THE INTERPLAY BETWEEN STATE CORPORATION AND FEDERAL SECURITIES LAW—SANTA FE, SINGER, BURKS, MALDONADO, THEIR PROGENY, & BEYOND

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I. INTRODUCTION

In his scorching article Federalism and Corporate Law: Reflections Upon Delaware, Professor William L. Cary, a distinguished former Chairman of the Securities and Exchange Commission (SEC), described state corporation law as a "race for the bottom" which Dela-

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ware had clearly won. Although undoubtedly harsh, Professor Cary's characterization of Delaware corporation law was shared by others. For example, one critical commentator asserted that "the sovereign state of Delaware is in the business of selling its corporation law."  

It bears emphasis, however, that Delaware was not alone in this race for the bottom. As Professor Cary pointed out, if Delaware had elected not to retain its position, other states would have surely assumed its lucrative position. Indeed, this trend toward greater permissiveness was pointed out by another distinguished scholar, Professor Ernest L. Folk, who served as reporter to the Delaware Corporation Law Revision Committee. Referring to such permissiveness, Professor Folk contended that this trend appeared irreversible, absent some unforeseeable changes in the fundamental structure of the American economy. As a final example of this race to serve only one constituent of the corporate community—management—reference is made to Mr. Bayless Manning's characterization of such state

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2. Commenting shortly after the passage of the Delaware Corporation Law of 1967, one critic asserted:
   The sovereign state of Delaware is in the business of selling its corporation law. This is a profitable business, for corporation law is a good commodity to sell. The market is large and relatively few producers compete on a national scale. The consumers of this commodity are corporations, and as we shall see, Delaware, like any other good businessman, tries to give the consumer what he wants. In fact, those who will buy the product are not only consulted about their preferences, but are also allowed to design the product and run the factory.
4. Speaking of corporation law generally, Professor Folk stated:
   Almost without exception, the key movement in corporation law revisions is toward ever greater permissiveness . . . . Explicitly positing an objective of "flexibility," statutory revisers . . . have usually sought to enlarge the ambit of freedom of corporate management to take whatever action it may wish . . . . Indeed the new statutes seem to be exclusively concerned with only one constituent of the corporate community—management—and have disregarded the interests of shareholders and creditors, let alone more tangentially interested parties, such as employees, customers, and the general public. . . . [I]t appears that these trends are irreversible, absent some presently unforeseeable changes in the basic structure of the American economy. State efforts to go against such deep-seated dispositions, even if desired, would be futile.

corporation statutes as "towering skyscrapers of rusted girders, internally welded together and containing nothing but wind." 5

In view of recent developments, it is somewhat surprising that many of these experts characterized Delaware and other state corporation laws in such pessimistic and hopeless terms as recently as a decade ago. From these developments, many of these experts would now have to admit that Delaware, above all states, has come a long way toward protecting the rights of shareholders and promoting the fundamental concept of corporate accountability.

How did all of this happen? On the surface, surprisingly, the starting point is not state corporation law but the United States Supreme Court and lower federal courts. Due to the perverse competition among the states, the adequacy of protection state corporation law provided investors was seriously questioned. In response to this situation, many commentators argued for the application of federal standards of corporate responsibility. 6 One approach to achieve this result has been a recurrent movement for the federalization of the law relating to the governance of large, publicly held corporations, either by way of federal chartering or by way of a statute imposing federal minimum corporate standards.7 Another suggestion urging federal intervention has been to construe the antifraud provisions of the federal securities laws broadly and remedially in a manner which brings the federal presence to bear on a wide range of corporate activities. 8 Indeed, the impetus for this response may have been provided by the federal courts themselves. For example, the federal courts

5. Manning, The Shareholders' Appraisal Remedy: An Essay for Frank Coker, 72 YALE L.J. 225, 245 n.37 (1962). See also Metzenbaum, Legislative Approaches to Corporate Governance, 56 NOTRE DAME L. 926, 931 (1981) ("States have competed with each other in what has been called a race to the bottom, to develop a permissive, management-oriented body of law that will attract corporations to domicile within their borders and provide corporate business."); Sachnoff, The Present System Does Not Prevent Long-Scal Fraud, in CORPORATE STRUCTURE AND GOVERNANCE 1977-78, at 232 (Schwartz ed. 1979) ("The simple fact is that the states have not done their job of protecting shareholders' interests.").


8. See, e.g., Fleischer, supra note 6; Folk, supra note 6.
have interpreted Rule 10b-5 in such a way as to protect purchasers and sellers from persons who improperly trade on the basis of inside information,9 to provide relief to participants in transactions involving misleading corporate publicity,10 and to relax the reliance requirement in cases of nondisclosure.11 In this regard, some commentators have urged that Rule 10b-5 should be expansively construed to serve as the "watchdog" for all corporate activity.12

Thus, one former Chairman of the SEC, Manuel Cohen, aptly described the then existing relationship between state corporation and federal securities law by stating:

The history of state corporation laws over the past decade . . . has been one of reducing protections for shareholders and expanding the discretion of corporate management. To some extent, this simply reflects the inability of any single state to exercise effective control over a corporation whose operations and shareholders are spread across the nation. In any event, it has necessitated the development of a body of law which some observers have described as a "federal corporation law" to fill the gap.13

9. See, e.g., SEC v. Geon Indus., Inc., 581 F.2d 39 (2d Cir. 1976); SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974); SEC v. Great Am. Indus., Inc., 407 F.2d 455, 465 (2d Cir. 1968) (Kaufman, J., concurring), cert. denied, 395 U.S. 920 (1969) ("[a]ny claim that material facts were withheld in a transaction in connection with the sale or purchase of securities must be scrutinized with care, whether or not there would have been liability at common law for such a deed."). But see Chiarella v. United States, 445 U.S. 222 (1980) (no duty to disclose under § 10(b) arises from mere possession of nonpublic material information). This prohibition against insider trading extends to tipnees as well. See, e.g., SEC v. Geon Indus., Inc., 531 F.2d 39 (2d Cir. 1976).


[A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.

Id. at 848.


12. See authorities cited note 6 supra.

13. M. Cohen, Introduction, in E. Aranow & H. Einhorn, Proxy Contests For Corporate Control XV (1968). As stated by another source:

It may be an oversimplification to emphasize the causal relation between federal regulation and state permissiveness—numerous other considerations were important in the "race for the bottom." Nonetheless, the development of a "federal corporation law" provided a plausible justification for state corporation laws and judicial decisions to discount the interests of investors and the public.

As noted above, rather than federal corporation law expanding, as many of these experts predicted, it has been significantly narrowed. As with the growth of such federal corporation law, the impetus for its downfall may be attributed to the United States Supreme Court. The decision which ultimately effected this result is *Santa Fe Industries, Inc. v. Green*, decided in 1977. In that case, the Court held that section 10(b) and Rule 10b-5 do not reach breaches of fiduciary duty, absent deception or manipulation.

Although the details of the *Santa Fe* case will be discussed at a later point, the states' reaction to *Santa Fe* is significant. Somewhat surprisingly, rather than continuing their race for the bottom, Delaware and certain other states have shown a greater tendency to safeguard shareholders' interests. This assertion is supported by two examples which will be addressed. The first is the reaction of Delaware and other states to the *Santa Fe* decision. The second is the reaction of certain state courts to the *Burks v. Lasker* special litigation committee scenario. A third development, and one which has yet to be definitively construed by the Delaware courts, is the application of the business judgment rule when control is a motive in the directors' actions.

II. *Santa Fe* and Its Progeny

*Santa Fe* involved the merger of the Kirby Lumber Corporation into its parent, Santa Fe Industries, Inc., which owned 96% of Kirby's stock. Availing itself of a simplified Delaware procedure known as a "short-form" merger under which a parent that owns at least 90% of a subsidiary's outstanding stock can absorb the subsidiary without being required to obtain approval by the shareholders of either corporation, Santa Fe informed the Kirby minority shareholders that they were now out of the picture, that they would receive $150 per share in cash, and that, if dissatisfied, they could seek appraisal in the Delaware courts.

The materials sent to the Kirby shareholders contained facts and figures that convinced one such recipient, S. William Green, that his stock was actually worth at least $772 a share. Green did not claim that these materials were deceptive. Indeed, he built his case on them.
Green's basic premise was that the gross undervaluation of the shares was itself a "fraud" within the meaning of that term as used in Rule 10b-5. Therefore, Green concluded that Santa Fe had committed a wrong under federal law, and that his class was entitled to redress for that wrong. The district court found this argument unpersuasive.20 A majority of a panel of the Second Circuit, however, accepted it, reasoning, in pertinent part, that "if there is no valid corporate purpose for the merger, then even the most brazen disclosure of that fact to the minority shareholders in no way mitigates the fraudulent conduct." 21

The Supreme Court reversed.22 Citing a Harvard Law Review commentator's statement that Santa Fe and a Second Circuit decision in a similar going private case 23 were the first appellate decisions to permit "a [Rule] 10b-5 claim without some element of misrepresentation or nondisclosure," 24 the Court held "that the transaction was neither deceptive nor manipulative and therefore did not violate either [section] 10(b) of the Exchange Act or Rule 10b-5." 25

It should be emphasized that Santa Fe is undeniably significant. If the case had been decided the other way and the Second Circuit's "new fraud" or "equitable fraud" concept had been sustained, minority shareholders would have had the federal shield of protection from exploitation and overreaching that many believe they need.26 Indeed, Mr. Justice White acknowledged this point at the conclusion of his opinion when he stated: "There may well be a need for uniform federal fiduciary standards to govern mergers such as that challenged in this complaint. But those standards should not be supplied by judicial extension of [section] 10(b) and Rule 10b-5 to 'cover the corporate universe.'" 27

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23. Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir. 1976) vacated and remanded for a determination of mootness, 429 U.S. 881 (1976), dismissed, 441 F.Supp. 299 (S.D.N.Y. 1977). In Marshel, the Second Circuit held that "when controlling stockholders and directors of a publicly-held corporation cause it to expend corporate funds to force elimination of minority stockholders' equity participation for reasons not benefiting the corporation but rather serving only the interest of the controlling stockholders such conduct will be enjoined pursuant to Section 10(b) and Rule 10b-5." Id. at 1281.
25. 430 U.S. at 474.
26. See authorities cited notes 6-7 supra.
27. 430 U.S. at 479-80 (footnotes omitted). Referring to Professor Cary's article, Mr. Justice White commented: "Professor Cary argues vigorously for comprehensive federal fiduciary standards, but urges a 'frontal' attack by a new federal statute rather than an extension of Rule 10b-5." Id. at 480 n.17.
Most significantly, Santa Fe had another aspect: The Court's comment in footnote fourteen that the majority's failure to provide the minority with advance notice of the merger was not a material nondisclosure because, as the plaintiffs conceded, "under Delaware law [the plaintiffs] could not have enjoined the merger because an appraisal proceeding [was] their sole remedy in the Delaware courts for any alleged unfairness in the terms of the merger." 28

Today, however, no plaintiff would make that concession in a Santa Fe-type situation. Six months after that decision, in Singer v. Magnavox Co., 29 the Delaware Supreme Court, viewing Santa Fe as a "current confirmation by the Supreme Court of the responsibility of a state to govern the internal affairs of corporate life," 30 held that appraisal was not a minority shareholder's sole remedy. 31 Thus, perhaps influenced by the Supreme Court's decision in Santa Fe, and the consequent likelihood of reduced federal regulation in the area of management malfeasance, the Delaware Supreme Court apparently has helped to fill this protective role.

Specifically, in Singer, minority shareholders, who had been frozen out by a long-form merger, sued for nullification of the merger and compensatory damages on the grounds that (1) the merger served no business purpose other than that of forcing their removal, and (2) the majority had offered grossly inadequate compensation for their stock. 32 In reversing the lower court's dismissal of the complaint on the rationale that appraisal was the exclusive remedy, the Delaware Supreme Court stated that "a [section] 251 merger, made for the sole purpose of freezing out minority stockholders, is an abuse of the corporate process; and . . . states a cause of action for a violation of a fiduciary duty." 33 Moreover, the court stressed that even the existence of a valid business purpose would not preclude relief to the minority shareholders:

On the contrary, the fiduciary obligation of the majority to the minority shareholders remains, and proof of a purpose, other than such freeze out, without more, will not necessarily discharge it. In such case the Court will scrutinize the cir-

29. 360 A.2d 969 (Del. 1977).
30. Id. at 976 n.6.
31. Id. at 980.
32. Id. at 972.
33. Id. at 980.
cumstances for compliance with the *Sterling* rule of "*entire fairness*" and if it finds a violation thereof, will grant such relief as equity may require.\(^{34}\)

Hence, under *Singer*, if it is alleged that the purpose of the merger is improper, the majority shareholders must prove a proper business purpose. Further, even if there is proof of a proper business purpose, a court must scrutinize the transaction for its entire fairness and award appropriate relief if a violation is found.

*Singer* thus was the harbinger of a new era in Delaware corporate law.\(^{35}\) Subsequent Delaware cases have confirmed and extended the viability of *Singer*‘s principles.\(^{36}\) Although these decisions need not be chronicled here, their dominant themes established that: (1) appraisal is no longer the dissenting shareholder's sole remedy,\(^ {37}\) (2) such a shareholder is entitled to judicial review of the entire fairness of the transaction, even if the merger is consummated for a proper pur-

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34. *Id.* (emphasis added). In so holding, the court relied on the *Sterling* rule, *Sterling* v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107, 110 (Del. 1952), that the majority must "bear the burden of establishing [the transaction’s] entire fairness . . . [which must] pass the test of careful scrutiny by the courts." *See Singer*, 380 A.2d at 976.


35. *But see* Weinberger v. UOP, Inc., 426 A.2d 1893 (Del. Ch. 1981), aff’d, No. 58–1981 (Del. Feb. 9, 1982), 14 SEC. REG. & L. REP. (BNA) 353–54 (Feb. 24, 1982), where the chancery court stated that "*Sterling* . . . is the bedrock on which *Singer*, Tanzer, and *Roland International* are built." *Id.* at 1344, citing, *Sterling* v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107 (Del. 1952). However, as recognized by one recent commentator, "[l]eft open after *Sterling* was the question whether appraisal was the exclusive remedy in an action challenging a completed interested merger and whether a majority stockholder had an absolute right to use his majority control to bring about a merger for whatever reason he chose, subject only to the duty to pay a fair price." *Sparks, State Regulation of Conflict Transactions* 235, 248 in *Standards For Regulating Corporate Internal Affairs* (The Ray Garrett, Jr. Corporate and Securities Law Institute 1981) [hereinafter cited as *Sparks*].

36. *See generally* cases cited notes 37–40 infra.

37. *See, e.g.*, Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121 (Del. 1977); Young v. Valhi, Inc., 382 A.2d 1372 (Del. Ch. 1978). *See also* Fins v. Pearlman, 424 A.2d 305 (Del. 1980) (intrinsic fairness of terms at the settlement, not proper purpose for the merger, is the standard to be applied to the settlement of an action challenging the merger); Bell v. Kirby Lumber Corp., 413 A.2d 137 (Del. 1980) (distinguishing entire fairness under appraisal statute from that of entire fairness standard under *Singer*). In *Young*, the chancery court issued a preliminary injunction barring the merger and held that, notwithstanding management’s assertion that the merger would result in tax savings and the avoidance of future conflicts of interest, "the basic purpose behind the merger now before the Court is effectuation of a long standing decision on the part of Conran to eliminate the minority shares of Valhi by whatever means as might be found to be workable." 382 A.2d at 1578.
pose,\textsuperscript{38} (3) a merger made primarily to advance the business purpose of the majority stockholder is proper as long as it has a bona fide purpose and is entirely fair to the minority,\textsuperscript{39} and (4) these principles apply to short-form as well as long-form mergers.\textsuperscript{40}

\textsuperscript{38} See, e.g., Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121, 1124–25 (Del. 1977). The “entire fairness” test applies not only to the price offered for the stock but to “all aspects of the transaction.” \textit{Id.} at 1125. See also Securities Act Release Nos. 6100, 6109 (Aug. 2, 1979), in which the SEC adopted Rules 13e-3 and 13e-4 relating to going private transactions by public companies or their affiliates. The Roland Int'l Corp. v. Najjar, 407 A.2d 1032 (Del. 1979), court's holding apparently signifies that an acquirer engaging in an integrated two-step transaction for cash of 100% of the subject company must show that both steps had a bona fide purpose and treated minority shareholders fairly. Note that this principle creates a possible inconsistency with SEC Rule 13e-3 which “excepts a second-step transaction effected by an offeror who became an affiliate by virtue of an earlier tender offer, provided that the second-step 'clean-up' transaction is effected within a year of the earlier offer on terms at least as favorable to the minority as those in the earlier offer.” Rothschild, \textit{supra} note 34, at 215. See generally Sheinberg v. Fluor Corp., [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,987 (S.D.N.Y. 1981). Recently, the Commission charged a tender offeror with inadequate disclosures in connection with a Rule 13e-3 transaction. In re FSC Corp., [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,886 (S.E.C. 1981).

\textsuperscript{39} 379 A.2d at 1124–25. Thus, the Tanzer court held: As a stockholder, IGI [the common parent] need not sacrifice its own interest in dealing with a subsidiary; but that interest must not be suspect as a subterfuge, the real purpose of which is to rid itself of unwanted minority shareholders in the subsidiary. That would be a violation of Singer and any subterfuge or effort to escape its mandate must be scrutinized with care and dealt with by the Trial Court. And, of course, in any event, a \textit{bona fide} purpose notwithstanding, IGI must be prepared to show that it has met its duty, imposed by Singer and Sterling . . . of "entire fairness" to the minority. \textit{Id.} at 1124 (citation omitted). One commentator remarks that the recent Delaware cases suggest that a cash-out merger, even though serving no corporate purpose, may, nonetheless, pass scrutiny if it serves a purpose of the fiduciary. Rothschild, \textit{supra} note 34, at 215.

\textsuperscript{40} Roland Int'l Corp. v. Najjar, 407 A.2d 1032 (Del. 1979). Applying the Singer principles, the court reasoned that "the need to recognize and enforce such equitable principles is probably greater when the size of the minority is smaller." \textit{Id.} at 1036.

Other general principles may also be proffered. For example, where applicable, full disclosure is required, thereby imposing a duty of "complete candor" in revealing the germane facts and circumstances surrounding the tender offer or shareholder vote. Lynch v. Vickers Energy Corp., 383 A.2d 278, 279–81 (Del. 1977). \textit{See} Junker v. Croy, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,236, at 91,568 (5th Cir. 1981) (under Louisiana law, corporate officers and directors are obliged "to disclose facts within their knowledge to shareholders and to deal with them in an atmosphere of trust and confidence."); Knauss, \textit{Corporate Governance—A Moving Target}, 79 Mich. L. Rev. 478, 486–87 (1981). \textit{See also} Lynch v. Vickers Energy Corp., 429 A.2d 497 (Del. 1981) (when fiduciary has breached a duty to those to whom it is owed, "rescissory" measure of damages is proper). Moreover, where a complaint alleges that the purpose of the merger was to eliminate minority shareholders, such a complaint may be immune from a motion to dismiss. See Kemp v. Angel, 381 A.2d 241 (Del. Ch. 1977). In a recent decision, Weinberger v. UOP, Inc., No. 58-1981 (Del. Feb. 9, 1982), the Delaware Supreme Court held that approval of a squeeze out merger by the minority shareholders will generally immunize the transaction from challenge, unless there are allegations that the majority ob-
It remains to be seen whether other states will adopt the Singer principles. For example, the Indiana Supreme Court has held that, in order to withstand attack under Indiana law, a merger must advance a corporate purpose.\textsuperscript{41} Interestingly, however, the Indiana Supreme Court only adopted the first prong of the Singer rationale.\textsuperscript{42} In another decision, the Supreme Court of Hawaii has held that "a merger effected for the sole purpose of freezing out the minority interest is a violation of fiduciary principles . . ." \textsuperscript{43}

In contrast, the Pennsylvania Supreme Court elected not to adopt Singer's two prongs, reasoning that appraisal is the sole postmerger remedy under the law of that state for aggrieved minority shareholders.\textsuperscript{44} The court's reasoning was based on the rationale that the state
tained the minority's "independent approval" in order to eliminate such shareholders or used its controlling influence to "coerce" the minority's approval. See 14 Sec. Reg. & L. Rep. (BNA) 353-54 (Feb. 24, 1982). Compare Michelson v. Duncan, 407 A.2d 211 (Del. 1979).

42. The court stated:
   The case before us is similar to the case of Singer v. Magnavox Co. . . . In that case, the Supreme Court of Delaware . . . relied upon agency principles of fiduciary duty to hold that a corporate merger is subject to judicial scrutiny concerning its "entire fairness" to minority shareholders. We see no need to go that far in deciding the question before us. Under the Delaware view, it appears that every proposed merger would be subject to having its \textit{bona fides} determined by judicial review. We do not believe the judiciary should intrude into corporate management to that extent.

267 Ind. at 388, 370 N.E.2d at 356. See Rothschild, \textit{supra} note 34, at 215-16.


The Hawaii Supreme Court acknowledged that the situation in Perl was arguably different from the Delaware cases in that the minority shareholders were not literally squeezed out. The court refused to distinguish the Delaware cases on this basis, reasoning that

[i]t makes little sense . . . to condemn cash out mergers on the one hand, and yet to permit mergers using preferred securities redeemable at the option of the majority on the other if the minority may be just as effectively eliminated from the corporation by the redemption of the stock as by the straight cash out method.


legislature intended that the appraisal statute serve as the sole post-merger remedy. Importantly, however, the Pennsylvania high court recognized the minority's right in the premerger period to seek injunctive relief to prevent the merger's consummation. In this regard, although all of the courts have not strictly followed Singer, significantly, they generally have recognized that an aggrieved minority shareholder may bring suit in state court to enjoin a merger which has not been consummated. Based on the rebirth of these fiduciary principles, Santa Fe might have been decided differently today.

The reason for this assertion is that since the minority shareholders in a Santa Fe-type situation have the right to seek redress in a Delaware or other appropriate state court to enjoin the consummation of a contemplated merger, they also have, subject to certain limitations which will be discussed below, a federal right to the information needed to determine whether those in control have breached their fiduciary duty under state law. The failure to provide minority shareholders with such information, according to a number of federal courts, is a material deception and, hence, actionable under Rule 10b-5. Significantly, this federal right to information extends well beyond the freeze out merger context. Indeed, subject to certain caveats, it conceivably encompasses every corporate transaction in securities that stockholders could have attacked under state law, had they known the facts. Since Santa Fe was decided, five appellate decisions—in the Second, Third, Fifth, Seventh, and Ninth Circuits—support such a construction. All of the cases were derivative actions, except the Third Circuit's decision in Healey v. Catalyst Recovery.

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45. 488 Pa. at 532-33, 412 A.2d at 1103-04. The majority's holding occasioned a vigorous dissent which relied on Delaware case law to assert that "shareholders who allege that a merger is 'fraught with fraud or fundamental unfairness' should be permitted to challenge the validity of said merger at any time, including post-merger." 488 Pa. at 534, 412 A.2d at 1105 (Larsen, J., dissenting) (citing as persuasive Roland Int'l Corp. v. Najjar, 407 A.2d 1032 (Del. 1979)).

Some states have elected to regulate such freeze-outs by statute and rule. See, e.g., CAL. CORP. CODE § 1312(b) (1977); IND. CODE ANN. §§ 23-1-5-7, 23-1-12-4 (Burns 1972); 8 WISC. ADM. CODE § 5.05 (1976). For further discussion on state legislation, see Roberts, The Status of Minority Shareholder Remedies for Oppression After Santa Fe and Singer and the Question of "Reasonable Investment Expectation" Valuation, 6 DEL. J. CORP. L. 16, 36-37 (1981).

46. See generally cases cited note 47 infra.

The challenged corporate transactions involved either matters for shareholder determination or decisions relegated to board approval in situations where the directors had a conflict of interest or other disability. All were founded on an alleged breach of fiduciary duty by controlling persons in connection with a securities transaction with the controlled corporation, plus a failure to disclose facts on which a state court action seeking redress for that breach could have been based.

It is not necessary in this context to scrutinize the variety of factual settings involved in these five appellate cases. By way of example, however, the Second Circuit's decision in Goldberg v. Meridor\(^4\) will be discussed. Goldberg involved an action by a minority shareholder of a subsidiary against the parent and the parent's controlling persons. The case was based on a transaction in which the subsidiary sold a substantial quantity of stock to the parent in exchange for some of the parent's assets. Goldberg, the plaintiff, alleged that the parent's assets were grossly overvalued and that it had, in effect, looted its subsidiary.\(^5\)

Goldberg began his action long before Santa Fe. His original theory was the same as that upon which the unsuccessful Santa Fe plaintiffs relied, \textit{i.e.}, that a breach of fiduciary duty in connection with the securities transaction is itself a sufficient basis for a Rule 10b-5 claim and that no showing of deception is necessary.\(^6\) After Santa Fe, Goldberg refined this theory by alleging that there had indeed been a deception by the failure of the interested parent and its controlling persons to disclose facts that, \textit{if disclosed}, would have enabled the minority to enjoin the transaction in a New York state court.\(^7\) There was also another aspect to the deception claim which involved press releases that the parent issued when the transaction was consummated. Goldberg complained that the releases were false and lulled the minority shareholders into inaction.\(^8\)

The Second Circuit found that if the facts were as Goldberg alleged them to be and if timely disclosure of those facts had been made, the minority shareholders could have brought suit to enjoin the trans-

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\(^6\) Id. at 211.
\(^7\) Id.
\(^8\) Id. at 211-12.
action under New York state law. The defendants' argument that all that was involved was "internal corporate mismanagement," which the Securities Exchange Act does not reach, was answered as follows by Judge Friendly, with whom Judge Timbers concurred:

We readily agree that if all that were here alleged was that UGO [the victimized or allegedly victimized subsidiary] had been injured by "internal corporate mismanagement," no federal claim would have been stated. But a parent's looting of a subsidiary with securities outstanding in the hands of the public in a securities transaction is a different matter. In such cases disclosure or at least the absence of misleading disclosure is required. It would be incongruous if Rule 10b-5 created liability for a casual "tip" in the bar of a country club, as we held in SEC v. Geon Industries, Inc., 531 F.2d 39 (2d Cir. 1976), but would not cover a parent's undisclosed or misleadingly disclosed sale of its overvalued assets for stock of a controlled subsidiary with securities in the hands of the public.

54. Id. at 219. The court observed that "[t]he problem with the application of § 10(b) and Rule 10b-5 to derivative actions has lain in the degree to which the knowledge of officers and directors must be attributed to the corporation, thereby negating the element of deception." Id. at 215. The court found the deception requirement satisfied by refusing to attribute the knowledge of management to the corporation because management was not disinterested—a theory of deception based on a long line of pre-Santa Fe cases. Id., relying on, Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975); Drachman v. Harvey, 453 F.2d 722 (2d Cir. 1972) (en banc); Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969); Ruckle v. Roto Am. Corp., 399 F.2d 24 (2d Cir. 1964). See also Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970); Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968); Dasho v. Susquehanna Corp., 380 F.2d 562 (7th Cir. 1967) (concurring opinion), cert. denied, 389 U.S. 977 (1967).

55. 567 F.2d at 211. See also the Second Circuit's statement in SEC v. Parklane Hosiery Co., 558 F.2d 1083 (2d Cir. 1977). There, the court asserted:

[H]ad the shareholders of Parklane been aware of Somekh's reasons for the going private transaction, they, or others, might well have been able to enjoin the merger under New York law as having been undertaken for no valid corporate purpose. . . . This case involves a failure to disclose when the non-disclosed information could have been used by the minority shareholders to attempt to enjoin the merger.

Id. at 1088.

The Goldberg majority evoked a strong dissent from Judge Meskill, who argued that "the majority has neatly undone the holdings of Green, Piper and Cort by creating a federal cause of action for a breach of fiduciary duty that will apply in all cases, save for those rare instances where the fiduciary denounces himself in advance." 567 F.2d at 225 (Meskill, J., dissenting). Reflecting on Goldberg's significance, one commentator opined:

[General application of the standard will allow a large number of suits involving breach of fiduciary duties against corporate directors into federal courts under rule 10b-5. . . . A federal cause of action will thus arise
Subsequently, the Second Circuit reaffirmed the Goldberg rationale in *IIT v. Cornfeld.* Moreover, as previously stated, four other circuits have adopted Goldberg's rationale. Representative of these cases is the Ninth Circuit's decision in *Kidwell v. Meikle,* where the court, in holding that inadequate disclosures by directors who have conflicts of interest give rise to a federal claim under Rule 10b-5, stated:

[T]here is room for Rule 10b-5 liability after *Santa Fe Industries* even when the only deceived parties are shareholders who are not entitled to vote in the transaction in question, and even though there may be a breach of fiduciary duty under state law. Indeed, under the Goldberg rationale, it is precisely because there are state law remedies for the shareholders that a deception can be found. Inadequate disclosures lull into security those shareholders who might bring derivative actions under state law to enjoin the securities transactions if all material facts were revealed.

The dilemma that these cases presents to the lawyer who counsels management is whether his clients will be best served by full and fair advance disclosure to the independent stockholders in every situation in which someone in control sits on both sides of the table and bar-


56. 619 F.2d 909, 917 (2d Cir. 1980).

57. See generally cases cited note 47 supra.

58. 597 F.2d 1273 (9th Cir. 1979). See United States v. Margala, 662 F.2d 622, 626 (9th Cir. 1981) (amended Feb. 8, 1982). (The Ninth Circuit made clear that a section 10(b) claim may be premised on grounds other than those which would support a state court action for injunctive relief. Accordingly, a fact is material if a reasonable investor "could respond to the fact's disclosure by protecting himself from possible financial loss.") citing, SEC v. Blatt, 585 F.2d 1925, 1931-32 (5th Cir. 1978); Wright v. Heizer Corp., 560 F.2d 236, 250 (7th Cir. 1977), cert. denied, 434 U.S. 1066 (1978).

59. 597 F.2d at 1292. See 14 U. RICH. L. Rev. 588 (1980).
gains with himself unfettered by a truly independent and palpably disinterested board of directors. While such advance disclosure may result in a state court action for breach of fiduciary duty, the other equally unattractive alternative, absent such disclosure, is that a Rule 10b–5 violation may ensue. On the other hand, for the lawyer consulted by a victim of corporate skullduggery, the lesson of Santa Fe and its progeny is that the disclosure aspects of such a situation must be examined with painful care; that Rule 10b–5, in certain situations, is alive and well; that although unfairness by itself is an insufficient basis for a federal law claim, there are circumstances, subject to certain limitations, in which unfairness coupled with either a failure to disclose or an affirmative misrepresentation remains a firm foundation for a federal claim; and that in such a situation counsel may have a choice between a state forum and a federal one.60

Counsel, however, should not leap to the conclusion that he has such a choice of forum. He must remember that the general rule is that corporations are monitored by their directors and not by their shareholders.61 Hence, even before Santa Fe, Rule 10b–5 claims founded on the premise that a corporation had been deceived in a securities transaction called for a showing that the corporation was “disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction.” 62 The need for such a showing of disability is even clearer today than in the past. For example, in the Third Circuit case of Biesenbach v. Guenther,63 a claim of deception founded only on the allegation that the directors had failed to inform the shareholders that they, the directors, had breached their state law fiduciary duty to the corporation was dismissed for legal insufficiency. To hold otherwise, the court reasoned, “would clearly circumvent the Supreme Court’s holding in Santa Fe.” 64

Moreover, it is also clear that management generally has no obligation to disclose its true purpose or motivation or to characterize the

60. Ferrara & Steinberg, supra note 13, at 286–87.
63. 588 F.2d 400 (3d Cir. 1978).
64. Id. at 402. The court further reasoned: Santa Fe made clear that absent deception, misrepresentation, or nondisclosure a breach of fiduciary duty does not violate the statute or Rule. . . . In effect, appellants are stating that the failure to disclose the breach of fiduciary duty is a misrepresentation sufficient to constitute a violation of the Act. We refuse to adopt this approach which would clearly circumvent the Supreme Court’s holding in Santa Fe. As Judge Higginbotham has reiterated:
transaction in pejorative terms. As aptly stated by one authority: "It is not necessary to say, 'this is a grossly unfair transaction in which the board of directors is overreaching the minority sharehold-
ers.' You just have to give them the facts." Another limitation of the Goldberg rationale is seen in Maldonado v. Flynn, where the Second Circuit upheld the dismissal of a Rule 10b-5 claim based on the
disinterested directors' decision to modify a stock option plan so as to benefit certain of the corporation's senior officers and directors at the corporation's expense. In so holding, the Second Circuit reasoned that "since the amendments [which modified the stock option plan] were thus validly enacted by a vote of disinterested board members who had been fully informed of all material facts, their knowledge was attributable to the corporation and no 'deception' occurred within the meaning of Rule 10b-5." 68

From the above description, the following conclusion can be drawn: although a broad reading of Goldberg and its progeny may imply that the bare availability of state court injunctive relief constitutes "deception" within the meaning of Rule 10b-5, this variable alone is not sufficient. Where shareholder approval is not required, the courts have held that full disclosure to a disinterested board of directors is equivalent to full disclosure to the shareholders. In such a case, knowledge of the disinterested majority is attributed to the corporation and its shareholders, thereby precluding a finding of "deception." 69 Where, however, corporate action requires shareholder approval or where the directors have a conflict of interest or other disability (regardless of whether shareholder approval is required), full disclosure of material information to shareholders must be made.70

Moreover, a question left unanswered after Santa Fe is whether a shareholder must show not only that he could have brought suit in state court, but also that he could have prevailed in the state court action. As noted by the Fifth Circuit, the Seventh and Ninth Circuits appear to require that the complainant must show that he would have prevailed in the state court action, whereas the Second Circuit in Goldberg "refused to dismiss a claim where a state suit would have been possible, even though there was no allegation that the shareholder would have succeeded [and] did not inquire further into the share-

68. Id. at 795 (emphasis added).
70. See generally cases cited notes 47, 69 supra. In determining whether a director is "disabled" [the crucial criterion should not be whether a director is financially interested, but whether he can exercise independent judgment on behalf of the corporation and its shareholders. Any conflict or disability that impairs a director's judgment poses the same threat to the best interests of the corporation and shareholders, regardless of whether it is financially based. Thus, a showing that a director has a conflict of interest—whether financially related, status-oriented, or otherwise—or that he is acting under some other disability, should prevent him from representing the corporation for the purposes of rule 10b-5 disclosure. Ferrara & Steinberg, supra note 13, at 290.
holder's likelihood of success in such a state action." 71 Between these two extremes are the Third and Fifth Circuits. Whereas the Fifth Circuit requires the plaintiff to show "a reasonable basis for state relief," 72 the Third Circuit's standard appears slightly more stringent, requiring the complainant to demonstrate "a reasonable probability of ultimate success." 73

From the above description, Santa Fe and its progeny exemplify the role that nonconstitutional "federalism" may play in regard to investor protection as interpreted by the federal and state courts. As the Supreme Court has made clear, with respect to Rule 10b-5, as well as other provisions of the federal securities laws, the degree of investor protection afforded will depend, in large part, on the applicable state law. 74 In this respect, it is interesting that the Goldberg-type cases brought in the federal courts alleging section 10(b) violations appear to present local law questions akin to those with which the federal judiciary deals in diversity cases governed by the long-standing rule of Erie Railroad Co. v. Tompkins. 75 Significantly, however, unlike the Erie doctrine, under which federal courts apply state substantive law in order to adjudicate state created remedies and liabilities, Santa Fe's


73. Healey v. Catalyst Recovery, Inc., 616 F.2d 641, 647 (3d Cir. 1980) (emphasis added). The court stated:

We . . . hold that in a case such as this the plaintiff must demonstrate that at the time of the misrepresentation or omission, there was a reasonable probability of ultimate success in securing an injunction had there been no misrepresentation or omission. . . . [W]e frame the test in terms of a reasonable probability for two reasons. First, we believe absolute certainty to be both an impossible goal as well as an impracticable standard for a jury to implement. Second, in most cases the state remedy will be a preliminary injunction, which looks to the likelihood of ultimate success.

74. See Burks v. Lasker, 441 U.S. 471 (1979); Cort v. Ash 422 U.S. 66, 77-85 (1975). In Burks, its most recent pronouncement on this subject, the Court remarked that "Congress has never indicated that the entire corpus of state corporation law is to be replaced simply because a plaintiff's cause of action is based upon a federal statute." 441 U.S. at 478. The Court accordingly held that even in a case arising under the Investment Company Act "federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the policy of the [Investment Company and Investment Advisers Acts]." Id. at 486.

75. 304 U.S. 64, 78 (1938) ("Except in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the State. And whether the law of the State shall be declared by its Legislature in a statute or by its highest court in a decision is not a matter of federal concern."). See Hanna v. Plummer, 380 U.S. 460 (1965); Byrd v. Blue Ridge Rural Elec. Coop., Inc., 556 U.S. 525 (1958); Guar. Trust Co. v. York, 326 U.S. 99 (1945).
footnote fourteen, as construed by the lower federal courts, arguably conditions the existence of a federal right upon the applicable state law. Stated somewhat differently, the maintenance of such actions along the Goldberg line of cases is dependent largely on the applicable state law of fiduciary duty. Only if the relevant state law recognizes the viability of the plaintiff's claim will a federal claim be possible.

Although such a rationale may appear incongruous, it should be recognized that Goldberg and its progeny represent an accommodation between the federal interest in promoting full disclosure under the federal securities laws and the state interest in redressing breaches of fiduciary duty. Moreover, because business enterprises often have national investor constituencies and national economic significance, the law governing the relationship between these enterprises and constituencies should also be national and uniform. However, the fiduciary duties of corporate management traditionally have been defined by state common law, which can be restated, reshaped, and adapted to contemporary local needs without legislative change. Thus, both the federal and state lines of cases, such as Goldberg and Singer, indicate that the degree of investor protection in this area may often depend on the interaction between federal and state law. Indeed, a recent series of events arguably suggest that state courts, at times, may be more inclined to protect shareholders' interests than federal courts.

III. Burks v. Lasker—The Special Litigation Committee Scenario

The issue referred to above is the special litigation committee scenario. The starting point in this regard is the Supreme Court's decision in Burks v. Lasker where the issue presented was whether a

76. See also United States v. Margala, 662 F.2d 622 (9th Cir. 1981) (as amended Feb. 8, 1982); Ferrara & Steinberg, supra note 13, at 294–97; note 58 supra.
77. 441 U.S. 471 (1979). The Second Circuit had held that “disinterested directors of an investment company do not have the power to foreclose the continuation of nonfrivolous litigation brought by shareholders against majority directors for breach of their fiduciary duties.” Lasker v. Burks, 567 F.2d 1208, 1212 (2d Cir. 1978), rev'd, 441 U.S. 471 (1979). Participating as amicus curiae, the SEC observed the vital statutory role served by disinterested directors as “watchdogs” under the Investment Company Act. In order to preserve this function, yet ensure that the disinterested directors act in the best interests of the shareholders, the Commission asserted that the traditional business judgment rule should be applied within a framework of certain safeguards: that a determination by disinterested directors to terminate a non-frivolous derivative suit should be given effect only where the court finds that the directors were independent, fully informed, and acted reasonably. Brief for the SEC as Amicus Curiae at 7, 12. See Gonson & Steinberg, The S.E.C.’s Administrative and Legislative Programs Aimed at Regulating Corporate Internal Affairs 317, 338–39, in Standards for Regulating Corporate Internal Affairs (The Ray Garrett, Jr. Corporate and Securities Law Institute 1981).
quorum of four statutorily disinterested directors within the meaning of the Investment Company Act could terminate a shareholder's derivative suit brought against fellow directors for violations of the Investment Company and Investment Advisers Acts. The four independent directors, who had been appointed by the defendant fund's board of directors and who were not named as defendants, had concluded, in the exercise of their good faith business judgment, that continuation of the litigation was not in the corporation's best interests.  

Rather than directly answering the question before it, the Supreme Court promulgated a two pronged test: (1) whether the applicable state law permits the disinterested directors to terminate a shareholders' derivative suit, and (2) whether such a state rule is consistent with the policies underlying the federal securities laws. Of course, if dismissal is sought in state court, the only determination is whether relevant state law authorizes such dismissal.

Subsequent to Burks, a number of federal courts, in applying Burks' first prong, have held that dismissal is proper under the applicable state law. For example, relying on the Eighth Circuit's decision in Abbey v. Control Data Corp., Judge Weinfeld stated in Maldonado v. Flynn that "under Delaware law a committee of disinterested directors, properly vested with the power of the board, may in the exercise of their business judgment require the termination of a derivative suit brought on the corporation's behalf." Further, in

78. Id. at 473-74.  


82. 603 F.2d 724, 730 (8th Cir. 1979), cert. denied, 444 U.S. 1017 (1980) ("As a matter of Delaware law, we agree with the district court that the rule apparently applies to any reasonable good faith determination by an independent board of directors that the derivative action is not in the best interests of the corporation.").

Lewis v. Anderson” the Ninth Circuit, in applying California law, held that dismissal was proper. In yet another decision, Genzer v. Cunningham, dismissal was held to be proper under Michigan law. In addition, the New York Court of Appeals in Auerbach v. Bennett recognized the propriety of a special litigation committee composed of disinterested directors, appointed by the board, to exercise its business judgment in terminating a shareholders' derivative action seeking damages against fellow directors. In such a situation, the New York high court held that a tribunal must confine its inquiry to assessing the “independence” of the members of the committee and the appropriateness and adequacy of the investigative procedures selected and pursued by the committee.

Apparently, however, these interpretations of state business judgment rules underestimated the sensitivity of some state courts to investor interests. For example, the plaintiffs in Maldonado v. Flynn, in addition to their federal claims, brought suit in the Delaware Chancery Court on various state law claims. The defendants argued, as they did in the federal district court, that the business judgment rule required dismissal of the state law claims. Noting the spate of recent federal court decisions permitting disinterested directors to bar derivative suits, the Delaware Chancery Court stated:

84. 615 F.2d 778 (9th Cir. 1979), cert. denied, 449 U.S. 869 (1980). The Ninth Circuit subsequently has reaffirmed this aspect of Lewis in Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981), cert. denied, 102 S. Ct. 1006 (1982).
85. 498 F. Supp. 682, 688 (E.D. Mich. 1980) (distinguishing Maldonado on the basis that in the case at bar “there is no allegation of personal gain by the directors”).
87. Id. at 650–54, 393 N.E. at 1000–02, 419 N.Y.S.2d at 925–28. Unlike Maldonado, however, Auerbach did not involve allegations of self-dealing on the part of the defendant directors.
88. Id. at 694–95, 393 N.E.2d at 1002–03, 419 N.Y.S.2d at 929. See Parkoff v. General Tel. & Elecs. Corp., 74 A.D.2d 762, 425 N.Y.S.2d 599 (1980); Falkenberg v. Baldwin, Sec. Reg. & L. Rep. (BNA) No. 545, at A–14 (N.Y. Sup. Ct. March 3, 1980). See also the New York Supreme Court’s decision in Auerbach which was subsequently reversed by the Court of Appeals. 64 A.D.2d 98, 408 N.Y.S.2d 83 (1978). There, the lower court approved the propriety of assessing the reasonableness of the special litigation committee’s determination. Factors that such a committee must consider in an improper payments case, and which a court presumably must assess, include “the reasons for the payments, the advantages or disadvantages accruing to the corporation by reason of the transactions, the extent of the participation or profit by the respondent directors and the loss, if any, of public confidence in the corporation which might be incurred.” 64 A.D.2d at 107, 408 N.Y.S.2d at 87–88. See also Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 275 (3d Cir. 1978), cert. denied, 439 U.S. 1129 (1979); Johnson, The Business Judgment Rule: A Review of Its Application To The Problem of Illegal Foreign Payments, 6 J. Corp. L. 481 (1981).
All of these cited federal cases . . . incorrectly assume that State law necessarily enables the corporate directors (or a committee thereof) to compel the dismissal of a pending stockholder's derivative suit by invoking the business judgment rule. . . . It is clear, however, that under well settled Delaware law, the directors cannot compel the dismissal of a pending stockholder's derivative suit which seeks redress for an apparent breach of fiduciary duty, by merely reviewing the suit and making a business judgment that it is not in the best interests of the corporation. 90

Thus, the court reasoned that the business judgment rule provides only a "shield" with which directors may protect their decisions from shareholder attack; nothing in the rule grants a corporate board of directors any independent power to bar a derivative suit against fellow directors. 91 Contrary to the corporation's assertion that a shareholder's right to bring suit is always subordinate to that of the corporation and therefore subject to a corporate decision to bar its continuance, the court asserted that "[a]ggrieved shareholders of Delaware corporations ought to be able to expect that an impartial tribunal, and not a committee appointed by the alleged wrongdoers, will decide whether a stockholder's derivative suit alleging breach of fiduciary duty has any merit." 92 In summary, the Delaware Chancery Court concluded:

[A]n analysis of the business judgment rule shows that while it is a limitation on liability and ordinarily protects corporate directors when they, in good faith, decide not to pursue a remedy on behalf of the corporation, it is not an independent grant of authority to the directors to dismiss derivative suits. Under settled Delaware law the directors do not have the right to compel the dismissal of a derivative suit brought by a stockholder to rectify an apparent breach of fiduciary duty by the directors to the corporation and its stockholders after the directors have refused to institute legal proceedings, because the stockholder then possesses an independent right to redress the wrong. 93

90. 413 A.2d at 1257.
91. Id.
92. Id. at 1263, citing, Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980).
93. 413 A.2d at 1262.
Subsequently, two federal courts applied the chancery court's rationale to preclude dismissal under the applicable state law. Thus, in *Abella v. Universal Leaf Tobacco Co.*, Judge Mergihe held that dismissal was improper under Virginia law. Also, in *Maher v. Zapata Corp.*, the district court held that Delaware law precludes directors or a committee thereof from dismissing shareholder derivative suits brought against fellow directors for alleged breaches of fiduciary duty. Although the court was not bound by the decision of the court of chancery, it was "convinced" that the Delaware Supreme Court would adopt the "thorough well-reasoned analysis" of the *Maldonado* court.

It is in this context that the Delaware Court of Chancery's decision in *Maldonado* had assumed such great significance. If the chancery court's rationale had been adopted by the Delaware Supreme Court, director dismissal of such shareholder derivative suits would have been effectively precluded. In view of the number of conflicting federal and state court decisions, however, it was difficult to perceive what was the "real" Delaware law on this subject. The stage was therefore set for the Delaware Supreme Court to clarify this important, yet uncertain, area of corporate law.

Reversing and remanding the chancery court's decision, the Delaware Supreme Court in *Zapata Corp. v. Maldonado* stated that "when stockholders, after making demand and having their suit rejected, attack the board's decision as improper, the board's decision falls under the 'business judgment' rule and will be respected if the requirements of the rule are met." However, the case at bar involved an instance where demand was properly excused. In such a situation...

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95. 495 F. Supp. 713, 717 (E.D. Va. 1980) ("Virginia law does not permit directors, interested or disinterested, to effect the dismissal of a derivative suit against a corporation and its directors, based simply on their business judgment that the suit is contrary to the corporation's best interests.").


97. Id. at 355.


99. Id. at 784 n.10.

tion, the court, balancing the corporation's interest to rid itself of vexatious litigation against the shareholders' interest to utilize the derivative suit as an effective intracorporate means to police boards of directors, held that a two-step test should be employed in the chancery court's exercise of "independent discretion" in determining whether to grant dismissal. 101 First, with the corporation bearing the burden of proof, the court should inquire into the special litigation committee's independence and good faith and the bases supporting its conclusions.102 Second, providing that the first step is satisfied, the court should apply "its own independent business judgment" and "should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests." 103

It is somewhat unclear from the Delaware high court's decision whether a tribunal may deny the corporation's dismissal motion even if the first step has been satisfied, without ever reaching the second step.104 A number of commentators, however, have apparently concluded that if the first step is satisfied, a court must proceed to the second step.105 In any event, it appears clear that a court cannot grant the corporation's motion only on the basis of the first step without

101. 430 A.2d at 788.
102. Id. Further, limited discovery may be ordered to facilitate these inquiries. In sum, regarding this first-step: "If the Court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the Court shall deny the corporation's motion." Id. at 789.
103. Id. at 789. In addition, two Texas state court decisions rejected attempts by defendants to dismiss derivative suits on the basis of recommendations of the board of directors. Sonics Int'l, Inc. v. Dorchester Enterprises, Inc., 593 S.W.2d 390 (Tex. Civ. App. 1980); Zauber v. Murray Sav. Ass'n, 591 S.W.2d 932 (Tex. Civ. App. 1980). See also Nussbacher v. Chase Manhattan Bank, 444 F. Supp. 973, 977 (S.D.N.Y. 1977) ("It is inconceivable that directors who participated in and allegedly approved of the transaction under attack can be said to have exercised unbiased business judgment in declining to bring suit based on that very transaction."); Swenson v. Thibaut, 39 N.C. App. 77, 250 S.E.2d 279 (1978) (court refused to apply business judgment rule to determination made by special litigation committee when defendant directors influenced members of the committee).
104. 430 A.2d at 789. ("If...the Court is satisfied...that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step." (emphasis added).
reaching the second step because the Delaware Supreme Court placed great emphasis on the latter step. Thus, in regard to the second step, the court asserted that this step provides "the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee." 106

The Delaware Supreme Court's decision will undoubtedly have a significant impact on the ability of special litigation committees to terminate shareholder derivative suits against fellow directors when demand on the board is excused. Yet, when demand must be made, the Delaware high court authorizes committee dismissal pursuant to the business judgment rule. In other words, the court seems to have drawn a distinction between shareholder derivative suits naming an "acquiescent" or "interested" majority of directors as defendants and suits naming only a minority of such directors.107 The apparent drawing of such a distinction signifies that the court impliedly concluded that the impartiality of, and judgments reached by, a special litigation committee depend on the number of "acquiescent" or "interested" directors named as defendants. Such a conclusion is misplaced. The inherent problems of "structural bias" 108 remain, regardless of whether the complaint accuses a majority or a minority of such directors of wrongdoing.109 Moreover, the court's holding in this regard, although arguably dicta, seems to assure that shareholders will attempt to excuse the demand requirement by naming at least a majority of "acquiescent" or "interested" directors as defendants whenever practicable in order to avoid application of the business

106. 430 A.2d at 789 (emphasis added).
107. See id. at 784-89. But see note 110 infra. See generally Comment, 44 U. CHI. L. REV., supra note 106: When a majority of the directors has engaged in fraud or self-dealing, such as appropriating a corporate opportunity, courts have generally not required demand. But when a majority of the directors are accused of approving or passively acquiescing in an allegedly injurious transaction, courts are split on whether demand should be required.


108. "Structural bias" may be defined as "inherent prejudice against any derivative action resulting from the composition and character of the board of directors." Note, The Business Judgment Rule in Derivative Suits Against Directors, 65 CORNELL L. REV. 600, 601 n.14 (1980). In a recent decision, the Fifth Circuit recognized the problem of structural bias, holding that, because of conflicts of interest, a corporation's board of directors was incompetent to compromise the plaintiff shareholders' derivative claims. Clark v. Lomas & Nettleton Financial Corp., 625 F.2d 49 (5th Cir. 1980), cert. denied, 101 S. Ct. 1738 (1981).

judgment rule.\textsuperscript{110} Thus, the next key issue to surface in this context may well entail the circumstances under which demand on the board is excused. Depending on how this issue is resolved, the Delaware Supreme Court's distinction between suits when demand must be made and those in which it is excused at best may have limited practical effect and, at worse, may spell the death knell to shareholder derivative suits against directors whenever demand must arguably be made.

In order to preserve the vitality of the shareholder derivative suit in this context, the Delaware courts should excuse the demand requirement whenever a majority of "acquiescent" as well as "interested" directors are named as defendants.\textsuperscript{111} Moreover, demand should be excused if a majority of the board is disabled, such as being under the domination of a controlling shareholder.\textsuperscript{112} In the above settings, the board should be deemed as "stand[ing] in a dual relation which prevents an unprejudiced exercise of judgment."\textsuperscript{113} The reason for this conclusion is fairly clear: If a majority of such directors (including "acquiescent" directors who approved the challenged transaction) are given authority to determine whether the suit should proceed, they will necessarily make a judgment, perhaps implicitly, on the propriety of their own conduct. To expect such directors who have authorized or benefitted from a challenged transaction (which has perhaps benefitted fellow directors as well) to judge in good faith whether the suit naming them as defendants is in the corporation's best interests is fu-


\textsuperscript{111} See Kim, The Demand on Directors Requirement and the Business Judgment Rule in the Shareholder Derivative Suit: An Alternative Framework, 6 J. Corp. L. 511, 513 (1981) ("Futility may be shown . . . when a majority of the board of directors actually participated or acquiesced in the alleged wrongdoing."); authorities cited supra notes 107–08.

\textsuperscript{112} See cases cited note 110 supra. In this regard, however, "a bare allegation of control without factual support cannot excuse demand since the required particularity in pleading is absent." Stepak v. Dean, 434 A.2d 388, 391 (Del. Ch. 1981), citing, Greenspun v. Del. E. Webb Corp., 634 F.2d 1294, 1208 (9th Cir. 1980); Vernars v. Young, 539 F.2d 966 (5th Cir. 1976); In re Kauffman Mut. Fund Actions, 479 F.2d 257, 265 (1st Cir. 1973).

tile. By the very nature of their participation in the alleged illegal conduct, such directors are incapable of rendering impartial judgment. A contrary holding discounts the realities of the corporate decisionmaking process and fundamental principles of corporate accountability.115

Returning to Maldonado, the Delaware high court's promulgation of the two-step test in instances when demand is excused represents an innovative approach. With regard to the first step, the court correctly placed the burden on the corporation to show independence, good faith, and reasons supporting its determination.116 Placing the burden on the party who selected the committee members, as the court implicitly noted, helps to remedy the appearance (and, indeed, perhaps the presence) of impropriety.117 Moreover, the court properly ordered inquiry into the reasonableness of the committee's investigation and bases for its conclusions. Although some courts have concluded that such an inquiry is outside the province of the business judgment rule,118 the better view is that the use of such committees to bar shareholder derivative suits against fellow directors reflects different policies than those present in the ordinary corporate decision clearly protected by the doctrine.119 In such a situation, the pressure on the disinterested directors to disregard the corporation's best interests is so great that only a court's careful assessment of the reasonableness of the committee's investigation and conclusions will ensure the protection of the entity's welfare.120

Turning to the second step, some commentators assert that, by requiring a court to exercise its own independent business judgment in determining whether to order dismissal, such courts are left with un-

114. This conclusion holds true regardless of whether self-dealing (e.g., remuneration benefits) or other types of misconduct (e.g., illegal foreign payments) are involved. The crucial criterion is that the majority of directors in this context are incapable of exercising good faith judgment.

115. See generally Steinberg, Application of the Business Judgment Rule and Related Judicial Principles—Reflections from a Corporate Accountability Perspective, 56 Notre Dame Law. 903, 915 (1981) ("although courts should apply the business judgment rule and related judicial principles in appropriate situations to shield management's conduct, they should be careful to ensure that their processes are not used as a sword by recalcitrant management to pierce legitimate shareholder interests.").

116. See 430 A.2d at 788.
117. See Steinberg, note 109 supra, at 27.
120. See Steinberg, note 109 supra, at 26.
duly broad and vague guidelines.\textsuperscript{121} While this assertion has some merit, it bears emphasis that the Delaware Supreme Court correctly recognized that committee members pass judgment on fellow directors, thereby providing the need to implement "sufficient safeguard against abuse, perhaps subconscious abuse."\textsuperscript{122} To help alleviate this deficiency, the court placed upon the movants the burden of proving independence, good faith, and reasonableness. Moreover, the court implicitly acknowledged that, even if this burden were met, to the shareholder seeking redress on the corporation's behalf, judicial deference to a special litigation committee's determination to bar the suit smacks of unfairness.\textsuperscript{123} To counteract this effect as much as practicable, yet retain the committee's authority to terminate such actions, the Delaware high court expressly authorized the chancery court to exercise its own business judgment and, "when appropriate, [to] give special consideration to matters of law and public policy. . . ."\textsuperscript{124}

Such a standard, although perhaps not subject to uniform application, may well be susceptible to practical implementation. The Delaware Supreme Court simply assured that the chancery court would independently consider the relevant factors and circumstances rather than relying on the committee's subjective assessment. Viewed another way, the chancery court's exercise of independent judgment may be another means by which to scrutinize the reasonableness of the committee's judgment. In this vein, such "reasonableness" transcends the sometimes narrow economic interests of the corporation and encompasses principles of shareholder welfare, public policy and, in essence, corporate accountability.\textsuperscript{125}

In summation, rather than being criticized, the Delaware Supreme Court should be applauded for its insightful approach to the issue of litigation termination when demand is excused. Although it is far too premature to venture whether the court's two-step test will lend itself to practical and equitable application, the Delaware high court innovatively sought a solution to a difficult conflict which was in dire need of clarification. By recognizing and attempting to reconcile these opposing interests—the need of a board to rid itself of unwanted,

\textsuperscript{121} See, e.g., Brodsky, \textit{supra} note 105; Hinsey & Dreizen, \textit{supra} note 105.
\textsuperscript{122} 430 A.2d at 787.
\textsuperscript{123} See id. at 788-89. See Steinberg, \textit{supra} note 109, at 25.
\textsuperscript{124} 430 A.2d at 789. See Steinberg, \textit{supra} note 110, at 387-88. The court drew "some analogy to a settlement in that there is a request to terminate litigation without a judicial determination on the merits." \textit{Id.} at 787, \textit{citing}, Neponsit Inv. Co. v. Abramson, 405 A.2d 97, 100 (Del. 1979) (and cases therein).
\textsuperscript{125} Steinberg, \textit{supra} note 110, at 388.
even if not frivolous, litigation and the accompanying problem of giving too much power to dissident shareholders against the need to provide an equitable resolution to legitimate corporate claims as expressed in a shareholder derivative action in light of serious problems of conflicts of interest and "structural bias"—the Delaware Supreme Court offered a refreshing approach. In this regard, although regrettably distinguishing between actions where demand is required as opposed to those where demand is excused, the court's decision in the latter area should be viewed as a welcome and needed judicial response addressing a fundamental concern in corporate accountability. 126

IV. "CONTROL" AS A MOTIVE—THE BUSINESS JUDGMENT RULE

The final subject to be addressed is one that has recently surfaced in the federal courts and generally deals with the federal courts' construction of the applicable Delaware law in regard to the business judgment rule. More precisely, the issue involves the showing required in order to rebut the presumption of the business judgment rule when control allegedly is a motive in management's actions. In both Johnson v. Trueblood, 127 decided by the Third Circuit, and the Seventh Circuit's decision in Panter v. Marshall Field & Co., 128 a majority of both panels held that the presumption of the business judgment rule is rebutted only where management's "sole or primary purpose" is to retain control. 129 To arrive at this conclusion, these courts

126. Id. at 388–89.
127. 629 F.2d 287 (3d Cir. 1980).
128. 646 F.2d 271 (7th Cir. 1981).
129. Id. at 293–94; 629 F.2d at 292–93. In Johnson, the court asserted that by the very nature of corporate life "a director has a certain amount of self-interest in everything he does." 629 F.2d at 292. To alleviate this conflict, "the rule . . . postulates that if actions are arguably taken for the benefit of the corporation, then the directors are presumed to have been exercising their sound business judgment rather than responding to any personal motivations." Id. The court concluded:

[U]nder Delaware law, at a minimum, the plaintiff must make a showing that the sole or primary motive of the defendant was to retain control. If he makes a showing sufficient to survive the directed verdict, the burden then shifts to the defendant to show that the transaction in question has a valid corporate business purpose.

Id. at 293, relying on, Petty v. Pentech Papers, Inc., 347 A.2d 140, 143 (Del. Ch. 1975); Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964); Bennett v. Propps., 41 Del. Ch. 14, 187 A.2d 405 (1962). But see Nathan & Ziegler, Issuer Stock Repurchases, 14 Rev. Sec. Res. 925, 927 (1981) ("the Cheff court expressly rejected the analysis of a lower Delaware court that had placed on the plaintiff the burden of proving that perpetuation of control was the directors' primary motive in authorizing a stock repurchase.").
applied what they believed was the applicable Delaware case law. In both of these cases, however, there were strong dissents. In *Johnson*, Judge Rosenn, dissenting, concluded that once the complainant demonstrates that retention of control was a motive in management's decision, the presumption of the rule should be rebutted and the burden should shift to management to justify the fairness of the transaction. 130 Construing the precise Delaware cases as the majority had, Judge Rosenn concluded that the majority's holding unduly expands the business judgment rule and is not consistent with Delaware decisions. 131 Agreeing with Judge Rosenn's interpretation of Delaware law, the dissenting judge in the *Marshall Field* case, Judge Cudahy, stated that "[t]his statement of the rule is compatible with the Delaware case law and the realities of corporate governance, and is by no means a minority position." 132 Moreover, in construing New Jersey law, the Second Circuit has adopted an approach similar to that of the dissents rendered in *Johnson* and *Marshall Field*, stating that "[o]nce a plaintiff demonstrates that a director had an interest in the transaction at issue, the burden shifts to the director to prove that the transaction was fair and reasonable to the corporation." 133

The majority's approach in both *Johnson* and *Marshall Field* is troubling. Under the expansive interpretation given to the Delaware

130. 629 F.2d at 299-301 (Rosenn, J., dissenting).
131. Judge Rosenn stated:
Unlike the majority, I believe that under Delaware law, once plaintiff has shown that the desire to retain control was a motive in the particular business decision under challenge, the burden is then on the defendant to move forward with evidence justifying the transaction as primarily in the corporation's best interests.

132. 646 F.2d at 501-04 (Cudahy, J., dissenting). See Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980); Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690 (2d Cir. 1980). In *Treadway*, the Second Circuit stated that "[o]nce a plaintiff demonstrates that a director had an interest in the transaction at issue, the burden shifts to the defendant to prove that the transaction was fair and reasonable to the corporation." 638 F.2d at 382 (emphasis added). The court then reflected:
In nearly all of the cases treating stock transactions intended to affect control, the directors who approved the transaction have had a real and obvious interest in it: their interest in retaining or strengthening their control of the corporation. It is this interest which causes the burden of proof to be shifted to the directors, to demonstrate the propriety of the transactions.

cases, management with the benefit of hindsight and the assistance of expert counsel can almost always rationally proffer, except in the most egregious circumstances, some purpose other than control to justify its actions.\textsuperscript{134} It appears to be only a matter of time before the Delaware courts squarely face this issue. As with the freeze-out merger situation, as evidenced by \textit{Singer} and its progeny, and the special litigation committee scenario, as seen in \textit{Zapata Corp. v. Maldonado}, the Delaware courts in this context as well may display a heightened concern for legitimate shareholder interests.

\textbf{V. CONCLUSION}

There is little question that the interplay between federal securities and state corporation law has developed into a most curious and intriguing relationship. As noted at the beginning of this Article, state inaction in this field of corporate malfeasance may have been due in part to perceptions that the federal government was largely responsible for the protection of shareholders. \textit{Santa Fe} and other decisions that have cut back on the scope of the "federal corporation law," however, have brought into question the continued viability of such views. Consequently, as the Delaware Supreme Court implicitly noted in \textit{Singer}, there may well be new pressure on the states to provide for the protection of investors, as the federal courts may no longer be perceived as the primary source of regulation. This observation of the state-federal relationship in the corporate area, along with such decisions as \textit{Singer} and \textit{Zapata Corp. v. Maldonado}, are consistent with the recent movement toward increased state court sensitivity to shareholder interests and suggest that state court protection for investors may continue to develop.

\textsuperscript{134} See Steinberg, \textit{supra} note 115 at 905–06. Possibly for this reason the Second Circuit has departed from the Third and Seventh Circuits on this point. See Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980); Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690 (2d Cir. 1980); authorities cited note 132 \textit{supra}. See generally Lynch & Steinberg, \textit{The Legitimacy of Defensive Tactics in Tender Offers}, 64 \textit{Cornell L. Rev.} 901, 926 (1979) ("Regardless of the tactic employed, management can easily manufacture a 'legitimate' corporate purpose for its action, even when it employed the tactic solely to perpetuate its own status.").