# THE STATE OF STATE CORPORATION LAW: 1986*

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## I. INTRODUCTION

The topic of this article is the state of state corporation law in the middle 1980s. To even a casual observer it should be clear that today state law is not only flourishing but is at the cutting edge of corporation law. State courts and legislatures are where the meaningful issues arise and where solutions must be found. They are, in short, where the action is and where the action is likely to be for the foreseeable future.

In order to appreciate where we are today, however, it is helpful to look at where state corporation law was a quarter century ago.

## II. THE STATE OF STATE CORPORATION LAW IN THE EARLY 1960S

The central nature of the role of state corporation law today can be put into focus by comparing it to the role of state corporation law just twenty-five years ago. The contrast is so sharp that it is hard to believe we are talking about the same body of law and, largely, the same body of statutes. Nowhere is the role of state corporation law during the 1960s better encapsulated than in a single, off-hand footnote penned by Bayless Manning, then a professor of law at Yale Law School and now a successful corporate practitioner in New York. Professor Manning wrote in 1962:

> One result of this break-through is that corporation law, as a field of intellectual effort, is dead in the United States. When American law ceased to take the "corporation" seriously, the entire body of law that had been built upon that intellectual construct slowly perforated and rotted away. We have nothing left but our great empty corporation statutes—towering sky scrapers of rusted girders, internally welded together and containing nothing but wind.

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> Those of us in academic life who have specialized in corporation law face technological unemployment, or at least substantial retooling. There is a good bit of work to be done to persuade someone to give a decent burial to the shivering skeletons.[1]

As Manning's vivid imagery suggests, state corporation law in the 1960s was neither an area of intellectual endeavor nor an area in which solutions to perceived problems were sought. Rather, it was a set of rules that attorneys complied with on a formal basis in order to achieve clients' desired ends. There was no significant regulatory component; instead, the state law was generally viewed as validating all actions that met such formal standards as quorum and voting requirements. Intellectual effort was involved, of course, in understanding how to manipulate the formal standards, and there was always some remote risk that a court might reject a result that met the formal standards but led to significantly unfair consequences.[2] Nevertheless, it was widely believed that state corporation law did not really matter and did not really affect outcomes or policies if a reasonable degree of sophistication was applied.

In the early 1960s, whatever effective corporate law policy existed was thought to be established almost exclusively through federal securities law, particularly the Securities Exchange Act of 1934[3] and Rule 10b-5 promulgated thereunder.[4] This was the era in which federal regulation was extended to most over-the-counter corporations by the Securities Exchange Act amendments of 1964,[5] of the routine implication of federal causes of action to assure adequate enforcement of federal statutes in the securities area,[6] and of the first attempts to regulate insider trading in publicly held securities by the Securities

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1. Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 245 n.37 (1962).

2. *See, e.g.*, Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) (The Delaware Supreme Court, in an oft-quoted decision, stated that "inequitable action does not become permissible simply because it is legally possible."); Farris v. Glen Alden Corp., 393 Pa. 427, 143 A.2d 25 (1958) (discussing the *de facto* merger doctrine).

3. 15 U.S.C. § 78a (1982).

4. 17 C.F.R. § 240.10b-5 (1985).

5. Pub. L. No. 88-467, 78 Stat. 565 (1964).

6. J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

and Exchange Commission (SEC).[7] Indeed, in the early 1960s, it seemed only a matter of time before the law relating to publicly held corporations would become almost entirely federalized, with state law possibly supplying some minor interstitial rules. This would have been essentially a federal common law of securities, though nominally grounded in broad language in federal securities acts and regulations.

State law would, of course, continue to regulate the small closely held corporation with limited multistate contacts and only a few shareholders. During this period the major issues of state corporation law were thought to be whether the closely held corporation needed special statutory treatment, whether increased flexibility could be provided by the general corporation statute, and, ultimately, whether increased flexibility was required at all.[8]

The 1950s and early 1960s was a period of stability in the economy; there were few extraneous economic pressures on corporations. The cash tender offer and related takeover techniques had not yet developed. The traditional learning was that incumbent management could be unseated only in a proxy fight or by collapse of confidence in management within the board of directors. Since a proxy fight was not very likely to be successful (except perhaps in the case of the most badly managed of companies), and management basically selected the entire board of directors, a major issue of corporate law was thought to be the development of mechanisms by which ineffective management could be eliminated. Further, 1960's thinking about the role of shareholders in the publicly held corporation was still largely shaped by the 1930's perception of Berle and Means[9] and the Temporary National Economic studies[10] that management

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7. *In re* Cady Roberts & Co., 40 S.E.C. 907 (1961).

8. *See* Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1965) (first major case calling for special treatment of closely held corporations). The first statute granting special treatment to such corporations was enacted in Florida in 1963, and similar legislation followed thereafter in Maryland, Delaware, and Pennsylvania. *See* Note, *Statutory Recognition of the Close Corporation in Florida,* 16 U. FLA. L. REV. 569 (1964); Recent Statute, 77 HARV. L. REV. 1551 (1964), and Bradley, *A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes,* 1968 DUKE L.J. 525 (1968); Comment, *The Close Corporation Comes of Age in Pennsylvania: Article III, Chapter B of the Business Corporation Law, 73* DICK. L.REV. 272 (1969).

9. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

10. *See* M. DIMOCK & H. HYDE, BUREAUCRACY AND TRUSTEESHIP IN LARGE CORPORATIONS (TNEC Monograph No. 11, 1940).

had become separated from ownership because of the fragmentation of share holdings in publicly held corporations. While it was recognized during this period that institutional investors were becoming increasingly important holders of shares, this was not viewed as an important development in the corporate governance sense because institutional investors were known to be even more reliable supporters of management than small, individual shareholders. Thus, the gradual increase of concentration of share ownership in such investors was viewed as increasing rather than decreasing the stability of the corporate world.

A final factor contributing to the stability of corporation law in the 1950s and early 1960s was the assumption at the time that, except for share repurchases or redemptions, a corporation was required to treat all shareholders of a class of shares in an identical way. Modern transactions that discriminate among shareholders, such as freeze-out mergers in which minority shareholders are required to accept cash for their shares while the majority shareholder ends up with all of the outstanding shares or exotic types of securities such as the modern "poison pill" preferred shares which vary in rights based on extrinsic events, were simply not permitted at all or were viewed as of very questionable validity.[11] The nonidentical treatment of shareholders in merger transactions originally arose not because of any state corporation law issue but because of changes in the Internal Revenue Code in the early 1960s that permitted triangular and reverse triangular mergers.[12] The amendments in state corporation statutes that now permit the use of cash or property consideration other than shares of the surviving corporation were

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11. One early case involving a cash-out merger was Matteson v. Ziebarth, 40 Wash. 2d 286, 242 P.2d 1025 (1952). While the case upheld the transaction in question, the facts involved a significant attempt by a minority shareholder to engage in a "hold up" or "blackmail." There was, furthermore, a dissent that argued strongly that the transaction was unlawful since it did not involve a "real" merger—a point of view that was widely accepted at the time.

12. I.R.C. § 368(a)(1) (1982) was amended to permit a tax-free reorganization in triangular and reverse triangular mergers by § 218 of the Revenue Act of 1964, Pub. L. No. 88-272 (88th Cong., 2d Sess.). Amendments to merger statutes followed thereafter since the language of most corporation statutes contemplated that all shareholders would receive shares of the surviving corporation in the merger rather than shares of the parent corporation of a corporation party to the merger. It should be added that the statutes of a few states had authorized cash-out mergers of the modern type for a limited class of corporations as early as the 1930s. *See* Weiss, *The Law of Take-out Mergers: A Historical Perspective,* 56 N.Y.U. L. REV. 624 (1981).

not viewed at the time of enactment as a significant change in corporation law but, rather, as minor amendments to permit corporations to take advantage of the new flexibility offered by the Internal Revenue Code defining tax-free reorganizations.

## III. THE STATE OF STATE CORPORATION LAW TODAY

The scene today is entirely different; federal law is now static or declining. There is no hiatus, however, because the resurgence of state law has more than covered any decline in federal law. Illustrative of this, during the past year most of the references in the financial press to the "supreme court" were not to the United States Supreme Court but to the Supreme Court of the State of Delaware; references to decisions by lower courts were usually not references to federal district courts or courts of appeal but references to the Chancery Court of Delaware.[13]

Similarly, one recent decision of the Supreme Court of Delaware, *Smith v. Van Gorkom,*[14] has received more attention in law review and bar commentary[15] (most of it initially negative) than all of the corporate and securities decisions of the United States Supreme Court during the 1984 Term, a Term in which the Court decided an unusually large number of securities cases.[16]

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13. There were, of course, some federal cases during this period brought under federal rather than state law, but in none of them did the Williams Act issue significantly affect the outcome of the particular takeover struggle.

14. 488 A.2d 858 (Del. 1985) (Delaware Supreme Court, in a sharply divided decision, held directors of Trans Union Corp. personally liable due to breaches of their duty of care during a merger transaction).

15. *See* Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1 (1985); Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. LAW. 1437 (1985); Moskins, Trans Union; *A Nailed Board*, 10 DEL. J. CORP. L. 405 (1985); Schwartz & Wiles, Trans Union: *Neither "New" nor "Bad" Law*, 10 DEL. J. CORP. L. 429 (1985); Prickett, *An Explanation of* Trans Union *to "Henny Penny" and Her Friends*, 10 DEL. J. CORP. L. 451 (1985); Quillen, Trans Union, *Business Judgment, and Neutral Principles*, 10 DEL. J. CORP. L. 465 (1985); Chittur, *The Corporate Director's Standard of Care: Past, Present, and Future*, 10 DEL. J. CORP. L. 505 (1985); Note, *Mining the Safe Harbor: The Business Judgment Rule After* Trans Union, 10 DEL. J. CORP. L. 545 (1985); Borden, *First Thoughts on Decision in Delaware on* Trans Union, N.Y.L.J. 1 (Feb. 25, 1985); Middleton, *Merger Decisions—Lawyers See Warning in Court's View of Business Judgment Standard*, Nat'l L.J. 8 (Feb. 18, 1985).

16. This change in emphasis has also been forcefully brought home to me in recent months as I have completed the process of preparing a third edition of my Corporations casebook. This casebook was originally published in 1976; a second edition was published in 1981. The significance of the change in emphasis from

At the present time, three principal areas of concern in corporation law are: (1) the scope and application of the business judgment rule in contests for control; (2) the power of a committee of the board of directors to determine that derivative litigation brought against other directors should be dismissed as a matter of business judgment;[18] and (3) the treatment of minority interests in a corporation upon a cash-out or squeeze-out merger.[19] Each of these issues is now viewed as a matter of state law, and on each of them the leading decisions have been recently handed down by the Supreme Court of Delaware. While all aspects of these decisions may not find approval in all quarters, the opinions are commendable in that they address squarely the most serious issues in corporate law and seek to reach in a reasoned manner an accommodation between basically conflicting interests and values. The Delaware Supreme Court has clearly come a long way from the image created of it by Professor Cary in his famous article of twelve years ago.[20]

### *A. The Application of the Business Judgment Rule in Contests for Control*

The growth of the takeover phenomenon has placed great strain

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federal law to state law was not entirely clear to me in 1980; there is no doubt about it today. As I have gone through the 1980 edition, eliminating comments or cases which seemed important and insightful five or ten years ago, but which are obsolete or dated today, I was struck by the number of changes that were in the direction of new developments and new principles in state law or in the direction of further restrictions on the existing federal jurisdiction. This experience of reexamining every element of a casebook for recent developments also reveals that the trend has accelerated in the last five years, and that in many ways the movement and turmoil today in corporation law is greater than at any time since the 1930s.

17. *See, e.g.,* Moran v. Household Int'l, Inc., 490 A.2d 1059 (Del. Ch. 1985), *aff'd,* 500 A.2d 1346 (Del. 1985); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

18. *See, e.g.,* Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Zapata v. Maldonado, 430 A.2d 779 (Del. 1981).

19. *See, e.g.,* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); Lynch v. Vickers Energy, Inc., 383 A.2d 278 (Del. 1977); Joseph v. Shell Oil Co., 482 A.2d 335 (Del. Ch. 1984).

20. Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* 83 YALE L.J. 663 (1974) [hereinafter cited as Cary, *Federalism and Corporate Law*]. In this controversial article, Professor Cary stated:

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

*Id.* at 670.

on the role of directors and the business judgment rule.[21] Since excess cash or liquidity attracts raiders, corporations traditionally have distributed cash, usually in the form of dividends, and loaded up on debt in order to become less attractive to aggressors. Modern defenses today run strongly in the direction of exotic new weapons that appear to be neither expressly contemplated by, nor expressly prohibited by, state or federal corporation law. For example, the "poison pill" defense involves the creation of new classes or series of preferred shares with voting or redemption rights that "kick in" upon the occurrence of some outside event,[22] and the selective buy-back, where a target company offers to redeem the shares of all shareholders other than the aggressor.[23] Another popular defense is the "lock up" transaction which is designed to place valuable assets—"crown jewels"—in the hands of friendly interests at bargain prices in the event of an unwanted takeover offer.[24]

In all of this takeover activity, there are two basic questions of business judgment: (1) the extent to which incumbent management may use corporate assets and corporate control to preserve their position with the corporation;[25] and, (2) whether management may

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21. Under the traditional view of the business judgment rule, directors' actions taken in good faith are presumed to be sound and the burden is on the challenging party to prove otherwise. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971); Miller v. AT & T Co., 507 F.2d 759 (3d Cir. 1974); Shlensky v. Wigley, 237 N.E.2d 276 (Ill. 1968).

22. *E.g.*, Moran v. Household Int'l, Inc., 490 A.2d 1059 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985).

23. *E.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

24. *E.g.*, MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., No. 8126 (Del. Ch. Oct. 9, 1985).

25. The issue whether management should remain totally passive in the face of a tender offer has evoked a lively controversy among academic economists. Easterbrook and Fischel have argued that incumbent management should be required to adopt a position of passivity with respect to takeover bids. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981). Their conclusion is based on broad economic arguments and does not address the issue of whether this principle should be mandated by state or federal law. Others have suggested that management should attempt to maximize the shareholders' gain by encouraging an auction. See the symposium on this question consisting of Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. Rev. 1 (1982); Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982); Gilson, *Seeking Competitive Bids Versus Pure Passibility in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982).

The courts have long rejected the Easterbrook-Fischel thesis and recognized that it is a business judgment whether or not to oppose an unwanted tender offer. Courts have also rejected the thesis that management should seek to encourage an auction and have recognized that management may seek to defeat an offer entirely

adopt tactics which in effect treat the aggressor differently from other shareholders.[26] A reading of the Delaware Supreme Court's recent opinions dealing with these questions impresses one with the court's attempt to articulate principles in this most difficult area. [27] It appears that the Delaware court is fashioning a new and more stringent version of the business judgment rule applicable to transactions involving the fundamental ownership rights of shareholders, without changing the traditional business judgment rule for other transactions.[28] This effort contrasts vividly with the simplistic, almost "knee jerk," reaction of the SEC[29] to that court's decision in *Mesa Petroleum v. Unocal, Inc.*[30]

### *B. Rules Relating to Cash Mergers*

*Santa Fe Industries v. Green*[31] withdrew federal law from the issue of the fairness of divergent treatment of shareholders of the same class in modern merger transactions between related entities. At the time of this decision, there was essentially no state law addressing

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rather than merely to facilitate or seek competing, higher offers. *See* Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir. 1981).

26. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

27. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (holding that Unocal directors had exercised reasonable business judgment in offering to repurchase a portion of its shares from all holders other than the aggressor, Mesa Petroleum, and its allies); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (holding directors liable for failing to exercise reasonable business judgment in soliciting, and then accepting, an offer to buy the company); MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., No. 8126 (Del. Ch. Oct. 23, 1985), *revised* Oct. 24, 1985), *aff'd*, Nos. 353, 354 (Del. Nov. 1, 1985) (oral decision) (invalidating a "lock-up" transaction that did not benefit the corporation and its shareholders).

28. *See supra* note 14 (law review and bar commentary on the continued vitality of the business judgment rule in the wake of the recent decisions of the Delaware Supreme Court).

29. In SEC Rel. 34-22198, 50 Fed. Reg. 27,976 (1985), the SEC proposed an "equality of treatment" rule for shareholders. The release contains no explanation of why this rule is desirable, and is apparently based on the uncritical acceptance of a major thesis of the Chicago School of law and economics. The release also does not explain why the corporation should be able to discriminate in favor of the aggressor in connection with an individual repurchase of its shares at a premium price (so-called "greenmail") without offering the same opportunity to other shareholders but should be prohibited from doing the converse. *See also* Herzel & Junewicz, *Does the SEC Have Power to Enact the "Unocal" Rule—and is it Wise?*, Nat'l L.J. 20 (Jan. 13, 1986) (a critical discussion of the SEC's proposed Rule 14d-10 which would require tender offers to be made to all shareholders without preference).

30. 493 A.2d 946 (Del. 1985).

31. 430 U.S. 462 (1977).

what should be done about unfair transactions that are approved as formally required by the corporation statutes.[32] State law does grant a right of dissent and appraisal that ultimately permits a dissatisfied shareholder to obtain a judicial appraisal of the value of his shares.[33] It is well known among persons relatively sophisticated in corporation law, however, that this remedy is surrounded by significant limitations and involves such substantial litigation costs that it is rarely invoked, and is certainly not a practical remedy for small economic interests in the corporation. It is interesting that while the reality of the traditional appraisal remedy is not always recognized by the United States Supreme Court[34] or by law professors of the "Chicago School" approach,[35] it is well understood by the Delaware Supreme Court. The Delaware Supreme Court stepped into this vacuum with an innovative opinion, *Singer v. Magnavox Co.*,[36] that imposed a "business purpose" test and a requirement of "inherent fairness" towards minority shareholders.[37] When the "business purpose" standard did not appear to work well, the court switched signals and adopted a quite different approach in another innovative opinion, *Weinberger v. UOP, Inc.*[38]

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32. Apparently the Supreme Court was unaware of how novel the cash merger transaction was and the resulting absence of state law on the issue. The Court stated that it was "reluctant to federalize the substantial portions of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden." *Id.* at 479. The Court did cite Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir.), *cert. denied*, 419 U.S. 844 (1974), a case where the court invalidated a cash-out merger that was clearly abusive as much on the basis of Rule 10b-5 as on the non-existent Georgia law on the question, *id.* at 479 n.16, and Stauffer v. Standard Brands, Inc., 41 Del. Ch. 7, 187 A.2d 78 (1962), a case decided during the era when courts generally permitted transactions that met the formal requirements of the statute without further consideration. *Id. Stauffer* was overruled by Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977), but thereafter resurrected by Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

33. *See* DEL. CODE ANN. tit. 8, § 262(a) (1983) (providing right of appraisal to shareholders who did not vote for, or consent to, a merger of the corporation).

34. *See Santa Fe Indus.*, 430 U.S. at 481 (Stevens, J., concurring in most of the majority's opinion, dissented from Part IV, where the majority refused to permit a cause of action for breach of corporate fiduciary duty under Rule 10b-5, as being unnecessary to the decision because the minority shareholders are protected by being "entitled to receive the fair value of their shares." *Id.*).

35. *See* Fischel, *The 'Race to the Bottom' Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. L. REV. 913, 926 (1982).

36. 380 A.2d 969 (Del. 1977).

37. *Id.* at 979-80.

38. 457 A.2d 701 (Del. 1983).

There, the court simplified the appraisal remedy, assured full disclosure in connection with such transactions, and substituted more sensitive approval mechanisms for the "business purpose" test.[39]

### C. *Rules Relating to the Power of Directors to Compel the Dismissal of Derivative Suits Against Directors*

A great deal of recent academic writing has addressed the issue of whether a decision by a "disinterested" committee of the board of directors that it is not in the best interest of the corporation to pursue derivative litigation against one or more directors should be conclusive under the business judgment rule. The Delaware Supreme Court's opinion in *Zapata v. Maldonado,*[40] holding that in a demand-unnecessary case the court should investigate not only the disinterestedness of the committee but should also apply its own business judgment rule as to the wisdom of dismissing the litigation,[41] has been extremely influential with other courts. It is true that the Delaware Supreme Court sharply limited the scope of *Zapata* in a later decision, *Aronson v. Lewis,*[42] where it held the rule in *Zapata* applicable only in demand-unnecessary cases and announced a restrictive rule as to when demands should be required. Other courts that adopted the *Zapata* approach apparently have viewed it as generally applicable without the *Aronson* limitations, or have even gone further than the Delaware court's original decision in *Zapata.*[43] Only time will tell whether that trend will continue in light of Aronson.

It is not necessary for one fully to agree with the opinions of the Delaware Supreme Court in each of these areas to applaud the willingness of that court to address in a remarkably clear and sensible fashion complex and sensitive issues of corporate law.

### D. *State Statutory Corporation Law*

There is also a renewed interest and resurgence in state statutory corporation law in the 1980s. For example, a recent proposal to

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39. *Id.* at 704, 710-15.
40. 430 A.2d 779 (Del. 1981).
41. *Id.* at 789.
42. 473 A.2d 805 (Del. 1984).
43. *See, e.g.,* Abella v. Universal Leaf Tobacco Co., 546 F. Supp. 795 (E.D. Va. 1982) (Virginia law); Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied sub nom.* City Trust v. Joy, 460 U.S. 1051 (1983) (a concurring judge notes "the majority goes beyond [*Zapata*]" in its belief that Connecticut would adopt the *Zapata* independent business judgment test. *Id.* at 897.).

amend the corporation law of New York to prohibit certain "mop up" mergers was the subject of widespread comment in the financial press. Somewhat similar legislation was enacted with less fanfare in Ohio, Pennsylvania, and other states in the recent past. Most of this legislation appears to be of a parochial nature, designed to protect local management from unwanted takeover attempts, and it is doubtful whether it will survive in the long run. The one area in which the influence of federal law is stable involves the decision by the United States Supreme Court in *Edgar v. Mite Corp.*,[44] involving the preemption of state tender offer statutes by the Williams Act.[45] It is interesting, however, that this case has not significantly readjusted the balance between federal and state law. Rather, it struck down only a particularly intrusive type of state law which, if upheld, would have made all takeover bids impractical.[46] The case did not affect the application of the state-created business judgment rule to other aspects of such bids.

At the present time there is legislation pending in Congress to amend the Securities Exchange Act and address some of the issues now being considered under state law.[47] Unless there is some dramatic development that reverses current trends, there appears to be no chance of enactment of such legislation. Indeed, the Reagan Administration opposed earlier versions of this legislation on the grounds that it constituted unjustifiable interference with the market and with state law. Also pending is a proposal by the SEC to enact new regulations which would effectively reverse the *Unocal* decision of the Delaware Supreme Court.[48] The enactment of such a regulation would be unusual in that most recent actions by the SEC have been to reduce rather than increase its participation in regulatory matters.

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44. 457 U.S. 624 (1982).

45. There are other recent federal decisions that broaden the scope of federal law but they are considerably less important. *See* Landreth Timber Co. v. Landreth, 105 S. Ct. 2297 (1985) (rejection of "sale of business" doctrine for closely held corporations under Rule 10b-5 and the Securities Act of 1933); Herman & Maclean v. Huddleston, 459 U.S. 375 (1983) (express remedies under Securities Act do not preclude recourse to Rule 10b-5).

46. *Mite Corp.*, 457 U.S. at 640. The statute at issue in *Mite* gave the Illinois Secretary of State, *inter alia*, the power to order hearings on the fairness of any tender offer before the tender offer could become effective. The Supreme Court saw this as an imbalance of the "level playing field" sought by the Williams Act, *id.* at 632, and concluded that such an advantage to incumbent mangement would make such takeover bids unreasonably difficult. *Id.* at 637.

47. *See* S. 1582, 99th Cong., 1st Sess. (1985). This bill proposes to amend section 14 of the Securities Exchange Act of 1934, 15 U.S.C. § 78n (1982).

48. *See supra* note 29.

## IV. How Did We Get from the 1960s to 1985?

The balance of this article addresses the factors which caused this major readjustment in the relative roles of federal and state law and makes some cautious predictions as to what seems to be in store for state corporate law during the next few years.

A number of important factors coalesced during the 1970s and early 1980s to explain the dramatic change in emphasis described above. Some of these changes were economic, some political, and some intellectual.

### *A. New Economic Conditions of Liquidity, Debt, and Undervaluation by the Securities Markets*

Because of changes in economic conditions, the modern takeover bid has emerged as a fearsome device to oust incumbent management. Most of the new and difficult issues of corporation law can be traced to that development.

The first takeover bids of the modern type occurred during the late 1960s, but they were tiny by today's standards. Then a cash offer totalling $100 million was viewed as large; today such an offer barely merits a "squib" in the *Wall Street Journal.* The response to the first tender offers in the 1960s was characteristic of that time: they were viewed as a federal problem, and Congress promptly amended the Securities Exchange Act of 1934 by adding provisions addressing such offers. These provisions are universally referred to as the Williams Act.[49] The Williams Act was viewed as favoring neither aggressor nor target; rather it created a "level playing field" by imposing disclosure obligations on persons who acquire more than five percent of a registered company's shares or who make a tender offer for those shares. It also imposed certain "rules of fair play" on the mechanics of tender offers which have shaped their form, yet have not materially changed their content or effect.[50] This legislation has become increasingly less relevant over the years as ingenuity, fueled by tremendous economic pressures, has caused the takeover device to move into new and unexpected channels, including two-

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49. 15 U.S. C. §§ 78m, 78n (1982) (commonly referred to as §§ 13(d), 13(e), 14(d), 14(e), and 14(f) of the Securities Exchange Act of 1934).

50. The Williams Act also imposed a broad antifraud provision that the United States Supreme Court has largely rendered innocuous. *See, e.g.,* Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977) (defeated tender offeror does not have private cause of action); Schreiber v. Burlington N., Inc., 105 S. Ct. 2458 (1985) (requiring actual nondisclosure rather than merely generally unfair conduct).

tiered tender offers and novel substitutes for a traditional tender offer.

During the 1970s and 1980s, immense pools of liquid capital have developed which are readily available to sophisticated individuals and aggressor corporations. The sources of these funds include institutional and large individual investors (many of which have allocated a portion of their assets for speculative investments), traditional financial institutions, the proceeds of prior successful forays into takeover battles, the profits from arbitrage transactions in connection with such takeovers, and the use of Eurodollar balances in overseas accounts. They also include internally generated cash by many corporations. In particular, amendments to the Internal Revenue Code in the early 1980s have enabled many corporations to amass large "war chests" through substantial positive cash flow with little or no tax liability, indeed, in many cases, a negative tax liability, despite tremendous surges in liquid assets and free cash. In recent years a market for so-called "junk bonds" has developed that enables individuals to obtain access to billions of dollars of capital to fuel personal takeover attempts of large publicly held corporations.[51] These bonds represent "boot strap" financing because their "security," and the ability of the borrower to carry them for a longer term, are dependent on the value of the cash flow of the target or, increasingly, the "bust up" value of the target's component parts.

This increased liquidity has led to cash offers being routinely made that involve billions of dollars and has completely changed the rules of the takeover game. Given this liquidity sloshing around in the economy, no corporation is too large to be purchased for cash.[52] Even corporations with substantial holdings by a founding family have become subject to takeovers. There is also the nearly incredible spectacle of a single individual with no visible prior experience in the airlines business raising over $500 million to purchase a majority interest in a major airline, Trans World Airlines, for cash.[53]

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51. The activities of T. Boone Pickens have been avidly followed and commented upon by the popular press, as well as Carl Icahn's takeover of TWA. Both are illustrative of this phenomenon. *But see Twilight for the Lone Raider?*, BUS. WK. 39 (Jan. 27, 1985) (concluding that "the battle has clearly swung from offense to defense, like a football game.").

52. An example of this is the recent acquisition of RCA by General Electric Company for an amount in excess of $6.3 billion cash. *See Not Just Another Takeover—Or Is It?*, BUS. WK 48 (Dec. 30, 1985).

53. At the time this article was being prepared Carl Icahn was attempting a takeover of TWA.

A second factor that has fueled the modern takeover scene is the apparent failure of the trading markets to value shares of publicly held corporations commensurately with the value of their assets or cash flow if broken up and sold as separate units. The reason that T. Boone Pickens can raise several billions of dollars to purchase Unocal, a major oil company, is the widespread belief that, broken up and restructured, Unocal assets will be worth much more than the market value of the shares before Pickens came on the scene. There is a major controversy among economists and others as to why this should be so even in the case of apparently well-managed companies. The most likely explanation appears to be that the market for control in which takeover bids is largely independent of the short-term secondary market in which securities are traded.[54]

### *B. The Decline in Federal Law*

The pressure on legal principles generated by changing economic conditions has been accompanied by a decline in the role of federal corporation law. In the late 1960s, or early 1970s, federal law of corporations and securities reached its peak.[55]

The predominant courts for corporate law matters, where most federal securities cases were brought, were the United States Court of Appeals for the Second Circuit and the United States District Court for the Southern District of New York. Beginning in 1975, however, the Supreme Court of the United States, under a more conservative majority, issued a series of limiting rulings under Rule 10b-5 that effectively reversed the trend toward continued federalization of corporation law.[56] These decisions, in fact, not only signaled a change in the growth of Rule 10b-5 but also marked the end of the growth of the federal law of securities.

In retrospect, it is clear that the holding in *Santa Fe Industries*

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54. It is also possible that artificial tax rules make certain control transactions attractive. Professor Lowenstein has recently argued persuasively that the attractiveness of so-called "leveraged buy-outs" has more to do with tax savings than with economic efficiencies of a corporation becoming privately held. *See* Lowenstein, *Management Buyouts,* 85 COLUM. L. REV. 730 (1985).

55. The precise time of the peak is a matter of controversy, but a popular choice is the day of the decision by the United States Supreme Court in Superintendent of Ins. of the State of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971).

56. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

*v. Green*[57] was the most important of these cases from the perspective of the relationship between federal and state law. That case basically limited Rule 10b-5 to cases of deception or nondisclosure and thus removed from the federal courts claims of unfairness arising from cash mergers and other transactions involving disproportionate treatment of shareholders.[58]

A second line of cases which also limited the growth of federal corporation law dealt with the implication of private causes of action to enforce federal statutes. Early decisions established that private causes of action existed under Rule 10b-5[59] and the SEC proxy rules.[60] However, in *Piper v. Chris-Craft Industries, Inc.*,[61] the Supreme Court surprised the corporate world by holding that an aggressor in a tender offer did not have standing to enforce violations of the antifraud provisions of the Williams Act, thereby signaling that tender offer issues were not to be judicialized by federal courts under that Act.[62] The federal courts got the message, and as a result federal law has not been a significant factor in the recent litigation over tender offers.[63]

The *Piper* decision, however, did have one very desirable additional consequence: it returned the issue of the success or failure of takeover bids to the economic arena and removed it from the courtroom.

### C. *Changes in the Regulatory Climate*

In the decisions limiting federal involvement in securities law, the Supreme Court was slightly ahead of the election returns. In the late 1970s, an important change in the intellectual and political climate in Washington occurred with respect to federal regulation. "Deregulation" became the watchword in a number of areas, including securities law. Deregulation, of course, was not limited to

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57. 430 U.S. 462 (1977).

58. The logical last step—that the same principle applied to the somewhat differently phrased antifraud provision in the Williams Act—did not occur until 1985. *See* Schreiber v. Burlington N., Inc., 105 S. Ct. 1358 (1985).

59. Karden v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).

60. J.I. Case v. Borak, 377 U.S. 426 (1964).

61. 430 U.S. 1 (1977).

62. *Id.* at 41-42.

63. In an earlier decision, the Court had limited § 13(d) of the Williams Act by holding that a showing of irreparable harm was necessary for a private litigant to enjoin voting of stock acquired in violation of that section. Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975).

securities: it has appeared in varying degrees in airline regulation, telephone regulation, antitrust law, and other areas as well.

Also, President Reagan's appointments to the Securities and Exchange Commission so strengthened the role of economists that they have come to dominate much of the decision-making within the agency. The general attitude has become one of laissez-faire—let the market handle it. If carried to its logical extreme, this would probably result in the repeal of virtually all federal statutes relating to securities. The only notable exception is in the area of insider trading, where the Commission has been more active than ever before. This change in climate has led the Commission to accept the Supreme Court decisions of the 1970s; in an earlier era, the Commission would likely have sought legislative reversal of at least some of these limiting decisions.

Illustrative of the abrupt change in attitude toward federal regulation over a single decade is the history of the ill-fated Federal Securities Code project of the American Law Institute (ALI). This systematic revision and restatement of the entire federal law of securities got underway in 1969, at or near the high point of federal influence. At that time it was viewed as a major project that would probably shape the future of securities law for generations to come.

Professor Louis Loss, the leading academic figure in securities law, was persuaded to be the Reporter, and other leading securities law scholars and practitioners willingly devoted a great deal of time and attention to the project. The ALI approved the final version of the Securities Code in 1977, just when the deregulation philosophy was taking hold. The unfortunate result is that the new Code is dead in the water. While it was formally approved by the SEC in a luke-warm manner and supported by the American Bar Association, it has never been introduced as a bill in Congress because of the lack of a credible sponsor. Unless there is a remarkable change in attitude, it will never be enacted and may never even be formally introduced.[64] This was an estimable project, involving many innovative ideas and a large investment of resources, but the timing simply could not have been worse.

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64. Some of the drive behind this legislation disappeared when the SEC adopted its integration and shelf regulations under the Securities Act of 1933, thereby achieving by regulation some of the major goals sought by the Code.

### *D. The Decline of "New Deal" Liberal Thought and the Rise of the "Chicago School"*

The rise of deregulation has also been accompanied by significant changes in underlying philosophy and ideology. There has been both a decline in interest in traditional liberal approaches towards corporate and securities law, and a rise in the vigor and influence of the "Chicago School" of law and economics.

It seems inconceivable today that less than a decade ago there was serious talk about the federal chartering of corporations and the enactment of a "Federal Corporate Uniformity Act" as proposed by Professor Cary in his influential *Yale Law Review* article.[65] Vestiges of these traditional liberal viewpoints may possibly be found in part of the current ALI Project on Corporate Governance, but the vitality and force behind the ideas themselves appear to have disappeared. This is not to say that these views have left no mark. Generations of lawyers and law professors were taught about the separation of ownership and control, the resulting concern that management was not subject to meaningful restraint, and that the major problems of corporate law were "shareholder democracy" and the lack of management responsibility. Further, Professor Cary's famous comment that Delaware corporation law involved a "race to the bottom"[66] clearly stung the Delaware judiciary as well as the Delaware Bar, and is unlikely to have been forgotten.

The decline in importance of federal law, the growth of the deregulation philosophy, and the decline of traditional liberal thought, all have undoubtedly been hastened by the development and dissemination of a different analysis of corporation law by the "Chicago School" of law and economics. Until the late 1970s, very little writing by persons with training in economics had appeared in the legal literature pertaining to corporation and securities law.[67] In the last few years there has been a great outpouring of this literature, which by-and-large is clearly and persuasively written and carries the basic message of laissez-faire. With arguments phrased in terms of the "efficient market hypothesis," "random walks," the "market for

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65. Cary, *Federalism and the Corporate Law, supra* note 20, at 700-02.

66. *Id.*

67. Early work was done by Professor Manne on securities markets and inside trading and by Professor Winter questioning the value judgments of the traditional liberal approach.

control," and analysis "*ex ante*" rather than "*ex post,*" this literature contends that everyone benefits from takeovers, that elimination of inefficiency is a natural phenomenon occurring in a free market but not in a regulated one, and that the traditional liberal concern about management being accountable to no one was misplaced, oversimplistic, and naive. The Chicago School further argues that regulatory efforts are likely to be counter productive, and that corporation statutes are basically a labor saving device to simplify the drafting of recurring provisions in corporate documents. I will not debate here the merits or values of this extensive Chicago School literature. In many respects, however, I believe it is based on oversimplified models, and its conclusions should be treated with caution.[68] Nevertheless, one cannot deny its forceful reasoning and analysis. Whether or not it is right, it is powerful and persuasive to many persons, and ultimately will have to be addressed by whichever court, agency, or legislature makes policy in the corporate and securities areas.

## V. WHERE WILL STATE CORPORATION LAW BE TEN YEARS FROM NOW?

Predictions as to the direction of corporation law in the next ten years will probably be as inaccurate as were predictions made in 1975 about today. Certainly, the direction of corporation law in the next ten years is partially dependent on whether the current economic forces continue as they have in the recent past. The most likely cause for a major change is a massive market collapse triggered by the tremendous amounts of debt which corporations recently have assumed. Such a collapse might create a point of discontinuity in corporate law patterns, and the results following such an event are simply not predictable or foreseeable. While I personally doubt that this is what the future portends, it is a possibility that cannot be ruled out.

Assuming there is no massive collapse, present trends are likely to continue. If events continue to be shaped by the Delaware Supreme Court in the takeover area, that court will have to address the

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68. Two examples of attempts to deal with the literature of the Chicago School without necessarily subscribing to all of its tenets are Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation,* 83 COLUM. L. REV. 249 (1983), and Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance,* 84 COLUM. L. REV. 1145 (1984).

arguments of the Chicago School more persuasively than in the past.[69]

At the present time, there are two other developments that appear likely to influence state corporation law during the next ten years. One of these is the Revised Model Business Corporation Act promulgated in 1984 by the Committee on Corporate Laws of the American Bar Association. The other is the Corporate Governance Project of the American Law Institute.

### *A. The Revised Model Business Corporation Act*

The Revised Model Business Corporation Act (Revised Model Act) is likely to be the principal source of revisions in state corporation statutes for the foreseeable future.[70] There appears to be roughly a thirty or forty year recodification cycle of corporation statutes, and the new Act comes at a good time in light of the initial wave of acceptance of the original Model Act that began in the early 1950s and continued well into the 1960s. The Revised Model Act already has served as the basis for the codification of the Virginia corporation statute in early 1985.[71] The next real test of its popularity will probably come in early 1986 when it is introduced in the legislatures of a number of other states.

The Delaware General Corporation Law has obviously been highly successful in persuading corporations to incorporate in Delaware. It has not, however, had a great extraterritorial effect: it basically has not served as a model for other state statutory enactments. Indeed, at the present time, the Delaware statute probably could benefit from a review in light of the Revised Model Act.

The Revised Model Act is not a major reform effort. Rather, it can best be described as one of incremental change. It was the product of a large group of sophisticated corporate attorneys from a variety of backgrounds and experience in a number of different states. In the course of its drafting, there was strong emphasis placed

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69. The only reference that I am aware of to this burgeoning literature in Delaware Supreme Court opinions is a footnote in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 n.9 (1985). This note rejects the conclusions of the Chicago School without directly responding to its arguments.

70. It is appropriate to disclose at the outset that I served as the reporter for this new statute, and that I, therefore, have a considerable personal interest in the ultimate popularity of this revised statute.

71. *See* VA. CODE § 13.1 (1985 replacement vol.).

on continuity with principles of the past. That continuity may not be self-evident on a simple comparison of language due to changes in organization, structure, and drafting style. On the other hand, a number of obsolete or obsolescent provisions have been eliminated,[72] and numerous incremental substantive changes were made to improve the balance between fairness and efficiency.[73] Further, the recodification permitted improvement of treatment in several technical areas that were only sketchily handled in the earlier Model Act.[74]

The Revised Model Act did not address at all certain sensitive areas, including several problems described earlier which have been addressed recently by the Supreme Court of Delaware.[75] After numerous drafting efforts, the Committee concluded that it was not able to define precisely the relationship between the duty of care and the business judgment rule.[76]

The provision relating to conflict of interest transactions[77] was amended, but not to the satisfaction of all committee members, and will probably be amended further in 1986. Also reserved for possible future consideration were several problems with derivative litigation, particularly the question addressed in *Zapata* and *Aronson* as to the power of disinterested directors to dismiss a derivative suit against other directors over the objections of the plaintiffs.

The Committee on Corporate Laws is a large committee accustomed to proceeding not by sharply split majority votes but by a process of adjustment and conciliation by which divergent views may be reconciled to the maximum extent possible. The instances in which the Committee was unable or unwilling to take firm positions

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72. Examples include par value and artificial restrictions on the kinds of securities a corporation may create.

73. For example, the provision that the proposal of a supermajority provision (e.g., an 80% vote to pass selected measures) must be passed by that chosen supermajority (80%), and provisions relating to distributions designed to provide realistic protection to creditors and shareholders with preferential rights without imposing unnecessary restraints on corporate activity.

74. For example, major improvements were made in the areas of share transfer restrictions, the statutory shareholder's right of dissent and appraisal, the right of the corporation to provide directors and officers with indemnification, class voting, the acceptance of proxy votes, and the problem of nominee registration of shares of publicly held corporations. These provisions were sometimes controversial within the Committee, and it is possible that they will also be controversial as this statute comes before state legislatures.

75. *See supra* note 27 and accompanying text.

76. Revised Model Business Corporation Act § 8.30 (1983).

77. *Id.* § 8.31.

on current sensitive problems reflect the continuing controversial nature of these issues and the concern of the Committee about prematurely making changes to the Model Act before the proposed solution has achieved some degree of consensus.

### *B. The American Law Institute's Corporate Governance Project*

The Corporate Governance Project, currently underway under the auspices of the ALI, has its roots in the early 1970s when the nation was shocked by widespread disclosures of illegal payments by many of the nation's largest and most prestigious corporations. The Project is now funded through 1988 and could possibly continue beyond that period. Conceivably it may suffer some of the same problems of the Federal Securities Code, as it writes prescriptions for today's problems, yet will not be implemented for three or more years. On the other hand, the Project, unlike the Federal Securities Code, is addressed to the state and federal judiciaries, as well as to the state or federal legislatures. Typically, the judiciary has been quite receptive to the positions taken by the ALI in its various restatements,[78] and the Corporate Governance Project may receive a similarly receptive treatment. However, the first drafts of the Project met a chilling and negative reaction from the business community, and it is possible that resistance to the Project's proposals may continue. With many controversial areas of the Project still to be discussed, its net long-term effect cannot be accurately assessed, but it will almost certainly be a factor of importance to be considered in the future.

## VI. CONCLUSION

At a recent conference for corporate counsel, Bayless Manning is reported to have commented that the present turmoil may herald "the golden age" of corporation law. He added, however, that it may be hard to tell, because "no one who lived in the Middle Ages knew that he was living in the Middle Ages."

Certainly today is a period of ferment in corporation law, and this turmoil seems unlikely to disappear in the foreseeable future.

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78. An illustration of this receptiveness is Klinicki v. Lundgren, 695 P.2d 906 (Or. 1985), applying the proposed Corporate Governance Project standard for corporate opportunities even before that standard has been considered by the body of the ALI. Corporate opportunity is, of course, a traditional common law area of corporation law not generally the subject of legislative definition.

State law, and particularly that which is being developed by the Delaware Supreme Court, is thriving and appears likely to continue to be a dominant force in this area. We may indeed be approaching a "golden age," but it is hard to tell.