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COMMENTARY

Delaware: The Race to the Bottom—Is an End in Sight?

CHARLES W. MURDOCK*

The Lord giveth, the Lord taketh away; Blessed be the name of the Lord.¹

Job's lament seems particularly appropriate in light of the trilogy of cases recently handed down by the Delaware Supreme Court in which the court staked out new territory with regard to fiduciary duties of majority shareholders, and then reclaimed a portion of it. This article will examine these cases and what the author perceives as a laudable shift in the thinking of the most influential state court in the corporate area. These cases may well represent a reversal in the development of the permissive, management-oriented body of corporate law which had come to be characteristic of Delaware and other states.

The import of these cases is enhanced by two factors: the prominent role Delaware courts have long occupied in the development of corporate law, and the United States Supreme Court's recent efforts to divert corporate litigation to state courts. Consequently, the impact of this Delaware trilogy upon the development of concepts of fiduciary responsibility in the corporate legal world will reverberate far beyond the borders of Delaware.

DELAWARE CORPORATE LAW IN PERSPECTIVE

The dominance of Delaware in the development of corporate law can hardly be questioned. For example, nearly half of the corporations listed on the New York Stock Exchange are incorporated in

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¹ Job 1:21.
Delaware, one of the least populous states. This disparity is, in part, a result of Delaware's orientation to favor management, often at the expense of shareholders. This "liberal" approach to corporate jurisprudence has led other states to "liberalize" their statutes. Additionally, since the franchise tax is such a substantial revenue item for the state of Delaware, the Delaware legislature further liberalized its policies through a major revision of its corporate statute in 1967 and significant amendments thereafter. The preamble to the 1963 statute, authorizing a review of Delaware's corporate statute, stated that "the favorable climate which the State of Delaware has traditionally provided for corporations has been a leading source of revenue for the State" and that it was "the public policy of the State to maintain a favorable business climate and encourage corporations to make Delaware their domicile." In 1966, the vice-chairman of the Delaware Corporation Law Revision Committee put this public policy into perspective when he stated that:

[while] a liberal corporation law does not necessarily attract businesses and plants . . . [n]evertheless, the franchise dollar is very important in many states, including Delaware, and when one state hears that a corporation is thinking of transferring to Delaware, for example, but instead has gone to Maryland, the state officials begin thinking of the franchise tax dollar, and frankly, that is one of the reasons for the formation of this committee—to modernize and liberalize the Delaware Corporation Law.

Unfortunately, the seduction of corporate management in Delaware is not limited to the legislature. In his article championing federal minimum standards for corporations, Professor Cary reviewed a series of decisions and concluded that "fiduciary standards

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3. See generally Cary, supra note 2.
4. Id.; see also Folk, supra note 2, at 1060-67.
5. According to Professor Cary, corporation franchise taxes represented $52 million out of a total of $222 million in state taxes collected, approximately one-quarter of the total, in 1971. Cary, supra note 2, at 668-69.
and standards of fairness generally have been relaxed" by the Delaware courts. In discussing the "clubby" atmosphere which prevails in Delaware, Professor Cary opined: "The whole process is reminiscent of musical chairs. In such a small state as Delaware, with a population of 548,000 and a bar of 733, of whom 423 are in private practice, we have in microcosm the ultimate example of the relationship between politics, the bar and the judiciary." This legislative and judicially fueled competition among the states to develop a permissive, management-oriented body of law in order to attract corporations to domicile within their respective jurisdictions has been characterized by Professor Cary as a "race for the bottom."

THE FEDERAL COURTS—THE CHALLENGE AND THE ABDICATION

As a result of the unresponsiveness of the body of corporate law in many jurisdictions, the 1960's and 1970's saw an ever increasing march of litigation into the federal courts. The federal judiciary met this need by fashioning a body of federal corporate law, basically around rule 10b-5 under the Securities Exchange Act of 1934. To many, it seemed that rule 10b-5 knew no bounds. As new abuses developed, imaginative counsel sought to draft their complaints within the compass of rule 10b-5. An example of one such abuse was the 1970's phenomenon of "going private." A variation on the squeeze-out theme, going private generally involved an issuer seeking to reclaim shares in the hands of the public through the medium of a tender offer, captive merger, reverse stock split or other device at a time when the price of the shares was depressed. Former Commissioner A.A. Sommer, Jr. exhorted the use of rule 10b-5 to remedy these new abuses.

However, the United States Supreme Court, in marked contradiction to its earlier stance, has handed down within the last three
years a series of restrictive decisions seeking to rechannel litigation into the state courts. Most recently, in *Santa Fe Industries, Inc. v. Green,* when faced with a going private transaction, the Supreme Court stated that "fairness of the terms of the transaction is at most a tangential concern" of federal law under rule 10b-5 and that, absent manipulation or deception, "transactions which constitute no more than internal corporate mismanagement" or a "breach of corporate fiduciary duty" should be relegated to "whatever remedy is created by state law."

**Proposed Rule 13e-3—Plugging the Dyke?**

In an effort to circumvent the impact of the *Santa Fe* decision, the Securities and Exchange Commission has promulgated proposed rule 13e-3 which defines those "going private" transactions

merger was a "sale" within the purview of Rule 10b-5. Two years later, in *Superintendent of Insurance of New York v. Banker's Life & Casualty Co.*, 404 U.S. 6, 30 L.Ed.2d 128 (1971), the Court held that the fraud need only "touch" the purchase or sale. One year later, in *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 31 L.Ed.2d 741 (1972), the Court held that positive proof of reliance is not a prerequisite to recovery when the evil involved was primarily a failure to disclose. The Court further interpreted the test for materiality as being that which a reasonable investor might have considered important in the making of the decision in question. Accordingly, causation in fact was established as a result of an obligation to disclose, coupled with the withholding of a material fact.


16. However, beginning in 1975, the Supreme Court began taking a rather conservative tack. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 44 L.Ed.2d 539 (1975), the Court held that the phrase "in connection with the purchase or sale of any security" in effect, established a standing requirement such that plaintiff, in a rule 10b-5 action, must either be a purchaser or a seller of securities to bring the action. A year later, in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 47 L.Ed.2d 668 (1976), the Court dealt with the question of scienter and laid to rest the dispute as to whether mere negligence was a sufficient standard of culpability to charge a defendant with liability under rule 10b-5. The Court pointed out that rule 10b-5 was promulgated pursuant to § 10(b) of the 1934 Act, which authorizes the Commission to promulgate rules prohibiting manipulative and deceptive devices. Implicit within this terminology is the notion of intentional wrongdoing; consequently, opined the Supreme Court, rule 10b-5 should not be extended to cover merely negligent conduct. While the initial reaction to this decision was that it substantially circumscribed the availability of rule 10b-5, one author has suggested that, in practice, the conclusion in *Hochfelder* will have only minimal impact on the "more than negligence and less than fraud" standard of the Second Circuit. Haimoff, *Holmes Looks at Hochfelder and 10b-5*, 32 Bus. Law. 147 (1976).

18. Id. at 478.
19. Id. at 479.
20. Id. at 477.
21. Id. at 478.
22. For a discussion of proposed rule 13e-3(b), see *Going Private Transactions*, supra note 13.
within its ambit and, in addition to disclosure requirements, imposes certain substantive mandates as well. For example, when a section 12 issuer or its affiliate goes private, proposed rule 13e-3(b) would impose a fairness standard upon the corporation when dealing with its shareholders. In support of its proposed end run of the Santa Fe decision, the Commission pointed out that Santa Fe itself, though rejecting extension of rule 10b-5 to cover going private transactions, intimated "no view as to the Commission's authority to promulgate . . . rules under other sections of the Act." The Commission also posited that its authority to deal with breaches of fiduciary obligation is broader under section 13e than under section 10(b).

That breaches of fiduciary duty were a concern of Congress in drafting the 1934 Exchange Act was illustrated in the House Report which stated:

As a complex society so diffuses and differentiates the financial interest of the ordinary citizen that he has to trust others and cannot personally watch the managers of all his interests as one horse trader watches another, it becomes a condition of the very stability of that society that its rules of law and of business practice recognize and protect that ordinary citizen's dependent position. Unless constant extensions of the legal conception of a fiduciary relationship—a guarantee of "straight shooting"—supports the constant extension of mutual confidence which is the foundation of a maturing and complicated economic system, easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of that system.

In its release, the Commission expressed its opinion that, should proposed rule 13e-3 be adopted, "it would be appropriate for the courts to construe its provisions in such a way as to imply a private right thereunder." Such an invitation would encourage unhappy minority shareholders to once again seek a forum in the federal courts when they are disadvantaged by insider squeeze-outs.

However, adoption of proposed rule 13e-3 and development of a body of law creating a private cause of action thereunder is hardly a foregone conclusion. Consequently, the development of a realistic body of state law to deal with problems of unfairness and breach of fiduciary duty is critical. This is especially true in those situations.

24. 430 U.S. at 473.
where the purported evil is not that a minority shareholder has been misled, but rather that such shareholder is powerless to prevent the majority from using the corporate form to the advantage of the majority and the disadvantage of the minority. Three recent Delaware decisions indicate a largely positive response to these problems.

**The Delaware Trilogy of Fiduciary Decisions**

*Singer v. Magnavox*

The first case in the trilogy is *Singer v. Magnavox Co.*, a class action decided on September 23, 1977. Plaintiffs were holders of common shares of Magnavox the day before Magnavox merged into T.M.C. Development Corporation (T.M.C.). Defendants were Magnavox Company, T.M.C., North American Philips Development Corporation (Development), and North American Philips Corporation (North American). T.M.C. was a wholly owned subsidiary of Development which in turn was a wholly owned subsidiary of North American.

In August 1974, North American incorporated Development and caused Development to offer to buy all Magnavox shares at a price of $8 per share. The offer was opposed by the Magnavox directors who wrote the shareholders that the "[c]ompany was shocked at the inadequacy of the offer of $8 per share in relationship to a book value in excess of $11..." In September, the managements of the respective companies met and compromised. The offering price was increased to $9 per share, two-year employment contracts were offered to sixteen officers of Magnavox, and Magnavox withdrew its opposition to the tender offer. Thereafter, Development acquired 84.1% of the common shares pursuant to the tender offer.

The following year, Development organized T.M.C. as a vehicle into which to merge Magnavox so as to eliminate the minority shareholders of Magnavox. Since Development did not own ninety percent of Magnavox' stock, a short form merger was not possible and it was necessary, first, for the directors of Magnavox to approve the transaction and, then, for the shareholders to approve it. At

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27. 380 A.2d 969 (Del. 1977).
28. Id. at 971.
29. The so-called "short form" merger under Del. Code tit. 8, § 253 (1974) would permit a parent corporation owning at least 90% of the outstanding shares of each class of stock of a subsidiary corporation to merge the subsidiary into itself without the vote of shareholders of either the parent or the subsidiary, solely by action of the board of directors of the parent.
   By way of contrast, the Illinois Business Corporation Act, in § 66a, would require that the parent own 99% of the subsidiary's shares. Ill. Rev. Stat. ch. 32, § 157.66a (1975).
30. Under the "long form" merger statute, Del. Code tit. 8, § 251 (1974), it is necessary
this time, four of the nine Magnavox directors were also directors of North American and three others had employment contracts with Magnavox and options to purchase 5000 shares of North American, effective upon consummation of the merger. And, since Development owned eighty-four percent of Magnavox, it was not surprising that the transaction received the requisite vote of the directors and shareholders.

Minority shareholders attempted to stop the merger by bringing a class action suit. Plaintiffs alleged initially that the merger was fraudulent in that it did not serve any business purpose; rather the only purpose was to force removal of public minority shareholders from an equity position in Magnavox at a grossly unfair price, thereby enabling North American, through Development, to obtain sole ownership of Magnavox. Plaintiffs further alleged that defendants breached their fiduciary duties to the minority shareholders by approving a merger at a cash price per share to the minority which was known to be grossly inadequate. The merger was also challenged as violating the recently enacted Delaware Securities Act in that it was accomplished through a proxy solicitation that was materially misleading.

Defendants moved to dismiss the complaint for failure to state a cause of action. The chancellor granted the defendants' motion to dismiss, holding that: (1) the merger was not fraudulent merely because it was accomplished without any business purpose other than to eliminate the Magnavox minority shareholders; (2) in any event, plaintiffs' remedy for dissatisfaction with the merger was to seek an appraisal; and (3) plaintiffs were not entitled to relief under the Delaware Securities Act because the misleading proxy materials did not have a significant impact on accomplishment of the merger. 31 The chancellor did not rule on the question of whether the Delaware Securities Act was applicable in a situation where plaintiffs resided in Pennsylvania and the contract was consummated in New York.

In what many observers believed was an unexpected turn, the Delaware Supreme Court reversed. The court recognized that technical compliance with section 251, the long form merger statute, had been met. However, the court stated that this did not make the merger legally unassailable since the plaintiffs had charged the defendants with a breach of fiduciary duty and even “complete com-

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31. 380 A.2d 969, 973 (Del. 1977).
pliance with the mandate of a statute does not, in every case, make the action valid in law."

The court viewed the problem as an "encounter between the exercise of a statutory right and the performance of the alleged fiduciary duty." In so doing, the court declined to resolve the question by merely addressing the issue of whether there was a business purpose for the merger. Instead, the relationship between the majority and minority shareholders of Magnavox and their competing claims was examined. That majority shareholders owe a fiduciary duty to minority shareholders in dealing with the latter's property was deemed a well settled rule in Delaware. Applied to the situation in Singer, where North American was in effect on both sides of the merger transaction, the court held that North American would have "'the burden of establishing its [the merger's] entire fairness' to the minority stockholders, sufficiently to 'pass the test of careful scrutiny by the courts.'"

Having established that corporate directors and majority shareholders owed a fiduciary duty to the corporation and its minority shareholders, the court looked to the "business purpose" or justification for the action of the majority. The notion advanced by defendants that they had met their fiduciary duty by offering fair value for the Magnavox shares was rejected. The error in such a contention was that it assumed that the rights of a shareholder are limited to the value of his investment. The court properly noted that a shareholder also has a legally protected right with respect to the form of his investment, and that this right is not adequately protected when the shareholder's sole recourse is to his statutory right of appraisal. Were this not the case, the majority shareholder, through manipulation of corporate forms and procedures, would have a power analogous to eminent domain to acquire the property of a shareholder against his will.

The court quoted with approval opinions stating that "action by

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32. Id. at 975.
33. Id.
34. Id. at 976.
35. Id.
36. Id.
37. Id at 977.
38. Id. at 978-79. Carried to its logical, or illogical, extreme, a parent owning 51% of the stock of the subsidiary could cause the subsidiary to merge into it and could cause cash to be the consideration offered in the merger. Thus the minorities' investment is at the sufferance of the parent as controlling shareholder of the subsidiary. While the minority shareholder of the parent would have a right to appraisal under the statute, this too would only result in the minority shareholder receiving cash. Somewhere along the line, public policy must take a stand against such power of the majority to convert the minority shares into cash.
majority stockholders having as its primary purpose the ‘freezing out’ of a minority interest is actionable without regard to the fairness of the price,"39 that “corporate machinery may not be manipulated so as to injure minority stockholders,"40 and that “inequitable action does not become permissible simply because it is legally possible."41 Nevertheless, the holding was limited to the proposition that “a § 251 merger, made for the sole purpose of freezing out minority stockholders, is an abuse of corporate process."42

Tanzer v. International General Industries, Inc.

The significance of this caveat in Magnavox became apparent less than one month later when, on October 18, 1977, the Delaware Supreme Court handed down its decision in Tanzer v. International General Industries, Inc.43 The facts were similar to those in Magnavox. International General Industries, Inc. (IGI) owned eighty-one percent of the common stock of Kliklok Corporation (Kliklok). In September 1975, IGI formed KLK Corporation (KLK) to serve as a vehicle into which to merge Kliklok. Thereafter the merger was approved, pursuant to section 251, by the respective boards of directors and stockholders of KLK and Kliklok.

As in Singer, plaintiffs argued that the merger lacked a business purpose; instead, the sole purpose was to serve the best interests of the parent corporation, IGI. However, IGI demonstrated to the chancellor that:

the principal reason for the merger, and evidently the only reason for the merger, is to facilitate long term debt financing by IGI. . . . IGI has a legitimate and present and compelling business reason to be the sole owner of Kliklok. IGI is not freezing out the minority just for the purpose of freezing out the minority."44

In coming to grips with the Tanzer factual situation, the Delaware Supreme Court recognized that the issue involved fiduciary obligations, the scope of which could not be measured merely by the business judgment rule. As in Singer, the court saw the problem as involving the fiduciary obligations of majority shareholders vis-a-vis minority shareholders. However, this was only part of the picture since the merger had to be approved not only by the shareholders

42. 380 A.2d 969, 980 (Del. 1977) (emphasis added).
43. 379 A.2d 1121 (Del. 1977).
44. Id. at 1124.
of Kliklok—a foregone conclusion since IGI owned eighty-one percent of Kliklok—but also by the board of directors of Kliklok who owe a fiduciary obligation to all shareholders. One element of a director's duty is to treat all shareholders evenly; however, a cash out merger hardly treats all shareholders evenly since one group—the majority, as the surviving entity in the merger—appropriates the assets and business of the subsidiary, whereas the minority is divested. While the value paid to the minority may be fair, i.e., it may reflect the going concern value of the assets and business acquired by the parent, fairness is at best an elusive concept. More importantly, as the court in Singer noted, an investor has an interest in the form of his investment as well as the value. Nevertheless, the court held that:

IGI is entitled to have its rights in dealing self-interestedly with Kliklok measured by reference to its status as stockholder. In other words, it would not be fair to IGI to examine only its director control of Kliklok which is a consequence of its power and not the source thereof.

Continuing in that line, the court noted that while the focus in Singer was upon minority rights, the majority has rights also. One of these rights is to vote its shares in its own interest, limited only by any duties owed to other shareholders. Accordingly, IGI had the right to look to its own corporate concerns in determining how to vote its Kliklok shares with regard to the merger. The only limitation imposed by the court upon this right was that the interest the majority seeks to further must be bona fide and not be a mere subterfuge for the real purpose of eliminating an unwanted minority interest in the subsidiary. Since the reason for the merger was to facilitate the parent's long-term debt financing, the court held that IGI was acting properly in its own interest, and that there was no basis to enjoin the merger.

One might have expected the opinion to end on that note. However, the court went on to hold that, notwithstanding the appropriateness of IGI proposing and voting for the merger, plaintiffs still were entitled to a fairness hearing under Singer. The court opined that the chancellor was mistaken in discussing fairness only in

46. 380 A.2d 969, 977 (Del. 1977). See discussion at note 38 supra.
47. 379 A.2d 1121, 1123 (Del. 1977) (emphasis added).
48. Id. at 1125.
49. Id. at 1124.
terms of the price offered the minority shareholders of Kliklok. In order to determine whether a transaction is "fair," all aspects of the transaction should be scrutinized for its "entire fairness." Unfortunately, the court did not indicate what factors besides fairness of the merger price ought to be so scrutinized.

**Lynch v. Vickers Energy Corp.**

On the same day that *Tanzer* was decided, a decision was also reached in *Lynch v. Vickers Energy Corp.* This case dealt with a tender offer by the parent corporation, Vickers Energy Corporation (Vickers), a wholly owned subsidiary of Esmark, Inc. (Esmark), to the minority stockholders of the subsidiary, TransOcean Oil, Inc. (TransOcean). At the time of the tender offer, Vickers owned 53.5% of TransOcean's common stock. Plaintiff tendered 100 shares and thereafter brought suit for the difference between the tender offer price and the fair value of the shares, alleging that defendants failed to make full and frank disclosure of the value of TransOcean's net assets. The chancellor entered judgment for defendants after a trial on the merits and concluded that plaintiff, in effect, was seeking appraisal rights in the context of a tender offer, a form of relief "not provided for in the Delaware Corporation Law or cognizable under general equitable principles." The chancellor had recognized that Vickers, as majority stockholder of TransOcean, owed a fiduciary duty of "complete candor" in disclosing fully "all of the facts and circumstances" surrounding the tender offer. The Delaware Supreme Court reversed the chancellor's judgment on the ground that the chancellor had misapplied the foregoing principle to the facts of the case in that the tender offer failed to disclose two critical facts: (1) a highly qualified petroleum geologist, who was a vice president of TransOcean, had calculated the value of TransOcean's net assets to be between $250 and $300 million, whereas the tender offer had only stated that it was not less than $200 million [approximately $16.00 per share] and could be substantially greater; and (2) Vickers' management, during the period immediately preceding the tender offer, had authorized open market purchases of TransOcean stock at up to $15 per share, while the tender offer (the price of which was $12 per share) stated only

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50. Id.
51. A.2d. (Del. 1977). *Lynch* differs from *Singer* and *Tanzer* in that it does not involve a merger.
52. Id. at ___; slip opinion at 3.
53. Id. at ___; slip opinion at 4.
that open market purchases had been made at an average price of $11.49 per share.

With respect to the question of net asset value, the court held that Vickers' disclosure had been inadequate and stated:

[W]hen, as here, management was in possession of two estimates from responsible sources—one using a 'floor' approach defining value in terms of its lowest worth, and the other a more expansive or 'ceiling' approach defining value in terms of its highest worth—it is our opinion that complete candor required disclosure of both estimates. If management believes that one estimate was more accurate or realistic than another, it was free to endorse that estimate and to explain the reason for doing so; but full disclosure, in our view, was a prerequisite.54

As to the open market purchases, the court again was of the opinion that Vickers had a duty to make a complete disclosure, including disclosure of the price at which it had authorized purchases. The court stated:

Whether the authorization price accurately stated Vickers' opinion as to the true value of TransOcean's shares, or whether it was a tool of convenience established to facilitate the acquisition of TransOcean's shares in a fluctuating market, it is not relevant in a context involving the fiduciary obligation of full disclosure. What is important is the fact that the authorization price was germane to the terms of the tender offer, and as such it should have been disclosed to the minority shareholders.55

In Lynch, it was emphasized that the duty of candor requires disclosure, not merely of "adequate" facts, as the chancellor apparently believed, but rather of all germane facts. As the court stated, "[c]ompleteness, not adequacy is both the norm and the mandate under present circumstances."56 The court also indicated its approval of the federal standard for disclosure; i.e., disclosure of those facts which a reasonable shareholder would consider important in determining whether to sell or retain his shares.57

**IMPLICATIONS OF THE TRILOGY**

What then is the significance of this trilogy of cases? Assuming arguendo that there has been a "race to the bottom," do the cases

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54. Id. at ___; slip opinion at 9.
55. Id. at ___; slip opinion at 12.
56. Id. at ___; slip opinion at 9.
represent a change in direction—at least as far as the judiciary is concerned?

A cynical response would be that whatever benefit the Delaware Supreme Court conferred in Singer, it took away in Tanzer. This cynicism would be predicated upon the fact that a plausible business purpose could be manufactured for almost any action.\(^{58}\) In Tanzer, the purported reason for the merger was to facilitate the parent's long-term debt financing. Before the cash-out, the parent, in addition to other assets, had cash plus an 81 percent interest in the subsidiary; afterward it had less cash but a 100 percent interest in the subsidiary. This hardly appears to be such a startling simplification of corporate structure as would induce a banker or other investor to feel more secure in extending long-term financing. The only advantage is that the parent may now utilize the assets of the subsidiary as it pleases without minority stockholders to complain of misuse.

The Tanzer opinion did not discuss how the proposed transaction would facilitate long-term financing. Such analysis was not necessary since plaintiffs did not contest, and in fact conceded, that the merger would have the alleged benefit.\(^{59}\) But it is interesting to speculate how the court would have responded if the alleged benefit to the parent as majority shareholder had been put in issue.

The starting point for this analysis would be the statement in Tanzer that any attempt to circumvent Singer would be scrutinized with care.\(^{60}\) From this, it appears the test of intrinsic fairness would apply and the parent would have the burden of proving a high degree of fairness in the transaction. This burden would require the parent to introduce evidence that a substantial benefit would flow to the parent from the proposed action. This evidence should then be scrutinized for its reliability. An example of unreliable evidence would be a favorable statement concerning the proposed action from a banking official seeking the parent's business. Such a statement ought to be suspect on the ground of conflict of interest—the opinion simply is not independent.\(^{61}\)

58. See, e.g., discussion of Hymen v. Velsicol Corp. at text accompanying note 66 infra.
60. Id. at 1124.
61. 'See, e.g., David J. Greene & Co. v. Schenley Indus. Inc., 281 A.2d 30, 33 (1971), where the court stated:
First of all, I am satisfied that self-dealing officers and directors of Glen Alden agreed on the basic terms of the reorganization plan here under attack and that the approval of Allen & Company, Incorporated was furnished, as it were, ex post facto, and because of close business relations between such bankers and those in control at Schenley such analysis cannot be deemed to be in any degree impartial.
In Massachusetts, the supreme judicial court recently handed down two decisions dealing with the fiduciary obligations of controlling shareholders. In one, Wilkes v. Springside Nursing Home, Inc., the court introduced the rather novel approach that the minority should be allowed to demonstrate that another alternative, less detrimental to its interests, was available to the controlling shareholder. The court stated:

When an asserted business purpose for their action is advanced by the majority, however, we think it is open to minority stockholders to demonstrate that the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority's interest. If called on to settle a dispute, our courts must weigh the legitimate business purpose, if any, against the practicability of a less harmful alternative.

It appears that the doctrine of least restrictive alternative, which has been a major force for reform in the mental health area, may find a place in the corporate field as well. This innovative theory has much to recommend it.

A classic illustration of a factual setting in which this approach could have been utilized was that examined in the case of Hyman v. Velsicol Corp., a case which represents the low water mark in Illinois in the corporate fiduciary duty area. Velsicol was organized in 1931 with a capital of $20,000, consisting of 200 shares of $100 par stock. Plaintiff held forty shares and two corporations each held eighty shares. Each of the two corporations also advanced $264,000 to Velsicol. In 1946, after earning approximately $350,000 the prior year, a plan of recapitalization was proposed in which the stock would be split at a ratio of ten to one, thereby lowering the par to $10. An additional 68,000 shares would be offered to the shareholders at $10, although the shares presumptively were worth substantially more. Plaintiff, as a twenty percent shareholder, had the right to buy 13,600 shares and each corporation had the right to buy

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62. Donahue v. Rodd Electrotype Co. of New England, Inc., 328 N.E.2d 505 (Mass. 1975), which required that insiders afford a minority shareholder the opportunity to resell a proportional number of shares to the corporation when the insiders permit one of their relatives to convert his holdings into cash, and Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1976), which held that majority shareholders owe a duty to a minority shareholder and may not arbitrarily terminate his employment.
64. Id. at 663.
65. Id.
27,200 shares. However, plaintiff was required to tender $136,000 in cash, whereas the two corporations were able to pay the bulk of their cost by surrendering their $264,000 demand notes. When plaintiff failed to exercise his preemptive rights, his interest in the equity of the corporation shrunk from twenty percent to less than one percent.

The recapitalization was triggered in part by the suggestion of a bank at the time it extended credit in 1946 that the demand notes of the corporations be subordinated or capitalized. Plaintiff had suggested that the notes be capitalized through the issuance of preferred stock which probably would have been nonparticipating and would have had only a minor impact on his equity interest. Instead, common stock at a grossly inadequate price was issued to redeem the notes. The court saw no problem with the issuance at par and held that the preemptive rights gave plaintiff the opportunity to protect his pro rata interest, notwithstanding the fact that he probably did not have the cash to exercise the rights and that such rights in a closely held corporation have no market value.

Had the Illinois court adopted the doctrine suggested in Wilkes, it could have enjoined the proposed recapitalization and left available to the majority the proposed preferred stock recapitalization. However, under the Tanzer doctrine, the majority shareholders in Velsicol could have demonstrated a business purpose for the recapitalization. But even Tanzer would afford some relief to the minority shareholder because the doctrine of intrinsic fairness would require inquiry into the price at which the majority acquired the additional shares in the recapitalization. An issuance of shares at par when they are worth substantially more would not be tolerated under the intrinsic fairness test.

Abnegation of Director Responsibility

Another cause for concern in the Tanzer opinion is the fact that it condones abdication of director responsibility when the directors are subject to control by the parent. As noted earlier, the long form merger statute requires action by both the board of directors of the subsidiary and the shareholders of the subsidiary. In declining to set aside the merger, the court ignored any fiduciary responsibilities that the directors of the subsidiary owed the minority shareholders in proposing a transaction which would have the effect of cashing them out. The court stated that it would not be fair to IGI to test the transaction by applying the fiduciary standards applicable to directors because its control over the board was the consequence, rather than the source, of IGI's power. The opinion then dwelt on numerous cases holding that shareholders do have the right to act in their own interest, whereas directors, as "pure" fiduciaries, have
responsibilities akin to those of trustees: they must act in the best interest of the corporation—the subsidiary, not the parent—and must treat all shareholders evenly. As previously discussed, a cash-out merger does not treat all shareholders evenly.

Although significant advances have been made in the last few years in articulating and developing a body of fiduciary duties for controlling shareholders, it is nonetheless true that the fiduciary duties of directors are more stringent than those of shareholders. Thus, the Tanzer opinion, by negating the fiduciary obligation of directors to the corporation and minority shareholders, undercuts the protection that should be afforded minority shareholders.

A comparison of long form and short form merger statutes may help to highlight this. Under a short form statute, no authorization is required of the shareholders of either parent or subsidiary. Moreover, no action need be taken by the directors of the subsidiary. Only the directors of the parent must take action, and they owe their duties of care and loyalty essentially to the parent. Thus the short form statute is, in effect, a legislative declaration that the equity interest of the subsidiary’s minority shareholders is de minimus and is an authorization for the parent to convert the minority’s holdings to cash in a manner akin to eminent domain. Fairness of the acquisition price is protected by the appraisal process. Arguably, the only duty owed the subsidiary’s minority shareholders by the parent’s directors is establishing a fair price for the cash-out.

A cash-out long form merger, on the other hand, is almost a contradiction in terms. As the Delaware Supreme Court said prior to the amendment of section 251 that permitted the issuance of cash in a merger: “A merger ordinarily contemplates the continuance of the enterprise and of the stockholder’s investment therein, though in altered form; a sale of all assets . . . ordinarily contemplates the liquidation of the enterprise.” Accordingly, in a long form merger, a heavy burden of justification rests upon the subsidiary’s board of directors when it adopts a cash-out merger eliminating minority shareholders from the ongoing enterprise.

All that can be said on behalf of the Delaware Supreme Court in Tanzer is that it did address the problem clearly, but chose to ignore any director responsibility by focusing on those it saw as the real parties in interest—the parent as majority shareholder, and minority shareholders. The danger in skirting the issue of director respon-

67. See text accompanying notes 44-45 supra.
68. Kaplan, supra note 9, at 887-88.
69. Compare § 251 of the Delaware General Corporation Law with § 253.
sibility is that such avoidance may be extended to unreasonable limits. In *Tanzer*, the parent owned eighty-one percent of the stock of the subsidiary. In Delaware, because of its majority vote requirement on a long form merger, the parent could have imposed a merger on the subsidiary even if it owned only fifty-one percent of the stock. Would the court still find no director responsibility to the forty-nine percent minority?

By not addressing the issue of director responsibility in the subsidiary, the opinion in effect took a "deputization," or perhaps a "dummy," approach with respect to the status of the directors of the subsidiary. If it is accepted that the subsidiary directors are merely agents or tools of the parent, serious questions arise concerning the independence of the subsidiary vis-a-vis the parent and the parent's liability for the acts of a subsidiary so controlled.

**Impact on Section 144**

Although the positive tone of *Singer* was marred by discordant notes in *Tanzer*, the *Lynch* decision once again harmonized with the development of sound fiduciary principles. In sounding a clarion call for full disclosure of all relevant facts—as opposed to mere "adequate" disclosure—*Lynch* is relevant not only in the context of a tender offer by a parent to its subsidiary's minority shareholders, but also in other situations in which a fiduciary is called upon to communicate with those to whom the duty is owed. *Lynch* is particularly significant with respect to the application of section 144 of the Delaware Code which was introduced in 1967.\(^1\)

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71. [Del. Code tit. 8, § 144 (1974)] provides:

**Interested directors; quorum**

(a) No contract or transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee thereof which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if:

(1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to his relationship of interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is
Several commentators have read statutes such as section 144 as establishing disclosure coupled with the requisite procedural technique as an alternative to fairness as a test in validating transactions between an interested director and his corporation. For example, Professor Kaplan has stated that "it is roughly accurate to say that these statutes recognize the validity of such a transaction if it is approved after being fully disclosed or, in the alternative, if it is fair and reasonable." Professor Folk has stated that "[m]ost of them [statutes requiring disclosure of a director's interest], including the Model Act's section 41, sustain an interest-tainted deal if 'the fact of such relationship or interest is disclosed or known to' the board of directors or committee of directors, or to the shareholders." Professor Folk, however, pointed out that the Delaware statute requires disclosure not only of the relational interest but also of operative facts material to the transaction.

Although the Delaware Supreme Court recently repudiated the notion that disclosure is an alternative to fairness, disclosure is still significant because section 144 necessarily implies that a transaction is voidable unless one of the three conditions is met. Under this interpretation, any one of the three conditions constitutes a threshold which the interested director must cross; otherwise the transaction is voidable solely because of the conflict of interest. In such a case there is more certainty in seeking to cross a procedural threshold, such as disclosure accompanied by approval of disinterested directors or the shareholders, than a substantive and conceptually elusive threshold such as fairness.

In order to cross the procedural threshold, section 144 requires disclosure of "material facts as to his relationship or interest and as to the contract or transaction." To this, Lynch adds the requirement of "'complete candor' in disclosing fully 'all the facts and circum-

72. Kaplan, supra note 9, at 894.
73. Folk, supra note 2, at 1045. Professor Folk's comment may be somewhat out of context since, earlier in the paragraph from which this quote was taken, he referred to such statutes as describing tests which prevent transactions from being "automatically void or voidable." Furthermore, in his landmark work on the Delaware Corporation Act, he stated that the "validating effect does not go beyond removing the specter of voidability which might otherwise arise from the presence of any one or more of these three elements." E. Folk, The Delaware Corporation Law: A Commentary and Analysis 82 (1972).
74. Folk, supra note 2, at 1045-46.
75. See text accompanying note 84 infra.
stances surrounding the transaction. Together with the earlier discussion of the facts in Lynch it should be apparent that the Delaware Supreme Court was imposing a most rigorous standard of disclosure.

PROCEDURE VS. FAIRNESS IN ASSESSING FIDUCIARY OBLIGATIONS

Application of a statute such as section 144 is deceptively troublesome. At one end of the interpretive spectrum is the view just advanced that clauses (1) and (2) of section 144 only establish certain thresholds which, if crossed, will not render the transaction voidable solely because of self-interest. However, the same transaction could still be attacked on grounds such as unfairness. But this interpretation treats the alternatives in section 144 (disclosure coupled with procedurally adequate director or shareholder approval vs. fairness) as conjunctive rather than disjunctive requirements.

At the other end of the interpretive spectrum, it has been urged that compliance with the procedural requisites of clauses (1) or (2) suffices to sustain a transaction irrespective of its fairness. Does it then follow that, for example, disinterested directors can approve an unfair transaction? If so, plaintiff's remedy is to sue the disinterested directors based upon breach of a duty of care. In that event, the burden would be on plaintiff to establish a breach and the disinterested directors would have the business judgment rule operating in their favor. If plaintiff were successful, the disinterested directors would bear the cost of the unfair transaction. The paradox then is that if the interested directors made proper disclosure, the disinterested directors would have no recourse against them, and the interested directors would reap the benefit of the unfair transaction. Therefore, the lesson to conniving directors would be to insure

76. A.2d ___, ___ (Del. 1977).
77. See text accompanying note 46 supra.
78. See, e.g., Fliegler v. Lawrence, 361 A.2d 218, 221 (Del. 1977); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952). In rejecting this contention, the California appellate court stated:

Here, undoubtedly, there was a literal compliance with subdivision b of the Section. The fact of the common directorship was disclosed to the stockholders, and the Sesennas, majority stockholders, did approve the contracts.

But neither Section 820 of the Corporations Code nor any other provision of the Law automatically validates such transactions simply because there has been a disclosure and approval by the majority of the stockholders . . . . Even though the requirements of Section 820 are technically met, transactions that are unfair and unreasonable to the corporation may be avoided . . . . It would be a shocking concept of corporate morality to hold that because the majority directors or stockholders disclose their purpose and interest, they may strip a corporation of its assets to their own financial advantage, and that the minority is without legal redress.

Id. at 418, 241 P.2d at 73-74.
that there are also "dummy" directors, literally and figuratively, on the board. In the author's opinion, the above scenario amply illustrates the fallacy of permitting procedure to be an alternative to fairness.

A third interpretive position, a middle ground, would hold that compliance with the procedural requisites of clauses (1) or (2) would shift the burden of proof from defendants to plaintiffs on the key issue for resolution, namely, fairness. Even here, however, two questions remain. First, what is a "disinterested" director? In the parent-subsidiary context in Singer, where four of the nine directors were also directors of the parent and three of the directors were employees of the subsidiary with stock options in the parent, seven of the directors were clearly interested. However, if the validity of director action had been at issue in Singer, should the votes of the two disinterested directors have had any special significance? Under section 144(a)(1), the votes apparently would be significant since the section requires approval of "a majority of disinterested directors, even though the disinterested directors be less than a quorum." But, to pose a different question, how independent are the two disinterested directors? Studies have indicated that it is not polite to disagree with the president; moreover, even "independent" directors on the board owe their presence to the willingness of the interested majority to slate them. Query: does disinterest require independence? If so, disinterest will rarely be found.

A second unanswered question is posed by clause (2) of section 144. In clause (2) dealing with shareholder approval, as contrasted with clause (1), nothing is said about disinterest. Therefore, can an interested director, who is, in effect, disqualified from voting upon a transaction because he is interested, take off his director hat, replace it with a shareholder hat, and thereby remove the taint from his vote? Clearly the affirmative vote of the parent holding eighty-four percent of the subsidiary's stock in the Singer case did not foreclose judicial scrutiny which set aside the transaction. Even in

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80. *Id.* at 1208. The author recounts an occasion when he differed with the chairman of the board and was informed that "[Y]ou have the choice of going along with me or leaving with the president."

81. See, e.g., Shlensky v. South Parkway Bldg. Corp., 19 Ill. 2d 268, 166 N.E.2d 793 (1960), where the court stated that it could not perceive how a lawyer for an interested director could be seriously characterized as "an independent and disinterested director representing only the Building Corporation." *Id.* at 284, 166 N.E.2d at 802.
Tanzer, where the court held that the parent may vote in its own self-interest, judicial scrutiny was not foreclosed.

Accordingly, the better approach would be to interpret clause (2) as requiring the vote of disinterested shareholders in order to have any relevant effect. This is supportable by the language of clause (2) itself which speaks of approval "in good faith by the shareholders" (emphasis added).

In effect, a form of class voting is created with the disinterested shareholders constituting a class, the approval of which must be obtained in order to draw any benefit from section 144(a)(2). If the requisite vote of disinterested shareholders is obtained, under this middle ground interpretation of section 144, the burden would shift to plaintiffs to establish unfairness. But it should be emphasized that even a vote of disinterested shareholders should not deprive plaintiffs of a hearing on the issue of fairness, as in Tanzer, at least where gross unfairness is alleged. As the Delaware Supreme Court stated in an earlier opinion: "An unconscionable deal between directors personally and the corporation they represent could not become conscionable merely because most of the stockholders were either indifferent or actually in sympathy with the directors' scheme."

Although the thrust of this article is to assess the impact of the trilogy of 1977 Delaware cases in stemming the "race to the bottom," such assessment of the present state of fiduciary obligation in Delaware would not be complete without some consideration of the Delaware Supreme Court's interpretation of section 144 in Fliegler v. Lawrence a year earlier.

82. Counsel argued this approach in Bastian v. Bourns, Inc., 256 A.2d 680, 682 (Del. 1969), but the court decided the case on other grounds.
84. 361 A.2d 218 (Del. 1976). Fliegler involved a shareholder derivative action brought by minority shareholders on behalf of Agau Mines, Inc., a Delaware corporation, against its officers and directors and against United States Antimony Corporation, a corporation created by the individual defendants. The suit arose out of the actions of the officers and directors of Agau in foregoing a corporate opportunity to acquire valuable property for Agau because, as the court agreed, Agau was not in a financial position to afford to purchase undeveloped property. Instead, these officers and directors formed another corporation, United States Antimony, through which they purchased the properties in question. It also was agreed that Agau would have an option to purchase United States Antimony if the properties proved to be of value.

The properties turned out to be quite valuable and Agau exercised its option. As a result of the defendants—in their capacities as directors and officers of Agau—exercising the option, defendants, as shareholders in United States Antimony, made a profit. Because these defendants stood on both sides of the transaction, the burden was upon them to prove the intrinsic fairness to Agau of the transaction. Defendants asserted that, under 8 Del. Code tit. 8, § 144(a)(2) (1975), the fact that the Agau shareholders ratified the transaction shifted the burden of proving fairness back to plaintiffs.
The Delaware Supreme Court's opinion in *Fliegler* provided some answers to the questions raised earlier. In so doing, it set a tone which presaged the current trilogy of opinions. The court rejected the notion that ratification by interested shareholders shifted the burden of proof on the question of fairness to plaintiffs, stating:

The purported ratification by the Agau shareholders would not affect the burden of proof in this case because the majority of shares voted in favor of exercising the option were cast by defendants in their capacity as Agau Shareholders. Only about one-third of the "disinterested" shareholders voted, and we cannot assume that such non-voting shareholders either approved or disapproved. Under these circumstances, we cannot say that "the entire atmosphere has been freshened" and that departure from the objective fairness test is permissible.\(^{85}\)

In thus concluding that compliance with the requirements of procedural fairness established by section 144 does not serve to shift the burden of proof on the question of fairness, the court seems to have aligned itself with the view that section 144 does not establish an alternative to fairness in validating transactions between an interested director and his corporation, but rather a *threshold* of procedural fairness which must be crossed.\(^{86}\)

**CONCLUSION**

The subtleties of a judicial change of direction are often difficult to identify, particularly since the holding of any case is inextricably intertwined with the facts. As a result, it is difficult to state with any degree of certainty what effect any decision may have on the development of the law. This is particularly evident in analyzing this trilogy of decisions. Many questions remain unanswered by the Delaware trilogy, including the apparent undercutting of *Singer* by *Tanzer*. Nevertheless, it is submitted that the caliber of Delaware jurisprudence has risen markedly in the area of fiduciary duties of majority shareholders as a result of these decisions.

The author submits that these cases mark, if not an emergence of a new corporate philosophy in Delaware, at least an effort to stem the erosion of minority shareholder's rights which had become a hallmark of Delaware's "liberal" corporate law. The cases have at least renewed the flagging vitality of the intrinsic fairness rule in.

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85. 361 A.2d at 221.
86. The court also stated that "[n]othing in the statute sanctions unfairness to Agau [the corporation the interested directors served] or removes the transaction from judicial scrutiny." *Id.* at 222.
Delaware which had been undercut by *Sinclair Oil v. Levien*87 and other cases. The Delaware Supreme Court should be lauded for its application of the intrinsic fairness standard in connection with the recognition of the rights of minority shareholders. While in *Tanzer* it may have overemphasized the interests of majority shareholders without recognizing the fiduciary duties and theoretically differing loyalties of the directors elected by them, it once again freshened the air in *Lynch* by sounding a clarion call for full disclosure in lieu of jesuitical reservation.

Thus, the trilogy of cases seems to represent a positive movement not merely in the articulation of the applicable law, but in the application of the law to the facts. With the federal door being closed by the United States Supreme Court in *Santa Fe*, it is both timely and appropriate that fairness, and not franchise fees, be the uppermost consideration for the Delaware Supreme Court.

87. 280 A.2d 717 (Del. 1971). In this case the Delaware Supreme Court overruled the chancellor’s application of the intrinsic fairness test in a situation where the parent had caused its 97% subsidiary to pay out $38 million of dividends in excess of earnings over a six year period. This move provided the parent with cash for expansion but denied the same opportunity to the subsidiary. The court ignored this impact and held that the intrinsic fairness test was not applicable because the parent received nothing from the subsidiary to the exclusion of the subsidiary’s minority shareholders—each received the same dividend per share. Therefore, the court reasoned that the minority shareholders were not injured and the business judgment rule was applicable. This is pure sophistry. Even though the court recognized that the defendants owed a fiduciary duty, it concluded that the duty was to be tested by the business judgment rule. Contrast this with the decision in *Tanzer* that the business judgment rule was not applicable to the decision of the parent to merge the subsidiary into it in that it was not the measure of IGI’s responsibility to the minority shareholders in its subsidiary.