. 1981); see also Green v. Santa Fe Indus., 533 F.2d 1283, 1306 (2d Cir. 1976) (Moore, J. dissenting), rev'd on other grounds, 430 U.S. 462 (1977) (discussing Delaware's short-form merger statute, Moore stated: "[U]nder § 253, the 10% minority shareholder is entitled to fair value of his shares, and not to any opportunity to thwart the will of the overwhelming majority.") (emphasis in original)); Staffer v. Standard Brands Inc., 41 Del. Ch. 7, 187 A.2d 78, 80 (1962) (stating that the purpose of § 253 is to allow the majority to eliminate the minority shareholders' interest and relegate them to monetary appraisal of their bought-out shares).
224. Coleman, 638 F.2d at 634 (recognizing that minority shareholders may have an interest in continued participation in the corporate enterprise); but see Borden, supra note 1, at 1020-21 (discrediting the position that shareholders have a vested right in corporate participation); Chazen, Fairness From a Financial Point of View in Acquisitions of Public Companies, 36 BUS. LAW. 1439 (1981); Easterbrook and Fischel, Corporate Control Transactions, 91 YALE L.J. 698 (1982) (arguing that the minority shareholders are entitled to nothing more than the market value of their shares).
225. Coleman, 638 F.2d at 634-35 ("An intermediate position allows the majority to relieve the minority of the right of participation, but only when it serves the corporate good; 'some what analogous' is the right of the sovereign to take the property of individuals under principles of eminent domain.") See Brudney, Equal Treatment of Shareholders in Corporate Distributions and Reorganizations, 71 CALIF. L. REV. 1073 (1983) (discussing whether the
position as the most equitable to all the parties involved in a leveraged buyout transaction. The current federal and state laws, however, have effectively rejected the moderate position, moving instead toward the extreme position that in most situations limits outside shareholders solely to the market value of their shares and mere disclosure of information bearing on the offered price. Adoption of the principles of the extreme position both at the federal and state levels will be discussed below.

1. Federal Level (Rule 13e-3 Disclosure)

Rule 13e-3, as originally proposed by the SEC in 1975, would have authorized courts to consider all relevant factors involved in a "going private" transaction. Further, it would have made the initiation of such a transaction unlawful if it was substantively or procedurally unfair to the outside shareholders. The original version of rule 13e-3 set forth many considerations by which substantive and procedural fairness would have been judged. It would have gone far beyond the disclosure requirements of current rule 13e-3 and far beyond the limited protection afforded by state appraisal remedy. The SEC, however, in adopting the 1979 version of rule 13e-3, abandoned the earlier proposed idea of a substantive fairness standard. At that time, the Commission expressed its belief that the substantive fairness question should be deferred until a later time. Because the current "going private" disclosure rules offer no meaningful protection to outside shareholders subjected to a potentially unfair leveraged buyout transaction, the time to consider a substantive fairness standard has arrived.

Rule 13e-3 and schedule 13E-3 do not require the proposed buyout trans-

A.A. Sommer, Jr., also seemed to adopt the moderate position. He stated that "[t]he shareholder must no longer be a second class citizen. Once he is invited to feast and he pays his admission, those who own the tent must not be able to usher him out at the end of the second course with only the menu at [sic] his souvenir." A. Sommer, supra note 1, at D-5.

226. See supra notes 158-74 and accompanying text.

227. Id.

228. Id.


[w]hile we are not persuaded that the Commission lacks the authority to adopt such a requirement, we do believe that the question should be deferred until there has been an opportunity to determine the efficacy of the present disclosure proposals as well as of the judicial remedies being created by the state courts in this area. . . . It is too early to tell whether it may be necessary for the Commission to provide substantive remedies in the future.

Id. at A-2.
action to be substantively "fair." Item 8 of schedule 13E-3 merely requires the control group to expressly state whether it reasonably believes the transaction is "fair or unfair" to the outside shareholders and to state the material factors upon which that belief is based. This disclosure rule does not compel fairness; it is designed merely to promote informed decisionmaking by the corporation's shareholders. Given the required information, the shareholders will presumably decide intelligently for themselves what weight to accord the opinion. Management's inherent motivation to offer outside shareholders a price "as low as reasonable pessimism will allow," however, casts a shadow on whether management's claim of "reasonable belief" as to fairness will provide any useful guidance for shareholders who are deciding whether to sell.

Thus, the task of deciding whether to sell shares can become increasingly difficult for the average shareholder. An example of this difficulty occurred in the Stokely Van-Camp, Inc. buyout. Although shareholders were told by the company's management that an offering price of fifty-five dollars per share was "fair and attractive," they actually received a competing offer price of seventy-seven dollars per share just seven weeks later. Stokely Van-Camp, Inc., however, was not in violation of rule 13e-3 because the company had fully disclosed pursuant to the requirements of schedule 13E-3. Moreover, the SEC may not be motivated to inspect fully the accuracy of these opinions once full disclosure has been made by the company. Therefore, the disgruntled shareholder, who is unsuccessful in alleging a violation of disclosure requirements under the federal securities laws, is relegated to state law for relief.

In addition to these deficiencies under rule 13e-3, the outside shareholder group receives minimal protection. The disclosure approach under the rule provides no forum for contesting the fairness of a leveraged buyout transaction. In the same vein, former SEC Commissioner, Bevis Longstreth, em-

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230. See B. Longstreth, supra note 3, at 7.

231. Material factors, in the context of the federal securities laws, include those items of information that a reasonable shareholder would consider important in deciding on a course of action. See TSC Indus. v. Northway, Inc., 426 U.S. 438 (1976); Austin v. Loftsgaarden, 675 F.2d 168, 176 (8th Cir. 1982).

232. See supra note 200 and accompanying text.

233. B. Longstreth, supra note 3, at 6 (quoting Brudney & Chirelstein, supra note 1, at 298).

234. Id.

235. Id. at 1 (reciting facts of a specific leveraged buyout transaction which "was to be accomplished through a merger with a newly formed private corporation which would [have] borrow[ed] the necessary funds and secure[d] that borrowing with Stokely's assets.")

phasized that the disclosure requirement by no means ensures a fair deal.\textsuperscript{237} It may, he suggested, nevertheless, prompt a somewhat improved deal than might otherwise be offered.\textsuperscript{238} Consequently, the outside shareholder works under the erroneous assumption that he actually will have a meaningful choice of action upon receiving the disclosed information.\textsuperscript{239} For example, an outside shareholder is not offered a realistic choice if he is bought out at a time when the company's stock is in a depressed state, even if he has a right under state law to demand an independent appraisal of the cash price being offered. The inherent unfairness of the lack of choice will remain, regardless of how much disclosure is motivated by rule 13e-3. Although rule 13e-3 may supply the outside shareholder with material information, he will remain powerless against unfair treatment of his interest in the corporation by the control group.

2. \textit{State Level (Fair Dealing)}

In the typical leveraged buyout transaction, the control group stands on both sides of the proposal and can dictate the terms of the transaction by forcing the outside shareholder group to receive cash consideration for its shares. As a result, the outside shareholders of the acquired company are deprived of their equity interest and the acquiring company gains complete control of the acquired company's assets.\textsuperscript{240} The control group, however, takes measures to demonstrate that it is acting in the interest of the outside shareholder group as required by state fiduciary principles. During this process, the control group has available a number of procedural devices to protect itself from legal challenge. These devices include approval of the proposed transaction by a majority of the outside shareholders, review of the proposed transaction by the outside directors, and an opinion from an independent investment banker regarding whether the proposed transaction is financially fair to the outside shareholders.\textsuperscript{241}

Nevertheless, each of these devices is less than adequate to ensure that the

\textsuperscript{237} B. Longstreth, supra note 3, at 17.
\textsuperscript{238} \textit{Id}. at 11.
\textsuperscript{239} \textit{See}, e.g., Kaplan, supra note 21, at 904, stating that
[\textit{w}hile it might be said in the simple buy-back offer type of going private that the public shareholder has a right to accept or reject the price tendered to him and should not be hindered from making such a choice, the element of volition is only a fiction if the result of the tender offer will be the elimination of a public market for the shares; moreover, there is no choice at all in the situation where public shareholders are ejected from the corporation against their will by an overwhelming vote cast by controlling shareholders.
\textsuperscript{241} \textit{See} B. Longstreth, supra note 3, at 7.
outside shareholders receive a fair deal. First, ratification of the transaction by outside shareholders is effective only if they are able to evaluate fully the terms of the transaction and are presented with some viable options should they reject the deal.\textsuperscript{242} Bevis Longstreth, however, notes that there have not been many viable options available to date.\textsuperscript{243} Second, review of the proposed transaction by the outside nonmanagement directors is not likely to ensure fairness to shareholders, because these directors may be biased by a strong sense of loyalty to management and because their discretion is protected under the business judgment rule.\textsuperscript{244} Finally, the financial opinion of an investment banker should be approached with caution. As evidenced in the Stokely Van-Camp, Inc. example,\textsuperscript{245} where shareholders were told by investment bankers that $55 was a fair price for a company's stock which shortly thereafter sold for $77 per share, the range of fairness can be so large that even expert financial opinions can fail to aid the outside shareholder in determining what constitutes a fair deal.\textsuperscript{246}

The \textit{Weinberger} and \textit{Rabkin} decisions minimally ensure the outside shareholders of receiving a fair deal. In \textit{Weinberger}, the Delaware Supreme Court stated that if the dissenting outside shareholder cannot demonstrate that the corporation engaged in specific acts of fraud or misrepresentation, or cannot show why appraisal remedy is insufficient relief,\textsuperscript{247} then the dissenting shareholder may be relegated to appraisal as the exclusive remedy, with no recourse to damages or rescission.\textsuperscript{248} The burden of proving fraud or misrepresentation may be very difficult for a plaintiff to overcome, because of the control group's use of the procedural devices\textsuperscript{249} to prevent the appearance of fraud or misrepresentation. Even the recent \textit{Rabkin} decision, which somewhat broadens the scope of \textit{Weinberger} to include procedural fairness questions having a reasonable impact on substantial issues affecting the offering price per share,\textsuperscript{250} does not go far enough to ensure the outside shareholders in a leveraged buyout transaction of an "entirely fair" examination and relief. To obtain a full procedural fairness examination under \textit{Rabkin} that includes a consideration of remedies beyond appraisal proceeding, the complaining shareholder must allege something more than just "unfair deal-

\begin{footnotesize}
\begin{enumerate}
\item[242.] \textit{Id.} at 10.
\item[243.] \textit{Id.}
\item[244.] \textit{Id.} at 9.
\item[245.] See \textit{supra} notes 12, 235, and accompanying text.
\item[246.] B. Longstreth, \textit{supra} note 3, at 8.
\item[247.] \textit{Weinberger}, 457 A.2d at 714.
\item[248.] \textit{Id.}; see L. Lederman, R. Citron & R. Macris, \textit{supra} note 9, at 300.
\item[249.] See \textit{supra} notes 241-46 and accompanying text.
\item[250.] \textit{Rabkin}, 498 A.2d at 1100.
\end{enumerate}
\end{footnotesize}
ing." The charge must allege facts of manipulative conduct. Therefore, the control group will continue to use these protective procedural devices to bolster its position in making the leveraged buyout transaction look "fair" to the outside shareholder group. Rabkin will not protect the outside shareholders in this situation unless they can show some form of misconduct by the control group. Thus, in Weinberger and Rabkin, Delaware has effectively adopted the extreme equity interest position stating that outside shareholders have no additional interests in the corporation other than the value of their shares, with the right of appraisal in most situations, as their sole remedy. This position, however, is inappropriate for the modern leveraged buyout transaction.

Conversely, the trilogy consisting of Singer, Tanzer, and Roland, adhered to the moderate position, allowing the control group to relieve the outside group of its right to corporate participation, but only when the business purpose "serves the corporate good." The core message expressed in the Singer trilogy is that outside shareholders cannot be forced to defend their right to corporate participation by a mere appraisal of their stock's monetary value. As expressly stated in Sterling and the cases of the Singer trilogy, the corporation's control group owes its shareholders a fiduciary duty of "entire fairness." The outside shareholder is better protected by the moderate position in the Singer trilogy than by the extreme position in the Weinberger case. Judicial review of the "entire fairness" of the terms of the proposed transaction is denied under Weinberger, unless the dissenting shareholder demonstrates fraud, misrepresentation, or other misconduct by the control group or the appraisal proceeding is shown to be inadequate relief. The Weinberger "entire fairness" test includes only fair dealing and fair price, not business purpose. Thus, in most cases, the dissenting outside shareholder will be limited to appraisal as his only remedy. This result seems harsh, especially in light of the control group's ability to use the procedural devices to prevent the appearance of fraud. A return to Singer would grant the outside shareholder an impartial, independent review of "entire fairness" without a demonstration of fraud. Moreover, the Singer "entire fairness" test includes fair dealing, fair price, and a business purpose. Having determined that a

251. Id. at 1105.
252. Id.
253. Coleman, 638 F.2d at 635. See supra note 225 (explaining the meaning of "corporate good").
254. 638 F.2d at 638.
255. See supra notes 44-49, 52-87.
256. Weinberger, 457 A.2d at 714.
257. See supra note 241 and accompanying text.
return to Singer would enhance the outside shareholders’ chance of receiving a fair deal, this Comment turns to the issue of fair price.

B. Fair Price

Low offering prices by control groups attempting a leveraged buyout have raised questions over the adequacy of the offered consideration. Primarily, an analysis of fair price should reveal whether the price offered per share to the outside shareholder group is fair, considering all the circumstances of the leveraged buyout transaction. The fact that the company’s own assets provide substantially all the financing to purchase the company should be a sufficient reason to require a higher standard of good faith by the control group than may be required of other “going private” transactions. Clearly, if the control group recommends to the outside shareholder group approval of the proposed buyout transaction at a cash price per share that the control group knows to be inadequate, then it has breached its fiduciary duty of fair price. Instead, however, the control group will implement a procedural device to clothe its proposed offer in apparently fair terms.

The procedural device involves review of the transaction by an investment banker. By obtaining an investment banker’s opinion as to a fair offering price, the control group assumes a neutral posture and, therefore, the announced opinion is presumed to be objectively and financially fair. A cooperative board of directors will often rely heavily on the fairness opinion in its judgment of whether the transaction is fair in complying with item 8 of schedule 13E-3. However, the financial opinions of investment bankers can be grossly below book value, as was demonstrated by the investment banker’s opinion in the Stokely Van-Camp, Inc. buyout. Additionally, the accuracy of financial opinions can be skewed by the limitations that the control group often places on the investment banker’s review.

Turning to Delaware case law, the Delaware Supreme Court reestablished in Weinberger that statutory appraisal rights in most situations would be the basic remedy of the bought-out shareholder. The court updated and ex-

258. See B. Longstreth, supra note 3, at 7-9.
259. See supra notes 235-36 and accompanying text.
260. B. Longstreth, supra note 3, at 8. A contract between an investment banker and the hiring company controls the terms of the review. In one fairness opinion, for example, the investment banker noted:

We were not requested to solicit and did not solicit other purchasers for [the corporation], the common stock of [the corporation] or the assets of [the corporation] as part of our engagement. If purchasers of [the corporation] were actively solicited or if the assets held by [the corporation] were liquidated in an orderly fashion, it is possible that a price in excess of the equivalent of $68 per share could be realized.

Id.
panded Delaware's appraisal remedy to require consideration of "all relevant factors" involving the value of a company.\(^{261}\) The court noted that an assessment of fair value requires generally accepted methods in the financial community.\(^{262}\) Therefore, absent a showing of fraud, misrepresentation, or misconduct, the dissatisfied shareholder in the leveraged buyout alleging an unfair offering price per share cannot seek rescission or damages relief, but only appraisal relief equal to "fair value."\(^{263}\) This could, however, amount to inadequate relief for the dissatisfied shareholder who may be bought out at a time when the market value of the shares is low and the elements of appraisal are favorable to the control group. Moreover, the dissenting shareholder views appraisal as an unattractive remedy and wishes to avoid it.\(^{264}\) The appraisal proceeding is often cumbersome and ineffective "because of the court's tendency to rely heavily on the preexisting market price and the fairness opinions used by management to support its bid."\(^{265}\) Not only does it usually require long delays while the price per share is being established, but litigation over the share value is expensive and often unrewarding.\(^{266}\) Furthermore, because the corporation is an active participant in the appraisal proceeding, has voluminous knowledge about its own affairs, and is seeking the lowest possible share valuation, the dissenting shareholder is in a significantly disadvantaged position.\(^{267}\) Above all, the appraisal proceeding is risky, because the dissenting shareholder can end up with less cash per share than the control group originally offered.\(^{268}\)

Another factor decreasing the chance for outside shareholders to obtain a fair price is the control group's inherently imprecise method of determining a fair price.\(^{269}\) A correlating factor that should be incorporated into the fair price equation is the incurrence of capital gains taxes or a capital loss by the outside shareholders independent of whether they are financially prepared to incur such taxes or losses.\(^{270}\) The outside shareholders may also incur brokerage fees in the process of reinvestment. To compensate for these costs, the outside shareholders may sometimes be offered the market value plus some arbitrary amount as an additional premium.\(^{271}\) But the additional pre-

\(^{261}\) *Weinberger*, 457 A.2d at 713.
\(^{262}\) *Id.* at 712.
\(^{263}\) B. Longstreth, *supra* note 3, at 10.
\(^{264}\) *See infra* notes 265-68.
\(^{265}\) B. Longstreth, *supra* note 3, at 2.
\(^{266}\) *Id.* at 10.
\(^{267}\) *See generally id.*
\(^{268}\) *Id.* at 10.
\(^{271}\) *See Brudney, A Note on "Going Private",* 61 VA. L. REV. 1019 (1975); see also De
mium may well prove inadequate to cover these financial costs.

The control group, on the other hand, may receive values substantially higher than those of the outside shareholder group because of the disparity between book values and market values of many corporations following a buyout. Additionally, although there are many intangibles such as goodwill that might significantly contribute to a corporation's profitability, these factors may not be counted fairly in the valuation of the outside shareholder's interest because of their intangible nature. A dissatisfied shareholder alleging an unfair offering price per share is nonetheless restricted under Weinberger to an appraisal remedy, which does not consider the "gain to the corporation resulting from a statutory merger." Moreover, the dissatisfied shareholder has no guaranteed forum in which to contest the control group's timing of the buyout, which is certainly timed to the control group's financial advantage. In the same manner, the disclosure requirements imposed by the federal securities laws do not ensure a fair price. Given the difficulties of fairly estimating the value of stock holdings together with management's ability to offer terms, which may be substantially below true value, the dissatisfied shareholder should be allowed remedies beyond mere appraisal to ensure "entire fairness."

A further factor adversely affecting the chance for outside shareholders to obtain a fair price is management's attitude toward disclosing its own financial figures on which it bases the terms of the deal. These are the real

Angelo & De Angelo, The Numbers Show Everyone Profits, N.Y. Times, Jan. 22, 1984, § 3, at 2, col. 2. The management-investor purchasing group may use the leveraged buyout transaction to buy out public shareholders at an unfairly low price despite the theoretical defense of management that the shareholders are paid an above-current market value for their stock, which they otherwise could not obtain. The authors examined 72 leveraged buyout proposals by New York and American Stock Exchange companies between 1973 and 1980 and found that in the typical transaction the compensation paid to public shareholders was on average 56% above prior market value. This figure was said to be similar to premiums in tender offers during the same period. Id. The authors failed, however, to address the issue of whether the "highest price" was paid to the shareholders when considering "all relevant factors."

In other fair price discussions, it has been argued that

[i]f the controlling shareholder makes a public tender offer for shares of the corporation with full disclosure of material information and the offer is accepted by a large body of shareholders, preferably including some sophisticated investors, the price paid may be assumed to be fair. If it is fair for such a tender offer, it should be fair for a going private transaction that immediately follows it.

A.B.A. Comm. on Corporate Laws, supra note 2, at 319. It should be noted, however, that the tender offer method of ascertaining a fair price is often not available at the time of management's proposed leveraged buyout. Id.

273. Note, supra note 174, at 797 n.31.
275. See Thomas, supra note 4, at col. 5.
figures, which are kept from the corporation’s outside shareholders and seem to be “management’s private preserve.” These real figures, which go beyond the assets and liabilities listed on the balance sheet, give “meaning and synthesis to otherwise discrete economic units.” For example, in the summer of 1983, David Mahoney, then chairman and chief executive officer of Norton Simon, Inc., made an unsuccessful leveraged buyout bid for Norton Simon, Inc. Not only was he not required to reveal the sources of his financing, but he was not required to share with the outside shareholders the internal projection figures he had calculated to obtain financing commitments from lenders.

The test of fairness, as discussed in subsections A and B above, is not bifurcated between fair dealing and fair price, but rather is a test of “entire fairness,” encompassing all the characteristics unique to the leveraged buyout transaction. The “entire fairness” analysis should embrace the idea that neither is the control group’s fiduciary duty diluted as its control percentage increases nor are the outside shareholder group’s rights determined by how small the ownership percentage may happen to be. When management has a control block of at least 50% of the outstanding shares, it naturally is in the strongest position to force its deal on its outside shareholders or reject competitive outside bids for the company. Nevertheless, when management has less than a majority of the shares but otherwise controls the company, it will frequently be able to implement the same procedural devices to convince its outside shareholders that the proposed deal is fair. Therefore, whether management has more or less than a majority of the shares, the same standard of fiduciary duty of “entire fairness” should apply to the leveraged buyout transaction to ensure that it is objectively fair to the outside shareholders. To further this objective, the business purpose of the transaction needs to be analyzed in the “entire fairness” analysis.

276. Id.
277. Id.
278. Id.
279. See Tanzer, 379 A.2d at 1125, where the Delaware Supreme Court found that [t]he Chancellor's opinion, announced at the preliminary injunction stage of this proceeding, discussed fairness only in terms of the price offered for the stock, but that was too restrictive. The test required by Singer, which applied the rule of [Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1952)], involves judicial scrutiny for “entire fairness” as to all aspects of the transaction.
280. See supra note 83 and accompanying text.
281. See supra notes 241-46 and accompanying text.
C. Business Purpose

A leveraged buyout should not only have fair dealing (which includes full disclosure) and a fair price, but also a valid business purpose. The concept of "entire fairness," therefore, consists of these three primary elements. The inclusion of a business purpose requirement in the fairness analysis will permit the outside shareholders to challenge the transaction for breach of fiduciary duty even though its structure, disclosure, and price may not be directly challenged.282 The outside shareholders should be able to retain their status as public shareholders until they either voluntarily sell their shares or are bought out for a business purpose that considers their best interests.283 Moreover, a valid business purpose implies a benefit to the corporation and its entire body of shareholders, and not merely a personal purpose of the control group.284 Therefore, to prevent the achievement of a personal rather than a business purpose, the purpose of the leveraged buyout should serve a specific corporate objective.

There has been much discussion and support for imposing a business purpose requirement in the “going private” context.285 Beginning in 1974,

282. A.B.A. Comm. on Corporate Laws, supra note 2, at 321. See also Cross v. Communication Channels, Inc., 116 Misc. 2d 1019, 456 N.Y.S.2d 971 (Sup. Ct. 1982) (holding that a shareholder has no cause for complaint that corporate funds are used to finance a buyout provided there is a valid corporate purpose for the merger and the minority shareholders receive a fair price for their stock).

283. See A.B.A. Comm. on Corporate Laws, supra note 2, at 323 & n.36 (citing for support Young v. Valhi, Inc., 382 A.2d 1372, 1377 (Del. Ch. 1978)) (finding that the exclusion of all the outside shareholders was unnecessary where the same alleged tax advantages could have been obtained by the control group through 80% ownership of the company’s shares as opposed to 100% ownership).

284. A.B.A. Comm. on Corporate Laws, supra note 2, at 322. (“The desire of the majority solely to obtain for itself the benefits of future profit growth is not a business purpose since it involves no benefit to the enterprise as such or to the entire body of its shareholders.” Id. See Brudney & Chirelstein, supra note 87, at 1365-70 (expressing their view that single company going private transactions can never be justified). In nonleveraged buyout transactions involving more than one corporate entity, however, a business purpose of the control group may be a consideration. Id. See, e.g., Tanzer v. International Gen. Indus., 379 A.2d 1121 (Del. 1977) (holding that a cash-out merger effected primarily to advance a business purpose of the majority stockholder is not rendered impermissible).

285. See Small, The Functions of Directors in Acquisitions of Controlled Corporations, reprinted in Ninth Annual Institute on Securities Regulation 47, 59 (1978). Mr. Sporkin, then SEC Director of Enforcement, qualified the requirement of business purpose by stating:

It is not simply a question of articulating a business purpose. It is a question of whether there is, in fact, a true business purpose. When the controlling person articulates one purpose and then litigation ensues and it is discovered that the real purpose was something altogether different, then the controlling person is really in some difficulty.

Id.; see also Tanzer Economic Assocs. v. Universal Food Specialties, Inc., 87 Misc. 2d 167, 182, 383 N.Y.S.2d 472, 483 (Sup. Ct. 1976) (for a proposed merger listing several items that
amidst the growing concern for fairness arising from the “going private” phenomenon, A.A. Sommer, Jr. stated that even if outside shareholders were adequately compensated for their bought-out shares, they should not be deprived of their future equity participation unless there exists the most “compelling business justification.”

In response to Sommer’s statements, in early 1975, the SEC proposed rule 13e-3, which would have required “going private” transactions to have a valid business purpose. The rule, however, was not adopted.

The Singer, Tanzer, and Roland trilogy specifically endorsed the requirement of a business purpose. In Singer, the Delaware Supreme Court stated that the elimination of the minority shareholders in a long-form merger without a “valid business purpose” was a breach by the majority of its fiduciary duty. In Tanzer, the Delaware Supreme Court mentioned that only a “bona fide” business purpose of the majority shareholders would justify a merger in which minority shareholders are eliminated. Finally, in Roland, the Delaware Supreme Court extended the business purpose requirement to include short-form mergers by calling for a “valid business purpose.”

The Roland court acknowledged that there was no presumption of proper purpose in a short-form merger, despite its relaxed procedures for implementing the transaction.

In 1979, despite receiving numerous complaints from dissatisfied shareholders in other “going private” transactions, the SEC adopted rule 13e-3, which abandoned the valid business purpose requirement. Although the rule requires the control group to discuss in reasonable detail the purposes and effects of the transaction, this is only a procedural disclosure requirement, without any substantive enforcement mechanism to adequately

would constitute legitimate business purposes); Outwater v. Public Service Corp. of New Jersey, 103 N.J. Eq. 461, 143 A. 729 (Ch. 1928), aff’d. 104 N.J. Eq. 490, 146 A. 916 (1929) (stating that no purpose would justify extinguishing shareholders from a corporation).

286. A. Sommer, supra note 1, at D-4.

287. See 1975 Proposed Rule 13e-3, supra note 163. Specifically, the alternative rule 13e-3B, would have required a valid business purpose for the transaction to exist.

288. Singer, 380 A.2d at 979. See supra notes 49-63 and accompanying text.


290. Roland, 407 A.2d at 1036. See supra notes 77-87 and accompanying text.

291. See supra notes 175, 193 and accompanying text.


293. See item 7 of Schedule 13E-3 of the Securities Exchange Act of 1934 which reads in relevant part:
protect the disadvantaged shareholder. Similarly, in 1983, the Delaware Supreme Court, in Weinberger, abandoned the requirement of a valid business purpose in corporate mergers as set forth in the Singer, Tanzer, and Roland trilogy. However, the Weinberger court's abandonment of this requirement is wholly inappropriate in the case of a leveraged buyout.

The most compelling reason to require a business purpose in leveraged buyouts is that the inherent potential for self-dealing may cause the control group to initiate the buyout for personal and economic purposes rather than for valid business purposes. Indeed, the control group should not be able to use its control for a purpose adverse to the interest of the corporation and the outside shareholders, such as buying back the public shareholders' interest at a fraction of the price paid by those shareholders for their stock. Further, the ability of the control group to increase significantly its ownership in the acquired company with only a small personal investment adds to the temptation of implementing a leveraged buyout and can muddle fiduciary and fairness issues. The foremost consideration should be the business purpose impact on the acquired corporation, not the purposes of the control group exclusively. Moreover, the business purpose should be determined based on the facts and circumstances of each individual transaction and if it cannot be properly justified, then the transaction should be thwarted.

In sum, the current state and federal laws addressing the leveraged buyout transaction fail to ensure adequate protection to the disadvantaged and often dissatisfied shareholder. The temptation for management to overreach is simply too great to go unchecked. Procedural devices, such as expert finan-

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294. See supra notes 193-201 and accompanying text.

295. Weinberger, 457 A.2d at 715. In Weinberger, the Delaware Supreme Court returned to the principle of Stauffer v. Standard Brands, Inc., 187 A.2d at 80 (interpreting a Delaware short-form merger statute as not requiring a corporation to state a business purpose). Id.; see also Gabhart v. Gabhart, 267 Ind. 370, 388, 370 N.E.2d 345, 356 (1977) (wherein a state court commented adversely on the valid business purpose requirement: "Under the Delaware view, it appears that every proposed merger would be subject to having its bona fides determined by judicial review. We do not believe the judiciary should intrude into corporate management to that extent.").

296. A.B.A. Comm. on Corporate Laws, supra note 2, at 321; see also supra notes 206-11 and accompanying text.

cial opinions, outside director approval of the transaction, and outside share-
holder ratification of the transaction, are advanced by management to
influence the public's perception of fair treatment. These procedural safe-
guards, however, have become "boiler-plated passkeys to an advantageous
buyout." These procedures are successful in protecting management
from attack, but inadequate in protecting outside shareholders from mis-
treatment, and merely afford a perception of fair treatment.

Leveraged buyout transactions are significantly different from other types
of corporate transactions and often result in disparate treatment between the
two groups of shareholders. The usual criteria of corporate behavior, which
consider the best interests of all shareholders, are absent from the leveraged
buyout transaction. Fiduciary and fairness issues can and do become
clouded because of the company's use of its own assets to supply the most
significant portion of the transaction's financing. Yet state and federal laws
fail to acknowledge the unique characteristics of the leveraged buyout trans-
action or make special provisions to ensure adequate fairness and equity to
the disadvantaged shareholder.

Providing additional credence to this
contention is the fact that Delaware, through its recent Weinberger decision,
has eviscerated the concept of "entire fairness" as initially and correctly set
forth in the Sterling decision and correctly developed in the Singer trilogy.
The SEC, similarly through its adoption of the 1979 version of rule 13e-3,
has reduced the concept of "entire fairness" to a mere subjective procedural
level, to a blueprint for corporations to follow and avoid full review of the
fairness of the transaction.

IV. PROPOSAL FOR A SUBSTANTIVE "ENTIRE FAIRNESS" STANDARD

The leveraged buyout, a particular type of "going private" transaction,
therefore, requires regulation beyond current state and federal laws. The
plight of the disadvantaged shareholder should no longer be left to the forces

298. B. Longstreth, supra note 3, at 16.
299. See A.B.A. Comm. on Corporate Laws, supra note 2, at 318.
300. The purpose of this discussion is to alert the securities industry that the outside share-
holder is not on equal footing with the control group. Notably, however, the outside share-
holder may realize a significant increase in the value of his shares than ever seemed likely in
the absence of a leveraged buyout transaction. See, e.g., Waters, supra note 4, at 48 (concern-
ing a Connecticut-based company, with wine distributing and graphic arts interests, that was
stagnating in the market at about $14 per share but paid its outside shareholders $28 per share
one month later following a buyout). This effect, although beneficial to the outside shareholders,
does not necessarily put him on equal footing with the control group, which enjoys a
panoply of benefits as a result of a leveraged buyout. See supra notes 205-11 and accompany-
ing text.
of the free market. A substantive fairness standard should be implemented embracing the Singer trilogy concept of an “entire fairness” analysis and its three elements, consisting of fair dealing (which includes full disclosure), fair price, and a valid business purpose. The goal of this advanced regulation should be to protect the public shareholder, as well as to enhance the corporate image. Enforcing these themes will tend to preserve the integrity of the marketplace and help to prevent the control group from unfairly using the leveraged buyout as a technique for snapping up a company at a cut-rate price. In the absence of a substantive fairness standard, however, leveraged buyouts could contribute to erosion of the financial markets’ integrity and could ultimately affect the ability of publicly-held companies to raise funds through stock offerings.

A substantive “entire fairness” standard raises several issues regarding what specific factors should be included in the “entire fairness” inquiry. Viewed broadly, the applicable fairness standard should both protect the disadvantaged shareholder and avoid complex and costly litigation impinging on the free market forces of competition. Each of the three elements in the “entire fairness” test should raise specific factor interrogatories.

The factors to be considered under the fair dealing element include a full disclosure and review of: whether and to what extent the control group’s conflicts of interest affect the outside shareholders; whether the transaction is structured so that approval of at least a majority of the outside sharehold- ers is required; whether the transaction requires approval by a majority of the outside directors; whether the outside shareholders are being shown the same financing figures that the control group is viewing; whether the control group is affording all potential outside bidders a reasonable investigation of the company; and whether the control group is using stock option plans, lock-ups, and other manipulative devices to prevent outside competing bids.

The factors to be considered under the fair price element include: whether the terms of the control group’s buyout proposal are similar to those made for comparable companies within a relevant time period; whether and to

301. But see B. Longstreth, supra note 3, at 16 (stating that under ideal circumstances, “the marketplace has proved to be the best protector of shareholder interests”) (emphasis added).
303. See supra note 197 and accompanying text.
304. See supra note 199 and accompanying text.
305. See Thomas, supra note 4, at 9, col. 6.
306. See B. Longstreth, supra note 3, at 17.
307. See id.
308. See Rothschild, supra note 30, at 230.
what extent the terms of the transaction are keyed to prevailing market prices as opposed to considerations of book value, replacement costs, and historical and prospective operational results;\textsuperscript{309} whether the estimated value of the benefits to be received by the control group after the transaction include items such as tax benefits, assets, and goodwill;\textsuperscript{310} whether, in the case of competitive bids, the control group matches or exceeds the highest bid price;\textsuperscript{311} whether and to what extent the seller of the corporation may have to assume any of the buyer's liabilities;\textsuperscript{312} whether there is an independent appraisal of the assets to be sold or leveraged;\textsuperscript{313} and whether the price per share offering is any lower than that recommended jointly by two qualified and independent investment bankers.\textsuperscript{314}

The factors to be considered under the business purpose element include: whether the control group is able to demonstrate a valid business purpose for the transaction rather than a self-interested purpose;\textsuperscript{315} whether the business purpose considers the best interests of the corporation and its entire body of shareholders;\textsuperscript{316} and, if the business purpose of the transaction is deemed "valid", whether the control group's subsequent actions are the least detrimental to the outside shareholder group. Although the three factor-lists are not exhaustive, they are indicative of the types of specific factors that should be considered in determining the "entire fairness" of the transaction. Under such an inquiry, either the courts or the SEC or both could examine the substantive aspects of the leveraged buyout, and could block those transactions in which the control group might treat the outside shareholder group unfairly.

Finally, a proposition calling for a substantive "entire fairness" standard raises an additional issue of whether resolution should evolve from the federal or state level.\textsuperscript{317} Because the modern corporation frequently engages in business on a nationwide basis and generally has a multistate shareholder base, it is reasonable that the problem be resolved at the federal level by the SEC. A uniform federal standard would bring an in-depth analysis cur-

\textsuperscript{309} Id.
\textsuperscript{310} See 1977 Proposed Rule 13e-3(b)(2)(G) to (J), supra note 164.
\textsuperscript{311} See B. Longstreth, supra note 3, at 17.
\textsuperscript{313} Id.
\textsuperscript{314} See 1975 Proposed Rule 13e-3, supra note 169.
\textsuperscript{315} See supra notes 282-84 and accompanying text.
\textsuperscript{316} A.B.A. Comm. on Corporate Laws, supra note 2, at 322.
\textsuperscript{317} The proper role of the federal and state judiciaries in regulating corporate management is a complex issue that is beyond the scope of this discussion. See generally Symposium, supra note 28.
rently not provided by disclosure laws. The SEC should work with the Congress and the states in formulating a satisfactory solution through legislation. Moreover, the SEC should seriously reconsider implementing its earlier proposed remedy addressing the leveraged buyout transaction: the appointment of a "special review person" to represent and negotiate on behalf of the outside shareholder group. In the same vein, Congress should consider legislating an explicit mandate enabling the SEC to regulate the substantive fairness of leveraged buyout transactions.

V. CONCLUSION

With the current proliferation of leveraged buyouts, a growing concern permeates the business community that the public shareholder is being relegated to a disadvantaged position. It is a genuine concern that the shareholder is being treated unfairly and being offered an unfair price for his equity interest. Delaware case law and federal securities laws have addressed this concern in the context of the "going private" transaction, but their actions have proven inadequate in mitigating potential inequities emanating from this unique form of "going private" transaction. Further, the procedural safeguards that have been advanced by the corporate community as "fair" are unworkable for the leveraged buyout. Consequently, the public shareholder often remains disgruntled and disadvantaged. Thus, leveraged buyouts present the danger that the public shareholder will become even more incensed by American corporate mores and the securities markets than he or she has become. The leveraged buyout transaction, therefore, demands a special substantive scrutiny that involves a review of its "entire fairness." This mandatory "entire fairness" analysis requires an examination of the transaction with respect to its fair dealing (which includes full disclosure), fair price and a valid business purpose. By implementing an upgraded form of regulation for the leveraged buyout transaction, such as the one outlined above that considers the particular character and sensitivities of this transaction, the public shareholder can gain the lost protection

318. See Note, supra note 174, at 802.
320. See Securities Exchange Commission Release No. 34-15572, supra note 203, 44 Fed. Reg. at 11,540. Understandably, this proposed remedy may have some shortcomings, such as an overambitious review person or a time delay in negotiating between the parties, but they can be assuredly rectified through administrative compromise.
321. See Note, supra note 174, at 816-17 ("Although the Santa Fe decision raises questions concerning substantive regulation of fraud under Exchange Act provisions, that case . . . does not render substantive regulation under the rule improper.").
322. See generally A. Sommer, supra note 1.
and increase his or her confidence in the securities markets and the American corporation.

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