CORPORATE INTERNAL AFFAIRS

A CORPORATE AND SECURITIES LAW PERSPECTIVE

MARC I. STEINBERG

Foreword by Harold M. Williams

CORPORATE INTERNAL AFFAIRS

A CORPORATE AND SECURITIES LAW PERSPECTIVE

MARC I. STEINBERG
Foreword by Harold M. Williams

Quorum Books
Westport, Connecticut • London, England

Library of Congress Cataloging in Publication Data

Steinberg, Marc I.
Corporate internal affairs.

Bibliography: p.
Includes index.
1. Securities—United States. 2. Corporation law—United States. I. Title.
KF1439.S73 1983 346.73'0666 82-16619
ISBN 0-89930-039-1 (lib. bdg.) 347.306666

Library of Congress Catalog Card Number: 82-16619
ISBN: 0-89930-039-1

First published in 1983 by Quorum Books

Greenwood Press
A division of Congressional Information Service, Inc.
88 Post Road West, Westport, Connecticut 06881

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

Foreword

I am pleased to write this foreword for Professor Steinberg's analytical treatment of many of the key corporate and securities law issues facing corporations and their legal counsel today. Professor Steinberg is the author of over fifty law review articles; this is his first book. It is a most timely and worthwhile one dealing with the very important subject of internal affairs—which I view as a critical dimension of corporate accountability.

One hears frequent comments from the corporate community and the bar to the effect that corporate accountability is no longer a matter of priority concern. Whether it is depends upon how its importance is defined and the time horizon within which it is viewed. If its importance is viewed primarily defensively and in reaction to the threat of government regulation or legislative intervention, then, in the short term, the urgency has diminished. In the longer term, however, history and experience inform us that the resurgence of the issue and the danger of increased federal intervention into how the American corporation is organized and operated is fully predictable. Only the events that will trigger that intervention cannot be precisely anticipated. The lessons of history are there to be understood and they are quite clear and straightforward.

But the subject of corporate accountability is of more fundamental importance. It is essentially a key element in assuring the effectiveness of American business over time and its contribution to American society and the American way of life. For indeed, the effectiveness of American business *over time* will impact not only the obvious, i.e., the quality of American business, but also will determine the extent to which this country remains a private economy and a democracy. I am satisfied that the two are inexorably intertwined. While a private economy may be able to exist without democracy, democracy as we know it, is dependent upon the existence of a healthy and essentially free private economy, which assures the standard of

living and the condition of society. The health of the private economy is, in turn, dependent on the *long term* effectiveness of the corporate community. Whether we continue to be a private economy will depend first and foremost on the extent to which the leaders of that private economy and the people who make it work recognize that interdependency and their responsibility for it and for conduct consistent with the *long term* interests of American business and the American society.

We are well past the point, if we were ever there, when American business can count on the blind support, indulgence or understanding of the American people and American polity. American business will need to exert great efforts to be understood and to be respected, and it must begin with how it governs itself and accounts for its conduct.

Periodic intervention of governmental, administrative and legislative bodies is a predictable reaction to occurrences in the corporate sector that are not acceptable to the public at large and to the body politic. This nonacceptance may stem from failure of public understanding of the business or corporate problems involved or, perhaps even more fundamentally, of the workings of the economy. Or it may result from failure of parts of our business system to deport themselves in socially acceptable and responsible ways. Regardless, governmental intervention, as it occurs, threatens increasingly over time to so fetter American business as to result, largely unintentionally, in the diminution of the potential growth and viability of American business.

The future of American business, and indeed of the American economy and society, is being impacted daily in the corporate board rooms of America. It is imperative that the corporate community and the bar recognize their responsibilities to the future of the system and make their decisions accordingly.

I became acquainted with Professor Steinberg during my tenure as Chairman of the Securities and Exchange Commission, when he served as Special Projects Counsel and confidential legal adviser to the General Counsel. This period was marked by extensive discussion regarding corporate accountability and internal affairs. These issues are as important and controversial today. For example, the proper composition of a corporation's board of directors, the duty of management to disclose "qualitative" rather than solely economically important information, the deference to be given to a special litigation committee's decision to terminate a shareholders' derivative action, the propriety of defensive tactics taken by target management when faced with a hostile take-over bid, and the role of inside counsel are all in need of further clarification.

During my tenure as Chairman, I addressed a number of these issues. With respect to the composition of corporate boards and committees, I am pleased that by the end of my chairmanship the overwhelming number of

publicly held corporations had a majority of disinterested directors on their boards and had established audit committees comprised solely of disinterested directors. In this regard, I urged that disinterested directors serve an increasingly meaningful role in the corporate accountability mechanism, even with respect to fundamental corporate changes such as corporate control contests. Along these lines, I also stressed the need for independence on the part of the accountants and attorneys who serve as advisers to publicly held corporations.

There were other difficult and controversial issues that the Commission focused upon during my tenure as Chairman and that continue to be of pressing importance. Examples include the application of the Foreign Corrupt Practices Act, the extent of disclosure required for practices that reflect upon the integrity of corporate management, and the much broader concern relating to the propriety and scope of governmental regulation that impacts on corporate internal affairs.

Professor Steinberg tackles these issues as well as several others. Although I by no means agree with all of the positions taken, Professor Steinberg's insightful analysis merits the attention of the corporate community and the bar. In short, this is a worthwhile book and I strongly recommend it.

Harold M. Williams

Acknowledgments

I owe many thanks to certain individuals for helping to bring this book to fruition. A plentiful source of the material contained in a number of chapters was several of my law review articles. Some of these works were coauthored. In particular:

(1) The chapter on the SEC's programs and policies that affect corporate internal affairs has been substantially expanded and revised, both in content and focus, from a paper coauthored by Paul Gonson, Solicitor, Securities and Exchange Commission, and me for the 1981 Ray Garrett, Jr., Corporate and Securities Law Institute sponsored by Northwestern University School of Law. The basis of the chapter appearing herein has been published, as a solely authored work, in 58 Notre Dame Law Review 173 (1982).

(2) The basis of the chapter on the disclosure of information bearing on management integrity and competency was originally published in 76 Northwestern University Law Review 555 (1981). I thank my coauthors on this piece, Ralph C. Ferrara, former General Counsel, Securities and Exchange Commission, and currently a partner at Debevoise & Plimpton in Washington, D.C., and Richard M. Starr, former Legal Assistant to SEC Commissioner Barbara S. Thomas and currently associated with Paul, Weiss, Rifkind, Wharton & Garrison in New York City. Also, portions of this chapter which discuss the "true purpose" cases and disclosure of antisocial conduct were separately published by me in 5 Corporation Law Review 249 (1982)[1] and 30 Emory Law Journal 169 (1981).

(3) The chapter on the use of special litigation committees to terminate shareholder derivative suits is largely derived from three separate articles

1. Reprinted by permission from the Corporation Law Review, Summer 1982, Volume 5, Number 3, Copyright © 1982, Warren, Gorham and Lamont, Inc., 210 South Street, Boston, Massachusetts. All Rights Reserved.

by the author which were published in 35 University of Miami Law Review 1 (1980),[2] 9 Securities Regulation Law Journal 381 (1982),[3] and 7 Delaware Journal of Corporate Law 1 (1982) (coauthored with Ralph C. Ferrara).

(4) The chapter on the corporate mismanagement-nondisclosure cases is principally derived from two articles, coauthored with Ralph C. Ferrara, which appeared in 129 University of Pennsylvania Law Review 263 (1980)[4] and in 7 Delaware Journal of Corporate Law 1 (1982). In addition, portions of the chapter which discuss state court decisions were addressed by the author in 9 Securities Regulation Law Journal 85 (1981).[5]

(5) The chapter on the duties of boards of directors and management in tender offer contests is derived, in substantial part, from an article published by the author in 30 Emory Law Journal 169 (1981). Also, portions of the chapter which recommend a framework for assessing the legitimacy of defensive tactics were originally addressed in 64 Cornell Law Review 901 (1979) (coauthored with Gary G. Lynch, Associate Director of Enforcement, Securities and Exchange Commission).[6]

(6) The basis of the chapter on application of the business judgment rule and related judicial principles was originally published in 56 Notre Dame Lawyer 903 (1981).

(7) The chapter on the role of inside counsel was derived in part from an article, coauthored with Ralph C. Ferrara, which appeared in 4 Corporation Law Review 3 (1981).[7]

The chapters contained herein have been expanded, revised, and edited from any article(s) from which they may have been derived. Moreover, as a former attorney at the Securities and Exchange Commission, I wish to make clear that, as a matter of policy, the SEC disclaims responsibility for any private publication by any of its employees. The views expressed herein are solely my own and do not necessarily reflect the views of the Commission or of my former colleagues on the staff of the Commission.

---

2. Reprinted from the University of Miami Law Review [35 U. MIAMI L. REV. 1 (1980)], which holds copyright on this article. All Rights Reserved.

3. Reprinted by permission from the Securities Regulation Law Journal, Winter 1982, Volume 9, Number 4, Copyright © 1982, Warren, Gorham and Lamont, Inc., 210 South Street, Boston, Massachusetts. All Rights Reserved.

4. Reprinted from the University of Pennsylvania Law Review [129 U. PA. L. REV. 263 (1980)], which holds copyright on this article. All Rights Reserved.

5. Reprinted by permission from the Securities Regulation Law Journal, Fall 1981, Volume 9, Number 1, Copyright © 1981, Warren, Gorham and Lamont, Inc., 210 South Street, Boston, Massachusetts. All Rights Reserved.

6. Reprinted from the Cornell Law Review [64 CORNELL L. REV. 901 (1979)], which holds copyright on this article. © Copyright 1979 by Cornell University. All Rights Reserved.

7. Reprinted by permission from the Corporation Law Review, Winter 1981, Volume 4, Number 1, Copyright © 1981, Warren, Gorham and Lamont, Inc., 210 South Street, Boston, Massachusetts. All Rights Reserved.

I wish also to thank certain individuals in addition to those mentioned above. In particular, I thank Valerie G. Richardson, whose editorial and research assistance was invaluable, and I express my gratitude to Samuel H. Gruenbaum who practices at Cohen & Ziskin in Los Angeles for his keen insight and helpful advice. Last, but certainly not least, I thank my mother and father, to whom I dedicate this book.

Contents

CORPORATE INTERNAL AFFAIRS

Introduction

This book represents an effort to compile in one source many of the significant issues that confront corporate management and its legal counsel. A number of these issues are in a state of flux; others, although more firmly defined, remain vitally important.

Although some subjects addressed herein concern corporate accountability and governance, the primary focus is on the broader theme of corporate internal affairs. Many of the divergent issues contained in the book are addressed from this broad perspective, the pertinent trends in the case law are analyzed and, where relevant, suggestions are proffered on how certain issues should be resolved by the courts.

The book is designed to be useful to a wide audience, including corporations, the corporate bar, accountants, and academicians. It presents a broad overview and analysis of seven topical and controversial subjects: the Securities and Exchange Commission's programs and policies that influence corporate internal affairs, disclosure of information bearing on management integrity and competency, the use of special litigation committees to terminate shareholder derivative suits, the corporate mismanagement-nondisclosure lines of cases, the duties of directors and management in tender offer contests, a corporate accountability analysis of the business judgment rule and related judicial principles, and the role of inside counsel.

The first subject addressed, the influence that the SEC's administrative, enforcement and legislative programs have on corporate internal affairs, takes the position that, while the Commission in the past has been interested in raising the level of corporate consciousness, its primary focus has been on addressing particular conditions, wrongdoings, and deficiencies. This point is reinforced by the Commission's direction under the present Chairman, John S. R. Shad. Hence, although there currently is little attention paid to the subject of corporate accountability, the actions taken recently

by the Commission, while having a very different focus, nevertheless indicate that corporate internal processes necessarily will be affected.

From this perspective, the discussion centers on a number of Commission programs and policies, including such diverse topics as the Staff's 1980 Corporate Accountability Report, accounting and financial reporting developments, proxy disclosure regulations, the adoption of the director-signature requirement with respect to Form 10-K, enforcement practices, developments in regard to the Foreign Corrupt Practices Act, the *amicus curiae* program, and the Commission's impact on advisers to corporate management, namely, lawyers and accountants.

Chapter 2 addresses an issue that is of considerable importance to corporations, the SEC, and the courts: the disclosure of information, not because such information is quantitatively material (because it does not impact significantly on an issuer's assets), but because such information reflects on the integrity and competency of corporate management. The proposition advanced is that, notwithstanding the broad statutory language contained in the securities acts, the Commission generally has suggested that the thrust of the disclosure requirements is to mandate the dissemination of information that is economically significant.[1] Three notable exceptions, however, have developed to this principle. First, the Commission has required affirmative disclosure by registrants of certain information routinely called for in registration statements, periodic reports, and proxy solicitations.[2] Second, under Section 14(a) of the Securities Exchange Act, subject parties may be required to include in their proxy materials information that is not quantitatively

1. *See* Securities Act Release No. 5627, 8 SEC DOCKET 41, 43, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,310, at 85,710 (Oct. 14, 1975) (hereinafter cited as SEC Release No. 5627), where the Commission stated that "[t]he Acts and the relevant legislative history also suggest that a prime expectation of the Congress was that the Commission's disclosure authority would be used to require the dissemination of information which is or may be economically significant."

This apparently narrow interpretation of the Commission's mandate has also been endorsed by a number of courts. *See, e.g.,* NAACP v. Federal Power Comm'n, 520 F.2d 432, 443 (D.C. Cir. 1975), *aff'd,* 425 U.S. 662 (1976), where the court, in commenting upon a Commission release addressing disclosure requirements pertaining to the pendency of civil rights proceedings, stated: "[i]n thus acting, however, the SEC appears to us merely to have been fulfilling its proper role of seeing that investors are fully informed of circumstances which bear on the financial prospects of securities-issuing corporations." *See also* Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981), *cert. denied,* 102 S. Ct. 1006 (1982).

2. *See, e.g.,* Item 402, Regulation S-K, 17 C.F.R. § 229.402 (1982). This item requires registrants to disclose affirmatively information about management remuneration in registration statements filed under the Securities Act, and in periodic reports and proxy solicitations regulated under the Exchange Act, irrespective of the economic materiality of the information. *See also* Securities and Exchange Commission, Brief for Appellee, at 27, SEC v. Falstaff Brewing Corp., 629 F.2d 62 (D.C. Cir. 1980), where the Commission argued that it is authorized to require disclosure of information called for in its rules, irrespective of economic materiality: "In addition, Rule 14a-3 and Schedule 14A establish certain minimum disclosure requirements that must be met regardless of a finding of materiality."

material to ensure that shareholders are adequately informed about issues to be voted upon at shareholder meetings.[3] This exception recognizes the vital distinction between information important to a voting decision and an investment decision. Third, the Commission has departed from economic materiality as the basis for disclosure when other criteria are mandated by an independent federal statute, for example, the National Environmental Policy Act (NEPA).[4]

With this background in focus, the chapter addresses the concept of qualitative materiality and the duty to disclose in the context of the securities acts. The chapter first presents an overview of relevant case law and Commission proceedings. Thereafter, the chapter addresses management self-dealing (including the "true purpose" cases), questionable and illegal payments, unethical or unlawful company policies, adjudicated illegalities and pending lawsuits against officers and directors, and business expertise and reputation of corporate officials. Finally, a standard for the disclosure of qualitatively material information—in both an investing and a voting context—is proposed.

Chapter 3 addresses the very topical subject of the use of special litigation committees to terminate shareholder derivative suits. At the outset of the discussion, it is pointed out that a corporation's board of directors will frequently appoint a special litigation committee when faced with a shareholder's derivative action against fellow directors. Not surprisingly, dismissal motions sought by such committees is the subject of increasing scrutiny by the courts.[5] The discussion thereupon analyzes the relevant federal and state

---

3. *See* SEC Release No. 5627, *supra* note 1, at 44, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,310, at 85,711: "It is also evident, however, that, insofar as the Commission's rulemaking authority under Section 14(a) of the Securities Exchange Act is concerned, the primacy of economic matters, particularly with respect to shareholder proposals, is somewhat less." *See also* Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970), where the Court stated that the underlying purpose of Section 14(a) of the Exchange Act is to promote " 'the free exercise of the voting rights of stockholders' by ensuring that proxies [are] solicited in 'explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought.' " *Id.* at 381 (quoting H.R. REP. No. 1383, 73d Cong., 2d Sess. 14 (1934) and S. REP. NO. 792, 73d Cong., 2d Sess. 12 (1934)).

4. Section 102(1) of NEPA provides that "to the fullest extent possible . . . the policies, regulations and public laws of the United States shall be interpreted and administered in accordance with the policies set forth in [NEPA]." *Id.* § 4332(1). Section 101(a) of NEPA provides that the "continuing policy" of the federal government is "to use all practicable means and measures" to protect environmental values. 42 U.S.C. § 4331(a) (1976 & Supp. III 1979).

5. *See, e.g.,* Burks v. Lasker, 441 U.S. 471 (1979); Abramowitz v. Posner, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,458 (2d Cir. 1982); Maldonado v. Flynn, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,457 (2d Cir. 1982); Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981), *cert. denied,* 102 S. Ct. 1006 (1982); Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980); Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), *cert. denied,* 101 S. Ct. 206 (1980); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied,* 444 U.S. 1017 (1980); Genzer v. Cunningham, 498 F. Supp. 682 (E.D. Mich. 1980); Abella v. Universal Leaf Tobacco, Inc., 495 F. Supp. 713 (E.D. Va. 1980); Maher v. Zapata Corp.,

court decisions and focuses on special procedures that should be employed to help insulate the decision reached by the special litigation committee from successful challenge. These procedures include that:

1. The board appoint only nondefendant, disinterested, and independent persons to the special litigation committee;
2. The board delegate binding, nonreviewable authority to the committee to investigate and determine whether the suit is in the corporation's best interests;
3. The committee employ thorough investigative procedures and resources, including the appointment of a reputable special counsel and law firm to assist in the investigation;
4. Reasonable measures be taken to help ensure that the directors and other relevant parties inform committee members of all facts material to the committee's decision; and
5. The committee conduct itself so as to withstand strict judicial scrutiny.

Chapter 4 addresses the corporate mismanagement-nondisclosure lines of cases. In *Santa Fe Industries, Inc. v. Green,*[6] the Supreme Court held that in order to state a cause of action under Section 10(b) and Rule 10b-5 of the Securities Exchange Act, deception or manipulation must be alleged.[7] In other words, under Section 10(b) and Rule 10b-5, breaches of fiduciary duty that do not involve any misrepresentation or nondisclosure are not actionable. In what has become a most significant footnote, however, the *Santa Fe* Court rejected the plaintiff's contention that the majority stockholder's failure to give them advance notice of the merger was a material nondisclosure. The Court pointed out that the plaintiffs had not indicated how they might have acted differently had they received prior notice of the merger. Indeed, the Court noted that the plaintiffs accepted the conclusion that they could not have enjoined the merger for alleged unfairness because an appraisal proceeding was their sole remedy under Delaware law. It therefore concluded that the failure to give advance notice to the minority shareholders was not a material nondisclosure within the meaning of Section 10(b) or Rule 10b-5.[8]

Shortly thereafter, however, the Delaware Supreme Court in *Singer v. Magnavox Co.,*[9] viewing *Sante Fe* as a "current confirmation of the Supreme Court of the responsibility of a State to govern the internal affairs of cor-

490 F. Supp. 348 (S.D. Tex. 1980); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

6. 430 U.S. 462 (1977).
7. *Id.* at 474.
8. *Id.* at 474 n.14.
9. 380 A.2d 969 (Del. 1977).

porate life,"[10] concluded that under Delaware law, appraisal was not a minority shareholder's sole remedy. Moreover, it held that if it is alleged that the purpose of the merger is improper, the majority shareholders must prove a proper business purpose. Additionally, the court concluded that even if a proper business purpose were shown, a court must scrutinize the transaction for its entire fairness and award appropriate relief if a violation is found.[11]

Subsequent Delaware cases have expanded upon *Singer*. The overwhelming rationale of these cases is that, regardless of whether a short- or long-form merger is effected, the merger must be for a proper purpose and must be entirely fair to minority shareholders.[12] Although other state court decisions have not strictly followed *Singer*, they generally stand for the proposition that a shareholder may enjoin a merger that has not been consummated if it is not being effected for a proper business purpose.[13]

Construing these recent Delaware and other state court decisions together with footnote fourteen of *Santa Fe*, a number of federal courts have found actionable claims under Section 10(b) when there has been a lack of adequate and fair disclosure that would have enabled the aggrieved shareholder to seek injunctive relief in a state court. Indeed, subject to a number of caveats which will be discussed in the chapter, this rationale has been adopted by

---

10. *Id.* at 976 n.6.

11. *Id.* at 975, 980.

12. *See, e.g.,* Roland Int'l Corp. v. Najjar, 407 A.2d 1032, 1034 (Del. 1979); Tanzer v. Int'l Gen. Indus., Inc., 379 A.2d 1121, 1123 (Del. 1977); Young v. Valhi, Inc., 382 A.2d 1372, 1374 (Del. Ch. 1978); Kemp v. Angel, 381 A.2d 241, 244 (Del. Ch. 1977). *See also* Harman v. Masoneilan International Inc., 442 A.2d 487 (Del. 1982); Lynch v. Vickers Energy Corp., 429 A.2d 497 (Del. 1981). *But see* discussion at 182 n. 97 *infra*.

13. *See* Perl v. IU Int'l Corp., 607 P.2d 1036, 1046 (Hawaii 1980) (followed *Singer*); Gabhart v. Gabhart, 267 Ind. 370, 388, 370 N.E.2d 345, 356 (1977) (followed *Singer*'s first prong in holding that the effectuation of a merger that eliminated a minority shareholder, even though in compliance with the technical requirements of the state's merger statute, must advance a corporate purpose in order to withstand scrutiny under Indiana law). *See also* Masinter v. Webco Co., 262 S.E.2d 433 (W. Va. 1980). Interpreting the California Supreme Court's decision in Jones v. H. F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 CAL. RPTR. 592 (1969), the Hawaii Supreme Court in *Perl* opined that the court would adopt the *Singer* principles: "Although *Ahmanson* did not involve a merger, it appears clear from the language of the opinion that the California Supreme Court would apply the fiduciary duty of good faith and inherent fairness to such a situation." 607 P.2d at 1047 n.12. However, in *In re* Jones & Laughlin Steel Corp., 488 Pa. 524, 412 A.2d 1099 (1980), the Pennsylvania Supreme Court rejected the approach adopted by the Delaware courts. The Pennsylvania court held that the appraisal statute served as the sole postmerger remedy for aggrieved minority shareholders. 488 Pa. at 531, 412 A.2d at 1103. In the premerger stage, the court recognized the minority's right to seek injunctive relief in order to prevent the merger's consummation. *Id.*, 412 A.2d at 1103. The majority's holding occasioned a fairly vigorous dissent. *Id.*, 412 A.2d at 1104 (Larsen, J., dissenting). *But see* Yanow v. Teal Industries, Inc., 178 Conn. 263, 422 A.2d 311 (1979) (appraisal exclusive remedy); discussion at 182 n. 97 *infra*.