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# WHY THE APPROACH OF HECKMANN V. AHMANSON WILL NOT BECOME THE PREVAILING GREENMAIL VIEWPOINT: RACE TO THE BOTTOM CONTINUES

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> [T]he shareholder in the modern corporate situation has surrendered a set of definite rights for a set of indefinite expectations. The whole effect of the growth of powers of directors and "control" has been steadily to diminish the number of things on which a shareholder can count; the number of demands which he can make with any assurance that they must be satisfied.
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> The stockholder is therefore left as a matter of law with little more than the loose expectation that a group of men, under a nominal duty to run the enterprise for his benefit and that of others like him, will actually observe this obligation. In almost no particular is he in a position to demand that they do or refrain from doing any given thing. Only in extreme cases will their judgment as to what is or is not to his interest be interfered with. And they have acquired under the corporate charter power to do many things which by no possibility can be considered in his interest. . . .[1]

## I. INTRODUCTION

In the case of *Heckmann v. Ahmanson*,[2] a California appellate court was faced with a situation in which a group of insurgents

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1. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 277 (1933).

2. 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985).

purchased approximately twelve percent of Walt Disney Productions' outstanding shares. After the group had accumulated the securities, the Disney board of directors repurchased the stock from the corporate raiders, allowing the raiders a sixty million dollar net profit.[3] Angry shareholders not included in the buyback brought suit against both Disney and the insurgents.

The plaintiffs claimed, in part, that the Disney directors breached their fiduciary duty by paying greenmail to the insurgents.[4] Although acknowledging that there has never been any case "in which a greenmailer was ordered to return his ill gotten gains,"[5] the California court placed a constructive trust on the insurgents' greenmail profits, finding a probability that the plaintiffs would be able to establish that the Disney directors breached their fiduciary duty to the company's shareholders by paying greenmail.[6]

*Heckmann v. Ahmanson* was the first published case in which a court indicated that a board of directors breached its fiduciary duty to shareholders by paying greenmail. However, shareholder rights activists need not become excited. The viewpoint taken in *Heckmann* will not likely signal a new trend towards protecting shareholder interests. As the years go by, *Heckmann* will most likely become more and more of an aberration in a long line of opinions allowing boards of directors unbridled discretion when attempting to preserve their directorships and the positions of the target company's management team.

This article will first provide a general introduction to greenmail. It will then discuss the applicability of both federal and state law to payment of greenmail by target companies, examining prominent cases where appropriate. Finally, it will explain why the *Heckmann* court's opinion will not become the majority viewpoint. Although the California appellate court in *Heckmann* reached a just and fair decision, race to the bottom[7] principles will prevent the position taken

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3. *Id.* at 124, 214 Cal. Rptr. at 181. The insurgents were Saul P. Steinberg, Reliance Financial Services Corp., Reliance Group, Inc., Reliance Group Holdings, Inc., Reliance Insurance Co., Reliance Insurance Co. of New York, United Pacific Insurance Co., United Pacific Life Insurance Co., and United Pacific Insurance Co. of New York. *Id.* at 123 n.2, 214 Cal. Rptr. at 180 n.2. Plaintiffs alleged in their complaint that each of these entities was controlled by Saul Steinberg.

4. *Id.* at 125, 214 Cal. Rptr. at 181.

5. *Id.* at 126, 214 Cal. Rptr. at 182.

6. *Id.* at 127, 214 Cal. Rptr. at 182-83.

7. "Race to the bottom" is derived from Professor William L. Cary's phrase, "race for

by the California court from becoming the wave of the future.

### A. *Greenmail—Generally*

The American phenomenon of greenmail has been defined from a foreigner's viewpoint as

> the blackmailing of corporate management by a raider who privately buys in a significant block of stock—typically just under 10%[8]—then announces he is considering making a tender offer for all the outstanding equity. The management then panics and buys out the raider at a fat premium over its share price.[9]

The Delaware Supreme Court recently noted that "[t]he term 'greenmail' refers to the practice of buying out a takeover bidder's stock at a premium that is not available to other shareholders in order to prevent the takeover."[10] *Heckmann v. Ahmanson* described the greenmailer's mission as creating "the threat of a corporate takeover by purchasing a significant amount of the company's stock.

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the bottom." Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 666 (1974). Presumably, Professor Cary coined the term after reading the following words from Justice Brandeis' dissenting opinion in Louis K. Liggett Co. v. Lee, 288 U.S. 517, 53 S. Ct. 481, 77 L. Ed. 929 (1933): "Companies were early formed to provide charters for corporations in states where the cost was lowest and the law least restrictive. The states joined in advertising their wares. The race was not one of diligence but of laxity." *Id.* at 558-59, 53 S. Ct. at 493-94, 77 L. Ed. at 949-50 (Brandeis, J., dissenting).

8. Insurgents often purchase under 10% in order to escape § 16(b) of the Securities and Exchange Act of 1934. This statutory provision requires one owning more than 10% of a class of securities to remit any profits to the issuer if he has realized a gain pursuant to a purchase and a sale, or a sale and a purchase, within less than six months of each other. *See* 15 U.S.C. § 78p(b) (1982). For example, in the Texaco-Bass brothers transaction, the acquisitors purchased just under 10% of the target company's shares before succumbing to greenmail offers. In that situation, the Bass brothers purchased 9.9% of Texaco. After they had held their 9.9% stake for 49 days, Texaco purchased their shares at a 12% premium over market price. This buyback netted the Bass brothers a profit of $280 million. *See* Simon, *Needed: A "Generic Remedy,"* FORBES, Nov. 5, 1984, at 40; Kirkland, *When Paying Off a Raider Benefits the Shareholders*, FORTUNE, Apr. 30, 1984, at 152 (estimating the Bass brothers' profit at $400 million).

9. Thackray, *America's Management Mischief*, MGMT. TODAY, Feb. 1985, at 83. One taking a macro perspective would say that each greenmail transaction causes the situation as a whole to deteriorate as each payment tends to promote a "snowball effect." The reason is that an insurgent often uses its greenmail profits to launch a subsequent corporate raid. For example, Clabir Corporation first threatened Edo Corporation, a small company based in Long Island. The profits gained in that undertaking helped finance Clabir's move on General Host Co. Later, profits obtained in the General Host transaction added strength to the acquisitor's run on Iroquois Brands and U.S. Industries. *See* Kesner & Dalton, *Antitakeover Tactics: Management 42, Stockholders O*, BUS. HORIZONS, Sept./Oct. 1985, at 20.

10. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 956 n.13 (Del. 1985).

He then sells the shares back to the company at a premium when its executives, in fear of their jobs, agree to buy him out."[11] Less judgmentally, a recent commentator has defined greenmail as "a targeted repurchase of securities at a premium price from an investor who holds more than 3% of the corporation's stock and has held the stock for less than two years."[12]

Further, it might be argued that a pure form of greenmail occurs only when the target company buys out the insurgent before he has acquired more than 5% of the target company's stock. The concept of greenmail, in its truest form, seems to connote management bringing about the stock repurchase in order to guarantee the continuation of their own jobs and to secure the future of the target company as an independent entity. If the target company is to remain independent, it is often essential that the targeted repurchase be effected before the insurgent reaches the 5% level.

When a shareholder acquires more than 5% of a company's securities, he is required to file a Schedule 13D with the Securities and Exchange Commission.[13] Depending on the reputation and resources of the raider, a 13D filing on the part of an insurgent may cause the target company to be "put into play."[14] When a company

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11. *Heckmann*, 168 Cal. App. 3d at 123 n.1, 214 Cal. Rptr. at 180 n.1.

12. Note, *Greenmail: Targeted Stock Repurchases and the Management-Entrenchment Hypothesis*, 98 HARV. L. REV. 1045 n.3 (1985); *see also* Office of the Chief Economist, Securities and Exchange Commission, *The Impact of Targeted Share Repurchases (Greenmail) on Stock Prices* 2 (Sept. 11, 1984) [hereinafter Office of the Chief Economist]. For additional definitions of greenmail, see Lester-Lawson, *Greenmail: Is It Just Passing the Buck?*, 6 PACE L. REV. 69, 75-76 (1985) [hereinafter Lester-Lawson].

13. 15 U.S.C. § 78m(d)(1) (1982).

14. A company is said to be "put into play" when a raider makes a public statement, by way of a Schedule 13D or otherwise, that it intends to gain control of the target company. When the public statement is made, the target company becomes fair game for anyone looking to acquire that particular type of corporation. Potential suitors then begin investigating the subject company's financial data in an attempt to determine whether the market has undervalued the company's true worth.

When a raider has filed a Schedule 13D and is later bought out at a premium, the financial community is more likely to learn of the greenmail transaction than if no Schedule 13D had ever been filed. If it becomes public knowledge that the target company has paid off one acquisitor, there is nothing to keep other insurgents from attacking in the hope that they too will be bought off at a premium. Thus, a company might be inviting future problems if it pays greenmail after the insurgent has passed the 5% mark. For example, after Walt Disney Productions paid off the Steinberg Group, which had garnered a 12% holding, Irwin Jacobs purchased an interest in the company. Jacobs' shares were then purchased at a premium by the Bass brothers, who at that time were acting as an ally of Disney. *See* Lester-Lawson, is put into play, arbitrageurs begin amassing a large percentage of the company's outstanding shares. An extremely volatile situation then develops. The arbitrageurs quickly want to resell their shares at a profit. Arbitrageurs are not discriminating sellers. They have absolutely no loyalty to the issuer and will sell their shares to whomever offers their asking price.[15] Thus, interested companies watching from the sidelines realize they could take over the subject company with relative ease by purchasing the holdings of the arbitrageurs. By this point, the question will often no longer be whether the target company will be purchased; rather, it will be to whom the company will be sold.[16]

Whatever the exact definition of greenmail may be,[17] it must be agreed that greenmail is disfavored by almost all.[18] Nevertheless, it proceeds apace.[19]

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*supra* note 12, at 78 n.55. The Bass brothers also purchased a large block of Disney stock from Ivan Boesky. *See* K. BIALKIN, A. FLEISCHER & E. GREENE, NEW TECHNIQUES IN ACQUISITIONS AND TAKEOVERS 497-98 (1985).

15. For an extreme example of how quickly large equity positions in a company can change hands once arbitrageurs assume a large stake in a company, see Hanson Trust PLC v. SCM Corp., 774 F.2d 47 (2d Cir. 1985). In *Hanson Trust*, commonly referred to as *Hanson I*, the insurgent launched a tender offer for the target, then terminated the offer after the target company granted a "lock-up" option in a third party's favor. But within hours of cancelling the tender offer, the insurgent purchased 25% of the target's stock, mainly through private transactions with arbitrageurs and investment bankers. It is believed that Ivan Boesky, a leading arbitrageur, was able to convey 12.7% of the target's shares in one transaction. *Id.* at 52-53; *see also* Crane Co. v. Harsco Corp., 511 F. Supp. 294, 297 (D. Del. 1981) (target company's purchase of a large number of its shares directly from arbitrageurs while attempting to defeat a tender offer held to be permissible).

16. *See* Sigler, *Rules for the Takeover Game*, FINANCIER, Mar. 1985, at 16-17 [hereinafter Sigler].

17. The term is broad enough to include camomail within its ambit. In a camomail transaction, the target company does not rely solely on cash to wrest its shares from the unfriendly stockholder. Rather, it utilizes other forms of payment, either in conjunction with or in lieu of cash, to procure the insurgents' shares at a premium.

In 1985, Coastal Corporation acquired a large block of stock in Sonat, Inc. After Sonat communicated its desire to reacquire the stock, the parties agreed to an innovative transaction. Sonat would pay $117 million to Coastal. However, rather than getting its stock back, Sonat would receive a $117 million, ten-year convertible bond issued by Coastal yielding an 8.5% return. The bond would be convertible into the amount of stock Coastal had purchased in Sonat. Thus, Sonat can exercise the conversion feature of the instrument and reacquire its stock. Presumably, this type of arrangement is preferable to the usual "stock for cash" swap, as it imposes no tax consequences on either of the parties. *See* Kantor & Banoff, *New Technique Avoids "Greenmail" Issues*, 64 J. TAX'N 191, 191 (1986).

A simpler form of camomail occurred after Carl Icahn acquired a stake in Cheeseborough-Pond's, Inc. Cheeseborough-Pond's bought back Icahn's 5% holding and in addition agreed

### B. *Why Do Greenmailers Present Such a Credible Takeover Threat?*

It is not surprising that executives heading a multibillion dollar company become unnerved when a lone individual who has procured an interest in their company tells them he will purchase the entire company if he is not bought out at a premium. Given the present state of affairs, the insurgent has a good chance of making good on his promise should management call his bluff. There are several reasons.

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to pay $95 million, which amounted to twice the book value, to Icahn for a company he owned. *See* Toy, *The Raiders*, Bus. Week, Mar. 4, 1985, at 89.

18. Even Irwin Jacobs, a notorious corporate raider, purportedly abhors greenmail. Says Jacobs: "I think greenmail is terrible . . . but if it's not stopped, I'm going to do it . . . my objective is to make money." Sloan, *Why Is No One Safe?*, Forbes, Mar. 11, 1985, at 140 [hereinafter Sloan]. *See also* Siegel, *How to Foil Greenmail*, Fortune, Jan. 21, 1985, at 157 ("Greenmail has no redeeming virtures"); Blustein, *More Firms Paying Premium Prices to Wrest Shares from Antagonists*, Wall St. J., Jan. 8, 1981, at 21, col. 4 ("[t]he practice comes close to extortion"); Simon, *Needed: A "Generic Remedy,"* Forbes, Nov. 5, 1984, at 40 ("it's a lot like buying off an election"); *cf.* Lipton, *'Greenmail' Is a Corporate Disgrace*, N.Y. Times, Apr. 15, 1984, at F2, col. 3. Lipton contends greenmail is a disgrace and should be eliminated. However,

> [t]he culprit is not the corporation that protects its shareholders by purchasing the accumulated shares. The culprit is a regulatory system that permits accumulations in excess of 10 percent. . . . There is a solution to these takeover abuses. It is a straightforward limitation on accumulations to no more than 10 percent. If someone wants to acquire more than 10 percent, it must be by a one-price offer to all the shareholders.

*Id.*

There are some who can nonetheless muster an argument in support of greenmail. *See, e.g.*, Kirkland, *When Paying Off a Raider Benefits the Shareholders*, Fortune, Apr. 30, 1984, at 152 ("compared with other options commonly used to fend off unwanted acquirers . . . greenmail causes the least disruption to the company's operations"); Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U. L. Rev. 630 (1985):

> [G]reenmail may not be as great an abuse as is generally thought, because if stocks have downward-sloping demand curves, greenmail does not *necessarily* reduce shareholder wealth. Rather, the greenmailer may be seen as buying up the lowest-priced shares until the market rises to a price that the greenmailer believes is fair. At that point the greenmailer proposes a partial buyout, at a premium, but in the meantime the shareholders most willing to sell have gained from selling in a rising market.

*Id.* at 663 (emphasis in original).

19. In 1984, corporations spent more than $3.5 billion on targeted share repurchases. This represented a total premium of over $600 million. *See* Office of the Chief Economist, *supra* note 12, at 15. From 1979 to 1984, approximately $5.5 billion was spent on targeted share repurchases, representing an aggregate premium of over $1 billion. "Many of these large premium payments clearly were made by target management to reduce the threat of losing control of the firm." *Id.* at 1.

First, on average, pension funds control approximately sixty percent of the outstanding shares of New York Stock Exchange companies.[20] Under ERISA's[21] "prudent man" rule, money managers presiding over a pension fund's investment strategy have a legal duty to obtain the highest and safest return on money under their control.[22] Thus, if a takeover bid is launched and the target company's stock begins to move smartly upwards, the pension fund directors will likely be under a fiduciary duty to dispose of their holdings in the target company.[23] An insurgent may therefore find it relatively easy to quickly gain control of a large number of equity securities, or at least cause the securities to move into the hands of arbitrageurs, merely by tendering, at a reasonable premium, for a subject company dominated by institutional shareholders.

Second, deregulation of the banking industry has reduced banking profit margins.[24] Lending profits have been cut because deregulation has caused banks to lose most of their cheap deposits and instead become "loaded with expensive money market accounts and other high-cost funds."[25] At the same time, margins on loans to large corporations are exceptionally slender because the corporations will simply issue commercial paper if bank financing becomes too expensive.[26] In contrast, banks enjoy a healthy markup on loans used to effectuate takeovers and, therefore, have a large incentive to provide a raider with financial backing.[27]

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20. *See, e.g.*, Priest, *The Takeover Game* (prepared for the Corporate Responsibility Task Force of the Business Roundtable), Mar. 19, 1985, at 3; Flanigan, *More Creation, Less Destruction*, FINANCIER, Mar. 1985, at 45; Sigler, *supra* note 16, at 15 (50% of the equity on the New York Stock Exchange is institutionally owned or professionally managed. However, for premier NYSE companies, between two-thirds and three-quarters of the equity is owned by institutions or is professionally managed.).

21. *See* 29 U.S.C. §§ 1001-1461 (1982).

22. *See id.* § 1104(a)(1).

23. Pension fund managers may well prefer cash to junk bonds and other debt instruments. Thus they often tender the pension fund's equity position in the subject company to arbitrageurs in exchange for cash. This transaction eliminates the pension fund's downside exposure and places the risk as to whether the takeover will ultimately be effected upon the arbitrageur.

24. *See U.S. Bureau of the Census*, STATISTICAL ABSTRACT OF THE UNITED STATES: 1986, 495, No. 828 (106th ed.). In 1980, the aggregate net income to average equity capital of U.S. banks was 14.1%; in 1982, this figure declined to 12.1%; in 1984, it stood at 10.7%. *Id.*

25. Sloan, *supra* note 18, at 135.

26. *Id.*

27. *Id.* at 135-36. The willingness of banks to provide financing for takeover attempts is shown by a recent SEC study finding that for the 1981-1984 interim, "bank borrowing

Third, a raider's ability to resort to junk bond financing also serves to make his threat more credible. Not long ago, respectable institutions would have shunned any thought of investing in debt instruments which were low rated-high yield from the point of issuance.[28] However, today many of these same institutions display a willingness to take on the added risk attending junk bonds in exchange for the heightened return.[29]

The ease with which junk bonds can be placed has made it easy for a raider with a track record to secure financing for his bid.[30] Drexel Burnham Lambert, Inc., an investment banking concern which dominates the junk bond industry,[31] has become one of the most potent forces in the takeover industry.[32] Its ability to float a junk bond issue on behalf of an acquisitionist so intimidates management

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accounted for 78.6% of tender offer financing." The figure for the first six months of 1985 was 77.6%. *See* Securities and Exchange Commission, Office of the Chief Economist, *Non-investment Grade Debt as a Source of Tender Offer Financing*, June 20, 1986, *reprinted in* [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 84,011, at 88,169 (June 20, 1986) [hereinafter *Noninvestment Grade Debt*].

28. *See* Bianco, *How Drexel's Wunderkind Bankrolls the Raiders*, BUS. WEEK, Mar. 4, 1985, at 91 [hereinafter Bianco]; Rudnitsky, Sloan, Stern, & Heller, *A One-Man Revolution*, FORBES, Aug. 25, 1986, at 34 (Drexel "has brought respectability to bonds of a type once unsalable to conservative investors.").

29. *See* Maisels, *Wall Street Stampedes After Drexel*, EUROMONEY, May 1985, at 87 [hereinafter Maisels]; *see also* Joseph, *High-Yield Bonds Aren't Junk*, Wall St. J., May 31, 1985, at 22, col. 4 [hereinafter Joseph] ($900 million worth of bonds which were high-yield from the very point of issuance were purchased in 1977. By 1984 this market grew to $14 billion.).

30. One prosperous entrepreneur recently stated: "When I started [buying companies] in 1976, no one was really geared up to finance this stuff. Today we could go out and raise probably $1 billion in two days." Toy, *supra* note 17, at 84 (quoting Wm. F. Farley); *cf.* Bianco, *supra* note 28, at 90 ("[W]ith Drexel doing the financing, anybody long on ideas and short on capital is a threat."); *see also Noninvestment Grade Debt*, *supra* note 27, at 88, 168. (finding that junk bonds were most likely to be used in hostile acquisitions and in takeover attempts on large corporations). The SEC study found that:

> In 1985, the percentage of junk bond financing in hostile deals was about 25%, while in friendly deals it was less than six percent. For the 30 tender offers in 1985 involving the smallest target firms, junk bonds accounted for 0% of all financing, while for the 30 largest targets, it accounted for about 33% of total financing.

*Id.*

31. *See* Dreyfuss, *The Firm that Fed on Wall Street's Scraps*, FORTUNE, Sept. 3, 1984, at 90; *Turning Junk into Profit*, EUROMONEY, May 1985, at 82 (chart shows Drexel to have underwritten 67.7% of 1984's high yield debt offerings; Drexel underwrote 58.1% of those instruments offered in 1983).

32. *Id. See generally* Farrell & Schiller, *How Junk Bonds Helped Build an Empire*, BUS. WEEK, June 2, 1986, at 82 ("Drexel's junk-bond alchemy is creating a new empire.").

that one target company proposing to make a greenmail payment to a raider conditioned its repurchase offer on Drexel's agreement to refrain for two years from aiding anyone attempting to take over the company.[33]

Investment bankers are able to place junk bonds with institutions because the high-risk debt securities can return a yield of three to four percent or more over investment grade debt,[34] while at the same time providing a default rate which is somewhat comparable to that of high-grade corporate bonds.[35]

However, the role of junk bonds may come to be of less significance in the future since, on closer inspection, the data proclaiming the attractiveness of these high-risk instruments may not be all that convincing.[36] For example, Drexel reports that between 1980

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33. This is reportedly the first time a standstill agreement was imposed on an investment bank, as opposed to the investment bank's client, as a condition precedent to a greenmail offer. Bianco, *supra* note 28, at 91.

34. *See* Maisels, *supra* note 29, at 82; *see also* Yemma, *Despite the Name, 'Junk Bonds' Aren't a Ride to the Poorhouse*, Christian Science Monitor, May 16, 1986, at B6, col. 3 [hereinafter Yemma] ("[J]unk bond funds are yielding 3 percent or more above US Treasury bills. . . ."); *cf.* Darby, *Pros, Cons of High-Yield Bonds Weighed: Many Public Plans Resist Lure of Junk Bonds*, PENSIONS & INVESTMENT AGE, Apr. 15, 1985. Darby notes that underwriters lining up junk bond financing for a takeover attempt seek commitments from institutional investors before the tender offer is made. Those institutions which obligate themselves to purchase high-yield debt early in the deal "can earn as much as 0.75% simply for agreeing to provide money if the deal succeeds. This commitment fee is paid whether the deal goes through or not." *Id.* at 3. Institutions obligating themselves to the attempt on Walt Disney earned 0.75% as a commitment fee, whereas those committing to the takeover attempt on Phillips Petroleum earned a fee of 0.38%. *Id.* at 82.

35. *See* Darby, *Junk Bond Risk Evaluated*, PENSIONS & INVESTMENT AGE, Apr. 29, 1985, at 23; *cf.* Joseph, *supra* note 29, at 22, col. 4 ("more money has been lost in the bond markets through the downgrading of investment grade debt than through defaults of below investment grade debt").

36. Additionally, the Federal Reserve Board issued an interpretive rule, effective January 10, 1986, which stated that the margin requirements of Regulation G are applicable to debt securities issued by a shell corporation to finance an acquisition of stock in a target company. Regulation G provides that, except as to banks or broker/dealers, no lender shall extend credit for the purpose of buying a margin stock (any equity security traded on a national securities exchange) which is secured directly or indirectly by that margin stock in an amount that exceeds 50% of the current market value of the margin stock being purchased.

The interpretive rule stated that debt securities issued by a shell corporation would be presumed to be secured indirectly by the target company's stock. The ruling stated that such a presumption would be appropriate since the shell would have virtually no business operations and the lenders could thus rely only on the target company stock as collateral. The Federal Reserve Board took care to point out that the presumption would not apply where: (1) the shell company's parent guaranteed the debt; (2) the merger was voluntarily entered into betw and 1984 an index of 100 junk bonds achieved a return superior to U.S. Treasury Bonds to the extent of 82%.[37] At the same time, a study financed by Morgan Stanley and Company[38] seemingly demonstrated the suitability of these bonds for risk-averse investors. The Morgan Stanley study showed that between 1978 and 1984, the default rate in junk bonds averaged a mere 1.5% per year.[39]

Closer examination might give one reason to question grounds for optimism in regard to junk bond performance. One study found the default rate for "pure junk bonds"[40] to be much higher. This study concluded that the rate of default for pure junk bonds was more in the neighborhood of eleven percent.[41]

Other observers claim that many junk bond issues will fall into default during the next recessionary period.[42] Additionally, it is

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the companies; (3) the acquiring company was an operating company with substantial assets; and (4) the investor's duty to purchase the junk bonds was made contingent on the shell company's obtaining a sufficient number of shares in the target company such that the shell company could conduct a short-form merger of the target company into the shell company. *See* Interpretative Rule, 51 Fed. Reg. 1771 (Fed. Res. Bd. 1986). Although it is commonly believed that this ruling will present only a minor obstacle to raiders wishing to utilize junk bonds to effectuate takeovers, John Shad, Chairman of the SEC, has expressed concern over "whether corporate counsels will be able to give clean opinions about avoiding [federal] review." *The Fed vs. The SEC, They Differ on Takeover Tactics*, BARRON'S, Jan. 13, 1986, at 32.

37. Bianco, *supra* note 28, at 91.

38. The Morgan Stanley study was conducted by Prof. Edward I. Altman and Scott Nammacher. Dr. Altman is Professor of Finance and Chairman of the MBA Program at New York University. Mr. Nammacher is an MBA graduate from New York University.

39. E. ALTMAN & S. NAMMACHER, THE DEFAULT RATE EXPERIENCE ON HIGH YIELD CORPORATE DEBT 10, Mar. 1985 (study performed for Morgan Stanley and Co.).

40. For purposes of this article, "pure junk bonds" are those which were classified as high risk, high yield from the very moment of issuance. Other junk bonds might be issued by "fallen angels." Fallen angels are companies which have been solid performers in the past but are currently experiencing financial difficulties. *See* Yemma, *supra* note 34, at B6, cols. 1-2.

41. Bianco, *Junk Bonds Are Starting to Live up to their Name*, BUS. WEEK, Feb. 17, 1986, at 65.

42. *See* McGough, *High-Yield Anxiety*, FORBES, Sept. 10, 1984, at 204; Forsyth, *Headed for the Scrap Heap? Why Junk Bonds Are Growing Riskier*, BARRON'S, Apr. 29, 1985, at 34. Those foreseeing widespread defaults upon junk bond issues during the next business downturn point out that most companies having issued high yield debt are overleveraged. If earnings should fall off due to a decline in business, some of these companies will be unable to service their debt obligations. Concern over the high debt ratio of American companies in general, and furtherance of this trend through junk bonds, prompted Federal Reserve Board Chairman Paul Volcker to support enactment of Regulation G as it now stands. It is reported that "[i]n a letter to Congress, Volcker noted . . . that current mounting debt burdens were not incompatible over time with economic and financial stability.' " *Junkbonds: Debt Worries*, THE

claimed that the academic studies showing junk bonds to be attractive investment vehicles do not accurately gauge the characteristics of today's pure junk bonds since those studies relate to high-yield bonds generally rather than specifically to debt categorized as high-yield right from the point of issuance.[43]

If junk bonds become viewed as a debt instrument carrying too much risk, a corporate raider's ability to finance takeovers will be somewhat hampered. This in turn might cause management to feel less intimidated and would most likely lead to less greenmail being paid. However, for the present, this situation has not occurred.

## II. Applicability of Federal Law to Greenmail Payments

### A. *Federal Incorporation Statute*

Because those in charge of making corporate decisions need to be effectively regulated, there has long been a push for a federal incorporation statute.[44] Efforts directed towards passage of such a statute have intensified from time to time.[45] Although there are strong

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BANKER, Feb. 1986, at 64. However, Volcker also noted that the margin requirements will not in themselves counter the trend towards the leveraging up of our economy as a whole. It was his opinion that this could only be stopped by redesigning those provisions of the tax code which "greatly favor the use of debt rather than equity instruments." *Id.*; *cf.* Carney, *Junk Bonds Don't Merit a Black-Hat Image*, Wall St. J., Apr. 29, 1985, at 24, col. 3 ("Any excessive leverage in the economy can be attributed not to junk bonds but to a tax structure that subsidizes debt.").

43. Forsyth, *supra* note 42. Obviously there is tension among the data concerning the likelihood of a junk bond issue falling into default. Resolution of the controversy is beyond the scope of this paper. However, part of the disagreement seems to be a product of a disparity in definition of the underlying instrument. Proponents of high-yield debt generally seek to include all types of junk bonds into studies measuring default rates, whereas doomsdayers tend to focus solely on pure junk bonds.

44. "At one time or another the proposal has caught the fancy of Presidents Theodore Roosevelt, Taft and Wilson . . . and other statesmen of national distinction disgusted with the situation in which 'the state with the lowest standards forces the hand of all the rest.' " Rutledge, *Significant Trends in Modern Incorporation Statutes*, 3 U. PITT. L. REV. 273, 305 n.160 (1937).

45. *See* 1 L. LOSS, SECURITIES REGULATION 107 (2d ed. 1961) (support for the passage of federal incorporation measures "increased particularly during the decade of 1904-1914. . . . Leading men of industry and prominent scholars stood shoulder to shoulder for federal incorporation"); FEDERAL TRADE COMM'N, COMPILATION OF PROPOSALS AND VIEWS FOR AND AGAINST FEDERAL INCORPORATION OR LICENSING OF CORPORATIONS, S. Doc. N. 92, 70th Cong., 1st Sess., pt. 69-A, at 44 (1934) (in 1908 the Democratic platform strongly proposed that major corporations be subject to federal licensing standards); H. HENN, HANDBOOK OF THE

arguments in support of such a codification of national business standards,[46] it is unrealistic to expect that such a bill will be enacted.[47] There is great opposition in the commercial sector to a statute which would sanction such pervasive governmental control over American industry.[48]

### *B. Federal Securities Laws*

Previously, it appeared as though federal securities laws might provide an adequate vehicle for federal regulation of corporate conduct. After all, an expansive reading of the federal securities law would encompass many day-to-day corporate activities. Indeed, for many years prior to 1975, the year in which the Supreme Court initiated a concerted effort to restrict the availability of federal securities laws to complaining shareholders,[49] it had become an accepted judicial practice to construe rule 10b-5[50] in a broad and

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LAW OF CORPORATIONS § 12, at 27 n.17 (3d ed. 1983). (In 1943 the American Bar Association Committee on Business Corporations drew up a model Federal Corporation Act "in case there should be a serious demand for such legislation."). *See generally* Reuschlein, *Federalization —Design for Corporate Reform in a National Economy*, 91 U. PA. L. REV. 91 (1942) (discussing corporate reform).

46. *See* Henning, *Federal Corporate Chartering for Big Business: An Idea Whose Time Has Come?*, 21 DE PAUL L. REV. 915 (1972); Schwartz, *Federal Chartering of Corporations: An Introduction*, 61 GEO. L.J. 71 (1972) [hereinafter Schwartz]; Note, *Federal Chartering of Corporations: A Proposal*, 61 GEO. L.J. 89 (1972).

47. Cary, *supra* note 7, at 700.

48. *Id.*

49. *See infra* notes 56-90 and accompanying text.

50. 17 C.F.R. § 240.10b-5 (1986). The rule provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading,
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

*Id.* The rule was promulgated by the Securities and Exchange Commission in 1942 under section 10(b) of the Securities Exchange Act of 1934, which states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—. . .
>
> (b) To use or employ, in connection with the purchase or sale of any security

expansive manner.[51] It was believed that a plaintiff could make out a 10b-5 claim merely by showing fraudulent activity which was highly attenuated from a securities transaction.[52] In short, it appeared as though the federal securities laws, largely through section 10(b) and rule 10b-5, were on their way to becoming[53] an omnipotent weapon[54] for attacking corporate mismanagement actions.[55]

In 1975, the Supreme Court handed down *Blue Chip Stamps v. Manor Drug Stores*,[56] holding that only an actual purchaser or seller of securities could maintain an action alleging a violation of section

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> registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1982).

51. *See, e.g.*, Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970); Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969); Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968).

52. *See, e.g.*, Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964); Pettit v. American Stock Exch., 217 F. Supp. 21 (S.D.N.Y. 1963); *see also* Cox, *Fraud Is in the Eyes of the Beholder: Rule 10b-5's Application to Acts of Corporate Mismanagement*, 47 N.Y.U. L. REV. 674, 680 (1972) [hereinafter Cox] ("The argument . . . is essentially a test of remoteness of the fraud.").

53. Jacobs, *The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Mismanagement*, 59 CORNELL L. REV. 27, 30 (1973). ("[T]he importance of Rule 10b-5 in the regulation of corporate mismanagement is great and, in view of . . . recent Supreme Court pronouncements, is likely to become greater."); *see also* Fleischer, *"Federal Corporation Law:" An Assessment*, 78 HARV. L. REV. 1146, 1175 (1965) (Rule 10b-5 "is now at the most creative, hence valuable, stage of its growth.").

54. Originally it was not certain whether a private litigant could maintain a suit under section 10(b) or rule 10b-5, as neither the statute nor the rule expressly provides for a private cause of action. Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) is credited with starting the trend which unleashed the potency of the statute when it stated that there was an implied private cause of action if the private litigant was within the class intended to be protected. *Id.* at 514. This position rapidly came to dominate the viewpoint of the courts. Twenty-four years later, the Supreme Court found it to be an "established [principle] that a private right of action is implied under § 10(b)." Superintendent of Ins. v. Bankers Life & Cas., 404 U.S. 6, 12 n.9, 92 S. Ct. 165, 169 n.9, 30 L. Ed. 2d 128, 134 n.9 (1971).

55. The Supreme Court itself reinforced the viewpoint that the strictures of the federal securities laws might be employed as a device for attacking fiduciary shortcomings which had traditionally been litigated under state statutes. In *Bankers Life*, the Court stated that the "in connection with" requirement was met so long as the alleged fraud merely "touched" a sale of securities. 404 U.S. at 12-13, 92 S. Ct. at 169, 30 L. Ed. 2d at 134. Additionally, the liberal wording of the *Bankers Life* opinion has been interpreted as suggesting that a breach of fiduciary duty, when coupled with an allegation of a securities transaction which simply gave rise to a financially unfair exchange, states a cause of action under section 10(b). Cox, *supra* note 52, at 683.

56. 421 U.S. 723, 95 S. Ct. 1917, 44 L. Ed. 2d 539 (1975).

10(b) or rule 10b-5.[57] In 1976 the Court furthered the trend towards limiting the availability of securities law. In *Ernst & Ernst v. Hochfelder*,[58] the Court held that a plaintiff must prove scienter in order to recover for an alleged violation of section 10(b) and rule 10b-5.[59]

In 1977[60] the Court decided the landmark case of *Santa Fe Industries v. Green*.[61] In *Sante Fe*, ninety-five percent of the stock in Kirby Lumber Corporation was owned by Santa Fe Industries. Sante Fe then acquired the remaining five percent of Kirby Lumber pursuant to a short-form merger.[62] After the merger, a minority

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57. Id. at 731-32, 95 S. Ct. at 1923, 44 L. Ed. 2d at 547. In 1975 the Supreme Court also decided Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 95 S. Ct. 2069, 45 L. Ed. 2d 12 (1975). In *Rondeau* the Court took the position that a private litigant was required to show irreparable injury in order to obtain an injunction for an alleged violation of section 13(d) of the Williams Act. *Id.* at 61, 95 S. Ct. at 2077, 45 L. Ed. 2d at 22. This holding overruled the Seventh Circuit's opinion, which stated that "Mosinee Paper need not show irreparable harm as a prerequisite to obtaining permanent injunctive relief." 500 F.2d at 1017. Cort v. Ash, 422 U.S. 66, 95 S. Ct. 2080, 45 L. Ed. 2d 26 (1975) was also decided in 1975. In *Cort*, the Supreme Court declined to find an implied cause of action under federal law when the complaint addressed an area which had been traditionally governed by state law. The Court reasoned that "[c]orporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilitites of directors with respect to stockholders, state law will govern the internal affairs of the corporation." *Id.* at 84, 95 S. Ct. at 2091, 45 L. Ed. 2d at 40.

58. 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976).

59. *Id.* at 201, 96 S. Ct. at 1385, 47 L. Ed. 2d at 681.

60. 1977 was also the year the Supreme Court pointed out that a tender offeror claiming that the Williams Act had been violated had no standing to bring suit for damages against a competing tender offeror. *See* Piper v. Chris-Craft Indus., 430 U.S. 1, 35, 97 S. Ct. 926, 946, 51 L. Ed. 2d 124, 149 (1977).

61. 430 U.S. 462, 97 S. Ct. 1292, 51 L. Ed. 2d 480 (1977). Had the Supreme Court not decided *Santa Fe*, or a controversy involving a factual setting similar to that in *Santa Fe*, rule 10b-5 would likely be a commonly used offensive device for aggrieved shareholders contesting a board of directors' decision to pay greenmail or for other corporate mismanagement actions. In Seigal v. Merrick, Fed. Sec. L. Rep. (CCH) ¶ 95,467 (S.D.N.Y. Mar. 11, 1976), a plaintiff brought suit under rule 10b-5 against both the individual directors of the target company and a greenmailer after the board of directors caused the target company to buy out the greenmailer at a premium of $2,400,000. Allegedly, the board of directors authorized the buyback in order to protect their personal interests and maintain control of the target company. *Id.* at 99,367. Just as in Heckmann v. Ahmanson, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (Cal. Ct. App. 1985), the *Merrick* greenmailer was claimed to have aided and abetted the directors in carrying out their wrongful act. In declining to grant the defendants' motion to dismiss, the *Merrick* court stated that a cause of action under section 10(b) or rule 10b-5 "is stated where facts are alleged which, if proved, would show a breach of fiduciary duty. . . ." Fed. Sec. L. Rep. (CCH) at 99,369.

62. *See* 430 U.S. at 462, 97 S. Ct. at 1295, 51 L. Ed. 2d at 485. DEL. CODE ANN. tit. 8, § 253 (1974) provided that a parent corporation holding at least 90% of a subsidiary's stock could merge the subsidiary into the parent without giving advance notice of the merger to the

shareholder of Kirby Lumber brought suit under 10b-5, praying that the court either rescind the merger or award damages. The trial court dismissed the plaintiff's complaint for failure to state a cause of action upon which relief could be granted.[63] The Second Circuit reversed.[64] The appellate court believed that the plaintiff had stated a claim cognizable under rule 10b-5 since 10b-5 reached "breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure."[65]

The Supreme Court reversed the Second Circuit's holding, stating that the liberal statutory reading employed by the Second Circuit was in conflict with the restrictive approach of *Hochfelder*.[66] The Court opined that section 10(b) did not apply to conduct involving neither manipulation nor deception.[67] Further, since the applicability of a rule promulgated by an administrative agency cannot exceed the scope of the statute upon which the rule is based,[68] the Court said it must also be held that a 10b-5 claim states a cause of action "only if the conduct alleged can be fairly viewed as 'manipulative or deceptive.' "[69] Since the activity complained of could not be classified as being either deceptive or manipulative, the Court concluded that the defendant's alleged actions could not have violated either section 10(b) or rule 10b-5, even if there had been a breach of fiduciary duty.[70]

### *C.* Goldberg v. Meridor

In *Goldberg v. Meridor*,[71] a stockholder of a subsidiary company brought suit against the subsidiary's parent company under section 10b and rule 10b-5. The plaintiff challenged a transaction in which the subsidiary issued the parent 4,200,000 shares of its stock in return for all of the parent's assets and liabilities.[72]

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63. 391 F. Supp. 849, 855 (S.D.N.Y. 1975).
64. 533 F.2d 1283 (2d Cir. 1976).
65. *Id.* at 1287.
66. 430 U.S. at 471-72, 97 S. Ct. at 1299-1300, 51 L. Ed. 2d at 490-91.
67. *Id.* at 473, 97 S. Ct. at 1301, 51 L. Ed. 2d at 492.
68. *Id.* at 472-73, 97 S. Ct. at 1300, 51 L. Ed. 2d at 491.
69. *Id.* at 473-74, 97 S. Ct. at 1301, 51 L. Ed. 2d at 492.
70. *Id.* at 474-77, 97 S. Ct. at 1301-03, 51 L. Ed. 2d at 492-94.
71. 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).
72. *Id.* at 211.

The trial court dismissed the plaintiff's claim on the basis that, although breach of fiduciary duty was alleged, the complaint failed to allege deceit.[73] Thereupon the controversy was appealed to the Second Circuit, which treated the complaint as though it had alleged deception.[74] The deceptive conduct revolved around the issuance of two misleading press releases[75] and an omission to bring out facts which, if disclosed, would have enabled the minority shareholders to enjoin the transaction in state court.[76] After viewing the conduct as characterized by both breach of fiduciary duty and deceit,[77] the majority displayed little reluctance in finding the transaction to be covered by section 10(b) and rule 10b-5.[78] In holding rule 10b-5 applicable, the Second Circuit might have stretched the facts in order to find a possible failure to make disclosure, but the court did not twist the applicable law.

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73. 426 F. Supp. at 1061. The plaintiff made no reference to deceit in his complaint, in part because he had filed his pleading more than one year before the Supreme Court decided *Santa Fe*. The plaintiff requested that the district court grant leave to amend so as to allow him to make an allegation of deception. The trial court denied the plaintiff's request, stating that the pleading of such element is expected prior to the third "go round." *Id.* at 1064. On appeal, the Second Circuit took the position that the refusal to grant leave to amend constituted an abuse of discretion and thus treated the pleadings as though the amendment had been made. 567 F.2d at 213.

74. 567 F.2d at 213.

75. *Id.* at 209 nn.1-2.

76. *Id.* at 217-19.

77. *Id.* at 218. Other circuits were quick to follow the *Goldberg* rationale. *See* Healy v. Catalyst Recovery, 616 F.2d 641 (3d Cir. 1980); Alabama Farm Bureau Mut. Cas. v. American Fidelity Life Ins., 606 F.2d 602 (5th Cir. 1979), *cert. denied*, 449 U.S. 820 (1980); Kidwell *ex rel.* Penfold v. Meikle, 597 F.2d 1273 (9th Cir. 1979); *see also* Wright v. Heizer Corp., 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978). *Wright* employed reasoning similar to that of the *Goldberg* majority; however, *Wright* could not have relied on *Goldberg*, as *Wright* was decided June 30, 1977, whereas *Goldberg* was not decided until September 8, 1977.

78. The Second Circuit deemed the defendants' acts to have met the materiality test of TSC Indus. v. Northway, Inc., 426 U.S. 438, 96 S. Ct. 2126, 48 L. Ed. 2d 757 (1977). The Court found the deceptive conduct to be material because had the plaintiff been given advance knowledge of the true state of affairs, he would likely have been successful in obtaining an injunction barring the defendants from going forward with the transaction at issue. The facts before the *Goldberg* court thus differed from those before the Supreme Court in *Santa Fe* in that both parties to the *Santa Fe* controversy agreed that, under Delaware law, the plaintiff would have had no chance of enjoining the merger. Because the plaintiff in *Santa Fe* could not have obtained an injunction had he possessed the subject information prior to the transaction, "the failure to give advance notice was not a material nondisclosure within the meaning of the statute or the rule." *Sante Fe*, 430 U.S. at 474 n.14, 97 S. Ct. at 1301 n.14, 51 L. Ed. 2d at 492 n.14.

There has been much criticism directed towards Judge Friendly's majority opinion in *Goldberg*.[79] Not the least of these criticisms was propounded by Judge Meskill in his dissenting opinion. Judge Meskill viewed the scenario as essentially focusing on an alleged breach of fiduciary duty with no attending deceptive conduct.[80] As such, the court, in his view, could only be in conformity with the Supreme Court's guiding light if it acknowledged that the action was controlled by state rather than federal law.[81]

More importantly, Judge Meskill interpreted the majority opinion as holding that rule 10b-5 would be violated, on the basis of nondisclosure, whenever there is a breach of fiduciary duty without the fiduciary first giving advance notice of his intent to commit such a breach.[82] Since directors rarely give advance notice of schemes to violate fiduciary duties, the dissent argued that Judge Friendly had effectively negated *Santa Fe*.[83]

The *Goldberg* critics need not be so critical. Judge Friendly may have swum against the tide of the Supreme Court's recent opinions by so readily embracing the applicability of a federal remedy when state law seemed better suited for governing the controversy;[84] however, a close examination[85] reveals that Judge Friendly did not violate

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79. *See, e.g.*, R. JENNINGS & H. MARSH, SECURITIES REGULATION 952 (5th ed. 1982) (the approach of *Goldberg v. Meridor* "ignores the entire opinion in the Santa Fe Industries case except for one footnote"); Note, 46 GEO. WASH. L. REV. 861, 875 (1978) ("[G]eneral application of the standard will allow a large number of suits involving breach of fiduciary duties against corporate directors into federal court under Rule 10b-5 . . . all breaches of fiduciary duty will give rise to an action under Rule 10b-5 except in those rare instances when a breaching fiduciary adequately discloses his intentions in advance."); *see also* Note, 64 VA. L. REV. 449 (1978) (fiduciary duties of directors of charitable organizations); Campbell, Santa Fe Industries, Inc. v. Green: *An Analysis Two Years Later*, 30 ME. L. REV. 187 (1979) (discussing *Santa Fe*).

80. *Goldberg*, 567 F.2d at 255 (Meskill, J., dissenting).

81. *Id.*

82. *Id.*

83. *Id.*

84. As the dissent noted, in three opinions immediately preceding *Goldberg*, the Supreme Court took pains to emphasize the primary role of state law regarding claims historically viewed as state actions. *Id.* at 225 (citing *Santa Fe*, 430 U.S. 462, 97 S. Ct. 1292, 51 L. Ed. 2d 480 (1977); Piper v. Chris-Craft Indus., 430 U.S. 1, 97 S. Ct. 926, 51 L. Ed. 2d 154 (1977); Cort v. Ash, 422 U.S. 66, 95 S. Ct. 2080, 45 L. Ed. 2d 26 (1975)).

85. After evaluating the superficial tension between *Goldberg* and *Santa Fe*, one federal district court concluded:

> [*Goldberg* and other] federal courts have been able to bring certain activities of corporate mismanagement within the scope of 10b-5, which at first glance appear

the legal principles set forth by the Supreme Court in *Santa Fe*.[86] Rather, he merely conformed the alleged facts to fit the body of law promulgated in *Santa Fe*. And it was not improper for him to do so since the plaintiff in *Goldberg* filed his pleadings more than one year before the Supreme Court decided *Santa Fe*. Furthermore, the trial court had refused to allow the plaintiff to amend his pleadings in order to allege deception.[87] So viewed, the difference between the holdings in *Goldberg* and in *Santa Fe* lies not in a varying interpretation of rule 10b-5, but in each court's construction of the factual setting before it. Judge Friendly went out of his way to construe the *Goldberg* situation as one involving a misrepresentation or omission of material information. In contrast, the Supreme Court stressed that the short-form merger in question involved neither a "material misrepresentation or a material failure to disclose."[88]

Judge Friendly acted properly in applying an expansive analysis to allegations of misrepresentations or omissions to make disclosure.[89] A trustworthy flow of information between majority and minority shareholders is essential to the well-being of the various national securities markets. As such, *Goldberg* may be read not only as protecting minority shareholders who have been subjected to a breach of fiduciary duty in conjunction with a deceptive act, but also as attempting to ensure the sanctity of the nation's capital markets in the exact manner which Congress intended.

Although the expansive reading of fraud employed in the *Goldberg* line of cases goes a long way in attempting to allow federal statutes to be construed to protect shareholders from directorial overreaching which is attended by deceit, it does not protect share-

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> to be nothing more than breach of fiduciary duty claims. However, upon closer examination these cases reveal an added element that was missing in the factual stance of *Santa Fe*: a misrepresentation or failure to disclose certain material facts regarding some corporate activity. . . .

Shamrock Assocs. v. Moraga Corp., 557 F. Supp. 198, 207 (D. Del. 1983).

86. Judge Friendly may be viewed as carrying out the desire of the high court which was expressed in *Santa Fe*: "[T]he 'fundamental purpose' of the Act [is] implementing a 'philosophy of full disclosure.' " 430 U.S. at 477-78, 97 S. Ct. at 1303, 51 L. Ed. 2d at 494.

87. *See supra* text accompanying note 73.

88. *Santa Fe*, 430 U.S. at 474, 97 S. Ct. at 1301, 51 L. Ed. 2d at 492.

89. In adopting the *Goldberg* viewpoint, the Third Circuit opined that the "distinction concerning the flow of information between the majority and the minority shareholders is persuasive. There is a strong federal interest, evidenced by the entire field of securities regulation, in ensuring a proper flow of information between the parties to a securities transaction." Healey v. Catalyst Recovery, 616 F.2d 641, 646 (3d Cir. 1980).

holders who have fallen prey to a breach of fiduciary duty unaccompanied by any hint of fraud. This is because, in order for the federal securities laws to apply, there must be both a breach of fiduciary duty and a fraudulent act.[90]

## III. State Law—The Business Judgment Rule

### A. *Development of the Rule*

It was early recognized that directors owed their corporation a duty of care.[91] At the same time, however, the judicial system realized that one cannot expect directors to be guarantors of a corporation's success and that directors must be accorded protection from lawsuits questioning the wisdom of a particular decision.

The business judgment rule was thus formulated by the courts.[92] The rule protects directors from liability for errors in judgment.[93]

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90. *See supra* note 50 (rule 10b-5).

91. One of the earliest reported common-law cases to recognize a duty of care is Charitable Corp. v. Sutton, 26 Eng. Rep. 642 (Ch. 1742). In that opinion, the court set forth a proposition which has long since been considered applicable to fiducial obligations: "By accepting of a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence. . . ." *Id.* at 645.

92. The earliest expression of the business judgment rule by an American court came in Percy v. Millandon, 8 Mart. (n.s.) 68 (La. 1829), where the Louisiana Supreme Court was evaluating the issue of liability on the part of a bank's board of directors for losses suffered by the bank. In absolving the directors of liability for errors of judgment, the court put forth the following public policy discussion:

> [W]hen the person who is appointed attorney-in-fact, has the qualifications necessary for the discharge of the ordinary duties of the trust imposed, we are of the opinion that on the occurrence of difficulties, in the exercise of it, which offer only a choice of measures, the adoption of a court from which loss ensues cannot make the agent responsible, if the error was one into which a prudent man might have fallen. The contrary doctrine seems to us to suppose the possession, and require the exercise of perfect wisdom in fallible beings. No man would undertake to render a service for another on such severe conditions. . . . The test of responsibility, therefore should be, not certainty of wisdom in others, but possession of ordinary knowledge; and by showing that the error of the agent is so gross a kind that a man of common sense, and ordinary attention, would not have fallen into it.

*Id.* at 77-78.

93. *See* 3A W. Fletcher, Cyclopedia of the Law of Private Corporations § 1039, at 45 (1986) [hereinafter Fletcher]; H. Henn & J. Alexander, Laws of Corporations § 242, at 661 (3d ed. 1983). In Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971), the Delaware Supreme Court set forth the following guidelines for employment of the rule: "A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment." *Id.* at 720.

The rule's grant of limited immunity allows directors to take calculated risks while overseeing a company's business strategy.[94] This element of risk-taking is deemed essential to the survival and prosperity[95] of the American business sector.[96]

### B. *Delaware: Application of the Rule to Strip Shareholders of Fiduciary Expectations*

The leading Delaware case involving application of the business judgment rule to a targeted stock repurchase is *Cheff v. Mathes.*[97] *Cheff* involved a shareholders' derivative suit in which stockholders of the Holland Furnace Company brought an action against the company's board of directors after the directors had authorized the repurchase of 155,000 Holland shares from Motor Products Corporation,[98] a greenmailer.[99] Holland repurchased its shares at a price of

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94. *See* FLETCHER, *supra* note 93, at 45.

95. The business judgment rule allows commercial entities to be directed effectively by encouraging qualified individuals to serve on the boards of directors with the assurance that the expected standard of care is not greater than that commonly exercised by them in their own business undertakings. And it prevents the judiciary from managing the often intricate affairs of American businesses. *See* Morris & Henry, *The Aftermath of* Zapata Corp. v. Maldanado: *What is Left of the Business Judgment Rule?*, 88 DICK. L. REV. 411, 412 (1984); *see also* Briggs v. Spaulding, 141 U.S. 132, 149, 11 S. Ct. 924, 930, 35 L. Ed. 662, 669 (1891) (the business judgment rule encourages "gentlemen of character and responsibility" to become directors).

96. The business judgment rule recognizes that corporate officers are more capable of guiding a company's direction than are judges. Before executives attain positions of great responsibility, their business acumen must first endure a Darwinian process of survival of the fittest. In contrast, a judge's commercial wisdom is not subjected to such testing, nor are judges selected on the basis of such a trait. *See* Easterbrook & Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277, 277-78 (1984). The fact that courts are ill-equipped to undertake an in-depth analysis into the merits of corporate strategies was recognized by the Second Circuit in Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983), when the court noted:

> [A]fter-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.

*Id.* at 886.

97. 41 Del. Ch. 494, 199 A.2d 548 (1964).

98. *Id.* at ___, 199 A.2d at 553.

99. Arnold H. Maremont was the Chairman of the Board of Motor Products Corporation. A Dunn and Bradstreet report which was presented to officials of the Holland Furnace Company showed Maremont to have a history of making quick profits by selling or liquidating

$14.40 per share, which represented a sizeable premium over the prevailing market price of between $10.375 and $11.50 per share.[100] The directors attempted to justify the stock repurchase by claiming that a large number of the sales staff was considering leaving and that approximately twenty-five "key men" had already been lost as a result of fear brought about by Motor Products' possible acquisition of the company.[101] The board of directors also stated that putting Holland out of business would be consistent with the raider's policy of liquidating newly acquired companies.[102]

The Delaware Supreme Court absolved the directors of all liability under the claims filed against them.[103] The court took the

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100. *See* Mathes v. Cheff, 41 Del. Ch. 166, ___, 190 A.2d 524, 525 (1963), *rev'd*, 41 Del. Ch. ___, 199 A.2d 548 (De. 1964). It is interesting to note that the Court of Chancery, which ordered certain directors to account for any loss to the corporation occasioned by the repurchase, emphasized the repurchase price of $14.40 per share in contrast to the much lower free market price of the stock. The Court of Chancery also pointed out that shortly after the repurchase, Holland stock traded for $10 or less. *Id.* at ___, 190 A.2d at 525. On the other hand, the Supreme Court of Delaware, which reversed the lower court and upheld the directors' actions, did not mention the extent of the premium paid for the shares but instead chose to place special weight on data indicating that approximately two years after the buyback Holland stock sold for as much as $15.25 per share. *See* 41 Del. Ch. at ___, 199 A.2d at 553.

101. 41 Del. Ch. at ___, 199 A.2d at 552.

102. 41 Del. Ch. at ___, 190 A.2d at 538.

103. After the Delaware Supreme Court looked to Kors v. Carey, 39 Del. Ch. 47, 158 A.2d 136 (Del. 1960) for guidance, it held that a target corporation could permissibly repurchase its stock that was held by a raider in order to preserve its customary business practices. In *Kors*, United Whelan Corporation acquired a 16% interest in Lehn and Fink in order to gain control of that company. Each of the Lehn and Fink directors wished to retain his position, and in addition it was conceded that the elderly president of Lehn and Fink wanted his son to succeed him in his leadership capacity. Sensing a proxy fight on the horizon and not wanting to lose their corporate offices, the directors authorized a buyback at a 10% premium. A complaint challenging the repurchase was filed. The court paid no heed to the plaintiff's self-preservationist allegations. Rather, it found the buyback to be justified based on the reasoning that the established business strategy of Lehn and Fink was different from the business policy advocated by the raider. *See id.* at ___, 158 A.2d at 137-42.

The *Cheff* court also based its holding on Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405 (1962). In *Bennett*, the principal executive of a large corporation wrote a letter to the chairman of a smaller company advising the chairman of his interest in the smaller company. In response, the chairman of the smaller corporation, without approval from the board of directors, purchased over one quarter of the smaller corporation's stock on the open market. At a subsequent board meeting, the chairman admitted that he caused the corporation to purchase its own shares in order that he and the other directors could maintain control. Based on this admission, the court found the protective shield of *Kors* to be inapplicable and laid down the rule that when an officer causes a company to procure its own shares so that he may maintain control over the company, the officer will be held liable to the company. *See id.* at ___, 187 position that a greenmail payment was justified if the board undertook the repurchase in furtherance of a sincere belief that it was necessary to do so in order to preserve the "proper business practices" of their company.[104] A greenmail payment would be unacceptable, in the court's view, only if directors brought about a repurchase "solely or primarily because of the desire to perpetuate themselves in office."[105]

In 1977, *Kaplan v. Goldsamt*[106] injected new vitality into the rule of *Cheff v. Mathes*. In *Kaplan*, a dominant shareholder, director, and founder of the company gradually came to advocate a business plan which was diametrically opposed to the commercial strategy of the company's board of directors.[107] As tension between the two factions increased, the founder and the other members of the board began exchanging heated and unpleasant barbs with each other at company meetings.[108] After the founder, and now greenmailer, suggested that he could control as much as thirty percent of the company's stock should he decide to launch a proxy fight, a member of the board inquired as to whether he could be bought out at $10 per share.[109] After the founder assented to the greenmail offer, one of the company's shareholders brought a derivative action on the corporation's behalf.[110]

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A.2d at 406-08.

One must ask whether it is possible for a sophisticated businessperson, acting under the guidance of experienced counsel, to violate the rule of *Bennett v. Propp*. Certainly such an individual would not admit to self-interest being the dominating factor behind any repurchase. Instead, the tutored businessperson would claim that the proposed business policy of the threatening entity conflicted with the company's established strategy. Better yet, the learned businessperson could have manufactured evidence while the repurchase effort was still in progress purportedly showing that the raiders' business plans motivated the buyback.

104. 41 Del. Ch. at ___, 199 A.2d at 554.

105. *Id.* Because almost every attorney who is even partially cerebral would be able retroactively to fabricate seemingly legitimate forces behind the buyback, the "solely" or "primarily" standard might reasonably be taken as an open license to pay greenmail. *See supra* note 103.

106. 380 A.2d 556 (Del. Ch. 1977).

107. *Id.* at 558-59.

108. Supposedly, the founder's unrestrained comments became so unsettling that the board of directors was forced to move one of their meetings out of the city in which the corporation was based so as to minimize the deleterious effect on management morale which the founder's comments might engender. *Id.* at 560.

109. *Id.* at 561. The company's shares were trading on the stock market at 6 7/8 to 7.

110. *Id.* at 557-58.

The Delaware Court of Chancery found the controversy to be controlled by *Cheff*.[111] The court recognized the greenmail payment as falling within the nearly boundless protections of Delaware's traditional interpretation of the business judgment rule.[112] Specifically, so long as the repurchase was taken to eliminate a threat to the company's business policy, and was not done solely or primarily to entrench management, the action was protected.[113]

Recently, in *Unocal Corp. v. Mesa Petroleum Co.*,[114] the Delaware Supreme Court indirectly reaffirmed the near obliteration of fiduciary duty expectations of a company's shareholders in regard to payments of greenmail by a threatened board of directors.[115] The *Unocal* court opined, with no apparent shame, that "it is now well established that in the acquisition of its shares a Delaware corporation may deal selectively with its stockholders, provided the directors have not acted out of a sole or primary purpose to entrench themselves in office."[116] Other recent Delaware decisions have similarly given shareholder rights activists genuine cause for concern.[117]

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111. *Id.* at 568 (citing *Cheff*).

112. *Id.* at 568-69.

113. *Id.* at 569.

114. 493 A.2d 946 (Del. 1985). *Unocal* involved a self tender by the target company with the shares of the raider being excluded from the issuer tender offer. The raider claimed that the discriminatory offer was impermissible. The court disagreed and held the discriminatory exchange offer to be a valid defense mechanism. *Id.* at 958-59. This holding in *Unocal* has now been effectively overruled by the Securities and Exchange Commission. On July 11, 1986, the SEC issued a release which stated that an "issuer's tender offer must be open to all holders of the class of securities subject to the tender offer. . . ." Securities and Exchange Commission, *Amendments to Tender Offer Rules: All-Holders and Best-Price*, Fed. Sec. L. Rep. (CCH) ¶ 84,016, at 88,186 (July 11, 1986).

115. 493 A.2d at 956-57. The Delaware Supreme Court also impliedly admitted that the term greenmail is a proper characterization of the transactions complained of in Kors v. Carey, 39 Del. Ch. 47, 158 A.2d 136 (1960), Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405 (1962), Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964), and Kaplan v. Goldsamt, 380 A.2d 556 (Del. Ch. 1977). *See* 493 A.2d at 957.

116. 493 A.2d at 953-54; *see also id.* at 957 ("the principle of selective stock repurchases by a Delaware corporation is neither unknown nor unauthorized").

117. In Crane Co. v. Harsco Corp., 511 F. Supp. 294 (D. Del. 1981), a federal district court, applying Delaware law, attempted to restrict protection provided by the business judgment rule. *Crane* stated that when a target company repurchases any of its outstanding shares during a tender offer of an acquisition-minded entity, there is an inherent conflict of interest. This conflict of interest causes the target company's board of directors to assume the burden of proof in regard to showing a permissible justification behind the repurchase. Thus, *Crane* removed a portion of the armor protecting management when it construed the established Delaware rule in a light more favorable to plaintiffs. The established Delaware rule said that

### C. *Limiting the Business Judgment Rule*

Shareholders do retain some glimmer of hope. Several recent cases, some of which were decided under Delaware law, have limited application of the business judgment rule both generally and within the context of corporate takeover attempts.

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the plaintiff had the burden of proof and must show that management acted solely or primarily to perpetuate its control.

However, in Moran v. Household Int'l, Inc., 490 A.2d 1059 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985), management's protective umbrella was reinvigorated when the court stated that a "mere conflict of interest" does not bring about the shifting of any burden. Rather, only implementation of a device producing a restructuring of the company in such a way as to shift power from the shareholders to the directors, as the court found to be true in the situation before it, would cause a burden to shift to the directors. And the burden so shifted would only be one of going forward with evidence of reasonableness. The directors would not be charged with carrying a burden of persuasion. *Id.* at 1076. On appeal, the Delaware Supreme Court further exacerbated the decline in shareholder rights by proclaiming that the device under consideration resulted in no undue restructuring of the company. The court reasoned that the case before it involved no excessive restructuring since many other valid defense mechanisms supposedly brought about a greater restructuring than did the device at issue. Moran v. Household Int'l, Inc., 500 A.2d 1346, 1354 (Del. 1985). Ultimately, the Delaware Supreme Court found no undue restructuring and no impermissible shift in power in favor of the directors even though the SEC's *amicus* brief stated that the "[p]lan will deter . . . virtually all hostile tender offers." *Id.*

In *Unocal*, the Delaware Supreme Court impliedly affirmed the lower court's opinion in *Moran* regarding the shifting of burdens when the board of directors has caused the company to make a defensive repurchase of its shares. The *Unocal* court took the position that in the context of a repurchase, the directors must assume the original burden. 493 A.2d at 955. That burden could be carried by the board's showing they reasonably believed "corporate policy and effectiveness" were endangered as a result of the threat. *Id.* That burden is most easily met. It can be sustained by a mere showing of "good faith and reasonable investigation." *Id.* The plaintiffs then must carry the burden of persuasion by showing, by a preponderance of the evidence, a breach of fiduciary duty on the directors' part. *Id.* at 958. The analysis employed by *Unocal* in this regard differed from that of the lower court in *Moran* only in the respect that the Court of Chancery required the directors to undertake a burden of going forward with the evidence *after* the business judgment rule had already been found to apply, *see* 490 A.2d at 1076, whereas *Unocal* stated that the directors must carry their burden of going forward with the evidence "at the threshold [and] before the protections of the business judgment rule may be conferred." *See* 493 A.2d at 954.

However, in the *Moran* supreme court opinion, issued approximately five months after *Unocal*, the Delaware high court contradicted and misconstrued its own statement set forth earlier in *Unocal*. The inconsistency pertained to the requisite burden which must be carried by the directors before they may invoke the umbrella of the business judgment rule. In *Moran*, the state high court held that the initial burden would lie with the directors *after* the business judgment rule had been held applicable to the board's adoption of the defensive mechanism. 500 A.2d at 1357.

### 1. *Norlin Corp. v. Rooney, Pace, Inc.*

In *Norlin Corp. v. Rooney, Pace, Inc.*,[118] the Second Circuit acknowledged that the business judgment rule granted nearly boundless discretion to a board of directors attempting to fend off takeover gestures.[119] The court decided that it could best apply an even-handed analysis by forbidding the board of directors an opportunity to invoke the rule's protective cloak. The three-judge panel thus stated that the business judgment rule is controlling only where the directors are not shown to have an interest in the transaction.[120] The panel then proceeded to prohibit the rule from taking effect by finding that there was more than enough evidence to support a holding of self-interest on the directors' part.[121]

### 2. *Smith v. Van Gorkom*

*Smith v. Van Gorkom*[122] is another of the recent Delaware cases which gives shareholders a glimmer of hope. At first glance, *Van*

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118. 744 F.2d 255 (2d Cir. 1984).

119. *Id.* at 264. As authority for this statement, the court relied on Treadway Cos. v. Care Corp., 638 F.2d 357, 380-84 (2d Cir. 1980) and Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690, 701-04 (2d Cir. 1980). *See* 744 F.2d at 264-65.

120. 744 F.2d at 265. The precedental value of this prescribed analysis is not as great as oppressed shareholders might desire since *Norlin* involved only a motion to enjoin the defensive measures, and did not involve a decision on the merits. *Id.* at 258, 269.

121. *Id.* at 265. The plaintiff made a prima facie showing of self-interest on the directors' part by establishing that, in response to an apparent imminent takeover attempt, the target company's board caused the company to: (1) transfer 28,395 shares of its common stock to a wholly owned subsidiary, allegedly in return for the subsidiary's cancellation of a promissory note; (2) make a conveyance of 800,000 shares of preferred stock to the subsidiary in exchange for a note; (3) transmit 185,000 shares of common stock to a newly created Employee Stock Option Plan and Trust [ESOP] in exchange for a promissory note (the court regarded the timing of the ESOP's creation as a most damning factor since the ESOP was brought into being the same day stock was issued to it); (4) arrange for all the stock so transferred to be voted by the target company's directors; and (5) appoint certain members of the target company's board to serve as ESOP directors. *Id.* at 259.

Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401 (Del. 1985) also dealt with a target company's quick resort to an ESOP in attempting to dilute the insurgent's interest in the target company. The board's actions in *Frantz*, however, were even more reprehensible than those in *Norlin* as the *Frantz* board did not establish the ESOP until the acquiring company had already gained control. In striking down the ESOP, the court stated that a board's defensive action occurring "*after* control has already passed to another group is not protected by the business judgment rule." *Id.* at 408.

122. 488 A.2d 858 (Del. 1985).

*Gorkom* may appear to take an antimanagement stance, but upon closer inspection it becomes evident that the holding can more accurately be viewed as an appropriate judicial response to egregious behavior. In the past, Delaware courts have displayed a similar willingness to limit the scope of the business judgment rule in situations involving outrageous behavior.[123]

*Van Gorkom*, commonly referred to as the Trans Union case, involved a setting where Jerome Van Gorkom, Trans Union's Chairman and Chief Executive Officer, was nearing the company's mandatory retirement age.[124] Van Gorkom privately considered the merits of selling Trans Union and then decided to approach Jay Pritzker, a well-known businessman.[125] Van Gorkom met with Pritzker at the latter's home. At the meeting, Van Gorkom indicated that Trans Union could be purchased at $55 per share, largely through debt, with most of the loan being paid off in five years.[126] Two days later, Pritzker notified Van Gorkom that he was indeed interested in acquiring the company.[127] There was no further discussion of price.[128] A special directors' meeting was called by Van Gorkom to consider a sale of the company.[129] This meeting was to be held only six days

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123. *See, e.g.*, Gimbel v. Signal, 316 A.2d 599 (Del. Ch. 1974), *aff'd per curiam*, 316 A.2d 619 (Del. 1974); Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405 (1962); *see also* Macandrews & Forbes v. Revlon, 501 A.2d 1239 (Del. Ch. 1985) (enjoining target company from engaging in certain transactions for the benefit of a white knight), *aff'd*, 505 A.2d 454 (Del. 1985).

124. 488 A.2d at 866. Mr. Van Gorkom thus may have had an incentive to exchange his equity interest in Trans Union for cash or a debt instrument, both of which offer greater security than stock.

125. *Id.*

126. *Id.* The $55 per share price represented a sizeable premium over the prevailing market price of $38 per share.

127. *Id.* at 867.

128. *Id.* Pritzker was granted an option to purchase one million Trans Union shares at $38 per share—only 75 cents above the closing market price of September 19, 1980, the day preceding the special meeting of the Trans Union board. *Id.* Mr. Van Gorkom was later criticized by Trans Union's chief financial officer for granting Pritzker the right to purchase one million Trans Union shares at a near market price. It was argued that this sale of shares, along with prohibitions on Trans Union against soliciting bids and furnishing inside information to prospective bidders, amounted to the granting of a "lock up" in Pritzker's favor. *Id.* at 867-68. The chief financial officer also claimed that the sale price was too low. *Id.* at 867 n.6. Nonetheless, Mr. Van Gorkom chose to ignore this advice and pressed the Trans Union board for a quick sale of the company. *Id.* at 877 n.19.

129. *Id.* at 867. No Trans Union director, with the exception of Mr. Van Gorkom and the company's president, was told prior to the board meeting that the meeting would focus on a proposal to sell the company. *Id.* at 874.

after the original discussion between Van Gorkom and Pritzker.[130] Trans Union's investment banker was not invited to attend the board meeting.[131]

At the board meeting, Van Gorkom outlined the terms of the pending sale. He did not disclose that he alone arrived at the sale price figure of $55 per share,[132] nor did he indicate that a study determining the intrinsic value of the company had not been performed.[133] The directors were not given an opportunity to study the merger agreement before voting on it.[134] Despite these shortcomings, the board promptly sanctioned the merger agreement, adjourning only two hours after the meeting had begun.

Several weeks later, the board reconvened to consider proposed amendments to the merger agreement.[135] The board approved the amendments, even though they were not given an opportunity to view them.[136] Trans Union shareholders then voted overwhelmingly in favor of the merger.[137]

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130. *Id.* at 867.

131. *Id.* Additionally, the court took pains to bring out Mr. Van Gorkom's failure to consult, prior to the board meeting, both Trans Union's former chief counsel and its acting chief counsel. *Id.* at 867. Outside counsel was retained by Mr. Van Gorkom one day before the board meeting. *Id.* Mr. Van Gorkom's failure to seek the advice of Trans Union's investment banker, and to a lesser extent the company's in-house counsel, proved to be neglectful acts of especially ruinous proportions. The court seized upon the absence of an investment banker's fairness opinion in support of its conclusion that "the Board lacked valuation information adequate to reach an informed business judgment" as to the adequacy of the sale price. *Id.* at 877-78. This part of the Van Gorkom opinion may thus be viewed as the "Lawyers and Investment Bankers Full Employment Act." *See also* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1357 (Del. 1985). In *Moran*, the Delaware Supreme Court found the directors' actions to be protected by the business judgment rule because, in part, there was "extended discussion between the Board and representatives of [the company's law firm] and Goldman, Sachs" before the board endorsed a course of action. *Id.* at 1356. *But see* Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1, 3 (1985).

132. 488 A.2d at 868.

133. *Id.* at 869, 876.

134. *Id.* at 868-69. The court's opinion is somewhat ambiguous on this point. The body of the opinion stated that copies of the Merger Agreement were delivered "too late for study before or during the meeting." *Id.* at 868. The court also represented that the directors approved of the merger solely on oral presentations and knowledge of the company's historical trading range. *Id.* at 869. In apparent contradiction to these statements, the court stated that it is not clear whether the board members were allowed an opportunity to study the agreement before passing on it. *Id.* at 868 n.7.

135. *Id.* at 869.

136. *Id.* at 869-70. The amendments were not even delivered until two days after they were

Disgruntled shareholders brought a class action lawsuit against Trans Union's board of directors. The court of chancery deemed the directors' actions to fall within the business judgment rule.[138] Appeal was then taken to the Delaware Supreme Court.

The court began its analysis by stressing that the business judgment rule was available only to those who complied with their fiduciary duty to fully inform themselves prior to acting upon corporate affairs.[139] After weighing the evidence against the directors, the court concluded that they had breached their duty of care.[140] The majority said that the board had not exercised an informed business judgment.[141] The court appeared disturbed over both Van Gorkom's unilateral promotion of the sale and his attendant dominance over Trans Union's directors.[142] Further, the court perceived the board to

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approved by the directors. Additionally, the amendments were not at all as Mr. Van Gorkom had represented them at the board meeting. When the amendments were delivered, Mr. Van Gorkom signed them, apparently without comprehending their ramifications. *Id.* at 870.

137. *Id.*

138. *Id.*

139. *Id.* at 872-73.

140. *Id.* at 874. *Van Gorkom* may be applauded not only for forcing directors to be more attentive to fiduciary obligations, but also because it is one of the few derivative cases holding directors liable in actions based solely on breach of duty of care. The great majority of decisions holding directors liable to shareholders involve situations tainted with self-dealing on the board's part. *See generally* Bishop, *Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968) ("The search for cases in which directors . . . have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack."). Professor Bishop found that in disputes involving nonfinancial corporations, only four decisions imposed liability on directors under a pure negligence theory. *Id.* at 1099-1100. In response, commentators have suggested that "it seems more likely than not that in the four cases cited by Professor Bishop, the courts perceived some element of self-dealing, but declined to articulate this theme for lack of clear evidence." Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 317 n.302 (1981). Under a somewhat strained interpretation, *Van Gorkom* may be viewed as a case involving self-dealing. First, it must be remembered that Mr. Van Gorkom was approaching 65 years of age and mandatory retirement. If Mr. Van Gorkom decided to bring about a sale of the company in order to dispose of his stock at a premium and invest the sale proceeds in instruments providing greater financial security, self-interest would be evident. Thus, *Van Gorkom* might be another of the pure negligence cases in which the court perceived self-dealing but declined to press the theory for lack of evidence.

141. 488 A.2d at 874.

142. *Id.* It is possible that the court would have been less offended by the board's exemplification of a "rubber stamp" attitude if the board had consisted largely of insiders. Submissiveness of inside directors can more readily be expected since each director's position in the company might depend on his remaining in the chairman's good favor. But outside

have been uninformed based on the directors' failure to request a financial opinion[143] regarding the company's intrinsic value and their approval of the sale after only two hours of consideration.[144]

The *Van Gorkom* decision has shocked the business community and the corporate bar.[145] However, these groups need not be astonished. Two factors explain the outcome. First, the court was most likely infuriated by the board of directors' nonchalance toward a decision of paramount importance.[146] Second, the court recognized that its reputation and the reputation of the Delaware legislature had been badly scarred by Professor Cary's "race to the bottom" pub-

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directors made up half of the Trans Union board. And these were no ordinary outsiders. Rather, they were men of considerable distinction. Because of their prominence, they cannot readily be thought to have been intimidated by Mr. Van Gorkom. Therefore, the more plausible explanation for their behavior lies in their preoccupation with other callings and in lack of interest about Trans Union's corporate affairs. Thus, in deciding *Van Gorkom*, the Delaware Supreme Court may have been sending a message to eminent figures of society that they are no longer to accept the prestige and remuneration attending directorial positions in return for their mere presence at board meetings. If a potential director's eminent credentials cause him to be overextended, he should decline invitations to become a director rather than attempt to fulfill such commitments in a half-hearted manner. *See id.* at 894 (McNeilly, J., dissenting) (a testimonial to the outstanding qualifications of Trans Union's outside directors).

143. 488 A.2d at 877-78. This aspect of the opinion may be termed the Lawyers and Investment Bankers Full Employment Act. *See supra* note 131.

144. The court condemned the directors' conduct even though it brought about a windfall to the company's shareholders by way of a significant premium. The directors' behavior was judged to be reprehensible, notwithstanding the windfall, primarily because they approved the sale after studying the situation for only two hours. 488 A.2d at 875-78. In contrast, well-considered directorial actions in *Moran* were ruled permissible even though, in the SEC's opinion, the defensive mechanism adopted by the board deterred "virtually all hostile tender offers," thus depriving shareholders of the right to receive a premium from antagonistic suitors. 500 A.2d at 1354. In upholding the board's actions, the *Moran* court emphasized that the directors had been given materials to study before the meeting and that there had been extensive discussion during the meeting between board members and outside counsel. *Id.* at 1356. Similarly, the Court of Chancery approved of the defensive mechanism employed in *Moran* after noting that one director "considered the Board's review of the . . . proposal as the most extensive discussion of a single topic in his twelve years on the Board." *Moran*, 490 A.2d at 1068. The Delaware courts thus seem to be saying that a board of directors may abuse fiduciary powers so long as it takes care in doing so.

145. *See* Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 Bus. Law. 1437 (1985); Baldo, *Delaware Rocks the Boat*, Forbes, Apr. 8, 1985, at 126; Leisner, *Boardroom Jitters: A Landmark Court Decision Upsets Corporate Directors*, Barron's, Apr. 22, 1985, at 34; Glaberson & Powell, *A Landmark Ruling that Puts Board Members in Peril*, Bus. Week, March 18, 1985, at 56.

146. Perhaps the "crown jewel" of the defendant's outrageous behavior was the following: "[I]n the midst of a formal party which he hosted for the opening of the Chicago Lyric Opera, Van Gorkom executed the Merger Agreement without he or any other member of the Board having read the instruments." 488 A.2d at 879.

lication.[147] The Delaware Supreme Court thus viewed *Van Gorkom* as an opportunity to resurrect its image[148] as an impartial arbiter of justice. Having so done, the court can return to its long-established promanagement stance.[149]

### 3. *Heckmann v. Ahmanson*

*Heckmann v. Ahmanson*[150] is the most intriguing of the recent decisions limiting the business judgment rule. As pointed out in the

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147. *See* Cary, *Federalism and Corporate Law: Reflections on Delaware,* 83 YALE L.J. 663 (1974). Professor Cary took the position that the Delaware legislature's primary motive behind the state's "liberal" statutory scheme derived from the state's quest for money. Cary further pointed out that the Delaware Supreme Court was a participant in this scheme. Professor Cary's views have been well received. *See, e.g.*, Murdock, *Delaware: The Race to the Bottom—Is an End in Sight?*, 9 LOY. U. CHI. L.J. 643 (1978); Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883 (1976); Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991 (1976); *see also* Schwartz, *supra* note 46, at 74-77 (questioning effectiveness of state incorporation laws); Conard, *An Overview of the Laws of Corporations*, 71 MICH. L. REV. 623, 631-646 (1973) ("race of laxity" among states seeking incorporators); Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 871-72 (1969) (Delaware, in seeking incorporators, is insistent upon having the most liberal incorporation laws). *But see* Arsht, *Reply to Professor Cary*, 31 BUS. LAW. 1113, 1113-14 (1976) (approval of broad corporate powers); Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 919 (1982) ("If incorporation in Delaware were really harmful to shareholders, shares of firms located there would trade for less . . . and the firm might be an attractive takeover candidate with the probable result that existing managers would be displaced.") [hereinafter Fischel]. One must wonder whether Professor Fischel could candidly advance this argument today in view of the Delaware Supreme Court's holdings in *Unocal* and *Moran*. In those cases, the court displayed a willingness to allow management exceptional leeway in taking defensive measures which had the effect of preventing themselves from being displaced.

148. *See* Fischel, *supra* note 147, at 1454 ("The one entity that appears to have been most influenced by Cary is the Delaware Supreme Court."); Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1 (1985) [hereinafter Manning]:

> [The Delaware Supreme Court] must seek to foster a congenial environment for Delaware's leading industry—corporate home basing. At the same time the court cannot, with professional dignity or long-term prudence, allow Delaware to come to be perceived as the corporate law equivalent of a tax-haven banana republic. The "race to the bottom" remark stung deeply.

*Id.* at 2; *see also* Hazen, *Corporate Inside Trading: Reawakening the Common Law*, 39 WASH. & LEE L. REV. 845, 853 (1982) (Delaware is "not known for its strict view of corporate fiduciary duties.").

149. *See, e.g.*, Pogostin v. Rice, 480 A.2d 619 (Del. 1984); Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971); Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964); American Hardware Corp. v. Savage Arms Corp., 37 Del. Ch. 59, 136 A.2d 690 (1957); Federal United Corp. v. Havender, 24 Del. Ch. 318, 11 A.2d 331 (1940).

150. 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985).

introduction to this essay, *Heckmann* resulted from the directors of Walt Disney Productions purchasing Disney stock from a group of greenmailers acting in concert.[151] The assembly of greenmailers, known as the Steinberg Group, was headed by Saul Steinberg, himself a notorious greenmailer.[152]

The Steinberg Group accumulated a holding approximating twelve percent of Disney's stock and then made clear its intent to purchase forty-nine percent of Disney's outstanding shares.[153] In response, and presumably with due regard for the desire of Disney executives to retain their positions, the board offered to buy out the Steinberg Group's holding—at a substantial premium, of course.[154] This greenmail transaction netted the Steinberg Group a sixty million dollar profit.[155] After the greenmail agreement was consummated, Disney's stock price fell rapidly.[156] Other Disney shareholders, seeing the value of their securities dropping precipitously, vented their anger by way of a lawsuit. The trial court enjoined the Steinberg Group from transferring or disposing of its profit. That injunction was then affirmed by an intermediate appellate court (the *Heckmann* court).[157] In upholding the trial judge's injunctive order, the *Heckmann* court deemed it likely that Disney's board would ultimately be held to have breached its fiduciary duty by advancing greenmail to the Steinberg Group.[158] The position taken by the court seems historic. Never before has a court held payment of greenmail to constitute a breach of fiduciary duty.

*Heckmann v. Ahmanson* placed a large crack in the thick shield protecting directors. However, it by no means represents a panacea for greenmail ills. The opinion leaves wide holes for the defense bar to drive through. First, and most obviously, the opinion's precedential value is weaker than desired since it only pertained to an injunctive motion. On the other hand, it is fitting for a judicial stance which

151. *Id.* at 124-25, 214 Cal. Rptr. at 180-81.

152. For a listing of each of the greenmailers, see *supra* note 3.

153. 168 Cal. App. 3d at 124, 214 Cal. Rptr. at 180.

154. *Id.*

155. *Id.* at 124, 214 Cal. Rptr. at 181.

156. On Friday, June 8, 1984, Disney's stock price closed at 65 1/8. On Monday, June 11, the company's stock price fell to 54 1/4. On Tuesday, June 12, it stood at 50 3/4 and by Wednesday, June 13, Disney's stock sold at only 49 1/8.

157. 168 Cal. App. 3d at 138, 214 Cal. Rptr. at 190.

158. *Id.* at 128, 214 Cal. Rptr. at 183.

rebukes a time-honored principle to first rear its head under circumstances of limited applicability. And notwithstanding *Heckmann's* limited scope, the decision will certainly serve as better authority for courts wishing to extend greenmail constraints than did the tangentially applicable cases *Heckmann* was forced to rely on.[159]

Second, the defense bar might persuade courts to limit *Heckmann* by arguing that it really amounted to nothing more than a prohibition on self-dealing. It can be argued that the precipitous timing of the board's greenmail proposal (extention of the repurchase offer on the very day the raider announced its intent to make a tender offer)[160] is explainable only through self-interest on the board's part.[161] Under a self-dealing analysis, *Heckmann* will not be persuasive in greenmail situations where the repurchase offer was extended after the raider and directors engaged in extensive and meaningful discussion. Similarly, *Heckmann* would not likely be considered compelling authority if a board could show it had given concerned thought to various alternatives[162]—including recommending to the

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159. Schilling v. Belcher, 582 F.2d 995 (5th Cir. 1978); Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 81 Cal. Rptr. 592, 460 P.2d 464 (1969); Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405 (1962); Andersen v. Albert & J.M. Anderson Mfg., 325 Mass. 343, 90 N.E.2d 541 (1950).

160. 168 Cal. App. 3d at 124, 214 Cal. Rptr. at 180.

161. *Heckmann* is analogous to Norlin Corp v. Rooney Pace, Inc., 744 F.2d 255 (2d Cir. 1984). Both cases involved an almost knee-jerk reaction on the board's part to an imminent takeover threat. In each instance, the court condemned the board's hastily considered measures, stating that the quickness of the response smacked of self-dealing. *Id.* at 265; *Heckmann*, 168 Cal. App. 3d at 128, 214 Cal. Rptr. at 183. If this method of analysis continues to play a dominant role in the judicial analysis of defensive measures, directors will be left in a quandry. A publicly held corporation attacked by a well-financed raider must seek to fend off the raider with utmost speed or it will either be swallowed by the insurgent or "put into play." *See supra* notes 14-16 and accompanying text. In fast moving takeover situations, where a company's independence is often snatched from it only weeks after the opening bid was announced, directors must act quickly. However, in doing so they may subject themselves to liability.

One solution calls for the implementation of defensive measures on an advance basis. By enacting defensive mechanisms prior to a takeover contest, directors would eliminate the possibility of a court seizing upon the timing of the defensive actions as support for a finding of self-dealing.

162. In the hectic arena of a takeover battle, the informed consideration rule of *Van Gorkom* should not be applicable to the same extent it is in business dealings involving less time pressure. Courts must recognize that in the context of a tender offer, reality leaves no time for peaceful reflection in the serenity of one's private office. The informed consideration rule of *Van Gorkom* should always be applied, but on a sliding scale gauged to the exigencies of the circumstances.

target shareholders that the tender offer be accepted—and then paid greenmail under the rationale that it posed the least harm to the company.[163]

The *Heckmann* court's willingness, perhaps even eagerness, to fault both parties to the greenmail transaction may have startled those viewing from the sidelines.[164] Nonetheless, observers should not allow themselves to become overly excited by the *Heckmann* decision. *Heckmann* does not signal the start of a new trend directed towards advancement of shareholder rights. Instead, as time passes, *Heckmann* will be perceived as more and more of an anomaly. In large part, this is due to "race to the bottom" principles.

## IV. Race to the Bottom Continues

### A. *Overview*

In 1933 Justice Brandeis put forth his famous dissent to *Liggett Co. v. Lee*.[165] He pointed out that it would be futile for a state's incorporation statutes to restrict authority granted companies. Such "local restriction would be circumvented by foreign incorporation. . . . Lesser states, eager for the revenue derived from traffic in charters, had removed safeguards from their own incorporation laws . . . And thus the race was one not of diligence but of laxity."[166]

### B. *Development of Corporate Statutes*

State incorporation statutes did not exist in the United States prior to 1800.[167] In 1811, New York enacted the first general incorporation statute.[168] Soon, other states followed suit by drafting such statutes of their own. In drawing up these statutes, states were

163. A board of directors would be well advised to procure legal and financial opinions supporting an action so taken. *See Van Gorkom*, 488 A.2d at 872-83.

164. It comes as no surprise to those attuned to the historical construction of the business judgment rule that the first case indicating an absence of protection under the rule for greenmail payments also involved fairly strong evidence of self-dealing. *See* Bishop, *supra* note 140, at 1095 (nearly all successful shareholder suits against directors for negligence have also involved self-dealing; only a few actions have triumphed solely on a negligence theory.).

165. 288 U.S. 517, 53 S. Ct. 481, 77 L. Ed. 929 (1933).

166. *Id.* at 557-59, 53 S. Ct. at 493-94, 77 L. Ed. at 948-51 (Brandeis, J., dissenting).

167. R. Baker & W. Cary, Cases and Materials on Corporations 11 (3d ed. 1959).

168. *Id.* at 9.

mindful that the enactment of stringent provisions would bring little benefit as companies would then simply incorporate in a neighboring state.[169] Incorporation statutes therefore tended towards ample use of liberal language. Gradually, New Jersey took the lead in the race for laxity.[170] As a result, New Jersey became the favorite state of incorporators.[171] New Jersey was so successful in attracting incorporators that it was able to finance state government operations largely on revenues generated from corporate charter taxes.[172]

Envious of revenues flowing into New Jersey's coffers, Delaware and other states decided to press harder for the incorporators' business.[173] In 1899 Delaware took on a promanagement policy.[174] At first, Delaware's newly found attitude had little effect.[175] New Jersey continued to be the preferred state for promoters. However, in 1913 Governor Woodrow Wilson took New Jersey out of the race for laxity with his support for the "Seven Sisters Acts."[176] The Seven

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169. *See* L. SOLOMON, R. STEVENSON & D. SCHWARTZ, CORPORATIONS—PROBLEMS, CASES AND MATERIALS 5 (1981).

170. II W. COOK, STOCK AND STOCKHOLDERS 1604 (3d ed. 1894).

171. *Id.*; *see also* H. HENN, *supra* note 55, at 17-18 ("New Jersey became the first 'mother of corporations.' ")

172. W. COOK, *supra* note 170, at 1604.

173. One author writing in 1899 noted:

> [L]ittle Delaware, gangrened with envy at the spectacle of the truck-patchers, sand-duners, clam-diggers and mosquito-wafters of New Jersey getting all the money in the country into her coffers,—is determined to get her little tiny, sweet, round, baby hand into the grab-bag of sweet things before it is too late.
>
> Little Delaware . . . has had the shrewdness and the thrift to enact a general corporation and trust law which beats that of New Jersey.

*Little Delaware Makes a Bid for the Organization of Trusts*, 33 AM. L. REV. 419 (1899); *see also* J. PARKER, WHERE AND HOW—A CORPORATION HANDBOOK 4 (2d ed. 1906) (quoted in Ligget Co. v. Lee, 288 U.S. 517, 558 n.34, 53 S. Ct. 481, 493 n.34, 77 L. Ed. 929, 949 n.34 (1933)) (Delaware and Maine also revised their laws, taking the New Jersey Act as a model, but with lower organization fees and annual taxes. Arizona and South Dakota also adopted liberal corporation laws, and contenting themselves with the incorporation fees, require no annual state taxes whatever.).

174. *See* R. LARCOM, THE DELAWARE CORPORATION (1937); *see also id.* at 166 ("The corporation policy of 1899 was adopted for the purpose of revenue, so that the success which has been achieved in attracting corporations to Delaware is reflected in the income which the state has derived from the organization fees and the annual franchise tax."); *see also* R. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 121 n.3 (1976) (Two years after the state took on a new pro-management policy, an official Delaware publication containing the newly enacted statute was released which stated: " 'It is believed that no state has on its statute books more complete and liberal laws than these.' ").

175. LARCOM, *supra* note 174, at 155.

176. *See* HENN, *supra* note 45, at 20.

Sisters Acts made New Jersey a less desirable home for incorporators.[177] With New Jersey out of the race, the number of incorporations in Delaware began increasing rapidly.[178] More importantly, the proportion of Delaware's corporation-derived revenue in comparison to its total state revenues rose dramatically. In 1913, twenty-five percent of Delaware's revenue consisted of incorporation income.[179] By 1917 this figure had increased to thirty-six percent, and in 1920 it stood at thirty-three percent.[180] By contrast, in 1899, the year Delaware joined the race, corporation revenues made up only seven percent of its annual intake.[181]

### *C. The Race in Modern Times*

Other states, similarly in need of money, have sought to attract incorporators by emulating Delaware's "'liberal' approach to corporate jurisprudence."[182] But Delaware takes comfort in the revenues derived from being the number one promanagement state. It thus maintains a policy of updating its statutes in order that it may

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177. LARCOM, *supra* note 174, at 155.

178. *Id.* at 156. In 1913 Delaware granted 1,613 corporate charters; in 1917 it granted 3,341 charters, and in 1920, 5,747 charters were issued. *Id.*

179. In 1913 Delaware's corporate revenues were $179,428 and its total state revenues were $719,005. *Id.* at 167.

180. In 1917 Delaware's corporate revenues were $492,922 and its total state revenues were $1,355,425; in 1920 its corporate revenues were $1,570,620 and total state revenues were $4,719,151. *Id.*

181. In 1899 Delaware's corporate revenues were $36,000 and its total state revenues were $511,767. *Id.*

182. Murdock, *supra* note 147, at 644. Antitakeover statutes of the various states are another symptom of race to the bottom principles. A multitude of courts have followed the lead of Edgar v. MITE Corp., 457 U.S. 624, 102 S. Ct. 2629, 73 L. Ed. 2d 269 (1982) and have stricken down state takeover statutes on commerce clause grounds, preemption grounds, or a combination of the two. *E.g.*, L.P. Acquisition Co. v. Tyson, 772 F.2d 201 (6th Cir. 1985); National City Lines, Inc., 687 F.2d 1122 (8th Cir. 1982); Icahn v. Blunt, 612 F. Supp. 1400 (W.D. Mo. 1985).

However, an Indiana statute hindering takeover attempts directed towards businesses incorporated in that state has recently been upheld by the Supreme Court in CTS Corp. v. Dynamics Corp., 107 S. Ct. 1637 (1987). After analyzing the situation, Martin Lipton, a noted securities lawyer, stated that he "anticipates a rush by other states to enact similar legislation. He said he wouldn't be surprised to see 30 to 40 states with similar statutes within 18 months." Wermeil, Ingersoll & Stewart, *Justices Uphold State's Curbs on Takeovers*, Wall St. J., Apr. 22, 1987, at 2, col. 2. Similarly, other attorneys stated that they expect Delaware to move quickly in updating its takeover legislation, in that Delaware likes to keep its corporation laws "state of the art." *Id.*

continue setting the pace.[183] Keeping current allows the state to maintain a healthy flow of incorporation revenue.[184]

And what about the judges of Delaware and other states engaged in the race? Are they participants in the general scheme tending towards laxity? Scholarly commentators have taken the position that Delaware judges are aware of their sovereign's thirst for incorporation revenue and thus seek to further the state policy of hospitality towards management.[185] In his "race to the bottom" article, Professor Cary stated:

> Judicial decisions in Delaware illustrate that the courts have undertaken to carry out the "public policy" of the state and create a "favorable climate" for management. Consciously or unconsciously, fiduciary standards and the standards of fairness generally have been relaxed. In general, the judicial decisions can best be reconciled on the basis of a desire to foster incorporation in Delaware.[186]

Judges of other states must similarly be aware of their role in "properly" construing corporate statutes.[187] For without judicial par-

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183. *See* Cary, *supra* note 7, at 668; *cf.* Comment, *supra* note 147, at 871-72 (other states have begun to join Delaware in the chase for corporate revenues).

184. In 1983 Delaware obtained 12% of its total state revenues through franchise taxes and general corporation fees. *See* U.S. Bureau of the Census, State Government Tax Collections in 1983, Table 3, 9, Series GF83, No. 1, U.S. Govt. Printing Office, Washington D.C. 1983. It is estimated that in 1985 Delaware gained 14.6% of its total state revenues through franchise taxes and general corporation fees. *See* U.S. Bureau of the Census, State Government Tax Collections in 1985, Table 3, 9, Series GF85, No. 1, U.S. Govt. Printing Office, Washington D.C. 1985.

185. *See* Murdock, *supra* note 147, at 644 ("unfortunately, the seduction of corporate management in Delaware is not limited to the legislature"); Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 Bus. Law. 883, 889 (1976) ("Delaware has diligently engendered a corporate climate too favorable to management, primarily in its terms of statutory provisions though, I believe, in judicial decisions as well."); Cary, *supra* note 7, at 672 ("The view is widely held that Delaware corporate decisions lean toward the status quo and adhere to minimal standards of director responsibility both to the corporation and its shareholders."). In his article, Professor Cary also noted that a legislature can always rectify the state's legal environment should the state's judicial sector be temporarily misguided onto an errant course. Cary then reported that the Delaware legislature revised a particular statute so as to allow management greater freedom in paying dividends after the courts interpreted the statute in a way contrary to management's desire. Cary, *supra* note 7, at 688, 689.

The Delaware legislature has recently utilized its authority to remind the state judiciary of the state's desire to attract incorporators. Shortly, after the *Van Gorkom* decision was handed down, the Delaware legislature enacted a statute which eliminates a director's exposure to personal liability for a breach of the duty of care. Del. Code Ann. tit. 8 § 102(b)(7) (Supp. 1986).

186. Cary, *supra* note 7, at 670.

187. If shareholders are unlikely to receive protection against greenmail payments from

ticipation, no state would be likely even to advance beyond the incorporator's first stage of consideration regarding forum selection.

## Conclusion

The *Heckmann* court broke new ground in indicating that the payment of greenmail by Disney directors constituted a breach of fiduciary duty. However, the position taken in *Heckmann* will most likely not usher in a repeat of the development of products liability law, where California led the way with the remainder of the country following suit. *Heckmann* is not to be viewed as the first wave of the coming shareholder rights era. Instead, it will become more and more of an anomaly.

A system which puts it upon the states to fight for the incorporator's business is bound to bring about the endorsing of liberal attitudes towards fiduciary duties. The individual states realize that it would be futile for them to adopt stringent standards, as that would only cause companies to incorporate elsewhere. On occasion, a particular court may forget about this aspect of futility. However, such occasions will be the exceptions. And should there, by chance, be widespread forgetfulness among the judges of a given state, that state's legislature will always be there to correct them.

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either legislatures or state courts, they might be wise to seek antigreenmail provisions for their corporation's by-laws. If a company's by-laws were amended so that the directors were forbidden to pay greenmail, the company would become a less desirable target for raiders aiming to extract greenmail payments. *See* Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1292 (1984) ("The basic lesson seems inescapable: the best way to resist extortion is to deny oneself the power to pay it."). *But see* R. FISHER & W. URY, GETTING TO YES: NEGOTIATING AN AGREEMENT WITHOUT GIVING IN (1981). These authors state that the efficient bargainer must sidestep and deflect his opponent's attack. Further, the negotiator is advised to resist his adversary's strength by "inventing options for mutual gain." *Id.* at 113-14. An insurgent might put this negotiation tactic to use when raiding a company by proposing that the threatened board extend camomail rather than greenmail. *See supra* note 17 (discussing camomail). By paying camomail, the board would sidestep the antigreenmail provision and at the same time benefit both itself and the raider.