THE FEDERAL SYSTEM AND CORPORATE LAW

THE CASE OF DELAWARE

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ABSTRACT

The American federal system that allows for competition between the states for corporate charters have led to the preeminence of the "liberal" corporate laws of the State of Delaware. Nowadays, over forty percent of all New York Stock Exchange listed companies are incorporated in Delaware and eighty two percent of all firms that reincorporate do so in Delaware.

This is the result of a historical process. During the nineteenth century the American corporations evolved from a "concession" granted by the state as a special privilege, to a "contract" created and performed by agreement among private parties. Corporations received broader powers to achieve their objectives, and managers predominated in corporate governance at shareholders' expense.

The process has continued during the twentieth century. The state corporate law revisions have represented a movement towards "liberality" that has posed serious questions: Has the balance between shareholders' protection and managers' discretion been broken? Is federal intervention required to restore that balance?

However, the development of the "liberal" corporate law of Delaware and other states has been balanced by the active role of the federal powers. The Supreme Court doctrine on the "interstate clause" that authorizes federal intervention on corporations doing interstate commerce is the basis of the federal legislation enacted during this century on matters of national interest.

Delaware's critics advocate reforming the current system and replacing it with some form of federal regulation in order to provide shareholders with adequate protection against managers. Delaware's defenders believe that the current system promotes the development of optimal state laws and the state should not be replaced by federal regulation.

Behind the controversy about Delaware there is a political contention on the distribution of competencies between the federal and state levels, and of the varied degrees of federal and state intervention in business associations. Thus the critique of Delaware's corporate law is a critique of the federal system.

Le système fédéral américain qui permet la compétition entre les états pour l'obtention des chartes des sociétés commerciales a conduit à la prééminence des lois de compagnies de l'état du Delaware, reconnues comme "libérales". Actuellement, plus de quarante pourcent de toutes les compagnies transigées au "New York Stock Exchange" sont incorporées au Delaware et plus de quatre-vingt-deux pourcent de celles qui se "réincorporent" le font au Delaware

Ce phénomene est le résultat d'un processus qui a pris naissance au siècle dernier. Pendent cette période, les compagnies américaines passèrent d'une simple concession octroyée par l'état à un contrat créé et exécuté par differents parties. Les compagnies reçurent des pouvoirs accrus leur permettant d'atteindre leurs objectifs et le dirigeants prédominèrent dans la gestion aux depens des actionnaires.

Le processus s'est poursuivi au vingtième siecle. Chaque amendement des lois du Delaware a représénte un mouvement vers le liberalisme et a souleve d'importantes questions. Est ce que l'equilibre entre la protection des actionnaires et la discretion des dirigeants a éte affecté? Est ce qu'une intervention féderale est necessaire pour rétablis cet équilibre?

Pourtant, le développement des lois des compagnies du Delaware et des autres etats a toujours été contre balancé par le role actif de l'autorité féderale. La doctrine de la Cour Supreme concernant la clause de commerce entre les états, qui autorise l'intervention fédérale auprès des corporations faisant affaires dans plusieurs etats, est la base de la législation fédérale du vingtième siècle qui fut décretée pour des raisons d'intérêt national

Les détracteurs du Delaware recommendent de réformer le système actuel et de le remplacer par une réglamentation fédérale de façon à mieux protéger les actionnaires des dirigeants. D autre part, les défenseurs du Delaware affirment que le système actuel promeut le developpement optimal de lois des états et ne devrait pas être modifié.

La controverse entourant le Delaware est l'expression d'un conflit politique sur la distribution des pouvoirs entre les autorités fédérales et les états, et sur l intervention du gouvernement auprès des societés commerciales. La critique des lois des compagnies du Delaware est donc une critique du système fédéral.

PREFACE

The nineteenth century competition between the states for corporate charters has had varied effects for American corporate law. This paper is an analysis of some of them and, in particular, of the most famous one: the Delaware corporate law, which has been considered the most influential in the United States since the beginning of this century.

Many reasons justify this assertion. Over forty percent of all the companies listed on the New York Stock Exchange are incorporated in Delaware and eighty two percent of all firms that reincorporate do so in Delaware. Over two hundred of the **Fortune** 500 largest industrial corporations are also incorporated in Delaware. Most of these are multinational or multistate corporations with a home base in a financial or industrial center located outside Delaware.*

What are the reasons for this success? From the legal point of view the reasons would likely be sought in Delaware corporate law itself. Under

* See N.Y.S.E. Guide (CCH) ¶ 725.799 (Jan. 31, 1986).

this perspective one might embark on any of three types of studies: a- a comparative law study between Delaware corporate laws and the corporate laws of western countries of similar economical and financial development, b- an analysis of the Delaware law concerning issues crucial to the relations among creditors, shareholders and managers (e.g. directors' fiduciary duties and shareholders rights); c- a comparative study of the statutory provisions and judicial decisions of other American states, to establish the different levels of "laxity" or "strictness."

The present paper adopts a combined approach and also intends to go beyond the formal rule structures. On one hand, it is a summary and analysis of the famous controversy about the origin and outcome of the Delaware corporate law and its impact in the corporate law of the United States. On the other hand, it analyzes certain features of the Delaware law, and their judicial constructions in order to assess the contenders' arguments and the reasons, if any, for Delaware's success.

Since the U.S. constitution provided the basic frame for the development of American corporate law, and for the competition among the states for corporate charters, this paper considers the implications of certain constitutional provisions and amendments, and its construction by the Supreme Court.

Together with the historical account of the Delaware role in the American corporate law, this paper deals with Delaware's rules on incorporation and reincorporation, shareholder rights, fiduciary duties of directors, managers and controlling shareholders, takeovers and mergers and derivative actions. Thus this study intends to integrate the constitutional framework of the relations between the federal system and corporate law with issues of substantial importance in corporate governance. It makes reference to four important corporate codes (California, Illinois, New York and Texas). Such references were made taking into account the peculiarities of the American federal system and the common law tradition.

Such a comparative law context allows us to situate Delaware corporate law in national perspective. It is an attempt to confirm or reject certain hypotheses about Delaware since the succinct exposition of isolated statutory provisions or judicial decisions does not afford any conclusion about the position of a corporate law in a federal system, particularly when both are constantly evolving.

A study like the present is delimited by the convergence of historical and juridical elements, that is to say, of the impact of politics and economics in the development of legal institutions: lawyers and historians that analyze the same facts may diverge on their meaning; political scientists and economists may find different cause-effect relations. Even when the conclusions are the same, the rationale for them is different. However, lawyers should to be conscious of their limitations in political or economic analyses, and historians should be careful in dealing with legal matters.

Thus the controversy on Delaware corporate law is affected by political or economical evaluations of the different elements of a legal system. Nevertheless, although any legal system is influenced by political struggles or economic structures, it has its own autonomous dynamism. Law is science by itself and it has its own principles and methods. Moreover, law has an important group of people working permanently on it, legislators, judges and lawyers. Their opinions and interests have to be considered.

TABLE OF CONTENTS

1

CORPORATIONS AND THE CONSTITUTION

1- INTRODUCTION

American law followed the tradition of English law about corporations and accepted the principle that they are created by the government:[1] corporations were not collectivities of citizens but instruments of the State. Since the question was what organ of the State should grant charters of incorporation, the Constitution and its amendments seemed to settle the question:

> "The Congress shall have power . . . : 3 To regulate commerce with foreign nations and among the several states and with the indian tribes . . 18. To make all Laws which shall be necessary and proper for carrying into execution the foregoing powers, and all other powers vested by this Constitution in

[1] A. Berle, **Historical Inheritance of American Corporations** (New York: N.Y. U. School of Law, 1950) at 189.

> the Government of the United States, or in any Department or Officer thereof." [2]
>
> "The powers not delegated to the United States by the Constitution, nor prohibited to the states, are reserved to the states respectively or to the people." [3]
>
> "Full faith and credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other state
>
> And Congress may by general Laws prescribe the manner in which such Acts, Records and Proceedings shall be proved, and the effect thereof." [4]

The states received the power to grant corporate charters, without prejudice of the powers of Congress to regulate the operations of corporations doing interstate commerce. Furthermore, the Constitution prevented the states from repudiating charters granted by other states and permitted Congress to regulate the effects of those charters. [5]

The balance between federal and state levels of government embodied in the Constitution arose from several different proposals at the Constitutional Convention: Congress received a jurisdiction delineated in specific powers expressed in broad terms. [6]

[2] U.S. Cons. Art. I, sec. 8.

[3] U.S. Cons. Amen. X (1791).

[4] U.S Cons. Art. IV, sec. 2.

[5] Note, "Federal Chartering of Corporations: Constitutional Challenges" (1972) 61 Geo. L. J. 123 at 125.

[6] The Convention endorsed a resolution that the national legislature should have power "to legislate in all cases for the general interests of the Union, and also in those to which the states are separately incompetent, or . . . in which harmony of the [United] States (continued...)

The "necessary and proper" powers clause became the central issue for advocates and opponents of a strong federal government, although its meaning was clarified by the same framers. A Hamilton and J Madison argued that this clause was not the embodiment of a distinct power but rather an appropriate means for executing the express powers conferred upon the federal government, a power that would be implied if not otherwise provided [7]

Nevertheless, Congress power to regulate interstate commerce was construed variously While some argued that it was not an indefinite jurisdiction but a specific authority to accomplish certain objectives, most commentators agreed that the commerce clause covered "problems which were not specifically provided for by other constitutional provisions " [8]

It is not strange that corporations and charters soon became a matter of conflict between defenders and enemies of federal interventionism and that the U. S. Supreme Court had given shape and focus to the limits implied in the clauses of the Constitution in order to balance state and federal powers on corporations.

[6](. .continued)
may be interrupted by the exercise of Individual legislation." (Ibid. at 132).

[7] See THE FEDERALIST, (J. Cooke ed. 1961) No. 33 at 204 and No 44 at 304.

[8] Note, (1971) 16 Vill. L. Rev. 766 at 771.

II - BALANCE BETWEEN STATE AND FEDERAL POWERS: DEVELOPMENT OF THE INTERSTATE CLAUSE

A POWERS OF STATE LEGISLATURES

The Court defined the powers of state legislatures concerning existent corporations in the case of **Darmouth College v. Woodward.** [9] On that occasion it held that the constitutional prohibition against state impairment of contracts protected a corporation's charter against alterations ordered by the state legislatures. Corporations were seen as artificial entities having only those powers conferred upon them by their charters, either expressly or implicitly. [10]

The critical problem, however was not the border between the legislatures' powers and the corporations' rights, but between the federal and state government's powers to regulate corporations. In **Gibbons v. Ogden.** [11] a case involving an attempt by New York to limit navigation in its waters, the Court observed that the power of Congress to regulate interstate commerce could prevent a state from regulating trade within its own borders, if that regulation affected interstate commerce. Thus, federal regulation of corporations doing interstate commerce would be sustained if the constitution provided no specific

[9] 17 U.S. (4 Wheat) 518 (1819).

[10] Ibid at 634

[11] 22 U.S. (9 Wheat.) 1 (1824).

prohibition against congressional regulation of the activity and the activity involved more than one state. [12]

The Court revised this doctrine in **Mayor of New York v. Miln** [13] and in **Cooley v. Board of Wardens of the Port of Philadelphia** [14] where it stated that congressional power over interstate commerce would be deemed exclusive only in those areas which by their nature demanded national regulation. Hence, areas which did not demand such regulation were included in the legislatures' powers.

B- REGULATIONS ON FOREIGN CORPORATIONS

One problem was to determine if the states could limit or control the activities of "foreign corporations," i.e., corporations chartered by other states. The Court in **Bank of Augusta v. Earle** [15] held that corporations chartered by one state were not "citizens" of that state, entitled to claim the constitutional protection of Art. IV, sec 2[16] against other states' laws. Although the court went on to say that it would presume an intended comity among the states, which would allow a

[12] Ibid. at 194-96.

[13] 36 U.S. (11 Pet.) 102 (1837)

[14] 53 U.S. (12 Howard) 299 (1851).

[15] 38 U.S. (13 Pet) 519 (1839).

[16] "1. The Citizens of each State shall be entitled to all Privileges and Immunities of the Citizens in the several states."

foreign corporation to make a contract there, it acknowledged that certain state restrictions would be upheld.

Forty years later the Court settled the issue in **Paul v. Virginia**.[17] Then the question was whether a state could impose restrictions on foreign insurance companies, when parallel restrictions were not imposed on domestic insurance companies.

The Supreme Court upheld the power of the state to do so on two grounds: a) a corporation was not a citizen of any state and therefore was not entitled to the non-discriminatory treatment that the privileges and immunities clause of the fourteenth amendment [18] guaranteed to citizens; and b) the sale of insurance in a state market was not a transaction involved in interstate commerce.

While on its face the decision looked as though it preserved the power of states, its effect was the opposite. A state could exclude or admit on condition a foreign corporation interested in engaging in intrastate commerce but that state could not exclude or admit on condition a foreign corporation doing interstate business. [19] Only the federal

[17] 75 U.S (8 Wall.) 168 (1869).

[18] ". . . No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

[19] H Henn, **Handbook of the Law of Corporations and other business Enterprises**, 1970 at 19.

government had the power to regulate corporations involved in interstate commerce.

With this doctrine the Court established the balance between federal and state intervention on multistate -and soon multinational- corporations. Even if a state decided to regulate the activities of its own corporations, the doctrine did not allow it to intervene in the activities of corporations chartered by other states. Therefore state restrictions would not prevent a corporation from doing business in the state, but would only cause it to seek its charter (and pay its taxes) elsewhere. Moreover, restrictive state corporate laws would have the effect of placing a state's chartered corporations at a competitive disadvantage with corporations chartered in states with more permissive corporate laws. [20]

III- TOWARDS A NEW BALANCE: EVOLUTION IN CONSTITUTIONAL DOCTRINE ON CORPORATIONS

In a series of decisions between 1874 and 1934 the Supreme Court held different economic regulations invalid because of perceived encroachments on constitutional rights The states and the federal governments should be confined in their inability to enact regulations

[20] H. Scheiber, "Federalism and the American Economic Order, 1778-1910" (1975) 10 Law & Soc'y Rev. 57 at 62.

on corporations activities. The Court was concerned with the principle of "laissez- faire" more than with the federal-state balance of powers, [21]

A- THE TENTH AMENDMENT DOCTRINE AND ITS DEMISE

Thus, the tenth amendment was invoked to impede federal intervention on corporations doing interstate commerce and in some cases the Supreme Court accepted this contention. In **Hammer v. Dagenhart,** [22] it invalidated a congressional enactment intended to prevent interstate commerce.

> "[T]he maintenance of the authority of the states over matters purely local is as essential to the preservation of our institutions as is the conservation of the supremacy of the federal power in all matters entrusted to the nation by the Federal Constitution." [23]

> "If Congress can thus regulate matters entrusted to local authority by prohibition of the movement of commodities in interstate commerce, all freedom of commerce will be at an end, and the power of the states over local matters may be eliminated, and thus our system of government practically destroyed." [24]

[21] W. Kirk, "A case study of Legislative opportunism: How Delaware used the federal-state system to attain corporate preeminence" (1984) J. Cor. Law 243 at 242.

[22] 247 U.S. 251 (1918)

[23] Ibid. at 275.

[24] Ibid. at 276

In **Hopkins Federal Savings & Loan Ass'n v. Cleary** [25] the issue was the **Home Owners' Loan Act** of 1933 [26] which allowed building and loan associations organized under state laws to be converted into Federal Savings and Loan Associations upon the vote of a majority of the stockholders, conversion not conditioned upon the consent of the state or compliance with state laws. The Court found that the provision was an unconstitutional encroachment upon the reserved powers of the states.[27]

However with the consolidation of the New Deal, these decisions were soon overruled. [28] The Court in **United States v. Darby** established the test for determining the distribution of powers between the federal and state levels in such a manner that if Congress regulates corporations which engage in interstate commerce, no Tenth Amendment problems should arise [29]

B- THE FIFTH AND FOURTEENTH AMENDMENT DOCTRINES AND THEIR DEMISE

In the cases of **Bank of Augusta** and **Paul** [30] the Supreme Court held that the term "citizen" used in the privileges and immunities clause of section one of the fourteenth amendment and section two of Art. IV did

[25] 296 U.S. 315 (1935).

[26] Ch. 64, se. 5, 48 Stat 132.

[27] **Supra** note 25 at 335.

[28] See **infra**

[29] Note, **supra** note 5 at 143.

[30] **Supra** note 15 and 17 and accompanying text.

not include corporations. Likewise, the term "person" as used in the fifth amendment's due process privilege applied only to natural persons, not to "fictitious persons" like corporations, according to the doctrine exposed in **Woodward**. [31]

These restrictive constructions were soon overruled. The term "people" as used in the fourth amendment encompassed corporations.[32] Corporations were "persons" protected by the due process and equal protection clauses of the fourteenth amendment [33] and the due process clause of the fifth amendment [34] Corporations were given status as litigants and the ability to hold property and to do business outside their charter states

At the end of the century the court dealt with the question of the extension of state and federal powers to "discriminate" between corporations When it applied the fourteenth amendment analysis in a business and economic context, distinction between different kinds of corporations did not seem to violate the equal protection clause so long as it bore a rational relationship to a legitimate state interest. [35]

[31] **Hale v. Henkel**, 201 U.S. 43, 74 (1906).

[32] **See v. Seattle**, 387 U.S 541, 545 (1967).

[33] **WHYY, Inc. v. Borough of Glassboro**, 393 U.S. 117, 119 (1968) (equal protection); **Wheeling Steel Corp. v. Glander**, 337 U.S. 562, 574 (1949) (equal protection); **Connecticut Gen. Life Ins. Co. v. Johnson**, 303 U.S. 77, 88 (1938) (due process).

[34] **Union Pac. R.R. v. United States**, 99 U.S. 700, 719 (1879).

[35] **Railway Express Agency v. New York**, 336 U.S 106 (1949).

Therefore, the Court has not invalidated every difference in treatment, rather only suspect classifications based on race, wealth, or religion are impermissible. [36] The size of a business enterprise is permitted as criteria of discrimination between large and small entities, for purpose of federal or state legislation. [37]

During the first third of this century, the Supreme Court continued to impose fifth and fourteenth amendment restraints upon state and federal attempts to regulate corporations. [38] In order to protect the "freedom of contract" the court insisted that corporations, like natural persons, were entitled to the equal protection [39] and due process [40] guarantees However, with the beginning of the New Deal Era the Court abandoned its strict interpretation of the fifth and fourteenth amendments and refused to invalidate federal and state economic legislation solely on these constitutional grounds.

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[36] **Hunter v. Erickson**, 393 U.S. 385, 392 (1969); **Loving v. Virginia**, 388 U.S. 1 (1967) [race]. **Tate v. Short**, 401 U.S. 395, 398-99 (1971); **Boddie v. Connecticut**, 401 U.S. 371, 388 89 (1971) [wealth].

[37] **Morley v. Doud**, 354 U.S. 457, 465 (1957); **Engel v. O'Malley**, 219 U.S. 129, 138 (1911).

[38] Between 1899 and 1937, 159 Supreme Court decisions held state laws unconstitutional under the due process and equal protection clauses. In addition, 25 statutes were invalidated under the due process clause coupled with some other constitutional provision. See Note, **supra** note 5 at 147.

[39] **Ligett Co. v. Lee**, 288 U.S. 517, 536 (1933)

[40] **Pierce v. Society of Sisters**, 268 U.S. 510 (1925).

> "[The] function of the courts in the application of the fifth and fourteenth amendments is to determine in each case whether circumstances vindicate the challenged regulation as a reasonable exertion of governmental authority or condemn it as arbitrary or discriminatory." [41]

IV FEDERAL PREVALENCE: NEW DEVELOPMENTS OF THE INTERSTATE CLAUSE

A INITIAL TESTS

In some cases the Court applied the "protective principle" according to which Congress should intervene in economy and business only to protect interstate commerce. In **Houston, E & W. Texas Ry. v. United States**, the Court held that Congress has power to regulate

> "[a]ll matters having such a close and substantial relation to interstate traffic that the control is essential or appropriate to the security of that traffic, [its] efficiency, and [unmolested conduct] . . . ." [42]

Such restrictive doctrines were abandoned soon, in accordance with new legislative tendencies. While before 1933 Congress had rarely legislated about corporations, [43] the **New Deal** years brought federal legislation affecting corporations doing interstate commerce. The focus was

[41] **Nebbia v, New York**, 291 U.S. 502 (1934).

[42] Ibid. at 351.

[43] The most important federal regulation of corporation was the Interstate Commerce Act (Sections 5 (2), 20 and 20a). Those required the approval of the Interstate Commerce Commission for consolidations and security issues of any railroad or other company subject to the provisions of the act and also gave the Commission power to regulate accounting practices. (See W. Cary, & E. Eisenberg, **Cases and Materials on Corporations** 6th ed. (1986) at 13).

increasingly on corporations' behaviour rather than on their finances and structure.[44]

B- NEW DEAL LEGISLATION

Some enactments referred directly corporate finance and structure. The **Communications Act**[45] (1934) gave a federal agency power over interlocking directorates and accounting practices in the communications industry. The **Federal Power Act**[46] (1935) gave other federal agency powers over electric utility companies, including competence to regulate their securities transactions or dispositions of property. The **Civil Aeronautics Act**[47] (1938) gave another federal agency powers over consolidations and mergers of air transportation companies and their accounting practices.

The acts administered by the Securities and Exchange Commission governed the registration, offering, and transactions on securities. The

[44] Some aspects of the corporate governance and activities had been previously regulated by the antitrust laws. The **Sherman Act** [15 U.S.C. s. 1-7.] prohibited any unreasonable interference, by contract, or combination or conspiracy, with the ordinary, usual and freely competitive pricing or distribution system of the open market in interstate trade. It was supplemented by the **Clayton Act**, [15 U.S.C. s. 12-27] that prohibited price discrimination, tying and exclusive dealing contracts, mergers, and interlocking directorates, where the effect may be substantially to lessen competition or tend to create a monopoly in any line of commerce (See also the **Robinson-Patman Act**, 15 U.S.C. S.13).

[45] 7 U.S.C. 1.

[46] 14 U.S.C 1.

[47] 52 Stat. 973.

Securities Act [48] (1933) provides for registration of securities which are to be sold to the public and for complete information on the issuer and the stock offering. The **Securities Exchange Act** [49] (1934) governs the operation of stock exchanges and over-the-counter trading and requires publication of information about stocks listed on these exchanges

Also relevant in corporate matters, the **Public Utility Holding Act**[50] (1935) seeks to restrict the operations of utility holding companies whose operations are integrated and confined to a single state or contiguous states. The **Trust Indenture Act** [51] (1939) protects investors in bonds by requiring that the trust indenture include protective clauses and exclude exculpatory clauses, and that trustees be independent of the issuing company [52]

C NEW APPROACHES

Initially the Supreme Court found constitutional infirmities in this legislation Its insistence upon protecting the states powers from encroachment by the federal interstate power resulted in a tightening of

[48] 15 U.S.C s. 77a et seq.

[49] 15 U.S.C s 78 et seq

[50] 15 U.S.C. s. 79-79z.

[51] 15 U.S.C. s 14.

[52] See also the **Investment Company Act** (1940) [15 U.S.C. s. 80a-1 et seq] and **the Investment Advisers Act** (1940) [15 U.S.C. s.80b.].

the standards used to determine the permissible extension of the commerce clause.

For example, in **Schechter Poultry Corp. v. United States** [53] the Court struck down the National Industrial Recovery Act of 1933, [54] holding that only intrastate practices "directly" affecting interstate commerce were subject to federal regulation. [55] In **Carter v. Carter Coal Co.** [56] the Court voided some provisions of the Bituminous Coal Conservation Act of 1935, [57] demanding that the effect should be "direct" and not only "indirect."

After 1936 the Court abandoned its restrictive interpretation of the interstate commerce clause. Upholding the National Labour Relations Act [58] in **NLBR v. Jones & Laughlin Steel Corp.** [59] the Court substituted the "direct effect" test for a wider "close and substantial relation" requirement. [60]

[53] 295 U.S. 495 (1935).

[54] Ch. 90, 48 Stat. 195

[55] **supra** note 53 at 546-550.

[56] 298 U.S. 238 (1936)

[57] Ch. 824, 49 Stat. 991

[58] 29 U.S.C. 151-68 (1970).

[59] 301 U.S. 1 (1937).

[60] Ibid. at 37.

"Although activities may be intrastate in character when separately considered, if they have such a close and substantial relation to interstate commerce that their control is essential or appropriate to protect that commerce from burdens and obstructions, Congress cannot be denied the power to exercise that control." [61]

In **Wickurd v. Filburn,** [62] upholding the **Agricultural Adjustment Act** of 1938, [63] the Court spoke in terms of Congress' power to regulate "activity even if not regarded as commerce . . . if it exerts substantial economic effect on interstate commerce." [64] Thus, the multiple effects of many seemingly insignificant acts could thus be held to add up to a substantial impact. [65]

In the last decades the Court has consistently applied the same doctrine. In **Heart of Atlanta Motel, Inc. v. United States,** [66] the Supreme Court sustained the hotel accommodation provisions of the Civil Rights Act of 1964 [67] as a valid exercise of federal commerce power.

"The power of Congress to promote interstate commerce also includes the power to regulate the local incidents thereof, including the local activities in both the States of Origin

[61] Ibid.

[62] 317 U.S. 111 (1942).

[63] 7 U.S.C. 608c, 612c, 1281-1407, 1501-1518 (1970).

[64] **Supra** note 62 at 125.

[65] See **Maryland v. Wirtz**, 392 U.S. 183 (1968).

[66] 379 U.S. 241 (1964).

[67] 28 U.S.C. 1447 (1970), 42 U.S.C. 1971, 1975 (a) - (d), 2000a to h-6 (1970).

and destinations, which might have a substantial and harmful effect upon commerce." [68]

In **Perez v. United States,** [69] the Court faced the question of whether the Consumer Credit Protection Act of 1968 [70] was a valid exercise of Congress' commerce power when applied to purely intrastate activities. It concluded that once the particular activity regulated or prohibited falls within the scope of the federal commerce power, there need not be proof that particular proscribed intrastate activity had an effect on interstate commerce. [71]

VI - CONCLUSION

The evolution of the Supreme Court doctrines on the scope and effects of the "interstate clause" and other constitutional provisions, coupled with the federal legislation enacted during this century on matters of national interest have led to an increasing federal intervention on corporations doing interstate commerce. In the same degree that federal legislation augmented in number and importance, state legislation diminished in effects and significance No longer could the states assume that their chartered corporations were only subjected to their corporate laws; on the contrary, corporations involved in interstate

[68] **Supra** note 66 at 258.

[69] 402 U.S. 146 (1971).

[70] 18 U.S.C. 891-94, 896 (1970)

[71] Note, **supra** note 5 at 151-155.

business were affected by the legislation of other states and by federal regulations.

The state powers on corporations were invoked to protect not only the states but also the corporations themselves against federal intervention Thus, the fifth, tenth and fourteenth Amendments were invoked by the supporters of the "laissez faire" principle in order to circumvent the growing tendency towards federal regulation. Although the Supreme Court accepted this contentions for more than fifty years, at the time of the New Deal it adopted an approach consistent with the economic reality of the twentieth century: national corporations operating in a national market have to be regulated by national powers.

Although the internal governance of the corporate entity is still reserved to the chartering states, the external affairs of the corporation have been subjected to the overriding regulation of the federal Congress or federal agencies State legislatures and courts have to take into consideration the impact of its statutes and decisions in a national perspective, since they affect not only corporations doing intrastate business but also corporations involved in interstate business.

II

CORPORATIONS AND THE STATES

I- THE SPECIAL CHARTERING SYSTEM

A- SPECIAL CHARTERS BY SPECIAL STATUTE

After the adoption of the Constitution the idea of corporations as franchises of the states made possible a process of incorporation by special charters. The legislature of each state issued all corporate charters one by one, by individual legislative acts. The special charter process did not seem awkward because in 1789 few corporations existed in the United States; probably no more than two dozen companies had been chartered by state legislatures during the Confederation period.[72]

[72] These corporations included banks, bridge and canal companies, trading and navigation enterprises, manufacturing and insurance companies. H. Butler, "Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges" (1985) 15 J. Leg. Stu. 129 at 138.

The idea of state franchise supposed that corporate status was only given for some state purpose, and for that reason many public utility companies received monopoly privileges and police powers in exchange for their financing and construction of quasi-public goods. [73] Sooner than later entrepreneurs demanded access to corporate status as an efficient manner to structure and finance business ventures of all types. The preamble of early manufacturing companies charters justified the acts of incorporation because the enterprises required more capital than could be obtained by traditional means. [74]

However, in the first third of the nineteenth century state governments preferred to restrict their granting of charters to industrial and commercial associations. Several considerations about the inconvenience of unfettered "state franchises" led to a combination of permissive policy in granting special charters and restrictive policy concerning their terms. Some corporate privileges as perpetual succession and limited liability were not affirmatively granted by these early charters. The theory underlying that policy was that individual legislative sanction provided the necessary control and regulation of a new form of business associations. [75]

However, limited liability was an important feature of a corporate association for the method of financing a corporation in the first half

[73] For example, eminent domain. Butler, **supra** note 72 at 139.

[74] Butler, **supra** note 72 at 139.

[75] Ibid

of the nineteenth century. The usual practice was to obtain a stock subscription on which only a small percentage was paid at the outset and then to assess the subscribers in order to meet future needs of the company. [76]

Common Law recognized the importance of limited liability. Before 1824 it was not clear whether a corporation necessarily included limited liability under the common law when the charter was silent about shareholders' obligations to creditors. However, after **Wood v. Dummer**[77] the courts settled the issue affirmatively.

B- SPECIAL CHARTERS AND GENERAL STATUTES

When the number of corporations increased in the first third of the nineteenth century, the passage of special charters and supplementary amendments occupied increasingly large portions of legislative sessions. For that reason, many legislatures passed general regulating statutes on corporations. These acts did not provide a procedure for incorporation different from the traditional one; instead they merely established the powers and limits applying to corporations created by special charter [78]

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[76] Butler, **supra** note 72 at 139.

[77] 3 Mason 308, 311 (C.C.D Me. 1824).

[78] W. Hurst, **Conditions of Freedom in the Nineteen Century United States** (1956) at 15.

By referring to the general regulating statutes, the special charters did not have to include such powers and limits. In practice, the passage of a special charter subject to the general statute involved the legislature filling out a form, adding a few details (the name of the corporation and its incorporators, and its capital stock). [79]

There were very few interstate corporations during this early development of the general corporation acts combined with special corporate charters. Incorporation in a state usually implied that the corporation would locate and operate in that state. Furthermore, the charters of this period generally required that the enterprise was located not only in the chartering state but also in a particular town. [80]

However, in the middle of the century it became more evident that the states wished to attract outside capital or prevent the flight of local capital. The state's political boundaries were ineffective barriers to capital flows when the economical and political expansion of the United States meant the creation of a coast-to-coast market, and the Supreme Court doctrines about the extent of state powers to regulate corporations doing interstate commerce.

II. DUAL SYSTEM FOR INCORPORATION: GENERAL AND SPECIAL CHARTERING

[79] Butler, **supra** note 72 at 140. A. Berle & G. Means, **The Modern Corporation and Private Property**, 1968 at 127-28.

[80] Butler, **supra** note 72 at 142.

A- PREVALENCE OF THE SPECIAL CHARTERS

Under this dual system of incorporation, it was possible to incorporate either by a general procedure under a general statute or by special charter. It seems that the first of such general statutes was enacted by New York in 1811 Nevertheless, general incorporation acts did not begin to predominate until near 1850, when states began to place constitutional restrictions or prohibitions to the use of special charters.

These general acts tended at first to be strict. A nearly universal feature was a limitation upon the maximum amount of authorized capital Many states set low ceilings, and raise them one or more times in the last quarter of the century. [81]

The early general acts usually set a limited number of purposes for which corporations could be formed. The power to incorporate for "any lawful purpose" was not common until the last decade of the century. The duration of corporations was also limited, usually to a period of twenty or thirty years. Besides, limits existed on the amount of indebtedness which could be incurred, and the power to hold the stock of other corporations. There was a widespread provision that until all capital

[81] Ligett, (Brandeis, J. diss.) **supra** note 39 at 550.

was paid in, stockholders were liable for twice the par value of their shares.[82]

The major difference between corporations formed by special charter and those formed under the general law was that the latter were smaller on average. The privilege of incorporation under the general acts was circumscribed with limitations and requirements that could be avoided by obtaining a special corporate charter.

It seems that a major difference between the terms of both charters related to the rules about directors' liability. Some of the general incorporation laws contained strict rules for directors' liability.[83] Almost all special corporate charters, on the other hand, were silent about directors' liability, and the common law did not hold, at that time, directors personally liable to creditors.[84]

The terms of special charters included several other advantages and exemptions. Many of the general laws also required annual reports to be submitted not only to stockholders but also to a government agency; these requirements, could be avoided by securing special charters. Special charters allowed a company to escape the low limits on

[82] L. Friedman, **A History of American Law** (1973) at 453.

[83] Butler, **supra** note 72 at 146.

[84] W Cadman, **The Corporation in New Jersey, Business and Politics 1791 - 1875**, 1949 at 169.

capitalization or the total debt limits established in the general laws, and to obtain power of mortgaging property and issuing bonds.[85]

Special charters even gave an exemption from state and local taxes that were payable by firms that incorporated under the general laws and included the capacity to issue stock in exchange for property other than money. Lastly the special charters could be modified and amended to reflect the new opportunities in business and finance [86]

It seems that two other conditions predisposed incorporators in favour of special charters, even when they contained nothing more than the same privileges as general incorporation charters. First, future legislatures could alter the general laws to restrict the advantages and privileges of all corporations formed under it, while it appeared less likely that the legislatures would pass many individual pieces of legislation to restrict the rights of specially chartered corporations, with the constitutional infirmities analyzed in **Darmouth College**. Second, a special act of the legislature was important to business promoters because it added prestige to the company and aided in marketing the initial stock issue.[87]

B- DECADENCE OF THE SPECIAL CHARTERS

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[85] Cadman, **supra** note 84 at 169

[86] Butler, **supra** note 72 at 147.

[87] Cadman, **supra** note 84 at 169-70

Between the late 1840s and the 1870s there was a growing concern for the burden that special charters placed on the legislators' time and on the state's budget by prolonging legislative sessions. It appears that the opportunities for lobbying had multiplied as the volume of special charters increased. Objections arose to the abuses of the special chartering system, specially in respect with the inequality of privileges and the granting of tax exemptions.

One of the typical responses to this political pressure and general criticism was to pass an act aimed at purifying the procedure of special chartering For instance, some states required a two-thirds vote of the legislature for granting special charters.

At the same the question raised of whether a corporation under special charter could do business outside the state of incorporation. Before the 1850s, it was either assumed or required that the operations of corporations under both special and general laws- would be confined to their chartering state Beginning in the mid-1850s, the articles of special charters included a provision authorizing the corporation to carry on part of its business outside the state, although the intention was that the corporation's primary place of business would remain in the chartering state. [88]

These provisions, coupled with the rules of comity announced by the Supreme Court in **Bank of Augusta**, allowed corporations chartered in the

[88] Butler, **supra** note 72 at 151.

state of their primary place of business to exercise their privileges in other places, subject to the regulations of the foreign state. The status of "foreign corporations" (corporations operating outside their state of origin) was uncertain and some corporations were hesitant to start their operations outside their state of incorporation.[89]

The practice of incorporating in a state other than the state of the primary place of business had its origins in this epoch. The situations varied. In most instances, the shareholders behind the incorporation were residents of the incorporating state; in some, however, the shareholders sought the special charters without regard to their residences or the location of the corporations's operations.[90]

Some restrictions prevailed in the corporate law of this period. Judges, for instance, held that all corporate acts which the legislature had not authorized would be prohibited. Such acts were held to be "ultra vires" or "beyond the powers," and the courts were reluctant to extend powers by implication.[91]

Other rules protected creditors. Under the "trust fund doctrine" the capital stock of a corporation was deemed to be a trust fund for the protection of its creditors; they could recover their credits from a corporation's shareholders up to the par value of the shares. Under the

[89] Ibid

[90] Butler, **supra** note 72 at 151-52.

[91] Ibid. at 453.

"true value doctrine" the property exchanged for shares must be measured at its true value, and that this must equal, at least, the par value of the shares issued. [92]

III THE GENERAL CHARTERING SYSTEM

Beginning in 1845, however, the constitutional conventions of most states were concerned with eliminating the special charters. The effect of the restriction and prohibition of special acts was that legislatures had to pass general incorporation laws or to revise the existent ones, in order to regulate different aspects of corporate governance and activities. [93]

Successive developments varied. In New England, where general incorporation laws were available, special charters nonetheless still accounted for approximately one-third of the business incorporations in the decade before 1875 [94] The demise of the special charter occurred in the decade beginning with 1875, although many New England states had not adopted a constitutional prohibition of special charters. [95]

[92] L. Larcom, **The Delaware Corporation** (1973) at 78.

[93] Butler, **supra** note 72 at 153. The absolute prohibition of special charters was adopted in constitutional conventions that were called to revise the state s entire constitution: however, seven of the constitutions containing absolute prohibitions were the original constitutions of the states

[94] Butler, **supra** note 72 at 159.

[95] In the nineteenth century Maine was the only state to adopt the prohibition Friedman, **supra** note 82 at 456

In other states, in spite of the constitutional restrictions and the general laws, legislators continued granting special charters invoking lacunae found in the respective constitution. For that reason some states abandoned their dual incorporation systems in favour of an absolute constitutional prohibition of special charters. Finally most of the legislatures stopped granting special charters around 1875. [96]

This legal development were parallel to economical development. That process fostered the market integration and the creation of corporations doing interstate business for which the place or form of incorporation was indifferent. In the early nineteenth century, entry barriers created by geographic isolation resulted in spatial monopoly for local producers. As the century progressed, technological improvements in transportation and communication led to the development of a national economy of integrated markets. [97] The Supreme Court's decisions commented in section I of this paper recognized the process, allowing corporations a broader scope for interstate activities and protecting them from federal and state intervention.

IV THE CASE OF NEW JERSEY

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[96] Butler, **supra** note 72 at 160.

[97] "The increased speed and certainty of distant transactions made possible by the telegraph network improved the functioning of extra-local markets and increased the feasibility of an integrated national economy." (Butler, **supra** note 72 at 154).

In the early part of the nineteenth century, the state of New Jersey followed the practice of chartering corporations only by special act. It passed its first general act in 1846. [98] From this year until 1875 it had the dual system of chartering, since the general act had not forbidden resort to special acts.

Entrepreneurs sought incorporation under special acts in order to overrule prohibitions or restrictions of the general act such as non-cash payment for stock, double liability on shareholders until all capital was paid in, issuance of bonds and mortgaging of corporate property, cumulative voting, majority of corporation directors being residents of New Jersey, etc. [99]

Opposition to special acts increased through the 1860s along with the number of such acts passed, and in 1875 New Jersey joined other states and amended its constitution to prohibit chartering by special act.[100] The same year the Legislature passed a general incorporation law. A few years later when the State experienced increasing financial difficulties the Legislature imposed additional filing fees and annual franchise taxes upon all the corporations chartered in the state. [101]

[98] Cadman, **supra** note 84 at 115.

[99] Kirk, **supra** note 21 at 246.

[100] It was the first state in which this constitutional provision was adopted as an amendment to an existing constitution. Cadman, **supra** note 84 at 186

[101] Kirk, **supra** note 21 at 247

The New Jersey general incorporation law of 1875, is the ancestor of modern incorporation laws. The procedure for incorporating was very simple; corporations could be formed without regard to the residence of the incorporators or the corporation's primary place of business. Directors might hold their meetings, have an office and keep the books outside the state. [102]

In 1887 James Dill (a New York corporation lawyer) and Leon Abett (former Governor of New Jersey) submitted to the New Jersey government a plan which New York had rejected. They proposed that the state "liberalize" its general corporation laws (i.e., make them attractive to incorporators): under the plan New Jersey would benefit from a substantial increase in revenues and the Corporation Trust Company of New Jersey would be organized to advertise the advantages of incorporating in New Jersey and to act as agents and handle the incorporation formalities for out of the-state incorporators. [103]

That plan received the backing of the Governor and legislature passed acts which allowed the corporations to buy, hold and sell the stock of any other corporation (1888); [104] to do all the business outside of the state (1892); [105] to be formed for any lawful purpose (1892), [106] to

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[102] Butler, **supra** note 72 at 158

[103] Larcom, **supra** note 92 at 61.

[104] See 8 Del. C. 131.

[105] Ibid.

[106] See 8 Del C. 102 [a].

give the directors broad powers to increase or decrease the amount of capital stock, to change common stock to preferred stock, and to amend the charter (1896),[107] to ease promoters to pay for their shares with property (1896).[108]

The success of the reform was evidenced by the number of corporations [illegible] charter in New Jersey. In 1894 most of New Jersey's state [illegible] in New Jersey [illegible] New York. Another measure of New [illegible] other states. Some [illegible] by [illegible] which was hostile to foreign [illegible] New York in a strategy of imitation. Among them Maine, West Virginia, Arizona and South Dakota. And Delaware. [illegible]

[illegible] DELAWARE

[illegible] DELAWARE [illegible] NEW YORK

[illegible] Delaware convention adopted a new constitution which affected [illegible]. The most significant amendments were the elimination of [illegible] charter for all business associations except banks, the

[107] [illegible]

[108] [illegible] Art. IX, sec. 3. Kirk, supra note 21 at 249.

[109] Kirk, supra note 21 at 250.

abolition of the limit of twenty years for corporate duration and of the limited list of permissible corporate business [110]

To carry out a plan similar to that of New Jersey, under which a "liberal" incorporation law would be adopted, the legislature held a special session to enact a general corporation law. An act was drafted and passed in the 1899 session of the General Assembly. [111]

Some innovative features of this act, that remain in modern acts, were the following: a corporation came into being when its charter was filed with the secretary of state; the requirement of submission to a judge was eliminated; [112] there was neither time limit for corporate existence nor an upper limit on capitalization; [113] Delaware companies could do business, have offices, and hold property outside the state if authorized to do so by their charters, [114] shareholder meetings could be held out of state if the corporation's by-laws allowed; [115] any Delaware corporation could buy, sell, hold, transfer, mortgage or otherwise dispose of the stock and bonds of other corporations of any state or nation; judgment of a corporation's directors would be presumed

[110] Del Cons. Art. XI sec 3 et seq S. Arsht, "A History of Delaware Corporation Law" (1976) 1 Del. J Corp L 1 at 4

[111] E. Folk, **The Delaware General Corporation Law** (1972) at 571

[112] 8 Del C 103 [c] [5].

[113] 8 Del C. 102 [b] [5], 242 [a] [3] Larcom, **supra** note 92 at 92

[114] 8 Del. C. 122.

[115] 8 Del C. 141 [g].

conclusive in their valuation of property exchange for stock, unless there was fraud in the transaction. [116]

Nevertheless some restrictions subsisted: each corporation was required to maintain a resident agent in the state to make service of papers;[117] for purposes of lawsuits, the stock of Delaware corporations would be deemed to exist in Delaware regardless of its actual location; the Court of Chancery could seize the stock to compel the appearance of its owner under penalty of forfeiture; [118] creditors could compel shareholders to pay up to the par value of shares subscribed by them; [119] dissenting shareholders were given the right to force the corporation to buy out their interests in the event of merger or consolidation [120]

Most of these provisions were borrowed from New Jersey's statute almost word by word but, as an additional advantage, Delaware's rates in the original filing fee and in the annual franchise taxes were lower The results of Delaware's policy were not as immediate or spectacular as New Jersey's, but were conclusive [121]

[116] 8 Del C 141 [c].

[117] 8 Del. C. 132 et seq.

[118] 8 Del C 163 et seq

[119] 8 Del. C 162 [a].

[120] 8 Del. C. 262

[121] Larcom, **supra** note 92 at 19.

The judiciary construed the statute in harmony with its precedents. In **Wilmington City Ry. Co. v. People's Ry. Co.,** [122] the Court of Chancery reasoned that the Delaware legislature, in adopting the language of the New Jersey Statute, had intended that Delaware courts adopt the New Jersey Courts' construction of the statute The effect of this interpretation was to confer a level of certainty on a new statute that normally would have taken years of local litigation to develop.

Even today, the preeminence of Delaware is attributed to Delaware's well-developed body of judicial decisions on the meaning of virtually any provision that might be the subject of litigation [123] Other part of the explanation for Delaware's success lies in the willingness of its legislature to modify its corporate statute as required to have an up-dated statute according to the necessities of corporations and incorporators, [124] in a short period of time.

Then in less than twenty years Delaware improved the "liberal" provisions of its statute in points crucial for corporate governance: directors, previously liable for illegal payments of dividends or reductions of capital, could only be held liable upon proof that the violation was willful or negligent (1911); [125] all the corporation's

[122] 47 A 245 (Del Ch. 1900)

[123] Butler, **supra** note 72 at 162

[124] Larcom, **supra** note 92 at 167

[125] 8 Del C. 141 [e].

directors were allowed to be non residents (1915); [126] corporations could issue stock with no par value, and boards of directors could determine the adequacy of payment for it (1917); [127] dividends could be paid from profits arising from any source, eliminating the requirement that profits arise from business (1917).

The evolution of the New Jersey corporate law fostered this tendency. As candidate for Governor of New Jersey in 1910 and for President in 1912, Woodrow Wilson had raised the issue of antitrust laws, making destruction of monopoly a keystone of his "New Freedom." On this issue his mentor was Justice Louis Brandeis, who afterwards became the author of the "Race to the Bottom" theory [128]

After being elected President he decided to pass antitrust acts while still being Governor. The "Seven Sisters," as the bills were called, outlawed attempts to create monopoly or suppress competition, and forbade the chartering of any new holding companies. Moreover, the acts provided that the directors of any corporation entering into agreements fixing prices or restricting competition could be fined $1000 dollars or imprisoned three years or both. [129]

[126] 8 Del. C. 102 [a]

[127] 8 Del. C. 153 [b].

[128] "Companies were early formed to provide charters for corporations in states where the cost was lowest and the laws least restrictive. The states joined in advertising their wares. The race was not of diligence but of laxity". Ligett, **supra** note 52.

[129] Kirk, **supra** note 21 at 257.

Despite the serious concerns expressed by the business community about the effects of the measures, New Jersey legislature passed the bills in 1913. The reaction of incorporators against the state was immediate and drastic. New Jersey lost its position as incorporating state. When in 1917 the legislature repealed the statutes, meanwhile Delaware had consolidated its position. [130]

B- OTHER STATES IMITATE DELAWARE

Since these attempts to regulate corporations at the state level were useless, other states imitated Delaware. By the 1930's most states had passed many laws inspired in the Delaware General Corporation Law. Even after de New Deal era, alongside the expansion of federal regulatory legislation some states still imitated Delaware's example. It appears that after the World War II thirty states did so [131]

The reason was obvious. Some states wished to encourage domestic companies to remain in them while others wished to attract "foreign corporations," in order to increase revenues The sound method to do so was to emulate Delaware by revising their acts along similar lines. Only two or three jurisdictions seem to have resisted that temptation. [132] In

[130] A. Link, **Wilson: The New Freedom** (1956) at 34.

[131] R Nader, **Constitutionalizing the Corporation: The Case for the Federal Chartering of Giant Corporations** (1976) at 60.

[132] G. Seward, **Basic Corporate Practice** (1966) at 5

spite of such efforts Delaware has preserved its character as the leading incorporating state.

Although at its birth in 1943 the Model Business Corporations Act represented an alternative corporation law varying major respects from Delaware's statute, over the years the Act has been modified to compete with Delaware on its own terms. Nowadays its underlying idea is similar to that of Delaware. Corporate laws are a collection of simple rules on internal matters for business associations, susceptible of contractual arrangements, leaving regulation of external activities either to the jurisdiction of the federal and state courts or to specific federal statutes enforced by administrative agencies. [133]

C DELAWARE IN THE LAST DECADES

In 1963 the Delaware legislature commissioned a Revision Committee to conduct a comprehensive review of the State's General Corporation Law After three years working the committee submitted a project that was promptly enacted and became effective on July 3, 1967.

The business community received the reform favorably [134] Delaware confirmed its tradition as an innovative state in corporate matters. The revision achieved the three objectives originally pursued: to update and

[133] A Gibson, "Surplus, so What?, The Model Act Modernized" (1962) 17 Bus Law 476

[134] Nader, **supra** note 131 at 65.

clarify the language of the existing corporation law, to simplify the mechanics for corporate action and to adjust it to the realities of modern corporate life; and to make changes in the substantive provisions of the statute where experience had shown that improvements could be made. The commission recognized the importance of keeping the body of precedents built up over more than sixty years, and for that reason it preserved as much of the traditional wording [135]

Under this revision some traditional restrictions on corporate activity disappeared from the Delaware corporations statute: [136] a) a duplicate stock ledger need not to be kept in Delaware, [137] and the stock ledger and other corporate records may be kept on magnetic tape, microfilm or any other information storage device; [138] b) if the by laws so provide, the date, hour and place of a shareholder meeting may be set each year by directors resolution, [139] c) a "restated certificate of incorporation" may be filed by a corporation which reflects all the original provisions of and all the successive amendments to the certificate which are at present in effect, and it supersedes all the underlying documents; [140] d) shareholders' meetings may be dispensed

[135] S. Arsht & W. Stapleton, "Delaware's New General Corporation Substantive Changes" (1967) 23 Bus. Law 75

[136] Ibid at 76

[137] 8 Del. C. 220

[138] 8 Del. C. 224

[139] 8 Del. C. 21 (a) & (b).

[140] 8 Del. C. 245 & 256.

with if a consent is signed by the number of votes necessary to take the intended action.[141]

[141] Del. C. § 228. For major changes since 1967 see subsequent discussion in sections IV and V.

III

DELAWARE AND THE THEORIES OF THE FIRM

1 SEPARATION OF OWNERSHIP FROM CONTROL

A GOVERNANCE OF WIDELY HELD CORPORATIONS

For the critics of Delaware corporate law the fundamental issue is "what a corporation law ought to be" as opposed to "what a corporation law is." They offer their own idea of a *"good"* corporate governance and its relations with federal and state law, by contrast with what they regard as a "bad" system.[142]

[142] W Cary, "Federalism and Corporate Law Reflections upon Delaware" (1974) 83 Yale L J 663, Comment, "Law for Sale A study of the Corporation Law of 1967" (1969) 117 U Pa L Rev 861; W Conard, "An Overview of the Laws of the Corporations" (1973) 71 Mich L Rev 623; M Eisenberg, "The Modernization of Corporate Law An Essay for Bill Cary" (1983) 37 U of Mia L Rev. 187; E Folk, "State Statutes: Their Role in Prescribing Norms of Responsible Management Conduct" (1976) 31 Bus Law 1031; R Jennings, "Federalization of Corporation Law Part Way or All the Way" (1976) 31 Bus Law 991; D Schwartz, "A case for Federal Chartering of Corporations" (1976) 31 Bus Law 1125

The basic premise in the Berle and Means' thesis that the separation of ownership from control in the widely held corporations eliminates the incentives of managers to act in interest of shareholders. Because shareholders are highly dispersed, they are unable to exercise effective control over corporate affairs. The real power lies in the hands of managers who usually hold only a small percentage of the corporation's shares.[143]

Shareholders have the right to vote and to sue for breaches of fiduciary duties, but they have no access to the relevant information needed to make a rational decision. Even if an individual shareholder wishes to take an active role in the corporation's affairs, he may lack the necessary information or the knowledge required to understand it. Delaware's critics observe that while economic concentration is increasing rapidly in certain industries through mergers and acquisitions, the power of vote of ordinary shareholders becomes diluted because ownership is spread over a diffuse and apathetic group. The easiest thing for an unhappy shareholder to do is to sell his stock and invest elsewhere.[144]

Aiding the divorce of ownership and control are the institutional investors (insurance companies, banks, trust departments, savings and loan association, mutual funds, and pension funds) who have themselves

143 Berle & Means, **supra** note 79 at 112-113

144 Comment, **supra** note 142 at 896

managers Since the they are one of the most important shareholders of American corporations, when they do not use their power, they help management in insulating from control.

For Delaware's critics, the present corporate structure means that the power of corporations is sustained by the bureaucratic structure within the corporation and for that reason corporate decisions will be largely anonymous and unaccountable. Isolated managers are emboldened to make decisions that aggrandize the power of the corporation, at the expense of stockholders, creditors and even society [145]

The conclusion for this critics is clear, state regulation has failed and federal intervention is necessary to prevent managers from exploiting shareholders; [146] only the federal government through specialized agencies can protect adequately dispersed and institutional investors, creditors and society

B CORPORATION'S CONFLICT OF INTERESTS

Delaware's success would have its explanation in the preference of managers who realize that Delaware corporate law benefits them at the

[145] Schwartz, **supra** note 142 at 1129

[146] 'So through various statutory changes the stockholders' position, once a controlling factor in the running of the enterprise has declined from extreme strength to practical impotence The legal changes probably have merely recognized the underlying economic fact " A Berle & G Means, **supra** note 79 at 141

expense of shareholders.[147] Certain judicial decisions would illustrate that the Delaware courts have undertaken to carry out the "public policy" of the state (i.e., raising revenues for the state[148]) creating a "favorable climate" for management (i.e., granting freedom to managers). In this sense Delaware corporate law is "bad."[149]

[147] After the publication of the Cary article, most commentators have agreed that Delaware provided inadequate protection for shareholders. The American Law Institute proposed **Principles of Corporate Governance and Structure: Restatement and Recommendations** (Tent. Draft. No. 1, 1982; Tent. Draft. No. 2, 1984; Tent. Draft. No. 4, 1985; Tent. Draft. No. 5, 1985) centered on the establishment of higher standards of directors' liability of corporate decisions.

[148] Cary, **supra** note 142 at 684. The legislature itself has recognized that fact in its Preamble to the statute that created the commission to study and recommend revisions to Delaware's corporation law (v. 54, ch. 218 [1963] Del. Laws 724):

> "WHEREAS, the State of Delaware has a long and beneficial history as the domicile of nationally known corporations; and
> WHEREAS, the favorable climate which the State of Delaware has traditionally provided for corporations has been a leading source of revenue for the State; and
> WHEREAS, many states have enacted new corporation laws in recent years in an effort to compete with Delaware for corporate business; and
> WHEREAS, there has been no comprehensive revision of the Delaware Corporation Law since its enactment in 1899; and
> WHEREAS, the General Assembly of the State of Delaware declares it to be the public policy of the State to maintain a favorable business climate and to encourage corporations to make Delaware their domicile ..."

The goal of the revision commission was "to ascertain what other states have to attract corporations that we do not have." (Comment, **supra** note 117 at 861). For similar reasons, the commission decided that the revision should not follow the ABA-ALI Model Business Corporation Act (1966 ver.): "... We do not want to be a "me too" state in view of the fact that in the past most of the other States had copied our laws and that we should be a leader not a follower" (Ibid. at 866-67).

[149] Cary, **supra** note 142 at 668.

A "good" corporate law has as "public policy" protecting various interests against any possible conflict. Hence Delaware's critics analyze the interests that corporate law ought to protect and propose the different legal devices that should be used

1 CREDITORS' INTEREST

Although creditors have no direct share in the success of a corporation, they lend it money or goods only on the strength of the corporation's promise to repay. Hence, they wish to ensure payment requiring the presence of substantial assets, preventing the encumbrance of those assets by obligations which would subordinate their claims to those of other creditors and limiting the paying out of those assets to shareholders.

Attainment of these objectives could be facilitated by various limitations in the laws governing corporations, precisely those that Delaware law (and most of the states') lacks: requirement that a corporation could not be chartered, or cannot begin business, until a certain amount of money or assets is paid in by shareholders; that shareholders who promise to pay a certain amount for their shares might be made personally liable for that amount, even if the enterprise never makes a start; that stock may only be issued for cash, or for property which has a definite value, and that the by laws set out specific circumstances under which the dividends may be paid to the shareholders.[150]

It seems clear that in this point the critics long for the traditional corporate law of the nineteenth century, whose features would perfectly coincide with the restrictions they suggest.

2. SHAREHOLDERS' INTERESTS

For Delaware's critics, separation between ownership and control, means that there are two categories of shareholders: management investors, who plan the organization of a corporation and retain control over its operation, with a position to profit at the expense of other investors and creditors, and outsider investors, who are not part of the management investors group, with a position similar to that of other creditors.

To avoid the inherent conflicts of interests, corporate laws should regulate strictly the organization and behaviour of the corporate entity, protecting the interests of outside shareholders, and not furthering the interests of a privileged management. By contrast, Delaware corporate law would lack the protection of adequate provisions on cumulative vote, preemptive rights, class votes, appraisal rights.

3. GENERAL INTERESTS

150 Kirk, **supra** note 21 at 237

Society is concerned with corporate activities for the impact on issues like pollution, salaries, prices, safety, etc. Since some abuses are possible, corporate laws should be aimed directly at balancing the relations between corporations and other associations and persons, imposing prohibitions and restrictions to dangerous conducts.

Delaware corporate laws would not include provisions to accomplish such purposes, more seriously, it would lack essential restrictions to the scope of a corporation's activities: upper limits on capitalization, prohibition against holding property or doing business outside the chartering state; limitations or prohibitions for corporations to hold shares of other corporations, requirement that one or more directors be state residents.[151] Once again the critics referred to the traditional restrictions of the nineteenth century corporate law.

II. THE CORPORATION AS "NEXUS OF CONTRACTS"

A. EFFICIENCY OF SEPARATION BETWEEN OWNERSHIP AND CONTROL

Delaware has also its defenders.[152] They reject the premise of the

[151] Kirk, **supra** note 41 at 242.

[152] S. Arsht, "Reply to Professor Cary" (1976) 31 Bus. Law. 1113; B. Baysinger & H. Butler, "The Role of Corporate Law in the Theory of Firm" (1985) 28 J. Law & Eco. 179; B. Baysinger & H. Butler, "Race for the Bottom v. Climb to the Top: The Ali Project and Uniformity in Corporate Law" (1985) J. Cor. Law 431; P. Dodd & R. Leftwich, "The Market for Corporate Charters: Unhealthy competition versus federal regulation" (1980) 53 J. Bus. 259; Easterbrook, "Two Agency Cost Explanations of Dividends" (1984) 74 Am. Econ. Rev. 650; Easterbrook,
(continued...)

dangerous effects of the separation of control from ownership. [153] It is true that ownership and control are separated in the large modern corporation. However, it seems rational that shareholders should not need or desire to exercise direct control over managers' decision making. [154]

> "Corporate efficiency calls for decisional and operational processes wholly inconsistent with periodic, much less constant, intrusion by shareholders. Such intrusion not only reduces efficiency but carries with it other costs, such as legal fees and increased personnel needs, which the shareholders themselves must ultimately bear." [155]

Both closely held and widely held corporations have their own mechanism in charters or by laws to assure shareholders their proper role in the

152 (continued)
'Managers' Discretion and Investor's Welfare: Theories and Evidence" (1984) 9 Del. J. Corp. L. 540; Easterbrook & Fischel, "Auctions and Sunk Costs in Tender Offers" (1982) 35 Stan. L. Rev. 1; Easterbrook & Fischel, "The Proper Role of A Target's Management in Responding to a Tender Offer" (1981) 94 Harv. L. Rev. 1161; D. Fischel, "The Race to the Bottom revisited: Reflections on Recent Developments of Delaware's Corporation Laws" (1982) 76 N.W. Law Rev. 913; D. Fischel, "The Corporate Governance Movement" (1982) 35 Vand. L. Rev. 1259; D. Fischel & Bradley, "The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis" (1986) 71 Cornell L. Rev. [illegible]; Kraakman, 'Corporate Liability Strategies and the Costs of Legal Controls" (1984) [illegible] Yale L.J. 857 at 864); J. Macey & G. Miller, "Toward an Interest Group Theory of Delaware Corporate Law" (1987) 65 Tex. L. Rev. 469; McBride, "Delaware Corporate Law: Judicial Scrutiny of Mergers: The Aftermath of Singer v. The Magnavox Company" (1978) 33 Bus. Law. 2231; R. Winter, "State Law, Shareholder Protection and the Theory of the Corporation" (1977) 6 J. Legal Stud. 251; Watts & Zimmerman, "Agency Problems, Auditors, and the Theory of the Firm: Some Evidence" (1983) 26 J. L. & Econ. 613.

153 See **supra** note 79 at 35.

154 Macey & Miller, **supra** note 152 at 476.

155 Winter, **supra** note 152 at 276.

life of the firm. Before the incorporation the potential shareholders themselves decide what is appropriate to their needs since they can write the type of charter they want. After the incorporation potential investors can examine the charter and by-laws to assess the role they will have, and they can refrain from investing or after investing they can require certain measures [156]

Delaware' defenders accept that the interests of shareholders often diverge from the interests of the managers. As rational economic actors, managers will be concerned with maximizing their own utility rather than the shareholders' utility and shareholders will have incentives to limit the extent of their risks, looking at the charter and by-laws and exercising all their vested rights.

However, it is very unlikely that investors entrust their money to managers without certain incentives to act in their interest and therefore that they voluntarily invest in firms located in Delaware if its law exacerbated the detriment to shareholders caused by the separation of ownership and control. The evidence is that investors buy and sell stock of Delaware corporations successfully, therefore there is no reason to suppose that they dislike the Delaware corporate law because it lacks the protection they need [157]

[156] Winter, **supra** note 152 at 277

[157] Fischel, The Race, **supra** note 152 at 913.

Delaware's defenders have adopted the "Nexus of Contracts Theory": corporations are nexus of contracts not property of shareholders. Corporations like other business associations, are simply "legal fictions" which serve as nexus for a set of contractual relationships between investors and management, among investors, between the corporation and suppliers of goods, services, labour and loans. Shareholders would not be the only "owners" of the firm, but one of the contracting parties in the "nexus." More exactly the corporate enterprise is a venture in which stockholders furnish the capital and receive dividends and management furnish services and receive remuneration.[157]

> [illegible] the contract under which the stockholder is said to offer [illegible] investment [illegible] exchange for managerial services) is "legitimate" and "freely" made by the parties, then on [illegible] competition, its performance makes each of the parties [illegible] and [illegible] a larger pie for society."[158]

[illegible] of capital from ownership of management is an [illegible] corporation, merely a case of [illegible] with efficient allocation of risk bearing.

[157] [illegible] Posner, **Economic Analysis of Law** (2d ed. 1977) at 292 [illegible] "Theory of the Firm: Managerial Behaviour, [illegible] (1976) 3 J. Fin. Econ. 305; [illegible] (1980) 7 J. Fin. Econ. 117, [illegible] Evolution Attributes [illegible] "The Contractual Nature of the [illegible]; Fama & Jensen, "Separation of Ownership and Control" [illegible] J. L. & Econ. 301; Fischel, "Labour Markets and [illegible] Compared with Capital Markets and Corporate Law" (1984) 51 U. Chi. L. Rev. [illegible]; [illegible] "Corporate Governance", (1984) 93 Yale L.J. [illegible]

[158] Fama & Jensen, **supra** note 157 at 291-292.

The rational investor chooses to hold a diversified portfolio containing securities of many firms and has neither the interest or the expertise to manage the affairs of a firm. Rather, he or she prefers to remain passive.[160]

Delaware's defenders observe that not even institutional shareholders have attempted to influence management behaviour. They have a very diversified portfolio and if they were to exert direct control over the firms in which they owned stock, they would have to hire more personnel to keep informed about the activities of each firm. The costs of such personnel probably would force such investors to reduce their diversification.[161]

> "The [management] group consists of people who are experienced in the business and involved in it on a full time, day to day basis. In contrast, the typical shareholder ... is not knowledgeable about the business of the firm, does not derive an important part of his livelihood from it, and neither expects nor has an incentive to participate in the management of the firm. ... It is no more anomalous that shareholders do not manage or control their corporation than that bondholders do not manage or control the corporation whose bonds they hold, or trust beneficiaries the trustee. All three groups have an investment interest."[162]

[160] Fischel, The Race, supra note 152 at 919-20; Winter, supra note 154 at 45[illegible].

[161] Winter, supra note 152 at 254.

[162] Posner, supra note 158 at 301. The distinction between trustees and management have been noted by Professor Winter. Trustees are not charged with the task of hiring the most efficient mix of productive inputs or with monitoring the use of these inputs so as to avoid shirking; they do not profit maximize in the context of the competitive market for products or services; they are not concerned with the innovation in products or methods of production or distribution, the

(continued...)

B. THE MARKET AND THE COSTS OF AGENCY

Delaware's defenders recognize that some costs arise from the separation of ownership and management. The "nexus of contracts" implies an agency in which shareholders are "principals" and managers are "agents." In any agency relationship the interest of the agent can diverge from those of the principal.[163]

Many legal rules and contractual arrangements are attempts to minimize the agency costs and risks that cannot be avoided. Independent committees in response to derivative suits,[164] public offerings of common stock when corporations are paying dividends,[165] and independent auditors of outstanding reputation reduce the costs of the inherent conflicts of interest between corporate managers and shareholders.[166] Arrangements like stock option plans and other compensation

[162] (...continued)
[illegible] they are not engaged in [illegible] effort which requires monitoring and the assignment of residual [illegible] they do not fear that beneficiaries may sell their interests to [illegible] who will install new trustees (Winter, supra note [illegible]).

[163] "Agency costs are said to be inevitable consequence of the [illegible] that come from delegating within the firm the performance of [illegible] to persons who are best (or better) able to perform them, but who have interests that conflict with those that the delegator contracts with them to advance and protect." Fama & Jensen, supra note [illegible] at [illegible].

[164] Fischel & Bradley, supra note 15? at 275.

[165] See Easterbrook, Two Agency Cost, supra note 152 at 654.

[166] See Watts & Zimmerman, supra note 152 at 613.

packages force managers to share the risk with shareholders, while providing managers with an incentive to act in shareholder's interest.

However, Delaware's defenders insist that the market forces provide protection for shareholders that legal rules or contractual bargains cannot provide. The stock market anticipates the costs of agency. The price which investors pay for stock reflects the risk of divergence of interests. It follows that costs have to be outweighed by gains if the price of the stock is to be maintained above it.[167]

From the market's point of view, the agency problem is as much a problem for managers as it is for shareholders. The corporation's success is a necessary condition for management's success. Only shareholders' enrichment can entail managers' enrichment. Only the corporation's success creates opportunities for management to profit.[168]

Delaware's defenders remark that managers, like other people, have strong incentives to maximize the value of their services, since the managerial labour market would use performance of the company to evaluate a manager's ability, with relation to that of other managers. It is harder for a manager to find alternative employment than for

[167] Fischel, The Race, **supra** note 152 at 918.

[168] Winter, **supra** note 152 at 264.

shareholders to find alternative outlets for their shares. The stock market makes alienation easier.[169]

Based on this premise Professor Manne, in a series of articles,[170] has argued that share price and the capital market exert discipline on the behaviour of corporate management. The lower the share price, the easier it will be for others to take over the corporation, profiting by the compensation received as successful managers and by capital gains generated by the increase in share price through greater earnings.[171]

Management tries to induce investors to choose their firm's stock instead of stock in companies incorporated in other states or other countries and other alternative forms of investment in the capital market. Thus management's tenure in office depends on the price of stock because the corporation's ability to compete effectively in the stock market depends on its ability to raise capital.

In other words, for Delaware defenders, the market for managers is a mechanism that should assure corporate stockholders that whatever may be

[169] These arguments are supported by Professor Kraakman's observation that a firm's officers and directors are less efficient risk bearers than a firm's shareholders because they are unable to diversify their human capital investment in the firm (Kraakman, Corporate Liability, **supra** note 1[illegible]2 at 864).

[170] H. Manne, "Cash Tender Offers for Shares — A Reply to Chairman Cohen" (1967) Duke L.J. 231; "Our Two Corporation Systems: Law and Economics" (1967) 53 Va. L. Rev. 259; "Mergers and the Market for Corporate Control" (1965) 73 J. Pol. Econ. 110; "Some Theoretical Aspects of Share Voting" (1964) 64 Col. L. Rev. 1427.

[171] Winter, **supra** note 152 at 266.

the discretion that "agency" vests in management, their corporation will employ managers of the best quality at the lowest cost. Neither managers nor shareholders have interest to see the ability of a corporation to raise capital impaired. Excessive management discretion affects investors and lenders' judgment about the long run earning potential of the firm because raising capital through equity and debt are closely related to managers' behaviour.[172]

In summary, if Delaware permits corporate management to exploit shareholders and other states do not, earnings of Delaware corporation would be less than earnings of comparable corporations chartered in other states; as a consequence Delaware corporations would be at a disadvantage in raising debt or equity in the capital market and would be in disadvantage in the stock market as well, thereby creating a threat of takeover which might replace management.

C. THE INTERACTION OF THE MARKET, MANAGERS' DISCRETION AND SHAREHOLDERS' WEALTH

[illegible] argue that the corporate agency problem is solved, on one hand, by efforts to [illegible] and [illegible] ways to regulate managerial discretion in a manner which [illegible] shareholders [illegible],[173] and on the other hand, by efforts to avoid investors' opportunism in the stock market. The

172 Winter, supra note 1[illegible], at 27[illegible].

173 B. Baysinger & H. Butler, The Role, supra note 157 at 178.

the balance between managers' discretion and shareholders' control is the crucial point of the interactions between the stock market and legal rules.

> [T]he [illegible] relevant discretion [illegible] is also directly related to management's efficiency in profit maximizing on behalf of the firm. The [illegible] that management which generates the highest stock prices will also have the most discretion in the use of corporate assets. [illegible] But shareholders in that firm also benefit from the high stock price. Management discretion and shareholder benefit, therefore, move in the same direction.[174]

Professors [illegible] and [illegible] suggest that the wholesale elimination of management discretion, rather than the definition and correction of [illegible] of shareholder value [illegible], would be detrimental to shareholders as economic organization could not allocate rewards to resources (capital, labour, management) according to their particular productivity.

As the other hypotheses, this is based on principles of economic efficiency and rationality. Extreme strategies of protection will lead to reduction in share price, as investors will become concerned with the [illegible] effects of such strategies, and go to the stock market in search of other profitable alternative investments.[175]

[174] Winter, **supra** note 152 at 2[illegible]1

[175] "For example, the manager who is not allowed to make errors will not be inclined to take risks", Baysinger & Butler, **supra** note [illegible] at 4[illegible]1. See also Easterbrook, Manager's Discretion, **supra** note 152 at [illegible]; Easterbrook & Fischel, Auctions and Sunk Costs, **supra** note 152 at [illegible]; Easterbrook & Fischel, The Proper Role, **supra** note 152 at 1169.

Professors Baysinger and Butler tested the hypothesis in a model[176] which relates shareholder protection with managerial discretionality (the more protection, the less discretion) and also shareholder protection with shareholder opportunism (the more protection, the more opportunism).[177]

The model led to the conclusion that the optimal governance structure for widely-held corporations has to avoid extremes: one which grants too much discretion to managers is not preferred by them because it can induce shareholders to sell their stock; while one which grants too little discretion is not preferred by shareholders because it also can induce a part of them to sell their stock in detriment of the other part and in benefit of "outside" investors. Therefore a balance is required to reduce the risks of excessive managers' discretion and excessive shareholders' opportunism.

Admitting that there is a case for legal restrictions on corporate management, Delaware's defenders insist that these have to be carefully delineated to reduce identified vulnerability of shareholders without creating disincentives to managerial discretion. One of the favorite devices, is that of "independent" directors, who can protect the corporation against management, checking unfair practices (self dealing,

[176] Baysinger & Butler, **supra** note 157 at 451.

[177] See also Maloney, McCormick & Tollison, "Economic Regulation, Competitive Governments, and Specialized Resources" (1984) 27 J. L. & Econ. 329 at 331.

excessive indemnification or compensation), insisting on proper auditing procedures and reviewing corporate decisions of a magnitude sufficient to entail risks.[176]

III. THE FREEDOM OF CONTRACTS ON TRIAL

A. SHAREHOLDERS AS CONTRACTING PARTIES

The economic analysis of Delaware's defenders is sound. Under its own premises it seems unbeatable. Nevertheless many objections have arisen, focused mostly on the notion of "contract". [illegible] critics doubt that such a notion can be used to describe either the process of bargaining or the arrangements between investors of publicly held corporations.

[illegible] shareholders cannot, and do not, "negotiate" with owners or managers of the corporation. "Stockholders vote for directors and have [illegible] to act for them. In that process, it is plain that

[176] A. Alchian & H. Demsetz, "Production, Information Costs and Economic Organization" (1972) 62 Am. Econ. Rev. A similar conflict could appear between minority and majority shareholders. There are cases in which a shareholder or group of shareholders seem to lose rights within the corporation (e.g. elimination of dividends). As Professor Winter points out, the problem is the trade-off between the benefits of eliminating all defeated minority expectations and the cost of injuring shareholders. "Legal rules which seek to minimize such problems by giving one side or another rebuttable or conclusive presumptions may, on the other hand, invite the unreasonable behaviour they seek to control." Winter, **supra** note [illegible] at [illegible] Independent committees are frequent in Delaware corporate code, see 8 Del. C.

stockholders have less knowledge and fewer possibilities of election, than the "nexus of contracts" theory assumes.[179]

Delaware's critics observe that most of the times the board is effectively nominated and elected by incumbent management, and the proxy system leaves stockholders with the passive role of voting for or against nominees who are preselected.[180] They know virtually nothing about the nominees since the information expressly required by SEC rules, apart from items concerning remuneration or compensation and possible conflict of interests, is a description of prior posts with the corporation and other business experience or occupation during the previous five year.[181]

On the same track, management's duties and rights are rarely defined by agreement, and more rarely stipulated to or negotiated with stockholder participation. At best the proxy statement informs stockholders of the array of awards management may receive by way of different forms of compensation or other benefits.[182] Even when the legally imposed terms are embedded in the contractual arrangements between investor and manager, stockholders' ability to learn about or affect the terms of the

[179] See 8 Del. C. 142 (a)

[180] See V. Brudney, "Corporate Governance, Agency Costs, and the rethoric of Contract" (1985) 85 Columb. L. Rev. 1403; M. Mace, "Directors: Myth and Reality — Ten Years Later" (1979) 32 Rutgers L. Rev. 293; Note, "The Propriety of Judicial Deference to Corporate Boards of Directors" (1983) 96 Harv. L. Rev. 1894

[181] **Securities Exchange Act Proxy Rules**, Schedule 14A, item 6

[182] Brudney, **supra** 180 at 1413

relationship are limited.[183] Such terms are ambiguous and permit a wide range of discrepancies as to the diligence and intelligence of managers.[184]

Besides, the critics remark, at any time the content of legally imposed restrictions on managerial discretion varies among jurisdictions because of the competition among the states. Moreover, in any particular jurisdiction changes occur in the law over time.[185]

> Experience and observation suggest that investors operate on gross (though not unreasonable) assumptions about how insiders will behave, and that few, if any, investors including sophisticated ones are capable of anticipating decisions like **Lieven v. Sinclair**, **Cheff v. Mattes** or **Barret v. Denver Tramways**

[183] Brudney, **supra** 140 at 1415.

[184] In particular, Professor Brudney notes that the case law has moved in the direction of giving directors and management unreviewable discretion in serving themselves at the expense of stockholders by expanding the applicability of the business judgment rule to measure performance of the duty of loyalty by the standards applied to the duty of care. For authorities see Brudney, **supra** 140 at 1414.

[185] Professor Brudney rejects the assumption that in deciding particular cases courts might limit managerial discretion by construing the expectations of the parties to what the parties rationally would have agreed on ex ante because in bargaining theory contingent considerations preclude uniquely "rational" answers and implicit value judgments infect apparently neutral "rational" answers. Thus "rational" answers will vary with differences in the circumstances under which the parties are assumed to bargain, and with the extent of individual autonomy envisioned as appropriate for society. Therefore, attempting to construe what the parties would have done leaves the arbiter considerable freedom of decision, often allowing quite contradictory results. See Brudney, **supra** 140 at 1415-16; see also Farnsworth, "Disputes over Omission in Contract" (1968) 68 Columbia L. Rev. 860 at [illegible]; [illegible], "The Economics and Jurisprudence of Convertible Bonds" [illegible] Wis. L. Rev. [illegible]; Burton, "Breach of Contract and the Common Law Duty to Perform in Good Faith" (1980) 94 Harv. L. Rev. 369, at [illegible].

"Security holders do indeed expect to be treated "fairly," but they have no accurate perception about the limits placed on fiduciary conduct by the states in which their issuers are incorporated, and of course not one investor in a thousand would be likely to be sure which state that was. In effect, fiduciary rights are not, and probably cannot be anticipated."

[illegible]

[illegible] expect management to work diligently and skillfully to maximize their wealth. However, investors' knowledge and volition are very different from the kind of knowledge and volition that are the [illegible] of contract and [illegible]

[illegible]

[illegible] supra [illegible]

[illegible] The Regulation of Corporate Governance: The Monitoring Board, and the Director's [illegible] (1983) [illegible] L. Rev. [illegible]; [illegible], "Are [illegible] Getting Out of Hand?" (1984) [illegible] L. Rev. [illegible]; [illegible], [illegible] the New Board: Behavioral Science and Corporate Law (1981) 80 Mich. L. Rev. [illegible]; Solomon, "Restructuring the Corporate Board of Directors: Fond Hope - Faint Promise?" (1979) 76 Mich. L. Rev. [illegible]

Directors are likely to identify more closely with officers and employees than with stockholders.[188]

B. LIMITS IN THE MARKET'S OPERATION

1. LIMITS IN THE MANAGERS MARKET

The critics state that the market for managers is exceptionally imperfect, especially because of due to top managers' limited mobility, difficulties in pricing managerial services or assessing the managerial quality. There is no disclosure that can explain either magnitude of managerial discretion, or the uncertainties of the connection between [illegible] and managerial inputs.[190]

[illegible] the empirical inquiries that suggest a relationship between [illegible] corporate performance and management's compensation, and between [illegible] corporate performance and management's displacement,[191] do not demonstrate that the managers' labour market either adequately describes the relation of stockholders and management or adequately aligns their interests in the corporation's prosperity. The question whether

[188] Bradley, **supra** 130 at 1431.

[190] See Klein, Contracting Cost and Residual Claims: The Separation of Ownership and Control' (1983) 26 J. L. & Econ. 367.

[191] Note, Management Compensation and the Managerial Labour Market (1985) [illegible] J. Acct. & Econ. [illegible]; Coughlan & Schmidt, Executive Compensation, Management Turnover, and Firm Performance: An Empirical Investigation (1985) [illegible] J. Acct. & Econ. 43; Murphy, "Corporate Performance and Managerial Remuneration: An Empirical Analysis" (1985) 7 J. Acct. & Econ. 11.

management receives more compensation and less responsibilities than what is necessary to induce optimal efficiency is still a field to be explored.

2. LIMITS IN THE STOCK MARKET

Delaware critics maintain that the stock market is not a guarantee for shareholders, since it does not encourage competition by managers in disclosing the extent of their discretion concerning inputs or rewards. Thus its operation does not remedy the disproportion between information available on managerial discretion and managerial quality.[182]

Rather, the general risks that affect all market assets affect the price of a particular stock and therefore this price does not reflect only firm-specific risk. Hence any decision to buy or sell stock incorporates aspects that are indifferent to managerial performance. Moreover it is doubtful that the market can incorporate in stock prices any adequate estimate and discount of the risks of changes in the rules limiting managerial discretion. Therefore the price cannot properly reflect stockholder preferences concerning the appropriate scope of managerial discretion.[183]

In other words, for Delaware's critics, the choice to buy or sell does not permit separation of treatment of the quality of management. From

[182] Brudney, **supra** 180 at 142[illegible]

[183] Brudney, **supra** 180 at 1425-26

other aspects (e.g., firm's present or expected success). Investors do not have the ability to separate and assess management apart from the other components of the enterprise.[184]

It is true that the stock market eases the takeover movement, that induces managements to be "efficient," i.e., maximizing shareholder wealth. However there is evidence of a direct relation between the size of the takeover and management buy out premiums paid in the last years.[185]

Although stock price analyses suggest negative performance by takeover targets before the takeover bid, that does not necessarily means that takeovers reflect the displacement of incompetent, or the replacement by more competent management. The post acquisition results have raised serious doubts.[186]

Takeovers might reflect more the desire for self-aggrandizing acquisitions of bidder managers to diversify their own risks at shareholders' expense, than efforts to displace "inefficient" target

[184] For a critique of this theory see Gordon & Kornhauser "Efficient Markets, Costly Information, and Securities Research" (1986) 60 N.Y.U. L. Rev. 111; T. Copeland & J. Weston, **Financial Theory and Corporate Policy** (2d ed. 1983) at 319-47; Ackley, "Commodities and Capital: Prices and Quantities" (1983) 73 Am. Econ. Rev. 1 at 4.

[185] Jensen & Ruback, "The Market for Corporate Control: The Scientific Evidence" (1983) 11 J. Fin. Econ. 5 at 23-26.

[186] Ibid. at 16-22. See also Gilson, "A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers" (1981) 33 Stan. L. Rev. 819 at 873-74; Levine & Aaronovitch, "The Financial Characteristics of Firms and the Theory of Merger Activity" (1981) 30 J. Indus. Econ. 149 at 157; Troubh, "Characteristics of Target Companies" (1977) 32 Bus. Law. 1301 at 1302.

management. Also, sale by the target's shareholders in response to bids is not necessarily a vote of confidence in the bidder's management.[197]

> "To argue that the investor trades off the prerogatives of a sole owner in exchange for liquidity and the ability to diversify, neither reduces the breadth of management discretion nor increases investor awareness of the problem. The questions of adequacy of knowledge and volition remain: Does the investor know what he is giving up and what he is getting? And should he (institutionally) be given a better opportunity (choice) to negotiate or receive a tighter bargain that the market offers him?"[198]

C. RISKS OF AGENCY

The main critique to the "nexus of contracts" theory is that the traditional agency relationship does not delineate the relationship between investors and management of large public corporation. The investor principal has neither control nor direction to his manager agent.[199] Stockholders do not direct management's activities. They do not have power or ability to interfere in management's activities (ex ante or ex post), in particular because there is no direct face to face

[197] See Easterbrook & Fischel, The Proper Role, **supra** note 152 at 1185. See also Amihud & Lev, "Risk Reduction As a Managerial Motive for Conglomerate Mergers" (1981) 12 Bell J. Econ. 605; Marris & Mueller, "The Corporation, Competition, and the Invisible Hand" (1980) 18 J. Econ. Lit. 32 at 40-45; Note, "The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach" (1979) 88 Yale L.J. 1238.

[198] Brudney, **supra** 180 at 1428.

[199] Brudney, **supra** 180 at 1430.

or personal communication or involvement by "the principal" in the operation of the enterprise.[200]

Delaware's critics observe that there are always severe limitations to the power of dispersed stockholders to control management's decisions, through "independent" directors or auditors. There are structural and institutional impediments for the execution of any kind of monitoring. Management's knowledge and experience in the corporate business are always superior to those who play a part time role and receive a part time compensation.

The resources available to management (for instance in terms of staff) are also superior to those available to "outsiders."[201] More seriously, if the "outside" directors were on equal footing with management, they would be "inside" directors. Such event would not provide an independent check on management discretion so much as duplicate and relocate the very same discretion.[202]

D. EROSION OF THE DUTIES OF LOYALTY AND CARE

For Delaware's critics, failure to appreciate the magnitude of the difference between true principal-agent relationships and the investor-management relationship leads to confusion between the

200 Ibid.

201 Brudney, **supra** [illegible] at 1403; Winter, **supra** note [illegible] at 285-86.

202 Winter, **supra** note 1?? at 288.

fiduciary duties imposed by the law of agency and the fiduciary duties suitable for corporations.[203]

1. Duty of Loyalty

The law of agency prescribes a categorical prohibition of transactions which, even if producing benefit for the principal, could result in a diversion of some benefit to the agent that would be difficult or impossible to detect or to measure; the only exception the law contemplates is informed consent by the principal to particular dealings.[204]

By contrast, state corporate law has relaxed the prohibition and its exception to permit direct and indirect self-dealing, and other diversionary transactions. Instead of prohibition, corporate law, in spirit, the "theory of contract," allows a majority of stockholders or "independent" directors to give consent to otherwise prohibited transactions, subject only to the constraint of "fairness."[205]

2. Duty of Care

[203] Brudney, **supra** note 152 at 14[illegible].

[204] Brudney, **supra** 1[illegible] at 14[illegible]. See also Marsh, "Are Directors Trustees? Conflict of Interest and Corporate Morality" (1966) 22 Bus. Law 35; Philips, "Managerial Misuse of Property: The Synthesizing Thread in Corporate Doctrine" (1979) 32 Rutgers L. Rev. 184 at 188-90.

[205] On the "independence" of directors, see M. Eisenberg, "Legal Models of Management Structure in the Modern Corporation: Officers, Directors and Accountants" (1975) 63 Calif. L. Rev. 375 at 380-84.

The critics note that the corporate law offers no more than admonitions to corporate agents to exercise care or to be diligent and prudent. There are no formal prohibitions or mandates that encourage the fulfillment of such duty. Management's and directors' fiduciary duty is addressed to minimal discharge and not to maximal efforts. Even the minimal [illegible] thus required seems to be less demanding, because of [illegible] that require the degree of prudence to be exercised by directors to be only that exercised by persons "in a like position" [illegible] in their own personal affairs."[206]

[illegible] standards of required behaviour is coupled by [illegible] according to which liability [illegible] from "gross" negligence and "mere" negligence and the "business judgment rule," which protects executives and directors, creates a 'presumption' of informed [illegible] in good faith and in 'the honest belief that [illegible] in the best interests of the company.'[207]

> In any event the law's admonitions are necessarily vague in directing management's and directors' efforts in any task that requires [illegible] (i.e., not self-serving) discretion in the effort to achieve the goal of maximizing stockholder wealth, whether in innovative strategic policies or in normal

[206] Cudney, **supra** [illegible] at 1110. See also Cohn, "Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule" (1983) 62 Tex. L. Rev. 591 at 626.

[207] See Veasey & Manning, "Codified Standard — Safe Harbor or Uncharted Reef" (1980) 35 Bus. Law 919, 926-30; Bishop, "Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Directors and Officers" (1968) 77 Yale L.J. 1078 at 1099.

> continuing operations. And the more such discretion the task requires, the less meaningful or compelling is the law mandate."[208]

For the critics it is obvious that for larger organizations, with specialized human and material assets and more complex information flows, the scope of managerial discretion is large and admonitions to exercise diligence or prudence are useless. Such a discretion can impose on society and investors costs that cannot be reduced by contractual solutions. One of the parties (stockholders) is unable to function effectively in the bargaining and monitoring process, without some federal intervention.[209]

C. RELATIONS BETWEEN PARENT AND SUBSIDIARIES

Other critics have observed that most of the American businesses are conducted through complex holding company systems. The business assets of these corporate systems are not held by the parent corporation but by those subsidiary corporations [illegible] so that the ownership of the assets is once, twice or more removed from the assets themselves.[210] State corporate laws, and Delaware among them, fail to deal with that problem.

[208] Brudney, **supra** 180 at 1442.

[209] Brudney, **supra** 180 at 1443. But see **Smith v. Van Gorkom, infra note** 483 and accompanying text.

[210] M. Eisenberg, "Megasubsidiaries: The Effect of Corporate Structure on Corporate Control" (1971) 84 Harv. L. Rev. 1577.

When the business assets are removed from effective control by the shareholders of the parent company,[231] the directors of that company are able to acquire or dispose of such assets or redeploy them among units without the necessity of obtaining permission from the shareholders, either of the parent company or of the subsidiaries. The directors of the parent company play the role of the shareholders of the [illegible] through exercising the voting power vested in the parent.[illegible]

[illegible] with compulsory [illegible]

> [illegible] exchange rate for the public [illegible] determined unilaterally by the [illegible] management, rather than through arm's length [illegible] the [illegible] of the merger is virtually [illegible] equivalent to [illegible] approval by the [illegible] subsidiary [illegible]

[illegible] appraisal right. Although [illegible], these rights cannot provide an [illegible] that kind of transaction, because appraisal [illegible] uncertain, and it is unlikely to produce a better [illegible] of [illegible] transaction.[illegible]

[illegible]

[illegible] The Legal Rules, supra note 234 at 384

[illegible] V. Brudney & M. Chirelstein, "Fair Shares in Corporate Mergers and Takeovers" (1974) 88 Harv. L. Rev. 297 at 298

[illegible] Eisenberg, The Legal Rules, supra note 234 at 85.

IV CONCLUSION

The critics maintain that Delaware corporate law enables managers to proceed with excessive discretion (not only for the entity's benefit but for that of the managers), and fetters the corporation with a minimum of responsibilities to its creditors, its shareholders, and the public.

[illegible] the major [illegible] of Delaware would be that its development influences the development of corporate law in other jurisdictions. Delaware [illegible] law of corporations. Any [illegible] for the protection of shareholders, [illegible] the public [illegible] than Delaware's [illegible] they can be nullified by the [illegible] reincorporating in another state.[215]

By contrast, [illegible] defenders maintain that [illegible] in the interest of management [illegible] which tends to [illegible] the competition between

215 [illegible], supra [illegible]. [illegible] pseudo-foreign corporation statutes of many states [illegible] of the state corporation law are of limited application. The typical statute provides that no foreign corporation may transact intrastate business without first having obtained a certificate of qualification from the Secretary of State (Cal. Corp. C. 2105; Ill. Bus. Corp. Act 13.05; N.Y. Bus. Corp. Act 1301) and that they must file an officers' certificate annually with the Secretary of State (Cal. Corp. C. 2108; Ill. Bus. Corp. Act 14.05) and other statements (Cal. Corp. C. 2107; Ill. Bus. Corp. Act 14.20). Pseudo-foreign corporations are required to comply with certain sections of state law for the protection of creditors and shareholders, to the exclusion of the law of the jurisdiction in which it is incorporated (Cal. Corp. C. 2115; N.Y. Bus. Corp. Act 1317).

states for charters is a competition on which legal systems provide an optimal balance between the two. If Delaware is the leading state in that competition, it is because Delaware's legal rules are the most appropriate for all the participants in the market.[211]

[illegible] because it provides the [illegible] shareholder and [illegible] would emerge in Delaware through [illegible] Adam Smith [illegible] which the self [illegible] and [illegible] legal [illegible] of [illegible]

[illegible] supra [illegible] For an analysis of the pattern [illegible] see infra note 556 and accompanying text.

[illegible] & Miller, supra note [illegible] at 477. "The liberality of state [illegible] evidence, not of management overreaching, but of the fact that state law has moved in a direction consistent with an economic model of the [illegible] function." Winter, supra note 1[illegible] at 290.

IV

DELAWARE AND SHAREHOLDERS

INTRODUCTION

Nowadays the [illegible] not the [illegible] flexible formalities or procedures for incorporation in Delaware or the wide scope allowed for corporate activities. Most of such provisions are now part of the corporate codes of other states. The controversy about the Delaware corporate law is now circumscribed to the balance between shareholders' rights and directors' duties. For this reason the next two sections deal with such rights and duties, rights and duties that delineate the range of shareholders' protection and managers' discretion.

Delaware Corporation Code [illegible] It authorizes and supports private arrangements that permit firms to contract around the statutory scheme by drafting or amending their corporate by-laws or charters. It follows the principle that a detailed and mandatory [illegible] statute may not be suitable for all sort of corporations. Hence most rules of the Delaware Corporation Code only apply in default of any [illegible] contrary in the corporate charter or by-laws.[218]

[illegible] flexibility [illegible] supplemented by a rule of interpretation under which an [illegible] section of the Code is [illegible] permitted if it is authorized under one other section of the Code [illegible] eliminates the necessity for those forming [illegible] all future [illegible] when [illegible] of the 1967 Revision [illegible] stop the [illegible] with unforeceable [illegible]

[illegible]

[illegible] internal affairs" [illegible] officers, directors, and [illegible] the relations between such

[illegible] Managers, supra [illegible] at 549

[illegible], 41 Del. Ch. 361, 365067, 195 A. 2d 375, 377-78 (1963)

[illegible] "The [illegible] of Expanded [illegible]: An Analysis of [illegible] Express and Implied Contract Terms" (1985) 73 [illegible] Rev. [illegible] at [illegible]

[illegible] Comment, supra [illegible] 143 at 884

[illegible] RESTATEMENT (SECOND) OF CONFLICT OF LAWS §. 301-313 groups and third parties, particularly creditors.[223] A few cases excepted,[224] the federal powers have not made regulations governing the internal affairs of corporations, no matter how extensive their connections with interstate commerce.[225]

As commerce [illegible] the [illegible] of [illegible] jurisdiction on corporations [illegible] in interstate commerce [illegible] with their expansion in number and importance [illegible] nineteenth century. The principle that a person [illegible] to *in personam* jurisdiction in the state where it is [illegible] was [illegible] corporations present not only in the [illegible] everywhere [illegible] at the same time. The [illegible] *in personam* jurisdiction with the [illegible] incorporated under one state [illegible] to other state courts, especially if [illegible] those states [illegible].[227]

The [illegible] *in personam* jurisdiction over [illegible] that each state [illegible] power to render judgment [illegible]

[223] [illegible] *supra* note [illegible] at 147.

[224] [illegible] with federal charter [illegible]

[225] Young, *supra* note 14 [illegible] at 147.

[226] International Shoe Co. v. Washington, [illegible] (1945).

[227] These statutes give states jurisdiction over foreign corporations "to the extent permissible under the Constitution." Macey & Miller, *supra* note 152 at 495.

[illegible] internal affairs. For the conflict-of-laws questions that [illegible], the courts accepted the need for certainty and coherence in the [illegible] law. [illegible] they have constantly applied the law of the [illegible] involving internal affairs of foreign [illegible] excepted.[228]

However [illegible] the law governing the corporation's [illegible] federal courts. Thus a case [illegible] or removed to [illegible] jurisdiction, provided that

[illegible] LAW, [illegible]

Rationale [illegible] the state of [illegible] by the choice-of-law [illegible] the interstate and international [illegible] and uniformity of result, [illegible] expectations of the parties and [illegible] of the law to be applied.

[illegible] officers and shareholders is [illegible] which [illegible] attained by having [illegible] with respect to [illegible] law. To the extent that [illegible] matter, these persons would usually [illegible] and duties with respect to the [illegible] the local law of the state [illegible] easy to identify, and [illegible] application is attained when the [illegible] applied.

[228] [illegible] involving the internal affairs of 'pseudo-[illegible] RESTATEMENT (SECOND) OF CONFLICT OF LAWS s. 302.

the citizenship requirements of 28 U.S.C. 1332 (a) [230] are met or under pendent jurisdiction as part of a case involving a federal issue [231]

Therefore in federal suits involving the internal affairs of Delaware corporations the Delaware laws ordinarily apply. There is an interplay between the **Erie** doctrine [232] (according to which the substantive law to be applied by the federal courts in any case is state law, except when the matter is properly a federal matter) and the conflict-of-laws principle [233] that the law of the chartering state governs the corporation's internal affairs [234]

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[230] 28 U.S.C. § 1332 (1976). This provision is applicable to derivative suits brought on behalf of a national corporation against management or controlling shareholders, for breach of fiduciary duties, if the corporation has a financial interest of more than $10,000 in the litigation. The difficulties to establish the diversity jurisdiction and to find a federal forum are discussed in Young, **supra** note 142 at 154.

[231] This doctrine enables a federal court to exercise jurisdiction over nonfederal claims for which there is no independent jurisdictional basis when these claims are related to federal claims properly before the court (Marcey & Miller, **supra** note 152 at 495). See **Forest Labs., Inc. v. Pillsbury Co.**, 452 F.2d 621, 629 (7th Cir. 1971) (finding that claims under Delaware law against a Delaware corporation could be brought in the federal court even without diversity if the claims are sufficiently related to federal claims also brought against the corporation).

[232] **Erie R.R. v. Tompkins**, 304 U.S. 64 (1938).

[233] In **Klaxon v. Stentor Elec. Mfg. Co.**, 313 U.S. 487, 496 (1941), and in **Day & Zimmerman, Inc. v. Challoner**, 423 U.S. 3 (1975), the Supreme Court decided that the **Erie** doctrine requires a federal court to apply the conflict-of-laws rules of the state in which the federal court sits.

[234] **First Nat'l City Bank v. Banco para el Comercio Exterior de Cuba**, 462 U.S. 611, 621 (1983).

It appears that a substantial proportion of actions are brought in Delaware. Partly because under the doctrine of **forum non conveniens** other states' courts may dismiss actions involving the internal affairs of a Delaware corporation on the ground that the litigation should properly be brought in the state where the firm is incorporated.[235]

In litigation involving corporate directors, jurisdiction is obtained in Delaware under 10 Del. C. §3114 (a) providing that all persons who serve as directors or trustees of a Delaware corporation are deemed to have consented to the appointment of the corporation's registered agents or the Delaware Secretary of State as their agent upon whom service of process may be made in all civil actions brought in the state involving the corporation.

In contrast to other states,[236] Delaware has no statutory provision requiring plaintiffs to post security for expenses in shareholder derivative suits.[237] Probably for this reason derivative suits have had

[235] **Rogers v. Guaranty Trust Co.**, 288 U.S. 123, 130 (1933).

[236] See Macey & Miller, **supra** note 152 at 311; Cal. Corp. C. §800 (plaintiff may be required to furnish security for costs and attorney's fees, of such nature and amount not exceeding $50,000.; Ill. Bus. Corp. Act 110-5.101 (nonresident plaintiff or appellant must furnish cost bonds or action may be dismissed); N.Y. Bus. Corp. Act 626 (corporation is entitled to request bond to cover reasonable expenses which may be incurred by it if action is instituted by holders of less than 5% of outstanding shares of any class, unless such shares have a market value in excess of $50,000); Tex. Bus. Corp. Act 5.14 (shareholders bringing suit in right of corporation may be required at discretion of court to give security for expenses).

[237] There is a general opinion that at least some fraction of derivative suits are "strike" suits. The statutory provision requiring

(continued)

an important development in Delaware courts. Besides, Delaware courts award attorneys' fees based on the relief obtained rather than the number of hours expended,[237] an attitude that might encourage counsel to suggest litigation in Delaware.

III. SHAREHOLDERS' RIGHTS

A. PREEMPTIVE RIGHTS

Prior to 1967, the only reference to pre-emptive rights in the Delaware Corporation Code was an authorization for charter provision limiting or denying such rights. In absence of such charter provision, common law pre-emptive rights existed.[238]

[236] (continued)
plaintiffs to post security for expenses is a device suited to curtail the incidence of such "strike" suits. See Macey & Miller, supra note 152 at [illegible].

[237] Dann v. Chrysler Corp., 42 Del. Ch. 508, 215 A.2d 709 (1965), aff'd, 43 Del. Ch. 252, 223 A.2d 384 (Del. 1966) (plaintiff's counsel in shareholder derivative suits were awarded fees on a common fund or quantum meruit theory); Thomas v. Kempner, 398 A.2d 320, 327 (Del. [illegible]) (attorneys' fees were a percentage of tangible benefits to the defendant corporation and additional compensation for intangible benefits based on the time expended and the effort exerted by plaintiff's counsel).

[238] See Arsht & Stapleton, supra note [illegible] at 77. Case law in the area left open questions as whether non-voting stock or preferred or special stock with limited voting power had preemptive rights, whether stock issued for property or services rendered, rather than cash, was subject to pre-emptive rights and how pre-emptive rights applied in a multi-class or a multi-series situation. See Yoakam v. Providence Biltmore Hotel Co., 34 F.2d 533, 538-9 (D.C.R.I. 1929).

> "The right of shareholders to subscribe for new shares issued by a corporation as an increase of its capital stock in preference to outsiders is well established, and is called a shareholder's preemptive right." [240]

In 1967 such common law rights were abolished but charter provisions can expressly grant pre-emptive rights: [241]

B- TRANSFER OF SECURITIES

Prior to 1967 the Delaware case law cast doubt on the validity of an agreement that a stockholder could not transfer his stock without the consent of the corporation or his fellow stockholders [242] and suggested that a right of first refusal in the corporation might be invalid unless it was somehow related to the objects and purposes of the corporation. [243]

Section 202 of the present Delaware Corporation Code validates the following restriction whether imposed in the certificate of

[240] **Kingston v. Home Life Ins. Co. of Am.**, Del. Ch., 101 A 898 (1917), **aff'd**, Del. Supr., 104 A 25 (1918).

[241] 8 Del. C. 102 (b) (3); Cal. Gen. Corp. C. 406 (board of directors may issue securities without first offering them to shareholders of any class); Ill. Bus. Corp. Act 6.50 (1982 revision, abolishing statutory preemptive rights); N.Y. Bus. Corp. Act 622 (preemptive rights can be established by certificate); Tex. Bus. Corp. Act. § 18, 2.22-1 (limitation or denial of preemptive rights is permitted by articles of incorporation).

[242] **Greene v. E.H. Rollins & Sons, Inc.**, 22 Del. Ch. 394, 2A 2d 249 (Ch. 1938).

[243] **Lawson v. Household Finance Corporation**, 17 Del. Ch. 343, 152 Atl. 723 (Sup. Ct. 1930).

incorporation, in the by-laws or in a stockholder's agreement: a) rights of first refusal granted to the corporation, any holders of securities and/or anyone else and exercisable within a reasonable time; b) restrictions which involve an obligation of the corporation, any holders of securities and/or anyone else to purchase the restricted securities; c) restrictions requiring the approval of the directors, or of the holders of any class of securities, as a prerequisite to transfer; d) restrictions prohibiting transfer to designated persons or classes of persons, if such designations are not "manifestly unreasonable".[244]

The restrictions have to be noted conspicuously on the stock certificate.[245] The term "securities" has been construed as to include [illegible] of interest [illegible] shares, namely, bonds, debentures, [illegible] and other forms of corporate ownership or indebtedness.[246]

[illegible] SHAREHOLDERS' [illegible] AND MEETINGS

Since 19[illegible], the Delaware Corporation Code has permitted a board of directors to sell substantially all the assets of the corporation when

[244] 8 Del. C. 202 (c). See Cal. Corp. C. 401 (articles of incorporation may establish and modify privileges and restrictions); Ill. Bus. Corp. Act 6.05 (articles of incorporation should state "qualifications, limitations and restrictions"), N.Y. Bus. Corp. Act 502 (preferences and limitations may be fixed in the certificate of incorporation or by the board of directors), Tex. Bus. Corp. Act 2.19, [illegible] (reasonable restrictions may be imposed in articles of incorporation, by-laws or written agreement).

[245] See Arsht & Stapleton, **supra** note 135 at 6[illegible].

[246] Joseph E. Seagram & Sons v. Conoco, Inc., 519 F. Supp. 506 (D. Del. [illegible]

authorized by majority of stockholders either in a meeting or by written consent. Since 1937, it has allowed a corporation to dispense meetings where all stockholders send their written consent to the proposed action.[247]

Since 1967, the Code also authorizes a corporation to adopt a charter provision permitting it to take all or some actions, including the election of directors, with written consent of the majority of stockholders, so long as the majority required in the charter provision is not less than the minimum majority required by the Code for the type of action involved,[248] and written consent may be given by proxy.[249]

The procedure has certain limits. The law requires that prompt notice of the decision adopted without a meeting be given to those stockholders or members of the record who have not sent in their consent,[250] unless a written waiver can be obtained.[251] [illegible] held that when an election of directors is at stake [illegible] contests for

247 Arsht & [illegible], supra note [illegible]

248 8 Del. C. § 228. See Cal. Corp. C. [illegible] (unless otherwise provided in articles, action may be taken without meeting and notice if written consent is signed by proper shareholders' majority); Ill. Bus. Corp. Act § [illegible] (except for voluntary dissolution of corporation and conditioned to proper notice to all shareholders); N.Y. Bus. Corp. Act § 615 (whenever shareholders [illegible] take any action by vote, such action may be taken without meeting on written consent); [illegible] Corp. Act § [illegible] (any action required to be taken at a meeting may be taken without a meeting with consent in writing).

249 8 Del. C. § 212

250 8 Del. C. § 228(d)

251 8 Del. C. § 229

proxy are equally applicable to contest for consents; hence, consent forms must permit choice from among nominees, and certain statements in solicitation can be materially misleading.[252]

The [illegible] that when more than [illegible] months have elapsed without a meeting of shareholders to elect directors and application is made by a shareholder for Court intervention, the court has power to make sure that such meeting and election take place as promptly as possible.[255] [illegible] the right of shareholder to vote his stock [illegible] he can vote selfishly or [illegible] inquired into by the court.[illegible]

[illegible]

[illegible] amendment to the corporation's [illegible] a resolution of the board of

[illegible] Pabst Brewing Co. v. Jacobs, [illegible] F. Supp. 1068 (D. Del. 1982).

[illegible] Tweedy, Brown & Knapp v. Cambridge Fund Inc., [illegible] A.[illegible] (1974); Coaxial Communications, Inc. v. CNA Fin. Corp., [illegible] A.[illegible] 981 (1976); Saxon Indus., Inc. v. NKFW Partners, [illegible] A.2d 1286 (1984). For closely-held [illegible] infra note [illegible] and accompanying text.

[illegible] Heil v. Standard Gas & Elec. Co., Del. Ch., 151 A. 303 (1930); Ringling Bros. - Barnum & Bailey Combined Shows, Inc. v. Ringling, Del. [illegible] A.[illegible] 441 ([illegible]); Beach v. KDI Corp., 336 F. Supp. 229 (D. Del. [illegible]).

[illegible] Du Pont v. Du Pont, 251 F. 937 (D. Del. 1918), aff'd, 256 F. [illegible], cert. denied, 250 U.S. 642, 39 S. Ct. 492, 40 S. Ct. 12, [illegible] directors, to be considered by a special or annual meeting of shareholders.[256]

Delaware courts have dealt with the issue of the "substantial limits" of a charter amendment. In 1936, the Delaware Supreme Court held that a charter amendment proposed to extinguish accrued but undeclared dividends as a part of a recapitalization was void, based on the stockholders' vested rights.[257]

However, in 1940 the same court held that accrued but undeclared dividend rights on preferred stock could be eliminated by merging a corporation into a wholly owned subsidiary formed for that purpose.[258] In 1943 following this precedent a federal court, applying Delaware corporate law, held that a parent corporation may merge with a wholly owned [illegible] subsidiary [illegible] preferred stock [illegible].[259]

[256] [illegible] amendment must be adopted by [illegible] majority of outstanding shares [illegible] Del. Corp. Act [illegible] resolution setting forth the proposed amendment [illegible] that it be submitted to vote at meeting of stockholders [illegible] Corp. Act [illegible] amendments may be authorized by vote of board, followed by vote of shareholders [illegible] Corp. Act [illegible] directors must adopt resolution setting forth proposed amendment and directing its submission to shareholders.)

[257] Keller v. Wilson & Co., 21 Del. Ch. 391, 190 A. 115 (Sup. Ct. 1936).

[258] Federal United Corporation v. Havender, 24 Del. Ch. 318, 11 A. 2d 331 (Sup. Ct. 1940).

[259] Hottenstein v. York Ice Machinery Corp., 136 F.2d 944 (3d Cir. 1943).

[illegible] Corporation Law authorizes a corporation by charter amendment [illegible] otherwise affect the right of the holder of the [illegible] which have accrued but have not [illegible] only with the approval of [illegible]

[illegible] amendment [illegible] alter or change adversely [illegible] rights [illegible] powers given [illegible] of authorized stock or [illegible] holders of the shares [illegible] that class are [illegible] majority [illegible] amendment [illegible]

[illegible]

[illegible]

[illegible]

[illegible] amendment [illegible] whether or not [illegible] Act [illegible] holders of outstanding shares [illegible] proposed amendments [illegible] N.Y. [illegible] Corp. Act [illegible] series are entitled to vote [illegible] amendment may be authorized only by vote of holders [illegible] entitled to vote [illegible] vote of at least two-thirds of shares [illegible]

[illegible] Hartford Accident & Indem. Co. v. W.S. Dickey Clay Mfg. Co., [illegible] Peters v United States Mtgt. Co., [illegible] Goldman v. Postal Tel., Inc., [illegible] F. Supp. [illegible]

> "[t]he right of the controlling stockholders to amend, though pursuant to charter authority, must be exercised with fair and impartial regard for the rights and interest of all of the corporate stockholders of every class, and not for the sole benefit of particular classes, to clear prejudice of other outstanding classes."[264]

Even though there is a presumption of fairness when a majority of the stockholders and directors, acting in good faith, speak for the corporation by taking action under appropriate statutory and charter provisions,[265] the exercise of power to amend is subject to review by courts of equity to determine whether there has been an oppressive exercise of power granted.[266] However, the motive for change is not a relevant consideration in determining the question of objective fairness.[267]

[illegible]

[illegible] 244 [illegible] payment has not

[264] See Hartford, supra [illegible]

[265] Bailey v. Tubize Rayon Corp. [illegible] 415 (D. Del. 1944).

[266] Barrett v. Denver Tramway Corp., [illegible] (D. Del. 1943), aff'd, [illegible] (3d Cir. 1944).

[267] See Bailey, supra [illegible]

[illegible] otherwise provided, such reduction does not release any liability of any stockholder whose shares have not been fully paid.[268]

[illegible] primarily for the protection of the creditors and [illegible] have accepted [illegible] by retirement of stock may be invoked to [illegible] management policy, [illegible] of any fraud or [illegible]

[illegible]

[illegible] required by [illegible] vote of the stockholders of the [illegible] required in the merger [illegible] class, or otherwise [illegible] result in the

[illegible] corporation for full [illegible] Ill. Bus. Corp. Act [illegible] holder of or [illegible] obligation to the [illegible] with respect to such shares other than to pay [illegible] N.Y. Bus. Corp. Act [illegible] holder or subscriber [illegible] corporation for unpaid portion of his [illegible] Tex. Bus. Corp. Act [illegible] holder or subscriber of [illegible] obligation to corporation except to pay full [illegible]

[illegible] State ex. rel. RCA V. Benson, [illegible] 1[illegible] A.2d 107 (1924)

[illegible] Martin v. American Potash & Chem. Corp., Del. Supr., 92 A.2d [illegible]

[illegible] supra, note 1[illegible] at 84 corporation's issuing shares of any class in a number in excess of 20% of the number of shares of the same class which it had outstanding immediately before the merger.[274]

I. CONSIDERATION

The original [illegible] of the Delaware Corporation Law [illegible] the general authorization for the merger of domestic corporations and foreign corporations and [illegible] that the agreement [illegible] among other things, the manner of converting the [illegible] of the constituent corporation into shares of the [illegible] corporation. [illegible]

[illegible] permitted only mergers in which there [illegible] corporations solely for [illegible] of the resulting or surviving corporation. But the Delaware

[274] [illegible] (19[illegible]) [illegible] 1971 [illegible] shareholder approval [illegible] required [illegible] corporation [illegible] shareholder after merger [illegible] surviving corporation's shares or [illegible] of surviving corporation's preferred shares remained unchanged. [illegible] Bus. Corp. Act [illegible] (any "parent" corporation owning at least [illegible]% of outstanding shares of each class of any other corporation may merge such subsidiary without approval by vote of shareholders); N.Y. Bus. Corp. Act 905 (any corporation owning at least 95% of outstanding shares of each class of another corporation may merge such other corporation without shareholder authorization); Tex. Bus. Corp. Act [illegible] (shareholder approval is not necessary for mergers in which parent corporation owned at least 90% of shares of each class of stock of subsidiary).

[275] [illegible] Del. [illegible]

Supreme Court held that these words did not limit the general authority conferred by the statute.[274]

There were a series of legislative amendments. In 1941 the statute was expanded by changing the dubious phrase to "into shares or other securities of the corporation resulting from or surviving such consolidation or merger."[275] In [illegible] a provision was added to both [illegible] the payment of cash for fractional [illegible][276]

[illegible] the statute which had previously prescribed a [illegible] and a wholly owned [illegible] and a 90% owned [illegible] of the parent [illegible] each or [illegible] by the surviving [illegible] none of the subsidiary corporation [illegible]

[274] Coyne v. Park & Tilford Distillers Corporation, 38 Del. Ch. [illegible], see also, **Federal**, **supra** note [illegible]

[illegible]

[276] [illegible]

[illegible] Stapleton, **supra**, note 135 at in 1967 the Delaware Corporation Code expanded the types of consideration that may be exchanged for shares of constituent corporations by specifically naming cash, property, rights or securities of corporations not involved in the merger along with rights or other securities of the surviving corporation.[278]

2. MERGER'S FAIRNESS AND PURPOSE

Concerning the question of "fairness" in matter of mergers, the basic rule is that a merger should not promote interests of one class of stockholders to the detriment of another.[279] Mergers which present a "going private" transaction call for the strictest observance of a fiduciary duty that is singular, and falls alike on those who control at least 90 percent of the outstanding shares, and those who control a majority but less than 90 percent."[280]

However, neither the benefit of the promoter[281] nor the inadequacy of

[278] 8 Del. C. 251 (b); see Cal. Corp. C. 409 (shares may be issued for such consideration as is determined by directors or shareholders, consisting of money paid, labour done, services rendered, debts or securities cancelled, property received), Ill. Bus. Corp. Act 6.25 (shares may be issued for such consideration as shall be authorized by board of directors), N.Y. Bus. Corp. Act 504 (consideration for issue of shares must consist of money or other property, tangible or intangible, or labour or services actually received by the corporation), Tex. Bus. Corp. Act 2.16 (consideration for shares must consist of money paid, labour done or property received, promissory notes or promise of future services cannot be payment or part payment for shares).

[279] **McFarlane v. North. Am. Cement.**, Del. Ch., 157 A. 396 (1928).

[280] **Roland Int'l Corp. v. Najjar**, Del. Supr., 407 A. 2d 1032 (1979).

[281] **McCrone v. American Capital Corp.**, 51 F. Supp. 462 (D. Del. 1943).

price[282] are sufficient evidence of constructive fraud inducing a consolidation.[283] The burden of proof is demanding:

> "[. . .] unfairness must be so clearly demonstrated as to impel the conclusion that it emanates from acts of bad faith, or a reckless indifference to the rights of other interested parties, rather than from an honest error of judgment. . ."[284]

> "[. . .] it must be plainly demonstrated that the overvaluation or undervaluation, as the case may be, is such as to show a conscious abuse of discretion before fraud at law can be made out. . ."[285]

That burden of proof is upon objecting stockholders,[286] because there is a presumption of **bona fides** of purposes,[287] except when defendant [illegible] or directors stand on both sides of the transaction through the control of the corporate machinery, in which case the burden of proof shifts to defendants.[288]

[282] Cole v. National Cash Credit Ass'n, Del. Ch., 156 A. 183 (1931); Muschel v. Western Union Corp., Del. Ch., 310 A.2d 904 (1973).

[283] Stauffer v. Standard Brands, Inc., Del. Ch., 178 A.2d 311, aff'd, Del. Supr., 187 A.2d 78 (1962).

[284] McCrone, **supra** note 281 at 482.

[285] Muschel v. Western Union Corp., **supra** note 308 at 904.

[286] Hottenstein, **supra** note 259 at 944.

[287] See Mc.Crone, **supra** note 281 at 4[illegible].

[288] Harman v. Masoneilan Int'l Corp., Del. Supr., 442 A.2d 487 (1982).

The reason for merger or the business necessity behind it are not matter for judicial determination.[288]

> "Delaware corporations may merge into a single corporation and whether such a transaction is good or bad, enlightened or ill advised, selfish or generous is not for Delaware court to inquire into the reasons."[290]

In **Singer v. Magnavox Comp.**[291] the issue was the violation of controlling shareholders' fiduciary duties by attempting to consummate a merger which did not serve any purpose other than the elimination of minority shareholders at an inadequate price.

The defendant's arguments were premised upon the proposition "that the shareholder's rights lie exclusively in the value of his investment, not in its form" and "that a dissenting shareholder has no legally protected right in his shares beyond the right to be paid fair value."

The Court rejected this contention: investors have legally protected rights in the form and in the value of their investment. A "proper and independent business purpose" for the merger of a corporation is necessary to justify the elimination of its minority shareholders.

[288] See **Bruce v. E.L. Bruce Co.**, Del. Ch., 174 A.2d 29 (1961).

[290] **Tanzer v. International Gen. Indus., Inc., Del. Ch., 402 A. 2d 382 (1979).**

[291] 380 A.2d 969 (Del. 1977). A majority stockholder of Magnavox attempted to acquire the rest through a merger. The other stockholders received notice of the proposed merger and price. Shareholders who decided not to accept the offer could seek the appraisal remedy

"a merger, under this section [8 Del. C. 251] made for the sole purpose of freezing out minority shareholders, is an abuse of the corporate process, and a complaint, which so alleges, states a cause of action for violation of a fiduciary duty for which the court may grant such relief as it deems appropriate under the circumstances." [282]

In **Roland** the Supreme Court held that the fiduciary duty owed by the majority to the minority of stockholders may not be circumvented by full compliance with procedures required by corporation statutes, nor is it discharged by remitting minority shareholders to an appraisal remedy.

In addition to the "business purpose," the Court held further that the fiduciary duty requires that the merger meet the requirement of "entire fairness," principle that was reiterated in **Young v. Valhi, Inc.**[283] where the Court of Chancery stated that

> The use of technically correct but devious corporate action on the part of a parent corporation, for the purpose of accomplishing a merger designed to eliminate minority stockholders of the subsidiary, is a manipulation of corporate machinery contrary to the strict standards of fiduciary behaviour required of majority stockholders by the Supreme Court of Delaware. [284]

However, in **Weinberger v. UOP Inc.** [285] the Supreme Court held that in

[282] **Ibid** at 982.

[283] Del. Ch., 382 A.2d 1372 (1978).

[284] **Young, supra** note 11[illegible] at 1372. Applied in **Bershad v. Curtiss-Wright Corp.**, Del. Supr., 535 A.2d 840 (1987).

[285] Del. Supr., 457 A.2d 701 (1983).

parent-subsidiary mergers the "fairness test," the appraisal remedy, and the Court's discretion, awarded enough protection to minority shareholders. Therefore, "no additional meaningful protection is afforded ... by the business purpose requirement" of **Singer**, **Tanzer** and **Roland**. That requirement was expressly abrogated.[286]

More recently the Court of Chancery have held that the "business judgment rule" never prevents the enforcement of the disclosure duties in cases of mergers and acquisitions:

> "The question whether shareholders have been provided with appropriate information upon which an informed choice on a matter of fundamental corporate importance may be made, is not a decision concerning the management of business and affairs of the enterprise of the kind the business judgment rule is intended to protect, it is rather a matter relating to the directors' duty to shareholders."[287]

In the same case the court attempted to avoid the effects of a choice between the "business judgment rule" and the "intrinsic fairness test," and suggested that in the event of takeover bids, "a flexible, intermediate form of judicial review is appropriate."[288] Where the court analyses a board defensive measure against a threat of change in the control of a company, it will require, first if there were some basis to conclude that a proper "corporate purpose" was served by the

[286] Ibid.

[287] **AC Acquisitions Corp. v. Anderson, Clayton & Co.**, Del. Ch., 519 A.2d 103 (1986).

[288] Ibid.

defensive measure, and second if the defensive measure is "reasonable" in relation to the threat of change in the control.[298]

The doctrine of the **de facto** merger applies when there is a sale of substantially all the assets by one corporation to another, the stockholders of the former becoming stockholders in the latter, notwithstanding there is no merger or authorization for one. Thus, the rule that "there can be no consolidated corporation de facto where there could be no de jure one,"[300] has been invoked in many cases for the protection of creditors or stockholders who have suffered an injury by reason of failure to comply with the statutory requirements.[301]

Although the [illegible] of stockholders who are dissatisfied with the effect or the terms of the merger is admitted, the Delaware courts have held that "public policy" does not permit a dissenting shareholder, [illegible] affirmative vote, to veto a merger agreement if its terms [illegible] the circumstances of the case."[302]

[illegible] the Delaware Legislature enacted Section 203[303] that forbids [illegible] combination between a corporation and any interested

[illegible]

[300] **Goat v. Live Poultry Transit Co.**, Del. Ch., 153 A. 801 (1931).

[301] See **Helbrunn v. Sun Chem. Corp.**, Del. Supr., 150 A. 2d 755 (1959).

[302] **Federal, supra** note 258 at 331.

[303] [illegible] Del. Laws, c. 204, § 1), effective on February [illegible], 1988.

stockholder for a period of 3 years following the date that such stockholder became an interested stockholder, unless there is approval by the board of directors or the stockholders by qualified majority.[804] The restriction does not apply when the certificate of incorporation or the by laws contains a express provision for that purpose, or the corporation does not require vote of stockholders for a merger.[805] Among the business combinations so restricted are mergers or consolidation, sale of assets, issuance and transfer of stock; an "interested stockholder" is any person or entity owning 15% or more of the corporation.[806]

3. PROXIES

In American Hardware Corp. v. Savage Arms Corp.,[807] the court dealt with an anti takeover maneuver involving proxy contests. The Court said that

804 8 Del. C. 203 (a). See, Ill. Bus. Corp. Act 7.85 (certain business combinations require affirmative vote of 80% outstanding voting shares and majority of outstanding voting shares held by disinterested shareholders); N.Y. Bus. Corp. Act 912 [c] (certain business combinations prohibited with interested shareholder owning at least 20% of voting stock, prohibited for five years after date such shareholder attains 20%, unless approved by board before shareholder attains 20%).

805 8 Del. C. 203 (b).

806 8 Del. C. [illegible]

807 [illegible] Del. Ch. 5[illegible], 1[illegible] A. 2d [illegible] (Del. 1957), cited by Cary, supra note 147 at [illegible]. The plaintiff (American) had acquired part of the stock of the defendant (Savage) and was preparing a registration statement to make a tender offer. In response, the defendant corporation's Board authorized the purchase, with its own shares, of stock of another corporation, in order to locate more equity into friendly hands before the tender offer. The purchase was conditioned upon approval of stockholders and a meeting was called on for that purpose.

[illegible] disclosure of the necessary information and inspection of the stockholders [illegible] are required only to enable plaintiffs to complete the [illegible] statement of the tender offer, but not to participate in a stockholders' meeting convoked with other purposes.

[illegible], whether or not a proxy statement was misleading in not [illegible] the number of directors opposed to the maneuver, the Court [illegible] although it is preferable to state all the facts, for the [illegible] all the requirements of the proxy rules [illegible]

[illegible] proxy were [illegible] in **Dolese Bros. Co. v. Brown,** [illegible] the court stated that

> [illegible] the rule that a stockholder cannot repudiate action taken under a general proxy has no application to a case in which the [illegible] director is charged with using the proxies to commit fraud [illegible] from the stockholders whose vote is [illegible], and in which no right of third [illegible]

[illegible] knowledge that a certain resolution was to be [illegible] were informed that the management of the corporation intended to present other resolutions, stockholders are not

[illegible] **supra** [illegible]

[illegible]

[illegible]

stopped by the proxy from asserting their rights.[911] The court may exercise discretion in determining whether material misrepresentations made during a proxy solicitation campaign warrant the ordering of a new election, according to section 225.[912]

C. APPRAISAL RIGHTS

Before 1967, the stockholder of any merging Delaware corporation could receive the appraised value of his or her shares by objecting to the transaction in writing prior to the stockholder vote and complying with a prescribed procedure.[913] An appraisal right was not granted, however, to stockholders who dissented from a sale of substantially all of the assets of their corporation, or from any other corporate change, or to a stockholder whose corporation merged into its [illegible] subsidiary in which it owned [illegible] or more of each class of stock.[914]

Relying on that provision, the Delaware Supreme Court refused to apply the "de facto merger" doctrine in **Hariton v. Arco Electronics, Inc.**[915]

911 Gottlieb, supra note [illegible].

912 In re Seminole Oil & Gas Corp., [illegible] A.2d [illegible] ([illegible]), app'l dis'd, Del. [illegible] A.2d [illegible] ([illegible]).

913 Except the shareholders of a target corporation in a short-form merger. Arsht & Stapleton, supra note [illegible].

914 Arsht & Stapleton, supra note [illegible].

915 [illegible] A.2d [illegible] ([illegible]). Criticized by Cary, supra note [illegible].

[illegible] in **Orzeck v. Englehart** [316] and held that no appraisal rights existed where two corporations were combined pursuant to a plan which, although consummated under other sections of the Delaware Corporation Code, had the same ultimate effect as a merger. [317]

The [illegible] eliminated the appraisal right in a merger for shares of any class [illegible] which are either registered on a national [illegible] or held [illegible] by not less than [illegible] stockholders. [illegible] accorded a stockholder of a [illegible] another corporation and does not, [illegible] or increase any class of [illegible] than 20%, [318] that is to say when no [illegible] the merger.

[316] **Supra** [illegible]

[317] [illegible] **Hariton** [illegible] a corporation [illegible] of the purchasing corporation [illegible] In **Orzeck** the transaction involved a [illegible] corporation for stock of another [illegible] corporation [illegible]

[318] [illegible]

[illegible] 1300 (each holder of [illegible] whose approval is required under merger, and those in [illegible] may require [illegible] corporation to purchase such [illegible] fair market value, no exceptions); Ill. Bus. Corp. Act [illegible] dissenting from merger, consolidation or sale of [illegible] all assets are entitled to fair value for shares [illegible] objection); N.Y. Bus. Corp. Act 910 (no appraisal rights for [illegible] of surviving corporation in short form merger or in any other merger unless such merger alters or abolishes preferential, preemptive, redemption or vote rights); Tex. Bus. Corp. Act 5.11 (dissenting shareholder who has filed written objection prior to [illegible] vote may demand payment of fair value of his shares, no exceptions).

However, the appraisal right exists if the certificate of incorporation so provides or if a stockholder's shares are not converted by the merger solely into stock of the surviving corporation. To exercise this right the shareholder must file his objection to the merger before the vote is taken; shareholder need not vote against but he must not vote in favour of the merger. [illegible]

In any event a stockholder may enjoin a merger if its terms are so [illegible] as to be beyond the scope of 'honest business judgment' [illegible] [illegible] the stockholder's burden of proof in order to [illegible] recapitalization by amendment of the certificate [illegible] appraisal remedy [illegible] have not established a [illegible] the burden of proof in the [illegible] remedy [illegible]

[illegible] developed these appraisal provisions in varied ways. The Supreme Court has recognised that the legislative intent is to [illegible] subject

[illegible]

[illegible] Cole v. National Cash Credit Ass'n, [illegible] Atl. [illegible] (Ch. [illegible]) "There are exceptional circumstances under which a stockholder [illegible] to accept the merger or to demand the value of his stock in money but may enlist the aid of a court of equity to restrain the consummation of the merger." Porges v. Vadsco Sales Corp., [illegible]

[illegible] See Bruce, supra note [illegible] at [illegible]; Schiff v. RKO Pictures Corp., 34 Del. Ch. [illegible] (Ch. [illegible]) [illegible], Davis v. Louisville Gas & Electric Co , 16 Del.Ch. 157, 142 Atl. 654 (Ch. 1928) [charter amendment]; Porges, supra note [illegible] at [illegible] [merger] only to the narrow limitation that one cannot take speculative effects of the merger into account.[323] Therefore the statutory requirements are [illegible] construed for the protection of objecting stockholders, within the boundaries of orderly corporate procedures and the purpose of the requirement."[324] Proof that shareholders have complied with the requirements is enough to establish their right.[325]

[illegible] that compensate for the [illegible] could block [illegible] the statutory duty of the [illegible] stockholders as to [illegible] demand. Hence, [illegible] will result in [illegible] about the [illegible]

[illegible] deliberate [illegible] overreaching are

[illegible] Cede & Co. v. Technicolour, Inc., [illegible] 542 A.2d 1182 [illegible]

[illegible] Raab v. Villager Indus., Inc., [illegible] A.2d 888, cert. denied, [illegible] (1976). See [illegible] Lichtmand v. Recognition Equip., Inc., [illegible] A.2d 771 [illegible] (1972); Kaye v. Patone, Inc., [illegible]

[illegible] Kaye, [illegible]

[illegible] Francis I. duPont & Co. v. Universal City Studios, Inc., [illegible]; Helbrunn, supra [illegible]

[illegible] Raab, supra [illegible]; Tabbi v. Pollution Control Indus., Inc., [illegible] involved, the chancellor's powers are complete to fashion any form of equitable and monetary relief as may be appropriate."[328] In other cases the court has emphasized that a determination of fair value does not involve an inquiry into claims of wrongdoing.[329]

Stockholders may split votes and apply for appraisal as to some of his shares,[330] but afterwards an appraisal claimant cannot split stock to seek appraisal of a portion.[331] In a case where a minority stockholder requested an offer from majority stockholder effecting a merger, such a [illegible] was held to be a demand for appraisal.[332] There is a simple procedure in which all the stockholders who have perfected [illegible] right to appraisal [illegible].[333]

[illegible] minority [illegible] adequately protected [illegible] courts have [illegible] appraisal [illegible] which include:

[illegible]

[328] See Weinberger, supra note [illegible]

[329] Cede, supra note [illegible] at [illegible]

[330] Colonial Realty Corp. v. Reynolds Metals Co., [illegible] 185 A.2d [illegible] (19[illegible]), aff'd, [illegible] A.2d [illegible]

[331] Lichtman, supra note [illegible]

[332] Bell v. Kirby Lumber Corp., [illegible]

[333] Raynor v. LTV Aerospace Corp., [illegible] A.2d [illegible] (1974).

[334] See Weinberger, supra note [illegible] Universal City Studios, Inc. v. Francis I. du Pont & Co., [illegible] A.2d [illegible] (1975).

The appraisers have great latitude in seeking evidence from which it may ascertain the value of the shares to be appraised, even apart from that supported by the parties.[136] Appraisers should state the value of the elements given independent weight and the weight given to each in order [illegible] the valuation process [illegible] little less arbitrary and [illegible] [illegible].[138]

[illegible] the transaction involves two basic aspects. [illegible] The [illegible] in **Weinberger** states that

> [illegible] questions of when the transaction was timed, [illegible] initiated, structured, negotiated, [illegible] and how the approvals of the directors and the stockholders were obtained. [illegible] fair price [illegible] the economic and financial considerations of the proposed merger, including all relevant factors: Assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. [illegible]

[illegible] shareholders. They are [illegible] intrinsic value of his share on a going concern basis [illegible] they are entitled to receive that sum which

[136] **General Realty & Util. Corp.**, Del. Ch., 52 A.2d 6 (1947).

[137] **Jacques Coe & Co. v. Minneapolis-Moline Co.**, Del. Ch., 75 A.2d [illegible]

[illegible] **Weinberger**, **supra** note 95 at 711. See also **Levin v. Midland Ross Corp.**, Del. Ch., 194 A.2d [illegible] (1963) and **Bershad**, **supra** note [illegible] represents the amount they would have received as stockholders in one way or another as long as the company continued in business.[338]

Earnings are to be determined by averaging over a reasonable period of time, for instance, five years;[339] the court must examine historical earnings and corporation's stability and prospects as of the date of merger.[340] Appraiser's determinations for arriving at a valuation are accepted by the court when they are within the "range of reason."[341]

Delaware courts accept a variety of evidence in questions of stock value: Earnings and dividends,[342] effective market value,[343] reconstructed market values, price-earnings ratios of comparable companies,[344] liquidation values,[345] original and depreciated asset values.[346] In cases of real estate the capitalization of net rental

[338] **In re Delaware Racing Ass'n**, Del. Ch., 206 A.2d 661, **aff'd**, Del. Supr., 213 A.2d 203 (1965).

[339] See **Francis I. duPont**, supra note [illegible] at 629.

[340] See **Universal City Studios, Inc.**, supra note [illegible] at 216.

[341] See **Bell**, supra note 332 at 147.

[342] **General Realty**, supra note [illegible] at [illegible]; **Racing**, supra note 334 at 207; **Poole v. Maatschappij**, Del. Ch. Supr., 224 A.2d 260 (1966).

[343] **Chicago Corp. v. Munds**, Del. Ch., 172 A. 452 (1934).

[344] See **DuPont**, supra note 326 at 629 and **Universal**, supra note 340 at 216.

[345] **Bell**, supra note 332 at 147; **Racing**, supra note 342 at 207.

[346] **Root v. York Corp.**, Del. Ch., 50 A.2d 52 (1946); **Felder v. Anderson, Clayton & Co.**, Del. Ch., 159 A.2d 278 (1960). For the problem of original and depreciated values, see **Heller v. Munsingwear Inc.**, Del. Ch., 98 A.2d 774 (1953).

value of the land, and the costs of the use of the land are accepted additional criteria.[347]

In awarding interest the Court of Chancery has established a rate at which a prudent investor could have invested money rather on how much it would have cost the corporation to borrow the money.[348] Concerning costs the rule is that the Court of Chancery tax all the appraisal costs against the surviving corporation in absence of a showing of bad faith on the part of the dissenting shareholders, (that is to say, that the statutory provision was made use of for the purpose of being "bought out").[349]

H. RIGHT OF INSPECTION

Delaware gives shareholders a broad statutory right to inspect corporate books and records, including lists of stockholders, provided that there is a "proper purpose," i.e., a purpose reasonably related to their interest as stockholders.[350] In order to avail themselves of this right, it does not require shareholders to hold their stock for any

[347] Racing, supra note [illegible] at [illegible].

[348] Lebman v. National Union Elect. Corp., Del. Ch., 414 A.2d 824 ([illegible]).

[349] Meade v. Pacific Gamble Robinson Co., Del. Supr., 58 A.2d 415 ([illegible]).

[350] [illegible] Del. [illegible]

minimum period, or to own a significant amount of stock.[351] And any provision in the certificate of incorporation limiting the inspection is void.[352]

Concerning the "proper purpose" Delaware courts have held that it is an interest not adverse to the interest of the corporation.[353] Thus:

> "The right of stockholder under this section is absolute unless the corporation is able to show that the purpose of examination is to gratify idle curiosity, or if for an improper or unlawful purpose, or for a purpose purely individual and in no way germane to the relationship of stockholder to the corporation."[354]

Hence the mere possibility that stockholder seeking inspection might use the information obtained to harm the corporation is not ground for any

[351] For analysis and comparison with other states, see Macey & Miller, **supra** note 152 at 513 and Comment, **supra** note 147 at 887. Cal. Corp. C. 1600, 1601 (shareholders have rights of inspection as to shareholders records, accounting books, records and minutes, no exceptions), Ill. Bus. Corp. Act 7.75 (any shareholder has right to examine for any proper purpose corporation's books and records of account, minutes, and record of shareholders, and to make extracts therefrom; no exceptions), N.Y. Bus. Corp. Act 624 (anyone who is shareholder for at least 6 months or holds at least 5% of any class of shares, has right to examine, in person or by agent, minutes of shareholder proceedings and record of shareholders); Tex. Bus. Corp. Act 2.44 (any shareholder for 6 months or of at least 5% shares can, upon written demand stating purpose, examine records and make extracts.)

[352] Loew's Theatres, Inc. v. Commercial Credit Co., Del. Ch., 243 A.2d 78 (1968).

[353] Skoglund v. Ormand Indus. Inc., Del. Ch., 372 A.2d 204 (1976); Skouras v. Admiralty Enter., Inc., Del. Ch., 386 A.2d 674 (1978).

[354] Miller v. Loft, Inc., Del. Supr., 156 A. 170 (1931).

The scope of inspection for purpose of ascertaining possible existence of corporate mismanagement was stated in **Skoglund**

> "[it] should extend to the corporate minutes and financial records in general during the period into which they seek to inquire, especially where the time span is reasonably related to the specific events cited as the basis for the demand." [303]

An unspecific demand unrelated to an imminent stockholders meeting or an important corporate event was held to fail to meet the requirements of the section.[304] And demanding an inspection to secure a list of the stockholders and their addresses with commercial purposes was held an "improper purpose."[305]

[303] **Skoglund, supra** note [illegible] at 204.

[304] **Weissman v. Western Pac. Indus., Inc.,** Del. Ch., 344 A.2d 267 ([illegible]). **Northwest Indus., Inc. v. B.F. Goodrich Co.,** Del. Supr., 260 A.2d [illegible].

[305] **Theile v. Cities Serv. Co.,** Del. Supr., 115 A. 773 (1922).

V

DELAWARE AND MANAGEMENT

I. FIDUCIARY DUTIES OF DIRECTORS, INCORPORATORS, STOCKHOLDERS AND THIRD PARTIES

A. THE "BUSINESS JUDGMENT RULE"

This rule states that courts will not interfere with directors' (or stockholders') business judgment,[366] unless there is fraud or illegal misconduct.[367] "Fraud, actual or presumed, or illegal or ultra vires

[366] **Mercantile Trading Co. v. Rosembaum Grain Corp.**, Del. Ch., 154 A. 457 (1931); **Perrine v. Pennroad Corp.**, Del. Ch., 43 A.2d 721 (1945), **aff'd**, Del. Supr., 47 A.2d 479 (1946), **cert. denied**, 329 U.S. 808, 67 S.Ct. 620, 91 L.Ed. 690 (1947); **Kaplan v. Centex Corp.**, Del. Ch., 284 A.2d 119 (1971); **Kaplan v. Goldsamt**, Del. Ch., 380 A.2d 556 (1977); **Partners v. Newmont Mining Corp.**, Del. Supr., 535 A.2d 1334 (1987).

[367] **Sandler v. Schenley Indus., Inc.**, 79 A.2d 606 (1951); **Lewis v. Hat Corp. of Am.**, 150 A.2d 750 (1959); **Puma v. Marriot**, Del. Ch., 283 A.2d 693 (1971).

misconduct must be shown to justify an interference by the courts with questions of corporate policy and management." [368]

There is a presumption that the judgment of directors of corporation was formed in good faith and was designed to promote the best interests of the corporation. [illegible] The presumption is not disturbed if any "rational business purpose" can be attributed to the decisions; [370] thus an "honest mistake" of business judgment on part of the directors is not reviewable by court. [illegible]

[illegible] FIDUCIARY RELATIONSHIP

[illegible] fiduciary relation to corporation and its stockholders, [illegible] sometimes Delaware courts have maintained that their [illegible] the relations of [illegible] the utmost good

[illegible] Mercantile, supra [illegible]

[illegible] Kors v. Carey, [illegible]; Gimbel v. Signal Cos., [illegible] A. [illegible], aff'd, Del. Supr., [illegible] A.2d 619 (1974).

[illegible] Goldsamt, supra [illegible]

[illegible] Perrine, supra [illegible]

[illegible] Lofland v. Cahall, Del. Supr., 118 A. 1 (1922); Finch v. Warrior Cement Corp., Del. Ch., 141 A. 54 (1928); Keenan v. Eshleman, Del. Supr., [illegible] A. [illegible] (19[illegible]); Bovay v. H.M. Byllesby & Co., Del. Ch., 12 A.2d 178 [illegible], Del. Supr., 38 A.2d 808 (1944); Petty v. Penntech Papers, Inc., Del. Ch., 347 A.2d 140 (1975).

[illegible] Loft, Inc. v. Guth., Del. Ch., 2 A.2d 225 (1938), aff'd, Del. Supr., [illegible] A. [illegible] (1939); Harriman v. E.I. DuPont De Nemours & Co., 372 F. Supp. [illegible] (D. Del. [illegible]) faith and fair dealing," especially where their individual interests are concerned.

Moreover Delaware courts have held that there is a fiduciary relationship between the promoters of a corporation and the corporation itself because "those who undertake to form a new corporation, to procure for it the capital through which it may carry out the purpose or purposes for which it was formed, are necessarily charged with the duty to act in good faith in dealing with it."[374] Incorporators cannot benefit from any "secret profit" which they may received at the expense of the corporation or of its stockholders and the corporation may recover such a profit.[375]

Fiduciary duties arise from the exercise of powers by any person who undertakes to dictate the destiny of the corporation, even absent any intrusion in the affairs of the board of directors.[376] Hence, "control" and "domination" may be exercised directly or through nominees. It is enough to direct the corporate conduct "in such a way as to comport with the wishes or interests of the corporation or persons doing control."[377]

[374] Gladstone v. Bennett, Del. Supr., 153 A. [illegible] 577 (19[illegible]); Henderson v. Plymouth Oil Co., Del. Ch., 13[illegible] A. 140 ([illegible]), aff'd, Del. Supr., 141 A. 197 (192[illegible]).

[375] Nye Odorless Incinerators Corp. v. Felton, Del. Super., 162 A. 504 (1931).

[376] Harriman, supra note 373 at 1011.

[377] Centex, supra note 366 at [illegible].

Therefore, a non-stockholder who usurps the function of the board of directors or otherwise directs its activities assumes the same fiduciary duty as directors have, the same happens to one who exercises control over a corporation which in turn exercises control over another corporation,[378] through voting shares held directly or indirectly by means of a third party's name,[379] or through any other means.[380]

> "When, in the conduct of the corporate business, a majority of the voting power in the corporation join hands in imposing their policy upon all, they are to be regarded as having placed upon themselves the same sort of fiduciary character which the law impresses upon the directors in their relation to all the stockholders."[381]

In **Merrit v. Colonial Foods**,[382] the Court said that when a controlling stockholder exercises his power to set the terms of a self-dealing transaction and compel its effectuation, he assumes a responsibility of establishing to an independent body (Court, independent directors or shareholders) on "full information" that the transaction was "fully fair".

[378] **Harriman**, **supra** note 373 at 1011.

[379] Italo Petroleum Corp. of Am. v. Producers Oil Corp. of Am., Del. Ch., 174 A. 276 (1934).

[380] Speiser v. Baker, Del. Ch., 525 A.2d 1001 (1987).

[381] Allied Chem. & Dye Corp. v. Steel & Tube Co. of Am., Del. Ch., 120 A. 486 (1923).

[382] Del. Ch., 505 A.2d 757 (1986).

> "Should a reviewing court be required to pass judgement upon the fairness of such a transaction, the self dealing fiduciary may be required to respond in damages or with another appropriate remedy if the transaction, despite any good faith on his part, is found to be not an entirely fair one to the corporation or to the minority shareholders."[883]

More recently the Delaware Supreme Court has held that the board of directors may deal selectively with the stockholders, so long as the directors "have not acted out of the sole or primary purpose to entrench themselves in office."[884]

C. SCOPE OF FIDUCIARY DUTIES

Delaware courts, and federal courts applying Delaware law, have developed the legal rules on directors' duties of care and loyalty. Such decisions have evolved markedly during the present century and surely will evolve in the future.

Broadly speaking, in any case of fraud, ultra vires acts, or acts of imprudence or negligence on the part of those charged with the management of the corporation, the offending directors or officers, and not the corporation, are liable.[885] And the fact that charter or by-law provisions may technically permit an action contemplated by the

[883] Ibid.

[884] Frantz Mfg. Co. v. EAC Indus., Del. Supr., 501 A.2d 401 (1985).

[885] Harden v. Eastern States Pub. Serv. Co., Del. Ch., 122 A. 705 (1923).

directors does not automatically insulate directors against courts' scrutiny of purpose.[386]

Delaware courts have restricted the "intrinsic fairness test" to evaluate the responsibility of directors and officers in respect with certain transactions. In a case enjoining a merger based on a claim of discriminatory overvaluation of corporate assets, the Court held that it must be plainly demonstrated that the overvaluation or undervaluation [illegible] before fraud at law [illegible].[387]

[illegible] Y OF LOYALTY

In Guth [illegible] the court made [illegible] exposition of the public policy that demands of directors undivided loyalty to corporations:

> "A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers."[388]

386 **Petty, supra** note [illegible] at [illegible]

387 **Muschel, supra** note [illegible] at [illegible]

388 **Guth, supra** note 373 at 503

A few years later the Court of Chancery restated the extension of the fiduciary relationship

> "If an officer or a director of a corporation, in violation of his duty as such acquires gain or advantage to himself, the law charges the interest so acquired with a trust for the benefit of the corporation and its directors while it denies to the betrayer all benefit and profit."[379]

Conversely a corporate officer or director is entirely free to engage in independent competitive business so long as he violates no legal or moral duty with respect to the fiduciary relationship.[380]

A. PAYMENT OF INTEREST

In **Sinclair Oil Corp. v. Levien**, [illegible] involving excessive distribution of dividend[381] the Delaware Supreme Court recognized that "parents" owed[?] subsidiaries a fiduciary duty, but held that the transactions between them should be tested by the "business judgement rule" and rejected the application of the "intrinsic fairness test" when the parent had not received a benefit to the exclusion and at the expense of the subsidiary.

[379] **Gottlieb**, Del. Ch., 20 A.2d 74 (1941).

[380] **Craig v. Graphic Arts Studio, Inc.**, Del. Ch., 166 A.2d 444 (1960).

[381] 280 A. 2d 717 (Del. 1971). Criticized by Cary **supra note** 142 at 680. Sinclair was majority stockholder of Sinven. At Sinclair's direction Sinven paid out, for several years, dividends in excess of earnings. Probably for that reason Sinven's activities declined and there was no opportunity for expansion. A minority stockholder brought a suit claiming the existence of a fiduciary duty and its violation by Sinclair

When all the subsidiary's stockholders received the dividends pro-rata, [illegible] did not represent self-dealing, an essential ingredient for invoking the intrinsic fairness test. Nevertheless the Court advised that

> [illegible] plaintiff [illegible] meet his burden of proving that a dividend [illegible] be grounded on any reasonable business objective, then the courts can and will interfere with the board's decision to pay the dividend."[382]

In **Gabelli & Co. v. Liggett Group, Inc.**,[383] the court held that if the parent corporation caused its subsidiary not to declare dividend, solely for [illegible] the transaction would not be shielded by the business judgment rule but rather should be tested for intrinsic fairness.

[illegible] have accepted that the motives for causing the declaration of dividends are immaterial unless the plaintiff can show that the action "resulted from improper motives and amounted to waste."[384] [illegible] declaration of dividend, [illegible] honest discretion of [illegible] shareholder director cannot profit from illegally

[382] **Sinclair**, [illegible]

[383] [illegible] Ch., [illegible] A. [illegible]

[384] **Sinclair**, **supra** [illegible]

[385] **Treves v. Menzies** [illegible] A.2d 520 (1958)

declared dividends and in such a case a corporation may assert the defence of lack of consideration.[386]

Delaware case law has recognized that courts have the power to compel directors to declare dividends after a demonstration that the corporation's affairs are in a condition justifying the declaration of the dividend as a matter of 'prudent business management' and that the withholding of [illegible] is justifiable only on the theory of "an oppressive or fraudulent abuse of discretion".[387]

Consistent with the treatment of the [illegible] corporation law, the Delaware Supreme Court has affirmed the [illegible] liability of directors for unlawful payment of dividends or unlawful stock purchase or redemption,[388] that [illegible] and restoration to the capital of the corporation of the entire amount thus illegally withdrawn and that made each director individually liable for the amount in question.[389]

[386] **Hannigan v. Italo Petroleum Corp.**, Del. Supr., 77 A.2d 209 (1949).

[387] **Eshleman v. Keenan**, Del. Ch., 194 A. 40 (1937), **aff'd**, Del. Supr., 2 A.2d 904 (1938).

[388] 8 Del. C. 174. See Cal. Corp. C. 506 (any shareholder receiving illegal distribution is liable to the corporation for the benefit of creditors and shareholders); Ill. Bus. Corp. Act 9.10 (sets forth in detail the circumstances under which dividends may be declared by directors); N.Y. Bus. Corp. Act 510, 719, 402 [b] (directors will be jointly and severally liable to corporation for the benefit of creditors and shareholders to the extent of injuries); Tex. Bus. Corp. Act 2.38 (authorization for and restrictions on distribution are set forth in detail).

[389] **John A. Roeblings Sons Co. ex. rel. Whitley v. Mode**, Del. Supr., 43 A.2d 480 (1899).

[illegible] REDEMPTION OF STOCK, REDUCTION OF CAPITAL AND RETIREMENT OF STOCK

Delaware courts have held that purchase of its own stock is not a [illegible] corporation, [400] and may not impair capital, i.e., reduce the capital below the amount represented by outstanding stock, [401] for protection of stockholders as well as of creditors. Although the rule is that in such cases the courts require of directors the "utmost good faith and good judgment," [402] in some cases the "business judgment rule" has been applied.

> A[illegible] that [illegible] own shares have been caused to be purchased by corporation for an improper purpose, courts should not normally interfere with such a transaction when carried out in compliance with the statute." [403]

[400] Brophy v. Cities Serv. Co., Del. Ch., 70 A.2d 5 (1949). See [illegible] (corporation may provide in its articles for [illegible] of corporation at price, time or happening of [illegible]; [illegible] Act [illegible] (no redemption of shares may be made [illegible] so that corporation would be insolvent or [illegible] amount payable to shareholders); N.Y. Bus. Corp. Act 513 ([illegible] the certificate, corporation may purchase [illegible] redeem its redeemable shares out of surplus except when [illegible] when it would thereby be made insolvent); Tex. Bus. Corp. Act [illegible] (reduction of authorized capital may be made by redemption and [illegible] of redeemable shares).

[401] In re International Radiator Co., Del. Ch., 92 A. 255 (1914) [illegible] 160. See also Passotu v. United States Guardian Corp., Del. Ch., 156 A. 255 (1931); Schwart v. Greene, Del. Ch., 163 A. [illegible]; Alcott v. Hyman, Del. Supr., 208 A.2d 501 (1965).

[402] Propp v. Sadacca, Del. Ch., 175 A.2d 33 (1961), mod'd, Del. Supr., [illegible] A.2d 405 (1962).

[403] Alcott, supra note 401 at 501. See also Crane Co. v. Harsco Corp., 511 F. Supp. 294 (D. Del 1981).

In **Cheff v. Mathes**,[404] a case involving the purchase of its own shares by a corporation, the Delaware Supreme Court concluded that directors and officers had satisfied the burden of proof of his fiduciary duty by showing that there were reasonable grounds to believe a danger to corporate existence (or at least existence in its present form) because of the other company stock ownership. By the way of analogy the court relied upon the Delaware cases permitting incumbent directors to use corporate funds in proxy contests.

Delaware courts have constantly applied 8 Del. C. §160(c) which deters a corporation from voting its own stock, to prevent those in control of a corporation from using corporate resources to perpetuate themselves in office.[405] Although according to the powers granted by 8 Del. C. §160 (a) stockholders at odds with management may be bought out, Courts have insisted on the propriety of purpose:

> "If the purchase of its own stock by the board was motivated by a sincere belief that the buying out of the dissident stockholder was necessary to maintain what the board believed to be proper business practices, the board will not be held liable for such decision, even though hindsight indicates the decision was not the wisest course."
>
> "... If the board in buying its own stock has acted solely or primarily because of the desire to perpetuate themselves in

[404] 41 Del. Ch. 494, 199 A.2d 548 (1964). Criticized by Cary, **supra** note 14 at 672. One company had purchased a substantial block of stock of another as the initial step toward a take over. The directors and the chief executive officer of the latter were concerned over this prospect and ultimately resorted to buying the former's holdings.

[405] **Insituform of N. Am., Inc. v. Chandler**, Del. Ch., 534 A.2d 257 (1987). For foreign corporations, see **McDermott Inc. v. Lewis**, Del. Supr., 531 A.2d 206 (1987).

> otherwise, the use of corporate funds for such purpose is improper."[406]

In keeping with this decision Delaware courts have held that where the use of corporate funds to purchase corporate shares will maintain management in control, the burden is on directors to justify the purchase as one primarily in the corporate interest and not in their own.[407] Concerning consideration for stock, the Delaware Supreme Court in **Bodell v. General Gas & Electric**,[408] established a flexible test.

> "The directors may from time to time issue no-par stock for any consideration they may see fit, even though the price they fix is far below its actual value. But equity will, in accordance with the principles which prompt it to restrain an abuse of power granted in absolute terms, lay its restraining hand upon the directors in case of an abuse of this absolute power."[409]

Therefore, directors ought to be required to market new issues of no par stock at a price that is "fair to the corporation and existing stockholders and best calculated to yield the largest possible capital." Under this test "market value," "book value," and "sales value" are only guides for the fixing of consideration.[410]

406 **Cheff**, **supra** note 404 at [illegible]. See also **Bennet v. Propp**, Del. Ch., [illegible] A. 2d 405, (19[illegible]).

407 **Petty**, **supra** note [illegible] at 140. See also **Crane**, **supra** note 404 at [illegible].

408 Del. Supr., 140 A. [illegible] (1927).

409 **Bodell**, ibid. See also, **East Syrian Lamp. Co.**, Del. Ch., 37 A. [illegible] (19[illegible]).

410 **Bodell**, ibid.

C. SALES AND DISTRIBUTION OF ASSETS

The Court of Chancery has held that although the terms and conditions of the sale must conform to the best interest of the corporation,[411] the business judgment rule weighs in favor of directors' decision, unless the complaining shareholders can prove either intentional or inferred fraudulent misconduct.[412] Mere inadequacy in price did not reveal fraud; the disparity must be so gross as to lead the court to conclude that it was not due to an honest error of judgment, but rather to bad faith or to reckless indifference to the rights of others interested.[413] However the burden of proof shifts when the seller company is dominated by the buyer and independent stockholder ratification cannot be given.[414]

Section 271 requires majority shareholder approval prior to board action on sale of assets,[415] when there is a sale of all or

[411] **Allied Chem.**, **supra** note [illegible] at [illegible].

[412] **Gimbel**, **supra** note 389 at 610. See also **Mitchel v. Highland-Western Glass Co.**, Del. Ch., 167 A.2d 831 (1960); **Schiff v. RKO Pictures Corp.**, Del. Ch., 104 A.2d 267 (1954); **Baron v. Pressed Metals of Am., Inc.**, Del. Supr., 123 A.2d 848 (1956); **Marks v. Wolfson**, Del. Ch., 188 A.2d 680 (1963).

[413] **Muschel**, **supra** note 366 at 564.

[414] **Abelow v. Symonds**, Del. Ch., 184 A.2d 173 (1962), **aff'd**, Del. Supr., 189 A.2d 675 (1963).

[415] **Gimbel**, **supra** note 389 at 610. See Del. Corp. C. § 271 (corporation may dispose of all or substantially all of its property if principal terms are approved by board of directors and majority of

(continued...)

"substantially all" of them.[416] Since this concept does not lend itself to a quantitative standard, a qualitative one has been used: whether or not the sale is made in the regular course of corporate business.[417]

Since **Allaun v. Consolidated Oil Co.**[418] if a sale of assets is only a "freezing out," by which the majority use their power to sell the assets to themselves and carry on in the business without the minority "equity would doubtless restrain it regardless of the fairness of the price."[419] However, in the same case the judgment of the directors in fixing the terms and conditions of the sale was held entitled to the presumption of good faith.[420]

Creditors' interests are protected with a doctrine of "liability of transferee," contrary to which, although the buyer is not liable for

[415] (continued)
shareholders; Del. Bus. Corp. Act [illegible] (disposition of all or substantially all property and assets must be approved by holders of two thirds of each class of shares); N.Y. Bus. Corp. Act (all disposition of all or substantially all assets of corporation must be authorized by board and by vote of holders of two thirds of all outstanding shares); Tex. Bus. Corp. Act 5.09 (disposition requires two-thirds vote of shareholders of each class or such greater and lesser number as may be authorized by articles).

[416] **Robinson v. Pittsburgh Oil Ref. Corp.**, Del. Ch., 120 A.2d 486 (19[illegible]).

[417] **Gimbel**, **supra** note [illegible] at [illegible].

[418] Del. Ch., 147 A. 257 (1929).

[419] Ibid.

[420] Ibid. See also **Robinson**, **supra** note 416 at 4[illegible]5.

contracts or torts of the seller before the sale is consummated,[421] some sales of assets can be void when the transaction is "a fraud on creditors."[422]

In case of distribution of assets Delaware Courts have protected small investors testing the "fairness of the plan," to determine whether or not the dominating shareholder's offering price was reasonable under the circumstances,[423] because

> "[i]f through stock ownership, an individual was in a position to require a corporation to dissolve pursuant to this section [8 Del. C. 275], the individual was under an obligation to adopt a plan of dissolution which would be fair to all the stockholders of the corporation."[424]

For the protection of creditors and stockholders of dissolved corporations, section 279 may be invoked at any time if the company refuses or neglects to settle and close its business.[425]

D. [illegible]

[421] Drug, Inc v. Hunt, Del. Supr., [illegible] A. [illegible] ([illegible]).

[422] McKee v. Standard Minerals Corp., Del. Ch., [illegible] A. 2d [illegible] ([illegible]).

[423] Sharage v. Bridgeport Oil Co., Del. Ch., [illegible] A. 2d 317 (1949).

[424] Ibid.

[425] 8 Del. C. 279. See Harned v. Beacon Hill Real Estate Co., Del. Supr., 84 A. [illegible] ([illegible]), Addy v. Short, Del. Supr., [illegible] A. 2d [illegible] ([illegible]), rev'd, Del. Supr., [illegible] A. 2d 136 ([illegible]), In re Citadel Indus. Inc., Del. Ch., 423 A. 2d 500 ([illegible]).

Before 1967 common law principles determined the effect upon a corporate transaction of the fact that officers or directors having an interest apart from that of their corporation had participated in authorizing the transaction.[426]

After 1967 Delaware Corporation Code specifies three situations in which that fact will not affect the transaction's validity:[427] a) where the material facts concerning the transaction itself are known to the board of directors, and the board, in good faith, authorizes the transaction by an affirmative vote of a majority of the disinterested directors present and voting; b) where the stockholders entitled to vote on the transaction are fully informed and approve the transaction in good faith (the stockholder vote called for is one of all of the stockholders entitled to vote and not of the disinterested stockholders only); c) where the court finds that the terms of the transaction are, in fact, fair.

The corporate transaction duly approved by the board of directors or the stockholders, or both, may be overturned if a

[426] An interested director could not be counted for purposes of establishing a quorum (**Kerbs v. California Eastern Airways**, 33 Del. Ch. 69, 90 A.2d 652 (Sup. Ct. 1952)), unless a sufficient number of disinterested directors attended the meeting to constitute a quorum by themselves. Any transaction approved at the meeting could be overturned without regard to its fairness or to whether the transaction subsequently received shareholder approval (**Martin Foundation v. North American Rayon Corp.**, 31 Del. Ch. 195, 68 A.2d 313, 316 (Ch. 1949)). See Arsht & Stapleton, **supra** note [illegible] at [illegible].

[427] 8 Del. C. § 144(a).

challenging stockholder proves that it could not have been the product of honest business judgment.[428]

Delaware Courts have held that business opportunities of no interest to the corporation may be utilized by directors or officers but opportunities of interest must be not accepted:

> "When a business opportunity comes to a corporate officer or director in his individual capacity rather than in his official capacity, and the opportunity is one which, because of the nature of the enterprise, is not essential to the corporation, and is one in which it has no interest or expectancy, the officer or director is entitled to treat the opportunity as his own, and the corporation has no interest in it, if, of course, the officer or director has not wrongfully embarked the corporation's resources therein.
>
> If there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is, from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity."[429]

Whenever the corporation is not in a position, either financially or legally, to accept the opportunity, directors and officers are entitled

[428] See Arsht & Stapleton, **supra** note [illegible], at [illegible].

[429] **Guth, supra** note [illegible], at [illegible]; **Johnston v. Greene**, Del. Supr., 121 A.2d 919 (1956); **Equity Corp. v. Milton**, Del. Supr., 221 A.2d 494 (1966); **Kaplan v. Fenton**, Del. Supr., 278 A.2d 834 (1971). The opportunity is in the line of a corporation's business when the opportunity is presented to it embracing an activity as to which it has fundamental knowledge, practical experience and ability to pursue, which logically and naturally, is adaptable to its business having regard for its financial position, and is one that is consonant with its reasonable needs and aspirations for expansion. **Guth**, ibid.

to [illegible] it for themselves after the corporations has rejected it.[480] In case of dealings with the corporation, Delaware public policy [illegible] the acts of corporate officers and directors "to be viewed with [illegible]

[illegible] directors or officers to show either that [illegible] corporate opportunity were in the exercise of [illegible] good faith' to the corporation or that the offer was made to [illegible]

[illegible] corporation to make loans to [illegible] the board of directors judges that the [illegible] the corporation. The board [illegible] and without security, and there is no [illegible]

[illegible]

A [illegible]

[illegible] Fliegler v. Lawrence, [illegible] A. 2d 213 (1976).

[illegible] Bovay, supra [illegible]

[illegible] Guth, supra [illegible] Keenan v. Eshleman, Del. [illegible]

[illegible] Comment, supra note 142 at 874

In **Graham v. Allis-Chalmers Manufacturing Co.** [434] the Delaware Supreme Court found that since the company's directors could not be expected to have personal knowledge of all corporate activities or to investigate personally all of the company's employees, they were entitled to rely on summaries, reports, and records.[435]

It held that the degree of care required of corporate directors in the selection and supervision of employees must be considered "on its own facts," giving regard to the nature of business, its size, the extent, method and [illegible] of delegation of executive authority, [illegible] of [illegible], honesty of purpose, etc.[436]

[434] [illegible] Del Ch [illegible] A.2d [illegible] 41 Del Ch [illegible] A.2d [illegible] Allis-Chalmers [illegible] **supra** note 11 at 66[illegible]. The [illegible] Allis-Chalmers in [illegible] equipment. The company [illegible] and as a result had been [illegible] fines and penalties [illegible] damage actions brought by purchasers of the equipment. It was impossible to establish actual knowledge on the part of any officers, but it was claimed that they should have had notice, or constructive knowledge, of what was happening.

[435] The rule was confirmed in **Prince v Benninger** Del. Ch., 244 A.2d [illegible] and in **David J. Greene & Co. v. Dunhill Int'l, Inc.**, Del. Ch., 249 A.2d 427 (1968), and [illegible] enacted [illegible] Del. C. 141 (e) [illegible] Corp. [illegible] may rely on information and other documents prepared by officers or employees, counsel, accountants, or committees, [illegible] after reasonable inquiry as [illegible] Corp. Act [illegible] directors may rely on balance sheets and profit and loss statements, under certain prescribed conditions, and may [illegible] consider [illegible] book value in authorizing distributions of dividends or assets. N.Y. Bus. Corp. Act 717 [illegible] directors and officers are entitled to rely on information, opinions, reports or statements prepared or presented by officers or employees, counsel, public accountants, and board committees; [illegible] Corp. Act 8.41 directors are entitled to rely on certain written reports, statements, written opinions of the corporation's attorneys.

[436] **Graham, supra** note 434 at [illegible]

The court distinguished between corporate directors in a small corporation, who may become personally liable "whenever they foolishly or recklessly repose confidence in an untrustworthy officer or agent," and directors in a large corporation whose operation is hedged about with "[illegible] and sometimes conflicting federal and state controls," to whom fiduciary [illegible] according to other standards.[437] The [illegible] with the principle that duties of directors are administrative [illegible] direction and control, the details of the [illegible] to [illegible] agents and employees.[438]

In **Zapata Corp v. Maldonado** [illegible] whether a board of [illegible] brought by dissident [illegible] the corporation, alleging breaches of [illegible] New York [illegible][441] held that [illegible] independent directors could, in its [illegible] termination of [illegible] derivative

[illegible]

[437] Cahall v. Lofland, Del. Ch., 114 A 224 (1921).

[illegible] **Maldonado v. Flynn**, [illegible] (S.D.N.Y. [illegible]), **rev'd in part**, [illegible], **Maldonado v. Flynn**, 413 A. 2d 1251 [illegible], **rev'd sub. nom Zapata v. Maldonado**, 430 A. 2d 779 [illegible] **supra note** [illegible]

[illegible] the derivative suit was commenced in Delaware and New York [illegible], Zapata's directors appointed a committee of independent directors. After an investigation the committee filed a report [illegible] that the shareholder suits were without merit and [illegible] Zapata's interest. Based on that report, counsel for Zapata [illegible] the suits in Delaware and in New York.

[illegible] **Zapata, supra**, [illegible] suit, the Delaware court [442] held that the corporation could not use such a procedure to frustrate the right of individual shareholders to bring a derivative suit.

On appeal, the Delaware Supreme Court rejected both conclusions. Neither does a shareholder possess an absolute right to initiate and maintain a derivative suit over the corporation's objection, nor does a business judgment rule prevent a court from reviewing a disinterested committee's decision to terminate a derivative suit.

The [illegible] "middle course" between both approaches was required. For a derivative suit to be dismissed pursuant to a report by an independent committee, the corporation [illegible] a pretrial motion that [illegible] the [illegible] conduct of the investigation and its findings and recommendations.

[illegible] on the motion. Then [illegible] apply a two-part test to determine whether the motion is appropriate. Under the first step, the court must inquire into the independence of the committee and the reasonableness of the bases supporting its conclusions. Under the second step, the court must determine, "applying its own independent business judgment, whether the motion should be granted." And the court should, "when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests."

442 Maldonado, supra note 4[illegible] at 12[illegible]

F. THE BUSINESS JUDGMENT STANDARD

In **Meyerson v. El Paso Natural Gas** Co.[443] upon a derivative suit against the parent by a shareholder of the subsidiary, seeking an accounting and an allocation of the tax savings resulting of a consolidated income tax return, the Court concluded saying that "[it] is [illegible] and subsidiary to set fair standards for [illegible]" and upheld the transaction.

[illegible] **Getty Oil Co. v. Skelly Oil Co.** [illegible] the Court applied the "business [illegible] held that when the parent received nothing from the [illegible] even though the parent [illegible] or frustration.

[illegible] according to the [illegible] **Lynch v Vickers Energy Corp.** [illegible] the Delaware Supreme

[illegible] supra note [illegible] the tax saving resulting [illegible] income [illegible] where [illegible] of the [illegible] of the parent. For that [illegible] tender offer to shareholders of the [illegible] in the tender offer.

[illegible] supra note 142 at [illegible] Gettys were in the business of [illegible] crude oil and its products. The Oil Import Board [illegible] the parent, but not the subsidiary, was entitled to a [illegible] For that reason the subsidiary suffered a [illegible] the parent [illegible] nothing.

[illegible] A. 2d 278 (Del. [illegible] A. 2d [illegible] 429 A. 2d (Del.

(continued . . .)

Court held that in case of tender offer, a parent breaches its duty of "complete candor" by failing to disclose material information to minority shareholders. The Court ordered that the plaintiff recover damages of an amount equal to the "increment in the value" that the parent enjoyed as a result of acquiring and holding the subsidiary stock. This increment in value was to be measured at the time of the conclusion of the trial on damages.[446]

C. VAN GORKOM AND ITS AFTERMATH

The Delaware Supreme Court's [illegible] decision in **Smith v. Van Gorkom**[447] [illegible] standard for [illegible] directors' [illegible] the [illegible] management [illegible] relying on

[illegible] **supra** [illegible]

[illegible] by the parent [illegible] the minority's stock [illegible] per share [illegible] the months [illegible] traded at around $7 per share [illegible] per share.

[illegible] minority shareholders were informed of management's belief about the company's [illegible] value, according to the speculative conditions affecting oil and gas. Plaintiff, one of minority shareholders, brought an action against parent claiming that the price was inadequate and that the parent had failed to disclose material information upon the [illegible] appraisal and [illegible]

446 [illegible], **supra** note [illegible]

447 [illegible] shareholders of a corporation filed a class action against the board of directors, seeking to [illegible] a merger of the corporation into a wholly owned subsidiary of other group. As a result of the merger stockholders [illegible] $[illegible] per share for their stock, which previously had [illegible] traded for approximately $34.00 per share.

the discretion afforded by the board of directors under the business judgment rule, granted judgment for the defendants. However the Supreme Court reversed and found that the directors had breached their duty to make an informed decision about the merits of the merger

The court [illegible] opinion focused on the inadequate procedures and missed information that the board needed to evaluate the terms of the merger proposal, the board had agreed too hastily to the merger in an effort to [illegible] demand for a rapid decision on the proposal [448]

> "A director may not abdicate his fiduciary duty to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders by leaving to the stockholders alone the decision to approve or disapprove the agreement." [449]

After [illegible] the directors [illegible] their duty of care by failing [illegible] proposed merger sufficiently, the court concluded that [illegible] does not provide an adequate basis upon [illegible] remanded the case to the [illegible] to award damages [450]

[illegible] **Moran v. Household International Inc.**, [illegible] Delaware Courts upheld a

[illegible]

[illegible] Ibid

[illegible] awarded to the extent that the fair value [illegible] per share." See **Smith**, ibid

[illegible] A [illegible] (Del Ch 1985), **aff'd.** 500 A 2d 1346 (Del [illegible] corporate board's adoption of a "poison pill" as a valid exercise of its business judgment, even though they recognized that a "poison pill" may alter the balance of power between shareholders and the board of directors by making firms essentially takeover-proof unless the acquisition has the approval of the incumbent management.[452]

> "Preferred share purchase rights plan giving shareholders one right per common share upon announcement of tender offer for 30% of corporation's shares or acquisition of 20% of corporation's shares by any single entity or group was authorized by [illegible] 157 and constituted a legitimate exercise of business judgment by directors concerned over takeovers."[453]

Even though the Delaware Supreme Court upheld the validity of the "poison pill," it suggested that the discretion given to management under the business judgment rule might be curtailed if managers failed to show that "the defensive mechanism was reasonable in relation to the threat posed." Thus, the Court declined to preclude the possibility that a firm with a poison pill could be acquired in an unfriendly takeover.[454] A similar approach was adopted in **Revlon, Inc. v. McAndrews & Forbes Holdings, Inc.**[455]

[452] **Dynamics Corp. of Am. v. CTS Corp.**, 794 F.2d 250, 254 (7th Cir. 1986). The "poison pill" is a device, adopted by a board of directors without shareholders' approval, that attempts to discourage hostile takeovers by entitling the company's shareholders to receive additional shares of common stock (or other securities) at a bargain price.

[453] **Moran, supra** note 451 at 1346.

[454] Ibid. at 1356-57.

[455] Del. Supr., 506 A.2d 173 (1986).

[illegible] courts have upheld other controversial operations, with similar reservations. The use of corporate funds to acquire shares of dissident [illegible] is proper exercise of "business judgment" if it is [illegible] to eliminate a threat to the future business or the existing policy [illegible] company, and [illegible] accomplished for the sole primary purpose of perpetuating the control of management.[illegible] Lock-ups (options to [illegible] of corporations and related agreements) are permitted [illegible] "untainted by director interest or other [illegible] fiduciary [illegible]."[illegible]

[illegible] by the presence of [illegible] bankers and [illegible] faith and reasonable [illegible] threatening [illegible]

[illegible]

[illegible] indemnification of anyone [illegible] threatened, pending or [illegible] administrative or

[illegible] Goldsamt, supra [illegible]

[illegible] Revlon, supra [illegible]

[illegible] Polk v. Good [illegible] A. [illegible] (1986)

[illegible] Comment, supra note [illegible] judicial, because he is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another business association.[458] The heirs and estates of such a person may also be indemnified.[459]

Indemnity is limited, in criminal actions, to situations where the person involved had no reasonable cause to believe his conduct was unlawful.[460] [illegible] person involved acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation. [illegible] indemnification [illegible] the [illegible]

[illegible]

[illegible]

direct, the decision may be made by independent legal counsel, or by the [illegible].[464]

The corporation may not indemnify a person as to any suit brought by or [illegible] behalf of the corporation, as to which the person has been held liable for negligence or other misconduct, in the performance of his [illegible] the [illegible] Corporation Code only permits indemnification when the court in which the suit is pending determines that the person is fairly and reasonably entitled to indemnity in view of all the [illegible].[465]

[illegible] third [illegible] [illegible].[467]

[illegible] employee [illegible] the defense of [illegible] expenses, [illegible] incurred by him in

[illegible]

connection with that portion of his defense which was successful.[40] Litigation expenses may be advanced with the understanding that the advances will be repaid if the recipient is ultimately determined not to be entitled to indemnification.[41]

The statute empowers a corporation to obtain insurance to protect anyone who could be indemnified, including protection against liabilities which the corporation cannot indemnify.[42] Finally, the power to indemnify is [illegible] other right to indemnification may [illegible] by [illegible] by law [illegible] without [illegible] limits of public policy [illegible] The provision requires that [illegible][43]

[illegible]

[illegible]

[illegible]

[illegible] supra [illegible]

[illegible] supra [illegible] supra [illegible]

[illegible] [473] Moreover, former directors have been held entitled to indemnification for legal fees and related costs incurred [illegible] effort for [illegible] expenses of [illegible] [474]

[illegible] attorneys' fees [illegible] of the questions [illegible] employment by the [illegible] results of the [illegible] the client, [illegible] of the [illegible]

[illegible] held that they [illegible] generally [illegible]

Merritt Chapman & Scott Corp. v. Wolfson [illegible] A.2d [illegible]

Hibbert v. Hollywood Park, [illegible]

Galdi v. Berg [illegible]

Bergestein v. Texas Int'l Co. [illegible]

McLean v. Alexander, [illegible], rev'd [illegible]

V. COMPENSATION OF DIRECTORS, OFFICERS AND OTHERS

Delaware Corporation Code empowers the corporation to establish benefit, incentive, and compensation plans, [illegible] stock option, [illegible] pension, [illegible] bonus, [illegible] retirement, for any or all of its directors, officers, and employees. There is no provision to require [illegible]

[illegible]

[illegible]

[illegible] Haber v. Bell [illegible]

[illegible] Lieberman v. Becker [illegible]

[illegible] Michelson v. Duncan [illegible] aff'd in part and rev'd in part [illegible]

[illegible] Beard v. Elster, Del. Supr., 160 A. 2d 311 (1956) [illegible] future date in order to avail himself of the [illegible] option. [illegible]

[illegible] fundamental requirement for such consideration [illegible] that the [illegible] may reasonably expect to receive [illegible], so that there be [illegible] the value of the benefits [illegible] to [illegible]

[illegible], they [illegible] faith and the [illegible]. Where there [illegible] proof. The [illegible] personal [illegible] consideration [illegible] conferred.

Beard [illegible]

[illegible]

Gottlieb, supra [illegible]

Olson Bros. Inc. v. Englehart [illegible]
Rosenthal v. Burry Biscuit Corp., [illegible]

Gottlieb, supra [illegible] Kaufmann v. Schoenberg [illegible]

Supra [illegible]

> to examine the facts consists solely in sufficient examination to determine whether the terms of the option plan were so unequal as to amount to waste or whether the question was so close factually as to fall within the realm of the exercise of sound business judgment. In the former case the court will revert to the discretion of the stockholder, in the latter it will not.[447]

In other words, if the stockholders, after [illegible] disclosure of all the facts, ratify [illegible] stock option plan approved by the board of directors [illegible] Forman v. Chesler [448] said [illegible]

[illegible]

[illegible] Pogostin v. Rice [illegible]

[448] Michelson, supra [illegible]

[illegible]

in deadlock situations and permit charter provisions which require more than a majority vote of directors for corporate action.[495]

[illegible] statute [illegible] the creation of "close corporations" and contains provisions applicable only to them. [illegible] a corporation must elect [illegible] that [illegible] specified number [illegible] thirty, [illegible] of stock shall be [illegible] and [illegible] the corporation [illegible] within the meaning of the Securities Act of 1933.[illegible]

[illegible] corporation [illegible] corporation, [illegible]

[illegible]

[illegible] more [illegible] that [illegible] provide that all [illegible] more restriction [illegible] N.Y. [illegible] Corp. Act [illegible] quorum and vote of directors [illegible] Act [illegible] board of directors [illegible] shareholders [illegible] board.

[illegible]

[illegible]

voluntarily terminating the close corporation status,[404] and for preventing involuntary termination of such status.[405]

Prior to the 1967 revision shareholders' agreements have generally been rendered invalid. In **Abercrombie v. Davies**,[406] the Court of Chancery overturned a stockholders' agreement for preserving control. The court said:

> While there may be some disagreement as to the final scope of this provision there can be no doubt that in certain areas the directors rather than the stockholders or others are granted the power by the state to deal with questions of management policy. [illegible] not permit [illegible] [illegible] substantial [illegible][407]

[illegible]

[illegible]

[illegible]

[illegible]

407 [illegible] **Lawson v. Household Finance Corporation**, [illegible]

management power is shifted from directors to stockholders, responsibility and liability are likewise shifted.

[illegible] corporation or any provision [illegible] the ground that they [illegible] partnership [illegible] classes of [illegible] stockholder. Thus, if [illegible] and the [illegible] may [illegible]

[illegible]

[illegible]

[illegible] corporation [illegible] board is so divided that the corporation's affairs can no longer be conducted.[illegible] The [illegible] authorizes the Court to appoint [illegible] or receiver for a close corporation which is being managed [illegible] and is deadlocked, if any other remedy has failed to solve the problem.[illegible]

VIII. [illegible]

[illegible] interest of all the parties [illegible] shareholders, managers, [illegible] Delaware courts have [illegible] useful precedent on [illegible] the [illegible] merit of such [illegible] governance.[illegible]

[illegible] other [illegible] characteristic of [illegible] uniformity [illegible] Delaware [illegible]

[illegible]

[illegible]

[illegible] *supra* [illegible]

[illegible] *supra* [illegible]

[illegible] "pro-management," or "pro-[illegible]

[illegible] absolute predictions [illegible] events and evidence. Since [illegible] of the [illegible] them are conditioned to the [illegible] The remote possibility of this [illegible] for successive [illegible], interested in [illegible]

[illegible] supra notam [illegible], 272, 278, [illegible], 484, 489, 470, 48[illegible]

VI

DELAWARE'S LAW-MAKING PROCESS

1. LEGAL HISTORY AND SOCIO-ECONOMIC HISTORY

Criticism of Delaware Corporate law originates in the work of scholars whose work has been focused on the historical analysis of the policy making aspects of the legal system, and the relationship between that system and socio-economic changes. This analysis has become an account of the manner in which interests groups are able to translate their desires into legislative actions[504] according to a theory of regulation that assumes that legal rules are demanded and supplied like any other commodity.[505]

504 Scheiber, **supra** note [illegible] at [illegible]

505 Theory inspired in the articles of G. Stigler, "The Theory of Economic Regulation" (1971) 2 Bell J. Econ & Mgmt. Sci. 3, S. Peltzman, "Towards a More General Theory of Economic Regulation" (1976) 19 J. Law & Econ. 211, J. Macey, "Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model" (1986) 86 Colum. L. Rev. 223, Landes & Posner, "The Independent Judiciary in an Interest Group Perspective" (1975) 18 J. L. & Econ. 875.

[illegible] supplied to those groups that successfully bid for it with compensation in the form of political support, campaign contributions, lobbying expenditures, and the like. The contours of a given law will therefore reflect a competitive equilibrium among the rival interest groups affected by the law. A further prediction [illegible] is that laws will tend to benefit small, cohesive special interest groups at the expense of the general public. [illegible]

[illegible]

[illegible] supra [illegible]

[illegible] The Legitimacy of Business Corporations in the Law of the United States 1780-1970 [illegible]

[illegible] Corporation Law [illegible]

Delaware became almost 'national' statute. Therefore, the 'interest groups' scholars maintain, modern American corporate law was 'made by management for management.' It provided optimal business opportunities for promoters, directors and officers.

Thus, Professor W. Hurst observes that during such a period of economic expansion it seemed unthinkable to restrict corporations in the performance of their functional role. At that time the emphasis was on utility and there [illegible] on the productive rather than the [illegible] of the corporate device. [illegible]

[illegible] at the federal level for the [illegible] when [illegible] the market had [illegible] required for the [illegible]

[illegible]

[illegible] The Legitimacy supra [illegible] the corporation and therefore the controls were directed at the [illegible] rather than at the corporation itself.[510]

[illegible], the [illegible] regulations at the federal level were separated from [illegible] state [illegible] and both had contrasting [illegible] of the features of the federal system and [illegible] Congress, the Supreme Court and the states [illegible]

[illegible]

[illegible]

[illegible] The Legitimacy, supra [illegible]

[illegible] supra [illegible]

[illegible]

[illegible] The state of Delaware appears as a small but able state with exceptional influence on the development of American corporate law [illegible]

[illegible]

[illegible] supra [illegible]

[illegible] supra [illegible] Wittenberg v. Federal Mining & Smelting Company [illegible]

Professor Cary compares in a table the membership of the Delaware Law Revision Commission in 1967 with that of the Supreme Court of Delaware from 1951 to 1969, and Delaware lawyers, and members of firms in [illegible] The table displays the permanent participation of the [illegible] in the lawmaking process performing different roles, and [illegible] in the [illegible] [illegible] in the

[illegible]

[illegible]

[illegible] supra [illegible]

[illegible] supra [illegible]

[illegible]

[illegible] They would not have spared their

[illegible]

> Delaware may be characterized as a tight little club in which the corporate bar cites unreported decisions before the courts in which they practice. Their major participation in state politics and in the leading firms inevitably would align the Delaware Judiciary solidly with Delaware legislative policy. Indeed, as leading members of the bar they may have contributed to its formulation before they became judges, and it may be might be disloyal to their state to pursue any other course." 518

[illegible] entry into Delaware [illegible] corporate [illegible] policy [illegible]

[illegible]

[illegible] "Comment" supra note [illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible] Shaffer v. Heitner, [illegible]

[illegible] supra [illegible]

[illegible] the right to litigate, but as [illegible] of the [illegible] State for the Delaware bar.[521]

> [illegible] approach to stockholder litigation [illegible] the executives of Delaware corporations [illegible] the corporation [illegible] Delaware Courts, and [illegible][522]

[illegible] AND REINCORPORATION

[illegible]

[illegible] the first [illegible] Delaware [illegible]

[illegible] process, [illegible]

[illegible] degree of [illegible] Delaware [illegible] depend upon the [illegible] considered and interpreted [illegible] corporate law

[illegible] *supra* [illegible]

[illegible]

[illegible] *supra* [illegible]

that are adequate for the structure and purposes of the projected or existent business association.

For incorporation, corporate law are "liberal" or "strict" according to the degree of freedom allowed to the contractual arrangements and the market forces. Liberal laws view the market forces as the most effective source of corporate governance and hence allow more managerial discretionary behaviour. Hence there is less intervention of stakeholders or protection mechanisms [illegible] in Delaware, Maryland, [illegible], Nevada and [illegible]

[illegible]

[illegible]

[illegible] supra [illegible]

[illegible] supra [illegible]

Delaware specializes in corporate law for publicly held corporations. Empirical evidence provides some support for this hypothesis: Delaware's greatest area of dominance over other states lies in the proportion of New York Stock Exchange firms incorporated or reincorporated there. [illegible]

[illegible]

[illegible]

[illegible] *supra* [illegible]

[illegible]

[illegible] *supra* [illegible]

Delaware earned positive abnormal returns of [illegible] over the twenty five month period preceding and including the month of the change.[59]

Therefore, for Delaware, [illegible] legal rules which enhance the [illegible] of mergers do not necessarily and inevitably injure the protection of shareholders. [illegible] the contrary, corporations [illegible] prosper in that state because its legal rules enhance the wealth of the corporation, and hence that of shareholders and managers.

[illegible] shareholder [illegible] continue to hold shares of [illegible] reincorporated in Delaware [illegible] while [illegible] that investors [illegible] shareholders, are able to [illegible] immaterial to invest in corporations [illegible] incorporated in [illegible] state [illegible] investors [illegible] incorporated in "[illegible]" states.[61]

[59] [illegible] *supra* note [illegible] concludes that [illegible] positive abnormal return.

[60] But the [illegible] of [illegible] wealth [illegible] the [illegible] What [illegible] the [illegible] *supra* note [illegible] at 146.

[61] [illegible] *supra* [illegible]

[illegible] chartered in 'strict' jurisdictions display a different percentage of shares held by institutional investors from those incorporated in 'liberal' jurisdictions. Delaware firms have more institutional investors and fewer individual investors than other firms.[illegible]

[illegible]

[illegible] a way to [illegible] movements. It observes that [illegible] that state. Most [illegible] with [illegible] and [illegible]

[illegible]

[illegible] *supra* [illegible]

[illegible] *supra* [illegible]

[illegible] state [illegible] corporations [illegible] statute is brought [illegible] begin to switch [illegible]

Professor Romano points out that the most influential advisors to corporate management are generally the firms lawyers.[504] Delaware legal system is particularly attractive to corporate counsel because their expertise can be centered on one jurisdiction, especially one with the experience and importance of Delaware.[505] Law firms within the state and around the country invest time and money in becoming experts on Delaware law.[506]

Moreover, professors Baysinger & Butler's study reveals that no significant difference is predictable between the financial performances of corporations in "strict" and "liberal" states. The same proportion of successful and unsuccessful [illegible] occur in both types of jurisdictions. More [illegible] reincorporation [illegible] that the previous legal rules were not optimal for either [illegible] after [illegible] structure [illegible] attractive [illegible] left [illegible]

[503] (...continued) [illegible] supra note 11 [illegible]

[504] Romano, supra note 1, at [illegible].

[505] See Macey & Miller, supra note 1 [illegible] at 4[illegible] [illegible]

[506] With some [illegible] extended to certain creditors, in particular banks [illegible] Romano, supra note 1[illegible] at 2[illegible]; Macey & Miller, supra note 1[illegible], at 1[illegible].

could reveal a change in ownership structure (from share dispersion to share concentration) that makes shareholder protection unnecessary.[587]

The decision of where to incorporate or reincorporate is one of the countless decisions the managers must make as agents for the firm and they have no incentive to injure themselves or the shareholders. Therefore Delaware would have achieved its prominent position because it is likely that its "liberal" corporation law maximizes, rather than minimizes, shareholder welfare in corporations that incorporate or reincorporate there.[588]

[illegible] THE ATTACK OF DELAWARE

Other states could duplicate the Delaware Corporate law in the statutory provisions as well as in the judicial opinions. Nevada and New Jersey have followed this course, adopting both the Delaware statutory and case law as it applies to corporations.[589]

[illegible] Delaware has been able to maintain its dominant position. This [illegible] has been attributed to a "guarantee of stability" Delaware [illegible] that its corporation law will remain attractive to managers in

587 This would be the answer to the question 'Why are not all firms incorporated in Delaware?' (Baysinger & Butler, **supra** note 152 at 458).

588 Delaware's preeminence would be attributable to success in a 'climb to the top' rather than in a "race to the bottom." Fischel, **supra** note [illegible] at [illegible]; [illegible], **supra** note 111.

589 See Cary, **supra** note 141 at 665; Macey & Miller, **supra** note 152 at [illegible]; Comment, **supra** note 142 at [illegible].

the future.[540] That promise would have both a static and a dynamic element. The law will be stable in the sense that existing favorable rules will not be replaced for unfavorable ones, and also that the law will be flexible to respond to the market forces.[541]

This "promise" would be bonded by the legislative and judicial process criticized by Professor Cary. Delaware lawyers, judges and legislators are more knowledgeable about and have a greater interest in corporate law than do people with similar positions in other states.[542] They have the expertise to guide the development of corporate law consistently with principles of stability and flexibility and the knowledge of the corporate tradition and the market forces to make the right changes at the right moment.[543] Since other states [illegible] "[illegible]" [illegible] similar [illegible], Delaware remains the undisputed "leader" in corporate law.

IV. INTEREST GROUPS AND LAW MAKING PROCESS

A. RESPONSIVENESS OF DELAWARE LAW MAKERS

540 Romano, **supra** note 15[illegible] at [illegible]. The promise is important because changing a corporate domicile [illegible] process. Macey & Miller, **supra** note 152 at 488.

541 Macey & Miller, **supra** note 152 at 487.

542 Macey & Miller, **supra** note 152 at 48[illegible]. According to professor Folk the Court of Chancery has been honored as "an outstanding and competent [illegible] many of its decisions are [illegible] and the [illegible] of its thinking." [illegible] Folk, **supra** [illegible].

543 Macey & Miller, **supra** note 152 at 48[illegible].

[illegible] that [illegible] interest [illegible] the [illegible] The Delaware [illegible] Delaware Constitution requires a [illegible] guaranteeing that small [illegible] claims will not [illegible] However, the rule has [illegible]

[illegible] from the [illegible] The effect [illegible] Delaware [illegible]

[illegible] supra [illegible] own [illegible] by a panel is only final [illegible] the case for [illegible] Miller, supra [illegible]

"[A]n independent judiciary can both impede or facilitate interest group bargains depending upon whether or not the legislation is interpreted in accord with the original interest group bargain. An independent judiciary, however, does not have the ability to nullify the bargains struck between interest groups and the legislature because the legislature [illegible] the court [illegible] subsequent [illegible]

[illegible]

[illegible]

[illegible]

547 Macey, [illegible] supra [illegible]

548 Macey [illegible] supra [illegible]

[illegible] ... have ... from Delaware ... tend to prefer Delaware corporate law and corporate ... [illegible]

[illegible] ... Delaware would be ... [illegible]

[illegible]

[illegible] ... corporate ... [illegible]

[illegible] ... that ... law ... [illegible] ... Delaware ... [illegible] ... requires that ... member of the state ... [illegible] ... Macey and Miller note that ... requirement ... [illegible] ... out of the state ... lawyer ... pro haec vice, ... matter of course. (Macey & Miller, supra ... [illegible]

[illegible] ... government ... commercial and ... [illegible] ... See Macey & Miller, supra note [illegible]

> [illegible] Delaware [illegible] portion of the indirect cost of Delaware incorporation fees [illegible] Delaware lawyers paid for work on behalf of Delaware corporations. These legal fees are functionally related to the number of charters [illegible] in the sense that the expected legal revenue will increase as the number of corporations chartered in the state increases. Accordingly, the bar would [illegible] because [illegible] the fees [illegible] the number of Delaware corporations. [illegible]

[illegible]

[illegible]

[illegible]

[illegible] Macey & Miller, *supra* note [illegible]

55 Macey & Miller, *supra* note [illegible]

[illegible] equilibrium between [illegible] expanding the [illegible] hand, and [illegible] the other [illegible] the amount of their [illegible]

[illegible]

[illegible]

[illegible] supra [illegible]

[illegible] supra [illegible]

[illegible] that could [illegible] the [illegible]

[illegible] know that the [illegible]

[illegible]

[illegible] *supra* [illegible]

[illegible]

[illegible] *supra* [illegible]

[illegible] [illegible]

[illegible] examined market [illegible] substantial [illegible] that can enhance [illegible]

[illegible], *supra* note [illegible]

[illegible] *supra* note [illegible] and accompanying text.

[illegible] White, [illegible] Econometrics and Indeterminacy: A [illegible] reactions to "changes" in corporate law" (1987) [illegible]

[illegible] White & [illegible] tested the following hypotheses: [illegible] investors [illegible] governance rules when they decide whether to buy or

(continued...)

The result displayed a general absence of significant reactions to Delaware court decisions, and suggested the possibility that the market approach might not be an appropriate technique for evaluating the consequences of judicial decisions. The researchers proposed two explanations for their findings.

[illegible] corporate governance rules [illegible]

[illegible]

[illegible]

[illegible] Delaware Supreme Court [illegible] (Singer v. Magnavox, Lynch I and Lynch II, Zapata Corp. v. Maldonado I and II [illegible] Weinberger v. VOP Inc. and Unocal Corp. v. Mesa Petroleum Co.)

[illegible]

[illegible]

[illegible]

Afterwards, [illegible] the changes in daily stock returns in the sample [illegible] the decision day and for twenty days more. The results were summarized in an equation and a table. (White & Weiss, supra note [illegible], at 57[illegible].)

[illegible]. In [illegible] the market [illegible] and therefore the [illegible] would not provide an accurate indicator of shareholders' [illegible] to different state laws, and such process [illegible] concerning where [illegible]

[illegible]

[illegible] market [illegible] an adequate indicator of [illegible] about corporate law. Moreover [illegible] some doubts concerning the validity of the [illegible] of contract theory according to which the [illegible] the stock market or the managerial markets and the [illegible] litigation would serve as disciplinary influence [illegible]. Rather, it seems that investors do not react to [illegible] rules that [illegible] their rights, and it is unlikely that they [illegible] litigation in a manner to affect corporation governance.

[illegible] See Weiss & White, **supra** note [illegible] at [illegible].

[illegible] White & Weiss, **supra** note 500 at [illegible].

B. INDETERMINACY OF COURT DECISIONS

Professors Weiss and White concluded that the nature of judicial decision in corporate cases makes it unlikely that the rule or rules a court applies in any given case will affect significantly the value of the stock of other companies eventually subject to these rules. Knowing what the "law" is in the sense of knowing that a court purported to set out some rule or rules [illegible] decide some case or cases, will not be sufficient to allow one to predict with confidence how that court or other courts will deal with certain transaction.

[illegible] however, could not interest investors [illegible] the doctrinal changes that the courts adopt [illegible] do not mean predictable differences in the outcomes of a substantial number of future corporate cases. All such cases involve transactions that are potentially distinguishable from the cases that Delaware courts have decided. On the other hand the rules, anchored in shareholder opportunism and managerial discretion, lead the courts to state cautiously any legal rule that can have substantial impact on corporate governance.

> [I]f the courts, in interest of protecting shareholders' rights, promulgate rules that allow any shareholder to challenge any transaction that arguably is adverse to his interest, some shareholders surely will react by behaving strategically, bringing nuisance suits that will enable them to enrich themselves at the expense of the shareholder population as a whole. In addition the threat of shareholder litigation will deter some managers from taking some prudent business risks or engaging in some potentially beneficial transactions with interested parties.

> [illegible] that they would not review the [illegible] of certain kinds of managerial decision [illegible] as [illegible] specified decision making procedures have [illegible] followed, some managers would [illegible] by making [illegible] others would scrupulously follow the [illegible] procedures in order to legitimate transactions in which they [illegible] themselves at shareholder expense. [illegible]

[illegible] of established [illegible] to which the Delaware [illegible] attempt [illegible] to resolve [illegible] of corporate law Delaware [illegible] will [illegible] the outcome of future [illegible]

[illegible] the definition of [illegible] of directors, officers and controlling shareholders [illegible] of such standards [illegible] render them useful. They are [illegible] situations and [illegible]

[illegible] White v. Weiss, supra note [illegible] at [illegible].

[illegible] supra note 11 at [illegible]. Although emphasizing the benefits of [illegible] fiduciary standards, A. A. Sommer recognized the [illegible] price that is paid for such flexibility and adaptability of [illegible] the inability to have [illegible] condition of the [illegible] clear [illegible] delineated, sharply [illegible] supra note [illegible] at [illegible].

The courts customarily rely on a combination of techniques. First, they couple the open-textured standards with certain doctrinal formulations that give the content of these terms, as applied to particular set of facts, [illegible] certainty that in future cases the courts will reach results that established doctrine might appear to preclude. Second, courts frame their decisions in terms that allow general, settled legal rules to be at least arguably relevant to the facts of most future cases.[566] For instance, when Delaware courts have dealt with lawsuits involving challenges to corporate transactions, they have based their decision either on whether the [illegible] duties have been complied with or on whether the [illegible] have been [illegible].

The [illegible] statements from certain [illegible] in certain cases are [illegible] that [illegible] hold [illegible] maintaining [illegible] balance between shareholder interests and management prerogatives. [illegible] the courts [illegible] substantially, that is, enough to [illegible] investors to react [illegible] the system's fundamental equilibrium.

This analysis can be extended to non-Delaware courts that have to deal with Delaware courts' decisions. Supposing that courts in other states will follow the decisions of the Delaware Court [illegible], investors would have to react to decisions [illegible] they affect both [illegible] and [illegible].

566 For instance, "independent directors", [illegible] "good faith inquiry", "reasonable basis" and "fair dealing". See [illegible] & [illegible], **supra** note [illegible] at [illegible].

Delaware companies equally, making it impossible to isolate the decisions' effects on either Delaware or non-Delaware companies.

[illegible] is different. Even though courts in other states often have looked to the Delaware courts' decisions for guidance as precedent, especially when the Delaware courts have dealt with an issue that non-Delaware courts have yet to resolve, there is no reason to suppose that they would follow every movement of Delaware doctrine in corporate law, particularly when Delaware courts have often changed their approach. The [illegible] the [illegible] system does not [illegible] predictions on future tendencies in the corporate law of each state.[567]

[illegible] Conclusion

The Delaware lawmaking process reveals an active role of the corporate bar in the creation and amendment of legal rules. It is evident that some present features of the Delaware corporate law have been influenced by the attitudes and opinions of a corporate bar with an [illegible] interest in the development of legal rules attractive for incorporators and managers.

Nevertheless, the corporate bar is not the only group interested in the Delaware corporate law. Other groups participate in the law-making process, and if the corporate bar has prevailed up to the present, that does not mean that the other groups have been unable to impose some

567 [illegible], supra note 56[illegible], at 60[illegible].

particular points of view or that legislators and judges follow any and all the advices of the corporate bar.

Moreover, even when the purposes of managers or incorporators have been achieved with a certain provision or judgment, the evolving nature of corporate law does not guarantee that the same provision will be construed in similar terms or that any given decision will influence all future decisions in cases involving similar facts. In this sense, court decisions are undetermined and are very unlikely to arrange the preferences of a particular interest in corporate governance.

supra

[illegible] during the interstate [illegible] the power of Congress [illegible] incorporate [illegible] McCulloch v. Maryland [illegible] Chief Justice Marshall stated that

> [illegible] corporation, though appertaining to [illegible], like the power of making war, or levying [illegible] commerce, [illegible] substantive and [illegible] cannot be implied as incidental to [illegible] executing them. [illegible] completed. [illegible]

[illegible]

[illegible]

[illegible]

[illegible] Osborn v. Bank of the United States [illegible]

[illegible]

[illegible]

[illegible] First National Bank v. Fellows ex. rel. Union Trust Co. [illegible]

[illegible] Smith v. Kansas City Title & Trust Co. [illegible]

[illegible] Missouri ex. rel. Burnes National Bank v. Duncan [illegible]

[illegible] Kansas v. Colorado [illegible]

[illegible] supra [illegible]

[illegible] Farmers & Merchants [illegible], 91 U. S. 29 (1875).

[illegible]

[illegible], supra [illegible]

[illegible]

[illegible]

Luxton v. North River Bridge Co.

California v. Pacific R. R.

Pensacola Tel. Co. v. Western Union Tel. Co.

supra

infra

supra

supra

supra

supra

[illegible]

supra

supra

[illegible]

[illegible] *supra* [illegible]

[illegible] *supra* [illegible]

[illegible] *supra* [illegible]

[illegible]

[illegible], The Case for Federal Chartering, Corporate Power in America (R. Nader and M. Green eds. 1973) at 67 [illegible] *supra* [illegible]

[illegible] *supra* [illegible]

[illegible] *supra* [illegible] *supra* [illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible] *supra* [illegible]

[illegible] *supra* [illegible] *supra* [illegible]

[illegible]

[illegible]

[illegible]

[illegible] supra [illegible] Wright [illegible]

[illegible] supra [illegible]

[illegible] supra [illegible]

[illegible] a more favorable [illegible]

[illegible]

[illegible]

[illegible]

[illegible]

In personam [illegible]

[illegible]

[illegible] supra [illegible]

supra [illegible]

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