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VOLUME 8 NUMBER 2 $3.00

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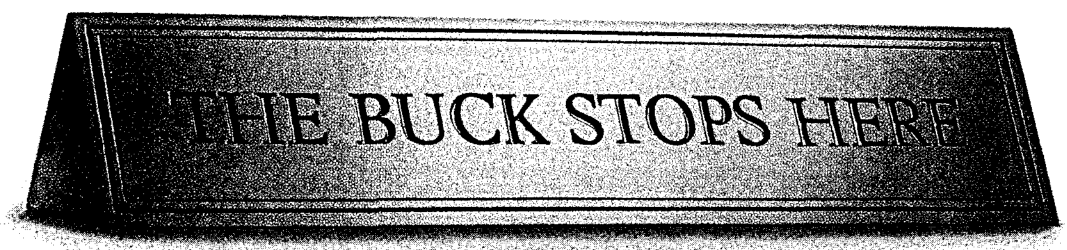

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VOLUME 8
NUMBER 2

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CONTENTS

Cover: For an issue devoted to corporations what could be more fitting than a view of the corporate charter of Delaware Bar Foundation, the publisher of this occasionally aperiodic periodical?

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Volume 8 Number 2
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FROM THE EDITOR

This issue of the DELAWARE LAWYER is devoted to what probably is Delaware's best known "citizen" - the Delaware corporation. United States District Court Judge Milton Pollack, for example, recently held that it is a "fact that Delaware has long been recognized as the fountain-head of American corporation and . . . its Courts of chancery are known for their expert exposition of corporate law." For American businesses, then, the Delaware General Corporation Law and Case Law is their "constitution", giving them their basic governance structure while also protecting the rights of its citizens, the stockholders.

This preeminence is not without its problems. The ignorant and the jealous criticize that which they do not understand, particularly when they are amazed to find out that New York or Washington does not dictate the Delaware corporate law. Even the judiciary is not spared thoughtless comment, occasionally on a national level. Nonetheless, Delaware's continued success is acknowledged, if only by the efforts of our sister states to copy our corporate law and to claim to do even better, as in Pennsylvania recently.

We in Delaware do not need to praise our corporate law or to dwell on the working relationship between the General Assembly, the Judiciary and the Bar that has nurtured that law for so long. All that is well known to us. However, what is not as well known are the many new developments in our corporate law over just the last few years. It is to these recent developments that this issue of the DELAWARE LAWYER is devoted.

Finally, my special thanks to each contributor to this issue. They are all busy people who took time out of their schedule to educate the rest of us. As always, of course, no issue of this magazine would be possible without its real editor, Carroll F. Poole, and its guiding light, William E. Wiggin.

Edward M. McNally

There is no field of the law in which the Delaware Bar, collectively, has more experience than in the one which forms the core of this issue. The reputation of our corporate specialists is well known throughout the profession. Thus, the quality of the articles in this issue should cause no surprise. On the contrary, the problem of Ed McNally, the issue editor, was in persuading very busy, highly skilled experts to expend their most valuable commodity - time. The contents which follow are the measure of his success. He has our appreciation; he is entitled to the thanks of the entire Bar.

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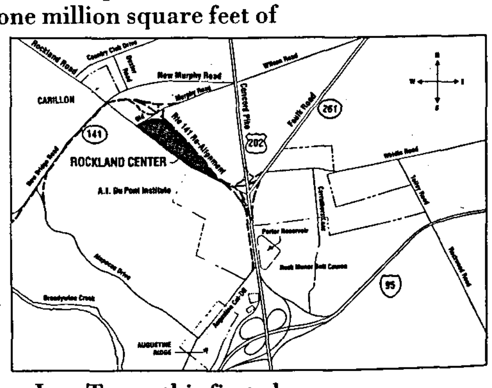

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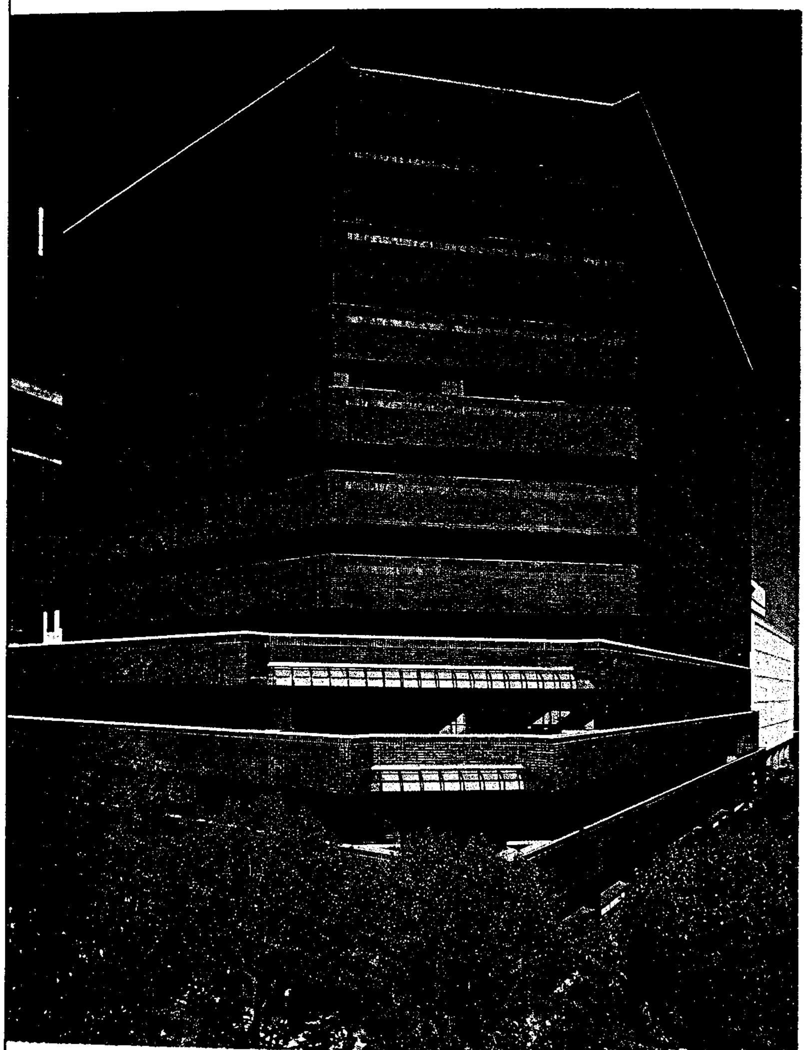

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DELAWARE LIMITED PARTNERSHIPS - AN IMPORTANT ALTERNATIVE *(Or Some Limited Partnerships and Legislation I Have Known)*

John H. Small

As the reader has seen, this issue of the DELAWARE LAWYER is devoted to various aspects of the Delaware General Corporation Law; a worthy subject indeed. Much of America's business capital is raised by corporations. Most American businesses of any size conduct their business in a corporate "form". And Delaware is the "forum" of preference for those corporations. However, any discussion of the Delaware corporation would be incomplete without mention of its flexible little sibling, the Delaware limited partnership. I have been asked to write a few words about this alternative form of business organization which, despite the Omnibus Budget Reconciliation Act of 1987 and the Technical and Miscellaneous Revenue Act of 1988, continues to grow in popularity and stature as an alternative to the corporate form for many businesses.

The typical reader has some sense of what a limited partnership is. Perhaps his landlord is a Delaware limited partnership formed by a few physicians as a real estate investment. Perhaps she has invested her IRA in a large publicly sold oil and gas limited partnership. There may be some sense that the general partner is ultimately and exclusively responsible for the limited partnership's operations and its debts.

But, the limited partners of a Delaware limited partnership may have as much (or as little) say in the partnership's operations as the partnership agreement permits with virtually no risk of personal liability beyond their investment in the partnership. And limited partnerships can be used as the business form for almost any type venture. I have been involved as Delaware counsel with limited partnerships in such diverse businesses as franchising the Bonanza Restaurant chain (USACafes, L.P.), acquisition and leasing of large passenger aircraft to commercial airlines (Pegasus Aircraft Partners II, L.P.), professional basketball (Boston Celtics Limited Partnership) and even machine gun weaponry (Uzi R&D Associates, L.P.). About the only businesses a Delaware limited partnership cannot undertake are those "of granting policies of insurance, or assuming insurance risks or banking as defined in Section 126 of Title 8"; and that is because the Delaware Revised Uniform Limited Partnership Act ("DRULPA"), at *Section 17-106, specifically prohibits* limited partnerships from carrying on those businesses. Indeed, under the DRULPA, a limited partnership is simply "a partnership formed by 2 or more persons under the laws of the State of Delaware and having 1 ore more general partners and 1 or more limited partners." Therefore, as one considers starting a business, one should consider not only forming that business in Delaware, but also consider whether to form that business as a Delaware limited partnership, rather than a Delaware corporation.

A SLOW CLIMB TO LEADERSHIP

To get a better sense of the recent and increasing popularity of Delaware limited partnerships, a little history is helpful.

49th In Line

In 1916, the National Conference of Commissioners on Uniform State Laws (the "Commissioners") promulgated the Uniform Limited Partnership Act (the "ULPA" or the "1916 Act"). As with other Uniform Acts (the Uniform Commercial Code is probably the best example), the Commissioners proposed the ULPA for adoption by the States as a means to obtain some uniformity in regulation and commercial expectations of limited partnerships. By the early 1970s, the ULPA had been adopted by all states but Louisiana, a civil law jurisdiction, which still has "partnerships in commendam" under the Louisiana Partnership Law, Articles 2801-2848 of the Louisiana Civil Code. Interestingly, although it long may have had a leadership role in corporate law, Delaware was the 49th state to adopt the ULPA, when it did so in 1973. The Delaware version of the ULPA closely tracked the 1916 Uniform Act. However, there was one particularly significant and popular variance: 6 *Del. C.* Section 1707(b)(6), a liberal "safe harbor" or "democracy" provision. This provision allowed limited partners to participate extensively in a partnership's activities without being deemed to participate in the control of the partnership's businesses as a general partner and thus losing their limited liability. It provided:

> (b) A limited partner shall not be deemed to take part in the control of the business by virtue of his possessing and/orexercising a power to:
>
> * * * * *
>
> (6) approve or disapprove such material matters related to the business of the partnership as shall be stated in the certificate and in the partnership agreement.

Only 7 Years Behind.

In 1976, the Commissioners promulgated and recommended a Revised Uniform Limited Partnership Act (the "1976 RULPA") and recommended its enactment in all states. This time, Delaware was not quite so slow in getting on the bandwagon. Effective January 1,1 1983, Delaware adopted its version of the 1976 RULPA, 6 *Del.C.* Chapter 17 (the "DRULPA"). With minor variations, it generally paralleled the 1976 RULPA. However, Delaware further expanded and liberalized its partner "democracy" provisions and "safe harbors" from general liability. DRULPA Section 303(b)(6) provided that mere possession or exercise by limited partners of the right to "approve or disapprove, by voting or otherwise, such material matters related to the business of the partnership as shall be stated in the certificate of limited partnership and in the partnership agreement" did not constitute participation in the control of the business within the meaning of the statute. This was and, in its 1988 expanded form continues to be, one of the DRULPA's most significant features because it permits entrepreneurs and investors to fashion decision-making procedures to satisfy their specific needs and still protect investors from the unlimited liability of a general partner.

First and Better.

Soon, Delaware was picking up momentum and taking the lead in the area of limited partnership legislation. Effective August 1,1 1985, Delaware adopted extensive amendments to DRULPA. Many of Delaware's amendments were improvements on those promulgated shortly *thereafter* by the Commissioners in what they named "The Uniform Limited Partnership Act (1976) with 1985 Amendments" (the "1985 Uniform Act").

Probably the most significant 1985 change to the DRULPA was the replacement of the lengthy certificate of limited partnership with a simplified certificate. The short form certificate filed with the Delaware Secretary of State need only contain the name of the limited partnership, the address of its registered office, name and address of its registered agent for service of process, and the name and business, residence or mailing address of each general partner. Only the general partners must sign the certificate of limited partnership. The certificate no longer has to contain the name, address and capital contribution of each limited partner or other possibly confidential financial information. This saves the substantial expense that used to result from filings to reflect new investors and avoids having to put such investor and partnership financial and business information on public record with the Secretary of State. On the other hand, such optional information still may be contained in the certificate, if the general partners so desire. As a result of amended DRULPA Section 201, most information previously contained in the limited partnership certificate now appears just in the agreement of limited partnership or other partnership records. Thus, careful draftsmanship of the limited partnership agreement has become more important than ever.

Two particularly unique provisions were also added to the DRULPA in 1985. The first was 6 *Del.C.* Section 17-108, specifically authorizing broad indemnification arrangements:

> Subject to such standards and restrictions, if any, as are set forth in its partnership agreement, a limited partnership may, and shall have the power to, indemnify and hold harmless any partner or other person from and against any and all claims and demands whatsoever.

Although no restrictions on indemnification are stated in the statute, it seems safe to predict that the Courts may apply certain public policy limitations in particular cases. One possibility is the "borrowing" of the public policy limitations on indemnification contained in Section 145 of the Delaware General Corporation Law. A second unique provision was 6 *Del.C.* Section 17-211, which specifically authorized the merger or consolidation of limited partnerships.

Extending the Lead.

Effective September 1, 1988, Delaware adopted further amendments to DRULPA. The amendments were the result of a 16 month study by a Special Subcommittee of the Delaware Bar in which we (i) reviewed our collective practice experience under the 1985 statute and (ii) examined the limited partnership statutes of several competing jurisdictions, including California, the District of Columbia, Illinois, Texas, Virginia and proposed New York legislation. Several significant improvements were made.

> 1. An expansion of the DRULPA's definition of "Partnership Agreement" so as to clarify and facilitate the mechanics which may be used in connection with entering into partnership agreements and the admission of limited partners to a limited partnership without signatures from those limited partners.

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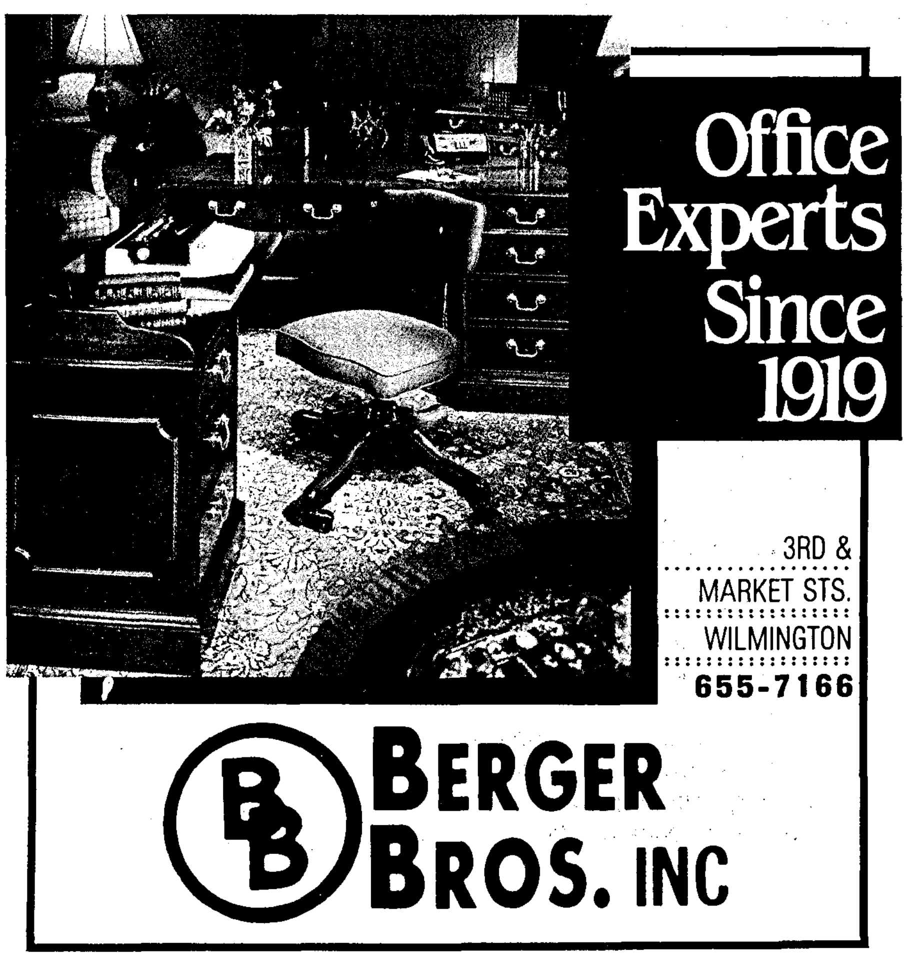

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(Continued from page 7)

These changes facilitate and provide specific statutory authority for subscription practices in publicly sold limited partnerships, such as telephone subscriptions and other signatureless procedures.

2. Clarifying that general partners and liquidating trustees are subject to service of process in Delaware and specifying the procedures for such service.

3. Clarifying the limited liability of a person acting as a liquidating trustee in connection with the dissolution of a limited partnership and other aspects of dissolution.

4. Clarifying who must execute certain documents on behalf of the limited partnership and authorizing the Secretary of State to accept for filing documents with facsimile signatures.

5. Now limited partnerships can merge and consolidate with corporations and other business entities, including business trusts and general partnerships, as well as other limited partnerships.

6. The "safe harbor" and "democracy" provisions have been restructured and broadened even further.

7. A partnership agreement may prohibit a limited partner from withdrawing from the limited partnership or assigning his partnership interest prior to the dissolution and winding up of the partnership.

8. Clarifying and limiting further the liability of the limited partner in connection with distributions made by the limited partnership and assignments of limited partnership interests. Now, limited partners are liable for distributions in violation of DRULPA for a period of three years from the date of the distribution only if the limited partner knew at the time of the distribution that it violated DRULPA's limitations.

9. Annual Tax added requiring the payment of $100 by all Delaware limited partnerships and those foreign limited partnerships which are qualified to do business in Delaware. However, the drafters were careful to make sure that failure to pay the tax would not result in dissolution of the partnership and threatened the limited liability of the limited partners.

And the Winner Is . . .

Delaware's efforts to take the legislative lead with respect to limited partnerships have been rewarded. As of December 31, 1983, there were only 1,739 domestic limited partnerships with their certificates on file with the Delaware Secretary of State. Six years later, on December 31, 1989, there were 9,679 domestic limited partnerships in good standing with the Delaware Secretary of State. That pace (as distinguished from volume) far exceeds the rate for formation of Delaware corporations during the same time period. As of December 31, 1983, there were 153,044 Delaware corporations. As of December 31, 1989, there were 197,963 domestic corporations in good standing with the Delaware Secretary of State.

The Important Role of the Courts.

Of course, the increased number of limited partnerships has meant increased partnership litigation in the Delaware courts. (The converse may also be true. It is generally acknowledged that the national stature of our Courts has contributed substantially to the popularity of Delaware as the forum of incorporation. The integrity, business sense and responsiveness of our judiciary has also drawn many venture capitalists, syndications, entrepreneurs and other business persons to form their limited partnerships in Delaware.) Three Court of Chancery decisions deserve particular mention.

The first is Vice Chancellor Hartnett's decision in *Boxer v. Husky Oil Co.*, Del.Ch., 429 A.2d 995 (1981). There, the Court enunciated a clear standard of fiduciary duty for general partners:

> When the provisions of the Uniform Partnership Act and the Uniform Limited Partnership Act are read together, it is clear that the general partner in a limited partnership owes a fiduciary duty to the limited partners. [Citations omitted.] It is also clear that a partner owes a fiduciary duty to the other partners at common law. [Citations omitted.]
>
> The duty of the general partner in a limited partnership to exercise the utmost good faith, fairness, and loyalty is, therefore, required both by statute and common law. This fiduciary duty of partners is often compared to that of corporate directors.

Id. at 997.

A second noteworthy decision is that authored by Chancellor Allen in *Seema S. Boesky, et al. v. C.X. Partners, L.P., et al.* Del.Ch., C.A. Nos. 9739, 9744, 9748, Allen, C. (April 28, 1988), 14 Del.J.Corp.L. 230 (1989). These suits were related actions seeking to enjoin a proposed partial liquidating distribution to some, but not all, of the limited partners of a Delaware limited partnership which was one of several limited partnerships through which Ivan Boesky conducted his stock arbitrage activities. The

(Continued on page 10)

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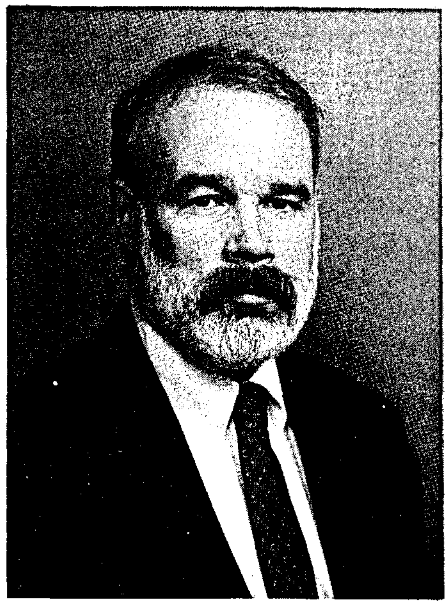
(Continued from page 9)
case contains a careful analysis of several provisions of the DRULPA, in particular Section 17-804 involving the winding up of a limited partnership, and the responsibilities of a liquidating trustee.

Last summer, in *PCIG Tower Center, Inc. v. Tower Center Development Associates Limited Partnership, et al.*, Del.Ch., C.A. No. 10788 (June 8, 1989), the Court of Chancery had its first opportunity to consider an application for judicial dissolution of a limited partnership. The petitioner, the general partner (who was faced with some difficult conflicts of interest), sought dissolution on the grounds that it was no longer reasonably practicable to carry on the business of the partnership. That business (to use property it purchased "for profit and as an investment" could only be conducted at a loss. The respondents, who were the limited partners, argued that the Court should construe DRULPA Section 17-802 narrowly and treat the statutory language "not reasonably practicable" as permitting dissolution only if the purpose of the partnership is completely frustrated. Vice Chancellor Chandler held that the standard is one of "reasonable practicability", not "impossibility." While the purpose of the partnership was to use the property "for profit and as an investment," it was heavily leveraged, its lessee was insolvent, and the depressed real estate market in Dallas made the procurement of a new tenant virtually impossible. The Court held that it was no longer reasonably practicable to carry on the business of the partnership and ruled that the partnership should be dissolved and a liquidating trustee appointed to wind up its affairs.

The Effort Continues.

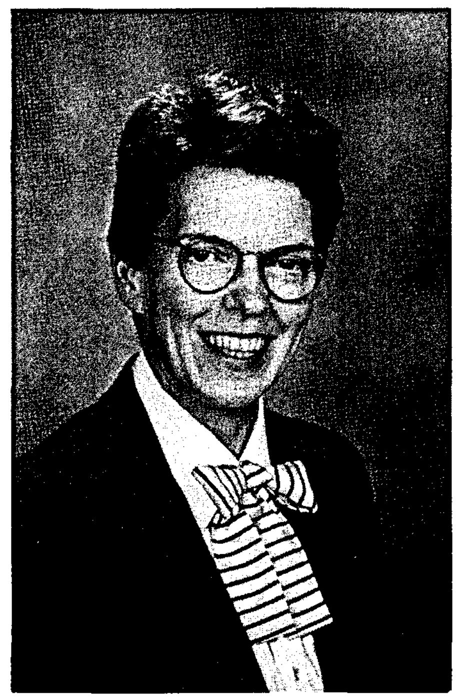
Delaware is not content with its leadership role as the jurisdiction of choice for the formation of limited partnerships. Many major industrial and commercial states have adopted or are in the process of studying our 1985 and 1988 DRULPA Amendments. Moreover, additional practice experience with this unique form of business organization has resulted in several suggestions for further improvements to our statute. Some of them are only fine-tuning. Others will be more substantive. This Spring, look for a new legislative package which should help maintain Delaware's leadership role in limited partnerships and further contribute to the needs of Delaware business.



John H. Small is a director in the law firm of Prickett, Jones, Elliott, Kristol & Schnee. He holds a B.A. from Georgetown University and a J.D. from the University of Virginia. He served as an advisor to the National Conference of Commissioners on Uniform State Laws in preparing the Uniform Limited Partnership Act (1976) with 1985 Amendments and currently chairs the Committee on Partnerships and Unincorporated Business Organizations of the American Bar Association Section of Business Law. He participated in the drafting of most of the last decade's limited partnership legislation in Delaware. That includes addressing the Delaware State Senate at 11:30 on Sunday night, June 30, 1985 in a last-minute, but successful, pitch for adoption of the 1985 Delaware Revised Uniform Limited Partnership Act before the end of the legislative session.

MISS GRAMMAR IS COMING

The next issue of DELAWARE LAWYER will introduce to our readers Karen Larsen, a former professor of English, who now acts as writing consultant to the Portland, Oregon firm of Miller, Nash, Wiener, Hager & Carlsen.



Competency in legal writing is suddenly fashionable, perhaps because it pays large dividends of enhanced professionalism. We believe you will find that reading MISS GRAMMAR will be entertaining and useful. Her excellent column also appears in the Oregon State Bar Bulletin.

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NONSTOCK, NONPROFIT CORPORATIONS : A DEARTH OF DIRECTION

Mary M. Johnston

Although Delaware is the corporate home of a disproportionate number of nonstock, nonprofit corporations, surprisingly little case law exists addressing the special problems faced by these unique entities. Fewer than ten series of Delaware opinions discuss circumstances peculiar to nonstock, nonprofit corporations in anything more than a peripheral manner. A few of the reasons for this paucity of case law are readily apparent. Those individuals involved usually have virtually no direct financial interest at stake and the charitable corporation tends to be controlled by a small, often related, group of people. By definition, no shareholders' rights are involved.

As the following will demonstrate, this lack of judicial direction is unfortunate because when problems arise in the nonstock, nonprofit corporation, the litigants all too frequently become submerged in the murky waters of issues of first impression. Further, attorneys advising nonstock corporations have precious little authority with which to guide their clients.

The threshold issue often is which area of substantive law governs. The parties frequently claim that principles of trust law apply since charitable corporations arguably are organized in a way more closely resembling a charitable trust relationship than a traditional corporate structure.[1] A charitable corporation, however, technically does not create a charitable trust. Thus, as a general matter, principles of corporate law rather than principles governing fiduciary trust relationships are applied[2] even though they may not exactly fit the situation.

Delaware corporation law is designed to permit a nonprofit corporation to regulate its own affairs to the greatest extent possible.[3] For example, Section 242(b)(3) extends the power to amend the certificate of incorporation to the governing body without member approval.[4] In contrast, the shareholders of a stock corporation ordinarily must approve the directors' amending resolution.[5]

A nonstock, charitable corporation typically is organized to permit the endowing family to maintain control over the corporation's affairs. The nonprofit corporation is governed by a board of directors or a board of "trustees". The corporation may even be run by one trustee.[6]

For example, in one charitable corporation, the bylaws provided that the members of the foundation were the lineal descendants of the founder, and such other persons as the descendants might elect.[7] During his lifetime, the founder himself dominated and controlled the activities of the foundation.[8] Following his death, disputes and disagreements arose among the members.[9]

Similarly, another foundation was controlled by the founder until his death and by the founder's son until he dies leaving the founder's four grandchildren as directors.[10] A dispute arose among the four siblings when three of them discovered the secret appointment by the fourth of his wife and four children as members.[11]

The directors or trustees generally are granted broad authority to manage the affairs of the corporation with little or no oversight by the members.[12] A board might even be empowered to elect members.[13] Members generally are not involved in the day-to-day operations of the charitable corporation.[14] Members may not meet for years or even decades.[15]

Professional, or mutual benefit, nonprofit corporations pose special problems regarding the juxtaposition of members and directors. In *In re Osteopathic Hospital Association of Delaware*,[16] the membership originally was restricted to physicians in good standing with the Delaware State Osteopathic Society. Lay persons could become members if elected by a majority of the members.17 A dispute arose over a bylaw amendment providing that the board of trustees became members.[18] The board of trustees largely was composed of lay persons. By becoming voting members of the corporation, the possibility emerged that the result would be to dilute perhaps indefinitely the power of the physician members to control their own professional destiny in the "unique organization."[19] In the context of a medical membership association, the court found the bylaw amendment unreasonable since it altered the *status quo* by fundamentally changing the corporation's structure.[20]

The organizational structure inherent in a nonstock, nonprofit corporation is problematic. Although arguments frequently arise analogizing members in nonstock corporation to shareholders in profit corporations, important distinctions between member and shareholders exist. Unlike stockholders, members have no vested interest in remaining members.[21] Nonstock membership normally cannot be transferred or inherited.[22] Members of a charitable corporation have no vested pecuniary interest in the assets of the corporation and cannot benefit from their positions.[23] Members may not even have an unlimited right to control who will be elected to membership. The corporation's certificate of incorporation may provide that the board of directors is granted substantial control over who may become or remain a member.[24] The directors' power to adopt bylaws governing admission to and expulsion from membership could grant directors the corollary power of electing members.[25] In contrast, it is unthinkable in a stock corporation that directors would be able to divest shareholders of their status and accompanying financial and property interest.

In the nonprofit corporation, however, the distinction between directors (or trustees) and members is blurred. In some corporations, the governing board and members are one and the same.[26] The question emerges: what realistically is the function of the membership?

The only power normally held by the membership is to elect directors. Since members of charitable (as opposed to professional, mutual benefit) corporations are not acting to protect their property interest, their only function appears to be to elect directors who will best serve the foundation's beneficiaries -- the general public. As a corollary matter, query whether it is necessary for directors, who indisputably have a fiduciary duty, in effect to be subjected to the oversight of members who also are fiduciaries. This type of fiduciary "checks and balances" system could be inefficient, unnecessarily unwieldy and predisposed to engender disputes between and among directors and members. These issues remain unresolved.[27]

Normally, the constituents of a nonstock, nonprofit corporation are not its members, but rather the intended beneficiaries of the charitable foundation. Most charitable corporations broadly are dedicated, for example, to "religious, charitable, scientific, literary and educational purposes,"[28] or to "such charitable benevolent, scientific and educational activities as will promote the well-being of mankind and the alleviation of human suffering."[29]

The beneficiaries, therefore, are not specifically identifiable as a practical matter. As opposed to individual beneficiaries, the Delaware Attorney General has the power to bring actions to enforce performance of their duties by the governing bodies of charitable foundations on behalf of the general public, who is deemed the group affected by the charitable trusts.[30] The necessity of such a rule is obvious. Since the charitable corporation's intended beneficiaries may be some or all of the members of a large and shifting class, the possibility of voluminous, unreasonable and vexatious litigation looms large.[31]

Although the issue is unresolved, the attorney General appears to have standing to seek any relief he feels required in the public's best interest. For example, the Attorney General has sought to have the Court of Chancery use its equitable power to name a successor trustee or trustees to manage the affairs of the charitable corporation where the founder made no provision for his successor in control.[32] In another action, the Attorney General requested that individuals outside the family be placed on the board of directors to resolve the differences between the family factions.[33]

Other special problems arise in actions involving nonstock, nonprofit corporations. Courts tend to treat these unique entities in ways significantly different from the consideration of issues involving corporations for profit. Unusual deference is paid to the wishes of the founder endowing the corporation. The founder's intent might govern who should succeed to control the corporation and manage its affairs in the absence of an explicitly stated methodology for the passing of control.[34] The founder's wishes also are accorded great consideration by a court's deference to the original organizational structure.[35]

In contrast, a stock corporation's control is determined by a large body of statutory direction and judicial precedent making subsequent consideration of the intent of the persons initiating the incorporation less significant.

In recent years, tax considerations have resulted in more and more of this country's great wealth being controlled and distributed by charitable foundations.[36] As citizens of the nation's premier state of incorporation, Delaware attorneys, legislators and courts have a serious responsibility to shape a body of statutory law[37] and a case precedent to guide the operation of nonstock, nonprofit corporations. Approximately forty-five other states have enacted not-for-profit corporation statutes.38 Especially in light of recent decline in assistance from the federal government, charitable corporations will have an ever increasing role in assisting the needy and sponsoring the arts, sciences and education.39 By holding these corporations to reasonable standards of fiduciary conduct, Delaware could lead a new "race to the top" in this emerging area of corporation law.

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1. *Wier v. Howard Hughes Medical Institute*, Del.Ch., 407 A.2d 1051, 1056 (1979); *Denckla v. Independence Foundation*, Del.Ch., 181 A.2d 78, 83 (1962), *aff'd* 193 1.2d 538, 541 (1963).

2. *Denckla*, 193 A.2d at 541.

3. *Oberly v. Howard Hughes Medical Institute*, Del.Ch., 472 A.2d 366, 391 (1984).

4. 8 *Del.C.* Section 242(b)(3).

5. 8 *Del.C.* Section 242(b)(2).

6. *Oberly*, 472 A.2d at 367.

7. *Denckla*, 181 A.2d at 80-81.

8. *Denckla*, 193 A.2d at 540.

9. *Id.*

10. *Kirby v. Kirby*, Del.Ch., C.A. No. 8604, Berger, V.C. (July 29, 1987). Ms. Johnston is associated with the firm of Morris, James, Hitchens & Williams, which represents the individual plaintiffs in this action. Following dismissal by the Court of Chancery, this case presently is on appeal before the Delaware Supreme Court, in part involving issues discussed in this article.

11. *Id.*

12. *Id.; Denckla*, 181 A.2d at 81. 8 *Del.C.* Section 102(a)(4) requires that nonstock, nonprofit corporations have members as opposed to stockholders.

13. *Cf. In re Osteopathic Hospital Association of Delaware*, Del.Ch., 197 A.2d 630, 632 (19164) (discussing an unincorporated association).

14. *See Kirby* (July 29, 1987 at 10).

15. *Kirby v. Kirby*, Del.Ch., C.A. No. 8604, Chandler, V.C. (Oct. 10, 1989) (Transcript at 1083).

16. Del. Ch., 191 A.2d 333, *aff'd*, 195 A.2d 759 (1963); *on remand*, Del.Ch., 197, A.2d 630 (1964).

17. *Id.* at 334.

18. *Id.* at 335.

19. *Id.* at 336.

20. *Id.* at 339.

21. *Kirby* (July 29, 1987 at 11); *Wier*, 407 A.2d at 1054-55.

22. *Wier*, 407 A.2d at 1058.

23. *Id., Chapin v. Benwood Foundation, Inc.*, Del.Ch., 402 A.2d 1205, 1211 (1979), *aff'd sub nom., Harrison v. Chapin*, Del. Supr., 415 A.2d 1068 (1980).

24. *Kirby* (July 29, 1987 at 11).

25. *Id.; Cf. Osteopathic*, 197 A.2d at 631 (discussing an unincorporated association).

26. *Chapin*, 402 A.2d at 1206.

27. *See Kirby*, Del.Ch., C.A. No. 8604, Berger, V.C. (July 29, 1987); Chandler, V.C. (Sept. 12, 1989 and Oct. 10, 1989 (Transcript)).

28. *Kirby* (July 29, 1987 at 1).

29. *Denckla*, 181 A.2d at 79.

30. *Wier*, 407 A.2d at 1057 (administrator of the trustee's estate lacked standing to seek a determination of a successor trustee); *but see Kirby v. Kirby*, Del.Ch., C.A. No. 8604, Chandler, V.C. (Sept. 12, 1989) ("As a fiduciary, the trustee of a charitable trust or director of a charitable corporation has a sufficiently concrete interest in the outcome of litigation involving a breach of fiduciary duty to the charitable entity that he has standing.").

31. *Wier*, 407 A.2d at 1057.

32. *Oberly*, 472 A.2d at 377.

33. *Kirby v. Kirby*, Del.Ch., C.A. No. 8604, Chandler, V.C. (Sept. 26, 1989).

34. *Oberly*, 472 A.2d at 392. The founder's intent also has been deemed relevant to the interpretation of a nonstock corporation's certificate of incorporation. *Kirby* (July 29, 1987 at 12-13); *Denckla*, 181 A.2d at 84.

35. *See supra* text accompanying notes 16-20. *See Oberly*, 472 A.2d at 391; *Chapin*, 402 A.2d at 1206-1208.

36. *Nielsen, The Big Foundations* 20 (1972).

37. Delaware should consider adoption of a nonprofit organization act, such as the Proposed Uniform Nonprofit Organization Act.

38. *See* Boyd, *A Call to reform the Duties of Directors Under State Not-For-Profit Corporation Statutes*, 72 Iowa L. Rev. 725, 735 n. 90 (1987).

39. *Id.* at 726.

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She has also involved herself in many community service activities.

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A BRIEF COMPARISON OF THE RECENTLY ENACTED PENNSYLVANIA BUSINESS CORPORATION LAW WITH DELAWARE CORPORATE LAW

Francis G. X. Pileggi

This article introduces selected portions of Pennsylvania's new Business Corporation Law and briefly compares those sections of the new law which reportedly provide advantages over the Delaware General Corporation Law, as well as several sections where the new Pennsylvania law claims to achieve parity with Delaware corporate statutes.

I. The New Pennsylvania Business Corporation Law and the Delaware General Corporation Law

(a) Background of the Pennsylvania Statute

On October 1, 1989 a new Pennsylvania business Corporation Law ("BCL") went into effect, repealing the amended 1933 BCL. The draftsmen of the new BCL hope it will lift Pennsylvania out of a "commercial backwater" and put it on par with Delaware corporate statutes.[1] After a ten-year moratorium from 1972 to 1982 during which no significant corporate legislation was introduced by the Pennsylvania General Assembly, a special subcommittee of the Pennsylvania Bar Association Committee on Business Associations, known as the "Title 15 Committee", was formed to draft a comprehensive revision of the corporation laws in order to halt the trend of some Pennsylvania businesses that were incorporating or re-incorporating in Delaware.[2] The Title 15 Committee used Delaware law as the benchmark, but apparently not with the goal of usurping Delaware's status as the favored state of incorporation. The drafter's intent was rather to provide a competitive economic climate in Pennsylvania for Pennsylvania businesses.[3]

The Title 15 Committee viewed Delaware law as providing flexibility to management in conducting its affairs while still affording "due consideration to the rights of shareholders."[4] Opponents of the new BCL attacked the statute because of its "Delaware-like innovations", characterized as giving management control at the expense of shareholders' rights.[5] Indeed, in July of 1989, the Belzberg Family of Canada and several other shareholders filed suits in federal and state courts challenging the management of Pennsylvania incorporated Armstrong World Industries of Lancaster under the new BCL.[6] The suits raise claims that the new BCL is unconstitutional because it entrenches management.[7]

(b) A Brief Comparison of the Purported Advantages of the Pennsylvania Statute over the Delaware Statute

The Pennsylvania Bar Institute has published a monograph that identifies sections of the new BCL that, the draftsmen claim, provide advantages over Delaware law.

1. *Redemption of Shares.* Unlike the analogous Delaware statute, Section 1521 of the new BCL provides for redeemable common stock.[8]

By comparison, Section 151(b) of the Delaware General Corporation Law (the "DGCL") only allows for the redemption of "stock which is entitled ... to a preference over another class or series of stock ...", with three rather limited exceptions.[9] It remains possible, however, for shareholders to enter into agreements which would address that "inequality in the Delaware statute. Also, the Delaware State Bar Association's Corporation Law Section is now considering the draft of a proposed amendment to the DGCL which would eliminate that statutory inequality.

2. *Removal of Directors.* Section 1726(a)(1) of the new BCL affords protection to boards that are not classified from removal without cause.[10]

By contrast, Section 141(k) of the DGCL only requires cause for the removal of classified boards. However, it must be noted that when less than the entire board is removed, subsection 141(k)(2) provides that even a director of a board that is not classified, but who was elected by cumulative voting, cannot be removed without cause "if the votes cast against his removal would be sufficient to elect him if then cumulatively voted at an election of the entire board of directors or, if there be classes of directors, at an election of the class of directors of which he is a part." Thus, as a practical matter, the cumulative voting provision also protects Delaware directors of non-classified boards from removal without cause.

3. *Special Treatment in Fundamental Transactions.* Section 1906 of the new BCL claims to give greater protection to shareholders who are divided into different groups on a basis other than the classes of shares that they hold.[11] In addition, an amendment of the articles of incorporation that creates such shares must be approved by: (i) a majority of shareholders entitled to vote; and (ii) a majority of the holders of shares whose rights would be diminished.[12] Also, "each subgroup of the holders of any outstanding shares of a class or series who are to receive the same special treatment under the amendment or plan shall be entitled to vote as a special class unless they are afforded dissenters' rights in lieu of this special class vote."[13] An "alternative to the first two categories of approvals is the determination by a court that 'such special treatment is undertaken in good faith, after reasonable deliberation and is in the best interest of the corporation'".[14]

There is no direct parallel in the DGCL to section 1906, though section 102(b)(1) of the DGCL would allow for the creation of similar rights among classes of stockholders in the certificate of incorporation.[15]

4. *Required Shareholder Vote.* Section 1757(a) of the new BCL provides that when corporate action is taken by a vote of the shareholders, it may be "authorized by

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a majority of the votes cast at a duly organized meeting of shareholders by the holders of shares entitled to vote thereon." This provision is touted as giving Pennsylvania corporations the benefit of allowing shareholder approval by a majority of shares voting at a meeting as opposed to an absolute majority.[16]

Section 216 of the DGCL provides, however, that the by-laws or certificate of incorporation of a Delaware corporation may provide for a quorum that consists of as few as one-third of the shares entitled to vote at a meeting. Moreover, Section 216(2) allows, in the absence of such specification in the by-laws or articles, for action to be taken by stockholders by "the affirmative vote of the majority of shares present in person or represented by proxy at the meeting and entitled to vote on the subject matter", except in the case of an election of directors.[17]

5. *Fundamental Provisions in By-laws.* The draftsmen of the new BCL claim that, unlike in Delaware, the following provisions may be contained in Pennsylvania by-laws, as opposed to the articles: (1) voting of certain shares as a condition to the exercise of corporate power (Section 1521(c)); (2) allowing for written consents of stockholders (Section 1766(b)); (3) allowing issuance of rights or options for the purchase of shares (Section 1525); and (4) determining that the corporation's shares shall be certificated ((Section 1528).[18]

By comparison, first, Section 151(a) of the DGCL provides that the certificate of incorporation shall state powers and preferences of the various classes or series of stock and Section 102(4) allows for the certificate to include special voting conditions for corporate action. Section 109(b) of the DGCL states that the "by-laws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees."

Second, Section 228(a) allows for the written consent of a majority of shares entitled to vote unless the certificate provides otherwise. Thus, this procedure is allowed even if not so provided in the by-laws.[19]

Third, it is true that Section 157(a) of the DGCL also allows the issuance of rights or options for the purchase of shares, "[s]ubject to any provisions in the certificate of incorporation ..."

Fourth, Section 158 permits the board of directors to provide by resolution for uncertificated shares. Therefore, it does not appear especially advantageous for a Pensylvania corporation that this provision could also be in the by-laws.

6. *Corporate Division.* Subchapter 19 of the new BCL allows for the procedure of "corporate division, which in effect, is the opposite of a merger".[20]

Although a similar provision has been considered in the past for inclusion in the DGCL, it was not adopted due to the absence of any perceived practical need.[21]

7. *Consistency with Law.* Section 130(a)(8)(ii) of the new BCL is reported to be a major development because it allows articles to contain provisions notwithstanding their inconsistency with law.[22]

It remains true that Section 102(b)(1) of the DGCL bars provisions in the articles that are contrary to state law, but it appears unlikely that illegal provisions in a Pensylvania charter would be upheld by the courts.[23]

(c) A Brief Comparison of Purported Similarities in the Pennsylvania and Delaware Statutes

Selected sections where the Pennsylvania draftsmen claim that the new BCL achieves parity with the DGCL include the following provisions;

1. *Amendment of By-Laws.* The new BCL has "[n]o requirement of notice that the purpose of a board meeting is to amend the by-laws."[24] Likewise, the DGCL has no such specific requirement.

2. *Consideration for Newly Issued Shares.* Section 1524 of the new BCL permits the issuance of shares for an amount of consideration determined by the board of directors.[25] Sections 152 and 153 of the DGCL provide analogous authority.

3. *Uncertificated Share are Authorized.* This is allowed under section 1528 of the new BCL[26] and pursuant to section 158 of the DGCL.

4. *Removal of Classified Directors.* Section 1726(a) of the new BCL only permits removal of classified directors for cause.[27] Section 141(k)(1) of the DGCL is a similar provision.

5. *Voting Rights of Directors.* Section 1729 of the new BCL is similar to section 141(d) of the DGCL which allows for more than one vote per director.[28]

6. *Proxies.* Both section 1729 of the new BCL and section 212(b) of the new DGCL provide that proxies have a life of three years, unless otherwise provided.[29]

7. *Judicial Supervision of Corporate Action.* Subchapter F of Chapter 17 of the new BCL provides, as do sections 211(c) and 225 of the DGCL, for judicial intervention when no annual meeting is held as well as in the event of a contested election.[30]

8. *Mergers with Business Trusts.* Section 1921(c) of the new BCL permits a corporation to merge "with or into a domestic or foreign partnership, business trust or other association. The surviving or resulting entity in such a merger or consolidation may be a corporation, partnership or other association".[31] This may be somewhat broader than the provisions of DGCL Sections 254 and 263.

9. *Merger of Subsidiary into Parent.* Both Section 1924(b)(1)(ii) of the new BCL and section 253 of the DGCL provide shortened procedures for the merger of a subsidiary at least 90% of which is owned by the parent corporation.[32]

10. *Post-Dissolution Claims.* This topic is similarly addressed by Subchapter 19H of the new BCL and DGCL sections 280-282.

11. *Partial Written Consent.* Neither section 2524 of the new BCL, nor DGCL section 228 require that notice be sent to the minority before the written consent of a majority of shareholders becomes effective.[33]

12. *Dissenters' Rights on Asset Transfer.* Neither section 2537 or the new BCL nor DGCL section 271 provide "mandatory dissenters' rights" upon the sale of all or substantially all of a corporation's assets.[34]

II Delaware Case Law and the New BCL

The Delaware Supreme Court has established that simply because there is no specific provision in the Delaware General Corporation Law to authorize a particular corporate action does not mean that such action is prohibited.[35] Indeed, one of the strengths of Delaware corporate law is the large collection of case law that has been developed over many years and which provides a stable and often predictable basis on which to interpret the Delaware General Corporation Law.[36]

Thus, even if it were arguable that another state has statutory law with most of the same provisions contained in the Delaware General Corporation Law, it remains unlikely that the case law of Pennsylvania approaches the same breadth and respectability of Delaware's corporate case law.[37] For example, section 1522(a)(18) of the new BCL authorizes a "just say no" defense to corporate takeover attempts and section 1525 or the new BCL authorizes shareholder rights plans, or "poison pills", as another takeover defense. Delaware courts have approved both the "just say no" defense and the "poison pill" defense, thereby making explicit statutory authorization unnecessary. Before discussing those cases, a brief background of the business judgment rule would be helpful.

(a) *The Business Judgment Rule*

The basic business judgment rule has been described by the Delaware Supreme Court as:

> an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a). It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse discretion, that judgment will be respected by the courts.[38]

If a board's decision can be "attributed to any rational business purpose," the court will not substitute its judgment for that of the board's.[39]

The business judgment rule has been applied by Delaware courts to many factual circumstances which have not been addressed in Pennsylvania. Based on Delaware's history of cases, a corporation subject to Delaware's corporate law can be more certain about how a Delaware court would rule in a variety of situations.

The business judgment rule has been applied in Delaware to uphold various takeover defenses.[40] In the famous cases of *Unocal Corp. v. Mesa Petroleum Co.*,[41] and *Revlon v. MacAndrews & Forbes Holdings, Inc.*,[42] the Delaware Supreme Court refined the appropriate analysis required when determining the applicability of the business judgment rule in light of a threatened takeover.

Due to the suspicion that a board may be acting primarily based on self-interest in addressing a pending takeover bid, in order to enjoy the protection of the business judgment rule in such a context, the directors must satisfy a two-part test.[43] First, the "directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed ..."[44] Second, the defensive measures taken in response to that perceived danger "must be reasonable in response to the threat posed."[45]

In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[46] the business judgment rule evolved once again. In *Revlon*, Justice Moore reasoned for the court that when "it became apparent to all that the breakup of the company was inevitable ... [t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[47] More specifically, in light of the inevitable breakup of the company, there were no longer any threats to corporate policy and effectiveness and the "whole question of defensive measures became moot".[48]

(b) *The "Poison Pill" Defense*

Section 1525 of the new BCL provides statutory authorization for shareholder rights plans, or "poison pills," as a takeover defense. By comparison, the Delaware

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Supreme Court has decided that such a rights plan is authorized by sections 157 and 141(as) of the DGCL.[49]

(c) *"Just Say No" Defense*

Section 1502(a)(18) of the new BCL authorizes the Board of directors to "accept, reject, respond to or take no action in respect of an actual or proposed acquisition, divestiture, tender offer, takeover or other fundamental change . . ."

There is also support in Delaware case law for the position that in certain situations a corporation can turn away an unworthy suitor by just saying no to the suitor's overtures. For example, in *Mills Acquisition Corp. v. MacMillan, Inc.*,[50] the Delaware Supreme Court acknowledged that an initial inquiry is whether a company is "for sale", thereby invoking the *Revlon* duties.[51] Justice Moore made it very clear that: "A refusal to entertain offers may comport with a valid exercise of business judgment."[52] The court added that:

> Circumstances may dictate that an offer be rebuffed, given the nature and timing of the offer; its legality, feasibility and effect on the corporation and the stock-holders; the alternatives available and their effect on the various constituencies, particularly the stockholders; the company's long term strategic plans; and any special factors bearing on stockholder and public interests.[53]

More recently, Chancellor Allen ruled that:

> Under Delaware law, directors are under no obligation to act so as to maximize the immediate value of the corporation or its shares, except in the special case in which the corporation is in a "Revlon mode." Thus Delaware law does recognize that directors, when acting deliberately, in an informed way, and in the good faith pursuit of corporate interests, may follow a course designed to achieve long term value even at the cost of immediate value maximization.[54]

In closing, the foregoing sampling of cases is an indication that Delaware corporate law must be compared not only based on its statute, but also in light of the wealth of its case law.

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Constraints of space make it impossible to include the author's extensive footnotes, but the numbers to these footnotes appear. The full footnotes will be made available upon request to the offices of this magazine.

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CT's role begins when it is contacted by the company facing a challenge to its slate of directors or to some proposal. It is not unusual for us to be engaged at the prompting or insistence of the dissident faction, which wants an "honest count". Often, professional proxy solicitation firms will recommend that we be engaged. In doing so, they cite our experience and efficiency, which ultimately will save their clients time and money.

Our formal entry (once a contract detailing our services has been signed) into the fight begins at the shareholders' meeting, where we collect floor ballots and take possession of the proxies filed with each faction. In some cases, this process requires much logistical forethought. In the GULF and TEXACO contests, we arranged for large trucks to transport the proxies (and the envelopes bearing the postmarks) to Wilmington. The FRUEHAUF and TWA contest required arrangement for dedicated airline cargo space.

At the meeting site, we will also take possession of master ballots from each faction. These ballots give effect to the instructions on the proxies. Also turned in at this time are any other proxies or ballots, such as those representing employee or investment plans, such as ESOPs or DRIPs. The importance of keeping the chain of voting authority intact was made evident recently in *Carey v. Pennsylvania Enterprises, Inc.*, 876 F.2d (3rd Cir. 1989). Holders were informed in the proxy statement and on the face of the management proxy that their beneficially held DRIP shares (LORIOT & CO, a nominee, was the record holder) would be voted in accordance with their instructions on the proxy card. We were furnished with a list by LORIOT, detailing its holders. However, we were not furnished with a pro forma letter from LORIOT, either passing the right to vote the shares back to the DRIP holders or attempting to vote for them, per their instructions. Not wishing to disenfranchise hundreds of holders (voting both pro and con management) holding tens of thousands of shares, we counted the votes and, when challenged, decided:

> "It is obvious to the judges that LORIOT & CO., holder of DRIP shares passed the right to vote shares to the participants in the Plan. This is evidenced by the inclusion of these shares in the management proxy, further evidenced by past practice of LORIOT in all cases where it held such shares, as well as publication of this practice in public documents (not submitted to the judges, but known to them). The judges credited both management and opposition proxies with the appropriate DRIP shares due them. To disenfranchise a whole category of holder due to the lack of a formal appointment would be unfair, in our opinion."

The District Court upheld us, observing that "...the basic duty of judges of election under the Pennsylvania Corporation Law is to be as reasonable as possible and to avoid disenfranchisement on mere technicalities." *Carey, slip op. at 14.* However, on appeal, the Third Circuit reversed, concluding "...that nothing in that section (Pa. Stat. Ann. tit. 15 [Purdon 1967]) can be construed to allow a beneficial owner in the situation of the DRIP shareholders to vote in place of the record holders absent a valid proxy." *Carey, slip op. at 15.* We found ourselves wondering how Chancery and the Delaware Supreme Court would have ruled, had this been a Delaware corporation.

The closing of the polls has become a contentious issue of late. There have been many attempts to vote proxies after the close of the polls. We always suggest that the meeting script include a formal "last call" and closing of the polls by the chair in order to avoid any questions as to when the polls actually closed. Nevertheless, there have been numerous attempts made through the courts to permit voting beyond the announced closing time. Fortunately for us, these attempts have been unsuccessful. Permit me to explain. Occasionally we are asked, during injunctive proceedings, to sequester proxies by time frame and tally accordingly, pending disposition of the issue. This is a very intricate procedure, especially insofar as broker votes are concerned. A broker may vote four or five times for each faction in a contest; his votes are cumulative, unless specific revocation language is added to the proxy. Freezing the effect of these proxies within a certain time frame can sometimes boggle the mind!

The actual tally is still an arduous undertaking, not lending itself to automation or computerization. Each holder may send in two, three, or sometimes a half dozen cards, some to each faction. Multiplying this by hundreds of thousands of holders and the result is upwards of a million pieces of paper, all of which must be immediately retrievable. This necessitates thousands of square feet of layout and work space. The reader may recall reading of our using Brandywine Raceway and the Padua Academy Cafetorium for the respective GULF and TEXACO meetings. Each faction uses a different numbering system on its card; some use telegrams (more on this subject later). Also, signatures and dates must be checked and envelopes pulled for postmarks, where appropriate. Physically, all the cards must be culled, the latest dated valid card counted and tabulated.

At the completion of the tally, we call the contestants and simultaneously give them the preliminary results. They then take a period of time to review the proxies in each other's presence, a sort of "discovery period", prior to the next step, the challenge session.

At the challenge session, each faction presents its challenges to either specific proxies or to categories of proxies. The inspectors or judges hear these challenges and rule on them, either orally or in writing, depending on the law of the state of incorporation.

Unless injunctive relief is sought at this point, a final report is issued by the inspectors or judges, summarizing the results of the election. These results are announced formally at the reconvened shareholders' meeting.

Two issues have arisen recently which affect our work: the acceptability of telegrams and resolution of overvotes by brokers.

Proxy solicitors, engaged by each faction to encourage holders to vote, often arrange for the holder to call a toll free telephone number. The operator then asks a series of "canned" questions, from which the text of the wire is elicited. In *Parshalle and Ariens v. Roy and Martin*, Del. Ch. 10937, it was decided that the particular datagrams used in that contest lacked the "...fundamental indicia of authenticity and genuineness needed to accord them a presumption of validity". The court did not address the validity of datagram proxies in general. It rested "...upon the fact that the datagrams lack any written signature or signature equivalent (such as a signature stamp or facsimile), or other identifying mark or characteristic that would verifiably link the proxy to a specific shareholder of record. *Parshalle, slip. op. at 19*. Needless to say, the telegram industry is scurrying about, intent on assuring itself that it has in place procedures necessary to meet this newly defined criterion. Critics of the use of wires hold that anyone can go to a phone booth, give a shareholder's name and address and phone in a spurious vote. Proponents of the use of wires say that the issuance to each holder of an ID number, known only to that holder (and the transfer agent and the telegram company) would obviate any difficulties, thus satisfying both the critics and the courts.

The second issue recently addressed is that of the method of resolution of overvotes. Brokers and banks hold stock in "street name" on behalf of their clients ("beneficial holders"). They, in turn, hold their stock through a depositary institution, such as Cede & Co., which is a nominee of the Depository Trust Company. This type of ownership is used to avoid the necessity of exchanging stock certificates on a daily basis, as balances fluctuate. On the corporation's record date, Cede and its participants must freeze their records. To further complicate matters, some Cede participants, namely banks, now also hold for other smaller banks, which, in turn, hold for their clients. Naturally, this record date freeze does not always result in a situation whereby institutions know what their exact record date positions are. Unfortunately, there is no system, as yet, to inform them of the precise situation. Therefore, they vote to the extent of what their own records indicate they hold.

Situations then arise whereby a broker submits cards which, when totalled, exceed its position on the records before the judges or inspectors. Often the mistake is clerical, i.e., a misunderstanding of the record date, duplicate cards for the same sub-account or an inadvertent voting of post-record date shares. We call the broker, identify ourselves and ask a few carefully worded questions, asking the proxy clerk responsible to check his records in order to determine how his client instructed him to vote. Often, he can tell us in a minute that two cards we are holding are duplicates (due to multiple mailings) or that one small vote is actually part of a larger vote submitted later. A written record of the call is made and submitted at the challenge session, in order to explain our resolution of the situation.

However, *Concord Financial v. Tri-State Motor*, Del. Ch. 10984 held, inter alia, that "...conflicting proxies irreconcilable on their faces or from the books and records of the corporation, may not be reconciled by extrinsic evidence". *Concord, slip op. at 12*. The inspectors or judges are now required to "...reject all identical but conflicting proxies when the conflict cannot be resolved from the face of the proxies themselves or from the regular books and records of the corporation". *Concord, slip op. at 12*. The court went on to say that "This rule satisfies the corporate need for finality in elections by simply requiring that stockholders exercise their right to vote by proxy with a *reasonable degree of care*". (emphasis added) *Concord, slip op. at 13.*

If any lesson is to be taken from recent case law, it is that the industry, viz. proxy solicitors, telegram companies and bank and broker offices, has undergone a redefinition of its duties and responsibilities. Complacency can be a fatal flaw when it results in a broken chain of voting authority resulting in a turnaround of the election. Making certain that one is not overvoting a position can result in that position's shares (sometimes in the millions) not being voted, with resulting possibility of litigation, if the share lot and vote could have tipped the scales the other way.

Explanation of Substance of Section 228 is Needed

What lies ahead? I foresee some trouble cropping up in contested consent solicitations. Some sections of the law (Del. Corp. Law. Sec. 228) are relatively new and have undergone little or no review by the courts. Already, some companies have adopted bylaw provisions in an attempt to set up some ground rules.

Recently, we were involved in a consent tabulation, wherein the first consent was filed with us on August 17, thus starting the statutory 60 day clock. Meanwhile, the company, in defense, began soliciting revocations. For some strategic reason, the initiators of the fight filed a new consent, dated August 29, revoking the prior one. Meanwhile, both factions, having filed their respective consents and revocations, were asking us for results, each insisting that we

(Continued on page 22)

(Continued from page 21)
use what they interpreted to be the proper "record date". The matter was mooted by a settlement prior to being heard by Chancery.

Although Section 228 allows a maximum of 60 days from the filing of the earliest consent as the latest submission deadline, it is entirely possible for a consent filer to walk in at any time prior and request a tabulation, based on consents submitted as of that time. If the filer thinks he has the requisite number of consents, he then demands a report from us. If he lacks the votes, he tries again, until he reaches the "magic" number. It would seem more equitable if a definite time were set, so that each faction could use that "deadline" as a target period for submission of consents and revocations.

Meanwhile, those members of the bar acting as counsel for public corporations would do well to review the corporate by-laws and, if necessary, insert provisions setting forth procedures to be followed in the event of a hostile consent solicitation.

As the reader might infer by now, duties of inspectors or judges of election are far more exciting and challenging than some might initially imagine. One fact is certain; when the fate of a corporation rests on a handful of cards, this "ministerial" function takes on a new light!

Frank J. Obara, Jr. is a native Wilmingtonian. He is currently Assistant Secretary of Corporation Trust Company (Del.) He has served as Inspector or Judge of Election in over a thousand routine annual meetings, as well as hundreds of contested meetings. From time to time he has also been appointed by the Delaware Court of Chancery to serve as Supervisor of Election to conduct meetings at which an impartial officer is required in order to conduct controversial corporate elections.

Mr. Obara received his B.A. degree from LaSalle College, now LaSalle University. He then attended Georgetown University School of Law. He is married and has two children.

We are fortunate to have the benefit of Mr. Obara's experience. His explanation of an obscure but important procedural aspect of corporate law is most welcome.

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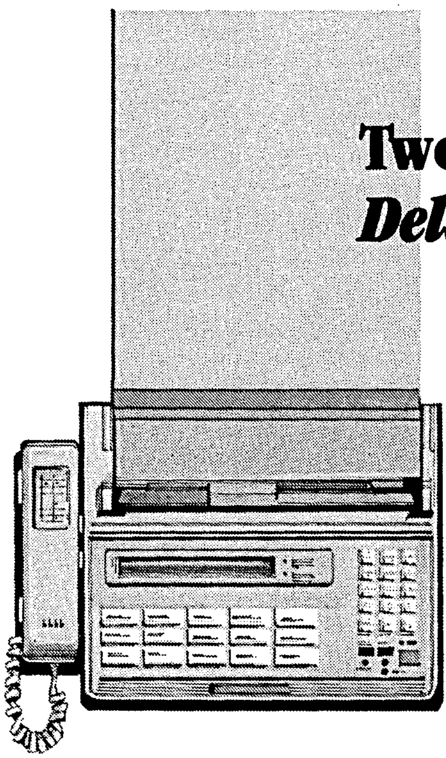

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EXPEDITING CORPORATE LITIGATION IN THE DELAWARE COURTS

Howard M. Handelman and Douglas R. MacGray

I. INTRODUCTION

The criteria and guidelines for expediting a case in the Court of Chancery, in the Delaware Supreme Court, and in the United States District Court for the District of Delaware are, of course, set forth in the rules of procedure of those courts. The purpose of this article is to present some of the practical procedural aspects of expediting a corporate dispute in those courts that are not covered by the rules of procedure.

Research for the article included interviews with almost all of the sitting chancellors, District Court judges, and Delaware Supreme Court justices.

II. SERVICE OF PROCESS

To expedite the service of process in the Court of Chancery, plaintiff's counsel must file a motion for the appointment of a special process server. The motion should not be incorporated as part of any other motion, because, unlike other motions to expedite the proceedings, it is generally granted *ex parte* by the master or by one of the chancellors. Once the motion for the appointment of a special process server is filed with the Register in Chancery, plaintiff's counsel should request that it be sent immediately to the master or, if the master is unavailable, to one of the chancellors.

The chancellors interviewed for this article stated that the court is very liberal in allowing such motions, but they cautioned against two mistakes made by some practitioners. First, the motion should not designate the plaintiff's attorney to be the special process server. Second, the motion should not request that "someone at our offices" to be appointed the special process server, *i.e.* the motion should name a particular person to be the process server. A common and acceptable practice in the Court of Chancery is to move for the appointment of more than one special process server.

The appointment of a special process server is not necessary in the District Court, because the Federal Rules provide that the summons and the complaint may be served by "any person who is not a party and is not less than 18 years of age." Fed. R. Civ. Proc. 4(c)(2)(A).

III. EXPEDITED SCHEDULING

A. Assignment of Judges.

While service of process is being effected, plaintiff's counsel should proceed to schedule a conference with a judge for presenting other motions to expedite the proceedings. Judges in the District Court and the Court of Chancery make a special effort to be available soon after the plaintiff's attorney contacts the court. If the circumstances warrant, and all necessary papers are in order, and all attorneys for the parties are available, an initial conference with a judge usually occurs on the same day or the day following the attorney's request for the conference.

In Chancery Court, the motions to expedite the proceedings are heard by the chancellor assigned to the case. In the interview with Vice Chancellor Berger, she stressed that one of the most important means of expediting a case is the assignment of a chancellor as soon as possible.

Counsel may expedite the assignment process by a telephone call to the master in chancery. After being apprised of the situation, the master will contact Chancellor Allen, or, if he is not available, the most senior available vice chancellor, to make the assignment. Such assignments are generally made on a rotation basis, although other factors influence the process. Obviously, conflicts play a role. An effort is made to assign factually related cases to the same chancellor.

If the master in chancery is unavailable, counsel should call Chancellor Allen's secretary, or, if Chancellor Allen is unavailable, the secretary of the most senior available vice chancellor. The secretary will inform the chancellor of counsel's request, and an assignment will be made immediately, if possible. Counsel should then contact the assigned chancellor's secretary to schedule an office conference to discuss an expedited schedule. There are occasions when the chancellor will not schedule an office conference, but will consider the motions for expedition on the papers submitted without any verbal input.

In the District Court, one of the active judges is designated the "Duty Judge" each week on a rotating bases. Counsel may determine which judge is the week's duty judge by calling the clerk of the court. The judge's secretary should be called directly to schedule a time for the office conference. In an expedited case, if there are no conflicts the duty judge (with the exception of Senior Judge Latchum) will be the judge assigned to the case.

B. Notice to Defendant of the Initial Conference.

There is no rule in either the Court of Chancery or the District Court requiring plaintiff's counsel to notify the other side before moving for expedited scheduling. There is a great reluctance, however, on the part of both the chancellors and the District Court judges to schedule a conference before knowing that the other side will be present or available by telephone.

At the very least, the court will want to know what efforts were made to contact defendant's counsel before the initial office conference. The court will generally delay the scheduling of the conference until a time when counsel for all parties can be present.

The court's reluctance to hold a scheduling conference in the absence of representation of all the parties is based not only upon fairness to all parties, but also on judicial economy. If scheduling orders are made *ex* *parte*, the other side often, for legitimate reasons, will ask to have the orders vacated or modified. Thus, it is important to give the defendant notice that a scheduling conference will be requested and to ascertain the opposing counsel's availability. Fortunately, in most corporate disputes it is not difficult to determine who will be representing the defendant.

Papers filed with the court, of course, must be served beforehand or at the same time on the opposing side. One chancellor, however, took the opportunity of the interview to express extreme disapproval of the practice of the moving party handing opposing counsel a copy of the motion or brief at the outset of the hearing or when the parties meet at chambers to confer with the judge.

C. The Initial Conference.

At the initial conference with the chancellor or the District Court duty judge, plaintiff's counsel should be prepared to present the motions to expedite the answer, to expedite the discovery, and to expedite the hearing.

The courts have interpreted their rules to require a showing of "good cause" before a party is entitled to have a case expedited. Therefore, motions for expedited proceedings should set forth specific grounds for the relief sought.

At the initial conference, the judge will want to be informed of the important dates and exactly what the plaintiff is trying to accomplish by the expedited schedule. The time frame within which a matter may be expedited will depend entirely upon the circumstances of each case. There is often a trade-off between the time period sought and the scope of discovery sought. As an example, Vice Chancellor Berger explained that if the plaintiff wants to depose seven individuals yet wants the hearing next week, there usually is some negotiating with the final outcome being either fewer depositions or an extra week.

It is essential that cases which are to be expedited be filed as soon as possible so that they do not have to be expedited any more than is necessary. At the initial conference, the judge will inquire into how long the plaintiff has been able to pursue the claim.

Understandably, because they are carrying heavy workloads, the judges normally need several weeks or even months before the hearing for preliminary relief to review the briefs and affidavits. The judges are willing to shorten that time dramatically, if the exigencies of the case require it. Counsel must constantly bear in mind, however, that such extraordinary accommodation by the judges is necessarily made at the sacrifice of their evenings and weekends. Accordingly, counsel must take care to avoid imposing on the court's time unnecessarily.

It appears counsel will more likely get a shorter period of time between the last brief and the hearing in Chancery than in District Court. Chief Judge Longobardi, who has sat on both benches, stated that the chancellors will bend over backwards to accommodate counsel in these cases, even to the point of receiving the last brief only hours before the hearing. Chief Judge Longobardi said that judges in the District Court are more likely to insist on keeping a reasonable period of time between the last brief and the hearing. For example, if circumstances permit, Chief Judge Longobardi prefers at least five business days.

Although the chancellors and District Court judges will not automatically approve a stipulated discovery schedule, the judges prefer the parties to agree to as much of the scheduling as possible before the initial conference.

IV. DISCOVERY DISPUTES

During the course of expedited discovery, it may be crucial to resolve a discovery dispute during the taking of an oral deposition. It is permissible in the Delaware courts for an attorney during the deposition to call the judge's secretary for a teleconference with the judge who will hear both sides of the dispute and make a decision immediately. Although all the judges interviewed expressed reservations about the use of this procedure, all but one expressed a willingness to make themselves available when asked.

Several judges commented that often it is a difficult task to decide these disputes. The attorneys have been engaged in the dispute for a while, but the judge must decide it during the teleconference cold without briefing. Vice Chancellor Berger explained that although it is often difficult, the court will almost invariably decide the dispute because (1) the dispute usually involves a question that has been previously encountered, and (2) the parties need a decision immediately in order to proceed.

Another reservation expressed by several of the judges concerning this procedure is the potential for abuse, thus the parties should do all they can to resolve these disputes themselves and to use the court only as a last resort. Some of the judges expressed an inclination to impose sanctions on the losing party or counsel. One judge stated that it is very rare for an attorney who is instructing his client not to answer to prevail, unless there is clearly a privilege. The judge observed that the Delaware courts take a broad view on the scope of discovery.

Judge Roth advised that she will make herself available to resolve a dispute on the telephone. In her experience, however, the parties often come to an understanding on their own as the teleconference progresses. In addition, she observed that often when the parties schedule a teleconference for later in the day, the parties resolve the conflict before the scheduled teleconference occurs.

V. TEMPORARY RESTRAINING ORDER

If the exigencies of the case warrant, the judges will hear a motion for a temporary restraining order on the same day the court is contacted. However, it is highly unlikely that such relief will be granted *ex parte*.

The judges interviewed appeared unanimous in their view that there is an aversion to granting a temporary restraining order *ex parte*. Judge Roth, for instance, cannot recall ever granting one, although they have been sought. The only instance in which such relief will likely be granted *ex parte* is when the notice itself will frustrate the relief.

VI. PRELIMINARY INJUNCTION

In the vast majority of cases, the hearing on the motion for preliminary injunctive relief will not involve live testimony. Although the chancellors in the Court of Chancery and the judges in the District Court have

(Continued on page 26)

discretion to hear live testimony, the preference, especially in an expedited case, is not to have live testimony.

Vice Chancellor Jacobs explained that live testimony is not allowed, because (1) it takes too much time, (2) the parties will usually have a difficult time limiting the testimony once it is allowed, and (3) if the case goes to trial, the testimony will have to be heard twice.

The entire record, therefore, will consist of documentary evidence consisting of briefs, appendices, deposition transcripts, and affidavits. How these documents are organized may be very important, because the judge has a very short period of time to read through these materials before the hearing and the decision. Vice Chancellor Berger suggested that it would be very helpful if the parties would put together a booklet with tabs containing the documents the party considers to be most vital. This would be in addition to the normal filing of all necessary documents. Vice Chancellor Berger recognized that this might not always be feasible given the time constraints.

VII. BRIEFS

During an expedited case, parties should deliver a courtesy copy of briefs to the judge's chambers. Even if it only takes one half of an hour for the Clerk or Register to get the brief to the judge, that time should be made available to the judge. In addition, as Chief Judge Longobardi stated, despite the "extreme efficiency" of the clerk's office, there is always the possibility for human error.

An issue on which the judges appear to have unanimous views is the subject of briefs which exceed the page limit. They do not like them. Although some judges are more tolerant than others, favor will not be won with any chancellor or District Court judge if the page limit is exceeded. If counsel needs to exceed the page limit, the judges indicated that caution should be used.

First, leave of court must be sought. If a party files a brief that exceeds the page limit without permission to do so, many of the judges will not accept it. One chancellor stated that some attorneys have filed long briefs with a stipulation that the parties have agreed to exceed the page limits. This practice is unacceptable. The page limitations are for the benefit of the judges, not the parties. Filing a motion to exceed the page limit contemporaneously with the filing of a long brief is also unacceptable to most of the judges.

If counsel discovers that more pages are needed, leave of court should be sought as soon as possible. One of the judges stated that if time limits are such that counsel realizes it is too late to pare down the brief, then counsel should call the judge as soon as this is learned. Even a phone call to the judge's secretary a few hours before the brief is to be filed would be helpful.

Second, if a party obtains the court's permission to exceed the page limit, they should be careful to ensure that the extra length is actually necessary. Several of the judges interviewed in the Court of Chancery and the Delaware District Court stated that, in the past, when they have granted motions to exceed the page limit, in retrospect the judges discovered that they were mistaken in allowing the motion. As one chancellor put it, when a motion to exceed the page limit is approved, "that is not a licence to be wordy." Many of the judges interviewed thought that many attorneys suffer from the view that they must include every argument that could possibly be presented in good faith.

In Delaware District Court, one of the judges indicated there is a strong possibility that in the near future the page limits on briefs will be shortened. The page limitations in the Delaware District Court presently are longer than in many other federal districts.

VIII. APPEALS TO THE DELAWARE SUPREME COURT

A. Certification of Question by Trial Court

Because of the speed with which expedited cases move, it is usually necessary to draft the petition for certification of the appeal before the chancellor's decision is issued on the motion for injunctive relief.

The chancellors indicated that they want to see a short petition (one chancellor suggested approximately four pages) with specifics on each criteria for certification upon which the movant is relying.

A form of order should be filed along with the petition for certification. Vice Chancellor Berger noted that the proposed form of order should not be several blank lines that the chancellor is expected to fill in. Rather, she suggested, the form or order should state why the certification is being granted, *i.e.*, because the order determined a substantial issue, established a legal right, and review may terminate the litigation. One of the interviewed justices commented that the decision made by the chancellor with regard to certification is a factor taken into account by the justices when considering whether to accept the certification.

B. Contacting the Supreme Court

Each month, one of the five justices of the Delaware Supreme Court is designated as the "Motion Justice." During a given month, all newly filed motions are handled by the motion justice, unless he recuses himself.

Counsel on both sides often draft the necessary documents to appeal the decision before the chancellor's decision is issued. Counsel, however, should not contact the Supreme Court until the decision is issued.

Until recently, some of the justices would take telephone calls from the attorneys on the morning of the day a chancellor was scheduled to issue the opinion. As a result of some abuse of this procedure, the justices now operate under the internal rule whereby they do not give an appointment until the decision by the trial court is issued.

One of the justices interviewed indicated that because the chancellor's decision on certification is likely to be made quickly, counsel may request an appointment with the motion justice once the chancellor's decision on the preliminary injunction issues, even if the decision on certification has not yet been made by the chancellor.

C. The Initial Conference With the Motion Justice

At the initial conference with the motion justice, counsel should present a package of motions. The motion for expedited scheduling can be, and often is, decided by the single motion justice.

The application for certification of an interlocutory appeal cannot be decided by the single justice. The motion justice, however, will often hear the application and make a conditional decision to accept and enter a scheduling order. The motion justice will then present in writing his views with regard to certification to two other justices for approval or denial.

D. "Good Cause"

Supreme Court Rule 25(d) provides that "[u]pon good cause shown . . . the court may order an expedited schedule . . ." When the justices were asked what constitutes good cause, they responded that good cause exists when a party can show that it will be prejudiced if the case were relegated to normal timing. In addition, in the words of the Chief Justice, "a well-prepared application always deals with the non-availability of alternatives."

The justices emphasized that they have no special bias for corporate cases and that they will expedite any case if the circumstances warrant.

The mere fact that a case has received a lot of media attention or has been expedited by the Court of Chancery is not considered good cause. Good cause may exist, the justices indicated, when parties are facing the expiration of financing arrangements or when a crucial directors' or stockholders' meeting is imminent.

Good cause must continue to exist throughout the expedited proceedings. If circumstances change such that the need for the expedited resolution no longer exists, counsel is obligated to apprise the court immediately. Several of the justices mentioned that there is no surer way to lose credibility with the court than for the justices to find out at some point that the need for expedited proceedings no longer exists. Two justices specifically recited one instance in which the court discovered during questioning at oral argument that the need for expedited proceedings no longer existed. This, in the words of one of the justices, was an abuse of the Court's goodwill, and the Court admonished counsel.

E. Expedited Appeal Time

In an expedited appeal, the justices prefer to allow somewhere in the vicinity of 25-30 days for the entire process to take place. If the parties make a proper showing of need, however, the briefing may take place in a matter of five to six days with oral argument a day later.

One justice expressed the concern that too expedited a schedule often results in substandard briefing. The justices want to give enough time for the parties to file quality briefs. Some attorneys in greatly expedited cases have merely filed a revised version of the brief filed in Chancery Court. The justices do not favor that practice.

The justices take into account several factors in determining how fast they will be able to act. The complexity of the legal issues is one important factor.

The voluminousness of the record is another important factor. The greater the volume of the record the justices must go through, the more time the justices will need. The justices had conflicting opinions as to the utility of filing a "stipulation of pertinent facts" to aid the court in cases of voluminous records. One justice said that such stipulations are helpful in expediting cases; another justice said that such stipulations can be helpful but the justices still want to examine the record; another justice said that such stipulation should not be encouraged.

It may be helpful if the parties agree to a tentative briefing schedule. The court, however, will not approve a briefing schedule it considers to be unrealistic.

There are some extreme time constraints which obviously are beyond the capability of the court. For instance, if an application for an expedited appeal is presented today and the tender offer expires tomorrow, the justices will tell counsel to either delay the expiration of the tender offer or forego the appeal.

F. The Panel

When an application for certification is filed with the Supreme Court, the immediate decision whether to accept the certification must be made by a three justice panel. (Supreme Court rule 4(a)). The make-up of the panel is never announced before the hearing.

The three justice panel normally consists of the current motion justice, the motion justice for the preceding month, and the motion justice for the succeeding month. These three justices will also be assigned to hear oral argument. The Chief Justice explained, however, that he or the assigning justice (if the Chief Justice is not available) can depart from the routine for assigning the panel at any time.

Many factors may change the general routine for the assignment of the justices. One such factor is availability. Another factor is conflict of interest. The justices have a regular practice for handling recusals. As soon as a case is filed, the docket sheet is circulated to every member of the court. If a justice can determine from the docket sheet that he is disqualified, he immediately recuses himself and the notice of recusal is sent to all attorneys of record. Notice of the recusal is also noted on the docket.

G. The Briefs

If possible, counsel should plan on filing briefs within the required page limits. Several of the justices are quite skeptical with regard to applications to exceed the page limit. If counsel needs to exceed the page limit, application should be made at the initial conference; otherwise, it is probably too late.

When counsel makes such an application, a strong showing should be made. One justice explained that every time a grant of a significant amount of extra pages has been allowed, after seeing the brief, the Court regretted having allowed the extra pages. As a result, the justices have become fairly "tough-minded" with regard to such applications.

One justice feels that there appears to be a mindset among some lawyers that the larger the brief is the stronger the case must be. The justice went on to say:

> Over and over the Court sees prolix and repetitious briefs where the arguments are not well-defined. A lawyer who asks for an expedited appeal should be able to file a brief that is cogent . . . It is

(Continued on page 28)

an issue of foremost professional confidence to be able to write a brief clearly and have the courage to be concise.

The justices, nevertheless, will discuss applications to exceed page limits with counsel, and a limited number of additional pages will allowed upon a proper showing. If additional pages are allowed, the finished brief should demonstrate clearly that the extra pages were needed.

H. Oral Argument and the Decision

If counsel needs more time than the normal thirty minutes to argue an expedited appeal, application for additional time should be made at the initial meeting with the motion justice. Such applications are viewed with disfavor by several of the justices. One justice observed: "If there is a good brief, there is no need for a longer argument, and if there is a bad brief, a longer argument won't save it."

Applications for additional argument time are frequently granted, but not for the purpose of giving counsel more time to argue the case. Rather, when extra time is granted it is because the justices anticipate that they will have a lot of questions.

During oral argument, counsel should be prepared to expect that most of the time allotted may be consumed by responding to questions by the Court. One justice recounted an instance where an attorney arguing in an expedited case had almost all of his time taken up with questions by the Court. At the end of the allotted time for argument, this attorney of "considerable reputation" complained that he did not have enough time to present his argument. This, according to the justice, demonstrated "a lack of appreciation for the purpose of appellate advocacy."

At oral argument, the justices want their concerns allayed. One justice explained that there is nothing that impresses the Court more than to have a legitimate concern allayed by counsel with logic and with the ability to analyze and respond in a way that proves to the justices that their concerns are unjustified.

After oral argument, the panel of justices will confer and endeavor to make a decision from the bench. It is the Supreme Court's position that if an appeal is expedited, the decision should be expedited. If the three justice panel agrees to a result, the senior justice will often announce the decision which is followed by an opinion at a later date. At times this oral ruling is a single sentence, at other times, a more elaborate oral ruling is required.

For various reasons, an immediate oral decision may not be forthcoming. If, when the three justices confer, it is clear that there cannot be a unanimous decision, the court will announce this and schedule a hearing *en banc* as soon as possible. The decision may also be delayed briefly to enable the three justices to resolve some initial disagreement in order to avoid an additional hearing *en banc*.

IX. CONCLUSION

The chancellors, judges, and justices of the Delaware courts are remarkably accommodating in expediting a case in which it is truly needed. The expedited procedures are available to all Delaware attorneys and in all types of cases. Delaware attorneys, however, have the special responsibility to protect this unique and valuable service from abuse.

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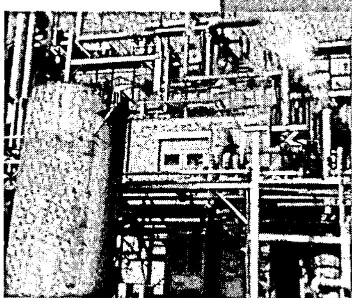

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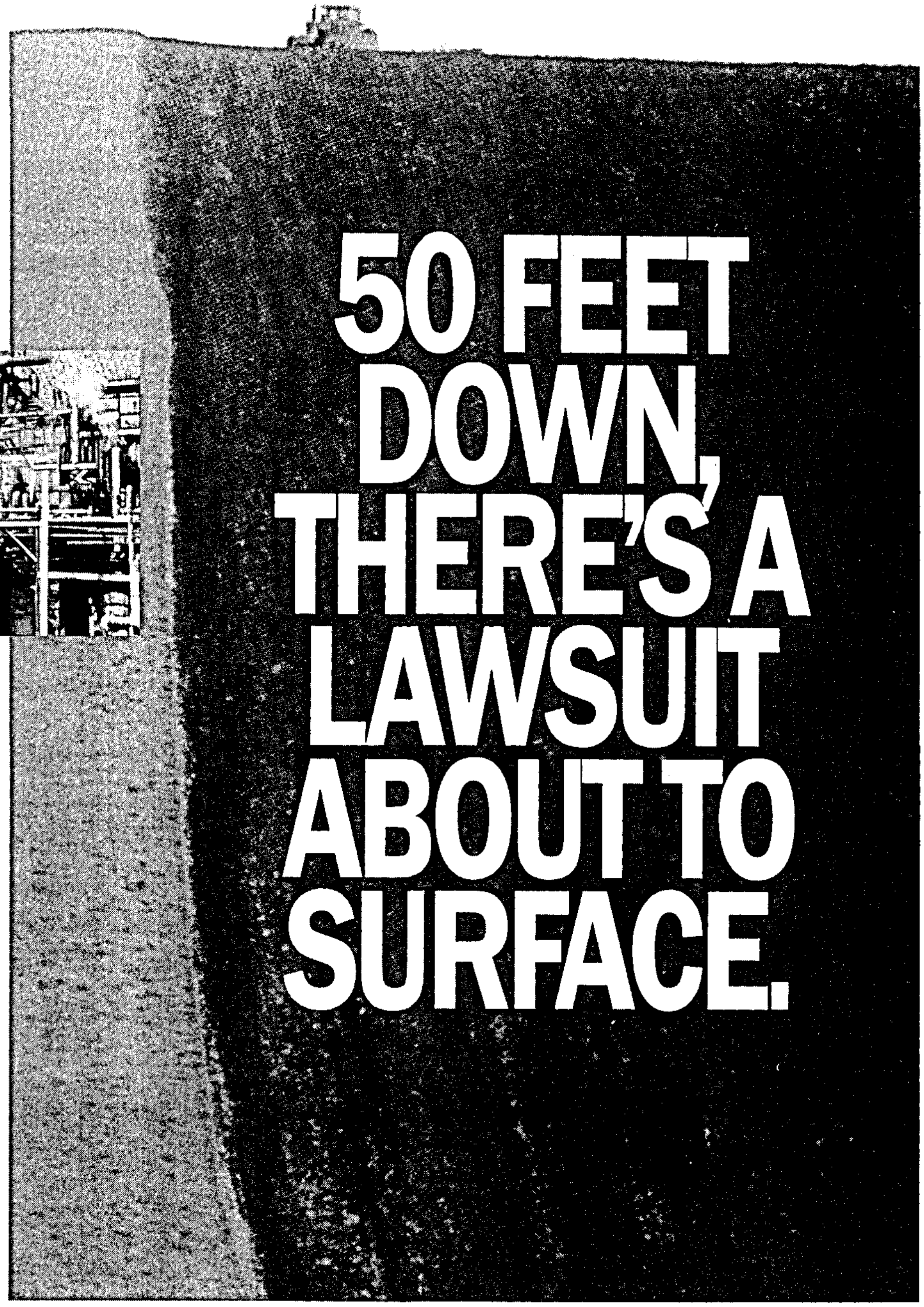

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COUNSELING DIRECTORS ON THE DUTY OF LOYALTY AND THE USE OF SPECIAL COMMITTEES©

E. Norman Veasey

Delaware lawyers are frequently called upon to counsel boards of directors on their fiduciary duties. The centerpiece of these counseling sessions is normally an analysis of the application of the business judgment rule and the consequences of falling outside the rule.[1] As Chancellor Allen noted in *Anderson, Clayton,* the judicial determination whether actions by directors fall inside or outside the business judgment rule is often outcome-determinative and that, despite the good intentions of directors, they may transgress the duty of loyalty line. [2] Duty of loyalty issues may arise in the context of various transactions, including sales to or purchases by the corporation from directors or entities in which the directors have an interest; dealings by a parent corporation with a subsidiary; unfair treatment by a majority stockholder of minority stockholders in corporate acquisitions and reorganization transactions; use of corporate funds to perpetuate control; sale of control; demands of stockholders to commence derivative suits; excessive compensation; insider trading; usurpation of corporate opportunities; competition with the corporation by officers or directors; and improper use of corporate position, property or information.[3]

The topic of counseling directors on the duty of loyalty is probably worthy of book-length treatment. This article is necessarily only a mere beginning of a discussion. Accordingly, I plan to mention briefly some counseling suggestions in only three areas: (1) interested director transactions governed by Section 144;[4] (2) the demand requirement in derivative actions; and (3) the duty of loyalty of directors of target boards in takeover contexts. Overlaying all of these issues is the growing use of special committees composed of disinterested and independent directors.

A. Background and Analytical Framework

Duty of loyalty is not a clear-cut concept. To be sure, there are "hard core" cases where a director or officer participates or acquiesces in corporate action which is to that person's personal, financial interest at the expense of the corporation. For example, in the old case of *Guth v. Loft, Inc.*,[5] where the court found that a director's personal financial interests in a corporate opportunity transgressed the line, the court said:

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, [corporate officers and directors] stand in a fiduciary relation to the corporation and its stockholders. [P]ublic policy... has established a rule that demands of a corporate officer or director . . . the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. . . . [A]n undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest. (5 A.2d 503 at 510)

Even though the term "duty of loyalty" is often used in the Delaware cases[6] and is part of the Delaware General Corporation Law,[7] there is no bright line definition.

While the general concept underlying the duty of loyalty -- that a director refrain from self-dealing -- is simple, application of the loyalty principle can be difficult and highly fact-intensive. When the duty of loyalty line is crossed, the directors must show entire fairness. As the Delaware Supreme Court stated in *Weinberger v. UOP, Inc.:*

> There is no "safe harbor" for... divided loyalties in Delaware. When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.... The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.[8]

In *Weinberger*, the court made it clear that entire fairness means fair price and fair dealing. [9] When directors do not act "fairly" in structuring a transaction which violates the duty of loyalty or is otherwise outside the business judgment rule, the result may be either an injunction or damages.[10]

The key threshold inquiry in any duty of loyalty problem is whether the director is interested in the transaction. Directors are considered to be "interested" under Delaware law if they either "appear on both sides of a transaction or expect to derive personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."[11] The paradigm hypothetical is that of the CEO who owns Blackacre which adjoins the company plant and the transaction involves the corporation's acquisition of Blackacre. Other examples include variations of cases involving business combinations of affiliates. [12] In the corporate control area, the focus is on whether a director's sole or primary purpose is to maintain control to the detriment of stockholders.[13]

Even if a director is not interested, the further inquiry is whether he or she is "independent:" *viz.*, capable of rendering independent judgment.[14] A director is deemed to be independent "when he is in a position to base his decision on the merits of the issue rather than being governed by extraneous considerations or influences."[15] A director's independence will be assessed by the "care, attention and sense of individual responsibility [he or she exhibits] to the performance of [his or her] duties. . . ."[16] While directors will have lost their independence if the facts "would demonstrate that through personal or other relationships the directors are beholden to the controlling person,"[17] a plaintiff's mere conclusory allegations of structural bias or domination and control will not suffice to demonstrate a disabling conflict or overcome the presumptions of the business judgment rule.[18] To establish a conflict of interest and rebut the presumption of propriety afforded by the business judgment rule, a plaintiff must prove that the interests of the directors in a proposed transaction affected the outcome of the board's vote.[19] If directorial decisionmaking is infected with lack of independence or self-interest or if proper intracorporate decisionmaking mechanisms are not used, the burden will be on the directors to show the entire fairness.[20]

Directors are presumed independent, but that presumption is, of course, rebuttable by evidence either as to relationships or behavior in a particular transaction.[21] While the issue of independence is inherently factual, questions of structural bias continue to seep into the cases and the literature.[22] Close familial or business relationships might be shown to affect adversely a director's independence, but these are not the only issues raising questions of independence. A director with seemingly attenuated relationships should be warned to consider his or her independence prior to voting or serving on a committee where a transaction involves a colleague's direct personal financial interest.[23]

B. Interested Director Transactions Governed by Section 144.

Most states have "safe harbor" statutes which govern cases where one or more directors are personally interested in a transaction with the corporation. These statutes were enacted to ameliorate the common law rule which made such transactions voidable whether or not they were fair or approved by other directors who were disinterested.[24] Delaware's safe harbor statute provides, in essence, that a transaction between a corporation and an officer or director is not void or voidable "solely" for this reason or "solely" because the officer or director is present and participates in the meeting which authorizes the transaction, if one of three conditions is met: (a) an informed[25] majority or committee of disinterested directors authorizes the transaction; or (b) the transaction is approved in good faith by informed, disinterested stockholders; or (c) the transaction is fair to the corporation.[26]

A question frequently arises whether the business judgment rule applies when a transaction with an interested director is approved or ratified by informed, disinterested directors acting in good faith with due care. As noted, Section 144 of the Delaware General Corporation Law is framed in the disjunctive, suggesting that approval by informed, disinterested directors implicates the business judgment rule.[27] The general rubric is that, in cases where the business judgment rule applies, there would be no judicial inquiry into the fairness of the transaction.[28] Nevertheless, even disinterested director approval or less than unanimous stockholder approval cannot overcome a showing of waste, illegality, *ultra vires* or fraud.[29]

The statutory test of Section 144 clearly is framed in the disjunctive and not in the conjunctive. What, then is the implication of the following *dictum* in *Fliegler v. Lawrence*?[30]

> We do not read the statute [Section 144] as providing the broad immunity for which defendants contend. It merely removes an "interested director" cloud when its terms are met and provides against invalidation of an agreement "solely" because such a director or officer is involved. Nothing in the statute sanctions unfairness . . . or removes the transaction from judicial scrutiny.[31]

The issue in *Fliegler* was that the interested directors (in their role as controlling stockholders) had participated in the stockholder vote approving the transaction. Since there was not the requisite vote of *disinterested* stockholders, the holding of the court is that, to be effective under Section 144(a)(2), a stockholder vote in an interested director transaction must be a vote by a majority of disinterested stockholders.[32] The issue whether informed, disinterested director approval under Section 144(a)(1) obviates a fairness inquiry was not before the Court in *Fliegler*, but the *dictum* quoted above has been interpreted by the Reporters to the ALI Corporate Governance Project as a construction of the Delaware statute "so as to permit judicial scrutiny of transactions even where there is disinterested approval."[33] Thus, *Fliegler* seems to be the kind of case which may be used by litigants to invite a court to look beyond procedural proprieties to rationalize some judicial review, perhaps in the nature of a "smell test." Whether or not such review is jurisprudentially justifiable is a subject for a scholarly debate far too complex to resolve in this article.[34]

The American Law Institute's Corporate Governance Project takes a stricter approach than the Delaware statute. Section 5.02, as tentatively approved by the ALI,[35] differs from Section 144 in several respects, the most important of which is that approval of a transaction by a majority of disinterested directors after full disclosure does not validate the transaction under the ALI scheme "unless the transaction could reasonably be believed to be fair to the corporation at the time of such authorization."[36] As one commentator has noted, "the ALI approach would in every case permit the 'fairness' issue to intrude into the 'safe harbor.'"[37]

The 1989 revision to the Model Business Corporation Act takes quite a different approach in creating an intricate, but clear bright line safe harbor, the essence of which is to reject the ALI approach and to provide that the various tests of disinterested director or stockholder approval (whether authorized in advance or by way of ratification) or a showing of fairness constitute disjunctive means of validating an "interested" transaction.[38]

(Continued on page 32)

C. The Demand Requirement in Derivative Litigation.

It is important to understand that, in a derivative suit, the cause of action which a stockholder-plaintiff seeks to assert is one belonging to the corporation. Therefore, the stockholder must make a pre-suit demand on the board to assert the cause of action belonging to the corporation, unless he or she can allege particularized facts showing that demand is excused.[39] If there is a majority of disinterested and independent directors on the board when the demand is made, and the demand is rejected, the plaintiff must allege particularized facts showing that the rejection was wrongful.[40]

Decisions in connection with the demand requirement in derivative actions suggest that a director must be a direct and substantial beneficiary of the challenged transaction in order for a court to conclude that the director is interested. The director does not become interested merely because the plaintiff sued the director or because a director voted for the transaction in question.[41] Moreover, the mere fact that a director has or had an association with entities which have had a commercial relationship with the corporation may not necessarily establish that the director is motivated by self-interested concerns.[42]

As an outgrowth of the differing levels of deference to directors' decisions in "demand-refused" and demand-excused" cases, there is a debate going on in the American Law Institute on the extent of the deference which should be given to decisions of independent directors in responding to demands in derivative suits. The debate has sometimes blurred the sharp distinction between the normal case where the "plain vanilla" business judgment rule applies to decisions of an independent majority of directors in acting on a demand[43] and the very unusual case where a majority of the board has a conflict of interest and the very rare device of the "special litigation committee" ("SLC") is sometimes used. In an SLC case, the *Zapata*[44] rule invites more intrusive judicial review than in the plain vanilla business judgment rule which applies to demand-refused cases. One of the key issues in the ALI debate is whether there should be any departure from the traditional business judgment rule where there has been a decision of a disinterested and independent majority of the board rejecting a demand in a case where the underlying claim (not the decision on the demand) is based on allegations of duty of loyalty violations involving persons other than those directors acting on the demand.[45] A number of commentators, including the author, have contended that judicial review of the reasonableness of the independent directors' decision to reject the demand exalts concepts of structural bias and departs significantly from the traditional business judgment rule treatment under existing law.[46]

D. Fiduciary Duties of Directors of a Target Board in a Hostile Takeover Setting.

When the incidence of hostile takeovers intensified in the late 1970s and the early 1980s and directors' positions of control were at stake, they often were accused of taking action which was not in the interests of the corporation or its stockholders,[47] but in furtherance of their own entrenchment.[48] Courts began in this period to develop a new framework to review the tactics of target boards in attempting to fend off hostile takeovers. That development intensified and became more sophisticated in the late 1980s with the surge of takeover deals which proliferated in that period. In the watershed year of 1985 in Delaware jurisprudence, the Supreme Court developed in the *Unocal* case the innovative "enhanced" business judgment rule.[49] Because of the "omnipresent specter" of director interest in maintaining control, the court altered at the threshold the customary presumptions of the business judgment rule. The application of enhanced judicial scrutiny to directors' decisions in contests for corporate control, as applied in *Unocal* and its progeny,[50] involves primarily two concepts which depart from the traditional formulation of the rule and its rationale. The first is a shifting in the burden of proof (or at least the burden of going forward with the evidence) requiring directors to show by their good faith[51] and careful investigation that they reasonably perceived a threat to corporate policy and effectiveness. The second involves judicial review of proportionality: was the action taken reasonable in relation to the threat?[52]

The "enhanced" business judgment rule with its proportionality test is not a finding that in such cases there is necessarily a violation of the duty of loyalty. Accordingly, *Unocal* does not necessarily require court review for entire fairness, unless it is determined that the business judgment rule does not apply. In *Revlon* and *MacMillan*, for example, the Court held that the board did flunk the *Unocal* test and violated both the duty of loyalty and the duty of care.[53] Interestingly, in *Polaroid I*,[54] Vice Chancellor Berger used an unusual judicial review technique by proceeding directly to the fairness issue without deciding that there had been any duty of loyalty violation and found the action of the target board to be fair under the circumstances.

Where there is a sensitive transaction such as a "crown jewel" lock-up, stock issuance to a white knight or ESOP, refusal to redeem a poison pill, a restructuring, a management led buy-out, an auction or other control transaction, the courts have examined the vigor and vigilance of the independent directors.[55]

E. Use of Special Committees.

The Delaware courts have held that the presumptions of the business judgment rule are heightened where there is a majority of disinterested and independent directors.[56] Today most boards of public companies consist of a majority of outside directors. While occasionally the independence of some outside directors may be open to question in certain contexts, today's directors (of public companies at least) are, for the most part, honest, conscientious and concerned about behaving properly, even punctiliously, in carrying out their fiduciary duties. Adverse judgments in derivative or class action cases brought against directors for damages based on the directors' alleged breach of the due care component of the business judgment rule in decisionmaking[57] or in directorial oversight in nondecisionmaking contexts[58] are few and far between. This is perhaps attributable in part to improved directorial processes (aided by improved counseling), to strict particularized pleading requirements and to state statutes like the Delaware statute which have exculpated directors from liability for damages in certain instances.[59] In an arguable duty of loyalty area, good counseling on the process of decision-making is crucial. The threshold question in many takeover battles is how the board deals with its *Unocal* duties. Is there a "threat?" Who are the decisionmakers? Can the decisionmakers "just say no?" Is the response proportional to the threat?[60] When is the company "for sale?" When is a special committee advisable? The scope or standard of judicial review of directorial decisionmaking will often be determined or shaped by the process used by the decisionmakers and whether they properly supervised and directed the process.[61]

A new body of law relating to the use of special committees of independent directors has been developing over the past few years.[62] The special committee approach has many applications in potential conflict settings, most notably those generating court skepticism in management-led buyouts.[63] It has been employed in interested director transactions including mergers of affiliates,[64] derivative suits[65] and in various applications of defenses to hostile takeovers.[66]

The space limits of this article do not permit a full exposition of the developing law of special committees in any of these various contexts, but a few staccato counseling observations in the takeover context are in order. These observations are sufficiently generic that they might be applicable in several settings, including, but not limited to, those implicated in a derivative action or when the company is in a "Revlon mode."[67] The key concepts to be applied to the composition, appointment and processes of the special committee of disinterested directors include: (1) independence of the disinterested directors and their advisors; (2) untainted appointment processes; (3) good faith; (4) vigorous efforts to obtain the best available information and to consider the proposed course of action; and (5) a documented record setting forth a logical decisionmaking framework and rational bases for the decision. There are, of course, subsets to these generic topics. Good counseling by legal and financial advisers is essential to instill and implement these concepts.[68] Pitfalls[69] to be avoided include, but are not limited to, the following: (a) the CEO should not participate in the process, including the appointment of the committee, if he has any taint of a conflict;[70] (b) the members of the committee should not have unusually close personal or business relations with the directors who have conflicting interests;[71] (c) the committee itself should exercise due care in hiring its own legal counsel and financial advisors;[72] (d) the committee's good faith should be genuine and it should be demonstrated throughout the process by its diligence, vigor and independence;[73] (e) the committee should not be, or give the impression that they are, "supine" or "torpid" or that their process is a "charade" when dealing with interested management;[74] (f) such management should be isolated from the sale or the work of the committee and the auction process should not favor or appear to favor one bidder over the other;[75] and (g) there should be adequate and objectively supported bases for the committee's final determination.[76]

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CONCLUSION

As noted above, this article only scratches the surface. A much more comprehensive analysis is needed by the counselor. It is hoped, however, that the footnotes to this article contain some clues to the sources to which one should look in developing an analysis and plan for counseling directors on the duty of loyalty and the use of special committees.

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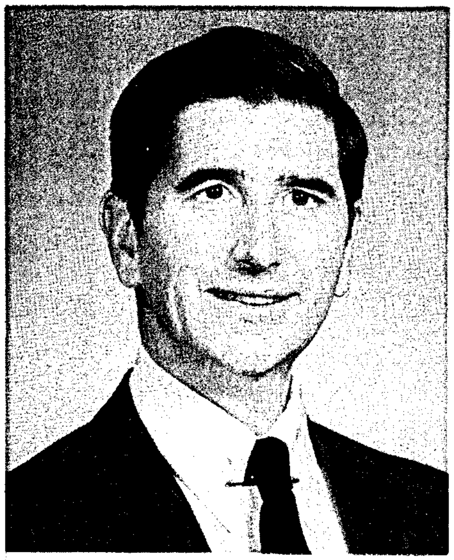
The author is grateful to Kevin G. Abrams and David L. Finger, both of Richards, Layton & Finger, for their valuable assistance in the preparation of this article. The firm was involved in some of the cases discussed in this article. The author reserves the right to publish this article or portions of it in other publications.



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TENDER OFFERS AND THE DELAWARE CORPORATION LAW -- DELAWARE'S BALANCED RESPONSE

Craig B. Smith and Clark W. Furlow

Events of great moment often pass unnoticed while those of lesser consequence may occasion much fanfare. So it is with Section 203 of the General Corporation Law. Enacted at the height of corporate takeover activity, amidst a heated national debate on the economic effects of corporate takeovers, Section 203 drew the attention of the national media, federal officials, and leaders of corporate America. But the economic winds have shifted. Junk bonds and those who masterminded them stand in disfavor. The hostile takeover, at least in the form addressed by Section 203, is for now a thing of the past, leaving Section 203 as a statutory sentinel to a bygone era in the economics of corporate control.

Comparatively little attention accompanied the 1967 revision of Delaware's merger statutes to permit elimination of stockholders in a merger. Prior to 1967, when corporations merged, stockholders of the constituent corporations received shares or other securities of the surviving corporation. The 1967 revision expanded the permissible consideration in a merger to include cash or securities of corporations other than the surviving corporation. This change vaulted the merger over a sale of assets as the preferred technique for acquiring other corporations.[1] At the same time, it laid the statutory foundation on which hostile takeovers would be constructed in the decade to follow. Twenty years later, Section 203 became a necessary counterpoint to the statutory power to cash out stockholders.

Acquirors learned that by offering stockholders a premium over market in a tender offer, and threatening to cash them out in a merger following the tender offer either at a price below the tender offer price, at an uncertain price, or for consideration of uncertain value, such as subordinated debentures, an acquiror could coerce stockholders into tendering. A failure to tender left the stockholder without a pro rata share of the premium over market paid in the tender offer, and with only the lesser value offered in the second step transaction. While the tender offer price might be above the current market price, it was typically below a perceived higher intrinsic value of the company as a going concern.

The decline in the junk bond market and other changes in the national economy have for now materially reduced hostile takeover activity. As takeovers recede in importance, so too does Section 203. However, the process by which Section 203 was drafted and enacted into law was remarkable. The Delaware corporate bar and the Delaware legislature proceeded deliberately and responsibly to fashion a statute that on the one hand addressed demonstrated injuries to stockholders and on the other assured that the ability of stockholders to sell into a fairly priced offer was not frustrated. The result was a statute that reassured Delaware corporations by placing additional negotiating power in the board of directors, protected stockholders from certain abusive takeover tactics, and encouraged fully priced non-coercive takeovers even if opposed by incumbent management.

Acquirors learned that by offering stockholders a premium over market in a tender offer, and threatening to cash them out in a merger following the tender offer either at a price below the tender offer price, at an uncertain price, or for consideration of uncertain value, such as subordinated debentures, an acquiror could coerce stockholders into tendering.

Section 203 balances the benefit of an unrestrained market for corporate stock against the generally recognized abuses incident to two-tiered, highly leveraged takeovers. The statute is designed to encourage an acquiror to negotiate an acceptable transaction or to make a fully-priced offer for all shares, while discouraging highly leveraged two-tiered offers. It achieves those objectives by prohibiting for three years any material transactions between the acquiring company and the target company unless the board of directors of the target company approves the acquisition in advance, the acquiror obtains 85% of the target's voting stock (excluding shares held by inside directors and certain employee stock ownership plans) in the transaction in which the acquiror first acquires over fifteen percent of the target's voting stock, or the transaction is approved by two-thirds of the stock not owned by the acquiror.[2] Thus, while the operation of Section 203 places an emphasis on pre-acquisition negotiations, should such negotiations fail, the statute encourages fairly priced offers for any and all stock. The eighty-five percent exemption allows stockholders to, in effect, overrule any decision by the board of directors to reject a proposed bid.

The current Section 203 operates in a more sophisticated manner than Delaware's first attempt in 1976 to protect stockholders from hostile takeovers. A "first generation" takeover law, former Section 203 was designed to delay both the commencement and the consummation of a tender offer by imposing an obligation to furnish certain information to the target company prior to the commencement of a tender offer.[3] Like similar statutes adopted in other states, Delaware's first attempt ran afoul of the United States Constitution. Perceived as imposing an indirect burden on interstate commerce in violation of the commerce clause and preempted by federal law regulating tender offers, Section 203 was held unconstitutional. The correctness of that view was confirmed by the United States Supreme Court's 1982 decision in *Edgar v. MITE Corporation.*[4]

(Continued on page 36)

In the wake of *Edgar v MITE*, other states began adopting "second generation" statutes designed to protect corporations and their stockholders from hostile takeovers. Delaware delayed the adoption of such a statute because of substantial doubts concerning its constitutionality. Indeed, lower federal courts generally refused to enforce such second generation statutes on pre-emption and commerce clause grounds. In April of 1987, however, the United States Supreme Court in *CTS Corporation v. Dynamics Corporation of America* found Indiana's second generation takeover statute to be neither preempted by federal law nor barred by the commerce clause.[5] That decision generated increased pressure on state legislatures to adopt new and more effective statutes to deter hostile takeovers. Many states hastily adopted clearly protectionist statutes, often to deter actual or threatened takeovers of corporations either incorporated in or having a principal place of business in the state.

From these efforts, four basic versions of takeover statutes emerged. "Control-share acquisition statutes" prevented an acquiror from purchasing a control block of stock or voting control unless a majority of the disinterested stockholders were permitted to vote to allow it to do so. In practical effect, such statutes allowed the minority stockholders to decide whether they wanted the change in control. A negative vote would leave the acquiror with ownership of a majority of the equity but no power to control corporate affairs. "Fair price laws" required the acquiror to offer to stockholders the same amount and kind of consideration in the second step of the acquisition, thereby eliminating the possibility of a front-end loaded two tier tender offer. "Control-share cash-out laws" provided that once a person acquired a specified percentage of the target's stock, remaining stockholders would have the option of selling their shares to the acquiror at an appraised fair value. "Business combination moratorium statutes" precluded the acquiror from effecting any "business combination" (a term broadly defined to include almost every conceivable method by which the controlling stockholder could cash out the minority) for a given period of time, generally three to five years.

Almost immediately after the United States Supreme Court's decision in *CTS*, the Delaware corporate bar began studying whether Delaware should adopt a second generation takeover statute. In November of 1987, the Delaware corporate bar distributed throughout the country a discussion draft of Delaware's proposed takeover statute. Over 150 comment letters were received, including letters from individual commissioners of the Securities & Exchange Commission and the Federal Trade Commission, principal executives of major corporations, corporate law departments, corporate lawyers, stockholders, trade unions, and others. Delaware in effect opened its deliberations to the public and actively sought comment. The national press followed the process with interest.

After consideration of and revisions in response to the many comments, the Corporation Law Section of the Bar Association approved the proposed statute in early January of 1988 after two hours of debate. Later that same day the Executive Committee of the Bar Association gave its approval.

When the Delaware legislature convened later in January of 1988, it immediately took up the proposed legislation. An intense period of lobbying followed, and the House and Senate Judiciary Committees convened a joint hearing to accept testimony for an against the statute. On January 26, 1988, while T. Boone Pickens, Jr., a well-known player in the takeover arena was speaking to the Senate in opposition to the legislation, the House of Representatives adopted the House bill. Two days later the Senate passed the House version of the bill, and on February 2, 1988 the Governor signed the bill into law.

The intense debate over Section 203 centered on three issues: whether such a statute was in the national economic interest; whether the 85% threshold for escaping the effect of the statute was appropriate; and whether corporations should be required affirmatively to elect the benefits of the statute.

Opponents of Section 203 argued that takeovers foster important and desirable economic goals, including facilitating the redeployment of assets to more efficient uses and encouraging management to improve corporate efficiency. The Delaware corporate bar, influenced by the fact that academic research on whether takeovers were beneficial or harmful was inconclusive, focuses on Delaware's role in corporate governance, reasoning in part that "directors have a fiduciary duty to protect their own stockholders from harmful takeover attempts even if takeovers in general can be shown to help the welfare of stockholders as a class. Indeed, any attempt to make boards of directors responsible to a wider concept of stockholder welfare instead of their own actual stockholders runs contrary to the entire thrust of corporate law."[6]

Nonetheless, national economic policy did play a part in the adoption of the statute. In signing Section 203 into law, the Governor noted that Delaware had a unique responsibility to American business and was thus required to address the national economy in adopting Section 203.[7] This concern for the national economy was, of course, balanced by legitimate local concerns. With approximately 17% of state revenue derived from corporate franchise taxes and fees, the failure to adopt a new takeover statute threatened that source of income, because existing corporations might reincorporate elsewhere and new incorporations might decrease.

In its original form, Section 203 contemplated a 90% threshold before Section 203 became inapplicable to an acquiror. Many commentators argued that the 90% mark was unattainable, thus making the exception mere illusion. There was also concern that a 90% threshold would enable incumbent management to erect a blocking coalition of stock that would forever preclude a change in control. Responding to such concerns, the 90% threshold was lowered to 85%, and stock owned by insiders and certain types of employee stock plans were excluded from the calculation. These changes effectively reduced the amount of stock that an acquiror would have to amass in a tender offer where insiders owned or controlled substantial blocks of stock.

Finally, much debate centered over whether the statute should apply automatically or whether corporations should be required to go to their stockholders to seek the protection of the statute. Opponents argued that Section 203 would so fundamentally shift the underlying assumptions on which stockholders make their investment decision that stockholders should decide whether the protection of Section 203 was necessary.

Proponents of Section 203 argued, successfully, that it would be unfair to force corporations to seek a stockholder vote, as that process itself would advertise the corporation's vulnerability to a takeover, that no other state adopting such a statute required corporations to affirmatively opt in, and that unless Section 203 applied without the need for a stockholder vote, corporations concerned about their vulnerability were likely to reincorporate in another more protectionist jurisdiction.

Adoption of Section 203 had an immediate effect. Critical to financing a tender offer is the acquiror's ability to eliminate the minority and thereafter deal freely with the acquired company's assets. Tender offers, and specially two-tiered leveraged offers, depend on the acquiror's ability to sell assets of the target or to mortgage all of the assets of the target as security for short-term debt used to finance the acquisition. By limiting the acquiror's ability to deal freely with the target company's assets immediately following the acquisition, financing becomes more expensive or, in some cases, unavailable.

Aside from its obvious effect, Section 203 may have had a more subtle influence. Before the adoption of Section 203, even where an acquiror made an all cash offer for all shares, the price of that offer need only be high enough to attract at least a majority of the stock. Thereafter, the minority could be eliminated. With Section 203's 85% threshold, in the all cash all shares offer, the offer price must be sufficiently high to attract not a majority but 85% of the stockholders. Takeovers became more expensive. That, alone, was hardly a death knell for takeovers. But when combined with the leveling-off of the economy, the apparent dismantling of the junk bond market that financed a substantial portion of tender offers, and the criminal indictment and prosecution of certain leading players in the takeover arena, it contributed to the decline of the hostile tender offer.

Following its adoption, acquirors immediately challenged the constitutionality of Section 203 in the federal courts. In large measure, the challenge was a replay of the debate that took place within the Delaware corporate bar and the Delaware legislature. There was substantial focus on the operation of the 85% threshold and whether the exemptions from the operations of Section 203 were real or illusory. The federal courts found that although Section 203 did restrict a stockholder's choice in the tender offer context, there was a legitimate state interest in protecting stockholders, Section 203 did not preclude tender offers, it protected stockholders from certain types of coercion, did not give inordinate advantage to management, created no delay, nor did it impose the state's own view of fairness on stockholders.[8] As one federal judge put it:

> "Section 203 is an exquisitely crafted legislative response to a variety of perceived problems. Were it less delicately constructed to remain within the sphere of constitutionality, the outcome of this court's analysis might be quite different. but nothing prevents a state legislature from extending its power to the limits of constitutionality."[9]

While Delaware's Section 203 appeared to push constitutionality to its limits, other federal decisions have since upheld even more stringent statutes restricting corporate takeover activity.[10] With the present decline in takeover activity, it seems doubtful that any significant pressure will exist for altering Section 203. Should it arise, however, the Delaware corporate bar and the Delaware legislature will have to wrestle again with the difficult issue of defining the circumstances under which corporate management may control when, to whom, on what terms and for what price an owner may sell his stock. No doubt the Delaware corporate bar and the Delaware legislature will again respond in a deliberate, responsible and balanced fashion.

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Footnotes

1. 2 E. Folk, R. Ward & E. Welch, *Folk on the Delaware General Corporation Law,* Section 251.2.

2. 8 *Del. C.* Section 203(a).

3. 60 *Del. Laws,* ch. 371, Section 1. Former Section 203 was repealed effective July 1, 1987. 66 *Del. Laws,* ch. 136, Section 6 (1987). The history of its unconstitutionality is summarized in *Lorrall Corp. v. Sanders Assoc., Inc.* 639 F.Supp 639 (D.Del. 1986).

4. 457 U.S. 624 (1982).

5. 107 S.Ct. 1637 (1987).

6. M. Goldman & E. McNally, *The Proposed Delaware Takeover Statute: A Report to the Delaware General Assembly,* p. 5, reprinted in C. Smith & C. Furlow, *Guide to The Takeover Law of Delaware.* Appendix P (1988).

7. Statement by Governor Castle regarding House Substitute One for House Bill 396, February 2, 1988, p.2, reprinted in C. Smith & C. Furlow, *Guide to The Takeover Law of Delaware,* Appendix CC (1988).

8. *See. e.g. Black & Decker Corporation v. American Standard, Inc.,* 679 F.Supp 1183 (D.Del. 1988); *BNS, Inc. The Koppers Company, Inc.,* 683 F. Supp 458 (D.Del. 1988); *R.P. Acquisition Corp. v. Staley Continental, Inc.,* 686 F. Supp 476 (D.Del. 1988); *City Capital Associates, Ltd. v. Interco, Inc.,* 696 F.supp 11551 (D.Del. 1988).

9. *BNS, Inc. v. Koppers Company, Inc.,* 683 F.Supp. 458, 473 (D.Del. 1988).

10. *Amanda Acquisition Corp. v. Universal Foods Corp.,* Civ. Nos. 89-1581 and 89-1712 (7th Cir. May 24, 1989), [1989 Transfer Binder] CCH Fed. Sec. L.Rep. Paragraph 94,436.

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THE ESOP AS AN ANTI-TAKEOVER DEFENSE

Peter J. Walsh, Jr.

Employee stock ownership plans (ESOPs) are tax qualified employee benefit plans regulated by the provisions of the Employment Retirement Income Security Act of 1974 (ERISA).[1]

Since their legislative creation, ESOPs have been implemented by corporate management principally to boost productivity and to cut corporate taxes. Increasingly, however, ESOPs are playing a significant role as takeover defenses in publicly-held corporations. By holding a relatively large block of stock that is likely to be aligned with management, an ESOP may impede stockholder action designed to acquire corporate control.

For those companies incorporated in Delaware, the effectiveness of an ESOP as an anti-takeover measure may be materially enhanced by the operation of the Delaware Business Combination Statute (Section 203).[2] Section 203 prohibits an "interested stockholder" -- generally defined as the beneficial owner of 15% or more of the outstanding stock -- from effecting a business combination with the issuing corporation unless one of several conditions is met. One of those conditions is that the interested stockholder acquire 85% or more of the outstanding shares in a tender offer. Specifically excluded from the 85% condition are shares held by officers and directors as well as shares held by ESOPs in which participants do not have the right to indicate confidentially whether shares held in their behalf should be tendered. Thus, by negative implication, stock held by ESOPs with confidential "pass-through" tendering or voting is included in the 85% calculation. Most ESOPs now provide for such pass-through voting.

Because employee participants generally are inclined not to tender in response to a hostile offer, especially when job security is in issue, it becomes increasingly difficult for a tender offeror to meet the 85% requirement as the percentage of shares held by the ESOP increases. Thus, for example, where an ESOP providing for confidential tendering holds 15% or more of the outstanding stock, a would-be hostile acquiror may find it virtually impossible to attain the requisite 85% of the shares, assuming the ESOP-held shares uniformly oppose the offer.

This potential blocking effect is what prompted Shamrock Holdings, Inc. to challenge the validity of an ESOP implemented by Polaroid Corporation in the now well-noted case of *Shamrock Holdings, Inc. v. Polaroid Corporation*.[3] In July of 1988, after Shamrock had expressed an interest in Polaroid but before it had commenced a tender offer, the Board of Directors of Polaroid approved the adoption of an ESOP to hold approximately 14% of Polaroid's outstanding shares. The Polaroid ESOP was "shareholder neutral," in that it would not be funded by the corporation and its stockholders, but rather by an ESOP loan and employee pay cuts. The ESOP provided for confidential pass-through voting and, moreover, contained a "mirroring" provision requiring the trustee of the ESOP to tender unallocated shares in the same proportion as allocated shares were tendered by individual employee participants. As is generally the case, unallocated shares would be held in a suspense account and would be allocated to individual employee accounts as the ESOP loan was repaid. As the Court of chancery recognized, although most of the shares held in the Polaroid ESOP had not yet been allocated to participants' accounts, those employees nonetheless effectively controlled the tendering decision with respect to the unallocated shares.

The Court of Chancery in *Polaroid* upheld the ESOP after a trial on the merits. Significantly, in ruling upon the validity of the Polaroid ESOP, the court did not apply the traditional (or even modified) business judgment rule, but instead applied the "entire fairness" standard, enabling the court to exercise its own judgment with respect to the ESOP. The Vice Chancellor reasoned that a review of this degree was appropriate because the Board failed to inform itself adequately of certain issues and to recognize its actions as defensive under the *Unocal* case.[4]

Despite applying this rigorous standard, the court ruled that the Polaroid ESOP was entirely fair to the corporation and its shareholders. The anti-takeover effect of the ESOP did not make it "less than fair," the court stated, but it "may mean that a potential acquiror will have to gain the employees' confidence and support in order to be successful in its takeover effort."[5] The court noted that the exclusion from Section 203 of ESOPs with pass-through voting suggested a policy determination that confidential pass-through voting was not presumptively to be viewed as interfering with an offeror's ability to attain the 85% ownership level.

The *Polaroid* decision was appealed to the Delaware Supreme Court, which remanded the case to be reconsidered in conjunction with subsequent defensive measures taken by Polaroid in response to Shamrock's tender offer. On remand, the Court of Chancery made no revisions to its earlier decision upholding the ESOP.[6] The Delaware Supreme Court refused to grant an injunction pending the appeal of this later decision, causing Shamrock to withdraw its offer and voluntarily dismiss the appeal.

The *Polaroid* decision thus stands as the latest word on the propriety of ESOPs as a takeover defense for Delaware corporations. While it is true that every case must rise or fall on its own facts, the *Polaroid* decision at least suggests that a "shareholder neutral" ESOP implemented before the emergence of a specific threat and in a fully informed manner is likely to be sustained, even though it may have an

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anti-takeover effect. The *Polaroid* decision may therefore spur many Delaware corporations to adopt ESOPs in part for their anti-takeover benefits.

But, significantly, the utility of an ESOP as a defensive measure is not without very real limitations and, for this reason, tax and business factors appear to be equally (if not more) important considerations for companies adopting ESOPs.[7] For example, as the Court of chancery recognized in *Polaroid,* although employees tend to be "friendly" to management in unsolicited takeover attempts, this is not necessarily so. Indeed, a key fact in the *Polaroid* case was the absence of proof that the ESOP participants necessarily would side with management in a hostile tender offer.[8]

Furthermore, uncertainty exists as to the propriety of proportionate or mirrored voting of unallocated shares, which in many cases constitute the bulk of the shares held by the ESOP. In the midst of the *Polaroid* litigation, the Department of Labor (DOL), which administers and enforces ERISA, wrote to the trustee of the Polaroid ESOP regarding the trustee's obligations under ERISA. In that letter of February 23, 1989, the DOL took the position that in response to a tender offer, the ESOP trustee was required by its fiduciary duty owed to the participants and beneficiaries of the ESOP to exercise its own judgment with respect to tendering unallocated shares.[9] According to the DOL's reading of Section 404(a)(1)(D) of ERISA,[10] a trustee may therefore be required to tender unallocated shares, even though the terms of the ESOP direct the trustee to tender or vote in proportion to the tendering or voting of allocated shares. Because Shamrock withdrew its offer, the DOL's position had no occasion to be tested. Moreover, the question remains as to what effect, if any, the DOL's position has on the 85% calculation for purposes of Section 203.

This issue has since been raised in *Kingsbridge Capital Group v. Dunkin' Donuts,Inc.*,[11] where a tender offeror sought a declaration that shares held in Dunkin' Donuts' ESOP should not be counted for purposes of Section 203. The Dunkin' Donuts ESOP provided for mirrored tendering of unallocated shares, which constituted virtually all of the stock held in the ESOP. The argument advanced by the offeror was that employees voting allocated shares were essentially fiduciaries *for those* employees to whose accounts unallocated shares would be distributed in the future. And, consistent with their duties as fiduciaries under ERISA and the common law, those employees did not have the "right" (within the meaning of Section 203) to make a confidential tendering decision. Unfortunately, the Court of Chancery never reached this issue, as it concluded that the offeror's request for declaratory relief was not ripe for adjudication.

As a result, the Delaware courts have yet to address the interplay between the tendering of unallocated shares and Section 203. For Delaware corporations with newly adopted ESOPs holding primarily unallocated shares, a resolution of the issue in favor of the DOL's position could have important ramifications. If mirrored voting provisions are invalid or must yield to the trustee's own discretion with respect to tendering, then the blocking feature of the ESOP may be wholly or partially eclipsed, rendering the ESOP ineffective against a hostile offer. Support for the DOL's position arguably can be found in several recent federal cases intimating that the trustee is required by ERISA to act solely in the interest of the plan beneficiaries.[12] None of those cases, however, specifically address the voting of unallocated shares in the context of Section 203. The resolution of this issue therefore warrants careful attention, as it will surely effect the role of ESOPs as a takeover defensive measure.

Footnotes

1 29 U.S.C. Section 1001 *et seq.*

2 8 Del.Ch. Section 203.

3 Del.Ch., 559 A.2d 257 (1989).

4 *Unocal Corp. v. Mesa Petroleum Co.*, Del.Supr., 493 A.2d 946 (1985). In *Unocal*, the Supreme Court of Delaware Explained that when directors oppose a hostile takeover, there arises "the omnipresent specter that a board may be acting primarily in its own interest, rather than those of the corporation and its shareholders..." *Id.* at 954. Accordingly, when a board of directors adopts defensive measures, the initial burden lies with the directors to show: (i) that they had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed," and (ii) that the defensive measure adopted was "reasonable in relation to the threat posed." *Id.* at 955. The directors must satisfy these conditions by showing good faith and reasonable investigation before their decision will be accorded the protections of the business judgment rule.

5 559 A.2d at 274.

6 *See Shamrock Holdings, Inc., v. Polaroid Corp.*, Del.Ch., 559 A.2d 278 (1989).

7 On November 22, 1989, Congress passed the Revenue Reconciliation Act of 1989, several of the provisions of which affect ESOPs. Perhaps the most significant of these is the preservation of a deduction for dividends paid on stock held by an ESOP if the dividends are used to pay the loan for the purchase of the ESOP-held stock. Chevron Corporation, a Delaware corporation and the nation's fourth-largest oil company, recently adopted an ESOP, citing this provision as its motivation for doing so. *See* Wall St. J. Nov. 28, 1989, at A3, col. 1.

8 *See* 559 A.2d at 274.

9 With respect to allocated shares, the DOL took the position that an ESOP may authorize the participant to instruct the trustee as to tendering and the trustee may observe that instruction, subject to the provisions of ERISA. Labor Department Opinion Letter On Tender Offers, Feb. 23, 1989, *reprinted in* Pens. Rep. (BNA), Vol. 16, No.1 9, at 390 (March 6,m 1989). *But see Central Trust Co., v. American Avents Corp.*, C.A. No. C-1-88-883 (S.D. Ohio, May 26, 1989). In that unreported decision, the United States District Court for the Southern District of Ohio considered the tendering responsibilities of the trustee of an ESOP for a closely-held Ohio corporation. The ESOP in *American Avents* had been amended to provide for pass-through voting with respect to allocated shares and was to be terminated, with each participant to receive $5 per share. A former employee of American Avents, however, made an offer to purchase all of the shares held in the ESOP for $12 per share. The trustee sought a declaratory judgment with respect to its decision to tender the ESOP shares pursuant to the offer. The court in *American Avents* held that, under ERISA and the common law of

trusts, the trustee could properly disregard the pass-through provision and could tender all of the shares of stock held by the ESOP. The court reasoned that Section 409(e)(3) of the Internal Revenue Code (IRC) did not require the application of the pass-through provision with respect to the allocated shares because the participants' voting rights were established not in the original issuance of shares but by an amendment to the ESOP. It would appear that IRC Section 409(e)(3) normally would require the trustee to observe the pass-through voting provision. *See* 29 U.S.C. Section 409(e)(3).

10 C.A. No. 10907, Del.Ch., Chandler, V.C. (Aug. 7, 1989).

11 29 U.S.C. Section 1104.

12 *See e.g., Leigh v. Engle*, 727 F.2d 113 (7th Cir. 1984); *Donovan v. Bierwirth*, 680 F.2d 263 (2nd Cir.), *cert. denied*, 459 U.S. 1069 (1982); *O'Neill v. Davis*, 721 F.Supp. 1013 (N.D. Ill. 1989).

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DELAWARE HOLDING COMPANIES - TAX PLANNING STRATEGY

Howard H. Simon and David R. Glickman

While corporations have long focused their tax planning strategies on federal income taxes, minimizing state and local taxes has taken on new importance. Labeled the "Small Wonder" state, Delaware has become a magnet to many corporations because of its favorable business environment. In fact, over 50% of the Fortune 500 companies and over one-third of the New York and American Stock Exchange companies are presently chartered in Delaware. Why Delaware? One reason is our favorable tax laws.

The Delaware corporate income tax code exempts from taxation corporations whose activities within Delaware are restricted to the management of intangible investments and the collection and distribution of income from these investments (Sec. 1902(b)(8) Title 30, Delaware Code). These corporations set up in Delaware are termed Delaware Holding Companies (DHCs). Intangible investments include investment in stocks, bonds, notes and other debt obligations. Also trademarks, trade names and similar types of assets are included in this definition. This translates into potentially big state tax savings for all corporations who would have been taxed on passive income in a domicile state other than Delaware.

The DHC can become a strategic part of state tax planning because it essentially shifts taxable income from the domicile state to tax exempt income in Delaware. Another bonus associated with DHCs is that the costs of incorporation are nominal. This article will review in detail the tax consequences of forming a DHC, the common uses and activities of such companies, and the potential state tax benefits from incorporating in Delaware.

Delaware Holding Company Activities

Forming a DHC provides corporations almost endless possibilities to structure transactions in order to shift taxable income to state tax exempt income in Delaware. A DHC may be formed to hold interest bearing securities, commercial paper or intercompany receivables. Any gain recognized on the sale of these securities is exempt from Delaware corporate income tax. Furthermore, royalty or license fee income earned as a result of patents, trademarks, copyrights and secret processes will be exempt from taxation. In some cases, a DHC's main objective is to create an expense, thereby reducing the parent company's tax. For example, a corporation with real estate holdings could set up a DHC to hold real estate and lease the use of the real estate back to the parent. The net result of this transaction would be twofold: 1) The lease income and monies earned on it would be state tax exempt for the DHC, and 2) the parent would incur an expense from the lease payments at the parent level.

Forming A Delaware Holding Company

The most common corporate structure operating as a DHC is where the parent establishes an investment subsidiary. In this structure, the parent capitalizes the DHC by exchanging intangible assets for stock in the newly created company. Pursuant to Internal Revenue Code Section 351, the exchange will not trigger any federal tax consequences. Section 351 states that no gain or loss shall be recognized when property is transferred to a corporation in exchange for stock and securities if the transferor is in control of the transferee corporation immediately after the transfer. Another option to consider is to have the parent of an operating subsidiary become the DHC itself.

There are a number of state income tax savings strategies which can be effectively implemented through DHCs. Specifically, the areas of investment income, royalty income, sales of a subsidiary, holding partnership interests, minority stock interests, and foreign source income will be considered.

Investment Income

The contribution of income-producing assets to a DHC in exchange for stock creates investment income recognized by the DHC that will be exempt from Delaware income taxation. If the parent needs funds from the holding company, the DHC can declare a dividend on earnings to the parent. If the dividend exceeds the accumulated earnings and profits of the DHC, the balance will constitute a return of capital.

Another technique often employed to get funds from a DHC to the parent is to have the holding company make a loan to the parent at prevailing market rates. The monies loaned to the parent could be obtained by the DHC through a third party using its investments as collateral or by liquidating some of the investments. Consequently, the interest received on the loan by the DHC will be exempt income. The parent receives a benefit because the interest expense incurred will reduce its taxable income.

Example - Assume a non-Delaware corporation earns $400,000 of interest income annually and that the company's effective state tax rate is 10%. By establishing a DHC and transferring the investments that generated the interest income, the parent would realize an immediate $40,000 state tax savings. The $400,000 could be transferred to the parent as a dividend or could be loaned to the parent. There would then be $400,000 available rather than $360,000.

Minority Stock Interest

Another way to take advantage of a DHC is to convert a minority interest by a non-Delaware corporation in the stock of another company into the stock of a wholly owned DHC. For example, assume a parent corporation owns a 10% interest in ABC Company. If the parent sets up a DHC and contributes the 10% interest in ABC Company to the DHC in exchange for all the stock of the DHC, dividends paid by the ABC Company will be exempt from tax in Delaware.

Sale Of Subsidiary

DHCs are often used to shield corporations from paying state taxes on a gain from the sale of a domestic or foreign subsidiary. By establishing a DHC and contributing the stock of the subsidiary to be sold the gain will be exempt from Delaware tax. However, parent corporations should be wary of the taxing authorities in their domicile state who could possibly void the benefits of transferring the stock on the grounds that it was undertaken solely to avoid state taxes. To minimize any possible exposure, time should be allowed to elapse between the transfer of the stock to the DHC and the subsequent sale of the subsidiary. From a planning perspective, the parent can let the DHC invest the sales proceeds into interest bearing securities, and earn interest income which will be exempt from state taxation.

Royalty And Other Income

Corporations that possess intangible assets such as patents, trade names, copyrights, franchises, and secret formulas can greatly enhance their tax position by forming a Delaware Holding Company. By exchanging intangible assets for stock in the DHC, the parent can easily shift taxable income from one state to exempt income in Delaware. Subsequent to the transfer, the investment subsidiary contracts with other related companies to use the intangible assets in exchange for royalty income. The income from these sources is collected and invested by the subsidiary. Pursuant to Delaware Code Sec. 1902(b)(8), the royalty income would be exempt from Delaware corporate income tax so long as the activities are limited to the maintenance and management of intangible assets. Consequently, the parent corporation will experience lower state taxable income and lower state taxes as a result of the royalty fees paid to the DHC subsidiary.

Holding Partnership Interest

Exchanging a partnership interest that ceases to shelter income for stock in a DHC may yield significant state tax benefits. In the early stages of a partnership, the partners typically recognize losses so as to shelter other income. Years later, however, when the assets are almost fully depreciated and the interest deductions are minimal, the partnership often begins reporting taxable income. Furthermore, if the partnership holds real estate, the partnership will usually recognize a gain upon the sale of the property. To reap tax benefits, the partnership interest should be retained by the operating company as long as the partnership generates losses that can be utilized to shelter other taxable income of the operating company. When the partnership begins to report taxable income, the partnership interest should be exchanged for stock in a DHC in order to save taxes. The holding of a partnership interest will qualify as a passive activity and the income generated will be exempt from Delaware taxes. Another reason to consider the technique described above is that if a partnership interest is held by a DHC, and is subsequently sold at a gain, the gain will be exempt from Delaware state taxes.

Howard H. Simon, CPA, managing partner of Simon, Master & Sidlow, P.A., has been in public accounting for more than 25 years. His area of specialization includes tax and management consulting. Before founding the firm, Howard was a partner with a Big Eight accounting firm. His affiliations include: Delaware Society of Certified Public Accountants. American Institute of Certified Public Accounts, Wilmington Tax Group, and CPA Associates.

A certified public accountant in the states of Delaware and Louisiana, he has lectured extensively on management and tax topics. He is a graduate of the University of Delaware where he received a B.S. degree with a major in accounting. He serves the University as a member of the Accounting Department Advisory Board.

International Business Activities

Income from a foreign source is an area in which corporations can make good use of a DHC. A foreign corporation that establishes a DHC for purposes of reinvesting income and accumulating capital in its U.S. operations will find its investment income exempt from state income taxation.

A foreign parent corporation that sets up a DHC does so to avoid foreign currency controls that may be imposed if the income is repatriated and the parent thereafter desires to reinvest the funds in the United States. Another reason foreign companies seek to retain income in the U.S. is to avoid foreign income taxes on dividends paid by U.S. companies, especially where the foreign tax is calculated with little or no

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David R. Glickman is a senior tax accountant with Simon, Master & Sidlow, P.A. Previously, David was a tax analyst with a national accounting firm. He also worked as a tax analyst at DuPont.

He graduated in 1982 from Villanova University with a B.S.A. in accounting. In 1986, David received his J.D. degree from Villanova Law School.

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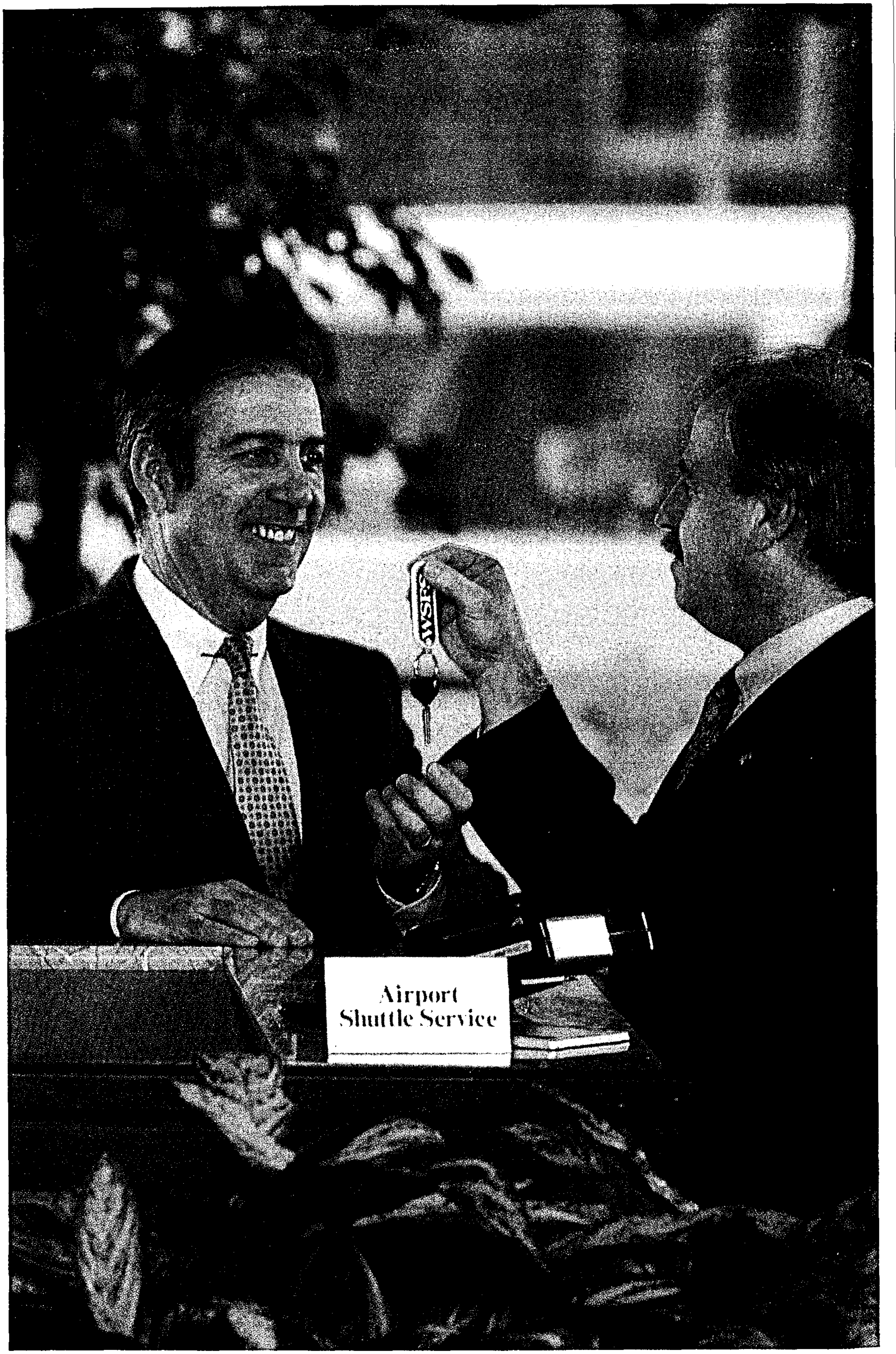

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WSFS V.P. and Relationship Manager Bob Gehring with Joe Longo, Chairman and CEO, Airport Shuttle Service/Diamond Cab/Yellow

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credit for deemed paid taxes by the subsidiaries. Furthermore, when a foreign parent company needs cash, the use of a DHC might lower the cost of repatriating funds through the use of capital loans or by timing distributions to achieve the maximum tax benefit to the foreign parent.

Requirements For A DHC

It is evident that a DHC can be a part of sound corporate strategy to reduce state income tax. However, in order to minimize the possibility of taxation of the holding company's income in another state, i.e. the state where the parent is headquartered, a DHC must have sufficient "substance" within Delaware in both facilities and capabilities. "Substance" or nexus is best accomplished by demonstrating that the taxpayer's principal place of trade or business is within Delaware. Accordingly, the DHC should make every effort to establish contacts between itself and the State of Delaware. The following is a list of arrangements and supporting services recommended to establish nexus in Delaware.

1. Own or lease usable office space, furniture and office equipment in Delaware.

2. Contracts should originate in Delaware and use a Delaware address.

3. The corporation should have officers and/or employees who reside within the State of Delaware.

4. The corporation should pay Delaware payroll taxes.

5. Bookkeeping and accounting functions should be performed by local Delaware Certified Public Accountants, or others capable of providing these services.

6. The corporation should maintain a checking account with a Delaware bank.

7. The corporation's directors should hold a meeting in Delaware at least once a year.

8. The custody of the assets invested should be within Delaware. Generally, this is accomplished by using the trust or custody department of a local bank or brokerage firm.

9. Income should be deposited in and distributed from a Delaware bank account.

10. Corporate stationery, telephone listing and business cards should utilize a Delaware address.

11. All tax returns should utilize a Delaware address.

The above elements are not requirements of the State of Delaware, but are considered to be the minimum arrangements necessary to establish nexus with Delaware. Delaware does require that the corporation have a registered agent as well as a registered office in Delaware. The costs for the administrative charges above along with any other expenses associated with a DHC are nominal. There is a one-time filing fee, plus necessary professional fees to establish the DHC. Besides the annual franchise tax based on authorized shares, no collateral taxes are assessed.

Summary

While the benefits of a DHC are obvious, the determination of whether or not one should be set up will ultimately depend upon the corporate income tax rate that would be applicable if the corporation did not qualify as a DHC. Another factor to consider is whether the state of domicile for the parent requires "combined reporting". In "combined reporting", the state combines the income of affiliated corporations in such a way as to include income from corporations which, but for the combined reporting, would not be subject to tax by the state. Combined reporting is geared towards those affiliated corporations associated with unitary businesses. Where a state requires combined reporting, it still allocates income among the states in which the income was produced. Despite the allocation, however, additional tax generally results from the combines reporting because allocation is based on factors such as payroll, property and sales. These factors are the basis for calculating the unitary tax. Thus, corporations doing business in one of these unitary tax states are likely to be taxed on any DHC income.

The ultimate decision as to whether or not the creation of a DHC is the correct tax strategy for a corporation depends upon the tax situation of the parent corporation. As illustrated in this article, if a corporation pays state taxes on dividends or interest from investments, owns valuable intangibles, pays state taxes on interest income realized from intercompany loans, then substantial state tax savings could be achieved by incorporation in Delaware. Furthermore, if a corporation owns stock in a subsidiary that is to be sold for a gain, or pays state tax on foreign source income or even owns a partnership interest, the income being subject to state taxes, then a DHC could be tax beneficial.

We have attempted to point out some of the benefits of DHCs. However, there are many others. Employing a Delaware Holding Company as part of tax planning strategy makes sense for many corporations. This planning tool is all too often overlooked. Careful evaluation by the corporation's advisors can lead to significant state tax savings. The corporation and its consultants are limited only by their willingness to aggressively plan.

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GUEST EDITORIAL

Suzanna J. Mitchell of the Rhode Island Bar

Abortion is one of the most hotly debated issues of our time. Legal, moral, ethical, and religious constructs provide some "answers" - but they are in conflict. As an attorney, a nurse and a mother, I deeply resent being told that a fertilized egg or an embryo[1] has the same rights as my daughters.

The female body naturally destroys one out of four fertilized eggs for various reasons; natural infanticide, if one accepts the pro-lifers' claim that a fertilized egg is a "person". Most of these early miscarriages go completely unnoticed by the putative mothers-to-be, because they resemble late, or heavy menstrual periods. If the pro-life advocates succeed in their quest to have a group of legislators proclaim that life begins at conception - "life" in which the fertilized egg has all the rights and privileges accorded by my five year old - then perhaps women should begin claiming tax exemptions for all miscarriages. Since the typical woman will have thirteen menstrual periods, she would be entitled to claim three additional exemptions based on the 25% natural infanticide rate. Although this is a ludicrous extension of the pro-life position, it is a logical one.

The concept of according full rights and privileges to a fertilized egg offends because it brands the use of an intrauterine device (IUD) as abortion. An IUD is a foreign object, usually wire or a synthetic, inserted into the uterus to prevent the implantation of a fertilized egg. It does not prevent conception. Thousands and thousands of women who have or previously used an IUD have been killing babies, apparently free of the grave psychological consequences which the pro-life forces insist affect women following abortions.

Mankind - theologians, doctors, judges, scientists - has debated the issue of when life begins for centuries, but no consensus has emerged. The pro-life movement disregards the ferment of this debate, and simply states unequivocally that the instant an egg and sperm fuse, that product of conception has the same rights to life, medical care, etc. possessed by my two daughters. Here is the conundrum; the fertilized egg has no brain and no brain waves.

Since the typical woman will have thirteen menstrual periods, she would be entitled to claim three additional exemptions based on the 25% natural infanticide rate. Although this is a ludicrous extension of the pro-life position, it is a logical one.

The Harvard Criteria for the removal of life support systems, based on the concept that death occurs on cessation of brain activity, requires documentation that brain waves are absent for a certain number of hours before the equipment is disconnected. Most hospitals accept these criteria. Even Catholic hospitals endorse the position that a "brain dead" person is actually dead, and so patients with heartbeats and blood pressure are removed from life support systems and allowed to die. When the criteria are utilized there is no contention that the comatose patient is being killed.

How is it that a fertilized egg or an embryo, which has not yet developed a brain and thus has no brain wave activity, is "alive" - and the woman who elects abortion is a murderess?

It is unfortunate that legislators, still overwhelmingly "white men of means", are becoming the arbiters of the most personal decision a woman can ever make. Let me remind them, as an unknown pundit observed; if men could get pregnant, abortion would be a sacrament.

1 *Medically, an embryo is the term applied to a product of conception through the third month; thereafter, the medical term is fetus.*

The discussion above appeared in the July-August 1990 edition of the Rhode Island Bar Journal. We thank the Journal and the author for permission to reprint it.

Ms. Mitchell's statement is one of the most ingenious and thought-provoking I have yet read about a topic that has become at once incendiary and shopworn. Her editorial has the considerable virtue of originating with someone whose training qualifies her to speak intelligently about the reproductive process.

Suzanna Mitchell holds bachelor and master degrees in nursing from Vanderbilt University. She also graduated magna cum laude from Pepperdine University School of Law. She and her husband, Robert Mann, practice law in Providence, Rhode Island. WEW

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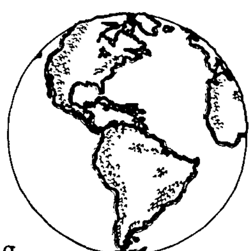

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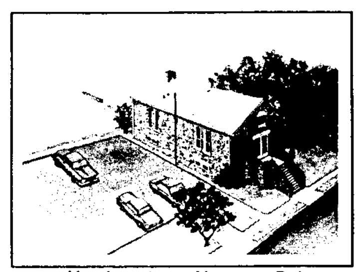

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