Liability for Greenmailers: A Tort is Born

I. Introduction

Corporate takeovers have been widely featured in the news media recently.[1] Such swashbuckling terms as white knights, crown jewels, poison pills, golden parachutes, raiders, and greenmail infuse a touch of romance and high adventure into the seemingly dull and dreary world of corporate finance. This aura of fantasy disguises a very real question concerning the future course of American corporation law: what can be done, if anything ought to be done, about the problem of one corporation buying into another, not for the purpose of investment or acquisition, but solely for the purpose of instilling fear into the target's directors and causing those directors to buy out the raider's[2] equity at a profit?

The recent California Court of Appeals case of *Heckman v. Ahmanson*[3] serves to highlight the nature of this issue. In *Heckman*, an intimation is given that California will no longer tolerate the practice of greenmail. Certain theories of greenmailer liability were discussed and found sufficiently persuasive to justify the grant of a preliminary injunction by a trial court.[4]

This Note will examine state common law for potential theories to hold a greenmailer liable for his harm to the target corporation. The focus will be on the wrong performed by the greenmailer rather than on the potential liability of directors or officers of the target, who may violate fiduciary duties by submitting to greenmail demands.[5] Because

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[1]*See, e.g.*, Dentzer, *Empty Seats on the Board*, Newsweek, August 5, 1985 at 46 (referring to an effect of Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)); Greenwald, *High Times for T. Boone Pickens*, Time, March 4, 1985 at 52 (cover story); Williams, *It's Time for a Takeover Moratorium*, Fortune, July 22, 1985 at 133.

[2]The use of such terms as "raiders" and "targets" is not intended to have a moral or judgmental implication but is intended for ease in identification of roles in the arena of corporate takeovers.

[3]168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985).

[4]The requirements for the grant of an injunction are: (1) a reasonable probability of success on the merits, and (2) the harm to the defendant resulting from the injunction is not greater than the harm to the plaintiff resulting from its denial. *See* Fox v. City of Los Angeles, 22 Cal. 3d 792, 800 n.1, 587 P.2d 663, 667 n.1, 150 Cal. Rptr. 867, 871 n.1 (1978) (Bird, C.J., concurring).

[5]Most commonly, target company directors are the defendants in shareholders' derivative suits alleging a violation of fiduciary duty in repurchasing shares from potential acquirors. *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir. 1981); Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690 (2d Cir. 1980). *See generally* Lynch & Steinberg, *The Legitimacy of Defensive Tactics in Tender Offers*, 64 Cornell L. Rev. 901 (1979).

federal abstention is the general rule in this area, this Note will concentrate on available state theories, especially those dealing with fiduciary duties of controlling and dominant shareholders. In this regard, *Heckman v. Ahmanson*[6] will be dissected, as it points to several theories allowing shareholders to recover from the greenmailer. Using *Heckman* as a springboard, other potential theories implying liability for the greenmailer will be analyzed, including particular problems inherent in each.

This topic is important because, absent a common law remedy and in light of federal abstention, greenmail can only become more prevalent. Essentially, it is a practice that perverts one of the strongest arguments for a free market economy—the argument favoring efficiency. The free market has been justified as one in which an "invisible hand" moves resources into their most productive spheres.[7] Greenmail involves the movement (or threat of movement) of large amounts of money into a productive enterprise, not to increase its productivity, but to bleed off its assets. Not only are the target and its shareholders worse off than before, but the assets of the greenmailer are not serving any productive task. And by this coup more funds are attracted to a non-productive use. Money is chasing money and nothing is being produced. If a common law solution can be found, it could halt this non-productive use of scarce resources and allow them to return to their proper roles in a free market economy.

II. Examination of Recovery Under State Common Law

A. Lack of a Federal Remedy

This Note concerns the problem of greenmail. A potential acquiror buys into the target company, generally on the open market. Then follows a tender offer[8] for a certain percentage of outstanding shares—enough for the raider to gain control. The target's board of directors, to rid itself of this offer, which would presumably result in their replacement by the raider, then buys out the equity of the raider at a substantial premium. This corporate repurchase of shares is *not* offered to any shareholders other than the raider.[9]

Greenmail is not presently subject to any direct federal prohibitions. The major federal statute with potential applicability is the Securities Exchange Act of 1934.[10] This Act prohibits "deceptive and manipulative"

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[6]168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985).

[7]A. Smith, The Wealth of Nations, Book IV, Chapter II (Cannan ed. 1776).

[8]A tender offer is an offer to purchase a given number of shares at a certain price. *See generally* Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. Pa. L. Rev. 647 (1984).

[9]*Id.* at 706-07.

[10]15 U.S.C. §§ 78a-78jj (1981).

devices in connection with the purchase or sale of any security.[11] However, it and Rule 10b-5[12] have been interpreted by the United States Supreme Court as being designed to insure "protection of investors who are confronted with a tender offer"[13] and as not including "a wide variety of corporate conduct traditionally left to state regulation."[14] Hence, in the absence of a federal statutory prohibition, the common law as interpreted by the states must be the source of any liability for greenmailers. The remainder of this Note will analyze in detail the various theories considered in *Heckman v. Ahmanson*[15] and then expand upon them to suggest additional theories of liability.

B. Heckman v. Ahmanson

In May, 1985, the California Court of Appeals issued its opinion in the case of *Heckman v. Ahmanson*.[16] This is the first case that provides a possibility for shareholders of a target corporation to hold a greenmailer responsible for the return of the greenmail.

In March, 1984, Reliance Insurance Company (Steinberg)[17] purchased over two million shares of Walt Disney Productions (Disney). Interpreting this purchase as a preliminary move for a takeover, Disney announced in May its intent to purchase Arvida Corporation for $200 million in newly issued stock (Arvida transaction). This acquisition would result in an assumption of $190 million of Arvida's debt. This "puff-fish" defense was designed to render Disney less attractive to Steinberg as a potential acquisition and also to dilute his equity by the issue of new stock. Steinberg filed a stockholders' derivative suit in federal court seeking an injunction to halt the Arvida transaction. That effort failed, and on June 6, the Arvida purchase was consumated.[18]

Further purchases of Disney stock continued until on Friday, June 8, Steinberg announced his intention to make a tender offer for 49% of Disney's shares. At that point, Steinberg owned about twelve percent of the shares and was the largest single shareholder in Disney. That

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[11] *Id.*

[12] 17 C.F.R. § 240.10b-5 (1985). Rule 10b-5 was enacted pursuant to authority granted in Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1981).

[13] Piper v. Chris-Craft Indus., 430 U.S. 1, 35 (1977).

[14] Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 478 (1977).

[15] 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985).

[16] *Id.*

[17] The named defendants (other than the Disney directors) were Saul P. Steinberg, Reliance Financial Services Corp., Reliance Group, Inc., Reliance Group Holdings, Inc., Reliance Insurance Co., Reliance Insurance Co. of New York, United Pacific Insurance Co., and United Pacific Life Insurance Company of New York. All are corporate entities dominated by Steinberg. *See* Appellant's Opening Brief at 1, Heckman v. Ahmanson, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985).

[18] Heckman v. Ahmanson, 168 Cal. App. 3d 119, 124, 214 Cal. Rptr. 177, 180 (1985).

Friday evening, Disney offered to repurchase Steinberg's holdings. By Monday, the deal was in final form: Steinberg agreed to dismiss his individual causes of action in the Arvida litigation and agreed not to make any further purchases of Disney stock. In return, Steinberg's shares were bought for $77 per share, resulting in a profit of $59.9 million for Steinberg. Upon the release of these details, the market price of Disney stock fell below $50 per share.

The plaintiffs (Heckman), Disney shareholders, filed a derivative suit against both the Disney directors and against Steinberg, alleging that Steinberg had utilized his derivative suit and tender offer to obtain a premium price for his stock. Basically, Heckman sought relief for a greenmail scheme against both the greenmailer and against those who submitted to the greenmail. The trial court issued a preliminary injunction requiring Steinberg to care for the $59.9 million profit in accordance with California standards of prudent trusteeship. The $59.9 million became the *res* of a constructive trust in Steinberg's hands pending the outcome of the trial on the merits. Steinberg's appeal of the grant of this injunction resulted in the opinion affirming that grant.[19]

Heckman's theories of recovery, presented in support of his request for an injunction,[20] were primarily based on common law tort theories.[21] His brief presented four sources of a duty of Steinberg to Disney and to Disney's shareholders, represented by Heckman.

Heckman's first theory was that by filing derivative litigation, Steinberg assumed a fiduciary status vis-a-vis the Disney shareholders.[22] A second theory, based on *Jones v. H.F. Ahmanson & Co.*,[23] was that Steinberg was a fiduciary by virtue of his status as a controlling shareholder.[24] A third alternative source of duty was the abandonment of the Arvida litigation by Steinberg. The greenmail was characterized as a payment for abandonment of a remedy sought on behalf of all shareholders; therefore, that payment ought to belong to all shareholders.[25] A final argument was the application of the duties of a volunteer.

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[19]*Id.* at 124-25, 214 Cal. Rptr. at 180-81.

[20]For the prerequisites of an injunction, see *supra* note 4.

[21]These theories involve the application of volunteer liability and aider-abettor liability to Steinberg. Also the intermediate relief requested was a constructive trust on the greenmail proceeds, based on an equitable theory. *See infra* notes 117-32 and accompanying text.

[22]"Steinberg expressly volunteered to 'fairly and adequately represent the interest of Disney and all other stockholders . . .' in his suit against Disney. With that statement and the filing of his action he became a fiduciary." Respondent's Opening Brief at 10, *Heckman*, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985) (citations omitted).

[23]1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

[24]Respondent's Opening Brief at 11-14, *Heckman*; *see infra* notes 133-63 and accompanying text.

[25]Respondent's Opening Brief at 14-17, *Heckman*; *see infra* notes 117-24 and accompanying text.

Because Steinberg "volunteered" to oppose the acquisition of debt by Disney, he ought to be obligated to oppose the further acquisition of debt reasonably foreseeable as a result of his greenmail operation.[26]

The court of appeals, in discussing whether or not there was a likelihood of success on the merits, consolidated Heckman's four theories into two possibilities—both based on the application of common law tort principles to prove the liability of a greenmailer *qua* greenmailer. Heckman's first possible avenue of success on the merits was that Steinberg may be found liable as an aider and abettor of Disney's directors' breach of fiduciary duty.[27] Relying strongly on the United States Supreme Court decision in *Pepper v. Litton*[28] as adopted by California in *Jones v. H.F. Ahmanson & Co.*,[29] the court first equated the duty of a director with that of "a dominant or controlling stockholder."[30] The court concluded that the business judgment rule[31] would not protect Disney's directors in this case, because they had a possible improper motive, and that consequently Steinberg may be found liable to the shareholders as an aider and abettor of the directors.[32]

The second theory of recovery discussed in the appellate opinion is that of a direct breach of fiduciary duty by Steinberg. Relying strongly on the arguments of Heckman, the court placed the source of the fiduciary duty on the Arvida litigation. "When the Steinberg Group filed suit against Disney to block Disney's purchase of Arvida it assumed a fiduciary duty to the other shareholders with respect to the derivative claims."[33] The court continued, buttressing its fiduciary analysis with the volunteer analogy. "It is significant that both the California and United States Supreme Courts focused on the volunteer status of a plaintiff in a derivative action, a 'volunteer champion' in the words of Justice Jackson."[34]

After analyzing these two possible theories of recovery, the court of appeals concluded that either or both theories could reasonably justify the preliminary injunction.[35] It was, therefore, unnecessary to analyze the duties of a controlling shareholder to a minority shareholder.[36]

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[26]Respondent's Opening Brief at 17-19, *Heckman*; *see infra* notes 125-30 and accompanying text.

[27]*Heckman*, 168 Cal. App. 3d at 127, 214 Cal. Rptr. at 182.

[28]308 U.S. 295 (1939).

[29]1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

[30]*Heckman*, 168 Cal. App. 3d at 126, 214 Cal. Rptr. at 182.

[31]*See infra* notes 68-105 and accompanying text.

[32]*Heckman*, 168 Cal. App. 3d at 128, 214 Cal. Rptr. at 183.

[33]*Id.* at 128, 214 Cal. Rptr. at 183.

[34]*Id.* at 132, 214 Cal. Rptr. at 186.

[35]*Id.* at 133, 214 Cal. Rptr. at 187.

[36]However, in a footnote, the court commented:

The record is inadequate at this time on the question whether the Steinberg

In the opinion the court adopted a decidedly negative stance toward Steinberg. The use of the word, "greenmail," in the first paragraph of the opinion, when it was unmentioned in either the Steinberg or Heckman briefs suggests that this court was going to do something about that practice. This interpretation is reinforced by reference to Steinberg's "ill-gotten gains"[37] and the court's portrait of Disney's shareholders as "citizens, of a town whose volunteer fire department quits fighting the fire and sells its equipment to the arsonist who set it (who obtains the purchase price by setting fire to the building next door)."[38] In the trial court, a similar tone was evident:

> The court then granted the preliminary injunction without any finding of irreparable harm, and without any reference to the merits other than its "gut feeling [that appellees] are going to recover something from somebody. . . . Indeed, when it was pointed out, during oral argument, that respondents' claims are unprecedented, the court merely observed that Reliance's counsel "may become famous for being involved in this case, then."[39]

These courts were both "activist" in that they applied traditional theories to facts in a novel way—without direct precedential authority. Prior to this case, there was no liability for greenmailers. "[W]e have found no case in which a greenmailer was ordered to return his ill-gotten gains, [but] precedent for such a judgment exists in California law."[40]

California was not the only state "ripe" for such a decision. In *Unocal Corp. v. Mesa Petroleum Co.*,[41] the Supreme Court of Delaware reversed a grant of an injunction requested by a greenmailer.[42] This court, instead of treating the greenmailer as a tortfeasor, utilized the business judgment rule[43] to justify a "poison pill"[44] defense by the directors

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> Group was a controlling shareholder when it sold its stock to Disney. Although it never owned more than about 12 percent of the outstanding Disney stock this is not determinative of control. The question, a factual one, is what amount of influence it could exert on the corporation by reason of its holdings.

Id. at 133 n.7, 214 Cal. Rptr. at 187 n.7.

[37] *Id.* at 126, 214 Cal. Rptr. at 182.

[38] *Id.* at 133, 214 Cal. Rptr. at 187.

[39] Appellant's Opening Brief at 9, *Heckman* (citation omitted).

[40] *Heckman*, 168 Cal. App. 3d at 126, 214 Cal. Rptr. at 182.

[41] 493 A.2d 946 (Del. 1985).

[42] *Id.* at 958-59.

[43] *See infra* notes 68-105 and accompanying text.

[44] The "poison pill" defense involves the creation of a special preferred stock (or provides for a conversion option to the preferred stock) for all shareholders who do not tender to a raider. If the raider subsequently acquires a controlling interest, the preferred stock becomes redeemable at a specified price and at a high priority. Greene & Junewicz, *supra* note 8, at 704-05.

of Unocal.[45] Both the Delaware and the California courts were willing to extend the application of certain common law doctrines to discourage or punish raiders' activities.

C. *Potential State Remedies*

Prior to a discussion of greenmail liability, it must be emphasized that although the corporate directors or officers who authorize the payment of greenmail are fiduciaries and, therefore, are most often the defendants in suits for recovery by target shareholders,[46] they may also be viewed as victims of the greenmailers. In an analogous situation, that of blackmail, it would be considered absurd to suggest that the payer of blackmail is the wrongdoer. Likewise, in a greenmail situation, a remedy ought to be available against the true wrongdoer—the greenmailer.

Certain desiderata characterize the "ideal" remedy. The remedy must be able to distinguish between a legitimate corporate repurchase of stock from a troublesome shareholder and a true greenmail scheme.[47] In the first situation, the impetus for the repurchase most often originates with the directors and is not sought by the shareholder, though he may accept the offer. Although greenmail also may often appear to originate with the directors of the target, it rarely will surprise the greenmailer, who often has a history of similar deals in his past. Analysis of an individual transaction will not serve to distinguish these two situations because of the vagueness of the distinction. Instead, a continuum must be imagined, with the poles as the archetypes just described. The closer a corporate selective repurchase approaches the greenmail scenario, the less protection ought to be offered by the business judgment rule. Conversely, the more the transaction is characterized by "legitimate" corporate interest, the more deference ought to be given to the directors.

The "ideal" remedy against greenmailers would also be one that would not needlessly require the "sacrifice" of innocent parties. The procedural stance of *Heckman* was a shareholders' suit against a greenmailer and against the directors of the target.[48] If a greenmail situation victimizes the directors of a corporation as well as the shareholders, it is evident that requiring the dual accountability of both directors and

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[45]493 A.2d at 955-57.

[46]*See supra* note 5.

[47]*Compare* Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964) (legitimate business purpose in stock repurchase to avoid a takeover) *with* Bennett v. Propp, 41 Del. 14, 187 A.2d 405 (1962) (wrongful repurchase to prevent takeover by outsider). *See generally* Comment, *Buying Out Insurgent Shareholders with Corporate Funds*, 70 YALE L. J. 309 (1960).

[48]*See supra* note 19 and accompanying text.

greenmailer is often unfair to the directors. An ideal remedy will hold the greenmailer directly responsible for the "tort" of greenmail.

The major obstacle to greenmailer liability is the lack of duty of the greenmailer to the target corporation or to its shareholders. *Heckman* presented some hints as to sources for such a duty. Such analysis will now be expounded.

D. Aiding and Abetting

The *Heckman* court began its analysis with a discussion of the likelihood that Steinberg would be found liable to the shareholders as an aider and abettor of the directors' breach of fiduciary duties in disgorging greenmail.[49] Although Heckman's brief does not contain an argument for liability of aiders and abettors, he evidently did make that argument in the trial court. Steinberg's brief opposes that theory as having no precedent[50] and as lacking the necessary predicate, i.e., "that the purchase of [Steinberg's] Disney stock by Disney was motivated solely by the directors' desire to perpetuate their own control, rather than by a good faith belief that the corporate interest was served thereby[,]"[51] and cites *Cheff v. Mathes*[52] in support of this defense. Here, Steinberg was attempting to assert the traditional Delaware business judgment rule[53] as a shield for Disney that would, in turn, protect him from liability as an aider and abettor. The appellate court, disagreeing with this version of the rule, instead applied the following version:

> Once it is shown a director received a personal benefit from the transaction, which appears to be the case here, the burden shifts to the director to demonstrate not only the transaction was entered in good faith, but also to show its inherent fairness from the viewpoint of the corporation and those interested therein.[54]

Although there was no evidence in the trial court that Disney's directors were improperly motivated, the court of appeals disclaimed any need

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[49]168 Cal. App. 3d at 126, 214 Cal. Rptr. at 182.

[50]"No California court has recognized a cause of action against a selling shareholder for aiding and abetting a breach of duty on the part of the directors who initiate the purchase." Appellant's Opening Brief at 25.

[51]*Id.*

[52]41 Del. Ch. 494, 199 A.2d 548 (1964). This case involved a corporate repurchase of stock from a third party interested in gaining control and changing the sales procedures and compensation programs of the target company. The Delaware Supreme Court found a legitimate business purpose in maintaining those corporate policies. Thus, the repurchase was justified. *Id.*

[53]*See infra* notes 68-105 and accompanying text.

[54]*Heckman*, 168 Cal. App. 3d at 128, 214 Cal. Rptr. at 183.

for a "smoking gun": "The acts of the Disney directors—and particularly their timing—are difficult to understand except as defensive strategies against a hostile takeover."[55] Directors merely undertaking defensive maneuvers is apparently enough to cast the burden on them to justify their acts as fair to their shareholders.[56]

The basis of the aiding and abetting liability pertinent to a greenmail situation is tort law. The tort of greenmail is one in which the wronged party is the corporation. The *Restatement (Second) of Torts* section 876(b) provides a general statement of liability for aiders and abettors:

> For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he
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> . . . .
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> (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself. . . .[57]

The application of this model to a greenmail case may appear somewhat questionable when considering the fact that all of the illustrations in the *Restatement* concern physical harms. However, there are many cases utilizing this section that do not limit the application to physical harms. Among those are a number of common law interpretations of violations of section 10(b) of the Securities Exchange Act of 1934[58] and of Rule 10b-5[59] enacted pursuant to that Act. Although these cases deal with the interpretation of a statute, they do point out the parameters of an action involving no physical harm based upon *Restatement* section 876(b).

A good example of the use of section 876(b) in this context by the courts is *Brennan v. Midwestern Life Insurance Co.*[60] There, the defendant insurance company's stock was sold to the public by a brokerage firm. The brokerage firm used the proceeds for speculation, eventually resulting in the broker's bankruptcy. The buyers of the stock had questioned the insurance company about their stock certificates, which they had never received. The breach of duty alleged against the defendant insurance company was its failure to inform either the Indiana Securities Com-

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[55]*Id.*

[56]If the Delaware rule were utilized, the greenmailer, as well as the directors, would be beyond the reach of the target's shareholders. *See infra* notes 68-105 and accompanying text.

[57]RESTATEMENT (SECOND) OF TORTS § 876 (1977).

[58]15 U.S.C. §§ 78a-78jj (1981).

[59]17 C.F.R. § 240-10b-5 (1985).

[60]259 F. Supp. 673 (N.D. Ind. 1966) (motion to dismiss denied), 286 F. Supp. 703 (N.D. Ind. 1968) (on merits).

mission or the Securities Exchange Commission, thereby aiding and abetting the broker's violations of the Securities Act.[61] The *Restatement (Second) of Torts* section 876(b)[62] was used to define the defendant's liability.[63] Responding to the defendant's motion to dismiss for failure to state a valid claim, the federal district court replied:

> A basic philosophy of the Securities Exchange Act of 1934 is disclosure . . . . The investor's protection is the paramount consideration . . . . The effect on an investor of an issuer corporation's failure to disclose improper activities of a brokerage firm . . . may be just as dangerous and equally as damaging as a failure by the issuer to disclose information of its own improper activities . . . . The loss to the investor may well be the same. . . . [A] statute with a broad and remedial purpose such as the Securities Exchange Act of 1934 should not easily be rendered impotent to deal with new and unique situations within the scope of the evils intended to be eliminated.[64]

Although the act of aiding and abetting in *Brennan* appears to have been an act of omission, the court found sufficient affirmative acts to hold the insurance company liable by the standards of section 876(b).[65]

Perhaps the most succinct encapsulation of the requirements for aider-abettor liability under section 876(b) was that of the Second Circuit in *Landy v. Federal Deposit Insurance Corp.*[66] "Three elements are thus required for liability: (1) that an independent wrong exists; (2) that the aider or abettor know of that wrong's existence; and (3) that substantial assistance be given in effecting that wrong."[67]

To hold a greenmailer liable for aiding and abetting, then, would require proof of the directors' breach of duty as a prerequisite to the greenmailer's liability. Of the three *Landy* elements, the most crucial is the first: the plaintiff must allege and prove that a wrong exists, independent of the acts of the greenmailer. The only possible wrong to the corporation, not involving the raider, is the payment of the greenmail by the corporate fiduciary. Because a greenmailer would not be liable absent proof of this breach, the greenmailers would use any defenses available to the directors to shield their decision to pay greenmail.

The traditional bulwark of directors defending their past decisions against shareholders has been the business judgment rule. This rule

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[61] *Id.* at 675.

[62] RESTATEMENT (SECOND) OF TORTS § 876 (1977).

[63] 259 F. Supp. at 680.

[64] *Id.*

[65] 286 F. Supp. 702, 708-28 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

[66] 486 F.2d 139 (3d Cir. 1973).

[67] *Id.* at 162-63.

allows a presumption that directors acted properly when making entrepreneurial decisions for a corporation.[68] This rule is closely intertwined with the concept of fiduciary duties that directors owe their corporation. The base facts that give rise to the presumption of good business judgment are that the obligations of due care and corporate loyalty have been met by the directors.[69] A third element often added to these basic prerequisites is that the director have had no personal interest in the questioned transaction.[70] This requirement, often phrased as one for a rational business purpose,[71] is probably best regarded as a sub-category of the duty of loyalty.

From these basic elements of the business judgment rule, loyalty to corporation, duty of care, and rational business purpose, some policies favoring the rule may be discerned. The most prevalent justification for the rule is the traditional reluctance of courts to substitute their judgment for that of corporate directors.[72] Not only is it unfair to judge from a point where the wisdom or folly of a risk is evident,[73] but also the judgment of directors is what the shareholders chose through the operation of corporate democracy.[74] In hindsight, almost any unsuccessful entrepreneurial decision may be criticized as wasteful, but many "crazy"

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[68]The business judgment rule has been defined as follows:

> Recognizing that, consistent with the business corporation's profit orientation, business judgment inevitably involves risk evaluation and assumption, and recognizing that the office of corporate director, as such, does not require full-time commitment to the affairs of the enterprise, the corporate director frequently makes important decisions which may eventually prove to be erroneous. A director exercising his good faith judgment may be protected from liability to his corporation under the Business Judgment Rule. While not part of the statutory framework, this legal concept is well established in the case law of most jurisdictions. When viewing the decisions of directors acting in the exercise of free and independent judgment, courts have been extremely reluctant to find that they acted negligently. Recognizing that business decisions may seem unrealistically simple when viewed with hindsight, and expressing reluctance to substitute their judgment for that of directors, courts have generally refrained from questioning the wisdom of board decisions.

Committee on Corporate Laws, Section of Corporation, Banking and Business Law, American Bar Ass'n, *Corporate Director's Guidebook*, 33 Bus. Law. 1591, 1603-04 (1978). *See generally* Block & Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata*? 37 Bus. Law. 27, 33-34 (1981); Manning, *The Business Judgment Rule in Overview*, 45 Ohio St. L. J. 615, 617-18 (1984).

[69]Whittaker Corp. v. Edgar, 535 F. Supp. 993, 950 (N.D. Ill. 1982).

[70]*Id.*

[71]*See, e.g.*, Manning, *supra* note 68, at 621-22.

[72]*Id.* at 622.

[73]Another policy reason subsumed in courts' reluctance to pass liability judgments on business decisions is the desire to have "good" businessmen undertake directorial duties. Block & Prussin, *supra* note 68, at 32.

[74]*See generally*, Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 Calif. L. Rev. 1 (1969).

ideas have succeeded. The Edsels and DeLoreans of the world are but the flip side of the hula hoops and frisbies. The policy may be that courts do not want to discourage the risk-taking function of directors by over-emphasis on the downside risk by imposing personal liability.

A final policy in favor of the business judgment rule, as it has developed, is the policy in favor of predictability.[75] A frank recognition by potential litigants of the burdens they must overcome to triumph against directors discourages a great deal of harassing and duplicative litigation.[76]

Interlaced with the business judgment rule is the intrinsic fairness test, applied when the initial presumption of the business judgment rule "bursts." This test requires the directors to come forward with affirmative proof of the intrinsic fairness of the questioned transaction.[77]

What the plaintiff shareholder must do to overcome the initial presumption and therefore trigger the intrinsic fairness test varies by jurisdiction. Generally, there are two rules with various intermediate positions. For ease in identification, the two prototype positions will be called the Delaware and the California rules.

The Delaware rule allows the presumption of good business judgment to "burst" and requires directors to prove the intrinsic fairness of their decision only when the plaintiff can demonstrate that the director's decision was "solely and primarily" caused by an interest conflicting with that of the corporation.[78] A typical case is *Johnson v. Trueblood*,[79] in which the Third Circuit interpreted Delaware law as requiring "at a minimum the plaintiff must make a showing that the sole or primary motive of the defendant [director] was to retain control. If he makes a showing sufficient to survive a directed verdict, the burden then shifts to the defendant to show . . . a valid corporate business prupose."[80] Not only must the Delaware plaintiff show proof of a forbidden purpose, but he also risks a directed verdict if he does not meet this heavy burden.

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[75]Of course, any legal rule that favors one party with strong presumptions approaches a high degree of predictability. The unpredicability of the business judgment rule is due to courts' present tendency to modify it.

[76]Traditionally, a plaintiff must overcome the presumption of directorial good faith by demonstrating a wrongful "sole or primary" motive. Directors could easily resuscitate the presumption by a *post hoc* "rational business purpose." *See generally*, Note, *The Misapplication of the Business Judgment Rule in Contests for Corporate Control*, 76 Nw. U.L. Rev. 980, (1982).

[77]*See* Maldonado v. Flynn, 413 A.2d 1251, 1255-56 (Del. Ch. 1980).

[78]Johnson v. Trueblood, 629 F.2d 287, 293 (3rd Cir. 1980); *see also* Arsht, *Fiduciary Responsibilities of Directors, Officers and Key Employees*, 4 Del. J. Corp. L. 652, 663 (1979).

[79]629 F.2d 287 (3d Cir. 1980).

[80]*Id.* at 293. This standard was recently reaffirmed in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

The California rule shows more willingness to shift the burden to the directors to justify their decision. In *Klaus v. Hi-Shear Corp.*,[81] the Ninth Circuit, interpreting California law, found the presumption of good business judgment "burst" with a showing of a *possible* conflict of interest.[82] In *Klaus*, the test was one of "balancing . . . the good to the corporation against the disproportionate advantage to the majority shareholders and incumbent management."[83] This test requires the directors, in a suit alleging a possible conflict of interest, to demonstrate a "compelling business purpose" in order to meet the good faith requirement of the business judgment rule.[84] The clearest definition of the California rule is in *Jones v. H.F. Ahmanson & Co.*,[85] where the California Supreme Court stated: "the comprehensive rule of good faith and inherent fairness to the minority in any transaction where control of the corporation is material properly governs controlling shareholders in this state."[86] In a case involving a potential change of corporate control, California will not allow directors the shield of the business judgment rule unless they first show the inherent fairness of the questioned transaction. Delaware would first require a showing of "sole or primary" purpose in conflict with that of the corporation before triggering such an obligation.

The primary arena for interpretation of the proper use of the business judgment rule is in corporate takeovers.[87] By the very nature of the challenge to the directors' authority, there is a conflict of interest. Judge Cudahy, concurring in part and dissenting in part in *Panter v. Marshall Field & Co.*,[88] pointed out the nature of this conflict:

> Directors . . . are, at the very least, "interested" in their own positions of power, prestige and prominence . . . . They are "interested" in defending against outside attack the management which they have, in fact, installed or maintained . . . . And

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[81] 528 F.2d 225 (9th Cir. 1975).

[82] *Id.* at 234.

[83] *Id.*

[84] *Id.*

[85] 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); *see also* Note, Jones v. Ahmanson: *The Fiduciary Obligations of Majority Shareholders*, 70 COLUM. L. REV. 1079 (1970).

[86] 1 Cal. 3d at 112, 460 P.2d at 474, 81 Cal. Rptr. at 602.

[87] *See, e.g.*, Block & Prussin, *supra* note 70; Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Gelfond & Sebastian, *Reevaluating the Duties of Target Management in a Hostile Tender Offer*, 60 B.U.L. REV. 403 (1980); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); Lynch & Steinberg, *supra* note 5; Manning, *supra* note 68; Nathan & Sobel, *Corporate Stock Repurchases in the Context of Unsolicited Takeover Bids*, 35 BUS. LAW. 1545 (1980).

[88] 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

> they are "interested" in maintaining the public reputation of their own leadership and stewardship against the claims of "raiders" who say that they can do better.[89]

From such characterizations of the "interested"-ness of all directors, even those characterized as "independent," has developed the "management entrenchment"[90] model of directional behavior. This model looks at the directors' behavior during a potential takeover situation as primarily motivated by a concern to retain their positions of power and influence. This model becomes more persuasive when account is taken of the type of defensive tactics presently available to the directors of a target and the effects of those defenses upon the shareholders of the target.

The interpretations of the business judgment rule by California and Delaware appear to differ in their applications of the rule to takeover situations. However, a series of Delaware cases shows a definite trend toward the California position. The Delaware case of *Cheff v. Mathes*[91] demonstrates the traditional operation of the Delaware business judgment rule in a greenmail context. In *Cheff*, the basis of the stockholders' complaint was the directors' repurchase of stock from a potential acquirer. This repurchase was ostensibly for the purpose of instituting a stock option plan, which never took place. The trial court found that the true purpose behind the selective repurchase was fear of a hostile takeover, but the Delaware Supreme Court found that the directors were justified in fearing such a takeover and "[i]n any event, this question was a matter of business judgment, which furnishes no justification for holding the directors personally responsible in this case."[92] To reach this conclusion, the court upheld the lower court's shifting of the burden to the directors to justify their decision, but held that burden was satisfied "by showing good faith and reasonable investigation . . . ."[93]

Two recent decisions of the Delaware Supreme Court appear to show a shift in emphasis from concern for the target directors toward a concern for the target shareholders. In *Weinberger v. UOP, Inc.*,[94] a majority of a subsidiary's stock was held by a parent corporation which, by purchasing the remaining shares, merged the subsidiary into the parent.[95] Certain shareholders, the plaintiffs, alleged that insufficient

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[89] *Id.* at 300-01 (Cudahy, J., concurring in part and dissenting in part).

[90] This term, management entrenchment, was developed in Note, *Greenmail: Targeted Stock Repurchases and the Management—Entrenchment Hypothesis*, 98 HARV. L. REV. 1045 (1985).

[91] 41 Del. Ch. 494, 199 A.2d 548 (1964).

[92] *Id.* at 508, 199 A.2d at 556-57.

[93] *Id.* at 506, 199 A.2d at 555.

[94] 457 A.2d 701 (Del. 1983).

[95] For background information on so-called "freezeout mergers," see generally Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978).

information was given to the minority who sold their shares to the majority.[96] The court, in a reverse analysis of the business judgment rule, agreed with the trial court that the ultimate burden of production is on the majority shareholder (the directors) to show intrinsic fairness. But prior to that obligation, the challengers must show "some basis for invoking the fairness obligation."[97] So far the traditional Delaware rule held—to bypass the business judgment rule defense, the plaintiff must show "some basis," traditionally, a demonstration of a forbidden sole or primary purpose. But the court continued with a precondition to that requirement: "[T]he burden clearly remains on those relying on the vote [of the shareholders] to show that they completely disclosed all material facts relevant to the transaction."[98] Thus, in *Weinberger*, the Delaware Supreme Court, by backing up a step in its analysis, essentially reached the position of the California rule, that the burden is on the corporate directors, when faced with a conflict of interest, to show their decision was fair to the corporation. The difference is one of form. Instead of "bursting" the presumption as in California, Delaware requires particular pre-conditions of fairness and disclosure to be demonstrated prior to the application of the rule.

This pre-test for the invocation of the Delaware rule was continued and refined in *Smith v. Van Gorkom*.[99] This case involved a shareholder's suit against corporate directors for approving a merger with another corporation at an insufficient price. This approval took place after a two hour meeting, opened by a presentation by the target's chairman.[100] Evidence at the trial showed that the chairman had approached the acquirer and had, in fact, suggested the price. The Delaware Supreme Court, reversing the Court of Chancery, found "no protection for directors who have made an unintelligent or unadvised judgment."[101] *Smith* demonstrates the willingness of Delaware to back away from blind adherence to a presumption of "good business judgment" and look into the facts to discern whether the requisites of the business judgment rule have actually been met. Instead of relying on the plaintiffs to show improper motives, Delaware will place the burden on the directors to show that their decisions were informed.[102] This approach does not invalidate the concept of gross negligence as the basis of directorial liability. Rather it defines lack of *informed* business judgment as gross negligence. "We

[96]457 A.2d at 703.

[97]*Id.*

[98]*Id.*

[99]488 A.2d 858 (Del. 1985); *see also* Spiegel, *The Liability of Corporate Officers*, 71 A.B.A. J. 48 (1985).

[100]488 A.2d at 869. The facts also show that the chairman was preparing to retire.

[101]*Id.* at 872.

[102]*Id.* at 873.

think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one."[103]

Smith v. Van Gorkom puts the Delaware rule into near congruence with the California rule.[104] In either state, directors can no longer blindly rely on the business judgment rule to shield any decision upon which can be placed a *post hoc* "rational business purpose." This interpretation is especially true in contests for corporate control. Therefore it becomes much easier for a plaintiff in a derivative suit to hold a greenmailer liable for his gains under a theory of aiding and abetting, for the plaintiff is able to prove the first element of his case—that is, that the greenmailer assisted the director to commit an independent wrong.

However, the use of section 876(b) has two distinctly unsatisfactory byproducts. First, the directors of the corporation, arguably acting for the benefit of the corporation,[105] must serve as the principal whose breach of duty was aided and abetted.[106] Even if the shareholders of the target sought recompense only from the greenmailer, and assuming that contribution[107] from the directors as co-tortfeasors of the greenmailer were prevented, some onus must still attach itself to the directors. Thus, section 876(b) provides only for secondary liability, one which requires a showing of a primary breach of duty on the part of the shareholders.

Secondly, the use of such a secondary liability may allow the use by the greenmailer of defenses available to directors, such as Steinberg's attempt to shield himself by invoking the business judgment rule to excuse the Disney directors' payment of greenmail.[108] This tactic was unsuccessful in *Heckman* because the California rule shifts the burden

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[103]*Id.*

[104]However *Smith* does not adopt the California rule. It reaches nearly the same position, but further court decisions are needed to ascertain the extent to which Delaware will require a showing of "informed" business judgment. The facts in *Smith* are so extreme that the decision may be reactive to those facts. Only when placed side by side with *Weinberger* can a pattern be discerned.

[105]The issue is one of motive, whether the directors acted in the best interest of the corporation or whether they acted selfishly to preserve their positions of authority. *See supra* notes 47-48 and accompanying text.

[106]All three subsections of § 876 of the RESTATEMENT provide for aider-abettor liability. RESTATEMENT (SECOND) OF TORTS § 876 (1977).

[107]For an excellent treatment of the problems inherent in contribution, see Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, in Pari Delicto, Indemnification and Contribution*, 120 U. PA. L. REV. 597 (1972).

[108]"The Steinberg Group contends there was no evidence presented to the trial court that the repurchase agreement was motivated by the Disney directors' desire to perpetuate their own control instead of a good faith belief the corporate interest would be served thereby." Heckman v. Ahmanson, 168 Cal. App. 3d 119, 127, 214 Cal. Rptr. 177, 183 (citations omitted).

to the directors to show inherent fairness in situations involving potential changes of corporate control.[109] However, more traditional jurisdictions may allow the raider to use the business judgment rule to shift the burden to the shareholders to prove that the payment of the greenmail was unfair to the corporation or was caused by the sole and primary purpose of the directors to save their positions of influence.[110]

Also, section 876 of the *Restatement (Second) of Torts* does provide for liability for one who "does a tortious act in concert with the other or pursuant to a common design" resulting in harm to a third person.[111] The use of this section relieves a plaintiff harmed by greenmail from showing the second *Landy*[112] element, "that the aider or abettor *know* of that wrong's existence,"[113] but the issue of directorial culpability still exists. The same objections exist as when using section 876(b).

However, section 876(c) gives a tantalizing glimpse at a third possibility, hinting at a direct liability for the greenmailer:

> . . . one is subject to liability if he
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> . . .
>
> (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.[114]

The *Restatement's* comment e to clause (c) excludes any need for the greenmailer to know that greenmail is a wrong to the corporation:

> e. When one personally participates in causing a particular result in accordance with an agreement with another, he is responsible for the result of the united effort if his act, considered by itself, constitutes a breach of duty and is a substantial factor in causing the result, *irrespective of his knowledge that his act or the act of the other is tortious.*[115]

There is no doubt that this comment provides for the aider-abettor's total liability for the joint wrong, but it is still a *joint* wrong, and whether or not the directors are sued or held accountable, some culpability must attach to them. The possibility of attributing a duty to the greenmailer via aider-abettor liability is one that does not meet the goal that an innocent director not be sacrificed to hold a greenmailer liable.

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[109] *See supra* notes 81-86 and accompanying text.
[110] *See generally* Note, *supra* note 76.
[111] RESTATEMENT (SECOND) OF TORTS § 876(a) (1977).
[112] *See supra* notes 66-67 and accompanying text.
[113] 486 F.2d at 162; *see supra* notes 66-67 and accompanying text.
[114] RESTATEMENT (SECOND) OF TORTS § 876(c) (1977).
[115] *Id.*, comment e.

Furthermore, section 876(c) requires that the aider and abettor's conduct itself constitute a breath of duty to the third person; hence, a greater showing with regard to the greenmailer's acts must be made under subsection (c) than under subsection (b).

E. Direct Liability—A Search for an Independent Duty

If it is conceded that greenmail is a wrong not only to the target corporation but also to the shareholders, the directors, and the officers of the target, then the missing element needed to render greenmail a business tort is a duty of the greenmailer to the corporation, to its management, or to his fellow shareholders.

Regarding possible sources of that duty, the *Heckman* court concluded that Steinberg's potential liability could reasonably be grounded on his breach of a direct fiduciary duty owed to Disney's shareholders.[116] This duty arose when Steinberg filed the Arvida litigation as the representative party in a shareholders' derivative suit.[117] The United States Supreme Court, in *Young v. Higbee Co.*,[118] found a breach of fiduciary duty in two plaintiffs' sale of their stock to a corporation against which they had filed a derivative suit. The sale occurred when the plaintiffs were in the appellate process contesting an adverse decision below. The Supreme Court found liability in their acts as a violation of the duties of a derivative suit plaintiff to those whom he represents.[119] Similarly, in *Heckman*, the plaintiff argued that the liability of Steinberg to Disney's shareholders arose from his representation of Disney shareholders.[120] In *Young*, the premium price for the plaintiffs' shares was found to be the property of all the represented shareholders who were deprived of the right to prosecute "their" appeal.[121] It was their interest that was sold by the derivative plaintiffs. In *Heckman*, the profits of Steinberg's sale of stock to Disney ought to belong to those whom Steinberg represented—and abandoned—in the Arvida litigation.[122]

Steinberg's attempt to distinguish *Young* from the facts in dispute was answered by the *Heckman* court:

> We do not believe the result in *Young* stemmed from its unusual facts. Rather, it was consistent with a long-established rule of

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[116]168 Cal. App. 3d at 134, 214 Cal. Rptr. at 187.

[117]*Id.* at 128-29, 214 Cal. Rptr. at 183-84.

[118]324 U.S. 204 (1945).

[119]*Id.* at 213-14.

[120]Respondent's Opening Brief at 16, *Heckman*.

[121]324 U.S. at 213.

[122]Steinberg's attempted distinction of *Young* relied on the Young plaintiffs' leaving their represented parties without a remedy. Here the suit was still intact and needed only another representative to prosecute the suit. Appellant's Opening Brief at 17-18, *Heckman*.

> equity, the rule of individual loyalty, which prevents a fiduciary from profiting at the expense of his beneficiary.[123]

The court's reasoning that Steinberg had assumed a fiduciary duty was reinforced by a volunteer argument offered by the *Heckman* plaintiffs.[124] Using a California tort case,[125] Heckman argued that in the Arvida litigation, Steinberg volunteered "to attempt to prevent Disney from acquiring the large debt" concomitant to that purchase.[126] The duties of a volunteer and the extent of those duties are self-imposed; here the duty was to prevent Disney from accumulating more debt. By selling his stock at a premium, which he knew or should have known would be financed by further borrowing, Steinberg brought about the precise evil he had "volunteered" to oppose. And, noted Heckman, this breach of duty was self-serving.[127]

Steinberg's opposition to the volunteer theory first noted its novelty and untried character:

> [T]he "Good Samaritan" rule has nothing to do with this action; it is purely a tort concept, requiring one who aids a personal injury victim to act with due care. It is not applicable to commercial business transactions, and respondents have not cited a single case which extends the principle beyond personal injury tort cases.[128]

Steinberg then disparaged the theory even as an analogy because the Arvida litigation proposed to dissuade Disney only from incurring the Arvida debt, not to oppose all debt Disney ever would acquire in any future transaction.[129] The Arvida litigation was specific, not general.

The use of a derivative suit as the source of a duty for a greenmailer is very persuasively presented by the *Heckman* court. This approach has the advantage of providing a direct source of liability, as opposed to the secondary liability offered by aider-abettor theory.[130] The greenmailer "volunteered" to serve the interests of the target's shareholders and cannot effectively deny that assumption of duty, especially when the filing of a derivative suit is one of the factors pressuring the directors to offer greenmail. This causal chain in *Heckman* is very short and very apparent.

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[123]168 Cal. App. 3d at 132-33, 214 Cal. Rptr. at 186.

[124]*Id.* at 133, 214 Cal. Rptr. at 186.

[125]Williams v. State, 34 Cal. 3d 18, 644 P.2d 137, 192 Cal. Rptr. 233 (1983) (involving an auto accident in which a policeman voluntarily aided an injured party).

[126]Respondent's Opening Brief at 17-18, *Heckman*.

[127]*Id.* at 19.

[128]Appellants' Reply Brief at 20, *Heckman* (citations omitted).

[129]*Id.* at 21.

[130]*See supra* notes 106-11 and accompanying text.

If this source of duty is ultimately used to attach liability to Steinberg (and the likelihood is strong), its weakness becomes evident: few raiders will undertake derivative suits. As in *Heckman*, the derivative action is most often not the heart of the raider's threat, but merely an additional source of directorial anxiety.[131] A more certain and less easily evaded source of duty is needed.

A possible alternate source of direct liability for a greenmailer stems from the attribution of fiduciary duties to a controlling shareholder. There are two theories regarding the source of a duty for the control-holder. In the first theory, the analogy of a trust is used: because the control-holder has custody of the assets of the non-controlling shareholders, principles of equity require him to care for those assets as a trustee, thus creating a fiduciary relationship.[132] Another theoretical source is derivative in nature: as officers and directors are bound by fiduciary obligations, the control-holder who operates through them ought to be similarly constrained.[133]

The fiduciary duties of a control-holder are further confused by the lack of a consensus as to the definition of "control." The Delaware Court of Chancery defined control by its results. " 'Control' and 'domination' . . . imply . . . a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling."[134] Even without any direct participation in corporate governance by a controlling shareholder, "it may be inferred that management consults such an outside [shareholder]."[135]

In *Perlman v. Feldmann*,[136] the Second Circuit Court of Appeals found that the sale of thirty-seven percent of a steel corporation by the largest shareholder, who was also president and chairman of the board of directors, to one of the company's customers at a premium price was a breach of duty to the steel corporation's other shareholders.[137]

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[131]"The goal is to so preoccupy management that it will buy out the investor's shares in order not to be diverted from running the company's business." Greene & Junewicz, *supra* note 8, at 706.

[132]*See, e.g.*, Pepper v. Litton, 308 U.S. 295, 306 (1939) (refers to powers of "dominant or controlling stockholders[s]" as "powers in trust"). *See generally* Bayne, *A Philosophy of Corporate Control*, 112 U. Pa. L. Rev. 22 (1963).

[133]Zahn v. Transamerica Corp., 162 F.2d 36, 46 (3d Cir. 1947) (refers to "puppet-puppeteer relationship").

[134]Kaplan v. Centex Corp., 284 A.2d 119, 123 (Del. Ch. 1971).

[135]Gottesman v. General Motors Corp., 279 F. Supp. 361, 368 (S.D.N.Y. 1967).

[136]219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

[137]Although there is some hint in the *Perlman* opinion that liability was imposed for depriving the corporation of an opportunity rather than the securing of a control premium, the ultimate holding was that a breach of fiduciary duty had occurred. The remedy, return of the control premium, may also be termed a return of the profits secured from a corporate opportunity that was wrongfully appropriated by Feldman. *See* Hill, *The Sale of Controlling Shares*, 70 Harv. L. Rev. 986, 1006-10 (1957).

The court placed the source of the duty to minority shareholders on defendant's role "[b]oth as director and as dominant stockholder . . . ."[138] This court went on to hold that the minority shareholders had the right to recover individually[139] their share of the purchase price that was found to have been for "control."[140] *Perlman* stands for the proposition that a controlling shareholder must be careful in his sale of stock, because the control premium,[141] which is conveyed as an inseparable incident to any sale of his stock, may be found to have been held in trust for the corporation or for his fellow shareholders.[142]

When the sale of a controlling block of stock is involved, the fiduciary duty of the controlling shareholder obligates him not to transfer control to a purchaser who is likely to misuse corporate assets, or who is likely to "loot" the corporation.[143] The seller of corporate control is therefore obligated to investigate the business reputation of a potential acquirer.[144] In a greenmail context, which normally involves a tender offer for a controlling number of shares, it may be argued by directors who pay greenmail that they were obligated, as guardians of corporate control, to forestall an acquisition by a corporate raider. There is some merit in this argument, though it can also cloak a clandestine motive to retain positions of authority.[145]

Corporate control—unlike other corporate attributes—is often obscured by its union with various corporate offices. In *Perlman*, the defendant was not only the controlling shareholder, but also the president and chairman of the board.[146] Any one of these positions would suffice to trigger a fiduciary duty to the corporation. Control is also fluid; it flows from place to place depending upon various factors. In *Box v. Northrop Corp.*,[147] two major corporate creditors were held to owe a

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[138]219 F.2d at 175.

[139]The reason for personal recovery appears to be that corporate recovery would merely benefit the acquiring control-holder. Though the rights of the minority shareholders derive from the sale of a corporate asset, the power to control, the minority was allowed to recover individually. The dissent by Judge Swan investigates this apparent contradiction. *Id.* at 180 (Swan, C.J., dissenting).

[140]*Id.* at 157. *See supra* note 137.

[141]*See generally* Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L. J. 37 (1982).

[142]*See generally* O'Neal, *Symposium: Sale of Control*, 4 J. CORP. L. 239 (1979).

[143]DeBaun v. First Western Bank and Trust Co., 46 Cal. App. 3d 686, 120 Cal. Rptr. 354 (1975); Gerdes v. Reynolds, 28 N.Y.S.2d 622 (N.Y. Sup. Ct. 1941).

[144]"Those who control a corporation . . . owe some duty to the corporation in respect of the transfer of the control to outsiders. . . . [They] are under a duty not to transfer [control] to outsiders if the circumstances . . . are such as to awaken suspicion and put a prudent man on his guard . . . ." Insuranshares Corp. v. Northern Fiscal Corp., 35 F. Supp. 22, 25 (E.D. Pa. 1940).

[145]*See supra* notes 87-90 and accompanying text.

[146]219 F.2d at 175.

[147]459 F. Supp. 540 (S.D.N.Y. 1978), *aff'd mem.*, 598 F.2d 609 (2d Cir. 1979).

duty as *de facto* controllers to a minority shareholder.[148] The *Heckman* court refused to discuss whether or not a greenmailer was a controlling shareholder, but stated in a footnote: "[t]he question, a factual one, is what amount of influence [Steinberg] could exert on the corporation by reason of [his] holdings."[149]

When control is united with an office having a fiduciary duty to the corporation, it is not difficult to justify imbuing control with similar fiduciary obligations. It is only when control is exerted by a person with no apparent duty to the corporation that an issue arises. *Box* ultimately found the duty owed by corporate control (in the guise of corporate creditors) was not breached. This finding made unneccessary a detailed analysis of the nature and extent of such duties appurtenant to control.[150]

In a greenmail case, where a greenmailer used a tender offer for control to induce directors to repurchase his shares, it is difficult to term him a "controlling shareholder." " 'Control' is what a tender offeror ultimately seeks; it is not obtained until the tender offer succeeds."[151] Though the greenmailer certainly "direct[s] corporate conduct in such a way as to comport with [his] wishes or interests,"[152] his direction is limited to a single transaction—the extraction of greenmail. One commentator, in urging the extention of fiduciary duties to all control-holders, posits a situation "in which a person who wielded a noncorporate power over the majority shareholder, such as a *blackmailer*, could hold control . . . ."[153] Another commentator lists four forms in which control may be found. One form is a person "whose stockholdings are negligible—possibly nil—who is in a position to cause the directors of the corporation to resign . . . and elect successors of the control-holder's choosing."[154] The goal of a greenmailer is not so much a matter of replacing directors of a target corporation as it is a matter of influencing them to repurchase his shares at a premium price. Although the goal is different, the result, bending the policies of the corporation to one's will, is the same.

If one accepts the premise that corporate control is a corporate asset,[155] it is reasonable for a court to find that a greenmailer's surrender of his tender offer is a surrender of potential control. Any premium

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[148]*Id.* at 547.

[149]*Heckman*, 168 Cal. App. 3d at 133 n.7, 214 Cal. Rptr. at 187 n.7.

[150]459 F. Supp. at 556.

[151]Appellant's Reply Brief at 14-15, *Heckman*.

[152]*Kaplan*, 284 A.2d at 123.

[153]Bayne, *supra* note 132, at 30 (emphasis added).

[154]Berle, *The Price of Power: Sale of Corporate Control*, 50 CORNELL L. REV. 628, 630 (1965).

[155]*See* Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931).

paid for this potential control may be regarded as a purchase of a corporate asset—control—and ought to be forfeited to the corporation. If, on the contrary, one believes that a shareholder may sell his shares for any price he can get,[156] a fact question may arise as to how much influence was exerted by the greenmailer upon the repurchasing directors. In determining the quantum of influence, significant attention must be given to the greenmailer's business reputation. Target directors and majority shareholders are required to take cognizance of a raider's probable motive;[157] courts ought to do no less.

An interpretation of *Jones v. H.F. Ahmanson & Co.*[158] would brand a greenmailer with an intermediate label, that of a "dominant" shareholder, a label also triggering fiduciary obligations. *Jones* restated the California business judgment rule as requiring "good faith and inherent fairness . . . in any transaction where control of the corporation is material."[159] Clearly a tender offer for corporate control falls within this category. And if the offeror does not qualify as a controlling shareholder, he certainly has a large influence, especially when he has financing arranged and is offering an attractive premium over market price. Considering these factors as well as the reputation of a "corporate raider," a court may well conclude that a greenmailer is a "dominant shareholder" in the same sense that the *Box* court concluded that the creditors of a corporation were *de facto* control-holders.

In *Jones*,[160] Chief Justice Traynor adopted the following quotation from *Pepper v. Litton*[161] as a statement of California common law to define the fiduciary duties of directors:

> 'He who is in such a fiduciary position cannot serve himself first and his *cestuis* second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. He cannot by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stock-

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[156]*See, e.g., Perlman*, 219 F.2d at 178-80 (Swan, C.J., dissenting).
[157]*See supra* note 145 and accompanying text.
[158]1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).
[159]*Id.* at 112, 460 P.2d at 474, 81 Cal. Rptr. at 602.
[160]1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).
[161]308 U.S. 295 (1939).

> holders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis*. Where there is a violation of these principles, equity will undo the wrong or intervene to prevent its consumation.' This is the law of California.[162]

This very same quotation was labelled by the *Heckman* court as "the shareholder's Magna Carta."[163] The *Heckman* court was willing to extend the fiduciary duties of a director at least far enough to bind a tender offeror. However, it should be emphasized that this is but one of two theories sufficient to give a possibility of success on the merits—it is not a judgment on the merits.[164]

If a fiduciary duty can be found to apply to a tender offeror, then the inherent fairness test of the California business judgment rule could be applicable.[165] While it may be fair for a greenmailer to purchase a control percentage from those willing to sell, especially at a premium price, it will probably not be fair to the minority to accept greenmail from the directors to cancel his tender offer.[166] Thus, a greenmailer will have no incentive to issue a tender offer unless he is willing to gain control of the target and has the ability to manage it more effectively than the current management.[167] Once he has effective control and exercises it, the greenmailer is subject to those fiduciary duties of a manager and director as well as to those applying to a control-holder. These duties will prevent any intention to "loot" the assets of the target corporation.

Whether termed a dominant shareholder or a controlling shareholder, a greenmailer will be held responsible for his acts by courts recognizing a common law fiduciary duty extending from a greenmailer to a shareholder. This solution satisfies both criteria stated above for an "ideal" source of fiduciary duty. It does not penalize directors as they would not be necessary parties where suit is brought for a breach of fiduciary

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[162] *Jones*, 1 Cal. 3d at 108-09, 460 P.2d at 471-72, 81 Cal. Rptr. at 599-600 (quoting 308 U.S. at 311).

[163] *Heckman*, 168 Cal. App. 3d at 126, 214 Cal. Rptr. at 182.

[164] *See supra* notes 3-4 and accompanying text.

[165] *See supra* notes 81-86 and accompanying text.

[166] *See* Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965) (argument that when control is sold, the acquirer ought to be required to offer the same terms to minority shareholders).

[167] This argument coalesces with the efficiency justification for the free market, which postulates that in a "free" market, resources, including a entrepreneurial expertise, will naturally gravitate to maximize productivity. *See supra* note 8 and accompanying text.

obligation based upon the greenmailer's status as dominant or controlling shareholder. And directors would still be free to repurchase stock from dissident shareholders so long as the requirements of the business judgment rule and the inherent fairness test are met.

The drawback to the directors is that they may no longer preserve their positions of authority by paying out corporate funds as greenmail. However, this is hardly a drawback insofar as the shareholders are concerned; corporate directors ought not have that motivation in any case.

III. Conclusion

When faced with litigation involving greenmail, courts must first determine who the guilty parties actually are. If it appears that the incentive to repurchase stock came from the corporate directors, courts must determine whether the business judgment rule is applicable. If corporate control was not involved, it is most probable that the directors had a rational business purpose and the intricacies of the business judgment rule ought to be applied.

If, however, it appears that corporate control was at issue, the business judgment rule ought to be set aside and the concept of intrinsic fairness should dominate. If the directors had a legitimate interest in repelling a raider, their conduct must be measured against the high standards of a fiduciary. Likewise, a raider, actively seeking either control or greenmail, ought to be judged against this same high standard.

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