Washington and Lee Law Review

Volume 36 | Issue 3 Article 2

Summer 6-1-1979

In Response To A Restatement Of Corporate Freezeouts

Michael D. Goldman

Donald J. Wolfe, Jr.

Follow this and additional works at: https://scholarlycommons.law.wlu.edu/wlulr

Part of the Securities Law Commons

Recommended Citation

Michael D. Goldman and Donald J. Wolfe, Jr., *In Response To A Restatement Of Corporate Freezeouts*, 36 Wash. & Lee L. Rev. 683 (1979).

Available at: https://scholarlycommons.law.wlu.edu/wlulr/vol36/iss3/2

This Article is brought to you for free and open access by the Washington and Lee Law Review at Washington and Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington and Lee University School of Law Scholarly Commons. For more information, please contact christensena@wlu.edu.

// Washington and Lee Law Review

Member of the National Conference of Law Reviews

Volume XXXVI	Summer 1979	Number 3

IN RESPONSE TO *A RESTATEMENT OF CORPORATE FREEZEOUTS*

MICHAEL D. GOLDMAN
DONALD J. WOLFE, JR.*

In *Singer v. Magnavox Co.*,[1] the Delaware Supreme Court declared that cash-out mergers initiated by a majority stockholder would be permitted only upon satisfaction of a two-pronged test: (1) that a proper business purpose for the contemplated merger can be demonstrated; and (2) that the terms of the proposed merger are entirely fair to the minority shareholders.[2] Perhaps the most interesting and provoking commentary in the welter of criticism that has arisen in the wake of *Singer*,[3] is that of Professors Victor Brudney and Marvin A. Chirelstein, in their 1978 article entitled *A Restatement of Corporate Freezeouts*.[4] Their treatise suggests that an objective standard be established to ensure fair dealing between inside and outside shareholders.[5] Such a standard would relieve the uncertainty prompted by the *Singer* decision and would permit the consequences of any transaction to be reasonably predictable. This article will review the *Singer* opinion and critique the standards promulgated by Brudney and Chirelstein in order to support the framework adopted by the *Singer* court for analyzing freezeout mergers.

Among the numerous 1967 revisions to the Delaware General Corpora-

* Members of the Bar of the State of Delaware.

[1] 380 A.2d 969 (Del. 1977). Certain shareholders of The Magnavox Co. brought the *Singer* action following the merger of that company into a wholly owned subsidiary of the North American Philips Corp. in July 1975. The plaintiffs alleged that the merger was fraudulent since it served no business purpose other than terminating the participation of the minority shareholders in the venture. *Id.* at 972. The shareholders sought nullification of the corporate merger and compensatory damages. *Id.* The Court of Chancery had dismissed the action, holding that the merger was not fraudulent merely because it accomplished no other purpose than to eliminate the minority shareholders. 367 A.2d 1349, 1358 (Del. Ch. 1976). However, the Delaware Supreme Court held on appeal that the complaint sufficiently alleged a cause of action against the majority shareholders for breach of fiduciary obligations and reversed the Court of Chancery. 380 A.2d at 980.

[2] 380 A.2d at 979-80.

[3] *See, e.g.*, 66 CALIF. L. REV. 118 (1978); 57 N.C. L. REV. 163 (1978); 54 NOTRE DAME LAW. 149 (1978); 31 VAND. L. REV. 183 (1978); 64 VA. L. REV. 1101 (1978).

[4] 87 YALE L. J. 1354 (1978).

[5] *See* text accompanying notes 33-37 *infra*.

tion Law was an amendment to section 251 which broadly expanded the types of permissible consideration to effect a long-form merger of Delaware corporations.[6] Prior to that revision, section 251(b) mandated that every shareholder of each corporation involved in the merger be given a continuing interest in the surviving corporation and permitted cash to be utilized only in lieu of issuing fractional shares.[7] However, even prior to 1967, when a parent merged with a subsidiary in which it owned 90% or more of the outstanding shares in a short-form merger, section 253 authorized a cash-out or squeeze-out merger.[8] In contrast, the 1967 amendment to section 251 provided that a freezeout or cash-out of shareholders could be effected upon *any* merger.[9] The amended statute created the apparent absolute power in a majority stockholder to eliminate the minority interests completely from further participation in the corporate enterprise by merging the corporation into a wholly owned subsidiary and exchanging cash for the minority shares. Although the Delaware Supreme Court specifically upheld the validity of the short-form merger statute in *Stauffer v. Standard Brands, Inc.*,[10] this broad power, at least in part, rendered inevitable the judicial inquiry undertaken some ten years later in *Singer v. Magnavox Co.*

While the *Singer* decision appears contrary to the philosophy of the

---

[6] 56 Del. Laws, ch. 50, § 251 (1967). Section 251(b) stated in relevant part:

> The board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation. The agreement shall state . . . (4) the manner of converting the shares of each of the constituent corporations into shares or other securities of the corporation surviving or resulting from the merger or consolidation and, if any shares of any of the constituent corporations are not to be converted solely into shares or other securities of the surviving or resulting corporation, the amount of cash or securities of any other corporation which is to be paid or delivered to the holders of such shares in exchange for or upon the surrender of such shares, which cash or securities of any other corporation may be in addition to the shares or other securities of the surviving or resulting corporation into which any of the shares of any of the constituent corporations are to be converted; and (5) such other details or provisions as are deemed desirable, including, without limiting the generality of the foregoing, a provision for the payment of cash in lieu of the issuance of fractional shares of the surviving or resulting corporation.

Id.

[7] 36 Del. Laws, ch. 135, § 18 (1929); 50 Del. Laws, ch. 467, § 4 (1955).

[8] 51 Del. Laws, ch. 121, § 253 (1957).

[9] 56 Del. Laws, ch. 50, § 251 (1967).

[10] 41 Del. Ch. 7, 187 A.2d 78 (1962). In *Stauffer*, the plaintiff-stockholder alleged constructive fraud in the merger of Standard Brands with Planters Nut and Chocolate Corp. based on the cash-out price paid for the outstanding minority stock. The plaintiff sought to set aside the merger and perhaps recover the difference in value of the shares. 187 A.2d at 80. The court upheld the validity of a short-form freezeout merger and held the plaintiff's statutory remedy of appraisal was exclusive. *Id.* Additionally, the court expressed skepticism concerning proof of such fraudulent conduct in any short-form merger "because the very purpose of the statute is to provide the parent corporation with a means of eliminating the minority shareholder's interest in the enterprise." *Id.* This rationale might equally apply to long-form mergers and thus appears inconsistent with the *Singer* decision.

short-form merger statute as expressed in *Stauffer*,[11] the legal principles relied upon by the *Singer* court are rooted in a number of solid decisions which were rendered well in advance of the 1967 statutory revisions.[12] Indeed, the *Singer* opinion represents the inevitable culmination of several longstanding lines of common law authority. Paramount among these converging legal principles is the fiduciary duty of fair dealing owed by a majority stockholder to the minority interests in a merger context.[13] This fiduciary duty is founded upon the potential for abuse of the corporate machinery which invariably arises when one of the parties stands in a position to control both sides of a transaction. In such a situation, even prior to *Singer*, the Delaware rule required the self-dealing majority shareholder to shoulder the burden of demonstrating the overall fairness of any proposed transaction in the face of careful judicial scrutiny.[14]

A second, more general common law maxim prohibits corporate fiduciaries, including officers, directors and majority shareholders, from manipulating the corporate machinery for personal interests to the detriment of minority shareholders.[15] Even corporate transactions which are facially proper and entirely in accordance with the literal requirements of a statute may be designed to accomplish improper purposes. For example, in *Schnell v. Chris-Craft Industries, Inc.*,[16] a group of minority shareholders attempted to challenge the incumbent management in a proxy contest.[17] To obstruct this effort, the management attempted to advance the date of the annual stockholders' meeting by altering the corporate by-laws. Although the Delaware Supreme Court acknowledged that the management had complied with the technical statutory requirements regarding this action, the court nevertheless enjoined the early meeting.[18] The *Schnell* court merely observed that "inequitable action does not become permissible simply because it is legally possible."[19] Therefore, because self-dealing can exist in spite of meticulous compliance with statutory procedure, the propriety of and necessity for judicial scrutiny of the motives and purposes behind corporate transactions remains.

---

[11] *See* note 10 *supra*.

[12] *See* text accompanying notes 12-27 *infra*.

[13] *See* Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107, 109-10 (1952); Bastian v. Bourns, Inc., 256 A.2d 680, 681 (Del. Ch. 1969), *aff'd* 278 A.2d 467 (1970); David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 434-35 (Del. Ch. 1968).

[14] Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107, 110 (1952).

[15] *See* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971); Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503, 510 (1939); Petty v. Penntech Papers, Inc., 347 A.2d 140, 143 (Del. Ch. 1975); Condec Corp. v. Lunkenheimer Co., 43 Del. Ch. 353, 230 A.2d 769, 775-76 (Del. Ch. 1967).

[16] 285 A.2d 437 (Del. 1971).

[17] In *Schnell*, a group of dissident shareholders organized to challenge the incumbent management in a proxy contest for control of the corporation. *Id.* at 438-39. The management altered the corporate by-laws to disrupt the challenge and employed other tactics to defeat the proxy solicitation efforts. *Id.* at 439.

[18] *Id.* at 440.

[19] *Id.* at 439.

An additional common law basis for the *Singer* decision is provided by a number of scattered opinions which focus on the qualified right of a stockholder to remain a participant in the corporate enterprise.[20] Although these cases were argued before the *Singer* court, they were not discussed at any length in its opinion. The first of these cases, *Starring v. American Hair & Felt Co.,*[21] involved an attempted redemption and selective reissuance of the common stock of the corporation, which thereby cashed out a pre-designated minority of the shareholders. The company apparently desired that control of the business rest solely in the hands of members of the tanning industry. Since non-industry shareholders previously had acquired a limited interest in the corporation, the company attempted to exclude this minority from further participation in the business through a redemption and reissuance plan.[22] The opinion does not recite whether a single majority shareholder controlled the corporation and it does not allude to or rely upon the presence of any fiduciary obligations. Although the *Starring* court ultimately prohibited the transaction on other grounds,[23] the court questioned the legality of the proposed action and expressed serious doubts about the capacity of a corporate entity to coerce stockholders into forfeiting continued participation in the venture.[24]

This judicial discomfort with procedures designed to eliminate selected stockholders solely to serve the interests of the remaining parties was also expressed in *Allaun v. Consolidated Oil Co.*[25] The *Allaun* action involved an unsuccessful attack upon a plan for the sale of corporate assets which had been approved by a majority of the stockholders, who also served as directors of the corporation. The directors allegedly had a personal interest in approving the sale at an inadequate price and had done so to the detriment of the excluded shareholders.[26] Apparently, the force of the evidence mustered by the plaintiff did not match the vehemence of his allegations,

---

[20] *See* text accompanying notes 21-28 *infra.*

[21] 21 Del. Ch. 380, 191 A. 887 (Del. Ch. 1937).

[22] The corporate charter of the American Hair & Felt Co. conferred the power on the company to call and redeem all of its outstanding common stock at a fixed price. 191 A. at 889. The majority shareholders adopted concurrent resolutions which redeemed outstanding stock and reissued the stock to members of the tanning industry currently holding such investments. *Id.*

[23] The *Starring* court held that no Delaware statutory authority permitted a redemption and selective reissuance to reduce the company's capital. 191 A. at 892.

[24] The *Starring* court questioned the equity of the redemption and reissuance plan, stating:

> Now admitting for the moment that the lawful authority exists in a corporation created under the Delaware act to take a power to redeem what is familiarly known as common stock, it may be a serious question whether it can exercise such a power when the avowed purpose is simply to get rid of certain stockholders of a given class whose presence in the stockholding group is undesirable to the rest, by compelling the undesirables to sell out to the chosen ones who are permitted to stay in.

191 A. at 890.

[25] 16 Del. Ch. 318, 147 A. 257 (Del. Ch. 1929).

[26] 147 A. at 259.

for the transaction ultimately was consummated without judicial intervention.[27] Although the *Allaun* court recognized the ability of the majority interests to compel abandonment of a venture by selling off corporate assets, the court nevertheless indicated that equity would restrain transactions designed solely to freezeout minority interests.[28]

The decisions placing fiduciary responsibility upon majority stockholders, and those declaring that such a duty will not be deemed satisfied through mere statutory compliance where an inequitable purpose is thereby served, are complemented by those which acknowledge that, independent of fiduciary considerations, the inherent right of a stockholder to continue his participation in the corporate enterprise must be preserved against routine abrogation. The Delaware Supreme Court obviously distilled from these separate lines of authority the basis for its *Singer* decision and used them synergistically to support its explicit suspicion of any cash-out merger through which the majority shareholder gains full equitable ownership of the enterprise. Thus, the *Singer* court declared that "a Delaware Court will not be indifferent to the purpose of a merger when a freezeout of minority shareholders on a cash-out basis is alleged to be its sole purpose."[29] The court implemented this judicial wariness by imposing the burden of proof upon those who would effectuate the freezeout to demonstrate a *bona fide* corporate purpose.[30] Unabashed attempts on the part of fiduciaries to eliminate the minority merely to serve the majority's personal interests are deemed intrinsically improper notwithstanding the purported fairness of the terms through which the contemplated elimination would be effected. The overall fairness of the terms of the cash-out, the second part of the standard, will be considered under the *Singer* analysis only after the majority has established that a valid corporate purpose exists.[31]

This primary emphasis by the *Singer* court on the purpose or motive of the majority is central to much of the criticism engendered by the decision. Clearly, the court was willing to admit that in some circumstances, however infrequent, the corporate enterprise as a whole could be

---

[27] *Id.* at 262-63.

[28] The *Allaun* court acknowledged that:

> [I]t is the right of the majority in a corporation to practically desert the corporate venture by selling out its assets and, thereby, in the case of a highly profitable concern, deprive their associates of the opportunity to reap gains in the future by continuing in the business, provided the terms and conditions of the sale are fair to the corporation. I suppose, however, if the sale is only a "freezing out" one by which the majority use their power to sell to themselves in another guise and thereby carry on in the business without their former associates of the minority, equity would doubtless restrain it regardless of the fairness of price.

Id. at 260. Similarly, in Bennett v. Breuil Petro. Corp., 34 Del. Ch. 6, 99 A.2d 236 (1953), the court stated that a freezeout majority action would be actionable without regard to the fairness of the price paid for the minority shares. *Id.* at 239.

[29] Singer v. Magnavox Co., 380 A.2d 969, 979 (Del. 1977).

[30] 380 A.2d at 976.

[31] *Id.*

improved by such a merger. The "proper purpose test," as it has been labeled, was undoubtedly designed to balance the potential for corporate improvement against the right of the minority to continue its participation in the venture. Even aside from the inherent problems of proof and credibility arising from this subjective standard, it must be conceded that the distinction between a purpose designed to benefit the surviving corporation and one designed to benefit the majority, who subsequently become the sole owners of the surviving corporation, is often difficult to perceive.[32] This difficulty has led some to suggest that the application of such a test in fact defeats the goal to which *Singer* aspires.[33]

Perhaps the most thoughtful and certainly the most inventive of the critical comments engendered by *Singer* are those of Professors Brudney and Chirelstein.[34] Their analysis generally takes the Delaware Court to task for the ambiguities created by the *Singer* opinion and identifies two particular errors: (1) a failure to perceive that all freezeout mergers are not alike;[35] and (2) the impossibility of predicting, through application of the proper purpose test, whether a freezeout is justifiable under any given set of circumstances.[36] The Brudney-Chirelstein proposal seeks to avoid these perceived deficiencies by (1) classifying all freezeout mergers into three distinct categories to be governed by three equally distinct rules;[37] and (2) eliminating all reference to the presence or absence of a valid purpose underlying the transaction.[38]

---

[32] The Delaware Supreme Court is itself aware of this difficulty. *See* Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121, 1123 (Del. 1977). In his original concurring opinion in *Singer*, Justice McNeilly criticized the court's emphasis upon the need for a business purpose in order to justify a freezeout, stating:

> I am inclined to think, however, that the opinion waffles in its attempt to establish guidelines for future merger litigation with emphasis on the coined phrase "business purpose" which standing alone connotes nothing magic or definitive. Does it mean to say that to satisfy the valid business purpose requirement a corporation must show a compelling corporate need to go private in order to function as a viable business, or does it mean something less? Repeating Justice Duffy's unanswered inquiries, whose purpose and whose business are we testing?

Singer v. Magnavox Co., No. 289, 1976 (Del. Sept. 23, 1977) (concurring opinion of McNeilly, J., subsequently withdrawn and revised).

Perhaps as a result of this criticism, the majority opinion was amended to delete many of the original references to the need for a business purpose. The opinion now focuses more clearly on the need for a proper purpose, i.e., not solely for the purpose of eliminating the minority. This amendment in turn led Justice McNeilly to delete this criticism from his concurring opinion.

[33] Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L. J. 1354, 1356 (1978).

[34] Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L. J. 1354 (1978) [hereinafter cited as Brudney & Chirelstein].

[35] *Id.* at 1356.

[36] *Id.*

[37] Brudney and Chirelstein suggest that freezeout mergers may be classified into three distinct categories: (a) two-step integrated mergers; (b) going private transactions; and (c) mergers of long-held affiliates. *See id.* at 1359-76.

[38] According to the Brudney and Chirelstein analysis, the presence or absence of a

The first category established in the Brudney-Chirelstein analysis is the multi-step merger transaction. Such a transaction generally is initiated by an unrelated third party, who first tenders for the outstanding shares of the target company, then obtains a majority interest, and subsequently completes the acquisition of 100% of the stock by a cash-out merger.[39] In this multi-step category, Brudney and Chirelstein see no basis for requiring the purchaser to demonstrate a valid purpose for the second-step merger or to shift the burden of proof so as to require him to establish that the terms of the merger are entirely fair to the soon-to-be-eliminated minority.[40] The only constraint suggested upon a multi-step merger is that the merger price be set no lower than the tender price so as not to induce a stockholder stampede during the initial step.[41] In addition, if an intention exists on the part of the offeror to consummate a second-step merger at the time the tender offer is initiated, Brudney and Chirelstein would also require that the intention be disclosed at the time the offer is commenced.[42]

Brudney and Chirelstein explain this indifference to the potential plight of the minority confronted by the second-step merger through a superficially appealing analogy between the multi-step acquisition technique and the one-step, arm's-length merger or sale of asset proposal. They view the multi-step technique as no more than a stylistic variation upon the one-step approach, in which the unrelated third-party suitor negotiates a proposal with the target's board of directors, obtains the approval of that board and successfully seeks stockholder ratification of the proposal.[43] In this setting, Brudney and Chirelstein observe that the outside suitor is not, nor should he be, constrained by fiduciary responsibilities either to the stockholders of the target as a whole or to that minority that may choose to reject the proposal.[44] Thus, the outsider need demonstrate neither a *bona fide* business purpose for his attempted acquisition, nor that the offered price is a fair one. The directors and shareholders of the target make the crucial decisions among themselves and, if a majority determines the price to be acceptable, they are free to force the dissenting minority to join them in being cashed out of the enterprise. The multi-step acquisition technique would be subject to no more rigorous regulation under the

proper business purpose will be presumed from the structure of the merger. *Id.* at 1356.

[39] *See id.* at 1360.

[40] *Id.* at 1365. However, Brudney and Chirelstein welcome judicial surveillance and enforcement of the fiduciary obligation of the target's management in such circumstances to fairly evaluate the tender offer. *Id.*

[41] *Id.* at 1361-62. Brudney and Chirelstein recognize that the public market transactions and the dangers of deception require a "modicum" of regulation for such mergers, but they reject the comprehensive review of the transaction which *Singer* permits. *Id.*

[42] *Id.*

[43] *Id.* at 1360-61. Rather than approaching the target's board of directors, a two-step merger bypasses the board and places the merger issue directly before the stockholders. Brudney and Chirelstein view the stockholders' decision to sell or retain their interest in the corporation as a majority rule vote on the merger itself. *Id.*

[44] *Id.* at 1361.

Brudney-Chirelstein approach. The initial step, they argue, merely constitutes the same type of direct referendum among the target stockholders who register their approval by tendering their shares.[45] The second step puts the majority approved plan into operation by forcing out the minority just as the one-step method permits. Accordingly, viewed as an integrated plan of acquisition, this technique is merely a fragmented form of the one-step merger under the Brudney-Chirelstein analysis.

Brudney and Chirelstein identify a second category of mergers which generally are referred to as "going private" in that the ultimate owner of the target company is already the target entity's controlling shareholder at the time the merger is conceived and effected.[46] In this situation, the controlling shareholders wish to terminate public participation in the venture, often because the market has undervalued the company's shares and prospects.[47] Professors Brudney and Chirelstein readily concede the presence of fiduciary responsibilities on the part of the majority stockholder in these transactions.[48] Their disdain for *Singer*'s motive inquiry arises from their conviction that no possible corporate purpose can justify the elimination of the public minority by insiders. In support of this conviction, they contend that such transactions are utterly void of economic or social benefit.[49] In addition, they note that the clear presence of fiduciary duties, coupled with the potential abuse where no adequate remedy is available, militate against such mergers. Therefore, Brudney and Chirelstein conclude that these transactions should be flatly prohibited, regardless of the underlying corporate purpose or considerations of fairness.[50] They advocate a conclusive judicial presumption that all such transactions constitute *per se* breaches of the fiduciary duties owed to the minority.[51]

The last of the three freezeout categories described in the Brudney and Chirelstein *Restatement* covers cash-out mergers between a parent and its partially-owned subsidiary where the interrelationship has existed over a reasonably long period of time.[52] Brudney and Chirelstein again acknowledge the existence of fiduciary responsibilities running from the parent to the minority shareholders of the subsidiary in this context and, therefore,

---

[45] *Id.* at 1360-61.

[46] *Id.* at 1365. *See* Note, *Going Private*, 84 YALE L.J. 903, 909-11 (1975). As Brudney and Chirelstein hasten to point out, the going private merger may in fact take the form of a multi-step acquisition where it is preceded by a tender offer by the target company for its own shares. Brudney & Chirelstein, *supra* note 34, at 1365 n.20. Notwithstanding their oft-repeated disdain for the proper purpose test, the authors appear to rely on precisely this factor to differentiate going private transactions from multi-step acquisitions in this situation.

[47] Brudney & Chirelstein, *supra* note 34, at 1365.

[48] *Id.* at 1365-66. Professor Brudney has previously advocated an even stricter standard than the *Singer* court adopted to enforce this fiduciary obligation. *See* Brudney, *A Note on "Going Private"*, 61 VA. L. REV. 1019, 1029-30 (1975).

[49] Brudney & Chirelstein, *supra* note 34, at 1366-68.

[50] *Id.* at 1368-69.

[51] *Id.* at 1367.

[52] *Id.* at 1370.

note the distinction between this form of transaction and the one-step, arm's-length merger.[53] Nonetheless, they view mergers between long-standing affiliates as distinct from going private cash-out mergers. The perceived difference lies in their recognition of a variety of valid purposes that may be served through unification of the parent and subsidiary.[54] Elimination of the minority is perceived as merely an unfortunate, but incidental, result. Brudney and Chirelstein view those transactions as "inherently purposive," if only because these mergers necessarily promote simplified internal management and administration. Therefore, they suggest that the courts release these mergers from the constraints of the *Singer* analysis.[55] Instead, they maintain that the courts should presume the existence of a valid purpose under such circumstances and restrict the extent of their review to an examination of the fairness of the proposed terms.[56] This limited review would require, at a minimum, a consideration of sufficient value to permit the minority shareholders to acquire the same proportionate interest in the surviving company that they would have received had the merger contemplated the issuance of common stock in the surviving corporation.[57]

Notwithstanding their oft-expressed disaffection with the proper purpose test, a review of the Brudney-Chirelstein analysis reveals that, rather than discarding the approach, they have chosen simply to presume the results of its application in advance. Indeed, each of the proposed classifications is based upon an unnecessarily inflexible fundamental assumption concerning the validity of the purpose served by each category of transaction. Brudney and Chirelstein merely begin their analysis at a point further along the continuum than the Delaware Supreme Court. Scrutiny of the underlying purpose, an indispensable aspect of the *Singer* analysis, thus is replaced in the Brudney-Chirelstein approach by a superficial examination of the outer form of the transaction. While such physical characteristics, in many instances, may provide helpful evidence of the underlying purpose for the freezeout, we disagree with the conclusive effect which Brudney and Chirelstein accord these indicia.

The crucial considerations in passing on the acceptability of freezeout transactions include: (1) whether the merger serves a proper purpose, and (2) whether that purpose is of sufficient economic and social value to

---

[53] *Id.* at 1370-71.

[54] Brudney and Chirelstein note the following benefits which often justify the acquisition of subsidiaries by the parent corporation: (a) operating economies, (b) elimination of duplicated functions, (c) tax savings, (d) financial and market gains, (e) elimination of fiduciary conflicts, and (f) other "synergistic" gains. *Id.* at 1371.

[55] *See id.* at 1371-72.

[56] *See id.* at 1372.

[57] *Id.* at 1374-75. As Brudney and Chirelstein suggest, such a test would not be sufficiently rigorous where the surviving corporation is a closely held parent since the use of cash or debt in any amount would in that situation still result in the effective eliminating of the minority from participation in the combined corporate enterprise. They therefore suggest that under such circumstances the use of cash or debt may be inherently unfair. *Id.* at 1374.

justify termination of the minority's continued participation.[58] Therefore, these considerations should remain the central aspects of freezeout evaluations. Although it is incontrovertible that shifting the focus from these often amorphous inquiries to an examination of the objective physical characteristics of the merger would simplify the judicial task and make the results of any transaction more predictable, such a shift would necessarily render the conclusion of the inquiry less accurate.

The *Singer* approach, for all its difficulties of application, is preferable for two reasons. First, the *Singer* analysis directly questions the purpose of the merger, which, in essence, is the primary factor in determining the acceptability of the freezeout. Second, this approach leaves open the question of what constitutes a proper purpose in any given factual circumstances and avoids the mechanical application of Brudney and Chirelstein's rigid classifications. Brudney and Chirelstein criticize *Singer*'s failure to recognize that all freezeout mergers are not alike. Yet, the rigidity fostered in their own approach, which results from assumptions respecting the relationship between corporate purpose and the external form of the transaction, render it similarly susceptible to these very criticisms. Moreover, placing dispositive emphasis on the Brudney-Chirelstein approach merely will require majority stockholders to structure transactions that "look right," without necessarily precluding those that operate inequitably. The application of the Brudney-Chirelstein analysis to the circumstances presented by typical merger transactions demonstrates the danger of rigid reliance upon form to the exclusion of substance.

A. *The Two-Step Merger*

Culled to its essence, the Brudney-Chirelstein analysis of two-step acquisitions stands or falls on the analogy it seeks to draw between such transactions and the one-step, arm's-length, negotiated merger or sale of assets. Since little or no examination of purpose or fairness is judicially required in the one-step situation,[59] comparison with the two-step acquisition leads Brudney and Chirelstein to conclude that the latter should be similarly unfettered.[60] The tendering of shares by the majority in the two-step merger is equated with majority stockholder votes in the one-step transaction, since the tendering stockholders in effect have registered their approval by selling their shares.[61] Yet, there exists a crucial distinction between the two transactions which justifies a more rigorous scrutiny of multi-step acquisitions. Specifically, in a one-step transaction, the board of directors of the target company actively participates in and approves of the merger. In order to reach the stockholders with a one-step merger or sale of assets proposal, the suitor first must obtain the approval of the

[58] *See* Singer v. Magnavox Co., 380 A.2d 969, 979-80 (Del. 1977).
[59] *See* Brudney & Chirelstein, *supra* note 34, at 1363.
[60] *Id.*
[61] *Id.* at 1360.

target's directors and assure them of the essential fairness of the proposal. This prerequisite ensures that the well-informed expertise and fiduciary responsibilities of the board will be brought to bear upon the suitor's proposal. Thus, the intrinsic fairness of the proposal is regulated, since unfair or inadequate proposals probably will not receive the approval necessary for stockholder consideration.

In the two-step acquisition, the protection afforded by an independent fiduciary's careful scrutiny is notably absent. Indeed, the two-step strategy is often adopted primarily to avoid the need to deal with a powerful, knowledgeable and potentially hostile board. The initiation of a tender offer acquisition severely erodes the bargaining power of the board. There is little or no room to repudiate. The target board's role is reduced either to providing a limited or neutral commentary on the proposal or waging an all out battle to defeat the offer at the risk of huge expense and potential exposure of personal liability to their own shareholders. Thus, even assuming that the terms of the second-step merger are publicized contemporaneously with the tender offer,[62] there is no negotiation or effective evaluation of either these terms or the offer price. The initial step is often little more than a proposed contract of adhesion at a price dictated solely by the state of the market for the target's shares, which may not provide an accurate barometer of such equity holdings. Even when they represent a premium over market values, tender offers generally do not produce as high a price as the board of directors could obtain through knowledgeable arm's-length negotiations.[63] This observation constitutes yet another factor which often prompts a suitor to choose the two-step method over direct negotiations with the target's board. Finally, even under the Brudney-Chirelstein proposal which would require that the second-step price be no lower than the final offer,[64] stockholders are faced with the choice of either immediately accepting the offered premium in the first step or gambling on the prospect of receiving the same price at a later date under uncertain market conditions and on terms set solely by the new majority owner. While simultaneously safeguarding minority interests, the stockholder vote that routinely characterizes one-step acquisitions is a more accurate test of the true desires of target shareholders than the "direct referendum" which the tender offer purportedly affords. Therefore, courts should thoroughly investigate the fairness of the second-step merger proposal to the non-tendering minority notwithstanding the prior tender of a majority of the outstanding shares.

Brudney and Chirelstein rely on the same analogy to an arm's-length one-step merger to establish their point that there is no need to examine the purpose behind the second-step freezeout.[65] In this regard, they argue

---

[62] *See id.* at 1361.

[63] *Id.* at 1363-64 n.18.

[64] *Id.* at 1361-62.

[65] *Id.* at 1360-61.

that the temporary status as majority stockholder between the first and second steps does not warrant the imposition of fiduciary duties so long as that status is merely transitional.[66] However, a majority stockholder who controls the corporation for any reasonable period of time should be saddled with the fiduciary duties of fair dealing and loyalty to the minority irrespective of his prior status as an unrelated outsider. His new position creates all of the potential for abuse of the corporate machinery that accrues to any majority-minority situation. He is privy to inside information and is able to evaluate market conditions, set the terms upon which the merger will be accomplished and select the most advantageous time from his own point of view to eliminate the minority. Such abuses are the same as those which Brudney and Chirelstein apprehend with alarm in the pure "going private" category.[67] The potential for abuse in this kind of transaction is alleviated only slightly by mandating a purchase price no lower than that offered in the first step tender offer. As the time between the first and second step increases, the potential for majority shareholder abuse increases as well. Therefore, the intensity of judicial scrutiny regarding the necessity of eliminating the minority from continued participation in the corporation should similarly increase. The minority should be entitled to retain their investment in the enterprise unless a valid reason for their elimination can be demonstrated. This protection is best afforded through the *Singer* proper purpose requirement.

Those shareholders who have refused to tender their securities have made a conscious decision to remain in the enterprise. In a second step freezeout, it makes little difference to them that the party fixing the terms of the merger on both sides of the transaction recently arrived on the scene by means of a tender offer. In both instances the shareholder is being forced out against his will by a party in a position to dictate the terms for his own benefit. The *Singer* decision holds that these stockholders may not be eliminated from the enterprise in the absence of both a proper purpose and equitable terms. Those stockholders who have refused to sell their stock at the initial tender offer stage have a right to remain in the company. They should not be frozen out simply because a suitor has succeeded in acquiring a majority of stock in the marketplace and now wants to eliminate them. Such action should be permitted only if there exists a proper purpose for doing so and if the terms guarantee that the minority will be treated fairly.

B. Going Private Mergers

While the most objectionable form of freezeout concededly is included within this category,[68] to bar all going private transactions absolutely is

---

[66] *See id.* at 1361.

[67] *See id.* at 1365-66.

[68] In a recent opinion, the Delaware Supreme Court noted the persuasiveness of Brudney and Chirelstein's position that a pure going private transaction may call for "the strictest

unduly rigid and would preclude some apparently justifiable transactions. In certain instances, valid corporate purposes may militate in favor of such consolidations.[69] Brudney and Chirelstein maintain that the avoidance of the burdensome and ever-increasing expenses of SEC reporting and accounting requirements is an inadequate purpose, since these costs are incurred for the benefit of the public minority to be eliminated.[70] Yet, it is difficult to perceive any difference between this allegedly improper purpose and the elimination of conflicts of interest, deemed "inherently purposive" by Brudney and Chirelstein in parent-subsidiary mergers.[71] These conflicts of interest also arise solely because of the participation of minority shareholders. The costs of public ownership in any degree are substantial and the burden imposed on the corporation because of these costs may be out of proportion to the benefits afforded to the minority interests. In any case, it appears senseless to dictate an inflexible rule which forecloses such possibilities. If a proposed freezeout is not justified under particular circumstances, the *Singer* tests adequately will serve to prevent the fruition of the transaction.

Situations will arise in which the majority of the minority wish to tender their shares for cash but are prevented from doing so because the majority owner will not buy less than all of the minority shares and a few holders do not favor the cash-out. If the majority is foreclosed from effecting a merger, as Brudney and Chirelstein advocate, these minority shareholders are "frozen-in" even though an absolute majority of the minority endorse the transaction. Although Brudney and Chirelstein reject this argument by asserting that the existence of a thin market itself does not justify the freezeout,[72] their approach is not responsive to the difficulties encountered by the frozen-in minority shareholder. Alternatively, we suggest that courts condition approval of this type of cash-out merger upon the affirmative vote of a majority of the minority shareholders. Assuming full and fair disclosure, the dangers of a controlling presence are rendered irrelevant since the majority cannot participate in the decision. At least, where a majority of the minority approval has been obtained, the burden of proof on the fairness issue should shift to a plaintiff challenging the proposed transaction.

The *Singer* court may not have considered or intended to address the freeze-in situation.[73] In one recent decision by the Delaware Court of Chancery, the court recognized the presence of this condition as a basis for distinguishing *Singer* upon a motion for certification of a class of minority

---

observance of the law of fiduciary duty." Roland Int'l Corp. v. Najjar, No. 153, 1978, slip op. at 13 (Del. Aug. 6, 1979). Nonetheless, the two-pronged *Singer* doctrine remains applicable.

[69] *See* Tanzer Econ. Assoc., Inc. v. Universal Food Spec., Inc., 87 Misc. 2d 167, 383 N.Y.S.2d 472 (Sup. Ct. 1976).

[70] Brudney & Chirelstein, *supra* note 34, at 1366-67.

[71] *Id.* at 1371.

[72] *Id.* at 1369.

[73] *See* Tanzer v. International Gen. Indus., Inc., 402 A.2d 382 (Del. Ch. 1979).

stockholders.[74] However, the Delaware courts clearly will confront and rule upon the effect of majority of the minority approval in freezeout situations in the near future.[75] Whatever approach is ultimately adopted by the courts, a flat prohibition against all going private transactions does not remedy the problems presented to the frozen-in minority shareholder. While the Brudney and Chirelstein approach may simplify the freezeout analysis, it does so at the expense of judicial flexibility and a responsiveness to diverse economic forces.

C. Merger of Affiliates

Brudney and Chirelstein posit that the existence of a valid business purpose with respect to mergers between parent corporations and their longstanding partially-owned subsidiaries is impossible to deny.[76] They note that cash-out mergers of this type are "inherently purposive" in nature due to the elimination of duplicated functions, tax savings, financial and stock market gains, and other synergistic increments to the value of the enterprise.[77] Moreover, Brudney and Chirelstein suggest that even if such commercial benefits are only minimally significant, other advantages such as avoidance of potential conflicts of interests and improvements in intercorporate administrative efficiency are *a priori* sufficient to satisfy the *Singer* purpose test.[78] A rigid and mechanical conclusion again results from

---

[74] Weinberger v. UOP, Inc., C.A. No. 5642 (Del. Ch. April 15, 1979). In the course of his decision, Vice Chancellor Brown states:

> Here, however, the situation differs [from that in *Singer*]. As the defendants point out, the merger agreement here was structured so that it could not be approved unless it received the favorable vote of a majority of the 49.5 percent minority shares. It could not be approved solely by the majority of UOP's outstanding stock controlled by Signal as was the case in *Singer*. As such, under the terms of the merger agreement, Signal lacked the capacity to use its voting position as majority shareholder to bring about a cash-out merger in violation of a fiduciary duty owed to the minority. Rather, the decision was left to the minority shareholders, and they voted overwhelmingly in favor of the merger and its cash-out terms.

Id., slip op. at 10. Also see the discussion of the effect of majority of the minority approval in Schulwolf v. Cerro Corp., 86 Misc. 2d 292, 380 N.Y.S.2d 957 (Sup. Ct. 1976).

[75] The matter was raised on remand in Tanzer v. International Gen. Indus., Inc., 402 A.2d 382 (Del. Ch. 1979) and discussed by Vice Chancellor Hartnett. The Vice Chancellor declined to decide the issue, however, citing the explicit instructions of the Delaware Supreme Court on the matter of burden of proof as the law of the case. *Id.* at 386.

Subsequently, in Wayne v. Utilities & Indus. Corp., C.A. No. 5744 (Del. Ch. July 19, 1979). Chancellor Marvel, in approving the settlement of an action in which the plaintiff sought to enjoin a freezeout merger, noted that the new settlement merger proposal required stockholder approval at a special meeting of the minority stockholders. This element "would appear to negative any contention that the majority stockholders are exercising their coercive power to effect a merger for their exclusive benefit and that such majority's business purpose in going private for its own best interests is not to be forced on the minority public stockholders." *Id.*, slip op. at 7.

[76] Brudney & Chirelstein, *supra* note 34, at 1371.

[77] *See* note 54 *supra*.

[78] Brudney & Chirelstein, *supra* note 34, at 1371-72.

the application of their test which is tied solely to the appearance of the transaction.

First, the purported benefits of such mergers will not always warrant the wholesale elimination of sizeable minority interests. Moreover, whatever laudable results these transactions produce may be merely incidental to the actual objective of eliminating an undesirable minority interest. For example, it is manifest that where the parent/majority stockholder effects a freezeout merger solely to promote its own interests, a court should restrain the transaction. Yet, the Brudney and Chirelstein analysis would deem the evidence of such a purpose meaningless, since the incidental (and perhaps insignificant) benefits would control. The mere presence of a prior relationship between a parent and subsidiary does not preclude the possibility that the parent may employ the freezeout technique solely for the purpose of eliminating the minority. Therefore, a court should subject all such transactions to the *Singer* standard regardless of prior relationships between the parties.

Second, none of the "inherently purposive" benefits recited by Brudney and Chirelstein compel the use of a freezeout merger. Elimination of duplicate departments, personnel, and corporate business processes, tax savings, financial improvements incidental to corporate unification and avoidance of conflicts of interests generally can be accomplished by issuing stock in the parent company as consideration for the merger. No reason immediately appears for terminating the minority's participation to accomplish these goals. Although particular circumstances may justify freezeouts in certain cases, the parent-fiduciary should carry the burden of demonstrating the necessity of such action. The fact that a merger would be commercially or socially beneficial alone does not warrant the conclusion that a freezeout of the minority is justified. In this category as well, the two-pronged *Singer* test should be employed. In the absence of a demonstration by the parent that a valid corporate purpose is served by cashing out the minority, the transaction should be prohibited.

There can be little doubt that the categories identified by Brudney and Chirelstein are of significant value in passing upon the presence or absence of a valid purpose for effectuating a cash-out merger and they create useful tools for the analysis of each transaction. However, they should not be given the conclusive effect that their creators propose nor should they be deemed to eliminate the need for an inquiry under *Singer* into the purpose of the transaction. Such an approach would result in unwarranted and mechanical judicial disapproval of innocuous merger proposals merely because of their form. Alternatively, the courts might create exceptions so numerous as to overwhelm the general rules themselves. The Brudney and Chirelstein article itself foreshadows the latter possibility since its footnotes recite a litany of suggested and potential limitations upon the appli-

cation of these catagories.[79] The expressed goal of simplifying the freezeout analysis would be ill-served in either event.

[79] *See, e.g., id.* at 1356-57 n.9, 1361-62 n.15 & 16, 1363 n.18, 1367 n.24, 1372 n.32, 1373-74 n.35.