Federalism and Corporate Law: Reflections Upon Delaware

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[T]he favorable climate which the state of Delaware had traditionally provided for corporations has been a leading source of revenue for the state. . . . The General Assembly . . . declares [this] to be the public policy of the State. . . . ¹

We are often asked “Why Delaware?” . . . Here’s why: Exceptionally favorable tax, trust, and corporation laws historically supported by sound court decisions in Delaware are major reasons.²

Delaware is both the sponsor and the victim of a system contributing to the deterioration of corporation standards. This unhappy state of affairs, stemming in great part from the movement toward the least common denominator, Delaware, seems to be developing on both the legislative and judicial fronts. In the management of corporate affairs, state statutory and case law has always been supreme, with federal intrusion limited to the field of securities regulation. Perhaps now is the time to reconsider the federal role.

I. The History of State Corporation Laws

A. Legislative Developments

In the early stages of the American economy there were grants of special franchises reminiscent of royal charters, but during the mid-nineteenth century there was a revulsion against them as anti-equal-

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I am grateful for the helpful criticism of Joseph L. Weiner, Esquire, of the New York Bar.


² Advertisement of Wilmington Trust Company, AMERICAN BANKER, Feb. 5, 1974. at 10, cols. 3 & 4.
tarian, monopolistic, and scandalous. For this reason, in revising its constitution of 1846, New York provided that corporations might not be created by special act "except . . . in cases where, in the judgment of the legislature, the objects of the corporation cannot be attained under general laws." By 1867 provisions of this character appeared in the constitutions of many states.

In 1896 New Jersey adopted what is regarded as the first of the modern liberal corporation statutes. As Mr. Justice Brandeis pointed out in *Liggett Co. v. Lee*, this act is commonly credited with attracting the incorporation of the New Jersey trusts, such as the old Standard Oil Company, which were not trusts at all but corporations operating as consolidated or holding companies. While corporation statutes had been restrictive, the leading industrial states began removing the limits upon both the size and powers of business units. The states, realizing that local restriction would be circumvented by foreign incorporation and eager for the revenue derived from the traffic in charters, joined in advertising their wares. In Brandeis' words, the race was not one of diligence but of laxity.

Shortly afterwards, Delaware, seeking new sources of revenue, copied very largely from the New Jersey act to establish its own statute. Then in 1913, at the insistence of Governor Woodrow Wilson, New Jersey drastically tightened its law relating to corporations and trusts with a series of provisions known as the seven sisters. Since Delaware did not amend its statute, it took the lead at that time and has never lost it, New Jersey by its own admission falling woefully behind. By 1915,
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the Delaware corporation law was commonly regarded as a modern and "liberal" act.12

In all fairness it should be noted that if Delaware had not entered the race, other states would have joined in to attract the lucrative business of incorporating. Indeed, Nevada has attempted to become the western Delaware but not with comparable success. At its birth in 1943 the Model Business Corporation Act presented an alternative draft corporation statute varying in major respects from the Delaware approach. It was prepared largely by lawyers of the Chicago Bar whose early experience had been in connection with the Illinois Business Corporation Act. Their spokesman commented that "[t]he Delaware statute bids for the corporate business of promotors [sic]. It makes little or no effort to protect the rights of investors. Hence in the opinion of the committee it was not the type of statute which the committee should present as a model for states intending to revise their laws."13 Over the years, however, the Model Act has been watered down to compete with the Delaware statute on its own terms rather than offering alternative approaches.14 Indeed, the recent indemnification provision of the Model Act15 is an exact duplicate of Delaware § 145.16 As stated by the chairman of the committee which prepared the 1962 amendments to the Model Act, "[C]orporate law has tended more and more in the direction of a simple set of workable ground rules for the corporate enterprise, leaving regulation either to the equitable jurisdiction of the courts or to regulation through statutes of a policing nature or through the informed judgment of administrative agencies."17 Because the Model Act has been endorsed by leaders of the corporate bar and is itself an American Bar Association committee product, it too accelerated the trend toward permissiveness. Indeed, the whole process is contagious. Other states understandably want

12. DEL. REV. CODE c.65 (1915); E. DODD & R. BAKER, supra note 6, at 38.
13. Campbell, The Model Business Corporation Act, 11 BUS. LAW. 98, 100-01 (1956). The first three chairmen of the committee on corporate laws within the section of Corporation, Banking and Business Law of the American Bar Association were members of the Chicago Bar.
14. See Scott, Changes in the Model Business Corporation Act, 24 BUS. LAW. 291 (1968). Among major changes are: § 4(f), permitting loans to officers; § 4A, relating to indemnification; § 5, permitting acquisition of a corporation's own shares by a vote of a majority of all shares instead of by a two-thirds vote; alternative § 24, denying preemptive rights except as provided in the articles rather than granting them unless limited in the articles; § 31, permitting multiple votes for shares; § 37A, relating to director conflicts of interest; §§ 67 and 72, reducing the vote required in a merger and sale of assets from two-thirds to a majority. See Folk, supra note 3, at 410.
15. 1 MODEL BUS. CORP. ACT ANN.2D § 5, ¶ 1.
to encourage companies to remain at home and therefore try to emulate Delaware by revising their acts along similar lines. Only two or three jurisdictions have resisted this temptation at all. This psychology has been responsible for much of the “modernization” of corporation laws everywhere. Today they are described as “enabling” acts—enabling management to operate with minimum interference.

Of course, many of the amendments have been salutary: They have effected simplification and flexibility and have eliminated unnecessary and vestigial procedures. At the same time, however, they have watered the rights of shareholders vis-à-vis management down to a thin gruel. Probably the best example of “the race for the bottom” appears in the Report of the Corporation Law Revision Commission of New Jersey in 1968, which stated:

It is clear that the major protections to investors, creditors, employees, customers, and the general public have come, and must continue to come, from Federal legislation and not from state corporation acts. . . . Any attempt to provide such regulations in the public interest through state incorporation acts and similar legislation would only drive corporations out of the state to more hospitable jurisdictions.

Professor J. W. Hurst has provided an interesting rationale for these developments. Through the 1920’s this style of corporation statute became a national norm, implying confidence in the productive rather than the speculative uses of the corporate device. Corporation law provided an open-ended opportunity for promoters and management to create the kind of vehicle they wanted. Since our country was growing at such breakneck speed, it would have been unthinkable then to hobble corporations in the performance of their functional role. At this stage, Professor Hurst says, the emphasis was upon utility. Indeed, because we regarded utilitarianism so highly, we even extended constitutional protections against government regulation.

In contrast, let us look at contemporaneous developments under the English Companies Act. According to Professor Loss, the Act of 1884

18. One sponsor of the new Michigan Corporation Law described it as an effort “with the primary purpose of providing a unified, simple code that would, in the words of some, out-Delaware Delaware.” Downs, Michigan to Have A New Corporation Code?, 18 WAYNE ST. L. REV. 913-14 (1972).
22. J. Hurst, supra note 3, at 62.
23. Id.
24. The most recent comprehensive statute is the Companies Act of 1948, 11 & 12 Geo. 6, c.38.
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was the first to introduce the principle of compulsory disclosure to the registration of prospectuses inviting subscriptions to corporate shares.\textsuperscript{25} The disclosure concept has been continuously strengthened and remains a fundamental part of the Companies Act.\textsuperscript{26} Based largely on English experience,\textsuperscript{27} disclosure has also become the keystone of our \textit{federal} securities legislation.\textsuperscript{28} By way of comparison, a recent check of the \textit{state} corporation laws reveals that as late as 1964 only 22 jurisdictions had corporate reporting requirements, but 14 making the reports available to shareholders; in three of these the requirements may be dispensed with by including a contrary stipulation in the bylaws. Specific requirements of content for reports to state agencies are generally nonexistent and only two jurisdictions require certification by a public accountant.\textsuperscript{29}

Professor Hurst contrasts the principle of utility with the growing need for responsibility. The latter came to be recognized in the depression of the 1930's when speculative abuse in the corporate system became manifest. The marketplace had not provided adequate control for our free enterprise-expanding society. Because abuse was rampant, regulation was required for the protection of the market itself.\textsuperscript{30} But the regulation did not take the form of corporation law nor was it directed at the companies themselves, except where abuse had gone beyond all bounds in two major areas, the public utility holding company and the investment company. In Hurst's words, "[T]o define and enforce the responsibility of corporate power the law turned more and more to specialized regulation outside the structure of the corporation."\textsuperscript{31} In our mass capitalist society the market has been of such transcendent importance that regulation has been directed at the securities offered and sold rather than at the corporations themselves. In general, the controls that emerged can be labeled as securities regulation (at the federal level) as distinguished from corporate law (at the state level). These developments have been loosely referred to as the growth of federal corporation law.\textsuperscript{32}

Professor Hurst's analysis provides a philosophical base for the con-

\textsuperscript{25} L. Loss, \textit{I Securities Regulation} 5 (2d ed. 1961).
\textsuperscript{26} Id. at 6-7.
\textsuperscript{27} Id. at 128.
\textsuperscript{30} J. Hurst, \textit{supra} note 3, at 110-11.
\textsuperscript{31} Id. at xii.
tanding developments in state corporation law on the one hand and federal securities legislation on the other. At the state level there appears to have been a failure to recognize the difference between the goals of industrial capitalism and the abuses of finance capitalism—the stage in which we appear to be today. Yet there appears to be no way out of the syndrome that has developed and that permits incorporation in any jurisdiction that may provide management freedom from restrictions. North Carolina initially, and New York subsequently, attempted to adopt some provisions in an effort to regulate foreign corporations doing business in the state (so-called pseudo-foreign corporations), but their efforts have been futile and the restrictions have been largely amended out of the law. State action cannot be effective in providing a responsible corporate statute.

B. The Primacy of Delaware

In light of these circumstances, Delaware understandably does not wish to surrender its lead. Amending its law in 1969, and again in 1970 and 1971, it is setting the pace. It likes to be number one. With some justification Delaware corporate counsel take pride in their role and enjoy the fees that flow from it. The system "engenders a volume of business for the bar which tends to be regarded as a vested interest, so that any attempt to retrace steps would encounter opposition in powerful quarters." Most important, the raison d'être behind the whole system has been achieved—revenue for the state of Delaware.

Stimulating incorporation in Delaware has some of the flavor of a community chest drive. According to a state official, "The response 'has greatly exceeded our expectations.' So far this year 6,556 companies have incorporated themselves in Delaware . . . . The total may hit 9,000 by Dec. 31 . . . . The influx boosted the state's incorporation tax take by $2.9 million in fiscal 1968 . . . ." In 1971 corporation

33. See W. CARY, supra note 3, at 11-12.
34. Id. at 12.
38. Delaware counsel may be expected to be alarmed over the fact that some companies have switched their incorporation from Delaware to Virginia because the latter has adopted anti-takeover legislation, placing further obstacles in the way of tender offers. See "Thiokol Holders Move To Thwart Unwanted Take-over Attempts," Wall St. J., Nov. 21, 1973, at 10, col. 4. In their minds the immediate question would be whether Virginia should be allowed to gain this advantage over Delaware. However, in the light of the Williams Bill, Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454, amending §§ 13 & 14 of the Securities Exchange Act, 15 U.S.C. §§ 78m-n (Supp. IV 1968) (codified at 15 U.S.C. §§ 78m-n (1970)), the fundamental question is whether this should be a subject for state legislation at all.
39. E. DODD & R. BAKER, supra note 9, at 38 n.7.
40. Wall St. J., Nov. 21, 1968, at 1, col. 5.
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franchise taxes represented $52 million out of a total of $222 million in state tax collections, approximately one-quarter of the total.\textsuperscript{41} For revenue reasons, "creating a favorable climate" is declared to be the public policy of the state.

Some of the features of Delaware law demonstrating liberality have been recited in publications for practitioners.\textsuperscript{42} These include:

greater freedom to pay dividends and make distributions; greater ease of charter amendment and less restrictions upon selling assets, mortgaging, leasing, and merging . . .; freedom from mandatory cumulative voting; permission to have staggered boards of directors; lesser pre-emptive rights for shareholders; [and] clearer rights of indemnification for directors and officers . . . .\textsuperscript{43}

In addition, full faith and credit must be given to Delaware Corporation Law as to companies organized there but operating in other states.\textsuperscript{44} The conflicts rules, and the application of \textit{Erie Railroad Co. v. Tompkins}\textsuperscript{45} in the federal courts, also compel reference back to the Delaware code and case law.

A few illustrations of the legislative approach reveal the Delaware position.\textsuperscript{46} For example, shareholders meetings may now be dispensed with if a consent is signed by the number of votes necessary to take the intended action,\textsuperscript{47} thus offering a technique to avoid disclosure. Protection from this abuse is provided through the proxy rules under federal law\textsuperscript{48} but they do not apply to firms that are unlisted or have less than 500 shareholders and minimal assets. Under § 109 of the Delaware law any corporation may in its certificate of incorporation confer the power to amend or repeal by-law provisions upon the directors\textsuperscript{49} and thus possibly foreclose any initiative outside the management.\textsuperscript{50}

The indemnification provisions relating to officers and directors

\begin{enumerate}
\item \textit{STATE TAX COLLECTIONS IN 1972}, at 16 (Dep't of Commerce, Dec. 1972).
\item See C. ISRAELS, CORPORATE PRACTICE 106 (1963).
\item Kaplan, \textit{supra} note 3, at 436.
\item Id. at 435.
\item \textit{394 U.S. 64} (1938).
\item See \textit{supra} note 3; sources cited note 3 \textit{supra}. See also Comment, \textit{Vestiges of Rights Under the New Delaware Corporation Law}, 57 GEO. L.J. 599 (1969).
\item Compare this provision with N.Y. BUS. CORP. LAW § 601(a) (McKinney 1963) ("but any by-law adopted by the board may be amended or repealed by the shareholders entitled to vote thereon as herein provided").
\end{enumerate}
have been criticized on several grounds. One is that the statutory remedy is nonexclusive as contrasted with the New York provisions. Furthermore, the new statute is broad and promises indemnity in areas where it is said that courts and commentators question the propriety of indemnification. Finally, Delaware authorizes insurance in situations where direct indemnity might not be permissible.

II. Judicial Developments

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. It is not clear, however, that the revenue thermometer should replace the chancellor's foot. This trend should be reversed. This article examines Delaware laws and decisions, compares their underlying principles with those operating in federal cases, and presents a proposal which would substantially alter the Delaware confluence.

Before proceeding to this inquiry certain underlying premises should be recognized. First, although there is not as much "free enterprise" as appears at first glance, ours is still a capitalist economy. At the same time, from the standpoint of legal rights and duties, we are tending toward a managerial, rather than a capitalist society—thanks in large part to the shift of authority to management.

Second, almost all of our business is transacted through corporations. For the year 1969 total business receipts amounted to $2.9 trillion, 84

53. See Folk, supra note 3, at 430.
54. Israels, A New Look at Corporate Directorship, 24 Bus. Law. 727 (1969), has summarized the doubts about the new Delaware indemnification provisions as follows: The areas of controversy include: New York's denial and Delaware's sanction of court approved reimbursement of expenses despite adjudication of breach of duty; indemnification for the expenses of a settled action; the "threatened" action, where New York denies and Delaware permits indemnification; the behavioral standards "in the best interest of the corporation" [N.Y. Bus. Corp. L. § 723(a)]; or "in a manner reasonably believed to be in . . . or not opposed to the best interests of the corporation." [Del. Code Ann., tit. 8, §§ 145(a) & (b) (Supp. 1968) (emphasis added)]. Is the Delaware language designed (or sufficient) to bring within the ambit of indemnification the expenses of a settled action involving a transaction in securities of the corporation and brought under Section 16(b) of the 1934 Act or under Rule 10b-5? Id. at 736 (footnotes omitted).
percent of which was accounted for by active corporations. Moreover, a substantial and growing fraction of the major corporations is organized in Delaware. Of the approximately 1,250 concerns listed on the New York Stock Exchange in 1965, 433 or 35 percent were Delaware corporations. And the percentage is growing. As of January 5, 1973, there were 1,505 listed companies, of which 606 or 40 percent were organized in Delaware. For this reason alone Delaware decisions have a profound impact upon the development of corporation law. Furthermore, similar to its influence on statutory modernization, Delaware's case law is cited constantly and relied upon in other jurisdictions. Every corporation law casebook for students is filled with Delaware decisions because it is the state where great companies are organized and where there is the most corporate experience to draw upon.

Next, it is of obvious importance that business should be conducted fairly, honestly, and competently. Indeed, these ingredients are essential to raise capital and make the system work. In another context I have adverted to a discussion in Washington some years ago with the Ambassador from a South American country. He came to seek advice because he wanted to encourage the investment of outside capital into private firms in his country and wondered how that could be achieved. I asked first, "Are your stock exchange facilities inadequate?" And he replied, "No, that really isn't the question. We have to get back to fundamentals. . . . My first concern is whether the public investor can trust anyone. The trouble with management in my country is that their only loyalty is to their relatives." This is not uncommon and it struck me forcefully; it emphasized the importance of confidence and a high standard of conduct by management as an essential ingredient before one can expect the private investor to entrust his funds to public companies. Such confidence can be sustained only by a combination of high standards coupled with disclosure and management accountability coupled with vulnerability to derivative or direct shareholder action.

Finally, we come back to a major focus of this article. It has been said that numerous members of the New York bar "felt Delaware was a more favorable forum than any other available." The necessary high

56. G. SEWARD, supra note 19, at 5.
59. See Comment, supra note 3, at 889.
standards of conduct cannot be maintained by courts shackled to public policy based upon the production of revenue, pride in being "number one," and the creation of a "favorable climate" for new incorporations. The view is widely held that Delaware corporate decisions lean toward the status quo and adhere to minimal standards of director responsibility both to the corporation and its shareholders. Although these generalizations are difficult to prove absolutely, a series of cases illustrates that this reputation is based upon an accurate analysis of the courts' decisions and that Gresham's law applies. One of the striking aspects of these opinions is that among the three supreme court justices there is rarely a dissent.

A. Mansfield Hardwood Lumber Co. v. Johnson—A Point of View

Mansfield Hardwood Lumber Co. v. Johnson⁶⁰ states the attitude of critics toward Delaware decisions. It involved the purchase of a minority interest without full disclosure and the company's subsequent liquidation for the benefit of the insiders. The first opinion of the Fifth Circuit,⁶¹ affirming the decision below, ordered a rescission of the stock sales and granted plaintiffs a pro rata portion of the assets realized upon liquidation. It was based upon general fiduciary principles under the law of Louisiana and upon the failure to disclose the facts concerning the asset values of the company.

Although the acts occurred in Louisiana, in view of the fact that the corporation was organized in Delaware a petition for a rehearing was filed, claiming among other things that such a fiduciary relationship did not exist in the state of incorporation and must be determined by its laws. In its second opinion the Fifth Circuit noted a number of decisions holding that "the conflict of laws rules of the forum require that court to refer to the 'law of the State of incorporation to determine the . . . relationship between corporation and stockholder . . . .'" The court said further, "Apparently Delaware imposes no fiduciary duty on the part of officers or directors or majority stockholders in buying stock from the minority or individual stockholders."⁶²

Nevertheless, it concluded that "[t]hose decisions are, however, in our opinion, either inapplicable or unsound where the only contact point with the incorporating state is the naked fact of incorporation . . . ." Applying conflicts of laws principles, it decided that "where

⁶¹ 263 F.2d 748 (5th Cir. 1959), aff'd 159 F. Supp. 104 (W.D. La. 1958).
⁶² 268 F.2d at 320 (footnotes omitted).
neither the charter nor the statutory laws of the incorporating state are applicable and all contact points are in the forum, we believe that the laws of the forum should govern. After discussing a number of decisions in the federal courts, the court said that "most of the other cases listed . . . involve situations where the courts were seeking to impose the fiduciary rule of the state of incorporation in order to escape the inequitable rule of the forum (generally Delaware)." It therefore denied the petition for rehearing.

Today such an action would almost certainly be grounded on Rule 10b-5 and brought in the federal courts under the Securities Exchange Act of 1934. Thus the court would reach the same result without concerning itself with refinements of conflict of law principles.

B. Proxy Contests and Take-Overs

One area in which Delaware seems aligned with management involves proxy contests and take-overs. The courts apparently allow reimbursement of incumbent directors for reasonable expenses in defending their positions in a policy dispute. By contrast, the law of New York still remains unsettled, although it may be moving in the direction of Delaware. At least three members of the New York Court of Appeals felt that the burden should be on the recipients to prove the propriety and reasonableness of the items to be reimbursed. Although the difference may not be great, the Delaware decisions indicate a clearer penchant in favor of management.

More important, the same philosophy carries over into the area of stock purchases. Cheff v. Mathes is a case in point. Cheff involved the purchase of its own shares by a corporation (Holland Furnace Co.) from a "raider" (Maremont through his company, Motor Products). The latter had purchased a substantial block of Holland stock as the initial step toward a take-over. Holland and its chief executive officer, P. T. Cheff, were concerned over this prospect and ultimately resorted to buying the raider's holdings. The vice-chancellor found that the actual purpose behind the purchase was the desire to perpetuate control and concluded that there was no real threat posed by Maremont, no sub-

63. Id. at 321.
64. Id. at 322 (emphasis added).
stantial evidence of intention by him to liquidate Holland, and that any alleged employee unrest could have been caused by factors other than Maremont's intrusion—"only one important employee was shown to have left and his motive for leaving is not clear."  

Despite the foregoing views of the vice-chancellor, who had heard the testimony of Mr. Cheff and his counsel, the Delaware Supreme Court concluded that the defendants had satisfied the burden of proof by showing that reasonable grounds to believe a danger to corporate policy existed because of the Maremont stock ownership. The court was impressed by the following facts: (1) that Maremont had deceived Cheff as to his original intentions (as most purchasers do); (2) that he had demanded a place on the board of directors and increased his purchases after having been refused a directorship (also standard practice); (3) that he had given Cheff some reason to believe that he intended to eliminate the retail sales force of Holland; (4) that, contrary to the finding of the vice-chancellor, there was justification for the belief that unrest among key employees had been engendered by the Maremont threat; and finally (5) that the past practice of Motor Products, indicating liquidation or quick sale activities, and the poor reputation of Maremont justified the defendants' action. By way of analogy the court relied upon the Delaware cases permitting incumbent directors to use corporate funds in proxy contests. Under the circumstances the court concluded that "the board of directors... believed, with justification, that there was a reasonable threat to the continued existence of Holland, or at least existence in its present form, by the plan of Maremont to continue building up his stock holdings."  

Therefore, all that was required to sustain the defendants' burden of proof was good faith and reasonable investigation of such a threat, and the court found "no evidence in the record sufficient to justify a contrary conclusion." No heed was paid to the fact that Mrs. Cheff and/or her investing company intended to purchase all or portions of the stock then owned by Motor Products if Holland did not do so.

Of course, the subsequent disastrous history of Holland Furnace Company is not proof of a judicial mistake but it does raise questions

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68. 41 Del. Ch. at 503, 199 A.2d at 553, quoting 41 Del. Ch. 166, 175, 190 A.2d 524, 529 (Ch. 1963).
69. 41 Del. Ch. at 508, 199 A.2d at 556.
70. Id., 199 A.2d at 556.
71. The court's expectations should be compared to the denouement of Holland after this decision. One basis for the court's findings that the board's purchases of Holland stock were justifiable was the evidence that, if he had obtained control, Maremont intended to end Holland's practice of doing its own retailing. Subsequent events suggest that both Cheff and Holland might have been better off had Maremont's plans
whether the status quo is always best or even respectable. The raider may sometimes be a better manager than the "raidee." As Israels states, "Cheff seem[s] to stand clearly for the proposition that directors of a Delaware corporation, once convinced that control is threatened by an outside interest which arguably would advocate some change classifiable with any verisimilitude as 'policy,' can decide a priori that such change would not be in the best interests of all the shareholders. Having so decided, they may with impunity proceed to make substantial expenditures of corporate funds to acquire at premium prices sufficient shares to assure that the general body of shareholders will be deprived of all opportunity effectively to exercise their franchise." 

C. Misleading Proxy Material

American Hardware Corp. v. Savage Arms Corp. demonstrates the contrasting attitude of Delaware and the federal courts in the field of proxies. Plaintiffs had acquired approximately 13 percent of the common stock of Savage Arms with the purpose of merging it into American Hardware Corporation. Savage was not interested. Having been thus rebuffed, American Hardware proposed to make a tender offer for Savage stock and was preparing a registration statement for this purpose. In response the Savage board authorized the purchase, with its economic consequences of Cheff's diversion of Holland were perhaps no better than the legal consequences. In 1955, about two years before Maremont came on the scene, Holland's net income was over $1 million. During the last three years of Cheff's rule ending in 1963, the company lost close to $10 million. For further detail see W. Cary, supra note 3, at 691-92.

The case has been widely criticized. See Andrews, The Stockholder's Right to Equal Opportunity in the Sales of Shares, 78 Harv. L. Rev. 505, 563 (1965); Israels, supra note 54, at 732 n.28; Israels, Are Corporate Powers Still Held in Trust?, 64 Colum. L. Rev. 1446, 1455-56 (1964); Israels, Corporate Purchase of Its Own Shares—Are There New Overtones?, 60 Cornell L.Q. 620, 624 (1965).

3. 64 Colum. L. Rev. at 1456; see also 50 Cornell L.Q. at 624; cf. Condec Corp. v. Lunkenheimer Co., 43 Del. Ch. 353, 230 A.2d 769 (Ch. 1967), in which the Chancery Court ruled against Lunkenheimer's management after a desperate and indefensible attempt to trade its shares for stock in a friendly company in order to frustrate a tender offer.


5. The transaction occurred in 1966, long before federal takeover legislation, i.e., Williams Bill, Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454, was conceived.
own shares, of stock of Aircraft Armaments in order to put more equity into friendly hands before American made its tender offer. The purchase was conditional upon approval by the Savage stockholders and a special meeting was called on only 16 days' notice.

Plaintiffs, as shareholders of Savage, sought an injunction to restrain Savage from taking any action at the meeting. They argued that time should be given for them to submit their exchange offer and that notice of the meeting was unreasonably short in view of the proxy fight the plaintiffs were conducting and the fact that one-third of the shares was in brokers' accounts and could not be voted without instructions from the beneficial owners. Rejecting these arguments the court relied upon the Delaware Corporation Law and the Savage by-law requiring only 10 days' notice.

Plaintiffs further claimed that defendants used unfair delaying tactics, refused inspection of the stockholders' list, and failed to supply necessary information. In response the court said that these were required only to enable plaintiffs to complete the registration statement relating to their proposed exchange offer and that "this was a matter wholly unrelated to the meeting." The plaintiffs further relied on the federal proxy rules as a basis for insisting that their proxy material be furnished to the Savage shareholders but the court pointed out that these rules did not apply and that "the courts of this state will not assume to trespass upon this exclusive [federal] jurisdiction."10

Finally, plaintiffs maintained that the proxy statement was false and misleading. Although four of eleven directors had opposed the proposed acquisition of Armaments, the proxy statement referred to only one director in opposition. The court said, "[W]e agree with the Chancellor that it would have been preferable to state all the facts," but stressed the fact that the dissenters had not objected in writing as the proxy rules seemed to require.

Compare the attitude of this court with the construction of the proxy rules by the Supreme Court in Mills v. Electric Auto-Lite Co.70 There, although the proxy statement asserted that Mergenthaler owned approximately 54 percent of the stock of the Electric Auto-Lite Company and therefore clearly controlled it, the Supreme Court concluded that the proxy statement was misleading by stating in bold type that the board of directors had carefully considered the terms of the merger and

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76. 37 Del. Ch. at 64, 136 A.2d at 693.
77. Id. at 65, 136 A.2d at 693.
78. Id. at 65, 136 A.2d at 694.
recommended that the shareholders vote to approve the plan. The mistake lay in the failure to divulge that the Auto-Lite board was dominated by Mergenthaler representatives. Yet from the proxy statement as a whole it should have been clear that Auto-Lite and thus its board was under the control of Mergenthaler. The statement, therefore, was misleading only if taken out of context. By contrast the Savage proxy statement appeared to have been drafted consciously to avoid indications of broad dissent.

It is not surprising that Delaware courts are reluctant to assist any group seeking a take-over. The term "raider" has a pejorative connotation and raiders are sometimes unattractive people although their action may benefit the other stockholders as well as themselves. If a court must elect, it would probably prefer the management. As a consequence it is not likely that Delaware would worry about the shortness of time a raider had to make a tender. Furthermore, it is too much to expect Delaware courts to apply the federal proxy rules. But deceptive acts should be construed the same way in the Delaware courts as in the federal courts. Management should not be permitted to act both precipitately and deceitfully to remain in office. The Savage board, in order to impede any take-over, purchased another company, in part by means of inadequate disclosure to the voting shareholders. In failing to pass upon questions of fraud the Delaware courts have abdicated a function they should be performing.

D. The Destruction of Accrued Dividends and Reclassifications

In corporate cases the Delaware courts have avoided looking through form to substance—quite in contrast to the federal courts in the tax and securities fields. One illustration involves a series of well-known cases relating to the destruction of dividend accruals on preferred stock. The earliest case was Keller v. Wilson & Co., in which the Delaware Supreme Court invalidated a charter amendment cancelling arrearages on the ground that they represented a "vested right of property secured . . . by the Constitution." But four years later in

84. 21 Del. Ch. 391, 190 A. 115 (1936).
85. Id. at 412, 190 A. at 125.
Federal United Corp. v. Havender,86 the very same objective was permitted by use of a merger.

It is understandable that the federal court in Hottenstein v. York Ice Machinery Corp.,87 faced with the same question and required to apply Delaware law under Erie R.R. v. Tompkins,88 found Keller and Havender irreconcilable. The court stated that the Havender decision constituted a repudiation of principles enunciated in Keller and that Keller remained a landmark in the law of Delaware only to signify that what cannot be done directly under one section of the General Corporation Law may be done by subterfuge under another.89 Keller's back thus broken, Hottenstein went on to say that under Delaware law a parent corporation may merge with a wholly-owned inactive subsidiary pursuant to a plan cancelling preferred stock and the rights to unpaid accumulated dividends.90

A reclassification plan of a solvent Delaware corporation involving alteration of rights of preferred stockholders also demonstrates the contrasting views of the federal courts with those of the Delaware judiciary. In Barrett v. Denver Tramway Corp.91 Judge Leahy had to determine whether the proposed plan was fair to the complainants representing preferred shareholders. Because the question of fairness is a matter of substantive law,92 he recognized that federal courts must decide the legality of the action under state law. As to the reclassification he then commented:

If a federal court is free to indulge an independent view of what constitutes unfairness in connection with action taken under . . . the Delaware Corporation Law, then I conclude the present plan is unfair to the preferred stockholders. . . . Regardless of fraud and bad-faith questions, I believe it inequitable to allow the lower class to benefit to the detriment of the higher, in view of the traditional contract between preferred and common stockholders.93

Nevertheless, the legal formula established by Delaware law compelled the result that plaintiffs' charge of unfairness could not be sustained.94

86. 24 Del. Ch. 318, 11 A.2d 331 (1940).
87. 136 F.2d 944 (3d Cir. 1943).
88. 304 U.S. 64 (1937).
89. 136 F.2d at 950.
91. 53 F. Supp. 198 (D. Del. 1943), aff'd, 146 F.2d 701 (3d Cir. 1944).
93. Id.
94. Id. at 205.
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E. The De Facto Doctrine

A somewhat similar approach has been adopted by the Delaware courts in connection with the de facto merger problem. In *Hariton v. Arco Electronics, Inc.*, a stockholder of Arco challenged the validity of the sale of its assets to Laurel and the immediate liquidation of Arco. The plaintiff contended that the transaction, though in form a sale of assets, was in substance and effect a merger and that the de facto merger was unlawful because the merger statute had not been complied with, thereby depriving stockholders in Arco of the right of appraisal. The court rejected this contention and stated that a reorganization plan might legally be effected under either a sale of assets statute or the merger route.96

It seems anomalous that the identical result can be achieved by means of a merger with some relief for dissenting shareholders, or by means of a sale of assets without affording them appraisal rights. The court has taken away one of the few protections a reluctant shareholder may have in the fusion of two companies.97 Yet the legislature would certainly have achieved the result approved in *Hariton* if the supreme court had not ruled as it did. Perhaps it would have been an idle gesture, therefore, for the Delaware court to emphasize substance over form and follow other jurisdictions in adopting the de facto merger approach. But this view raises the interesting jurisprudential question of how far a court should go in guarding the rights of shareholders when it is aware of state legislative policy opposing it.

F. Fairness between Parent and Subsidiary

The Delaware courts have tended to encourage freedom of action on the part of parent companies incorporated in that state and have indicated little concern over the fairness of dealings with subsidiaries. The consistent philosophy favors controlling shareholders and leaves fiduciary questions to the business judgment of an indentured board. The old concept that each party is "entitled to what fair arm's length bargaining would probably have yielded"98 has been enveloped in a new and labyrinthian rationale.

95. 41 Del. Ch. 74, 188 A.2d 123 (1963).
96. Id. at 76, 188 A.2d at 125.
97. For the view that the right of appraisal may serve no useful purpose, see Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 Yale L.J. 223 (1962).
The most recent example in the Delaware Supreme Court is *Sinclair Oil Corp. v. Levien.* Sinclair totally dominated Sinclair Venezuelan Oil Company (Sinven), in which it held 97 percent of the stock. Plaintiff represented the three percent minority interest suing derivatively. At Sinclair’s direction Sinven paid out over six years $108 million in dividends ($38 million in excess of earnings). Thus Sinven’s activities declined; there was no opportunity for expansion despite Sinclair’s company-wide policy of developing through its subsidiaries new sources of revenue.

Recognizing that by reason of Sinclair’s domination, Sinclair owed Sinven a fiduciary duty, the Delaware Supreme Court nevertheless held that the transactions should be tested by the business judgment rule under which a court will not interfere unless there is a showing of gross and palpable overreaching. The chancellor in the court below had applied the intrinsic fairness test and ruled against Sinclair. The supreme court, on the other hand, reversed and said, “[T]he basic situation for the application of the [intrinsic fairness test] is the one in which the parent has received a benefit to the exclusion and at the expense of the subsidiary.”

Since all the stockholders received the dividends pro rata, these distributions did not represent self-dealing, an essential ingredient for invoking the intrinsic fairness test. The plaintiff, bearing the burden of proof, proved neither that business opportunities came to Sinven independently nor that Sinclair took to itself or denied opportunities to Sinven. It would have been surprising for Sinclair to generate new expansion when its whole motive was to drain the cash from Sinven.

One cannot be deeply concerned over an outside interest of three percent. Sinven could have eliminated the outsiders by a short merger. As long as a minority interest existed, however, perhaps a parent should not be permitted to shrink a company under its control during an era of expansion. The traditional concepts of fairness should not be so readily dismissed. It is true that the courts have gradually moved away from the doctrinaire position of declaring void or voidable all transactions between interlocking boards. But to what extent should the burden of proof in such cases fall upon the complainant? It is not

99. See the later case of Chasin v. Gluck, 282 A.2d 188 (Del. Ch. 1971), where the vice-chancellor’s ruling virtually defeated the opportunity for plaintiff to force a defendant to bear the burden of proving fairness. The court said that plaintiff must first demonstrate gross or palpable overreaching or a disadvantage before the defendant need prove the fairness of the transaction. See Folk, Conflicts of Interest under State Law, Third Annual Institute on Securities Regulation 165-66 (P.L.I. 1971).
100. 280 A.2d 717 (Del. 1971).
101. Id. at 720.
rational for the court to rely on the "business judgment" of the directors when they represent one of the competing interests exclusively and thus cannot be expected to exercise total impartiality. The court seems ready to develop a new theory by which it can ignore a basic conflict of interest—quite in contrast with the attitude of the federal courts.\textsuperscript{102}

\textit{Getty Oil Co. v. Skelly Oil Co.}\textsuperscript{103} poses much the same question. In this case both parent and subsidiary were in the business of refining and marketing crude oil and crude oil products. The Oil Import Board ruled that the subsidiary, because it was controlled by the parent, was no longer entitled to a separate allocation of imported crude oil. The subsidiary then contended that it had a right to share the quota of crude oil allotted to the parent. Although the subsidiary suffered a loss through the administration of the oil import quotas, the parent gained nothing because its quota was derived solely from its own past use. Applying the business judgment standard, the court held that, since the parent received nothing from the subsidiary to the injury of the minority stockholders of the subsidiary, there was no self-dealing.

It is not that clear, however, that the outside shareholders accordingly should suffer. Since Skelly would have been entitled to its own allocation if it had not been controlled by Getty, it has some equitable interest in the quota of the parent whose dominance prevented it from being accorded separate treatment. The majority should not always receive a benefit at the expense of the minority. There is no major difficulty in allocation; the court easily could, and in fairness should, have applied the ratio between the original two quotas to the total amount allowed to determine the new quota for each party. If either party was to be blamed for the loss of Skelly's quota, it must be the parent who acquired the interest in the subsidiary. The failure to make any allocation was an abdication of responsibility by the court.

In \textit{Getty} the supreme court cited with seeming approval\textsuperscript{104} \textit{Meyerson v. El Paso Natural Gas Co.},\textsuperscript{105} relying upon it for the proposition that "the court will not interfere [with the business judgment of a parent corporation] absent a showing of 'gross and palpable over-reaching.'"\textsuperscript{106} The case involved unjust enrichment—whether the parent (El Paso) dealt unfairly with the minority stockholders of a subsidiary (Northwest) by retaining all the tax savings resulting from filing consolidated

\begin{flushleft}
\textsuperscript{102} See pp. 688-92 infra.
\textsuperscript{103} 267 A.2d 883 (Del. 1970).
\textsuperscript{104} Id. at 886-87.
\textsuperscript{105} 246 A.2d 789 (Del. Ch. 1967).
\textsuperscript{106} 267 A.2d at 883, quoting 246 A.2d at 794.
\end{flushleft}
income tax returns where losses of the latter offset taxable income of the parent. El Paso had made a tender offer to shareholders of Northwest to obtain sufficient additional shares in order to qualify under the consolidated income tax provisions; no mention, however, was made of this intention in the offer. A minority shareholder of Northwest sued derivatively to seek an accounting and an allocation of the tax savings.

In analyzing the question of fairness, the court questioned whether the minority stockholders would in any event benefit from an allocation because a company losing money was unlikely to declare a dividend. The chancellor further concluded that the attempt to make an issue of El Paso's motive was not persuasive and asked, "What then would be a fair allocation? . . . [The] plaintiff makes no suggestion . . . . The obvious reason for his failure to do so is that it is impossible, as between parent and subsidiary, to set fair standards for allocation agreements."107

Traditionally, however, this is precisely the function of chancery. The court might say that this impossibility does not justify allocating the entire tax-savings to the loss-subsidiary, but it does not follow that the latter is entitled to nothing. Query whether this is a true case for business judgment "with which the court should not interfere absent a showing of 'gross and palpable overreaching.'"108

The tortured rationale of the Delaware courts contrasts markedly

107. 246 A.2d at 793-94. See generally Folk, supra note 97, at 188, 190. Views contrary to those expressed here may be found in Note, Fiduciary Duty of Parent Corporation, 57 Va. L. Rev. 1225 (1971); Note, Corporate Fiduciary Doctrine in the Context of Parent-Subsidiary Relations, 74 Yale L.J. 338 (1964).


Perhaps the latter two cases could be distinguished because they involved a loss-parent taking advantage of a profit-subsidiary, but the distinction is somewhat tenuous. Even though they both support the chancellor, it should be noted that there was some indication of dissent in both instances. In Case v. N.Y. Central R.R., the appellate court ruled the other way, but was overruled by the Court of Appeals. In Western Pacific, the case went to the Supreme Court on the question of rehearing en banc; the only justice who spoke to the merits, and relied upon the theory of unjust enrichment, was Mr. Justice Jackson. Certainly he has strong support in modern business practice for the statement, "It may seem anomalous at first glance that a sustained loss can be realized upon as an asset. But it is not the loss; it is the right to use the loss as an offset that is valuable. The market for it is restricted, of course, but this detracts nothing from its value to one in a position to utilize it." 346 U.S. at 276. He concluded that "the plaintiff is entitled to what fair arm's length bargaining would probably have yielded." Id. at 277. In this connection it should be noted that "trafficking" in loss corporations has become a commonplace transaction in the last decade.
with the more straightforward approach taken by the federal courts in parent-subsidiary cases. In *Lebold v. Inland Steel Co.*, the parent steel company attempted to freeze out the minority interest in a subsidiary through liquidation. The subsidiary owned three ships which were sold for their fair value rather than on the basis of earning power. Despite the fact that the profits of the steamship business were derived exclusively from carrying the parent's ore, the court awarded damages: "That there was value over and above physical assets is perfectly obvious from the fact that a prosperous business existed and is still being conducted; that plaintiffs, if they had not been deprived of their interest, would be still sharing in the returns from that business and that at the present time all the profits of such are being enjoyed by defendant to the total exclusion of plaintiffs."110

G. The Directors' Duty of Care

*Graham v. Allis-Chalmers Manufacturing Co.* is an example of the low standard that Delaware shares with most other jurisdictions as to the duty of care on the part of directors. *Graham* involved a derivative action on behalf of Allis-Chalmers in connection with the much publicized price-fixing conspiracy involving electric equipment in the late 1950's. The company, together with four nondirector defendants, pleaded guilty to the indictments and as a result had been subjected not only to fines and penalties but to treble damage actions brought by purchasers of the equipment.

In this case it was impossible to establish actual knowledge on the part of any officers, but it was claimed that they should have had notice, or constructive knowledge, of what was happening. One reason why a duty might arise here is that in 1937 (19 years before the illegal action) the Federal Trade Commission had issued a cease and desist order from alleged price-fixing in connection with the sale of many of the same items. However, the point was made by the vice-chancellor that such an order was "entered at a time when none of the Allis-Chalmers directors here charged held a position of responsibility with the company."112

The supreme court upheld the lower court's ruling for the defendants, finding that since the company's directors could not investigate personally all of the company's employees they were entitled to rely on

109. 125 F.2d 369 (7th Cir. 1941), *cert. denied*, 316 U.S. 675 (1942).
110. *Id.* at 374. See also *Seagrave v. Mount*, 212 F.2d 389 (6th Cir. 1954).
112. 40 Del. Ch. at 341, 182 A.2d at 331.
summaries, reports, and corporate records. No one would expect the directors to have personal knowledge of all corporate activities. However, a student Note suggests that a state less hospitable than Delaware might have imposed upon directors the duty of installing an internal control system to prevent repeated antitrust violations. There had been ample warning. And directors of financial institutions, particularly banks, have been expected—indeed required—to provide a proper system of supervision. Even if a court should refuse to impose such a duty on all the directors, certainly where almost the same action previously had been found in violation of law at a time when the present senior officers had been employees the inside directors should be held responsible.

III. Hypothetical Tests of Public Policy

Perhaps there is no public policy left in Delaware corporate law except the objective of raising revenue. The attitude of the Delaware courts as demonstrated in the foregoing cases can be analyzed in order to determine how far they are willing to go in relaxing standards by examining three hypothetical situations. The first is presented by *S.E.C. v. Transamerica Corp.* In its by-laws Transamerica Corporation had provided that “these by-laws may be altered or amended . . . at any . . . meeting . . . if notice of the proposed alteration of amendment be contained in the notice of the meeting, . . . provided that the amendment so adopted shall first have been proposed by a resolution passed by a vote of a majority of the whole Board . . . .” In other words, a roadblock was adopted to prevent any issue from coming before the shareholders except with the prior approval of the board of directors. As decided by the court in this case, the shareholder proposal rule (§ 14(a)(8) of the Securities Exchange Act of 1934) makes the question academic with respect to a corporation subject to the proxy rules. But if there were fewer than 500 shareholders, so that the proxy rules would not apply, the Delaware Supreme Court might hold as a matter of policy that shareholders have no inherent power unless the direc-

113. 41 Del. Ch. at 85, 188 A.2d at 130.
117. 163 F.2d 511 (3d Cir. 1947).
118. Id. at 516 n.9.
119. See p. 669 supra.
tors approve. There is some likelihood that it would so hold and in so doing rule that a management-inspired by-law is mightier than what some would consider public policy.

In the second hypothetical the management of Kansas City Southern Industries, Inc., a Delaware corporation, was concerned about a possible tender offer and take-over by an outsider. Therefore, it proposed a series of eight major amendments to its certificate of incorporation, many of which were standard techniques to scare off tender offers. Their cumulative in terrorem effect would be overwhelming if management had control of 31 percent of the shares. A suit was brought contesting management's action in the United States District Court for the District of Delaware, but was later withdrawn.

One argument justifying federal jurisdiction here might have been that the action taken was in violation of the federal proxy rules, but the decision might still hang on the interpretation of Delaware law. The contention could be made that the amendments would disenfranchise the shareholders and prevent mergers for the purpose of perpetuating the defendants in office and were therefore contrary to public policy. Delaware, however, seeking revenue and proud of its leadership in the race for incorporation, must please management, and management clearly does not like "raiders." Furthermore, the judiciary would adhere to Delaware policy that provisions of the corporation law are of equal dignity and that actions taken pursuant to them are of independent legal significance. In other words, there is no authority for look-

121. The amendments were:
   (a) reclassifying the Kansas City directors into three classes, each composed of six directors to serve for staggered terms;
   (b) increasing the number of authorized shares of common stock from 4,100,000 to 7,000,000;
   (c) creating a new series of preferred stock with rights and terms to be later specified by the board of directors;
   (d) cumulative voting for directors, if the proposal for a staggered board of directors described in subparagraph (a) is adopted;
   (e) increasing to 70 percent the shareholder vote required (i) in connection with certain mergers, sales, and similar transactions not approved by the board of directors, and (ii) to amend this provision;
   (f) increasing to 70 percent the shareholder vote required for changing the amendments referred to in subparagraphs (a) and (d) and requiring such a vote for increasing the number of directors to more than 18;
   (g) eliminating restrictions on investment company activities;
   (h) eliminating the right of shareholders to establish by resolution stockholder inspection rights, place for meetings, provisions for retention of records, and eliminating the requirement that the nature and extent of inspection rights be specified in corporation's by-laws.
Notice of Special Meeting on July 8, 1969. See also Proxy Statement, dated June 6, 1969, at 1-6.
123. If federal jurisdiction rested upon diversity, Erie Railroad Co. v. Tompkins, 304 U.S. 64 (1938), would then of course require adherence to state law.
124. See p. 679 supra.
ing through form to substance. On this premise, nothing that can be achieved through amendments to the by-laws or to the certificate of incorporation will offend a Delaware court so long as the rules of the game are scrupulously observed.

Third, Delaware's new § 145 states: (f) that the "indemnification provided by this section shall not be deemed exclusive of any other rights to which those seeking indemnification may be entitled under any by-law agreement, vote of stockholders or disinterested directors or otherwise, ..." and (g) that a "corporation shall have power to purchase and maintain insurance on behalf of any ... director ... against any liability asserted against him ... whether or not the corporation would have the power to indemnify him against such liability under the provisions of this subsection." These sections suggest a legislative intent to permit indemnification, directly or through insurance paid by the corporation, in any and all circumstances. Does the public policy of Delaware impose any limit upon this broad indication of legislative intent?

IV. The Freedom to Litigate in Delaware—The Other Side of the Coin

In response to such criticisms of Delaware's policy approach, counsel may point to the relative ease of entry into Delaware courts for suits against corporate directors. For example, Delaware, unlike New York, Pennsylvania and other states, does not require the posting of security for expenses. Although this obstacle can be overcome, it nevertheless has had some effect in reducing shareholder litigation in the jurisdictions where it applies. Indeed, it was designed to dampen the "strike suit."

Furthermore, Delaware offers a method of bringing suit against non-resident directors by quasi in rem jurisdiction. Though described as
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archaic, cumbersome, and inefficient, the sequestration process authorizes the courts of chancery to "compel the appearance of the [nonresident] defendant by the seizure of . . . his property" and treats the situs of "the capital stock of all Delaware corporations . . . as in this State." Although these provisions may be seen as some indication of Delaware policy to enforce fiduciary standards by encouraging the right to litigate, they are more likely based on the solicitude of the state for the Delaware bar. The committee that drafted the Delaware amendments of 1967 consisted primarily of Delaware lawyers who enjoy a lucrative Wall Street practice in a comparatively pastoral setting. Indeed, the drafting committee consisted of three men, each of whom was a member of a leading firm in Wilmington. They have a direct interest in permitting suits to be brought in Delaware.

The point is dramatically illustrated in connection with sequestration. In 1966 the representatives of the corporation service companies serving as members of the Delaware Law Revision Commission proposed its elimination on the theory that there would then be many new incorporations. Indeed, it has been said that some corporate lawyers will recommend against Delaware incorporation simply because of sequestration. The lawyers on the Commission, however, opposed its abolition, several of them freely admitting that they voted for sequestration in part because it meant more business for them. From the standpoint of the bar, it would indeed be killing the goose that laid such golden fees. If sequestration had been abolished, Delaware could, of course, have become the corporate haven par excellence, but any true counselor possessed of judgment, beyond technical skill, would recognize that such action might go too far and generate adverse political consequences. It is not surprising, therefore, that the Commission continued to favor a tortuous and sometimes unsuccessful sequestration process that necessitates complex litigation rather than a simpler and truly effective long-arm statute that would surely discourage corporations from organizing in Delaware.

134. Id. § 169 (Supp. 1968).
136. Id. at 889.
137. Id. at n.202.
138. Id. at 890.
139. For means of avoidance, see Folk & Moyer, supra note 132, at 796.
140. See Comment, supra note 3, at 890. See also Folk & Moyer, supra note 132, at 798, recommending the substitution of a long-arm statute. In all fairness, it should be noted that only a few states have such a law.
Consonant with the philosophy of the Delaware legislature, the Delaware judiciary in two respects has also taken a relatively liberal attitude toward obstacles to the bringing of suits. It has broadly construed the shareholder’s right of inspection, particularly the requirement of a proper purpose on the part of a stockholder to examine the list of shareholders. Furthermore, in *Mayer v. Adams* the supreme court of Delaware, interpreting subsection 23(b) of the Chancery Rules, reversed the vice-chancellor and held that a preliminary demand on shareholders is not generally required in a derivative suit. The supreme court’s construction of the rule is generally the law in most jurisdictions today, but the Delaware court would have had current precedent for a contrary holding.

Delaware’s approach to litigation, both legislatively and judicially, appears clearly contrary to its general attitude presented in the preceding sections of this article. Although there is no legislative history to support it, the concept of a competing interest in the Delaware bar, members of which draft the statutes and constitute the court, seems to provide a reasonable explanation. To summarize in the salty words of Professor Bishop, “Delaware’s general approach to stockholder litigation . . . is to make it easy to sue the executives of Delaware corporations, no matter where they reside or where the corporation does business, so long as the suit is in Delaware Courts, and conducted by Delaware counsel.”

V. The Philosophy of the Delaware Court

A. The Potential for Legislative Change

If the cases point to the conclusion that Delaware has a laissez-faire attitude toward the fiduciary role and responsibility of management to its shareholders, the next question is whether there is any reason underlying it. A state policy based on revenue production and pride in remaining the foremost state for incorporation should not necessarily influence the thinking of the judiciary. From a jurisprudential viewpoint, where the legislature has not already spoken, underlying policy probably should not have any impact upon ethical standards, equity, or fairness. On the other hand, individual judges will surely be cau-

144. For a recent example, see *Bell v. Arnold*, 175 Colo. 277, 487 P.2d 545 (1971).
145. Bishop, supra note 52, at 1084.
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tious if they realize that their rulings may cast some doubt on the general acceptability of Delaware law to corporations and that the legislature will merely change the law in response. There thus tends naturally to be a sense of futility about establishing higher corporate standards.

That the Delaware Supreme Court is aware of the potential for legislative reaction is demonstrated by a case now more than 40 years old: Wittenberg v. Federal Mining & Smelting Co.\textsuperscript{146} The complaint, brought by a preferred stockholder, alleged that the company's total net assets were less than the par of the outstanding preferred stock and that the common stock had no equity whatsoever. It further alleged that the company had declared a dividend on the common stock out of current profits (calculated without regard to depletion) and sought an injunction to restrain the payment. A demurrer was filed based upon the proposition that a wasting asset company need pay no attention to depletion. Referring to the Delaware statute forbidding impairment of capital, the chancellor noted that the policy of calculating profits without regard to depletion would leave the preferred stock with a preference as to capital but none to divide and therefore overruled the demurrer.

In February 1927, the injunctive order was affirmed, the supreme court concluding its opinion by noting:

Whether corporations engaged in the exploitation of wasting assets shall be excepted from the operation of our law is a question for the Legislature of the State to decide. It may be fortunate that the Legislature is now in session.\textsuperscript{147}

The Legislature quickly responded by an Act of March 2, 1927.\textsuperscript{148} It revised the Delaware dividend statute to permit distributions by wasting assets companies without taking depletion into consideration. After the amendment, when the Wittenberg case again came before the chancellor for final hearing, he adopted the amended statutes as "the rule for this case."\textsuperscript{149}

There may be good reason for permitting a mining company to work itself out of business, but surely not for the benefit of the common stockholders at the expense of creditors or preferred stockholders.

\textsuperscript{146} 15 Del. Ch. 147, 133 A. 48 (Ch. 1926), aff'd, 15 Del. Ch. 409, 138 A. 347 (1927).
\textsuperscript{147} 15 Del. Ch. at 420, 138 A. at 352.
\textsuperscript{149} 15 Del. Ch. 351, 353, 138 A. 352, 353 (Ch. 1927). Therefore the only issue remaining was whether, if the dividend on common stock should be paid, the net assets would fall below the asset preferences of the preferred. In view of the fact that the balance sheet in one year showed an excess over the preferred more than the proposed dividend, the chancellor said "this is enough in itself to warrant a refusal of a permanent injunction of that dividend." Id. at 354, 138 A. at 353.
There was no need for a court that felt compelled to decide for the preferred to offer the suggestion that the law be changed. The Wittenberg case is no credit to either the court or the legislature.

B. The Close Link between Legislature, Judiciary, and the Bar

Another reason for the laissez-faire attitude articulated in the Delaware opinions is the nexus between the legislative process and the judiciary. This comment is not intended as a sociological exposé. Indeed, it is refreshing to find leading lawyers occupying such responsible roles in public service. Yet the close link between the two can best be illustrated by comparing the membership of the Delaware Law Revision Commission of 1967 with that of the Supreme Court of Delaware.

The Commission itself, made up of 10 persons, was organized by the Secretary of State. One of its mandates was “[t]o ascertain what other states have to attract corporations that we do not have.” The chairman was the late C. A. Southerland, who served for 12 years as chief justice and was later counsel to one of the leading firms in Delaware. The other members consisted of three persons who were senior partners of other leading firms in Wilmington, one of whom resigned to join the Delaware Supreme Court; a delegate from the plaintiffs’ bar; a representative of the Corporation Trust Company; and the president of the U.S. Corporation Trust Company of New York. The mission of the last two, of course, was to develop business in Delaware. Finally, there was the then head of the Corporation Department in the Office of the Secretary of State—later executive vice-president of the Corporation Service Company.

The table below compares this Commission with the background of the seven justices of the Supreme Court from 1951 to date. What is

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<th>Chief Justices:</th>
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<tr>
<td>1963-64</td>
<td>G.L. Terry, Jr. (ii)</td>
<td>Chairman, Newcastle County Democratic Committee 1947-49</td>
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<td>Hughes, Terry and Terry to 1957 (became judge in 1938)</td>
<td>Attorney, Delaware legislature, 1933-34</td>
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<td>(one of the leading firms in Delaware; later, Potter, Anderson and Car- ron) 1947-49</td>
<td>Sec’y of State, 1937-38</td>
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<td>Governor 1965-69</td>
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striking about the membership of the court in the last 23 years is that almost all the justices were drawn from the group responsible for the 1967 revision of the corporation law. In fact, two of them were members of the Commission. A majority of the justices practiced law in the firms which represent the important corporations registered in Delaware. Justices Southerland and Wolcott had been partners in a distinguished firm. Justice Tunnel eventually joined another, and Justice Herrmann was the senior partner of still another bearing his name. Three left the bench, two of them to return to leading firms in Dela-

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<tr>
<td>1951-63 C.A. Southerland (iii) (deceased 1973)</td>
<td>Southerland, Berl and Potter (see Wolcott, supra); Counsel to Potter, Anderson and Cartoon (successor firm) (iv)</td>
<td>Attorney general 1925-29</td>
</tr>
<tr>
<td>1964- D.L. Herrmann (v)</td>
<td>Herrmann, Bayard, Brill and Russell (counsel for numerous insurance companies) 1958-65 (vi); Director and member of Executive Committee, Delaware Power &amp; Light Co. 1962-65</td>
<td>Chairman, State Goals Comm'n 1960-64; Chairman, State Planning Comm'n 1962-64</td>
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<td>1951-64 D.F. Wolcott</td>
<td>See supra</td>
<td>See supra</td>
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<td>1963- J.B. Carey</td>
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<td>No public information (in judiciary since 1945)</td>
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<td>1962-63 C.L. Terry</td>
<td>See supra</td>
<td>See supra</td>
</tr>
<tr>
<td>1951-54 J.M. Tunnell, Jr. (ix)</td>
<td>Tunnell and Tunnell, Georgetown, 1936-51; 1954-58 (counsel for numerous banks and credit companies) Morris, Nichols, Arsht and Tunnell, 1958- (one of the leading firms in Delaware) Director, Wilmington Trust Co.; Delaware Power &amp; Light Co.</td>
<td>No public information</td>
</tr>
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Sources:

i. 37 Who's Who in America 3462 (1972-73).
ii. 35 Who's Who in America 2168 (1968-69).
iii. 33 Who's Who in America 1890 (1964-65).
ware, and one to become Governor. With the exception of Justice Carey, who served from 1945 on the bench in various roles, all but two of the justices have been directly involved in major political positions in the state. The three chief justices have been chronologically (1) Attorney General, (2) Secretary of State and Governor, and (3) the Democratic candidate for Attorney General. Two other justices were Chairman of the State Planning Commission and attorney for the Delaware Senate. The whole process is reminiscent of musical chairs. In such a small state as Delaware, with a population of 548,000 and a bar of 733, of whom 423 are in private practice, we have in microcosm the ultimate example of the relationship between politics, the bar, and the judiciary. There is certainly nothing "wrong" or surprising about these relationships. Yet it is clear that Delaware may be characterized as a tight little club in which the corporate bar cites unreported decisions before the courts in which they practice. Thus major participation in state politics and in the leading firms inevitably would align the Delaware judiciary solidly with Delaware legislative policy. Indeed, as outstanding members of the bar they may have contributed to its formulation before they became judges and at any rate might be disloyal to their state to pursue any other course.

VI. The Contrasting Federal Approach

The attitude of the Delaware courts is in dramatic contrast to the approach taken by the federal courts in corporate cases. In the proxy field reference has already been made to *Mills v. Electric Auto-Lite Corp.* There are other cases which demonstrate an equally rigorous standard with respect to deceptive statements in proxy material.

In *S.E.C. v. Transamerica Corp.* the Third Circuit found no difficulty in bowling over the argument that management could use the notice requirement in a Delaware by-law "as a block or strainer to prevent any proposal to amend the by-laws, which it may deem unsuitable, from reaching a vote at an annual meeting." It concluded by saying,

154. Id. at 159.
155. 396 U.S. 375 (1970); see pp. 676-77 supra.
157. 163 F.2d 511 (2d Cir. 1947).
158. Id. at 516.
“If this minor provision may be employed as Transamerica seeks to employ it, it will serve to circumvent the intent of Congress in enacting the Securities Exchange Act of 1934. It was the intent of Congress to require fair opportunity for the operation of corporate suffrage. The control of great corporations by a few persons was the abuse at which Congress struck in enacting Section 14(a).”

The broad construction of § 10(b) and Rule 10b-5 has been the subject of extensive discussion in both law reviews and books. Suffice to say that there has been an explosive development of the law based upon a few phrases in § 10(b) and Rule 10b-5. This may be due in part to the fact that the common law has been “laggard.” On behalf of the investor the Rule has been extrapolated to protect purchasers or sellers against persons who receive inside information themselves or communicate it to others and to persons who in turn were improper recipients. The concept has been further broadened to include transactions involving misleading corporate publicity and transactions where there was

159. Id. at 518.
161. Professor Louis Loss has stated:
So far as the great Rule 10b-5 is concerned, which seems to be taking over the universe gradually, I would not, as I now think about it, attempt to codify the law in that area completely. Most people who have thought deeply about this field recognize, I think, that the development under 10b-5—certainly a great deal of it—is a healthy one, and was long overdue. Indeed, as so often happens in our jurisprudence, the rapidity with which the federal courts are developing the law here is, perhaps, the best testimonial to the fact that the common law was a bit laggard in this area.

One of the draftsmen of the 1967 Delaware amendments compared the federal approach under Rule 10b-5 with the state court position in another area as follows:
Of considerable interest is the way in which federal courts may be expected to handle questions of substantive fairness when the board of directors has a personal interest but the transaction is not demonstrably injurious or unfair. Under state law, especially the more recent statutes [citing DEL. CODE ANN. tit. 8, § 144 (Supp. 1971), and N.Y. BUS. CORP. LAW § 713 (McKinney Supp. 1969)], the existence of a personal interest in a transaction requires a showing that the transaction satisfied a majority of the disinterested directors or was approved by the shareholders, or, if neither of these conditions is met, that it was substantively fair. Hopefully, federal courts that apply the Schoenbaum fairness concept will not fall into the habit of showing undue deference to the so-called disinterested directors, who often hold that badge of merit without being truly dissociated from their fellow control directors. . . . Once embarked on the Schoenbaum course, courts should not disappoint expectations by denying shareholders what may be their sole opportunity to secure an independent appraisal of the merits of a transaction uncorrupted by personal or pecuniary interests of those normally vested with that power.
only a tenuous connection between the securities transaction and the actual fraud. In addition, on the basis of the Securities Act of 1933, a federal court has confirmed the duties of directors in connection with disclosures in registration statements.

With respect to the Investment Company Act, Judge Friendly, in Brown v. Bullock, used a broad brush to provide a basis for liability of directors. In the same case he also examined § 15, which makes it unlawful for a person to act as investment advisor of a mutual fund for more than two years after the execution of the contract setting up this arrangement unless his continuance "is specifically approved . . . by the board of directors" or by vote of the shareholders. The defendants, directors of the fund, and the management company contended "that all Congress has done in § 15 . . . is to require annual action by directors, standards for whose performance . . . have long been prescribed by state law, and there is thus no reason to suppose that Congress meant to create any different standard." In reply Judge Friendly said, "It is . . . unreasonable to suppose that Congress would have wished to permit its purpose to protect investors in all investment companies . . . to be frustrated if a particular state of incorporation should be satisfied with lower standards of fiduciary responsibility for directors than those prevailing generally."

In Rosenfeld v. Black, a more recent case under the Investment Company Act, Judge Friendly affirmed his belief in the well-established principle of equity that a personal trustee, corporate officer, director, or other person standing in a like relationship with another may not sell or transfer his office for personal gain. He concluded that "[e]ven ratification by the beneficiaries would not save a fiduciary from accountability for any amounts realized in dictating or influencing the choice of successor unless this was secured with notice that the beneficiaries were entitled to the profit if they wished, . . . and it is questionable whether even such ratification by a majority of the beneficiaries could bind others . . . ."
The question arises why the federal courts should approach corporate standards in one way and the Delaware courts in an almost diametrically different way. It could be a difference in the interpretation of public policy or it could be that the federal courts have a tradition of independence and impartiality—freedom from a constrictive state policy. The fact is that these judges are chosen to serve for life and are not serving any constituency. Typically they do not resign to return to private practice and they would not entertain any feelings of disloyalty even if they were aware that their state or region would suffer by their judgments. Thus, they are not faced with the jurisprudential dilemma that must unconsciously affect the thinking of the Delaware judiciary. Their efforts extend the fiduciary concept while the approach of the Delaware courts is to shrink it. It cannot be that Delaware judges are more realistic and experienced in the corporate field; one federal judge who has written a substantial number of the advanced opinions was one of the most effective practitioners in Wall Street before his appointment to the bench.173

The argument may be made that the difference between federal and the Delaware decisions discussed in this article is that the federal courts were carrying out a policy to protect investors clearly articulated by the securities laws. To some extent this is true, although it may well be argued that the Rosenfeld case rests upon the common law and would have been decided in much the same way without reference to the Investment Company Act, under which the fund was regulated. Furthermore, the federal courts' interpretation of the generalized words in Rule 10b-5 represents a very expansive approach which the courts did not need to take in light of the statutory history of the securities acts.

However, we need not limit ourselves to cases under the securities acts to illustrate that the federal courts are reaching out in a quite different direction than the courts of Delaware. It has already been noted that the federal courts will look through form to substance in tax cases as well.174 In Perlman v. Feldmann175 the Court of Appeals for the Second Circuit found in the common law a controlling shareholder's duty not to sell his shares at a premium if the corporation might suffer by the transfer. The case was heralded as a major step in extrapolating the concept of fiduciary responsibility.176 Similarly, in Sea-

173. Judge Friendly was both a senior partner of a distinguished firm bearing his name and vice-president and general counsel of Pan American World Airways.
174. See note 82 supra.
175. 219 F.2d 173 (2d Cir. 1955).
grave v. Mount the Court of Appeals for the Sixth Circuit enjoined a majority of shareholders from selling out at a substantial profit under the rubric of constructive fraud. The concept developed by the Sixth Circuit permits equity to act in situations in which there may have been good faith actions not founded on an attempt to harm the corporation, but in which the actor has placed himself in a position of conflict between his fiduciary obligation and his own private interests. In bankruptcy the federal courts also have developed a high standard of good faith and fair dealing on the part of the trustees and officers of a debtor in reorganization, recognizing that the possibilities of conflicts of interest for the director engaged in purchasing the debtor's securities are intensified as the corporation becomes less a going concern and more a prospective subject of judicial relief.

In the light of these cases it seems clear that in the field of management conduct federal courts, shorn of the inhibitions felt by the Delaware court, are moved to extend the concept of fiduciary duty beyond its traditional bounds. It is interesting to find Judge Friendly reiterating the familiar wisdom of Mr. Justice Cardozo in Meinhard v. Salmon: "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. . . . Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." The Delaware courts seem never to refer to it.

VII. Up from Delaware—Federal Standards of Corporate Responsibility

A. Underlying Premises

Even if it is assumed that the Delaware courts have contributed to shrinking the concept of fiduciary responsibility and fairness, and indeed have followed the lead of the Delaware legislature in watering down shareholders' rights, the question is whether anything should be done about it. The principle of states' rights and the idea that each state is a laboratory are strong in this country.

On the other hand, one can fairly hope that the growth of the law in a civilized society should be evolutionary. It therefore seems reason-

177. 212 F.2d 389 (6th Cir. 1954).
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able to suggest several principles on which we should proceed. The first is to recognize the importance of an independent and impartial judiciary. The second is to preserve public policy as a standard to be observed by the courts. The third is to emphasize the need for uniformity, so that states shall not compete with each other by lowering standards for competitive reasons or for the purpose of generating revenue. Finally, there should be as much federal concern about the management of the public issue company and about its share owners as about the investor engaged in the purchase and sale of its stock.

Concerning the independence of the judiciary, a recent decision by the Supreme Court in Ward v. Village of Monroeville, Ohio\textsuperscript{181} is relevant. The petitioner objected to a conviction for traffic offenses and a fine of $100 on the ground that the proceeding before a mayor who also had responsibilities for revenue production denied him the right to be tried before a disinterested and impartial judicial officer guaranteed by the Fourteenth Amendment. Almost one-half of the village income was derived from fines, forfeitures, costs, and fees imposed by the mayor's court. Conceding that the revenue produced from the mayor's court provided a substantial portion of the municipality's fund, the Supreme Court of Ohio had nevertheless held that "such fact does not mean that a mayor's impartiality is so diminished thereby that he cannot act in a disinterested fashion in a judicial capacity."\textsuperscript{182}

The United States Supreme Court disagreed, holding that "[p]etitioner is entitled to a new trial and detached judge in the first instance." It relied on Tumey v. Ohio,\textsuperscript{183} involving convictions for prohibition law infractions, in which the Court found a violation of the Fourteenth Amendment where the judge had "a direct, personal substantial pecuniary interest in ruling against the [defendant]."\textsuperscript{184} Quoting further from the Tumey case, the Court said, "The test is whether the mayor's situation is 'one which... might lead him not to hold the balance nice, clear, and true between the state and the accused'.... Plainly that 'possible temptation' may also exist when the mayor's executive responsibilities for village finances may make him partisan to maintain the high level of contribution from the mayor's court."\textsuperscript{185}

By analogy, the state of Delaware derives a substantial portion, roughly one-quarter, of its income from corporation fees and franchise

\textsuperscript{181} 409 U.S. 57 (1972).
\textsuperscript{182} Village of Monroeville v. Ward, 27 Ohio St. 2d 179, 185, 271 N.E.2d 757, 761 (1971).
\textsuperscript{183} 273 U.S. 510 (1927).
\textsuperscript{184} 409 U.S. at 60 (quoting 273 U.S. at 523).
\textsuperscript{185} Id. (quoting 273 U.S. at 532, 534).
taxes;¹⁸⁶ in the words of one of its Law Revision Commission members, "[T]he franchise tax dollar is very important...[;] that is one of the reasons for the formation of this committee—to modernize and liberalize the Delaware Corporation law."¹⁸⁷ Thus both the courts and the legislature may be said to lack the neutrality and detachment "to hold the balance nice, clear, and true" required in passing upon the complaints of shareholders.

With respect to public policy, the question arises whether the policy of a single state occupying a critical position should be permitted to grant management unilateral control untrammeled by other interests. Should one state set social policy in the corporate field when a cornerstone of that policy is to stay ahead of (or behind) the rest? It is understandable that Delaware would choose not to let its premier position in American corporate law go by default, but it must also be understood that the generic reason for attaining it was revenue.

There is a need for uniformity in standards to prevent the application of Gresham's law. The integrity of management is increasingly important in a country which until recently has boasted of widening mass capitalism. One cannot overemphasize the importance of confidence, and a high standard of conduct by directors, as an essential ingredient to private investment in public-issue companies.¹⁸⁸ There is no reason to believe that the plight of our country today is only political and does not spill over into the corporate world. Indeed, recent disclosures reveal ominous links between the two.

This is not a wide-open plea for shareholder democracy. Indeed, that phrase itself may be an imprecise cliché. Stockholders are no longer sacrosanct; there are other interests to consider. The important point, however, is to recognize the continuing desirability of criticism and oversight in a corporate society and the overwhelming need for integrity.

Management should not be omnipotent. Corporate charters and by-laws should not be molded for its benefit. In most jurisdictions the corporate charter can provide that a corporation may do anything it chooses, have an unlimited reservoir of authorized stock, and engage in acquisitions ad nauseum without reference to shareholders. Under state corporation law no vote may be required, the only obstacle being a rule of the major stock exchanges.¹⁸⁹

¹⁸⁶. See note 41 supra.
Managements want freedom from bothersome stockholders, government agencies, public opinion, and judicial review. This is also what most of the corporate bar would prefer: flexibility and certainty. This segment of the legal community is management-oriented; our principal clients are the companies that can afford us. The idea of publicizing a transaction, preparing a proxy statement with the precision required under the current cases, obtaining a vote of shareholders, or approval of any agency, or even public acceptance and judicial oversight, is a burden to a corporate technician whose object is swift consummation of the “deal.” Some chief executives have recently asked whether there is any reason left for an annual meeting of the shareholders. Management’s action, however, should be disclosed to and monitored by outside groups; as a practical matter this group should be the shareholders. It may well be that other groups such as labor will have a role as they had in Germany, but at the moment this is not sought by organized labor in this country.

Finally, federal laws have been designed to protect the purchasers and sellers of stock through the medium of the securities acts. It should also protect the real investors, those who own the stock of corporations. After all, investment counsel are wont to say that every “hold” is a “buy.” Yet although they have stretched the definitions considerably, most of the courts of appeal have adhered to the Birnbaum doctrine that in any Rule 10b-5 action the plaintiff must be a purchaser or seller. Furthermore, the Second Circuit seems reluctant to expand the concept of fraud to embrace the use of controlling influence to induce a securities transaction and thus bring cases involving mismanagement within the ambit of Rule 10b-5.

Some commentators and indeed the SEC itself would like to break the barriers surrounding Rule 10b-5, and to treat it as the watchdog of all corporate activity. Although sharing the conviction that standards should be raised and having some credentials as a friendly interpreter of Rule 10b-5, I must confess my respect, however, for the intellectual integrity of persons who recognize some restraints upon extending

190. See comments on J.B. Fuqua’s proposal to the New York Stock Exchange that annual stockholder meetings be eliminated. N.Y. Times, March 15, 1972, at 66, col. 4.
191. See Vagts, Reforming the Modern Corporation & Perspectives from the German, 80 HARV. L. REV. 23, 65-67 (1966). See also Winkhaus, Co-Determination of Employees in West German Companies, 27 BUS. LAW. 878 (1972).
the rule to cover the corporate universe. It seems anomalous to jigsaw every kind of corporate dispute into the federal courts through the securities acts as they are presently written. In another context I have elaborated on the value of disclosure as a prophylactic which prevents people from taking an action that they know might be publicized. But disclosure alone is not enough. It is absurd that a corporate transaction, clearly unfair though perhaps not fraudulent, should be subject to attack in the federal courts only upon the ground that it has not been disclosed to the shareholders rather than because of its inherent inequity. In my opinion, therefore, the counterattack against the erosion of standards should be frontal and by statute, and separate from the A.L.I. Federal Securities Code project.

There is no justification for a federal law disciplining or holding a tippee liable for misusing inside information concerning management decisions but not monitoring the misconduct of management itself. Even if it is said that the securities laws focus exclusively upon protection of the securities market, confidence in the market generally and in any particular stock may depend as much upon the probity of management as upon the mechanism of the market. If we accept the soundness of the securities laws, then there should be a federal interest in providing a standard of conduct for management and the corporations on which much of the economy depends.

B. The Need for Federal Standards

The discussion thus far might seem to lead to the recommendation of federal incorporation. In my opinion, however, this is politically unrealistic. It has been raised many times in Congress and in the literature but has no public appeal. American business would unanimously reject such a convenient vehicle for government control of the major industries of this country.

195. See Judge Friendly's concurrence and caveat in S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833, 864 (2d Cir. 1968). A question might well be raised whether Errion v. Connell, 236 F.2d 447 (9th Cir. 1956) (involving a fraudulent sale of worthless oyster lands for a portfolio of securities and valuable real estate), should have been brought within the ambit of Rule 10b-5.

196. See Cary, Corporate Standards and Legal Rules, 50 CALIF. L. REV. 408 (1962). One suggestion might be to expand §10(b) by amendment in the A.L.I. proposed Federal Securities Code, see Tentative Draft No. 2 (1973), but that may go beyond the guidelines upon which Professor Loss is proceeding in his craftsmanlike systemization of the securities laws. Furthermore, this would not be enough to arrest the trend led by the Delaware legislature and judiciary.

197. For a brief history of past proposals of federal incorporation, see Note, supra note 3, at 125-28.

198. To substantiate their fears, industry leaders need look no farther than England and current proposals of the militant wing of the Labor party to nationalize 25 leading enterprises in that country. See The Economist, June 23, 1973, at 18.
It is true that business talks about free enterprise but asks for government intervention in the event of financial crisis or possible takeover bids. It is also true that many forms of federal regulation already exist. In the words of Professor Loss, "I think it's not too much to say that Section 12(g) of the Exchange Act... is at least second cousin, if not first cousin, to federal incorporation in substance, not in form." 200 Yet, I do not advocate, or even conceive of, federal incorporation as an imminent possibility except in the event of a catastrophic depression or a corporate debacle.

However, in order to remedy the Delaware syndrome it does appear that federal standards of corporate responsibility are called for. This can best be achieved by prescribing minimum corporation law provisions which shall be applicable to companies doing business in interstate commerce and construed by federal judicial standards. Uniformity is of the essence. Efforts must be made to insure that provisions are not interpreted differently owing to varying state interpretations of public policy. There should also be wide-ranging service of process upon directors and officers of corporations. The participation of a government agency such as the Securities and Exchange Commission is not contemplated in this proposal.

Ideally, consideration should be given to a much broader inquiry perceptively suggested by Professor Eisenberg. In his opinion "Traditional corporate statutes fail to deal with many important structural decisions which are common in today's business world." 201 We might go even farther and ask what representation the modern constituency of the corporation—employees, consumers, and the public, as well as shareholders—should have in the governance of the corporation. Consideration of this issue is not contemplated here. The first step is to escape from the present predicament in which a pygmy among the 50 states prescribes, interprets, and indeed denigrates national corporate policy as an incentive to encourage incorporation within its borders, thereby increasing its revenue.

C. A Proposed Federal Corporate Uniformity Act

As an alternative, I propose a Federal Corporate Uniformity Act applying to all corporations having more than $1 million of assets and 300 shareholders, thus paralleling the proposals made in the American Law Institute's proposed Federal Securities Code. 202 To prevent dis-

200. Loss, supra note 161, at 29.
parity in the law, however, it might be preferable to make such an act apply to all public companies engaged in or affecting interstate commerce. A line might be drawn arbitrarily, however, at $250,000 of assets and 50 shareholders, the latter being the test for a private company under the Canada Corporations Law.203

Conceivably this act might cover every business, but it would not be necessary to include closely-held companies. Only in the last decade have they received separate treatment in this country under statutes granting them wide latitude to operate outside the corporate norm or as a partnership, if provisions in the charter so provide.204 Thus the closed corporation may soon become a product of contract rather than of a prescribed operating procedure.

The proposal is to continue allowing companies to incorporate in the jurisdiction of their choosing but to remove much of the incentive to organize in Delaware or its rival states. Such companies, nevertheless, must be subject to the jurisdiction of the federal courts under certain general standards. To illustrate, some of the major provisions of such a federal statute might include (1) federal fiduciary standards with respect to directors and officers and controlling shareholders; (2) an "interested directors" provision prescribing fairness as a prerequisite to any transaction; (3) a requirement of certain uniform provisions to be incorporated in the certificate of incorporation: for example, authority to amend by-laws, initiate corporate action, or draw up the agenda of shareholders' meetings shall not be vested exclusively in management; (4) a more frequent requirement of shareholder approval of corporate transactions, with limits placed upon the number of shares authorized at any one time;205 (5) abolition of nonvoting shares; (6) the scope of indemnification of directors specifically prescribed and made exclusive; (7) adoption of a long-arm provision comparable to §27 of the Securities Exchange Act206 to apply to all transactions within the corporate structure involving shareholders, directors, and officers.

The foregoing suggestions do not pretend to offer a complete model for a minimum standards act. Indeed it can scarcely be expected that even these would survive political pressure unscathed. It is true that Delaware has only two senators and a representative, but its real lobby is Big Business and its counsel. A number of recently published articles

203. 13-14 Eliz. 2, ch. 52, § 3(j) (1965).

204. See, e.g., Del. Code Ann. tit. 8, §§ 341-56 (1953), particularly § 354 entitled "Operating Corporation as Partnership."


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should be helpful as a base for developing a satisfactory statute. It is not too soon for the American bar to assume this responsibility, instead of resting upon the existing Model Act that represents the least common denominator, constantly lowered through competition generated from Delaware.

D. Constitutional Aspects

The ambit of the commerce clause seems clearly broad enough to cover the federal over-lay proposed above. A recent student Note concluded that going the whole way—federal incorporation—would be constitutional. The legislative history of various securities acts using the commerce clause as a basis for regulating firms that are "in or affecting interstate commerce" are often devoid of discussion or consideration of the act's constitutionality. No one has questioned the constitutionality of amended § 12(g) of the Securities Exchange Act of 1934 enacted in 1964. Referring to the securities acts, one writer in 1936 said, "[I]f the courts are convinced that there is a paramount public necessity for centralized and uniform control of all industrial or commercial corporations, Congress will be found to have the power of regulation to the fullest extent."210

In the words of Chief Justice Hughes, speaking for the Court in National Labor Relations Board v. Jones & Laughlin Steel Corp., "Although activities may be intrastate in character when separately considered, if they have such a close and substantial relation to interstate commerce that their control is essential or appropriate to protect that commerce from burdens and obstructions, Congress cannot be denied the power to exercise that control." Reference to past cases shows that the broad sweep of the commerce clause has been used to establish the basis for coverage at least as broad as the provisions proposed here.212

207. See Conard, supra note 3; Eisenberg, supra note 200. See also Ruder, Current Developments in the Federal Law of Corporate Fiduciary Relations—Standing to Sue under Rule 10b-5, 26 Bus. LAW. 1299, 1290 (1971) (subheading entitled "Federal Corporate Law is Desirable").


211. 301 U.S. 1, 37 (1937).

In determining the substantiality of action necessary to affect interstate commerce sufficient to invoke federal regulation, one need only look to the Supreme Court decision in *Wickard v. Filburn*. The case involved only a single wheat farmer and dealt exclusively with the wheat to be used for home consumption. The Court ruled that since the amount to be used at home affected that to be shipped in commerce it could be regulated by the federal government. Numerous other cases have upheld Congress’ right to regulate the conditions for use, and the users, of interstate commerce. The 1964 Civil Rights Act has been applied in a number of cases in which the effect on interstate commerce was far from substantial. In *Heart of Atlanta Motel v. United States* the Court upheld its application to a motel which simply sought to rent, through advertising, and in fact did rent rooms to interstate travelers. Without elaboration, therefore, it can be said that the constitutionality of a corporate uniformity act involving companies of any magnitude seems no longer questionable in light of the broad construction given to the commerce power today.

E. The Role of the Federal Judiciary

The proposal of federal standards of corporate behavior raises the question of the role of the federal courts. Perhaps contrary to the hopes of the present Chief Justice, the proposed amendments would flood the federal judiciary with litigation; Rule 10b-5 has already added to their burden. The state and federal courts have concurrent jurisdiction over violations of the Securities Act of 1933 but nevertheless almost all the litigation has centered in the federal courts. Yet Judge Friendly in his recent diagnosis of federal jurisdiction did not go so far as to prescribe a separate court to handle securities litigation.

Concern over the growth of federal litigation is a separate issue. If this is a matter of crucial importance, and if the grant of concurrent jurisdiction would be futile because plaintiffs typically would sue in the federal courts, then I would propose that the federal standards

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219. See H. FRIENDLY, supra note 217, at 153 passim.
written into corporation law be subject initially to state court interpretation, with some form of certiorari jurisdiction on the part of the courts of appeal to achieve uniformity. If necessary, there could be a special corporate court to handle such cases.

This suggestion has the virtue of novelty. Yet if the federal courts may be granted exclusive jurisdiction, a part of that authority may be ceded to the state courts subject only to review for purposes of establishing uniform standards. Once the federal law is interpreted uniformly throughout the United States and suit may be brought against all parties, including the directors and management in other jurisdictions, then there should be no pressure on state courts to relax standards and uphold a particular legislative policy founded upon hospitality and encouragement to companies incorporating there. And if a uniform act is applicable in all jurisdictions where companies may be incorporated, there is no reason why the state judiciary should not feel independent of parochial loyalty and be governed by the same philosophy that prevails today in the federal courts. They may not be as confident or zealous to carry out federal policy and to make new law, but at least they will not be circumscribed by legislative policy based on the production of revenue and competition to attract incorporations.

Conclusion

In summary, as long as we operate within a capitalist society and as long as confidence in management is prerequisite to its continuance, there should be a federal interest in the proper conduct of the corporation itself as much as in the market for its securities. A civilizing jurisprudence should import lifting standards; certainly there is no justification for permitting them to deteriorate. The absurdity of this race for the bottom, with Delaware in the lead—tolerated and indeed fostered by corporate counsel—should arrest the conscience of the American bar\textsuperscript{220} when its current reputation is in low estate.

\textsuperscript{220} See generally Mr. Justice Stone's speech at the dedication of the University of Michigan Law Quadrangle, \textit{The Public Influence of the Bar}, 48 \textit{Harv. L. Rev.} 1 (1934).