THE ELIMINATION OF THE MINORITY INTERESTS BY MERGERS PURSUANT TO SECTION 251 OF THE GENERAL CORPORATION LAW OF DELAWARE

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MUCH HAS BEEN WRITTEN in the last several years concerning the attempts by many corporations to "go private." Going private usually entails the elimination of a large segment of the public stockholders of the corporation, resulting in a small group, generally insiders, owning all of the issued and outstanding stock of the corporation and the corporation delisting under the Securities Act of 1934. Most of the articles dealing with the subject have covered the morality of going private, questions of federal securities laws involved, the necessity for a business purpose to effect a merger, and requirements of good faith by insiders when dealing with the minority shareholders.

Very little has been written about the application of the General Corporation Law of Delaware, specifically Section 251 (8 DEL. C. § 251), and the various decisions of Delaware to a going private transaction. Section 251 is the general merger statute of the General Corporation Law of Delaware and provides for merger between two Delaware corporations by a majority vote of the shareholders entitled to vote. Going private is accomplished by merging the public company with another Delaware corporation pursuant to Section 251. The stockholders of the public company are paid cash, securities or other property for their shares of the public company.[1]

Emphasis on Delaware law in determining the propriety of freeze-out mergers pursuant to Section 251 may be increasingly important in light of a recent decision of the Court of Chancery temporarily enjoining such a merger. In *Pennsylvania Mutual Fund, Inc. v. Todhunter International, Inc.*,[2] the Court of Chancery of Delaware tem-

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1. If the majority shareholder of the public corporation is another Delaware corporation, the public corporation can be merged directly into the parent. Frequently, the parent corporation will create a subsidiary for the sole purpose of merging it with the public corporation. However, if the majority shareholder is an individual or a group of individuals, they form a new Delaware corporation for the purposes of the merger and transfer their stock to the new corporation.

2. Civil Action No. 4845, Letter Opinion, August 5, 1975, Delaware Court of Chancery in and for New Castle County.

porarily restrained a merger between two Delaware corporations to be accomplished pursuant to Section 251. Officers and directors of defendant Todhunter formed a new Delaware corporation to which they transferred their shares of the public corporation, which *in toto* constituted a majority of the issued and outstanding shares of Todhunter. The new corporation[3] was to be merged into Todhunter with each of the public shareholders receiving debentures of Todhunter. Thus, the public shareholders would no longer be entitled to an equity participation in their former corporation and were to continue as creditors of the corporation. The plaintiff, a public stockholder of Todhunter, sought to enjoin the merger because, *inter alia,* it alleged the freeze-out could not be accomplished pursuant to Section 251. Rather than to permit the action to become moot, the Court enjoined the merger. In doing so, the Court raised several questions with respect to the proposed merger:

> (1) whether a freeze-out merger can be accomplished pursuant to Section 251 as opposed to Section 253;
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> (2) whether a merger can be accomplished pursuant to Section 251 without a valid business purpose; and
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> (3) whether an operating company can be merged with a "shell"[4] corporation to achieve a freeze-out of minority shareholders.

The questions were never resolved inasmuch as dismissal was subsequently agreed to. However, these questions raise serious consequences for anyone contemplating a freeze-out merger under Section 251.

This article will attempt to review statutory history and relevant Delaware decisions in an effort to determine whether there are satisfactory answers to the questions posed by the Court in *Todhunter.* The "morality" of such a merger and possible federal securities laws consequences will not be considered.

THE STATUTORY HISTORY[5]

Under the common law of Delaware one shareholder could prevent a merger.[6] The Delaware Legislature realized that a single shareholder

3. Actually, the new Delaware corporation formed a subsidiary, and the subsidiary was to be merged into the Delaware corporation.

4. In this context, a "shell" corporation is a non-operating company created solely for purposes of the merger.

5. A convenient history of Sections 251 and 253 can be found in FOLK, THE DELAWARE GENERAL CORPORATION LAW, pp. 318–26, 351–52.

6. Reynolds Metals Co. v. Colonial Realty Corp., 41 Del. Ch. 183, 190 A.2d 752 (Sup. Ct. 1963).

should not be permitted permanently to prevent a merger of his company, and enacted the predecessor of Section 251 in 1899 as part of Delaware's first general corporation law.[7] As originally enacted, the predecessor of Section 251 required that the shareholders of the constituent corporations receive shares of stock of the surviving corporation. Thus, the statute did not provide a means for excluding shareholders from an equity participation in the surviving corporation.

In 1941, the Legislature added a provision permitting the merger agreement to provide for the conversion of shares of stock of the constituent corporations into either shares of stock or other securities of the surviving corporation.[8] This amendment permitted a stockholder to be deprived of his right to continue as an equity participant in the surviving corporation, but did require that such stockholder be permitted to continue as a creditor of the surviving corporation.

Section 251 remained in that form (for present purposes) until the comprehensive amendment to the General Corporation Law in 1967. Effective July 1, 1967, merger agreements were authorized to provide for converting shares of stock into cash as well as stock and securities of the surviving or resulting corporation and securities of a constituent corporation.[9]

The development of Section 253, the so-called "short merger" statute, is likewise significant. Section 253 enables a parent corporation to effect a merger of a subsidiary by the resolution of the board of directors of the parent. It was enacted in 1937 to facilitate paperwork involved in mergers between parents and their subsidiaries.[10]

As originally enacted, Section 253 applied only to wholly-owned subsidiaries. In 1957, Section 253 was amended to permit a short merger between a parent and a subsidiary owned 90 percent or more by the parent.[11] The amendment also permitted the minority stockholders to be paid in cash as well as stock or securities for their shares of stock of the subsidiary. Thus, in 1957, the Legislature determined that in a merger accomplished pursuant to Section 253, a minority shareholder in the subsidiary corporation could be eliminated from the continuing enterprise and be paid in cash for his equity investment in the subsidiary.

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7. 21 DEL. LAWS ch. 273. The predecessors of Section 251 have existed under a variety of code section numbers over the years. For ease of reference, Section 251, as well as its predecessors, will be referred to as "Section 251."

8. 43 DEL. LAWS ch. 132.

9. 56 DEL. LAWS ch. 50. In 1968 (56 DEL. LAWS ch. 186) and 1969 (57 DEL. LAWS ch. 148), the permissible consideration was expanded to include property, rights and securities of any corporation.

10. 41 DEL. LAWS ch. 131.

11. 51 DEL. LAWS ch. 121.

Thus, both Sections 251 and 253 permit the same consideration to be paid to the stockholders of the constituent corporations. With this background in mind, we will turn to the relevant decisional law.

THE DECISIONAL LAW

A. *The General Rule Against Oppressive Activities by the Majority.* The courts of Delaware have long been in the forefront in the protection of the minority interest of shareholders from oppressive or improper activities by the holders of a majority of the shares of their corporation. From time to time the courts have been called upon to deal with efforts of the majority to freeze out the minority under procedures permitted by the General Corporation Law of Delaware. The general rule which has been applied to such activities is that inequitable activities will not be condoned by the courts of Delaware even if the statutory law of Delaware is rigorously followed.

The general rule is perhaps best exemplified in *Condec Corporation v. Lunkenheimer Co., et al.,*[12] where the Court of Chancery enjoined the issuance of stock by the defendant in an attempt to prevent control from passing to the plaintiff. The Court determined that even if the Delaware statutory procedure were strictly observed, the stock could not be issued for an improper purpose such as maintaining control of a corporation. The Court analogized the situation to an attempt by the majority to "freeze out" the minority and noted the rule that corporate machinery may not be used by the majority to injure the minority, citing *Bennett v. Breuil Petroleum Corp.*[13] Similarly, in *Schnell v. Chris-Craft,*[14] the Court prohibited the management of a corporation from changing the by-laws of the corporation to accelerate the date of the annual meeting. The proposed change would have had the result of prohibiting dissident stockholders from soliciting proxies because of the time required to comply with federal requirements for the solicitation of proxies. Management had rigorously followed the statutory law of Delaware in effecting the change. However, the Court determined that the result would be inequitable and thus declined to permit management to achieve an inequitable result by use of the Delaware General Corporation Law.

Perhaps the earliest Delaware decision to enunciate this doctrine in a freeze-out context is *Allaun v. Consolidated Oil Co.,*[15] which dealt with the sale of assets by the defendant corporation. The Court stated

12. 43 Del. Ch. 353, 230 A.2d 769 (Ch. 1967).
13. 34 Del. Ch. 6, 99 A.2d 236 (Ch. 1953).
14. 285 A.2d 437 (Del. Sup. Ct. 1971).
15. 16 Del. Ch. 318, 147 A. 257 (Ch. 1929).

that if the majority had used their power to effect a sale of assets to themselves and thereby freeze out the minority and carry on the business without the minority, the Court would enjoin the merger without regard to the adequacy of the price being paid for the assets.[16]

The same principle was later applied in a freeze-out situation involving the issuance of stock by the majority shareholders to perpetuate their control of the corporation.[17] To date, this reasoning has not been applied in a merger context to test the ability of the majority to freeze out the minority, other than in the *Todhunter* litigation where the Court raised, but did not resolve, the question.[18]

B. *The Section 253 Decisions.* Since freeze-outs of minority stockholders by the payment of cash have been permitted by Section 253 for nearly 20 years, the decisions under that section may be instructive in interpreting the more recent amendments to Section 251.

In *Coyne v. Park & Tilford Distillers Corporation,*[19] the plaintiff attacked a merger accomplished pursuant to Sectioin 253, contending that he could not be forced out of the corporate enterprise by means of such a merger.

The plaintiff argued that Section 253 did not contain an independent grant of power permitting the plaintiff to be paid in cash and that, even if it did, such provision was unconstitutional as depriving the plaintiff of his securities in the corporation. The Court expressly held that Section 253 permits the payment of cash for shares of stock

16. *See also* MacFarland v. North American Cement Corp., 16 Del. Ch. 172, 157 A. 396 (Ch. 1928) (one class of stock cannot be treated unfairly in a merger).

17. Bennett v. Breuil Petroleum Corp., *supra* n.13. As a result of *Allaun* and *Bennett,* two familiar freeze-out techniques are impermissible in Delaware. Assets may not be sold and stock may not be issued in attempts to eliminate minority stockholders. In addition, a third may be in doubt. If stock may not be issued to freeze out a minority, the converse may also be true: a reverse split reducing the number of shares outstanding and payment of cash for fractional shares may not be permitted. This latter technique has, however, been approved by one state court. Treschner v. Chicago Title & Trust Co., CCH CORP. L. GUIDE [Sept. 1971-Nov. 1974 Tranfer Binder] (Ill. Sup. Ct. 1974). The technique of a tender offer followed by a short merger has also been employed. *See* Braash v. Goldschmidt, 41 Del. Ch. 519, 199 A.2d 760 (Ch. 1964), and *In re* Olivetti Underwood Corporation, 246 A.2d 800 (Del. Ch. 1968). This technique is presently being questioned in the pending action of Lynch v. Vickers Energy Corporation, Civil Action No. 4645, Delaware Court of Chancery in and for New Castle County.

18. In David J. Greene & Co. v. Dunhill International, Inc., 249 A.2d 427 (Del. Ch. 1968), the Court noted that the actions by the majority to freeze out the minority are always actionable. However, since the merger was not a freeze-out merger, the Court did not have to apply the doctrine. The statement was made in the context of evaluating the duty of majority shareholders wih respect to the usurpation of a corporate opportunity. The Court applied the "intrinsic fairness" standard enunciated in Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952), since the stockholders were to continue in the enterprise. *See supra* n.21.

19. 37 Del. Ch. 558, 146 A.2d 785 (Ch. 1958), *aff'd,* 38 Del. 514, 154 A.2d 893 (Sup. Ct. 1959).

of the minority and that minority stockholders may thereby be forced out of the continued enterprise.

In a later comment on the short merger statute, the Court of Chancery reaffirmed *Coyne*. In *Stauffer v. Standard Brands, Inc.*,[20] the plaintiffs attempted to set aside a merger between Standard Brands and a subsidiary of Standard Brands. The plaintiffs were minority shareholders in a Pennsylvania corporation, of which Standard Brands owned more than 90 percent of the issued and outstanding stock. From the reported decision, it appears that Standard Brands set up a wholly-owned Delaware "shell" corporation into which the Pennsylvania corporation was merged, resulting in the plaintiffs becoming minority shareholders of the Delaware corporation. The day after the merger was accomplished, Standard Brands merged the Delaware corporation into itself pursuant to Section 253. The plaintiffs argued that the corporate existence of a Delaware subsidiary should be disregarded and that the merger should be viewed as one by the Pennsylvania corporation into Standard Brands. The plaintiffs also argued that cash paid to them pursuant to the merger of the Delaware subsidiary into Standard Brands resulted in the plaintiffs being forced to accept an unfair price per share. In effect, the plaintiffs' first argument was that the use of a "shell" corporation created specifically for the merger somehow violated their rights to have the merger construed as a direct merger between Standard Brands and the Pennsylvania corporation. The Court easily disposed of that argument by noting that in the absence of fraud, a corporate existence is not to be disregarded. Thus, the Court upheld the validity of the use of a "shell" corporation to accomplish a freeze-out merger under Section 253.

In dealing with the plaintiffs' second contention, the Court considered the relationship of Section 251 to Section 253. The Court's comments are quite instructive considering the subsequent amendments to Section 251:

> "It is to be observed from the provisions of sections 251 and 252 that minority stockholders of corporations merging thereunder may not be summarily eliminated from the continuing enterprise, but are given the option of accepting securities in the surviving corporation, or, alternately, of demanding payment in cash for their holdings by an appraisal proceeding pursuant to § 262. The difference in the rights of minority stockholders in merger proceedings under these sections and those conferred by § 253 are immediately apparent. Since a majority stockholder may not under a § 251 or § 252 merger eliminate minority stockholders as participants in the continuing enterprise, it is obvious that the

20. 40 Del. Ch. 202, 178 A.2d 311 (Ch. 1962), *aff'd*, 41 Del. 7, 187 A.2d 78 (Sup. Ct. 1962).

majority should not be permitted to force the minority stockholder to elect his appraisal rights and thereby force his withdrawal. The courts of this state have, therefore, rightly held that in a merger under sections 251 and 252 gross undervaluation of the shares of minority stockholders may be shocking to the court's conscience and, therefore, constructivelly fraudulent. However, in a § 253 merger the holder of more than ninety per cent of the outstanding stock of a subsidiary has the right to pay minority stockholders the value of their shares and thereby eliminate them from continuing participation. The only requirement is that the surviving corporation shall notify the stockholder that the certificate of ownership and merger has been filed and recorded and the terms and conditions of the merger. If a stockholder is dissatisfied with the value placed upon his shares he may, failing an agreement upon value, proceed to an appraisal. The dissenting stockholder is thus provided with an adequate and complete remedy. That it is also, under the circumstances presented by the present complaint, an exclusive remedy is evident, for it was obviously the intention of the Legislature that disputes as to the value of shares of minority stockholders should be settled by an appraisal proceeding."[21]

In summary, the Court held that by utilization of cash as the consideration in a short merger accomplished under Section 253, the Legislature had determined that the stockholder could be eliminated from the continuing enterprise. The Court noted that the absence of cash as a valid consideration under Section 251 mergers did not permit a Section 251 merger to eliminate shareholders from participation in surviving corporations.[22]

The Supreme Court affirmed the Court of Chancery in all respects, holding that "the very purpose of the [short merger] statute is to provide the parent corporation with a means of eliminating the minority shareholders' interest in the enterprise."[23] These cases established the principle that the very purpose of the provisions for payment of cash to the minority in a short merger under Section 253 is to "freeze out" the minority stockholders.

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21. *Supra* n.20; 40 Del. Ch. at 208-09. It cannot be inferred from the Court's comment on the test in valuing a Section 251 merger that the test is one of "fraud." In a "freeze-out" merger, there is by definition a majority stockholder on both sides of the transaction, requiring the application of the more stringent "intrinsic fairness" standard of Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 20, 89 A.2d 862 (Ch. 1952), *aff'd*, 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952), at least where the minority shareholder is afforded the opportunity to continue in the enterprise. *See* David J. Greene & Co. v. Dunhill International, Inc., 249 A.2d 427, 430 (Del. Ch. 1968).

22. The Court did not comment on the fact that it was then permissible to eliminate a stockholder as an equity participant in the continued enterprise by the use of a debt security. Apparently, it equated the equity participation with the creditor participation for the purposes of is discussion.

23. *Supra* n.20; 187 A.2d at 80.

It is interesting to note that in neither *Stauffer* nor *Coyne* did the Court mention the general rule that if the purpose of the majority in effecting a transaction is to freeze out the minority, injunctive relief is available without regard to the merits of the transaction.

On the surface, the two lines of decisions — those approving freeze-outs under Section 253 and those stating that a freeze-out is actionable under any circumstances — are irreconcilable. The apparent conflict is compounded by Delaware cases approving freeze-outs of minority shareholders pursuant to Section 251 mergers.

C. *Section 251 Decisions.* Any discussion of Section 251 mergers in a freeze-out context must start with a decision applying the law of Georgia. *Bryan v. Brock & Blevins Co., Inc.,*[24] is widely regarded as the leading decision on the elimination of minority interests via a "long merger." The merger involved was one between two Georgia corporations, and the Court held, without citation to authority from Georgia or any other state, that a "business purpose" was required to effect the merger under the law of the State of Georgia. *Bryan* has since been cited as authority for requiring a business purpose in mergers under the long merger statutes of all jurisdictions, including Delaware.

In *Bryan,* four of the five shareholders of Brock & Blevins Co., Inc., desired to eliminate the fifth stockholder. All attempts to purchase his shares of the corporation proved fruitless. The four stockholders then established a new Georgia corporation and transferred their shares of Brock & Blevins to the new corporation. The directors then adopted a plan and agreement of merger which would merge Brock & Blevins into the new corporation, paying cash for the stock of Brock & Blevins held by the one minority shareholder. The Court, in addition to finding violations of federal law, found that the procedure of creating a new corporation and merging an existing corporation into it for the purpose of eliminating minority shareholders violated Georgia law.[25] The Court applied what it perceived to be basic equity principles. The nub of the Court's decision was that in the absence of a "business purpose" for the merger, the creation of the new corporation and the subsequent merger were a "sham" utilized to circumvent the "rule of law" which prohibits the majority shareholders from forcing a minority to surrender their stockholdings, absent a charter provision to the contrary. If *Bryan* were to be followed by the courts of Delaware, there would be no need to continue the discussion. However, the few deci-

24. 490 F.2d 563 (5th Cir. 1964), *cert. denied,* 419 U.S. 844 (1974); followed in Albright v. Bergendahl, Civil No. 74-134 (D. Utah, September 4, 1974) (Utah Corporation Law).

25. The Georgia statute involved (GA. CODE ANN. § 22-1001(b)(3)) is similar in wording and permissible consideration to Section 251, and permits cash to be paid for shares of stock of constituent corporations.

sions to reach the question under Delaware law indicate that the Delaware courts would not adopt *Bryan* as the law applicable to all freeze-out mergers.

One of the first decisions to reach the question under Delaware law is a freeze-out context was *Grimes v. Donaldson, Lufkin & Jenrette, Inc.*,[26] where the Court briefly discussed the necessity for a business purpose under Section 251, and concluded that a business purpose was present under the merger there in question.[27] The proposed merger was one between a wholly-owned subsidiary of defendant Donaldson, Lufkin & Jenrette, Inc., and Meridian Investing & Developing Corporation, 57 percent of the stock of which was owned by Donaldson, Lufkin, all Delaware corporations, pursuant to Section 251, with the minority shareholders of Meridian receiving $8.50 cash per share. The plaintiff sought to enjoin the merger on the basis of *Bryan*. The Court determined that under Delaware law, there was no impropriety in creating a new subsidiary (a "shell" corporation) for the purpose of a merger, citing *David J. Greene & Co. v. Schenley Industries, Inc.*[28] The Court also determined that under Delaware law, the minority may be forced to accept cash for their shares of stock and that "it is clear that the Delaware Legislature has determined that a stockholder has no absolute right to his interest in the corporation and may be forced to surrender his shares for a fair cash price,"[29] citing *Coyne v. Park & Tilford Distillers Corporation*.[30] The Court, while stating that the minority has a right not to be subjected to inequitable conduct on the part of a majority stockholder, found that Delaware law clearly provides that stockholders of Delaware corporations have "a right to have their corporations merge under Delaware law with the minority receiving cash for their interest. While plaintiff may not care to see this happen, since there is no evidence of fraud or overreaching he is not entitled to enjoin the merger,"[31] citing *Stauffer v. Standard Brands, Inc.*,[32] and *Schenley Industries*.

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26. 392 F. Supp. 1393 (N.D. Fla. 1974).

27. On the issue of business purpose, the Court determined that valid business purposes existed for the merger in that the two entities being merged had similar operations and that a merger was thus logical; that so long as the minority was outstanding, there would be a problem with dealings between the corporations by reason of potential claims of conflict of interest; and that the merger could effect savings in the day-to-day operations of the two corporations involved. The Court did not determine whether a business purpose is necessary under Delaware law in order to merge two Delaware corporations and freeze out the minority by paying cash to them for their shares. 392 F. Supp. at 1401-02.

28. Del. Ch., 280 A.2d 30 (1971).

29. *Supra* n.26; 392 F. Supp. at 1403.

30. *Supra* n.19.

31. *Supra* n.26; 392 F. Supp. at 1404.

32. *Supra* n.20.

The few relevant Delaware decisions support the result of *Grimes* and further support a holding that inquiry into the purpose of a merger is not warranted. In *Bruce v. E. L. Bruce,*[33] the minority shareholders of E. L. Bruce were being required to accept shares in the survivor of the merger to be accomplished pursuant to Section 251 (not a freeze-out merger). The minority shareholders raised questions concerning the self-interest of the directors of E. L. Bruce in approving the merger. The Court stated that the reasons for a merger or the business necessity behind the merger are not matters for judicial inquiry. The Court also stated that it was the policy of the courts of Delaware to permit corporations to take full advantage of the Delaware statutes permitting the consolidation of enterprises, absent fraud or a showing that the terms of a proposed merger are so unfair as to shock the conscience of the Court.[34] The use of "shell" corporations to accomplish mergers for other purposes has also been upheld.[35]

The Court of Chancery has been faced with at least one situation similar to *Grimes* where the minority was being frozen out under Section 251. The Court had the opportunity to apply the principle that the majority could not freeze out the minority no matter what the price, but did not even discuss the principle.

In *David J. Greene & Co. v. Schenley Industries, Inc.,*[36] minority shareholders attempted to prevent a merger of Schenley into Glen Alden Corporation, which owned approximately 84 percent of the stock of Schenley with voting power. Glen Alden had created a wholly-owned subsidiary for purposes of the merger and Schenley was to be merged with the subsidiary of Glen Alden. A portion of the plaintiff's attack was based on an allegation that the merger was to be undertaken for the benefit of Glen Alden and at the expense of the minority shareholders. The Court determined that since cash and a debenture were

33. 40 Del. Ch. 80, 174 A.2d 29 (Ch. 1961).

34. It should be noted that the Court was applying the "fraud" test to evaluate an interested merger when perhaps the "intrinsic fairness" standard should have been applied. However, it is questionable whether the Court would have delved into the reasons for the merger had it been applying the "intrinsic fairness" test. In MacCrane v. American Capital Corporation (D. Del. 1943), the Court declined to consider the reasons for a merger while applying something less than a "gross unfairness" standard.

35. In Federal United Corporation v. Havender, 24 Del. Ch. 318, 11 A.2d 331 (Sup. Ct. 1940), the Supreme Court upheld a merger between a parent and an existing but inactive subsidiary for the purpose of eliminating accrued dividends on preferred stock. A merger was undertaken to avoid the effect of Keller v. Wilson & Co., 21 Del. Ch. 391, 190 A. 115 (Sup. Ct. 1936), prohibiting such an elimination by a charter amendment. The Court of Chancery held the merger to be improper and by way of *dictum,* noted that if the merger could be upheld, then a subsidiary could be created for the merger. It was proved correct as the procedure was upheld in Hoffenstein v. York Ice Machinery Corporation, 136 F.2d 944 (3d Cir. 1943).

36. *Supra* n.28.

being offered for the minority shares of Schenley, the intrinsic fairness test of *Sterling v. Mayflower Hotel Corp.*[37] was inapplicable, and that the Court did not have to compare the value of each of the corporations. Thus, it appears that the Court treated the debenture and the cash as though the stockholders were receiving cash only.[38] The Court then applied the standards applicable to a short merger under Section 253:

> "In short, I am of the opinion that the rights of the plaintiffs and other minority shareholders of Schenley, viewed in the light of Glen Alden's holding of approximately 84% of the common stock of Schenley, are no greater under the present Delaware merger statute here involved (8 DEL. C. § 251) than those under the so-called short merger statute (8 DEL. C. § 253). Thus, if plaintiffs and others are not satisfied with the value placed on their shares by Glen Alden, and no fraud or blatant overreaching is demonstrated, their recourse is to an appraisal, Stauffer v. Standard Brand, supra. Compare, Bruce v. E. L. Bruce, 40 Del. Ch. 80, 174 A.2d 29."

Had the merger involved the payment of cash for the minority interests, the Court would have been clearly correct in applying the decisional law of Section 253 to a merger under Section 251. In light of the amendments since 1967 to both sections, there is no substantive difference between a merger under Section 251 and a merger under Section 253.[39] Therefore, the decisions involving cash freeze-outs under Section 253 apply equally to cash freeze-out mergers under Section 251.

RECONCILING THE DECISIONS

The decisions discussed above seem to run a parallel course without discussing the principles enunciated in the other line of authority. On the one hand, there is the principle contained in *Allaun, Bennett, Condec* and *Schnell* that a minority freeze-out by the majority is always actionable without regard to the price. On the other hand, *Coyne, Stauffer, Grimes* and, to a certain extent, *Schenley* state that the very purpose of paying cash in a merger is to freeze out the minority, and that

37. 33 Del. Ch. 20, 89 A.2d 862 (Ch. 1952), *aff'd*, 33 Del. 293, 93 A.2d 107 (Sup. Ct. 1952).

38. Such an approach may be somewhat inconsistent with the *dictum* in Stauffer v. Standard Brands, Inc., *supra* n.20, where the Court apparently considered "securities" under Section 251 to be participated in the enterprise.

39. Professor Folk agrees that so far as freeze-outs and permissible consideration are concerned, there is no difference between Section 251 and Section 253. Folk, *The Delaware General Corporation Law*, p. 381 n.61. The only differences are the paperwork involved and the fact that Section 251 requires a stockholders' meeting and a vote of the stockholders prior to the minority being frozen out. The fact that the insiders or majority shareholders generally control the requisite number of shares to approve the action makes this distinction meaningless.

there is no actionable wrong in so freezing out the minority. Reconciling these two lines of authority, which at first blush seem irreconcilable, may lead to the proper standards for Delaware courts to apply to freeze-out mergers under Section 251.

The legislative history of Section 251 is significant. It was not until 1967 that it was permissible to convert shares of stock into cash in accomplishing mergers or consolidations under Section 251. The leading decision, *Allaun v. Consolidated Oil Co.,* espousing the view that the freezing-out of the minority is an actionable wrong, was decided prior to 1941. At that time, there were no means by which minority shareholders could be eliminated from equity participation in the corporation surviving a merger. Section 253 had not been enacted, and Section 251 required the conversion of shares of stock of the constituent corporations into shares of stock of the surviving corporation.

The initial step to permit the freezing-out of minorities was taken in 1941 when Section 251 was amended to permit the payment of "securities" of the surviving corporation to shareholders of the constituent corporations. It was only possible to convert the shareholder from an equity participant in the resulting enterprise to a creditor of the continuing enterprise. In the traditional sense, the creditor is not a participant in the continuing enterprise.[40]

However, with the 1957 amendment to Section 253, the Delaware Legislature expressly provided for the freezing-out of stockholders by means of paying cash for their shares. Decisions such as *Coyne* and *Stauffer* were based on that fact. It would have been difficult for the courts to have determined that the end result was unfair and inequitable in light of legislative approval. Thus, *Allaun, Bennett, Condec* and *Schnell* cannot apply to a situation where the Legislature has not only authorized the procedures for the corporate action taken, but has expressly authorized the purpose for taking the action and the result of taking the corporate action. By way of contrast, the Legislature has not approved the issuance of stock to free out a minority (*Bennett*) or the manipulation of corporate by-laws to prevent dissident share-

40. For example, a convertible debentureholder lacks standing to maintain a derivative action. Harff v. Kerkorian, et al., Del. Ch., 324 A.2d 215 (1974), *aff'd,* Del. Supr., ___ A.2d ___ (October 17, 1975). Also, a creditor lacks standing to enjoin a merger. Cole v. National Cash Credit Association, 18 Del. Ch. 47, 156 A. 183 (Ch. 1931). However, a debentureholder may be given voting rights and generally afforded all of the rights of a stockholder by the certificate of incorporation. 8 DEL. C. § 221. Despite the comments of the Court in *Schenley* equating debentures to cash in an interested merger, some doubt remains in the view of the *dictum* in *Stauffer* equating debentures to a continued interest in the corporation. Thus, a freeze-out for debentures does not conveniently fit within the cash freeze-out decisions, although logically the cash freeze-out decisions should be applicable.

holders from soliciting proxies (*Schnell*), but the Legislature has approved the freezing-out of minority shareholders by the payment of cash for their shares in the constituent corporation (*Coyne* and *Stauffer*). The Legislature is presumed to have had knowledge of the *Coyne* and *Stauffer* interpretations of Section 253 when it enacted the amendments to Section 251 to permit the payment of cash for the shares of constituent corporations.[41]

This view is supported by *Federal United Corporation v. Havender,* where the Supreme Court permitted cancellation of the right of preferred stockholders to receive accrued dividends in a merger pursuant to Section 251.[42] The Court of Chancery examined the purposes of the merger and found that they did not serve any genuine purpose which mergers are designed to serve. The Supreme Court held that Section 251 was clear and unambiguous and that it granted authority for the actions taken. The Court stated that judicial exceptions should not be grafted onto the clear language of the statute. The fairness of the merger was not questioned, and, thus, the question of disparate impact on different classes of shareholders was not resolved.

All of the decisions discussed above dealing directly with the propriety of freeze-out mergers (*Coyne, Stauffer* and *Grimes*) involved the use of cash for the freeze-out. The use of debentures or other securities to eliminate the minorities as equity participants in the ongoing enterprise is not so clear. Although such a procedure was approved in *Schenley,* with the minority being relegated to the appraisal remedy, a Delaware court has not to date spoken definitively on the use of securities as a device to freeze out the minority. Arguably, there should be no difference, however, the somewhat curious nature of the debentures may cause a court to review such consideration in a different light. Until a court has spoken definitively on the use of debentures, such a merger should be viewed with suspicion.

Havender also exemplifies the general rule that each section of the General Corporation Law has an independent and separate legal significance.[43] Thus, the elimination of accrued dividends could be accomplished by a merger, but not by charter amendment. This doctrine requires the exercise of caution before automatically applying the decision involving freeze-outs by means other than a merger to the merger context.

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41. Application of Delaware Racing Association, 42 Del. Ch. 406, 213 A.2d 203 (Sup. Ct. 1965).

42. *Supra* n.35; and *see* the discussion set forth in n.35.

43. The doctrine of independent legal significance is set forth in Orzeck v. Englehart, 41 Del. Ch. 361, 195 A.2d 375 (Sup. Ct. 1963), and Hariton v. Arco Electronics, Inc., 41 Del. Ch. 74, 188 A.2d 123 (Sup. Ct. 1963).

However, there may also be a word of caution to be gleaned from a comparison of the decisions. All of the decisions approving the freezing-out of minority interests under Sections 251 and 253 involve a corporation eliminating the minority interests in a subsidiary. As the Court in *Grimes* noted, the elimination of the management problems inherent in parent-subsidiary relationships[44] may very well constitute a good reason for the elimination of minority interests. However, if the going private attempt constitutes an attempt by a group of insider shareholders to continue the enterprise without the minority shareholders, the courts may be less tolerant of freeze-out mergers and may be inclined to disregard legislative sanctions of such mergers.

In *Allaun, Bennett, Condec* and *Schnell,* the courts were basically concerned with the actions of individuals taken by the use of the Delaware Corporation Law. The courts appear to have been concerned with individuals (generally management) obtaining an advantage over other individuals or major stockholders by corporate action. Under existing Delaware law, a short merger is subject to attack if it is a portion of an overall fraudulent scheme to acquire the interests of a minority at a depressed price.[45] To date, such reasoning has not been applied in Delaware to the mergers where a fraudulent scheme is not alleged other than in *Todhunter* where the questions were raised but not resolved.

This analysis may be supported by *Havender* where the Court emphasized the stockholder's view of the transaction. The stockholder is presumed to be aware of the merger statutes and their possible effect on his stock. However, clear and unambiguous language did not put the stockholder on notice that the same result could be attained by a charter amendment.

Applying this line of reasoning to a freeze-out context may mean that public stockholders of a subsidiary corporation can be expected to be aware that they are subject to being merged out of the enterprise. However, there is no clear and unambiguous statement in the Delaware statutory scheme which would put the minority shareholder on notice

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44. *Dunhill* provides a good example of such problems in a merger context. Allegation of the usurpation of an opportunity of the subsidiary by the parent were instrumental in the Court's decision to issue a preliminary injunction against the merger.

45. In Braash v. Goldschmidt, 41 Del. Ch. 519, 199 A.2d 760 (Ch. 1964), the Court refused to dismiss a complaint attacking a freeze-out merger under Section 253. The complaint alleged mismanagement and seizure of corporate opportunity by the parent. There were also allegations of a conspiracy by certain defendants to acquire the subsidiary for themselves. The merger had been preceded by a tender offer which the plaintiffs allged was accomplished by false and deceptive solicitation materials. Thus, the merger was alleged to be the final step in the fraudulent scheme. The Court noted that the end of freezing out the minority was not unlawful in and of itself, but that if the means to accomplish the end were unlawful, then the merger itself would be tainted.

that he is subject to being eliminated from the enterprise by a group of insiders by means of a "shell" corporation and a freeze-out merger.

Thus, it would seem possible to apply the rule against manipulation of corporate machinery by the majority to the detriment of the minority to a situation where a group of stockholders combines to obtain control of a public corporation by freezing out the minority shareholders. This situation may give rise to a judicial gloss on the freeze-out of minority shareholders by the merger process. Thus, a merger which is a portion of a plan by majority shareholders to acquire the corporate enterprise for themselves and to continue to operate for their benefit must be viewed with uncertainty until such time as a Delaware court resolves that uncertainty. In this limited area, *Bryan* may have some applicability in Delaware.

CONCLUSION

If one relies strictly upon the Delaware decisions and the statutory history of Sections 253 and 251, it appears that all of the questions posed by the Court in *Pennsylvania Mutual Fund, Inc. v. Todhunter International, Inc.*, must be answered in a manner favoring freeze-out mergers pursuant to Section 251. The decisions under Section 253 should be applied to permit cash freeze-out mergers to be accomplished under Section 251. The 1967 amendments to Section 251 should constitute the same legislative sanctioning of freeze-out mergers under Section 251 as was the case for Section 253 freeze-out mergers. Thus, there does not appear to be any basis for holding that freeze-out mergers can only be accomplished pursuant to Section 253.

The Delaware courts traditionally have not inquired into the reasons for a merger in cases involving Section 251. In the analogous decisions involving Section 253, the courts have determined that the very purpose for a cash merger is the freezing-out of the minority, and that this was the very purpose envisioned by the Legislature when it amended Section 253 in 1957. Now that Sections 251 and 253 are substantively the same, it can be presumed that the Legislature has approved cash mergers accomplished under Section 251 for the very purpose of freezing out the minority. There should be no further inquiry into a "business" or other purpose for the merger.

The third question posed by the Court, whether a "shell" corporation can be utilized to accomplish a merger, is to be answered in the affirmative. In practically every one of the Section 251 mergers discussed hereinabove, a non-operating subsidiary corporation was created expressly for the purpose of effecting the merger. Thus, in the true sense, a "shell" corporation was involved.

However proper each activity standing by itself may be, it is sometimes necessary to view the transaction in its entirety. If the merger and other activities are undertaken as part of a large plan by insiders to acquire the corporation for themselves, all activity may be viewed with suspicion.

In conclusion, one is unable to state with certainty what the future of all freeze-out mergers will be under Section 251. Mergers between two operating corporations resulting in the minority shareholders of one being precluded from the operation by the conversion of their shares into cash should be upheld. The prior history of Section 253 indicates that Section 251 was amended to accomplish that very purpose. In the somewhat gray area is a merger involving the conversion of shares into "securities." Whatever labels the courts attach to their inquiry, they will, in all probability, continue to view with suspicion a plan by a group of majority shareholders to acquire the corporate enterprise for themselves.