NEWS
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

HOLD FOR 12:00 NOON RELEASE, THURSDAY, NOVEMBER 14, 1974

"GOING PRIVATE": A LESSON IN CORPORATE RESPONSIBILITY

An Address By

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Law Advisory Council Lecture
Notre Dame Law School
South Bend, Indiana

November 14, 1974

"GOING PRIVATE": A LESSON IN CORPORATE RESPONSIBILITY

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Few topics are as likely to quicken the pulse of businessmen and reformer alike as that of corporate responsibility. In the eyes of the reformer, the American corporation has been sorely derelict in meeting its responsibilities to society. It has, they say, devastated the landscape in the name of profits, fought every social reform to the last, been heedless of the safety of its employees and indifferent to the social consequences of its actions. To many businessmen these charges are ridiculous and dangerous; they overlook, they say, the simple fact that corporations exist to make profits for their shareholders and that a corporation indifferent to this simple fact will soon find itself without recourse to the capital markets, out of business, with loss not only to shareholders and management, but the entire economy.

As is true of most of the debates that characterize our society today there is a modicum of truth on both sides. There is still in the hearts of many businessmen the old attitude of Colonel Vanderbilt who suggested "the public be damned." There is much corporations could have done, and should be doing, for the environment, education, racial equality and safety without unduly imperilling profits. On the other hand, extraordinary concern with such matters might have eventuated in the demise of the overly conscientious corporate citizen. Notwithstanding the sometimes harshness of the debate and seeming intransigence of the debaters, there is probably today more corporate commitment to the welfare of society than we have ever known before and the affirmation by the executive of his dedication to the social functions and obligations of the corporation have become commonplace.

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I would not today add my voice to the squabble; there may be perhaps too many voices now and the only way one seems to be able to gain attention is with a dramatic overstatement or with an uncharacteristic statement, as when the chief executive of a major oil company indicates that profitability is of secondary importance to the corporation, and says it in a way that indicates that the secondary follows far behind the primary.

I would rather like to focus upon a kind of corporate responsibility different from that which has been the focus of the debate, but which is nonetheless of enormous importance. It is often said that charity begins at home; I would suggest that corporate responsibility begins at home. The responsibility of which I speak is that of management and those controlling corporate enterprise to the shareholders of the company. I speak of this with urgency and feeling because there are increasing evidences that some corporate managements and the others who control corporate enterprise have lost sight of their role, their obligations, the way they have achieved what they have.

Let's begin with some basic propositions. Corporations are not something created by the Almighty to help man in his effort to wrest a livelihood from a resistant environment. Rather, they are creations of men, ingeniously conceived, developed to a considerable degree of efficiency, indispensable to the economic effort of our nation and, for that matter, the world. They exist by the permission of the state -- in this country, the individual states, for there is, unlike Canada, no such thing as a federal corporation, with the exception of specially created entities such as the Securities Investor Protection Corporation and the Communications Satellite Corporation. What a corporation can do legally, what shall be the relations between the corporation and its constituent parts -- management, directors, shareholders, creditors -- is

largely determined by the laws of the fifty states, although increasingly these have become of increasing concern under the federal securities laws. While efforts to make state laws uniform have had some success, still there are significant variations one state to the other, with Delaware notorious for the favor its laws show to management, often at the expense of shareholders.

In general, corporation laws have favored management and tended to place considerable restraints on the rights of shareholders. For instance, in many states under the corporation law a contract between a corporation and a director can be sustained regardless of fairness if it is approved by a majority of disinterested directors. Anyone who knows the camaraderie of directors knows the flimsiness of this safeguard. Conflicts of interest are tolerated, and often the path a dissident shareholder must trod to secure rights is strewn with financial and legal hardship of such magnitude few find it worth the effort.

Too often the law and those who manage and control corporations lose sight of a very basic fact: the wealth of the corporation is the shareholder's wealth, and that includes minority shareholders as well as majority or large shareholders. The corporate managers make their reputations and their fortunes by utilizing the money of others: individuals, institutions (which are often simply the surrogates of numerous individuals), people like you and me.

The ease with which this simple idea is lost sight of was brought home to me the other day during an interview with a journalist who was inquiring about some recently adopted SEC rules concerning the contents of annual reports. He suggested that to some extent these rules created a situation in which the "corporation" was pulling one way, the shareholders the other. What an absurd dichotomy! As if the corporation is distinguishable from the shareholders. Perhaps the management is, perhaps the directors are, but far more truly than either of those groups, the shareholders *are* the corporation.

This confusion of roles, this confusion of loyalties and obligations is appearing in the financial world in a new manner and it is that which I would like to discuss with you today.

During the sixties and early seventies innumerable companies "went public", that is, publicly offered their securities. During the period from 1967 to 1972 over 3,000 companies filed registration statements with the Commission for the first time, indicating it was their first major public financing. In addition to that, innumerable other companies tapped the public well through offerings confined to a single state which do not have to be registered with the Commission, others made so-called "Regulation A" offerings, now permitted for offerings of $500,000 and less. All of these companies invited the public to share in their fortunes. In some cases all of the proceeds of the offerings went to the corporations to advance corporate purposes: buy new plants and equipment, pay off debt, increase working capital. In others, some or all of the proceeds went to the shareholders who owned the company prior to "going public" and who sold part of their holdings to the public. Often the initial offerings were followed by others which, like the first, sometimes brought money into the corporate coffers, in others enriched the dominant shareholders.

There is nothing wrong with that process. This has been the means by which America's free economy has prospered: drawing upon the accumulations of numerous individuals and channelling them into productive enterprise. Despite the desirability in principle of this, the unfortunate fact is that a desirable means of corraling and using wealth became a fad, and as with all fads, was carried to a disastrous extreme. Large numbers of companies "went public" with the help of ebullient underwriters that had no

business using public money. They should have looked to private sources, typically more discerning, for their capital, and if those sources, with their greater insight, refused, then that should have signalled that the enterprise was not worthy of financial support or that the proprieters put too high a value on their creation. Often a turndown by sophisticated investors was only a first step toward securing the funds from unsophisticated individuals through public offerings. During an earlier period we experienced a similar love-feast with "new issues"; that was between 1952 and 1962. In 1963 the Commission sampled the companies that went public. It found that approximately 37% of these companies either could not be located or were inactive, liquidated, dissolved, or in receivership or reorganization.

God willing, there will be a time in the not distant future when worthy companies can "go public" again and draw upon the savings of the public to finance future growth. I would hope that those in the underwriting profession will, when markets permit such, be alert, diligent, discerning and cautious, and that they will keep the debacle of the recent past unique and unrepeated. And I would hope that the investors will remember their wounds and not fall for the promises of miracles from companies having little assets or prospects beyond those only intimated by a catchy or currently favored name. But the "new issue" problem will undoubtedly emerge again. When it does, let me simply say that the measures the Commission has taken since the last orgy will hopefully restrain the greed of those who made the last new issue epidemic the inglorious chapter in American finance that it was.

It is not this phenomenon I wish to talk about today, as intriguing as it is. I speak today of a newer and currently, at least, more disquieting fad. That is the fad of "going private." Daily we read of companies which are offering to buy out all, or substantially all, of their shareholders, thus enhancing the control of the controlling shareholders and freeing the corporation of the "burdens" of being publicly-held. In other instances clever and indeed most imaginative devices are used to afford the small shareholders little, if any, choice in the matter. What is happening is, in my estimation, serious, unfair, and sometimes disgraceful, a perversion of the whole process of public financing, and a course that inevitably is going to make the individual shareholder even more hostile to American corporate mores and the securities markets than he already is.

Let's see what happens when a corporation goes public. It acquires a new "family" consisting of people who, overwhelmingly, have no ties with the corporation other than their shareholdings, which they acquire with the hope that they will be a means of profit: appreciation, dividends, a combination. These shareholders are typically welcomed to the family with a chatty letter from the president expressing the delight of management with the confidence they have shown, promising that their confidence will not be misplaced, and then dwelling glowingly upon the future of the company. If the corporate management has been astute enough to have on its staff or hire competent public relations counsel, that letter is only the first of many sent to foster "shareholder relations."

If the corporation chooses to list its securities on an exchange, or if it has more than a million dollars of assets (and virtually all companies which go

public have that) and ends up with five hundred or more shareholders, the federal securities laws cloak the shareholders with a number of protections and rights. They become entitled to receive proxy statements and annual reports with specified contents; the corporation is required to file and make available to them extensive additional financial information; their "insiders" can't reap short term profits and profits derived from use of inside information, and they are entitled to have information about transactions by insiders made public; they have the right to submit proposals which must in turn be submitted to the vote of all the shareholders; they are protected in numerous other subtle ways. As soon as the number of shareholders drops below 300 the corporation is relieved of many of these obligations, e.g., the necessity of soliciting proxies with specified disclosures, the restraints on short-term trading and reporting by insiders.

One of the things a stock purchaser in a corporation wants is liquidity -- that is, the assurance that when he wants to sell there will be a reasonable market for the stock. On the exchanges this is accomplished through the auction process and the presence of the specialist, in the over-the-counter market by the market maker. In both instances the process works and liquidity is present only if there is a sufficient amount of stock in the market place to assure reasonable activity. With exchanges, when the level of public ownership drops below specified levels, the corporation is delisted; in the over-the-counter market, when that happens the market makers simply lose interest and quit buying and selling the stock.

What is happening now is this: as market prices of stock have plummeted, often to levels below book value, many companies have commenced the process of going private. They justify this on the ground that their own stock has become a "good investment"; that they want to ease the financial burdens of compliance with SEC, and in some cases exchange, requirements; that the small shareholders cost more, because of the need of maintaining records and sending them communications, than their presence is worth; that the corporation can avoid the constant threat of litigation if some action appears out of step with the increasingly onerous and restrictive laws governing corporate conduct.

The means by which companies "go private" are varied. I will discuss only a few of them: the tender offer, the squeeze out merger and the reverse split.

The simplest way is an offer to pay the shareholders who accept a stipulated price, usually something in excess of the market price. This seems simple enough: the shareholder can take the offer or leave it, he is under no compulsion, and in fact, the offer may be a significant favor to him, since it may be the highest price he will see for some time. But even this simple approach has within it, in my estimation, troublesome elements. Usually, because of the necessities of full disclosure in our corporate life -- largely policed and demanded by the SEC -- the document which communicates the tender offer tells the awful truth. First, if significant numbers of shareholders respond to the tender, the shareholder who considers staying aboard faces significant losses. If the number of shareholders drops under 300 he will lose the network of federal protections built over a period of forty years for his benefit: no assurance of comprehensive

disclosure, only limited protections against insider chicanery and so on. If he chooses to stay aboard he may find the liquidity of his investment -- the ability to sell readily at a price reasonably proximate to the last sale -- reduced, perhaps completely destroyed. Further, if management buys or otherwise acquires or has the power to bring it about, it may "merge out" the remaining minority and compel them in effect to sell their investments. Under the laws of the states in which most public corporations are incorporated, so-called cash mergers are allowed, that is, the shareholders of a company being acquired by another, instead of receiving stock of the acquiring company (the pattern of the typical merger) can be compelled to take cash in the amount determined by the merger agreement. Thus the typical pattern is for the insiders wishing to eliminate the public shareholders to create a new corporation wholly owned by the insiders, placing their stock in the public company in the new one. This new corporation then enters into a merger agreement with the publicly-held company which provides that the public shareholders will receive cash for their shares -- and remember at this point the management and controlling shareholders usually have the power to vote whatever action is necessary, including approval of a merger agreement. Result: the controlling shareholders of the old company end up as the <u>only</u> shareholders of the new corporation, which has exactly the same business as the old company and assets the same only depleted to the extent of payments to the minority, and the public shareholders of the old corporation end up with cash. Oh, they have a choice: if they think the amount they receive is too low, they can exercise their so-called "dissenters' rights" and demand that a court award them more if they prove the value of their shares exceeds that given them in the merger, although in some states even that right is attenuated if the number of shareholders is large enough

or the securities are listed. Anyone who has been through one of these so-called "appraisal proceedings" knows their difficulties. First, they take forever, and during that time typically the dissatisfied shareholder is locked in with an asset he can't sell and he receives no dividends. Furthermore, these actions do not take that form most dreaded by management, the class action; each shareholder must individually assert his claim. It must be said that increasingly there is a tendency for federal courts to find that the appraisal remedy is not the only opportunity for redress the shareholder has; but more of that in a moment.

Faced with the prospect of a force-out merger, or a market reduced to glacial activity and the liquidity of the Mojave Desert, and deprived of most of the benefits of the federal securities laws, how real is the choice of the shareholder confronting the offer of management to acquire his shares, usually not with their own resources, but with the corporation's resources that really belong to him and his fellow shareholders? In short, he usually decides he damn well better take the money and run.

The harsh dilemma posed is not confined by any means to the small unsophisticated investor. I recently spoke with an officer of a very large foundation concerning this. He complained of the dilemma in which fiduciaries are placed by such conduct. The fiduciary, if he thinks his investment has value beyond the amount of the offer and would like to hold it, confronts the danger that he will be squeezed out for less or end up with a security having no market for holdings of the size he has.

Note some interesting characteristics of all this. Often, better, usually, the corporation making the offer reaped dollars at the time of previous public offerings at sharply higher prices than those offered for

repurchase; often controlling shareholders also participated and pocketed ample amounts. The money for the repurchase, though, almost invariably comes from the corporate till; there are mighty few instances in which a tender offer has been made by the controlling holders who gained from the corporation's going public.

Another route that is being taken to squeeze out public shareholders is the so-called "reverse split." One company proposes to convert its common stock on the basis of one new share for each five hundred outstanding. You and I are more accustomed (during balmier market days than those current now) to the split of each outstanding share into two or three shares; the process of which I speak runs the other way, with five hundred shares becoming one share. This is to be done in a state which allows no fractional shares to be outstanding. Thus a shareholder with less than five hundred shares has either to take cash for his interest, or put up enough money to bridge the gap between the shares he had and five hundred; this amount might go into the thousands of dollars! In another case the shareholders weren't even given the chance to put up more money to remain as shareholders; if they had less than one hundred shares, they simply received cash for their interest. In these cases, they didn't even have the right, nebulous and thin as it is, to petition the court for an appraisal of the value of their shares.

With regard to all this, I would ask two questions, one ethical and one legal.

Is all this ethical? I would say to you there is at the minimum deep doubt of that. The spectacle of entrepreneurs inviting the public in when they can command high prices for their stock, and then squeezing them out

with little or no practical choice in the matter at substantially reduced prices is hardly one to warm the soul of Thomas Aquinas or Aristotle. The corporation, and often the controlling interests, have been enriched with the proceeds of the public offerings of the past; with those proceeds the corporation grew and prospered, then, with the power deriving from their managerial positions and shareholdings, the insiders take over the whole corporation for themselves.

In one recent instance public offerings netted $696,000 for the corporation, over $12,500,000 for the offering shareholders. The corporation has now proposed to acquire all the stock held by minority shareholders for $11.00 per share. If all of the minority shareholders tender, they would receive $3.00 in cash and $8.00 in ten year subordinated debentures (which the company believes will sell at a substantial discount) for shares which were originally offered at $17.50 a share and three years ago at $21.75 a share; the dominant shareholder would go from a 7% interest to 43%, with over 3.7 million dollars (less taxes) provided by the public now safely locked up for her benefit. On a pro forma basis, had all public shares been repurchased on the basis proposed at the beginning of 1973, the corporate profits attributable to her interest would have risen from $236,000 to $1,107,000 in 1973 -- over 400% -- and from $167,000 to $688,000 for the first ten months of 1974 -- again over 400% -- and without a single dime of additional investment by her!

I would suggest there is something wrong with that. I would further suggest that under well established legal principles such conduct may also be unlawful. It is well established in the law that officers and directors of corporations, as well as those shareholders who control it, owe fiduciary duties to the other shareholders of the corporation. Listen to the words of the Supreme Court:

> "He who is in such a fiduciary position cannot serve himself first and his cestuis second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters...He cannot utilize... his strategic position for his own preferment ...He cannot use his power for his personal advantage and to the detriment of the shareholders...no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements." 1/

Increasingly such fiduciaries are held to the standard enunciated by Judge Cardozo: "Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate."

With these general principles as guides, it is hard to see how the sort of conduct I have described can possibly meet the standard. These tender offers and these squeeze-outs usually benefit the insiders enormously: they in effect buy assets at less than book, increase their leverage, and remove the dangers of judicial and Commission scrutiny of their conduct. How can this be squared with their responsibility to the minority shareholders? Is there not a clear conflict of interest when the shareholders are offered the empty choice of tendering or being forced out one way or another while the controlling shareholders reap benefits? I believe that federal courts will increasingly be inclined to find in Rule 10b-5 the basis for concluding that the conduct which is at the heart of "going private" violates federal securities laws.

Specifically, I would suggest that 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. That liquidity is a benefit that the shareholder

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1/ Pepper v Litton, 308 U.S. 295,311 (1939)

pays for and he should not be deprived of it by those who have fiduciary responsibilities to him. Further, absent such considerations they must do nothing to deprive him of the value of his investment if he chooses to retain it.

In my estimation, it is no longer possible for this overreaching to enjoy the protection of the mechanical provisions of state law. Increasingly the courts are correcting the deficiencies of state law by imaginative applications of federal securities law, particularly Rule 10b-5 which makes it unlawful to employ any device, scheme or artifice to defraud or 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 securities. And interestingly, there are signs that courts are finding in state law itself limits on the apparent carte blanche that state corporation laws appear to accord management and controlling shareholders. For example, in one case 2/ the controlling shareholder caused the Board of Directors of a corporation to recommend to the shareholders an amendment to the certificate of incorporation authorizing the corporation to issue a new class of non-voting common stock. The proposed amendment was approved by vote of over 72% of outstanding shares. Some five years earlier the company had gone public. In the prospectus used at that time there was a representation which stated, "The company intends to make application for listing of the Common Stock on the New York Stock Exchange" and the stock was listed on the New York Stock Exchange shortly after the public offering. Prior to submitting the proposed amendment to the shareholders, the Board of Directors had been advised that if the proposed amendment became effective, the New York Stock Exchange would take action to delist the company's stock. The issuance of the non-voting common

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2/ United Funds, Inc. v Carter Products, Inc. CCH Fed.Sec.L.Reptr.[1961-64] ¶91,288

stock was enjoined on two grounds. First, that the statement in the prospectus some five years earlier was an implied promise that the company would seek listing and would not voluntarily take any action which would result in a delisting. Further, the court found that this promise was a continuing one. Secondly, the court found that the controlling shareholder breached his fiduciary duty to the minority shareholders by acting in a manner adverse to the interests of the minority shareholders and without a valid corporate purpose. One further point. The controlling shareholders contended that, since they only controlled 51% of the 72% that voted for the proposed issuance of additional non-voting common stock, the shareholders had ratified the proposal. The court said that since the minority stockholders who voted for the proposal could reasonably have believed that the action was for the benefit of the corporation, they were thereby placed in a dilamma. In one respect a vote in favor would be beneficial for the corporation, in another, it would be prejudicial to their own interests. The court resolved the dilemma by saying:

> "The position in which they were placed wasn't fair to them; they had no effective freedom of volition. Under such circumstances, as in the question of the validity of a ratification of an alleged breach of trust, the vote of the minority stockholders who approved the amendment cannot be taken as an independent and legally binding act."

In another case[3/] a court held that a cause of action was stated by a complaint which alleged that the minority shareholders of a savings and loan association were disadvantaged by the act of the holders of 87% of the savings and loan association when the controlling shareholders exchanged their holdings for the stock of a holding company. The holding company then went public thereby creating liquidity for their holdings which did not exist for the minority shareholders of the savings and loan

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3/ Jones v H.F. Ahmanson & Co., 460 P. 2nd 464 (Calif.S.Ct. 1969)

association. Subsequently, the holding company attempted to buy out the remaining holders of the savings and loan association. The court held that there had been a breach of fiduciary duty and that controlling shareholders are governed by a "comprehensive rule of inherent fairness from the viewpoint of the corporation and those interested therein" and that "majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority."

A recent case[4/] involved in an attempt by the majority shareholders to squeeze out the holder of approximately 15% of the corporation's stock. They did so by exchanging their 85% for the stock of a new corporation and then proposing to merge the two corporations and pay the minority shareholder cash for his minority holdings. While in strict technical compliance with the applicable state merger statute the transaction was nevertheless enjoined on the ground that it involved a breach of fiduciary duty. The court found implicit in the state merger statute a requirement that there be a valid business purpose behind the proposed merger -- and forcing out minority interests was not a valid business purpose.

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

4/ Bryan v. Brock & Blevins Co., Inc., 490 Fed. 2d 5o3 (5th Cir. 1974)

I can assure you that the Commission is not indifferent to these developments. We are enjoined by Congress under the statutes which we administer to protect investors and to preserve the efficiency and the fairness of the securities markets. Speaking only for myself, I find it very difficult to believe that the use of the tactics I have discussed in order to freeze out minority shareholders or deprive them of a market for their stock or the protection of the federal securities laws, really constitute protection of them or contribute anything to the integrity of the market place.

The absence of the individual investor from the market place is deplored on all sides. While I feel that in large measure this absence has been the consequence of inflation, high interest rates, more profitable investments elsewhere, I do believe that to some extent the departure of the small investor from the market place has been the consequence of a deepening suspicion of the motives and the fairness of many responsible for the conduct of corporate enterprise. Surveys have indicated time and again that small shareholders believe they are disadvantaged vis-a-vis large and institutional investors as far as information goes. I cannot imagine that the continued flourishing of schemes through which small shareholders are squeezed out against their will, or given an alternative between surrendering their ownership and engaging in prolonged and expensive litigation, does anything to promote confidence in the markets.

And certainly this experience -- in in good times, out in bad times -- is not going to make tapping the public market easier the next time small companies in large numbers seek public financing. Without venturing a prediction or presuming to speak on behalf of anyone other than myself, and certainly not the other Commissioners, I would hope that the Commission will deal aggressively and firmly with this problem and identify clearly the wrongs which I think are inherent in these practices. When we have done that, I think we will have further carried out the mandate which we have been given.

We are witnessing a significant raising of the standards of corporate responsibility, including the responsibility of those who manage and control corporate wealth toward their junior partners. The 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 as his souvenir. While the argument about the broader meanings of corporate responsibility continues, in this one area the responsibility is clear. The ethical implications are clear; so are the legal.