GOVERNING INSIDERS GOING PRIVATE ON INSIDE INFORMATION

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I. INTRODUCTION

Going private transactions represent a unique niche in corporate law; they are distinct in that "the arms-length bargaining that is present in the majority of inter-corporate transactions is absent,"[1] and thus they raise special concern regarding conflicts of interest. This creates a situation ripe for misconduct, and must be specifically addressed.

A number of doctrines can be applied to such transactions, including some that were developed in other contexts. For example, the doctrines of fiduciary duty, corporate opportunity and insider trading govern insiders' conduct generally. In addition to these broader doctrines, Federal securities regulations addressed this going private conflict of interest with the promulgation of Rule 13e-3,[2] the only doctrine developed specifically to police going private.

This paper examines the application of these different doctrines to a particular type of going private conflict: the challenge insiders of a corporation face when choosing to take a corporation private on the basis of inside information. This topic is particularly relevant today because of the recent increase in going private transactions. This increase can be attributed in part to depressed stock prices (as a result of the recent market decline) that made it cheaper to buy out stockholders, and to heightened corporate regulation in the wake of recent corporate scandals,[3] particularly in the form of Sarbanes-Oxley,[4] which has increased the costs for companies to remain public.

Part II of this paper provides an overview of going private and explains the different forms of going private

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[1] Patrick S. Dunleavy, *Leveraged Buyout, Management Buyout, and Going Private Corporate Control Transactions: Insider Trading or Efficient Market Economics?* 14 FORDHAM URB. L.J. 685, 687-8 (1986).

[2] 17 C.F.R. § 240.13e-3 (2003).

[3] Recently witnessed crisis in investor confidence began with Enron in 2001 and have spread to corporate and accounting failures in other industries.

[4] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified at 15 U.S.C.A. § 7201 *et seq.* (West Supp. 2003)).

transactions. Part III describes the various doctrines applicable to going private transactions, demonstrates their application, and highlights the interaction between them. Part IV conducts an analysis of the doctrines, focusing on practical litigation considerations. Part V concludes with a discussion of how to optimize the effectiveness of the current regimes, and provides recommendations for additional legislative measures.

II. GOING PRIVATE—AN OVERVIEW

As used in this paper, the term "going private" refers to any transaction that falls within the ambit of Rule 13e-3, promulgated under the Securities Exchange Act of 1934, "in which certain of the existing stockholders or affiliates of a public target become stockholders of the entity surviving the acquisition of the target and the target is no longer subject to Section 12(g) or Section 15(d) of the Exchange Act."[5]

This paper will focus on management buyouts because they prominently illustrate the specific type of conflict of going private based on inside information. In such transactions, there is an inherent conflict because management's interests are not aligned with shareholders' interests. Rather, management stands on the opposite side of the transaction from the shareholders. As a result, management is faced with the choice to either benefit individually or tend to the interests of the corporation. "In its fiduciary capacity, management is seeking to sell the corporation and, therefore, must have concluded that a sale is in the best interests of the shareholders. In its proprietary capacity, management is seeking to purchase the corporation, and must have concluded that it can do so at a price favorable to it. In short, management is dealing with itself."[6]

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[5] STANLEY FOSTER REED & ALEXANDRA REED LAJOUX, THE ART OF M&A 658-59 (2d ed. 1995).

[6] Bevis Longstreth, *Fairness of Management Buyouts Needs Evaluation*, LEGAL TIMES OF WASHINGTON, Oct. 10, 1983, at 15, col. 3.

As an illustration of this type of conflict, consider the following scenario, which will be referred to throughout this paper:

Suppose an insider knows of an opportunity that the corporation may be able to benefit from, such as the discovery of a mineral deposit capable of being mined that belongs to the corporation. This discovery is not yet public knowledge and thus is not reflected in share price. The insider decides to purchase the corporation at the low share price. In doing so he chooses his interest over the corporation's because his purchase is taking the benefits of this discovery away from the corporation, i.e. away from the pre-existing shareholders.

The possibility of management facing this type of choice is the cause of jurisprudential hostility to going private transactions. This hostility is accompanied by fear that insiders are exploiting inside information. Insiders can choose not to publicize inside information that will lead to an increase in the corporation's price, and reap a considerable gain by freezing out the minority through purchasing the corporation at a suppressed price.[7]

III. APPLICABLE DOCTRINES

'There is nothing private about going private. It is a transaction that happens in a goldfish bowl.'[8]

Due to the conflict inherent in management buyouts, heightened attention is directed toward these self-dealing situations, where the acquiring group is often in a position to manipulate the financial condition of the corporation. They may attempt to make the corporation unattractive to other bidders in order to further their own agenda of acquiring the

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[7] *See* Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 730 (1982).

[8] Meredith M. Brown, *The Duties of Target Company Directors Under State Law: The Business Judgment Rule And Other Standards of Judicial Review*, *in* CONTESTS FOR CORPORATE CONTROL: CURRENT OFFENSIVE & DEFENSIVE STRATEGIES IN M&A TRANSACTIONS, at 205, 274 (PLI Corp. Law and Practice Course Handbook Series No. 1288, 2002).

corporation at the lowest possible price, whether or not the acquisition is in the corporation's or public stockholders' best interests.[9] These transactions can take many different forms and are often coercive in effect. For example, a minority of public stockholders may be forced by majority rule to accept cash or debt in exchange for their stock in a statutory merger. The U.S. corporate law jurisprudence contains several doctrines that apply to this situation both at the federal and state level; these doctrines are presented below.

A. State Fiduciary Duty

1. Elements

Delaware, which will be used in this paper as a proxy for corporate law at the state level, has three distinct standards of review for decisions by directors: the business judgment rule, intermediate scrutiny, and entire fairness. Entire fairness under Delaware case law, which applies to conflict of interest situations and hence covers management buyouts, is the most exacting standard of the three.

Entire fairness requires the courts to determine whether the decision is entirely fair to the stockholders.[10] In ascertaining entire fairness under Delaware law, courts weigh both the procedural and substantive fairness considerations; that is, they require both fair dealing and fair price.[11] Fair dealing includes questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. Fair price relates to the economic and financial considerations of the transaction, including all relevant factors: assets, market

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[9] *See* Harvey L. Pitt, et al., *Tender Offers: Offensive and Defensive Tactics and the Business Judgment Rule*, *in* CONTESTS FOR CORPORATE CONTROL, at 7, 223 (PLI Corp. Law and Practice Handbook Series No. 730, 1991).

[10] *See* Brown, *supra* note 8, at 259.

[11] Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983); Kahn v. Lynch Communications Systems, Inc., 638 A.2d 1110, 1115 (Del. 1994).

value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.[12]

2. Application

State law, however, may be a weak vehicle for the regulation of going private transactions. Due to state competition many commentators agree that state corporate law is 'likely to work poorly with respect to issues that are significantly redistributive, including self-dealing, taking of corporate opportunities, and insider trading.'[13] More specifically, in the governance of transactions and processes that involve potential transfers between public shareholders and a dominant shareholder, including going private freeze-outs, state competition is likely to result in value decreasing rules.[14]

Indeed, even some race to the top proponents have conceded that although generally beneficial, state competition does not correct for all of managers' incentives to pursue their own interests at the expense of shareholders.[15] Another section of this survey addresses these concepts of state competition in more depth.[16]

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[12] *Weinberger*, 457 A.2d at 711.

[13] Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1484 (1992).

[14] *Id.*

[15] *See* FRANK H. EASTERBROOK, THE ECONOMIC STRUCTURE OF CORPORATE LAW, 222-23 (Daniel R. Fischel ed. 1991); *see also* Bebchuk, *supra* note 13 at 1455-58.

[16] Jason Quintana's paper on state competition in going private provides a more thorough analysis as to why governance of going private transactions under state law fiduciary duty is ineffective. *See* Jason M. Quintana, *Going Private Transactions: Delaware's Race to the Bottom?*, 2004 COLUM. BUS. L. REV. 547.

3. Remedies

Under the entire fairness standard, when shareholders challenge a self-interested transaction, the burden of proving fairness is on management.[17] Approval by a properly functioning committee of independent directors[18] or by the holders of a majority of the corporation's publicly held shares[19] shifts the burden to the plaintiff. A violation of the duty of loyalty generally leads either to rescission of contract, or to a requirement of accounting for the difference between the fair price and the contract price. Given the difficulties of rescission, courts have been unwilling to apply it in situations where the transaction is consummated and thus difficult to undo, thus preferring to limit awards to monetary damages.[20]

Another consideration to be taken into account regarding state law remedies is the difficulty of obtaining class action rights under state law. This may be an obstacle to shareholders attempting to bring forth a direct cause of action.[21] Due to both the substantive weakness and the

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[17] *Weinberger*, 457 A.2d at 711, 714.

[18] *See* Kahn v. Tremont Corp., 21 DEL. J. CORP. L. 1161 (Del. Ch. 1996).

[19] *See* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985).

[20] *Weinberger*, 457 A.2d 701 (for a more detailed discussion on damages).

[21] In light of the growth of Rule 10b-5 litigation, procedural aspects of class actions have become highly significant in corporate practice. Some problems raised by class actions are almost identical to those raised by derivative suits. Some issues are relatively unique, such as when individual rights can be bundled into a class action, and when members of a class must be given notice that a class action has been filed. In *Zahn v. International Paper Co.*, the Supreme Court held that the claim of each member of the class must involve the jurisdictional amount for diversity cases (now $75,000) in Rule 23(b)(3) actions brought in federal court on diversity grounds. 414 U.S. 291 (1973). However, corporate class actions brought in federal courts under the securities acts require no jurisdictional minimum. Additionally, in *Eisen v. Carlisle & Jacquelin*, the court held that when a class action is brought under Rule 23(b)(3), Rule 23(c)(2) requires the plaintiff to give individual notice to all members of the class who can be identified through reasonable effort. 417 U.S. 291 (1973).

procedural difficulties this doctrine is unlikely to provide adequate protection to shareholders. Consequently, it will not be addressed throughout the rest of this note.

B. Corporate Opportunity

The doctrine of corporate opportunity arises when a director or officer, on the basis of his position, takes advantage of an opportunity that rightfully belongs to the corporation. The case of *Hawaiian International Finances, Inc. v. Pablo*[22] stated that such conduct was not permissible. Under traditional corporate law, any profit arising out of the use of corporate assets rightfully belongs to the corporation. Even if the corporation suffered no harm in another person appropriating these profits, it may have gained from appropriating that profit itself.

A typical example of this type of situation involves an insider usurping the corporate opportunity for individual use rather than relinquishing of the opportunity for the benefit of the corporation. For example, if an officer of a corporation receives notice of termination of the corporation's lease, he may not use this knowledge as an opportunity to resign, subsequently obtain the lease without disclosure to the corporation, and thus reap the benefits of obtaining the lease without competition.

Under this doctrine, an insider taking a corporation private through stock repurchase lends itself to two modes of analysis. They focus on different alleged opportunities that were taken: the first is the ability to buy stock at below market value (below true value), but this is not usurpation

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Often the class is so large and the individual claims are so small that the cost of such notice would be prohibitive. However, the typical securities action involves relatively large individual claims and a smaller number of purchasers and sellers, so that in this area the financial burden of a notice requirement is often not prohibitive.

[22] 488 P.2d 1172 (Haw. 1971) (Case where a corporation sued its president for broker commissions he received while negotiating the purchase of real estate on behalf of the corporation. The court found that in acting for the corporation a corporate officer or director may not retain commissions absent disclosure to and consent by the corporation).

because the corporation could not have legally purchased its own stock on the basis of inside information (this activity would have amounted to insider trading, and is thus not considered an opportunity available to the corporation). The second alleged opportunity is the use of the mineral deposit. The corporation could benefit from the mineral deposit, and thus taking the corporation private is usurpation. By looking beyond the form of the transaction to its substance, one can see that the insider benefits from the mineral deposit, rather than the corporation. Consequently, usurpation is established because the corporation can take advantage of this opportunity.

1. Elements

Courts have used several tests to determine when an opportunity rightfully belongs to the corporation, or, alternatively, when insiders are permitted to take advantage of such opportunities. The first of these tests is the line of business test, which states that an opportunity rightfully belongs to the corporation if: (1) it is in the line of business of the corporation, (2) the corporation is financially able to take advantage of it, (3) it presents a practical advantage to the corporation, and (4) the corporation reasonably expects to have an interest in it.[23]

The second alternative is the fairness test. In *Durfee v. Durfee & Canning, Inc.*[24] the court measured the overall unfairness that would result from the corporation not taking advantage of the opportunity when an insider appropriated it. According to *Durfee*, this test calls for application of ethical standards of what is fair and equitable to a particular set of facts. The basis of the doctrine rests on the unfairness

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[23] Guth v. Loft, 5 A.2d 503 (Del. 1939).

[24] 80 N.E.2d 522 (Mass. 1948) (Here, a director of one corporation (Durfee) had an interest in another corporation (Pacific Gas), and made profits from transactions overcharging Durfee for natural gas purchased from Pacific. The court found that director breached his fiduciary obligations to the corporation, and that he should not be allowed to retain the secret profits made at the expense of Durfee).

of particular circumstances; where an insider takes advantage of an opportunity for personal profit and the interest of the corporation justly calls for protection.

The third test is the expectancy test, which is similar to the last element of the line of business test. This test states that an opportunity belongs to the corporation if the corporation has an interest already existing, or an expectancy growing out of an existing right in the opportunity. This test also has a second component of interference-with-corporate-purpose, which means that interference by an insider will in some degree balk the corporation in effecting the purposes of its creation.[25]

The fourth test is a two-step test that combines the line of business test with the fairness test. First, it must be determined whether the corporate opportunity is within the corporation's line of business, then a fairness test is applied to the set of facts to determine the result of the corporation not taking advantage of it.[26]

The American Law Institute ("ALI") endorses a different approach than that of the tests above. Rather than focusing on the opportunity itself, the ALI approach focuses on the conduct of directors and management in an attempt to determine whether they knew or should have known that the opportunity was being offered to the corporation.[27] Additionally, the ALI suggests that it should be ascertained how the appropriating person came to know about the opportunity (i.e., whether they become aware of the opportunity through the use of corporate property). Finally, the ALI approach includes an inquiry into whether the insiders became aware of or knew that the opportunity taken

[25] Lagarde v. Anniston Lime & Stone Co., 126 Ala. 496 (Ala. 1900) (Directors of a corporation purchased land they learned about through their capacity as directors without corporation's knowledge or consent. The Corporation had been negotiating with a third party to purchase same land, and the court found directors breached their duties to the corporation in purchasing land the corporation had an expectancy in).

[26] Miller v. Miller, 222 N.W.2d 71 (Minn. 1974).

[27] PRINCIPLES OF CORPORATE GOVERNANCE § 5.05(b)(1)(A) (1992).

was closely related to the business of the corporation.[28] Thus if an insider possesses any of the requisite knowledge stated above, this knowledge amounts to the required mental state, which if proven translates into usurpation of an opportunity.

There are exceptions to the general rule of insiders not being able to take advantage of a corporate opportunity: either when a corporation (composed of disinterested directors or alternatively disinterested shareholders) rejects the opportunity or, when the corporation is not able to take advantage of the opportunity.[29] These exceptions require a director or officer who becomes aware of a corporate opportunity to disclose it to the corporation first, and a failure to do so constitutes an automatic breach of a fiduciary duty.[30]

2. Application

(i) Application in Theory

In applying these tests to the fact pattern in part II (example of the insider taking the corporation private to benefit from the discovery of a mineral deposit), we first consider the requirements of the line of business test. The first requirement of this test is that the opportunity be within the corporation's line of business. In order to establish this requirement a comparison needs to be drawn between the value of the opportunity to a corporation that is in the same line of business as the opportunity, and one that is not. For example, if the corporation is in the mining business then it is highly unlikely that the discovery of a mineral deposit would not fit into its line of business, and that the corporation would not be able to take advantage of the opportunity to its benefit. However, it could be strongly argued that if a tobacco producer discovers a mineral deposit it may not fall into its line of business.

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[28] *Id.* at § 5.05(b)(2).

[29] *Id.* at § 5.05(a)(2).

[30] *Id.* at § 5.05(a)(1).

The second requirement of the test is that the corporation be financially able to take advantage of the opportunity. It is important to note that if insiders cause the financial inability (for example by pursuing an aggressive dividend policy to render the corporation financially unable to take advantage of the opportunity), then financial inability will not be excused. It is also important to note that financial ability includes the borrowing capacity of the corporation. Even if it does not have the cash on hand to pursue the opportunity, if the corporation's balance sheet is strong enough to support enough debt, then the corporation will be considered financially able to pursue the opportunity.

Once the first two requirements are met, the final two requirements of the line of business test are easy to dispose of. Presumably, if the discovery of a new mineral deposit falls into the line of business of a corporation, it presents a practical advantage to it. It would be difficult to imagine fact patterns where this would not be the case, unless the mineral deposit is unprofitable or possibly other specialists are needed to pursue the opportunity (for example special mining techniques for which the corporation is not equipped). Finally, the corporation must also reasonably expect to have an interest in the opportunity. Again, it would be an unusual fact pattern where a corporation did not have an expectation of interest in an opportunity that the insiders are taking the corporation private to pursue.

Applying the fairness test, we must determine whether the result of the aforementioned fact pattern is fair and equitable. The result is that the appropriation of the opportunity by the insider is clearly unfair; the insider took the opportunity rather than giving it to the corporation, and hence realized its profits instead of allowing the shareholders this realization. The corporation's interests did call for protection in this instance, but the insider chose to put his own personal gain ahead of the corporation's.

If the ALI approach is applied to the fact pattern in part II, the focus would not be on the opportunity itself, but rather on the conduct of the insider and whether he knew or should have known that the opportunity was being offered to

the corporation. The factors that would help in determining whether the required mental state is present, according to the ALI, are how the appropriating person came to know about the opportunity (i.e., whether they become aware of the opportunity through the use of corporate property), and whether the insider became aware of or knew that the opportunity taken was closely related to the business of the corporation. Thus if the above factors can be attributed to the insider's conduct, particularly his state of mind, a finding of usurpation of corporate opportunity would be established.

The aforementioned exceptions, where a corporation (composed of disinterested directors or alternatively disinterested shareholders) rejects an opportunity or is not able to take advantage of it, are inapplicable to this scenario because they require a director or officer who becomes aware of a corporate opportunity to disclose it to the corporation first. In this case, the insider did not do so, and consequently there is an automatic breach of a fiduciary duty.

The logical conclusion is that the doctrine of corporate opportunity would apply to this going private scenario of the fact pattern. In effect, this going private decision is also the usurpation of a corporate opportunity. Consequently, the next inquiry is whether the courts have also arrived at the same conclusion.

(ii) Application by Courts

The doctrine of corporate opportunity has not often been applied to going private where the usurpation of the opportunity was the misappropriation of the corporation itself, rather than some opportunity from or within the corporation (i.e., when the opportunity has been one the corporation could have taken advantage of and an insider misappropriates it, courts have readily applied the doctrine as in the cases above). This disparity may reflect not an inherent unsoundness in the doctrine as applied to going private transactions, but rather a preference for other doctrines such as insider trading (discussed in more detail below).

However, *Glidden Co. v. Jandernoa*[31] involved a management buyout (again through purchase of stock) by insiders. Though the court states that the findings and conclusions contained in its opinion are expressly interlocutory and govern only the discovery of this case, the discovery dispute overlapped to a certain extent with the ultimate merits of the case. In this case, the court asserted the existence of a fiduciary duty owed to the parent corporation (sole shareholder of subsidiary's stock) by the subsidiary's directors. The existence of this fiduciary duty required the directors of the subsidiary to continue their duties of candor and disclosure to the parent, despite the directors' secondary role as prospective stock purchasers. The court found that in an attempt to suppress the purchase price of the stock, the subsidiary directors failed to disclose necessary information to the parent shareholders. The court held that this constituted a breach of duty, and thus refused to sustain subsidiary directors' claims of attorney-client privilege with respect to information requested by its parent.

Through refusing the subsidiary's claim of attorney-client privilege with respect to the parent, the court acknowledges a continuing fiduciary duty. The breach of this continuing fiduciary duty led to the parent's loss of its subsidiary (that had a more optimistic future than the parent was led to believe) and ultimately resulted in the misappropriation of a corporate opportunity. The court thus reaches the merits of the case (and the ultimate finding of a misappropriation of a corporate opportunity).

In *Kohls v. Duthie*[32] the court found that the plaintiffs had stated a claim upon which relief may be granted against a defendant who engaged in a stock repurchase. The court concluded that the plaintiffs' derivative suit adequately stated a claim for loss of corporate opportunity through

[31] 173 F.R.D. 459 (W.D.Mich. 1997).

[32] 791 A.2d 772 (Del. Ch. 2000) (President purchased thirty percent of stock of corporation from largest shareholder at nominal price without exploring corporation's options in buying those shares. Court found adequate claim established for usurpation of corporate opportunity).

applying the line of business test to the facts. In this case, an insider of the corporation chose to repurchase shares of the corporation, and plaintiffs filed suit alleging that he usurped a corporate opportunity seeking to enforce the corporation's right to purchase those shares.

The defendant attempted to argue that the corporation could not statutorily repurchase its owns shares because its capital was impaired,[33] that the provisions of its debt instruments prevented a repurchase, that the corporation was prevented from repurchasing its common shares at a time when its dividends were in arrears, and finally that the corporation had no expectancy in the opportunity. However the court found in favor of plaintiffs despite all arguments presented by defendants.[34] Though this case did not involve going private on the basis of inside information, it stands for the proposition that the doctrine of corporate opportunity can be applied to stock repurchases where insiders take an opportunity at the expense of shareholders. The facts of the case did not allow for a determination of whether a claim for corporate opportunity would have been found if the insider had repurchased *all* shares of the corporation, effectively taking the corporation private. The conclusion, therefore, for the purposes of applying the doctrine of corporate opportunity to going private, is that this doctrine has been applied, though not broadly, in governing such transactions.

3. Remedies

The judicial remedy to make a corporation whole if a director has usurped a corporate opportunity is for the court to create a constructive trust for that opportunity. The purpose of the trust is so that all of the benefits that arise out of the opportunity ultimately inure to the corporation's

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[33] *See* DEL. CODE. ANN. tit. 8, § 160 (2004).

[34] An interesting point that must be noted about this case is that in a similar class action filed against the corporation in *Kohls v. Kenetech Corp.*, 791 A.2d 763 (Del. 2000), the court found that shareholders failed to state a claim upon which relief could be granted, that differed from claims brought by other shareholders in prior actions.

benefit and not the directors'.[35] Thus the remedy appears to lay in redirecting the benefits of the opportunity from the misappropriating insider to the corporation.

In the context of going private through usurpation of a corporate opportunity (where the opportunity is ownership of the corporation itself), this remedy appears to be difficult to apply because the corporation itself would have to have a constructive trust created for it. Since the corporation would belong to misappropriating owners, and presumably rescission would be difficult to obtain, courts may prefer monetary damages as a remedy (as discussed above). In *Kohls* the court stated that to the extent the stock could not be transferred back to the corporation, the possibility of finding the defendants jointly and severally liable to the corporation amounted to a remedy. Finally, it must be pointed out that since this doctrine is seen as a substantive fiduciary duty, it probably does not provide adequately for class action rights.

C. Insider Trading

Insider trading occurs when a person possessing material inside information about a corporation uses it to his personal benefit and gains an advantage over outside investors. In order for conduct to constitute insider trading, the purportedly misused information must be material. Insider trading is governed by section 10(b)[36] of the Securities and Exchange Act, and by Rule 10b-5,[37] enacted by the Securities and Exchange Commission ("SEC") to implement the Act. Rule 10b-5 makes it unlawful to defraud or deceive a person in connection with the purchase or sale of securities. This rule is written very broadly and can catch a wide variety of acts within its ambit.

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[35] Eric G. Orlinsky, *Corporate Opportunity Doctrine and Interested Director Transactions: A Framework for Analysis in an Attempt to Restore Predictability,* 24 DEL. J. CORP. L. 451, 524-25 (1999).

[36] 15 U.S.C §78j(b) (1994).

[37] 17 C.F.R. § 240.10b-5 (2003).

A typical insider trading case could begin with an insider tipping off a friend about an upcoming merger. The friend would then use this information to buy shares in the corporation, thus profiting from the presumable rise in share price when the information is made public. Another example would involve an insider buying stock in his own corporation after the discovery of a mine, assuming the mine is profitable. If the mine turns out to be profitable, the insider benefits from his investment.

There has been some debate among the courts about exactly to whom Rule 10b-5 applies, and case history shows us how this matter was resolved. The SEC has consistently taken the position that Rule 10b-5 applies to securities transactions by any person and not just directors and management of a corporation. The seminal case in this regard is *In the Matter of Cady, Roberts & Co.*[38]

Some courts agreed with the SEC's view and adopted the 'equal-access-to-the-market-theory,' which basically states that all persons should have equal access to information regarding the markets, and if any person possesses material information about the stock of a corporation that is not known to outsiders and that would affect the price of the stock if known, then that person should 'disclose or abstain'[39] from trading.

The Supreme Court did not initially adopt this standard, and in *Chiarella v. United States*[40] the Court narrowed the scope of to whom Rule 10b-5 should apply. The Court held that there must be some kind of fiduciary relationship between the person possessing the material confidential

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[38] 40 S.E.C. 907 (1961). In this case, the partner of a firm is informed by the director of an issuer of a security of a reduction in its dividends, and the partner trades on this information knowing it is non-public. The Court held that this was a willful violation of the anti-fraud provisions of the securities acts.

[39] Securities and Exchange Comm'n v. Texas Gulf Sulphur Co., 401 F.2d. 833 (2nd Cir. 1968).

[40] 445 U.S. 222 (1980).

information and the corporation in order for a 'disclose or abstain' duty to apply.[41]

The Supreme Court, in *Dirks v. Securities and Exchange Commission*,[42] later broadened its holding in *Chiarella* to include 'tippees' (person receiving inside information). The court ruled that a 'tippee' violates Rule 10b-5 if he receives inside information regarding a stock from an insider of a corporation, and the 'tippee' knew or should have known that the insider was violating his fiduciary duty to the corporation's shareholders for his own personal gain. The Supreme Court again broadened its position in *United States v. O'Hagan*,[43] holding that a person could violate Rule 10b-5 by misappropriating material confidential information by trading in breach of a duty owed to the source of the information.

1. Elements

A person "trades," purchases, or sells securities, "on the basis of" while aware of material nonpublic information.[44] Information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision.[45] To fulfill the materiality requirement, there must be a substantial likelihood that a fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[46] Information is nonpublic if it has not been disseminated in a manner making it available to investors

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[41] *Id.* at 227.

[42] 463 U.S. 646 (1983).

[43] 521 U.S. 642 (1997).

[44] Selective Disclosure and Insider Trading, Securities Act Release No. 33-7787, 64 Fed. Reg. 72,590 (proposed Dec. 28, 1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, 249).

[45] TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); *see also* Basic v. Levinson, 485 U.S. 224, 231 (1988) (materiality with respect to contingent or speculative events will depend on a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of company activity).

[46] *TSC Industries*, 426 U.S. at 449.

generally.[47] Causation is also a required element required to find a violation on the basis of insider trading, but because the law on the causation issue is not settled,[48] for the purposes of this paper it will not be of significance whether or not it is a required element.[49]

The Supreme Court held that the element of scienter is required for section 10(b) violations.[50] Scienter is the knowledge making a person legally responsible for his acts and the mental state consisting of intent to deceive, manipulate or defraud.[51] The scienter concept arises most frequently in the context of securities fraud under section 10(b), since it is considered the catch-all provision for fraud. Thus the mental state requirement for insider trading requires knowledge or intentional misconduct, and not just negligence or intentional activity.

2. Application

(i) Application in Theory

When we apply the elements of insider trading to our fact pattern in part II (example of the insider taking the corporation private to benefit from the discovery of a mineral deposit), we find that the elements of insider trading are present. The insider has 'traded' through purchasing the corporation (i.e. purchasing its stock). He did so 'on the basis of', while aware of, 'material non-public information'. The information is material because there is a substantial likelihood that the discovery of a mineral deposit would significantly alter the total mix of information available to a reasonable investor, and hence she would consider it

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[47] In re Investors Management Co., 44 S.E.C. 633, 643 (1971).

[48] Allan Horwich, *Possession Versus Use: Is There a Causation Element in the Prohibition on Insider Trading?*, 52 BUS. LAW. 1235 (1997)

[49] Whether causation is a required element is not significant to the analysis in this paper, and thus whether it is present or not will not change the analysis of the doctrines one way or another.

[50] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

[51] BLACK'S LAW DICTIONARY 1347 (7th ed. 1999).

important in making her investment decision. The information is non-public because it has not been disseminated in a manner making it available to investors generally.

(ii) Application by Courts

The absence of arms-length bargaining and the dominant position insiders possess relative to shareholders make this form of abuse particularly troublesome in the context of going private. Courts have based their decision on whether going private is a form of insider trading depending on whether the elements of insider trading are present (including the mental requirement). Courts have traditionally treated Rule 13e-3 claims separately from Rule 10b-5 claims. For example, if a plaintiff brings forth a claim on the basis of a fraudulent going private transaction, courts will only bring Rule 10b-5 into play if the elements of insider trading are all present.

In *Brewer v. Lincoln International Corporation*,[52] the court allowed a claim of an insider trading violation, in the context of a going private transaction, to proceed. The court arrived at the conclusion that as long as the required the elements necessary for insider trading liability are present, the Rule 10b-5 claim was satisfied.

In *Nutis v. Pennsylvania Merchandising Corporation*,[53] the court refused to characterize a going private merger as an insider trading case. In this case, the lacking element was the allegation that defendants traded on inside information. The court states that the plaintiffs did not allege that defendants traded on the basis of inside information, but that "defendants were purchasing Old Penn common stock in execution of their plan to take Old Penn private."[54] This points to the fact that defendants were striving to increase their control in Old Penn, and the court acknowledges that the defendants may have breached

[52] 148 F. Supp.2d 792 (W.D.Ky. 2000).

[53] 615 F. Supp. 486 (Pa. D. 1985).

[54] *Id.* at 489.

certain fiduciary duties in going private, but held that their failure to publicize their intentions (of going private) was not the type of material nondisclosure contemplated by the 'disclose or abstain' rule. The court believed that the defendants were not obliged to announce the obvious fact that their purchases of Old Penn stock would increase their control.

3. Remedies

Neither the Securities Exchange Act nor Rule 10b-5 expressly provides for a private cause of action. Additionally, the language of Rule 10b-5 seems to imply that only the SEC has authority to bring forth an action under the Act. However, federal law has evolved to allow for such a right of action by a private party and for compensation for damages suffered.[55] Under section 20A of the Act, any person engaging in insider trading may be liable to other persons who contemporaneously traded in the same class of securities. There is no requirement of privity between the insider and the trader. However, damages are limited to the amount of profit gained or the loss avoided by the defendant.[56]

D. Rule 13e-3 'Fairness'

1. Elements

Federal law in the corporate governance field, particularly Rule 13e-3, tends to focus on detailed disclosure requirements. Rule 13e-3 requires that management make a statement of the transaction's fairness as required by Item 8

[55] Kardon v. National Gypsum, 69 F. Supp. 512 (E.D. Pa. 1946), endorsed by the Supreme Court in Superintendent of Insurance v. Bankers Life & Casualty Co, 404 U.S. 6 (1971).

[56] *See,* Mark D. Wood et al., *Liability for Exchange Act Violations, in* UNDERSTANDING THE SECURITIES LAWS, at 781, 822 (PLI Corp. Law and Practice Course Handbook Series No. 1385, 2003).

of Schedule 13e-3.[57] The rule requires that this fairness statement must be filed with the commission and disclosed to the corporation's security holders.

The rule imposes two distinct obligations. The first is a disclosure obligation, which broadly parallels disclosure requirements in other SEC regulations. However its treatment of concepts of half truths, misstatements and omissions is somewhat stricter than the jurisprudence of other SEC regulations. The other requirement goes to the fairness of the transaction; if management states the transaction is fair, then it has to really be fair. The two types of obligations relate to different objectives: the first relates to the facts of the transaction, and the second relates to its fairness. The disclosure aspect is more concerned with the procedural elements of acquiring the information, while the fairness aspect focuses on the substantive fairness of the transaction.

The fairness requirement presents an interesting jurisdictional hook considering that the SEC's remit is normally considered procedural rather than substantive. The rule places management in a situation where they must choose either to misstate that the transaction is fair (when they know it is not), and face sanctions by the SEC, or to publicly inform shareholders of the unfairness of the transaction, which will more than likely lead shareholders to reject the transaction. Thus, although the rule purports to focus solely on "procedural" disclosure requirements (by instructing managers to disclose whether the transaction is fair), it touches on substance through this required disclosure. "To be sure, the Securities and Exchange Commission (SEC) occasionally uses the rubric of disclosure to affect substance, as when it demands that insiders not trade without making 'disclosures' that would make trading pointless, when it requires that a going private deal 'disclose' that the price is 'fair.'"[58]

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[57] 17 C.F.R. § 229.1014 (2003).

[58] Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors,* 70 VA. L. REV. 669 (1984).

2. Application

(i) Application in Theory

When we apply this Rule to our fact pattern in part II (example of the insider taking the corporation private to benefit from the discovery of a mineral deposit), we find that the insider was obliged by law to state his opinion on the fairness of the transaction. Presumably the insider stated that the transaction was 'fair' in his opinion, otherwise the shareholders would have not agreed to it. This misstatement on the fairness of the transaction will trigger liability under the fairness prong of Rule 13e-3 if the transaction is deemed unfair. To determine whether the transaction is unfair we can look to analogies in other sources such as state law and other fields of federal law.

Generally, concepts of fairness, especially the more rigorous concepts that would likely be applied to such conflicted situations, typically include procedural elements relating to disclosure. These would likely rule out this type of transaction in which the insiders are taking the corporation private without revealing certain important information to the counterparties, i.e. the shareholders. The transaction would thus be deemed unfair, and management will be liable for a misstatement regarding the fairness of the transaction.

In addition, an analysis of the disclosure prong of Rule 13e-3 suggests that management will likely be liable under this prong as well. It would be quite difficult for the management of a corporation in such a situation to avoid triggering liability. For example, if it discloses its existing mining operations but omits that a new mineral deposit it is stating a half truth. Or similarly if a pharmaceutical corporation discloses that it has six drugs in the pipeline but does not disclose that two of them passed a certain milestone recently, it is stating a half truth. And since it is very difficult for a mining corporation not to mention its existing mining operations at all, or for a pharmaceutical corporation

not to mention what is currently in its pipeline avoiding half truths becomes almost impossible.

(ii) Application by Courts

In applying a Rule 13e-3 claim, the court in *Howing Company v. Nationwide Corporation*[59] recognized the similarities in the anti-fraud provisions of Rule 13e-3 and Rule 10b-5 claims.[60] It acknowledged that though the antifraud provisions stem from distinct statutes, they both parallel the common law of fraud and deceit. This gives the impression that liability triggered under the antifraud provision of Rule 10b-5 would trigger liability under Rule 13e-3 (discussed further below).

The court in *Howing* chose to focus on misstatements and half truths in the context of the required fairness opinion, and ruled that omission of disclosure required by Rule 13e-3(e) will constitute a violation of the antifraud provisions of sections 10(b) and 13(e) only where the information is necessary to prevent half truths.[61] The court went on to state that though the violations of Rule 13e-3, Item 8, cited by the plaintiff in this case do not constitute fraud, they should still be considered violations of the Rule 13e-3.

Thus by virtue of not recognizing liability for omissions under 10b only, the court is in effect distinguishing between Rule 10b-5 and Rule 13e-3 in that liability would have been triggered under 10b-5 as well as 13e-3 if the fairness opinion contained a half truth, but since it only contained an omission it was actionable under 13e-3 alone. It is important to underscore this distinction between the 13e-3 jurisprudence and the 10b-5 jurisprudence. Liability under 10b-5 can be triggered by half truths and misstatements whereas under the disclosure prong of 13e-3 liability can be triggered by omissions as well.

In applying this stricter requirement for disclosure, embodied in the disclosure prong of rule 13e-3, the court in

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[59] 826 F.2d 1470 (6th Cir. 1987), *aff'd*, 927 F.2d 263 (6th Cir. 1991).

[60] *Id.*

[61] *Id.* at 1481.

Howing conducted a detailed analysis of the disclosures required under Item 8 of schedule 13e-3 and discussed the Commission's guidance to prospective issuers,[62] specifically its concern that in many instances the Item 8(b) disclosures being made to security holders is vague and non-specific and is therefore of limited utility to security holders. The court went on to state that the Commission requires each factor which is material to the transaction be discussed and, in particular, if any of the sources of value indicate a value higher than the value of the consideration offered to unaffiliated security holders, the discussion should specifically address such difference and should include a statement of the bases for the belief as to fairness in light of the difference.

The court found that defendants made exactly the kind of conclusory statements prohibited by the Rule in their proxy statement (with regard to Item 8(b) compliance). Subsection (b)(2) of Rule 13e-3 states that "it shall be unlawful for an issuer. . .to engage, directly or indirectly, in a Rule 13e-3 transaction" unless the issuer complies with the filing, disclosure, and dissemination requirements of the Rule.[63] The court found that defendants did not comply with the disclosure obligation imposed by the Rule, and this failure was unlawful under subsection (b)(2) of the Rule. Since non-disclosure was found to be the only violation (and there was no fraud resulting from half truths) liability was thus triggered under Rule 13e-3 alone.

Note that the court in *Howing* only discussed the disclosure prong of rule 13e-3. Under the fairness prong the SEC could conceivably deem the insiders liable for "unfairness" (which, in the SEC's clever jurisdictional hook, is a misstatement of the fairness of the transaction) even if all other disclosure requirements are met. It remains unclear what additional force this prong adds to rule 13e-3; to date no court has applied that prong.

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[62] *Id.* at 1478.

[63] 17 C.F.R. § 240.13e-3(b)(2) (2003).

3. Remedies

The ultimate impact of Rule 13e-3 may seem open to doubt because it is simply a disclosure rule, and federal securities laws do not provide a remedy for a fully disclosed breach of fiduciary duty. However, relatively few fiduciary breaches are ever fully disclosed, thus the rigorous disclosure standards in Rule 13e-3 function in practical effect as a substitute for rules requiring substantive fairness.[64]

Section 13(e) does not expressly provide for a private right of action, and there have been conflicting views with regard to the exact remedy provided by section 13(e).[65] However, the court in *Howing* did recognize a private cause of action under Rule 13e-3, and as a result, a class action can be maintained for its violations.[66] By recognizing that a private right of action exists, the court merely extended a remedy that has long been available to plaintiffs suing under several other provisions of federal securities law, such as the implied right of action for damages under Section 14(a) for violations of the Commission's proxy rules.[67] Under Section 14(a) of the Act, it is unlawful to solicit any proxy in contravention of rules and regulations as the commission may prescribe.[68] Thus, shareholders have a well-established cause of action under section 14(a) to redress violations of the Commission's rules regulating solicitation of proxies, including the portion of Rule 13e-3 relating to proxies. Whether this private cause of action leads to money damages

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[64] John C. Coffee Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications*, 93 NW. U. L. REV. 641, 688-89 (1999).

[65] Ndiva Kofele-Kala, *Some Unfinished Business, Some Unresolved Issues: Section 13(E) and the SEC's Going Private Rules After* Howing Co. v. Nationwide Corp., 20 U. TOL. L. REV. 625 (1989).

[66] *See e.g., Howing*, 826 F.2d 1470 (upholding private cause of action under Rule 13e-3).

[67] J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

[68] Diane Sanger et al., *Recent Developments in Tender Offer Regulation*, *in* 22ND ANNUAL INSTITUTE ON SECURITIES REGULATION, at 139, 171 (PLI Corp. Law and Practice Handbook Series No. 713, 1990).

or only injunctive relief is not completely clear either.[69] Based on past situations where the SEC has tried to expand the scope of protection under other doctrines, it can be expected that the SEC will be a strong proponent of finding the strongest possible remedy under rule 13e-3.

E. Interaction Among the Regimes

The governance regimes of insider trading and corporate opportunity interact with the going private regime to govern going private transactions conducted through the particular forms of abuse they cover. Though different criteria of disclosure exist separately for each doctrine, the disclosure prong of Rule 13e-3 supplements them, by providing litigants with additional information.

The common element in all three doctrines lies in the same prohibition: the inability to utilize inside information to the disadvantage of shareholders. Not surprisingly, the elements of the offense under the different regimens overlap to some extent. The argument can therefore be made that, although the doctrines of insider trading and corporate opportunity work independently to govern going private transactions, disclosure of information through one of these doctrines may greatly aid bringing an action under another doctrine.

A brief review comparing the coverage of each doctrine may be helpful to the practitioner. As an example, the fact pattern in part II (example of the insider taking the corporation private to benefit from the discovery of a mineral deposit) could be an insider trading claim, a usurpation of a corporate opportunity, and a violation of Rule 13e-3. The governing doctrine is determined on the basis of the claim the shareholder chooses to bring forth. That claim is limited by the circumstances of the going private transaction, and the availability of the elements needed under each doctrine.

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[69] Victor I. Lewkow et al., *State and Federal Law Implications in Leveraged Buyouts of Public Companies*, *in* LEVERAGED ACQUISITIONS AND BUYOUTS, at 179, 249 (PLI Corp. Law and Practice Handbook Series No. 588, 1988).

It has been established above that the doctrine of corporate opportunity can be applied in this situation, but only through a particular mode of analysis focusing on the opportunity itself, not the stock purchase. Under some tests, e.g. the line of business test, there may be factors that limit the reach of the corporate opportunity doctrine, making it narrower than the others (e.g. line of business). Another useful comparison is between the insider trading and Rule 13e-3 regimes.

It appears that by default if the elements of insider trading are present then liability is triggered by the insider's faulty disclosures. The court's opinion in *Brewer* discussed above clearly illustrates this: "The plaintiffs' Rule 13e-3 claim is based on the same factual allegations which form the basis of the plaintiffs' Rule 10b-5 claim. Having found that the plaintiffs have sufficiently alleged fraudulent conduct on the part of the defendants in connection with the purchase or sale of securities, we have no trouble concluding that the plaintiffs have similarly succeeded with respect to their Rule 13e-3 claim."[70]

The court treated the two claims as distinct claims, conducting a separate analysis to ascertain liability under each rule. The court compared Rule 13e-3(b)(1)(i)-(iii) with Rule 10b-5(a)-(c), stating that "whereas Rule 10b-5 prohibits fraudulent conduct 'in connection with the purchase or sale of any security,' Rule 13e-3 proscribes similar conduct 'in connection with a Rule 13e-3 transaction. . .'"[71] Thus the court arrived at the conclusion that both the Rule 13e-3 claim and the Rule 10b-5 claim were satisfied, but required the elements necessary for liability under each rule be present.

Although courts have dealt with each of the doctrines separately, suggesting jurisprudential interaction between the claims is limited, there is considerable practical interaction among them. This interaction manifests both in the ability to use information disclosed uner Rule 13e-3 to

[70] *Brewer*, 148 F. Supp.2d 792 (W.D.Ky. 2000).

[71] *Id.* at 811.

enhance the ability to litigate under the other dictrines and in the overlap between elements of the offense in the different doctrines.

IV. PRACTICAL CONSIDERATIONS IN LITIGATION

The conflict of interest problem faced during going private transactions is not a simple one. It is a complex web of relationships between the different parties involved, particularly when the decision to go private is the result of insider information or misappropriation of a corporate opportunity as described above.

The previous section outlined the different regimes potentially applicable to going private transactions. Their nuances can affect going private in different ways and to different degrees. The examination of the doctrines thus far has been primarily in terms of the conduct they cover. This section expands that discussion and considers the various attributes of the different doctrines that are relevant to a potential litigant. These attributes include not only the extent of coverage, but also the ability to bring class action suits under each doctrine, the respective remedies and statutes of limitations relevant to each, and broader considerations of transparency.

A. Coverage and Remedies

Based on the above illustrated interaction, the question naturally arises regarding which of the doctrines a shareholder would prefer to use in bringing forth his claim and why. The answer probably is the claim that is easiest to bring forth, and that has the most generous remedies. In terms of remedy, it appears that the insider trading regime and Rule 13e-3 have the best remedies, based on a well developed federal jurisprudence.

In terms of coverage, it appears, as discussed above, that the insider trading regime is narrower than the 13e-3 regime. The main difference between the two doctrines seems to center on the requirements of scienter as a mental state for insider trading, and the presence of material inside

information. The value added from applying the insider trading regime to a going private transaction is that once a court concludes that an insider trading claim is satisfied, the fraudulent going private claim is, by default, satisfied as well.

B. Class Action

Another point that needs to be taken into consideration by shareholders assessing which doctrine to bring a claim under is the availability of class action rights. A shortcoming under the entire fairness standard and corporate opportunity doctrine pertains to class action rights and the difficulty in obtaining them, whereas with federal law (doctrine of insider trading, and Rule 13e-e) class action rights are more readily available.

C. Statute of Limitations

Another consideration is the statute of limitations limiting the possibility of bringing forth claims after their expiration. In 2002 Congress enacted an all purpose limitations period applicable to a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws.[72] The limitations period runs two years from the date of discovery, with a five year repose period running from the time of the violation. As for state statutes of limitations, different states apply different periods to bar actions for allegations of common law fraud. They vary in the time allowed after the fraud is discovered or should have been discovered;[73] shareholders then lose their right to bring forth a suit for damages.

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[72] 28 U.S.C.A. § 1658 (b) (West Supp. 2003)

[73] Courts look to analogous state blue sky laws or general antifraud laws for statutes of limitations applicable to 10b-5 actions (two to six years) and equitable tolling doctrines are often at issue.

D. Reduction in Transparency

When corporations go private there is an inevitable reduction in transparency. This reduction exacerbates the statute of limitations problem because it will take longer for information to be revealed, and thus harder for plaintiffs to bring forth timely claims. It will also be harder to get access to the information, and plaintiffs may be less inclined to attempt to access the information if they feel that delays may cause the statute of limitations to run out. Thus difficulties are posed to potential plaintiffs while they are in the process of suing private corporations, and may even deter them out of fear of investing in the start of a lawsuit which may not meet the deadline of the statute of limitations.

V. CONCLUSION AND RECOMMENDATIONS

A. Policy Considerations

Going private transactions represent a complex phenomenon. Governing such transactions is difficult and can almost never be complete. Yet the importance is not in the completeness of the governance regime, but in the flexibility to recognize when a corporation going private is an attempt to defraud investors, and when a corporation going private is simply just a corporation going private.

The existing jurisprudence governing going private transactions includes a number of doctrines that were not developed specifically for these transactions. A possible result of using such non-tailored doctrines is over- and under-regulation of the conduct in question. This final section examines how the existing doctrines pose the possibility of such over- and under-breadth, and closes with some recommendations for enhancing the current jurisprudence.

1. Overregulation

There are a number of genuine benefits from a going private transaction. The regulatory costs of being a public corporation —recently increased as a result of Sarbanes-Oxley — are avoided. Ownership and management become more closely overlapping, increasing management's incentives and potentially improving their performance. A proper regulatory regime will not penalize companies that seek to go private for those reasons, or the insiders who initiate such a process.

However, the current regime arguably does penalize them. If insiders are aware of positive information that they prefer not to reveal for competitive reasons, they may be liable under 13e-3 for failure to disclose. Moreover, the insiders will be required to pay the "fair value" of the shares, which is higher than the current market price; a third-party outsider, however, for instance a takeover specialist that happens to learn of the inside information, would only be obliged to pay the market price. This disadvantage of insiders may lead them to delay going private until the information leaks out to the public in the natural course of events, thus inefficiently continuing to incur public corporation costs (both regulatory and potentially agency costs). Alternatively, the advantage of third-party takeover artists may lead to unnecessary changes of corporate management, causing needless disruption.

Allowing management the opportunity to participate in going private transactions may at times be the best option for the corporation. "Management will play a critical role in many successful going-private transactions. Unless the corporation is to be immediately broken apart and its assets sold, it is critical that incumbent management join the acquisition group. Only current management will know if there has been any past corporate malfeasance; and even then due diligence will be required to uncover hidden

problems with the operating business to the satisfaction of equity investors and lenders."[74]

Arguments have also been made in favor of not automatically condemning decisions by management to go private, but rather to focus on the manner in which they conduct the transaction. Conflicts of interest (including corporate opportunity situations and a director's transactions with the corporation) are not inherently improper and should not be regarded as an adverse reflection on the board or the interested director. "It is the manner in which an interested director and the board deal with a conflict situation that determines the propriety of the transaction and the director's conduct."[75]

2. Underregulation

If the jurisprudential elements of the various doctrines discussed above may lead to overregulation, it would appear that some of the practical difficulties in bringing a claim under those doctrines may lead to underregulation, Thus, some corporations that go private for wrongful purposes may escape liability due to the difficulty of certifying a class action (under some doctrines), an inadequate statute of limitations, or insufficient remedial power. Perhaps most grievously, the flow of information to the (ex)public shareholder is cut off precisely when it is needed most. After the lump of information mandated by Rule 13e-3 is disgorged to the public, the corporation dives into the obscurity of private ownership. Past shareholders are in a poor position to ascertain if the corporation's activities may reflect wrong-doing – e.g., a suspicious "discovery" of mineral deposits shortly after the going private transaction.

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[74] Kimble Charles Cannon, *Augmenting the Duties of Directors to Protect Minority Shareholders in the Context of Going-Private Transactions: The Case for Obligating Directors to Express a Valuation Opinion in Unilateral Tender Offers After Siliconix, Aquila, and Pure Resources*, 2003 COLUM. BUS. L. REV. 191, 214-15.

[75] American Bar Association, *Committee on Corporate Laws*, 49 BUS. LAW. 1243 (1994).

B. Recommendations

1. Reporting Recommendation

To address the problem of insufficient transparency after the going private transaction, disclosure rules should be updated to provide some measure of transparency in the period closely following the transaction. This change should probably be made through SEC regulations, to take advantage of an existing, well-developed disclosure jurisprudence and battle-proven enforcement mechanisms. Specifically, this paper proposed extending a watered-down version of public corporation reporting requirements (both periodic, e.g. 10-K and 10-Q, and event-driven, e.g. 8-K) for a period of one to two years after a corporation goes private. The watering down would include removing strict liability for incorrent or incomplete disclosure, and probably removing negligence liability as well.

Other modifications might include more lenient filing requirements, less stringent timeliness rules, and the like. These modifications would eliminate much of the cost of compliance with the reporting requirements. However, there would still be a high level of transparency regarding the corporation's activities and operations, backed by existing penalties for fraud, willful blindness, and perhaps gross negligence in preparing the various disclosure reports.

Such a regime would have the benefit of flexibility. On the one hand, "honest" going-private transactions would be able to reap most of the regulatory cost-reduction benefits of a less onerous reporting regime. On the other hand, going private transactions motivated by improper use of inside information will emit enough information into the public sphere to allow ex-shareholders to reach a proper determination of whether to bring action. Alternatively, the insiders may choose to "sit on" the opportunity for the relevant period (one to two years), and use it only once the reporting requirements have passed. This delay, however, would render such opportunities less appealing, and reduce

the incentive to engage in such wrongful going private transactions.

2. Statute of Limitations Recommendation

Another proposal is to extend the statute of limitations for shareholders to bring forth causes of action. The purpose of this extension is to prevent fraudulent going private on immediate information. The only way an insider would be able to benefit is if the advantaged information they possess remains advantaged longer than the statute of limitations, which is unlikely in today's world. Of course, this extension proposal would have to be combined with the above proposal of continued disclosure; otherwise, the SEC or the public may not have reason to suspect transactions, even if the statute of limitations is extended.

Admittedly, there may be costs associated with extending the statute of limitations. Anytime a corporation that has gone private within the last five years makes a breakthrough or announces a surge in profits, former shareholders will probably be able to state a claim cognizant enough to begin discovery, which may be very costly to the corporation. This extension of the statute, combined with disclosure requirements, may prevent some efficient going private transactions from occurring. Ultimately, there exists a trade off between shareholders rights to investigate possible infringements, and the corporation's right to be free from lagging suspicion if its profits increase. Which choice is preferable depends on which side of the transaction you're asking, and what policies regulators feel are more of a priority: the protection of shareholders, or, the freedom for insiders to make efficient decisions vis-à-vis their corporations.

A regulatory scheme governing going private transactions would be complex and hard to implement. However, many other forms of conduct that are monitored are even more complex and are implemented and working well.[76] The issue

[76] The doctrine of insider trading itself if complex and involves judgment calls on materiality that are not judged by some bright line rule,

is not one of the difficulty or practicality of governance. Once we have committed to regulation as the chosen method of governance, the issue is how regulation should be enforced in a precise enough manner not to chill market activity in other spheres.

for example under Rule 16(b) if an insider trades within a six month period he must hand over any profits to the corporation.