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Speaking with Complete Candor: Shareholder Ratification and the Elimination of the Duty of Loyalty

by
J. ROBERT BROWN, JR.*

Introduction

Few corporate law doctrines matter more than the duty of loyalty. Designed to protect the shareholders from the consequences of improper self-dealing, the duty applies to transactions with the corporation that benefit officers, directors, or other fiduciaries. The duty of loyalty imposes a high standard of utmost fairness. Moreover, recognizing that directors may act out of self-interest rather than out of the best interest of shareholders, the duty of loyalty places the burden of establishing fairness on the fiduciary with the conflict of interest.¹

Recent controversies have reaffirmed the need for strict regulation of the duty of loyalty. Whether the severance package given to John F. (Jack) Welch, the former CEO of General Electric,² or the \$400 million loan to Bernie Ebbers, the former CEO of

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1. *See infra* notes 25–26.

2. Companies must make detailed disclosure of executive compensation. *See* Item 402, Regulation S-K, 17 C.F.R. § 229.402 (2002). Disclosure of severance packages is less robust. Welch received a lucrative package that, in addition to annual payments of \$9 million, included around-the-clock access to the company jet, a Mercedes Benz, courtside tickets, and apartments, complete with fresh flowers and a cook. The information only came to light as a result of the filing of a financial affidavit in divorce proceedings. *See* Michael Barbaro, *A King's Ransom in Retirement Benefits; GE Pays Ex-CEO Millions a Year in Pension, Perks*, WASH. POST, Sept. 7, 2002, at E1. In response to the criticism, Welch ultimately agreed to pay for the perks, which he valued at approximately \$2 million a year.

WorldCom,³ corporate executives sitting on the board have obtained huge personal benefits from the companies they oversee. Despite the central importance of fairness to the duty of loyalty, however, the trend has been to eliminate any analysis of fairness, replacing substantive review with procedural safeguards.

This has been particularly true with respect to ratification by disinterested shareholders. If done properly, disinterested ratification results in the application of the business judgment rule. In those circumstances, courts will not examine the fairness of the transactions. Aggrieved shareholders are left only with a cause of action for waste, an all but insurmountable standard.⁴

The wisdom of a policy allowing a majority of disinterested shareholders in a public company to consent to, and thereby immunize from challenge, self-dealing is questionable.⁵ Shareholder approval involves the usual problems associated with collective action, including shareholder apathy. More important, disinterested approval does not expunge the taint arising from a conflict of interest. Interested shareholders and directors may still participate in, and influence, the decision-making process.⁶ Therefore, interested influence remains, notwithstanding disinterested approval.

There is also reason to doubt that disinterested approval is actually disinterested. Delaware courts have not defined "disinterested" shareholder. Management, therefore, has considerable discretion in determining which votes to count. Management also has no express obligation to implement a system designed to insure that interested shares are not counted in the final total. With shareholder identity easily obscured through nominee accounts and other forms of beneficial ownership, this possibility amounts to more than a theoretical concern.⁷

3. See Proxy Statement, WorldCom, Inc. (April 22, 2002) (describing terms of offer), available at <http://www.sec.gov/Archives/edgar/data/723527/000091205702015985/0000912057-02-015985.txt>.

4. See *infra* notes 19, 44.

5. See *infra* notes 41, 42. For a discussion of these concerns, see generally Victor Brudney, *Revisiting the Import of Shareholder Consent for Corporate Fiduciary Loyalty Obligations*, 25 J. CORP. L. 209 (2000).

6. See *Cede & Co. v. Technicolor*, 634 A.2d 345, 363 (Del. 1993):
Nothing we said [in *Pogostin v. Rice*, 480 A.2d 619 (Del. 1984),] suggests that one director's self-interest, or even an act of disloyalty by that director, so infects the entire process that the board itself is deprived of the benefit of the business judgment rule. This Court has never held that one director's colorable interest in a challenged transaction is sufficient, without more, to deprive a board of the protection of the business judgment rule presumption of loyalty.
(italics omitted). See also *infra* note 67.

7. For public companies, section 16 under the Exchange Act provides a mechanism for identifying beneficial ownership of directors, executive officers, and 10% shareholders. See 15 U.S.C. § 78p(a) (2002). The provision extends to shares beneficially owned by

Finally, the courts universally give effect to disinterested ratification only if shareholders are properly informed. Informed shareholders must have all material information when consenting to the self-dealing. In practice, however, they often do not. Delaware courts repeatedly consider immaterial categories of information among the most important to shareholders in deciding how to vote. As a result, disinterested shareholders in reality are not informed at the time of ratification.

The uninformed nature of the decision making process is the clearest in two contexts: sale of the business and conflicts of interest. With respect to sale of the business, Delaware courts decline to find as material categories of information suggesting the inadequacy of the offering price. They do not require the disclosure of additional, higher-priced offers, alternative formulas used to compare value, even if presented to the board, or other valuations in the company's possession. The courts have even gone so far as to characterize this type of information as harmful.⁸

Similarly, with respect to conflicts of interest and improper managerial behavior, Delaware courts use the "self-flagellation" doctrine to exempt the information from disclosure. The doctrine traditionally exempted companies from any obligation to characterize improper behavior or otherwise admit to legal violations. They did, however, have to disclose the surrounding facts, allowing shareholders to draw their own conclusions. Delaware courts have expanded the self-flagellation doctrine to encompass surrounding facts. As a result, they characterize as immaterial information suggesting that management will benefit from the transaction, has engaged in improper behavior, or has motivations not necessarily consonant with the best interests of shareholders.

The interpretation of materiality by Delaware courts lies in sharp contrast to that used in the federal system. Although both rely on an

these actors. *Id.* Public companies would, therefore, have some idea of the number of shares held by insiders and large shareholders. The provision does not necessarily cover all shares that would be held by interested parties. More to the point, section 16 identifies the number of shares held by these individuals but does not identify the accounts. *Id.* Companies may know the total ownership of the insiders but, to the extent shares are held in street name accounts, will not necessarily know the number actually voted. *Bielski v. Cabletron Sys. (In re Cabletron Sys.)*, 311 F.3d 11, 34 (1st Cir. 2002) ("Merely stating in conclusory fashion that a company's books are out of compliance with [Generally Accepted Accounting Principles ("GAAP")] would not in itself demonstrate liability under section 10(b) or Rule 10b-5.") For a discussion of the use of nominee accounts and their implications for corporate governance, see J. ROBERT BROWN, JR., *THE REGULATION OF CORPORATE DISCLOSURE* § 15.04 (3d ed. 1999 & Supp. 2003).

8. See *infra* notes 82, 190 and accompanying text. Some have suggested that disclosure would amount to misrepresentation. See *infra* notes 227, 254-56 and accompanying text.

identical definition of materiality,⁹ a comparison of cases suggests that, while state courts use the same terminology, they rely on a far more restrictive interpretation. As a result, shareholders do not always receive information that federal courts would deem “important” to a “reasonable investor.”¹⁰

The comparison between state and federal case law exposes a central weakness in the use of disinterested shareholder approval to ratify conflicts of interest. To the extent that substantive review gives way to procedural safeguards, the procedural safeguards must be meaningful. Meaningful safeguards require full disclosure. Yet at least in the area of disinterested shareholder approval, this has not occurred.¹¹

This Article has four parts. The first examines fiduciary obligations and the impact of disinterested shareholder ratification. The second analyzes the development of the duty of complete honesty and the fiduciary obligation to keep shareholders informed. The third section compares state and federal disclosure cases, highlighting the difference in the application of the materiality standard. The last section discusses the implications of using disinterested shareholder approval to eliminate an examination of the fairness of the transaction.

I. Shareholder Ratification and the Duty of Loyalty

A. Fiduciary Duties

Fiduciary obligations have a talismanic quality in the corporate context. They represent the only significant limitation on board action. Although corporate law originally contained a large number of absolute restraints on managerial behavior, most were repealed, either by statute or judicial interpretation.¹² As a result, the board

9. See *In re BankAmerica Corp. Sec. Litig.*, 78 F. Supp. 2d 976, 992 (E.D. Mo. 1999) (noting that Delaware has adopted “the federal standard” for materiality). The antifraud provisions generally include section 17 of the 1933 Act, 15 U.S.C. § 77q (2002), and Rules 10b-5, 14a-9, and 14e-3 of the Exchange Act. 17 C.F.R. §§ 240.10b-5, 240.14a-9, 240.14e-3 (2002).

10. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

11. See *infra* notes 136–52; 173–225 and accompanying text.

12. Corporations were originally subject to strict limitations, particularly on size. Those restrictions are discussed at length in a dissent by Justice Brandeis in *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 548–64 (1933). Gradually, these restraints were repealed, and the issue became a matter of board discretion. Blank-check preferred stock provisions allowed management to issue new classes of shares without shareholder approval. See DEL. CODE ANN. tit. 8, § 151(a); REV. MODEL BUS. CORP. ACT § 6.02 (1984). Elimination of purpose clauses enabled managers to dramatically change the nature of the business without shareholder consent. See REV. MODEL BUS. CORP. ACT

gained more discretion, with fiduciary obligations the only significant guarantor of the integrity of the actions.

Fiduciary obligations include the duty of care, which commands that directors act in the best interests of shareholders, and the duty of loyalty, which requires directors engaging in self-dealing to act with utmost good faith and scrupulous fairness.¹³ Under the duty of care, directors must discharge their duties “in good faith, in a manner . . . reasonably believe[d] to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.”¹⁴ In the case of board action,¹⁵ courts will not

§ 2.02. More recently, Delaware courts have eliminated long-standing prohibitions on discriminatory treatment of shareholders within the same class, *see Unocal v. Mesa Petroleum*, 493 A.2d 946, 957 (Del. 1985), and the requirement that fiduciaries not usurp a corporate opportunity without first presenting the matter to the board of directors. *See Broz v. Cellular Info. Sys.*, 673 A.2d 148, 157 (Del. 1996).

13. The Delaware Supreme Court characterizes the board’s fiduciary obligations as a triad that includes care, loyalty, and good faith. *See, e.g., Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998); *Cede & Co. v. Technicolor*, 634 A.2d 345, 361 (Del. 1993). The Supreme Court has provided little content to an independent duty of good faith. Moreover, the lower courts have largely ignored it, treating it as a subcategory of loyalty. *See Orman v. Cullman*, 794 A.2d 5, 14 n.3 (Del. Ch. 2002):

Because the duty to act in “good faith” is merely a subset of a director’s duty of loyalty, my consideration of Orman’s duty of loyalty allegations necessarily includes a consideration of whether the facts pled suggest the defendants did not act in good faith with regard to their duty of loyalty to the Company.

See also Emerald Partners v. Berlin, No. 9700, 2001 Del. Ch. LEXIS 20, at *87 n.63 (Del. Ch. Feb. 7, 2001):

Although corporate directors are unquestionably obligated to act in good faith, doctrinally that obligation does not exist separate and apart from the fiduciary duty of loyalty. Rather, it is a subset or “subsidiary requirement” that is subsumed within the duty of loyalty, as distinguished from being a compartmentally distinct fiduciary duty of equal dignity with the two bedrock fiduciary duties of loyalty and due care.

See also In re Gaylord Container Corp. S’holders Litig., 753 A.2d 462, 475 n.41 (Del. Ch. 2000) (“Within which traditional duty [of loyalty] would logically rest the subsidiary requirement to act in good, rather than bad, faith toward the company and its stockholders.”).

14. 1 PRIN. CORP. GOV. § 4.01(a) (1993). This Article does not address the heightened standards of board behavior that occurs during a change of control. *See Revlon v. MacAndrews & Forbes Holding*, 506 A.2d 173, 184 (Del. 1986); *Unocal*, 493 A.2d at 954.

15. The business judgment rule does not apply to board inaction, except where deliberate. *See Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984).

However, it should be noted that the business judgment rule operates only in the context of director action. Technically speaking, it has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act. But it also follows that under applicable principles, a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule.

consider whether behavior has violated the duty of care unless plaintiffs rebut the presumption of the business judgment rule.¹⁶

The business judgment rule insulates board decisions made in good faith, on an informed basis, and in the best interests of shareholders.¹⁷ Courts largely limit the analysis to the process used in making the decision.¹⁸ To the extent boards follow the proper procedures, plaintiffs are reduced to claims for waste, an extraordinarily difficult standard to meet and one “very rarely satisfied.”¹⁹ The result of this approach is a “rubber-stamp” of director behavior.²⁰

Id. (footnote omitted). For the standards applicable to inaction, sometimes labeled the duty to monitor, see *In re Caremark Int'l Derivative Litig.*, 698 A.2d 959, 967–70 (Del. Ch. 1996).

16. See *McMullin v. Beran*, 765 A.2d 910, 916 (Del. 2000) (The business judgment rule creates “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” (quoting *Aronson*, 473 A.2d at 812)).

17. *Aronson*, 473 A.2d at 812. Successfully rebutting the presumption that the business judgment rule does not result in *per se* liability. Instead, the burden shifts to the directors to show the “entire fairness” of the transaction. See *McMullin*, 765 A.2d at 917; *Cinerama v. Technicolor*, 663 A.2d 1156, 1162 (Del. 1995); *Cede*, 634 A.2d at 361.

18. Wells M. Engledow, *Structuring Corporate Board Action to Meet the Ever-Decreasing Scope of Revlon Duties*, 63 ALB. L. REV. 505, 508 (1999) (“Thus, at bottom, the business judgment rule reflects little more than process inquiry.”).

19. *Steiner v. Meyerson*, No. 13139, 1995 Del. Ch. LEXIS 95, at *3 (Del. Ch. July 18, 1995); see also *In re Limited Inc. S'holders Litig.*, No. 17148-NC, 2002 Del. Ch. LEXIS 28, at *37 (Del. Ch. Mar. 27, 2002) (“The plaintiffs have failed to demonstrate that the Company received no benefit in exchange for these two transactions or that these transactions, taken together, served no corporate purpose.”); *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 892 (Del. Ch. 1999) (“The pleading burden on a plaintiff attacking a corporate transaction as wasteful is necessarily higher than that of a plaintiff challenging a transaction as ‘unfair’ as a result of the directors’ conflicted loyalties or lack of due care.”). Waste “entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade.” *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997). The imposition of a waste standard in the case of shareholder ratification preceded the adoption of section 144. See *Gottlieb v. Heyden Chem. Corp.*, 91 A.2d 57, 58 (Del. 1952) (In the case of shareholder ratification, “the objecting stockholder must convince the court that no person of ordinarily sound business judgment would be expected to entertain the view that the consideration furnished by the individual directors is a fair exchange for the options conferred.”). Some courts have questioned the need for an action for waste that survives the application of the business judgment rule. See *Harbor Financial Partners*, 751 A.2d at 895–902. Nonetheless, unless changed significantly in Delaware, the courts have long recognized that a board can be insulated from waste only by obtaining unanimous approval of shareholders. See *Saxe v. Brady*, 184 A.2d 602, 605 (Del. Ch. 1962); see also *Lewis*, 699 A.2d at 335. In any event, it may make no difference. See *Rosser v. New Valley Corp.*, No. 17272, 2000 Del. Ch. LEXIS 115, at *23 (Del. Ch. August 15, 2000) (“So while fully informed shareholder ratification may not be tantamount to the death penalty for breach of fiduciary duty claims, application of the business judgment rule will lead to the same end result in virtually every case.”).

20. Engledow, *supra* note 18 at 507. See also Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 299–300 (1999).

The business judgment rule essentially represents an over-inclusive protection designed to insulate directors who take risks.²¹

There seems to be consensus that the benefits of protecting risk-taking outweigh the harm of allowing directors to occasionally escape liability for mismanagement.²² This rationale, however, only works in cases devoid of conflicts of interest. In the absence of competing motivations, courts presume that the board tried to do what was best for shareholders, no matter how disastrous the decision turned out to be in hindsight.²³

B. Duty of Loyalty and Disinterested Approval

In contrast, transactions involving conflicts of interest give rise to heightened concern because of the possibility that the board was motivated by something other than the best interests of shareholders.²⁴ With the presence of competing motivations, the transaction has no presumption of validity. The board, therefore, has a higher burden²⁵ and must demonstrate that the transaction meets the standard of “entire fairness.”²⁶ Entire fairness, in turn, requires a showing of both fair price²⁷ and fair procedure.²⁸

21. See *Cede & Co. v. Technicolor*, 634 A.2d 345, 360 (Del. 1993) (“The business judgment rule . . . operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation.”).

22. *Joy v. North*, 692 F.2d 880, 885–86 (2d Cir. 1982); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1980); 18B AM. JUR. 2D *Corporations* § 1704 (2002).

23. See *McMullin v. Beran*, 765 A.2d 910, 916 (Del. 2000); *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985); *Aronson*, 473 A.2d at 812; *Zapata*, 430 A.2d at 782; *Kaplan v. Centrex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971).

24. The duty applies whenever board members have an interest in the transaction at issue. Interest occurs where directors “appear on both sides of a transaction [or] expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally.” *Aronson*, 473 A.2d at 812.

25. The standard has been described as “uncompromising.” *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

26. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983):

When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain. The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.

(citation omitted). See also *Telxon Corp. v. Meyerson*, 802 A.2d 257, 265 (Del. 2002) (“Like any other interested transaction, directoral self-compensation decisions lie outside the business judgment rule’s presumptive protection, so that, where properly challenged, the receipt of self-determined benefits is subject to an affirmative showing that the compensation arrangements are fair to the corporation.”); *Emerald Partners v. Berlin*, 787 A.2d 85, 89 (Del. 2001) (“When shareholders challenge actions by a board of directors, generally one of three standards of judicial review is applied: the traditional business

The case law addressing the impact of disinterested shareholder approval has been confused and has changed over time. The evolution largely turned on an inaccurate reading of section 144 of the Delaware Corporate Code. Adopted in 1967, section 144 provides that certain interested transactions shall not be “void or voidable”²⁹ solely because of participation by interested directors³⁰ if:

- (1) The material facts as to the director’s or officer’s relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the *disinterested* directors, even though the *disinterested* directors be less than a quorum; or
- (2) The material facts as to the director’s or officer’s relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or
- (3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.³¹

The provision has a number of limiting features. First, it applies only to a narrow category of self-dealing transactions. Specifically, the section governs transactions between the corporation and its officers/directors or the corporation and any entity controlled by the directors.³² Other self-interested transactions fall outside the statute.³³

judgment rule, an intermediate standard of enhanced judicial scrutiny, or the entire fairness analysis.”). The duty of loyalty applies to both common and preferred shareholders. *See Jackson Nat’l Life Ins. Co. v. Kennedy*, 741 A.2d 377, 386 (Del. Ch. 1999).

27. Fair price requires a showing “that the price offered was the highest value reasonably available under the circumstances.” *Cede & Co. v. Technicolor*, 634 A.2d 345, 361 (Del. 1993).

28. Entire fairness applies where “self-interest may have colored the directors’ actions.” *Thorpe v. CERBCO*, 676 A.2d 436, 443 n.9 (Del. 1996). The interest must, however, be “substantial.” *Cinerama v. Technicolor*, 663 A.2d 1156, 1169 (Del. 1995).

29. DEL. CODE ANN. tit. 8, § 144(a) (2002).

The essential distinction between voidable and void acts is that the former are those which may be found to have been formed in the interest of the corporation but beyond the authority of management, as distinguished from acts which are *ultra vires*, fraudulent or gifts or waste of corporate assets.

Michelson v. Duncan, 407 A.2d 211, 218–19 (Del. 1979).

30. Specifically, the provision applies to any “contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest.” DEL. CODE ANN. tit. 8, § 144(a) (2002).

31. *Id.* (emphasis added).

32. *Id.*

In particular, the section does not apply to transactions with controlling shareholders,³⁴ a situation particularly applicable in the context of parents and subsidiaries.³⁵ Nor does it apply where a director benefits from, but is not a party to, the transaction.³⁶

Second, the provision provides protection for transactions approved by a “good faith . . . vote of the shareholders.”³⁷ It does not require disinterested approval.³⁸ Although an argument could be made that “good faith” implicitly requires disinterest, the argument ignores the specific reference in the statute to the need for approval by *disinterested* directors.³⁹ A literal reading of the statute, therefore, permits directors who own a majority of shares to approve their own transaction with the company.⁴⁰

33. It does not apply, for example, to a transaction with a third party where the director benefits. See *Cinerama*, 663 A.2d at 1174 (director received a finder's fee as a result of merger).

34. Wholly owned subsidiaries would not create significant problems. On the other hand, majority-owned subsidiaries with outside shareholders would raise concerns and require a more exacting analysis of transactions between parent and subsidiary.

35. See *id.* at 1169 n.24.

36. See *id.* at 1174 (“hope of better employment opportunities” as a result of transaction not covered by section 144). Courts have also applied principles under section 144 to entities other than for-profit corporations. See *Oberly v. Kirby*, 592 A.2d 445, 469 (Del. 1991) (applying principles to transaction with a nonstock charitable corporation). The provision is not exclusive, even for transactions that fall squarely within the statute. Approval may be impossible where, for example, a quorum cannot be obtained or shareholders and directors are evenly divided. Failure to obtain the requisite approval does not result in a *per se* rule of voidability. Instead, courts will still apply a fairness analysis before deciding whether to void the transaction. See *Marciano v. Nakash*, 535 A.2d 400 (Del. 1987) (statute inapplicable because of deadlock by shareholders and interested nature of board; rather than void transaction, court relied on common law and examined transaction for intrinsic fairness).

37. DEL. CODE ANN. tit. 8, § 144(a)(2) (2002).

38. Delaware courts repeatedly and imprecisely characterize the language in section 144(a)(2) as requiring approval of a majority of “disinterested” shareholders. See, e.g., *In re Wheelabrator Tech. S'holders Litig.*, 663 A.2d 1194, 1203 (Del. Ch. 1995); *Marciano*, 535 A.2d at 405 n.3.

39. An argument could be made that the phrase was intended to mean a majority of all disinterested shareholders. Nonetheless, internal consistency within the section suggests otherwise. To the extent it intended this meaning, the statute did so explicitly. See DEL. CODE ANN. tit. 8, § 144(a)(1) (2002) (specifying that approval was to be by a “majority of the disinterested directors”).

40. Indeed, some courts interpreting comparable statutes have suggested that shareholder approval, even if by controlling shareholders, reduces a claim to waste. See *Camden v. Kaufman*, 613 N.W.2d 335, 340 (Mich. App. 2000). Perhaps the requirement of “good faith” in section 144 could be interpreted to mean disinterested. No case has ever grounded the requirement in such an analysis and for a number of reasons it seems an unlikely interpretation. Foremost, good faith seems to modify “vote” rather than “shareholder.” Moreover, to the extent the statute means disinterested, it uses the word specifically when describing the requirements of board approval.

Delaware courts have adopted a confused and result-oriented interpretation of the shareholder ratification requirement in section 144. The section says nothing about the impact of shareholder approval on the fairness analysis and it certainly does not state or otherwise imply that it was intended to make actions by management essentially unreviewable by the courts. Indeed, the earlier cases interpreted section 144 as nothing more than a provision that eliminated claims of voidability based solely on the presence of interested directors in the decision-making process.⁴¹

More recent decisions, however, have gone much further and relied upon section 144 to substantively alter the standard of review for transactions approved by disinterested shareholders.⁴² They have concluded that informed approval by disinterested shareholders⁴³ eliminates any analysis of fairness.⁴⁴ Instead, the transaction becomes

41. See *Fliegler v. Lawrence*, 361 A.2d 218, 222 (Del. 1976) (approval under section 144 “merely removes an ‘interested director’ cloud when its terms are met and provides against invalidation of an agreement ‘solely’ because such a director or officer is involved.”); see also *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 900 n.80 (Del. Ch. 1999) (“A non-comprehensive review of the treatises suggests that the law earlier in the century was far less clear about whether ‘interested’ persons could vote as stockholders to ratify or approve transactions.”); *Michelson v. Duncan*, 407 A.2d 211, 219–20 (Del. 1979) (“If shareholders have approved an otherwise voidable act, their approval extinguishes any claim for losses based on prior lack of authority of the directors to undertake such action.”). As one commentator noted: “The Delaware statute . . . essentially eliminates the automatic common law taint of self-interested transactions.” Michael P. Dooley & Michael D. Goldman, *Some Comparisons Between the Model Business Corporation Act and the Delaware General Corporation Law*, 56 BUS. LAW. 737, 743 (2001). One lower court, however, has suggested that *Fliegler* is no longer good law. See *Lewis v. Vogelstein*, 699 A.2d 327, 335 n.12 (Del. Ch. 1997) (noting that “[e]arly on it was narrowly held that compliance with that section simply removed the automatic taint of a director conflict transaction, but nevertheless left the transaction subject to substantive judicial review for fairness”).

42. In justifying the interpretation, the courts often relied on the language in, and purpose of, section 144. As the Court of Chancery noted in *In re Walt Disney Co. Derivative Litigation*:

[O]ur courts have treated fully informed shareholder ratification under § 144(a)(2) as validating the transaction and removing it from the purview of entire fairness review. The business judgment rule applies to the ratified transaction, and to rebut its presumption, the plaintiff must allege facts showing that no person of ordinary sound business judgment could view the benefits received as a fair exchange for the consideration paid by the corporation, i.e., the transaction amounts to corporate waste.

731 A.2d 342, 368 (Del. Ch. 1998), *rev'd on other grounds*, 746 A.2d 244 (Del. 2000) (footnotes omitted).

43. The same standard applies to approval by a board, the majority of which is disinterested and independent. Doing so will “bring [the transaction] within the scope of the business judgment rule.” *Oberly v. Kirby*, 592 A.2d 445, 466 (Del. 1991); *accord*, *Cinerama v. Technicolor*, 663 A.2d 1156, 1170 (Del. 1995).

44. At one time it seemed that Delaware courts might go even further and eliminate all claims, including waste. The court in *Smith v. Van Gorkom*, 488 A.2d 858, 890 (Del.

subject to the business judgment rule, with plaintiff's cause of action limited to claims of waste.⁴⁵ Courts have done so with little analysis,⁴⁶

1985), noted in dictum that “[t]he settled rule in Delaware is that ‘where a majority of fully informed stockholders ratify action of even interested directors, an attack on the ratified transaction normally must fail.’” (quoting *Gerlach v. Gillam*, 139 A.2d 591, 593) (Del. Ch. 1958). The case did not, however, involve a conflict of interest, at least not one recognized by the court. *Id.* Recent cases have declined to read *Smith* so broadly and have generally held that shareholder ratification does not eliminate a claim for waste. See *Rosser v. New Valley Corp.*, No. 17272, 2000 Del. Ch. LEXIS 115, at *23 (Del. Ch. August 15, 2000); *In re Lukens Inc. S’holder Litig.*, 757 A.2d 720, 737 (Del. Ch. 1999) (noting that *Smith* stands for the proposition that, “in the appropriate case, a fully informed vote of stockholders approving a merger will extinguish a claim for breach of fiduciary duty stemming from a board of directors’ failure to reach an informed business judgment in authorizing that transaction.”). The interpretation is also consistent with traditional analysis of claims for waste. Courts in Delaware have long recognized that claims for waste can only be eliminated upon unanimous approval of shareholders. See *Harbor Fin. Partners*, 751 A.2d at 882 (“But, under an unbroken line of authority dating from early in this century, a non-unanimous, although overwhelming, free and fair vote of disinterested stockholders does not extinguish a claim for waste.”). This approach can be compared with the Revised Model Business Corporations Act (“RMBCA”), which eliminates all claims following approval by a disinterested majority of shareholders. REV. MODEL BUS. CORP. ACT § 8.61 (1984). At least one commentator has called for an absolute rule:

Accordingly, a shareholder should be precluded from bringing an action against an interested transaction that has been ratified by a fully-informed, disinterested majority. Delaware courts should adopt a bright-line rule providing that fully-informed shareholder ratification extinguishes claims based on the presence of self-interest in a transaction between a director or controlling shareholder and the corporation.

See Mary A. Jacobson, Note, *Interested Director Transactions and the (Equivocal) Effects of Shareholder Ratification*, 21 DEL. J. CORP. L. 981, 1021 (1996).

45. See *Marciano v. Nakash*, 535 A.2d 400, 405 n.3 (Del. 1987) (“On the other hand, approval by fully-informed disinterested . . . stockholders . . . permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction.”); accord, *Disney*, 731 A.2d at 368 (Del. Ch. 1998); see also *Lewis*, 699 A.2d at 336 (“In all events, informed, uncoerced, disinterested shareholder ratification of a transaction in which corporate directors have a material conflict of interest has the effect of protecting the transaction from judicial review except on the basis of waste.”); *In re Wheelabrator Tech. S’holders Litig.*, 663 A.2d 1194, 1203 (Del. Ch. 1995) (“[T]he operative effect of shareholder ratification in duty of loyalty cases has been either to change the standard of review to the business judgment rule, with the burden of proof resting upon the plaintiff, or to leave ‘entire fairness’ as the review standard, but shift the burden of proof to the plaintiff.”).

46. In assessing the impact of shareholder ratification and the elimination of any fairness analysis, Delaware courts have gone so far as to allow advanced approval to insulate an action under the duty of loyalty. In *In re 3Com Corp. Shareholders Litigation* shareholders ratified a stock option plan. No. 16721, 1999 Del. Ch. LEXIS 215, at *8 (Del. Ch. Oct. 25, 1999). Plaintiff challenged not the plan, but the award of options by an interested board. *Id.* The court held that shareholder approval of the plan rendered the duty of loyalty inapplicable. *Id.* at *11. In fact, the “precedent” cited by the court for this proposition was not precedent at all. The court cited *Steiner v. Meyerson*, No. 13139, 1995 Del. Ch. LEXIS 95, at *11 n.10 (Del. Ch. July 18, 1995). Most of the discussion in the case involved an analysis of the impact of shareholder ratification on the plan itself, not awards

largely ignoring the structure of section 144 and earlier law indicating that section 144 affected voidability, not fairness.⁴⁷ Moreover, they have done so despite the fact that the requirement of disinterested shareholder approval appears nowhere in the statute.⁴⁸

In other cases involving transactions that fall outside of section 144, the courts have adopted a different approach, retaining a fairness analysis.⁴⁹ For conflicts of interest involving controlling shareholders,⁵⁰ a category not expressly covered by the provision,⁵¹ approval by disinterested shareholders shifts the burden of demonstrating unfairness to the plaintiff.⁵² Courts explain the

under the plan. *Id.* at *22. Moreover, the awards appeared to be set, with no discretionary authority by the board. The decision effectively removed from the duty of loyalty a transaction involving a clear conflict of interest. *Id.* at *32. The fact that the interested board acted within plan parameters approved by shareholders did not eliminate the risk of self-serving behavior and the need for a more exacting level of review. *Id.*

47. *See supra* note 41.

48. *See, e.g.,* Cede & Co. v. Technicolor, 634 A.2d 345, 366 n.34 (Del. 1993) (stating that section 144(a)(2) required approval by “disinterested shareholders”). Recognizing this, at least one court interpreting a comparable statute has suggested that shareholder approval (rather than disinterested approval), even if by controlling shareholders, reduces a claim to waste. *See* Camden v. Kaufman, 613 N.W.2d 335, 340 (Mich. App. 2000); *see also* Dooley & Goldman, *supra* note 41, at 744.

49. Courts have, therefore, sometimes stretched to bring matters within the statute. For example, although the provision requires that shareholders have “authorized, approved or ratified” the transaction, Delaware courts have held that the tendering of shares qualifies. *See* Cinerama v. Technicolor, 663 A.2d 1156, 1176 (Del. 1995) (noting that “the Court of Chancery properly found the tender by an overwhelming majority of Technicolor’s stockholders to be tacit approval”).

50. The definition of “controlling” is narrowly drawn. *See* Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 70 (Del. 1989):

[A] shareholder who owns less than 50% of a corporation’s outstanding stocks does not, without more, become a controlling shareholder of that corporation, with a concomitant fiduciary status. For a dominating relationship to exist in the absence of controlling stock ownership, a plaintiff must allege domination by a minority shareholder through actual control of corporation conduct.

(quotations and citation omitted).

51. *See supra* notes 36–40 and accompanying text.

52. *See* Kahn v. Lynch Communication Sys., 638 A.2d 1110 (Del. 1994); Rosenblatt v. Getty Oil, 493 A.2d 929, 937 (Del. 1985) (minority stockholder ratification “shifts the burden of proving the unfairness of the merger entirely to the plaintiffs.”); Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983) (majority-of-the-minority shareholder ratification of a parent-subsidiary merger will shift the burden to the plaintiff “to show that the transaction was unfair to the minority.”); Strassburger v. Earley, 752 A.2d 557, 570 (Del. Ch. 2000); *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 368 (Del. Ch. 1998), *rev’d on other grounds*, 746 A.2d 244 (Del. 2000) (“In the context of disinterested shareholder ratification of a deal between the corporation and a majority shareholder, the trial court’s deference manifests itself as a shift in the burden of persuasion under the entire fairness standard.”); *In re* Wheelabrator Tech. S’holders Litig., 663 A.2d 1194, 1203 (Del. Ch. 1995). *But see* Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971):

differing treatment in the two types of transactions by noting the inherent ability of controlling shareholders to influence the outcome.⁵³ In the more limited context of a parent-subsidiary cash-out merger, retention of a fairness analysis is sometimes justified by the absence of the need for a business purpose for the transaction.⁵⁴

C. Criticism

The use of “disinterested” shareholder ratification to eliminate fairness analysis raises two significant concerns. First, little real justification exists for distinguishing classes of self-interested transactions. Disinterested shareholder approval in non-controlling shareholder cases results in application of a waste standard, eliminating any consideration of fairness.⁵⁵ For those transactions

On the contrary, the valuations of the property companies and the Marriott stock were made by a majority of Marriott directors, whose independence is unchallenged, based upon appraisals, analysis, information and opinions provided by independent experts, whose qualifications are not questioned. In these circumstances it cannot be said that the [controlling shareholder] stood “on both sides of the transaction” within the meaning of the rule followed in the cases above cited. Therefore, the test here applicable is that of business judgment, there being no showing of fraud.

53. See *Citron v. E.I. du Pont de Nemours & Co.*, 584 A.2d 490, 502 (Del. Ch. 1990): Parent subsidiary mergers . . . are proposed by a party that controls, and will continue to control, the corporation, whether or not the minority stockholders vote to approve or reject the transaction. The controlling stockholder relationship has the inherent potential to influence, however subtly, the vote of minority stockholders in a manner that is not likely to occur in a transaction with a noncontrolling party.

The differing effects of disinterested shareholder approval appears to have been accidental. In *Michelson v. Duncan*, 407 A.2d 211, 219 (Del. 1999), the court used imprecise language when describing the effect of shareholder ratification. The court applied a waste standard but on several occasions in the opinion stated that the burden shifted to plaintiffs. In *Weinberger*, the court cited *Michelson* for the proposition that, in the context of a controlling shareholder, ratification simply shifted the burden. 457 A.2d at 703. The conclusion, therefore, appeared to be based upon a misreading of *Michelson*. Only later did courts provide some type of independent justification for the distinction. See also *Kahn*, 638 A.2d at 1116 (“The controlling stockholder relationship has the potential to influence, however subtly, the vote of [ratifying] minority stockholders in a manner that is not likely to occur in a transaction with a noncontrolling party.” (quoting *Citron*, 584 A.2d at 502)); *Wheelabrator II*, 663 A.2d at 1205 (justifying application of entire fairness standard even where shareholders ratify controlling shareholder transactions because of overriding concerns that “the controlling stockholder’s continued presence might influence even a fully informed shareholder vote”).

54. *Kahn*, 638 A.2d at 1116 (“Thereafter, this Court recognized that it would be inconsistent with its holding in *Weinberger* to apply the business judgment rule in the context of an interested merger transaction which, by its very nature, did not require a business purpose.”).

55. See *supra* notes 42–45 and accompanying text.

involving controlling shareholders, approval merely shifts the burden of proving fairness to the plaintiff.⁵⁶

Distinguishing these two types of transactions has little merit. In general, disinterested shareholders will be influenced by the board of directors. It is the board that submits the matter to shareholders. Management has the corporate treasury at its disposal and the attendant ability to spend conspicuous sums to obtain approval of the interested transaction.⁵⁷ At the same time, shareholders suffer from collective action problems,⁵⁸ making concerted opposition difficult. Moreover, disinterested opposition also risks retribution.⁵⁹ Without the benefit of secret ballots, management will know the vote cast by each "disinterested" shareholder.

The board's authority exists whether or not the transaction involves a controlling shareholder.⁶⁰ While a controlling shareholder may sometimes influence other owners apart from the actions of the

56. See *supra* note 52 and accompanying text.

57. Nor, in contrast with proxy contests, will someone independent of management put before shareholders the other side of the transaction.

58. See *Lewis v. Vogelstein*, 699 A.2d 327, 335 (Del. Ch. 1997) ("Thus the collective nature of shareholder ratification makes it more likely that following a claimed shareholder ratification, nevertheless, there is a litigated claim on behalf of the principal that the agent lacked authority or breached its duty."); see also *Brudney, supra* note 5, at 218 ("The problems of collective action (free riders and rational apathy) among dispersed shareholders fairly erode the volitional quality of consent obtained by the proxy process in public corporations, particularly when the request for their approval is unopposed."). For a discussion of collective action problems, see *Jacobson, supra* note 44, at 1018 n.208. The article, however, suggests that the increased institutionalization of the market will alleviate these problems. Whatever the trends in the market, the phenomena of increased ownership by institutions does not apply to all companies under all circumstances. At a minimum, therefore, the problem of collective action will always be present for some companies.

59. See *George W. Dent, Jr., Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 904:

Shareholders also tend to vote for management because assertive shareholders encounter management hostility. Managers can deny rebellious shareholders valuable information. Bank trust departments hesitate to oppose managements for fear of offending them as commercial clients. Although the managers of issuer-sponsored pension funds are supposed to be independent, they can be fired by the issuer's management and are, therefore, loathe to oppose its will. Executives sometimes badger officers of other companies to pressure their fund managers to approve anti-takeover measures. Even absent specific pressures, fund managers know that executives dislike active shareholders, and, therefore, the fund managers keep a low profile to protect themselves.

(footnotes omitted).

60. The term "control" includes "the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." Rule 405, 17 C.F.R. § 230.405 (2002); Rule 12b-2, 17 C.F.R. § 240.12b-2 (2002). It is sufficient to show an indirect means of influence. See *Maher v. Durango Metals*, 144 F.3d 1302, 1305 (10th Cir. 1998).

board, so can a well-positioned officer.⁶¹ The *Disney* litigation did not involve a controlling shareholder, but did involve a powerful executive officer and director who could presumably influence disinterested shareholders.⁶² Since both controlling shareholders and powerful officers have the ability to influence the voting process, there seems to be no good reason to differentiate in the outcome of shareholder approval in these two circumstances.

Consistent treatment, however, still leaves the applicable standard unresolved. Disinterested shareholder approval ought to have some type of sanitizing effect on the challenged behavior. A number of reasons, however, militate against an approach that accedes too much deference to the shareholder approval process and limits claims to waste. As a practical matter, waste represents a residual claim in duty of care cases, a substantive standard available even if the procedural safeguards of the business judgment rule have been met.⁶³

The focus of a claim for breach of the duty of care, however, is mismanagement.⁶⁴ In contrast, fairness under the duty of loyalty focuses on self-dealing. As a result, fairness “is not a function of inattentiveness or lack of effort or bad judgment that seeks to benefit stockholders. It derives solely from self-appropriative acts by which management seeks to take for itself property or potential that would otherwise belong to the corporation or its stockholders.”⁶⁵

It would seem, therefore, that the application of a standard regulating mismanagement would be wholly inapposite to situations designed to limit self-serving behavior.

Courts replacing fairness with waste apparently do so out of the belief that disinterested approval somehow eliminates the taint associated with the conflict of interest. In fact, this is not the case. Duty of care cases presuppose that the transaction involves no conflict and, as a result, no ulterior motivation.⁶⁶ In contrast, disinterested shareholder approval of self-dealing concedes the existence of a conflict of interest but excludes those with an interest

61. See *supra* notes 2–3.

62. In 1998, Michael Eisner, the CEO of Disney, beneficially owned 3.6 million shares, less than one percent of the total outstanding shares. Proxy Statement, Walt Disney Co. (May 4, 1998), available at <http://www.sec.gov/Archives/edgar/data/1001039/0000898430-98-001707.txt>. Few would deny that Mr. Eisner exercised considerable control over Disney. See *Brehm v. Eisner*, 746 A.2d 244, 250 (Del. 2000).

63. *Brudney, supra* note 5, at 225.

64. See *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1980).

65. *Brudney, supra* note 5, at 225.

66. See sources cited *supra* note 23.

from the final vote tally.⁶⁷ Interested directors and shareholders may participate in the discussion, vote on the matter, and lobby others.⁶⁸ The directors with the conflict of interest may well have a role in running the campaign designed to induce disinterested approval of the transaction. Thus, unlike cases involving the duty of care, the presence of an alternative motivation remains and the possibility that it may influence the outcome cannot be eliminated.

In addition, some interested shares will likely be counted in the disinterested total. Delaware law does not define “disinterested”⁶⁹

67. Case law in the area has made clear that interested directors may participate; they simply cannot be counted in the final total. *See Cinerama v. Technicolor*, 663 A.2d 1153, 1156 (Del. 1995), *aff'd*, 663 A.2d 1156, 1174 (Del. 1995):

In my opinion, a financial interest in a transaction that is material to one or more directors less than a majority of those voting is “significant” for burden shifting purposes (or is “instrumental” or “material under the second part of the materiality standard”) when the interested director controls or dominates the board as a whole or when the interested director fails to disclose his interest in the transaction to the board and a reasonable board member would have regarded the existence of the material interest as a significant fact in the evaluation of the proposed transaction.

(italics omitted). Similar to directors, no case has held that interested shareholders must be excluded from participation.

68. *See supra* note 6. With respect to directors, Delaware law does not require the exclusion of those with an interest in the outcome of the transaction, only that the action receive approval of disinterested directors. Interested directors can, therefore, participate in the discussion on the matter. *See Telxon Corp. v. Meyerson*, 802 A.2d 257, 264 (Del. 2002) (“A party alleging domination and control of a company’s board of directors bears the burden of proving such control by showing a lack of independence on the part of a majority of the directors.”); *see also Orman v. Cullman*, 794 A.2d 5, 22 (Del. Ch. 2002):

To rebut successfully business judgment presumptions in this manner, thereby leading to the application of the entire fairness standard, a plaintiff must normally plead facts demonstrating “that a majority of the director defendants have a financial interest in the transaction or were dominated or controlled by a materially interested director.”

(citation omitted). Even if excluded, substantial uncertainty exists over whether “disinterested” directors can truly act in an objective fashion when deciding matters involving their fellow board members. *See Kenneth B. Davis, Jr., Approval by Disinterested Directors*, 20 IOWA J. CORP. L. 215, 216 (1995).

69. Definitions of a sort do exist in the RMBCA. Section 8.63(a) limits those eligible to vote to “qualified shares.” REV. MODEL BUS. CORP. ACT § 8.63(a) (1984). The phrase means any shares except those that, “to the knowledge, before the vote, of the secretary (or other officer or agent of the corporation authorized to tabulate votes), are beneficially owned (or the voting of which is controlled) by a director who has a conflicting interest respecting the transaction or a related person of the director, or both.” *Id.* § 8.63(b) (1984). “Related person” includes the following persons sharing the same house with the director: the director’s spouse or spouse’s parent or sibling and the director’s child, grandchild, sibling or parent. In addition, related person includes any trust or estate in which the director is a “substantial beneficiary” or where the director acts as executor, trustee or other fiduciary. *Id.* § 8.60(3) (1984). The American Law Institute’s formulation has a similar framework. *See* 1 PRIN. CORP. GOV. § 1.23(b) (1993); *see also id.* § 1.03(a)(1) (defining “associate” in a manner identical to “related person” under the RMBCA). As

and the courts have not filled the gap.⁷⁰ Under any rational interpretation, the definition should exclude shares owned by the directors who are parties to the transaction.⁷¹ Other categories of disqualified shares, however, are less clear. The definition used by the Revised Model Business Corporation Act (“RMBCA”) does not, for example, exclude the shares held by a corporation where the official with the conflict serves as director.⁷² As a result, either by the courts or legislature, the definition of “disinterested” effectively rests

one commentator explained, “[t]he reason for the more limited test of interestedness for shareholders is practical: the difficulty in the case of corporations with numerous shareholders in making all the determinations required in deciding whether a shareholder is interested.” A.A. Sommer, Jr., *The Duty of Loyalty in The ALI’s Corporate Governance Project*, 52 GEO. WASH. L. REV. 719, 728 (1984).

70. The trend in the case law suggests that a rigorous definition of “disinterested” will not emerge. Perhaps the best example of result oriented, internally inconsistent analysis of the concept of disinterested in the context of directors occurred in *In re Walt Disney Co. Derivative Litigation*, 731 A.2d 342, 356–60 (Del. Ch. 1998), *rev’d on other grounds*, 746 A.2d 244 (Del. 2000). In that case, the court concluded that, to be interested and under the control of the CEO, a director had to receive from the company a material payment. *Id.* Materiality was relative; it depended upon the particular wealth of the director. *Id.* at 356. The analysis raised concerns, particularly the possibility that a rich director would never be interested since payments would invariably be immaterial. *See id.* At the same time, however, the court also concluded that, as a matter of law, directors’ fees never resulted in a board member becoming interested. *Id.* at 357. The court applied this approach to an elementary school principal sitting on the Disney board, despite the apparent materiality of the payments. *Id.* at 360. In addition to the internal inconsistency with the materiality, the analysis ignored the inflation in directors’ fees. *See, e.g.*, Reed Abelson, *Enron Board Comes Under a Storm of Criticism*, N.Y. TIMES, Dec. 16, 2001, at C3:

Enron directors certainly were well compensated. They are ranked seventh in total remuneration in 2001 with \$380,619 worth of cash and stock, according to a director compensation study by Pearl Meyer & Partners, a New York based compensation consulting firm, which based the rankings on the value of a company’s stock on the date of its annual meeting.

71. The definition in the RMBCA is limited to the director and shares controlled by the director. *See* REV. MODEL BUS. CORP. ACT § 8.50. The definition was deliberately made more narrow than the definition of “conflicting interest” transactions in section 8.60(1)(ii). It was also more narrowly drawn than the definition of non-qualified directors in section 8.62(d). In explaining the distinction, the commentary noted that the director typically “will have no control over those persons and how they vote.” *Id.* § 8.63(b) cmt.

72. *See id.* § 8.63(b) cmt. (“There is, in reality, no reason to strip [the second corporation] of their voting rights as shareholders, for in the usual commercial situation they will vote in accordance with their own interests, which may well not coincide with the personal interest of [the interested director].”). Thus, the shares of a controlling shareholder are “qualified” even if the director with the conflict sits on the board and owns 10% of the controlling shareholder. *Id.*; *see also* 1 PRIN. CORP. GOV. § 1.23 cmt. (1993) (fact that interested director on boards of both companies does not automatically make corporate shares interested).

with management, with little likelihood that all interested groups will be excluded.⁷³

Even assuming an adequate definition, public companies confront logistical problems in ensuring only disinterested shares are counted. Management has no obligation to develop a system that identifies all disinterested shares.⁷⁴ With the rise of street name accounts and other forms of beneficial ownership, companies do not automatically know who owns the shares voted at a meeting.⁷⁵

The disinterested approval process, therefore, allows for participation of interested shareholders and directors, does not adequately define "disinterested," and presents logistical problems associated with tallying disinterested votes,⁷⁶ all suggesting that the

73. Management has an incentive to make the definition as narrow as possible. Thus, in *Citron v. E.I du Pont de Nemours & Co.*, the parent proposed a merger with the subsidiary, contingent upon the approval by a "majority of the minority." 584 A.2d 490, 493 (Del. Ch. 1990). The "minority" included all shares other than those owned by the parent. *Id.* Thus, they may have included shares owned by officers, directors or family members of the parent. These were apparently not excluded. Similarly, in *Chesapeake Corp. v. Shore*, 771 A.2d 293 (Del. Ch. 2000), the board of Shorewood Packaging adopted a bylaw requiring that shareholder initiated bylaw changes receive supermajority approval. *Id.* at 297. In determining to change the percentage from 67% to 60%, the board determined that 20% of the shares were interested, leaving 80% disinterested. *Id.* at 315. Thus, a bylaw would have to obtain the "interested" shares and half of the disinterested ones in order to pass. In making the calculation, the board included in the category of "interested" a shareholder that had sold much of its holdings to the acquiror (but still had some shares remaining) and did not include the shares held by the directors themselves. As the court noted: "The most fundamental flaw in the board's reasoning [supporting the supermajority provision] is the disparate treatment the board gave their own self-interest." *Id.* at 341.

74. See 1 PRIN. CORP. GOV. § 1.23 cmt. (1993) ("When seeking shareholder approval, the corporation is not obliged to determine whether shareholders are interested, although it may do so."). The RMBCA has only slightly more. The Model Act requires the exclusion of shares only where the tabulator *knows* they were owned or controlled by a director with a conflict of interest. Thus, the tabulator must have "actual knowledge" of the ownership. REV. MODEL BUS. CORP. ACT § 8.63(b) cmt. 2. Despite the high standard, the provision does little to ensure that the tabulator will have the requisite knowledge. The only affirmative requirement is that directors with a conflict have an obligation to notify the secretary. *Id.* § 8.63(d). Thus, neither the company nor the tabulator have any independent obligation to ascertain the existence of interested shares. Moreover, to the extent interested shares are improperly included in the total, "the vote cannot be attacked on that ground." *Id.* § 8.63(d) cmt.

75. See *supra* note 7. For a more complete discussion of problems associated with beneficial ownership, see J. Robert Brown, *The Shareholder Communication Rules and the Securities and Exchange Commission: An Exercise in Regulatory Utility or Futility?*, 13 J. Corp. L. 683 (1988).

76. Most, if not all, of these factors are typically absent in the context of disinterested director approval. Moreover, disinterested directors have fiduciary obligations that govern their decisions and, in most cases, have more information than what is provided to disinterested shareholders. Thus, the two groups are not on an equal footing when asked to approve a conflict of interest transaction.

taint of the conflict of interest cannot be treated as dissipated.⁷⁷ Moreover, use of the business judgment rule results in the application of a standard designed to protect directors from mismanagement and risk-taking, not self-dealing. All of these factors militate against a rule that replaces fairness with waste.⁷⁸

II. The Myth of Informed Approval

A more serious concern, however, supports the retention of fairness analysis, even after approval by “disinterested shareholders.”⁷⁹ Disinterested approval presupposes full disclosure of all material information. However, Delaware courts have opted for a definition of “fully informed” that does not ensure shareholders have all material information. Inadequate information raises the risk that shareholders will approve an unfair transaction.⁸⁰

Delaware courts consistently refuse to require disclosure of material information in at least two critical circumstances. In the context of mergers or sale of the business, the board may have information suggesting alternative valuations to the one offered shareholders. This occurs most often where the company has received other offers or has calculated values using alternative formulas. The information may suggest the possibility of a higher price, something shareholders would presumably want to know.⁸¹ Delaware courts routinely characterize the information as immaterial, concluding that suggestions of a higher price would only “confuse” investors.⁸²

77. See also Brudney, *supra* note 5, at 222 (“Stockholder approval . . . embodies small consensual value in view of the problematic independence of disinterested directors, and the thin informational base and rational apathy from which such decisions by dispersed stockholders are constructed.”).

78. The RMBCA goes even further and eliminates all causes of action following disinterested shareholder approval, including waste. See REV. MODEL BUS. CORP. ACT § 8.61(b)(2) (following shareholder approval, a transaction “may not be enjoined, set aside, or give rise to an award of damages or other sanctions”). As the commentary notes, a director is not “legally vulnerable” following approval. *Id.* § 8.61(b) cmt. 2.

79. Of course, directors also must be informed when making decisions. For cases addressing this issue, see *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985); *Wisconsin Investment Board v. Bartlett*, No. 17,727, 2000 Del. Ch. LEXIS 42, at *15 (Del. Ch. Feb. 24, 2000); and *In re Walt Disney Co. Derivative Litigation*, 731 A.2d 342, 366–67 (Del. Ch. 1998), *rev'd on other grounds*, 746 A.2d 244 (Del. 2000).

80. Some have noted that the proxy system itself provides far less information than is available to fiduciaries when making a decision. See Brudney, *supra* note 5, at 218.

81. See *infra* notes 173–174; 226–238 and accompanying text.

82. See *Goodwin v. Live Entm't*, No. 15,765, 1999 Del. Ch. LEXIS 5, at *38 (Del. Ch. Jan. 22, 1999) (“The risk that an unreliable analysis could lead stockholders to reject a good deal based on the false hope that a better deal was around the corner is one a board must consider in assessing whether to disclose.”); see also *Brown v. Perrette*, No. 13531, 1999 Del. Ch. LEXIS 92, at *28 (Del. Ch. May 14, 1999) (“[D]isclosure of a single

In other circumstances, the courts have consistently refused to require disclosure of facts suggesting improper behavior or conflicts of interest by management, characterizing them as unnecessary “self-flagellation.”⁸³ Self-flagellation subsumes the widely accepted view that directors do not have to characterize corporate behavior as mismanagement, as a violation of law, or in any other negative fashion. Delaware courts have gone much further and used the self-flagellation doctrine to encompass wide swathes of factual data that suggest potential conflicts of interest or improper behavior.⁸⁴

Analysis of the disclosure regime entails more than a subjective evaluation of Delaware cases. Federal courts have also interpreted the meaning of material information under the antifraud provisions of the federal securities laws.⁸⁵ Both rely upon the identical definition of materiality. Although using the same language and the same standards, Delaware courts are in fact more willing to characterize as immaterial information that would likely be considered material under the federal standard.

A. Evolution

The state law obligation to keep shareholders informed arose in Delaware accidentally. At one time, a statute expressly prohibited publication by a corporation of any written statement “that [was knowingly] false in any material respect.”⁸⁶ The provision imposed no affirmative disclosure obligations but did require accuracy and completeness once disclosure occurred. In characterizing the requirement,⁸⁷ the Delaware Supreme Court found that a company

unadorned fact can quickly snowball into wide-ranging disclosure of facts and opinions that otherwise would never come before the shareholders.”)

83. *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 143 (Del. 1997); *Stroud v. Grace*, 606 A.2d 75, 84 n.1 (Del. 1992); *Michelson v. Duncan*, 407 A.2d 211, 218–19 (Del. 1979).

84. *See infra* notes 141–55, and accompanying text.

85. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

86. 21 Del. Laws 451 (1898). The provision was repealed in 1967. For an extensive and thoughtful discussion of the development of the duty of candor, see Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087 (1996).

87. *See Hall v. John S. Isaacs & Sons Farms*, 146 A.2d 602, 610 (Del. Ch. 1958); *see also Kelly v. Bell*, 254 A.2d 62, 71 (Del. Ch. 1969) (relying on *Hall* to conclude that “directors owe a duty to honestly disclose all material facts when they undertake to give out statements about the business to stockholders”). Two earlier cases involved allegations of misleading disclosure. Neither, however, represented a true duty of candor case. *See Gerlach v. Gillam*, 139 A.2d 591, 594 (Del. Ch. 1958) (failure to disclose conflict of interest; issue turned upon whether shareholders were fully informed for purposes of validating conflict under duty of loyalty); *Empire Southern Gas Co. v. Gray*, 46 A.2d 741,

had an obligation to ensure that documents distributed to shareholders “honestly” disclosed all material information.⁸⁸ The statute, however, was eventually repealed.

The modern impetus for the requirement of full disclosure occurred in *Lynch v. Vickers Energy Corp.*⁸⁹ In that case, Vickers, a controlling shareholder of TransOcean, made a tender offer for the remaining shares of the company.⁹⁰ After tendering her shares, plaintiff filed suit alleging that Vickers had failed to make full and frank disclosure of the value of TransOcean’s assets.⁹¹ The Supreme Court concluded that Vickers had affirmative disclosure obligations under a duty of “complete candor.”⁹² The duty required the court:

to examine what information defendants had and to measure it against what they gave to the minority stockholders, in a context in which “complete candor” is required. In other words, the limited function of the Court was to determine whether defendants had disclosed all information in their possession germane to the transaction in issue. And by “germane” we mean, for present purposes, information such as a reasonable shareholder would consider important in deciding whether to sell or retain stock. The objective, of course, is to prevent insiders from using special knowledge which they may have to their own advantage and to the detriment of the stockholders.⁹³

In applying the standard, the court found that Vickers violated the duty by omitting to disclose asset valuations showing the approximate value of each share to be \$20.⁹⁴

In explaining the source of the disclosure requirements, *Lynch* focused on the fiduciary nature of the obligation, suggesting that the doctrine arose out of a majority shareholder’s fiduciary obligations and the duty of loyalty.⁹⁵ Subsequent decisions suggested that the

748 (Del. Ch. 1946) (concluding that nonmanagement shareholders could not state in a proxy solicitation that the board had approved their acts).

88. See *Hall*, 146 A.2d at 610; see also *Kelly*, 254 A.2d at 71.

89. 383 A.2d 278 (Del. 1977).

90. *Id.* at 279.

91. *Id.*

92. *Id.*

93. *Id.* at 281 (citations omitted). In defining what must be disclosed, the court extended the requirement only to “germane” information. *Id.* “Germane” suggested a standard different from materiality. Later cases, however, expressly adopted the materiality standard used by federal courts. See *infra* note 128. Had that interpretation remained in place, Delaware courts would have found themselves free of direct comparison with the federal standard.

94. *Id.* at 280.

95. *Id.* at 279.

obligation of complete candor and honesty could arise out of either the duty of loyalty or the duty of care.⁹⁶

The fiduciary basis of the doctrine had a number of implications. Most significantly, the duty extended to the directors or other fiduciaries, not to the corporation.⁹⁷ Thus, unlike the federal system, Delaware courts refused to impose liability directly on the entity that actually made the statement.⁹⁸ Moreover, a breach of fiduciary obligations (at least the duty of care) under state law theoretically required a lower level of fault than under Rule 10b-5 of the federal

96. See *Zirn v. VLI Corp.*, 621 A.2d 773, 778 (Del. 1993) (duty to disclose in a merger arises out of both duty of care and loyalty); see also *Cinerama*, 663 A.2d at 1166 (noting that duty of candor arose out of a "combination of the duty of care and loyalty"); *Wolf v. Assaf*, No. 15339, 1998 Del. Ch. LEXIS 101, at *12 (Del. Ch. June 16, 1998) (duty of candor can arise under duty of care or loyalty).

97. Rule 10b-5 applies to the person making the statement, which, in the corporate context, is usually the corporation. Liability can also extend to those who actually prepared the statement and otherwise had substantial involvement in the drafting process. See *BROWN*, *supra* note 7, § 2.03[4] (Supp. 2003). With the elimination of aiding and abetting liability, however, this represents a relatively narrow category of individuals. See *Central Bank v. First Interstate Bank*, 511 U.S. 164, 191 (1994). For a discussion of primary liability under the antifraud provisions, see *BROWN*, *supra* note 7, § 10.02 (Supp. 2002).

98. See *Arnold v. Soc'y for Savings Bancorp.*, 678 A.2d 533, 540 (Del. 1996) (declining to allow breach of fiduciary duty of disclosure claim against corporation rather than directors). The fiduciary basis of the doctrine has important consequences. Many of the cases have involved third-party tender offers. In general, bidders have no affirmative state law disclosure obligations, at least in the absence of control over the target company. See *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 70 (Del. 1989). Of course, a bidder may need to comply with the disclosure requirements of the federal securities laws. See Rules 14d-1-14e-7, 17 C.F.R. §§ 240.14d-1-240.14e7 (2002). Similarly, management has no disclosure obligations with respect to inaccurate statements by third parties. See *Citron*, 569 A.2d at 70 (noting that board had no responsibility for alleged nondisclosure in shareholder offer "absent some proof that the two boards engaged in joint conduct to mislead the shareholders"); see also *Solash v. Telex Corp.*, [1987-1988] Fed. Sec. L. Rep. (CCH) ¶¶ 93,608, 97,729 (Del. Ch. Jan. 19, 1988) ("However, I am aware of no Delaware case that holds corporate directors accountable for the quality of disclosure in a third party's offer to purchase."). The Delaware courts have, however, recognized theories of secondary liability that could hold these companies responsible. See *Sonet v. Plum Creek Timber Co.*, No. 16931, 1999 Del. Ch. LEXIS 49, at **24-25 (Del. Ch. Mar. 18, 1999) ("When controlling persons seek shareholder approval of a transaction, they have a fiduciary duty to honestly provide full and fair disclosure of all material facts relating to that transaction."); *In re Shoe-Town Stockholders Litig.*, No. 9483, 1990 Del. Ch. LEXIS 14, at **22-23 (Del. Ch. Feb. 12, 1990); see also *Solash*, [1987-1998] Fed. Sec. L. Rep. (CCH) ¶¶ 93,608, 97,730 ("In any case, it is well established that the one who knowingly participates with a fiduciary and a breach of trust renders himself liable to the injured beneficiary."). An unrelated third party may, however, have an obligation of completeness arising not from a fiduciary relationship but from equitable fraud which gave rise to detrimental reliance. *Zirn*, 621 A.2d at 777.

securities laws:⁹⁹ gross negligence¹⁰⁰ rather than reckless or intentional conduct.¹⁰¹

As the doctrine developed, Delaware courts divided over a number of issues. It was initially unclear whether the obligation of complete honesty amounted to an extension of the traditional duties of care and loyalty or was a free-standing duty under the board's general fiduciary obligations.¹⁰² Similarly, while the doctrine extended to instances of shareholder action, its application to press releases and other materials disclosed to the market remained uncertain.¹⁰³

The Delaware Supreme Court resolved some of these issues in *Malone v. Brincat*.¹⁰⁴ Plaintiffs filed a class action alleging that directors of Mercury Finance violated their fiduciary duty of candor by overstating the financial condition of the company for a four-year period.¹⁰⁵ The company ultimately became insolvent, costing investors more than \$2 billion.¹⁰⁶ Plaintiffs alleged that the directors "knowingly and intentionally" breached their fiduciary duty of disclosure.¹⁰⁷

The lower court dismissed the claim, concluding that a fiduciary duty to disclose did not exist absent a request for shareholder

99. 17 C.F.R. § 240.10b-5. The rule was adopted under section 10(b), 15 U.S.C. § 78j(b) of the Securities Exchange Act of 1934 (2000).

100. See *McMullin v. Beran*, 765 A.2d 910, 921 (Del. 2000).

101. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976). For a discussion of the cases interpreting the scienter requirement in the aftermath of the adoption of the Private Securities Litigation Reform Act, see BROWN, *supra* note 7, § 1.04[2][[e]] (Supp. 2002). Whether in practice there is much of a difference in the two standards remains unclear.

102. See *Zirn*, 621 A.2d at 782 (referring to duty as a "fiduciary duty of candor.").

103. See *Uni-Marts ex rel. Dairy Mart Convenience Stores v. Stein*, LEXIS 95 n.10 (Del. Ch. August 10, 1996) (duty did not apply in absence of shareholder action and cases cited therein). For a time, only one Delaware court had extended the doctrine to market information. In *Marhart, Inc. v. CalMat Co.*, [1991-1992] Fed. Sec. L. Rep. (CCH) ¶¶ 96,655, 93,098, 18 DEL. J. CORP. L. 330 (Del. Ch. Apr. 22, 1992), defendants allegedly issued a misleading press release. *Id.* at 333. As part of the defense, they argued that they could not violate any fiduciary duty since the disclosure had not been issued in connection with the transactions requiring stockholder action. *Id.* at 335. The court, however, disagreed with the reasoning. "It is entirely consistent with the settled principle of law that fiduciaries who undertake the responsibility of informing stockholders about corporate affairs, be required to do so honestly." *Id.* at 336; see also *Ciro, Inc. v. Gold*, 816 F. Supp. 253, 266 (D. Del. 1993) ("It is also well-established Delaware law that once directors voluntarily undertake to make certain disclosures to the stockholders, they are obligated under the so-called duty of complete candor, to disclose all material facts. This duty arises even when voluntary disclosure is made by the directors and no shareholder action in reliance thereon is requested or contemplated.").

104. 722 A.2d 5 (Del. 1998).

105. *Id.* at 7.

106. *Id.* at 8.

107. *Id.*

action.¹⁰⁸ The Delaware Supreme Court, however, reversed. The court found that the disclosure obligations “did not operate intermittently” and concluded that the directors had an obligation to speak honestly when issuing public statements available to shareholders.¹⁰⁹

Whenever directors communicate publicly or directly with shareholders about the corporation’s affairs, with or without a request for shareholder action, directors have a fiduciary duty to shareholders to exercise due care, good faith and loyalty. It follows *a fortiori* that when directors communicate publicly or directly with shareholders about corporate matters the *sine qua non* of directors’ fiduciary duty to shareholders is honesty.¹¹⁰

Shareholders, therefore, had a right to rely on the honesty of communications emanating from the board. Moreover, the duty was not a free standing obligation but arose under the obligation of loyalty and care.¹¹¹ The context of the suit, however, mattered. In the case of a request for shareholder action, the disclosure claim had to be maintained as a derivative suit. The suit could be brought without proof of reliance, causation, or actual monetary damages. It was enough to establish the materiality of the information.¹¹² Materiality had to be determined with reference to the specific matter to be decided by shareholders.

Although imposing an almost absolute duty to reveal all material information in the context of shareholder action, *Malone* built in a defense.¹¹³ The duty to disclose had to be balanced against the

108. *Id.* at 9.

109. *Id.* at 11.

110. *Id.* at 10; see also *Weiss v. Samsonite Corp.*, 741 A.2d 366, 374 (Del. Ch. 1999) (directors have a duty “honestly to provide full and fair disclosure of all material facts relating to” the transaction to be approved by shareholders).

111. Delaware courts have made clear that the duty to disclose is not a free standing fiduciary obligation but a subset of the traditional duties of care, loyalty and good faith. See *Malpiede v. Townson*, 780 A.2d 1075, 1086 (Del. 2001) (“We begin by observing that the board’s fiduciary duty of disclosure, like the board’s duties under *Revlon* and its progeny, are not independent duties but the application in a specific context of the board’s fiduciary duties of care, good faith, and loyalty.”); *Crescent/Mach I Partners v. Turner*, No. 17455, 2000 Del. Ch. LEXIS 145, at *60 (Del. Ch. Sept. 29, 2000) (“The fiduciary duty of disclosure arises as a subset of a director’s fiduciary duties of loyalty and care.”).

112. See *In re Tri-Star Pictures Litig.*, 634 A.2d 319, 327 n.10 (Del. 1993); *Grubb v. Babley*, No. 13802-NC, 1998 Del. Ch. LEXIS 30, at *5 (Del. Ch. Feb. 25, 1998) (“Delaware law is settled that there is no reliance requirement in a claim for breach of a fiduciary duty of disclosure.”).

113. At one level, *Malone* represented an easy case to parse. The court reaffirmed that, in the context of shareholder approval, the only issue was materiality. 722 A.2d at 20. See also *Emerald Partners v. Berlin*, 726 A.2d 1215, 1223 (Del. 1999) (“When stockholder action is requested, directors are required to provide shareholders with all information that is material to the action being requested and ‘to provide a balanced, truthful account of all matters disclosed in the communications with shareholders.’” (citation omitted)).

board's "concomitant duty to protect the corporate enterprise, in particular, by keeping certain financial information confidential."¹¹⁴ Thus, directors only had an obligation to provide a "balanced, truthful account of all matters disclosed in the communications with shareholders."¹¹⁵ Whatever the language meant precisely, it was clear that the court anticipated that confidentiality would sometimes take precedent over disclosure.¹¹⁶

With respect to non-derivative actions, *Malone* refused to duplicate federal law by recognizing a fraud-on-the-market theory of reliance.¹¹⁷ Instead, actual reliance would be required, limiting the number of possible plaintiffs in any given action.¹¹⁸ The holding made class actions—a staple at the federal level—all but impossible. Similarly, by negative implication, elements of a non-derivative claim would be substantially more difficult than a derivative action, requiring both proof of damages and an elevated state of mind.¹¹⁹

Moreover, the obligation of complete honesty arose in this context, whether or not the approval involved self-dealing. See *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 369 (Del. Ch. 1998) ("The duty of disclosure is now recognized whenever the Board seeks shareholder action, regardless of whether the approval sought is for an act or transaction in which the board itself is conflicted."). Nonetheless, the presence of a conflict of interest, while not altering the standard, may invite heightened scrutiny. See *Sonet v. Plum Creek Timber Co.*, No. 16931, 1999 Del. Ch. LEXIS 49, at *25 (Del. Ch. Mar. 18, 1999) ("In that context [conflict of interest], the materiality standard remains unchanged, but the scrutiny of the disclosures made in that context is more exacting."). This did little more than reaffirm that shareholder approval had to be premised upon complete information.

114. *Malone*, 722 A.2d at 21. The company did have to provide "all information that is material" and a "balanced truthful account of all matters." *Id.* At one time a few federal cases suggested a business judgment exception at the federal level. See BROWN, *supra* note 7, § 6.01[3][a] (Supp. 1999).

115. *Malone*, 722 A.2d at 12.

116. The court may have been building in a business judgment defense to inadequate disclosure. See *Fin. Indus. Fund v. McDonnell Douglas Corp.*, 474 F.2d 514, 518 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973).

117. For a discussion of fraud on the market, see *Basic, Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988).

118. The courts will have to wrestle with the obvious difficulty in establishing reliance in an omission context. In the context of Rule 10b-5, federal courts have opted for a presumption of reliance. See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970).

119. As the court noted, "directors who knowingly disseminate false information that results in corporate injury or damage to an individual stockholder violate their fiduciary duty . . ." *Malone*, 722 A.2d at 9. As for the source, the obligation of honesty did not arise as an independent duty. Instead, the Court noted that the need for honesty amounted to "a specific application of the general fiduciary duty owed by directors." *Id.* at 10. In the context of Mercury Financial, therefore, the issue was whether the directors breached "their more general fiduciary duty of loyalty and good faith by knowingly disseminating to the stockholders false information . . ." *Id.* Said another way, inaccurate disclosure could result in a "violation of the fiduciary duties of care, loyalty or good faith." *Id.* at 11. See also *Cinerama v. Technicolor*, 663 A.2d 1156, 1163 n.9 (Del.

B. Implications

Despite some confusing analysis, *Malone* reemphasized the fiduciary nature of the requirement of complete candor and honesty.¹²⁰ Although the case involved allegations of false disclosure under the duty of loyalty,¹²¹ the court made clear the obligation could also arise under the duty of care.¹²² Moreover, companies had an obligation of complete honesty anytime they communicated in a manner that would reach shareholders. The duty was not limited to communications involving shareholder action.¹²³

Nonetheless, the practical effect of *Malone* was to limit claims for inadequate disclosure to derivative suits involving shareholder approval of matters implicating the duty of loyalty. The difficulty in showing individualized harm meant that actions for false disclosure would likely be limited to derivative suits. Similarly, derivative suits alleging false disclosure in the non-shareholder approval context confronted the difficulty in showing harm to the corporation.¹²⁴

1995) ("This Court has recently held that a violation of the duty of disclosure is not necessarily a breach of the duty of loyalty.").

120. See *Malone*, 722 A.2d at 10.

121. *Id.* at 14 ("The issue in this case is not whether Mercury's directors breached their duty of disclosure. It is whether they breached their more general fiduciary duty of loyalty and good faith by knowingly disseminating to the stockholders false information about the financial condition of the company.").

122. The court characterized the board's duty as one of care, loyalty, and good faith. *Id.* at 11. Presumably, therefore, the obligation to speak honestly could sometimes arise under the duty of good faith. The court provided no explanation of how this would occur.

123. *Malone* went beyond Rule 10b-5 in one significant respect. Under that reasoning, a suit could be maintained by injured shareholders, whether purchasers or sellers. See *id.* at 13. ("Here it is to be noted, the claim appears to be made by those who did not sell and, therefore, would not implicate federal securities laws which relate to the purchase or sale of securities."). Thus, those fraudulently induced to retain their shares would presumably have a cause of action. In the context of shareholder action, the court suggested that a plaintiff need only establish the materiality of the omitted or misstated information. See *id.* at 12. While that might suffice for an injunction seeking supplemental disclosure, it would presumably not be enough in an action for damages. See *Brown v. Perrette*, No. 13531, 1999 Del. Ch. LEXIS 92, at *28 (Del. Ch. May 14, 1999) "[P]laintiff seeking recovery for breach of the duty of disclosure must set forth the shareholder's economic interest or voting right harmed by the breach and request damages commensurate with the harm.").

124. A derivative suit could also be brought for market disclosure in the absence of shareholder action. The claim would, by negative implication, require proof of reliance, causation, materiality and "actual quantifiable monetary damages." *Malone*, 722 A.2d at 12. Shareholders would presumably have to show harm to the corporation. This may not be an easy matter. See John C. Coffee, Jr., *Disclosure Duties: New Law and New Issues*, N.Y.L.J., Jan. 21, 1999, at 5 ("Where fraudulent statements enable the corporation to raise funds, attract customers, gain credit from suppliers, or acquire other firms, the conduct may be egregious, but damages are typically lacking."). Fluctuations in share prices would probably not be enough since they do not necessarily result in harm to the company. Fines imposed as a result of false disclosure or other types of special damages might

As a practical matter, therefore, actions for false disclosure would be the most viable only in the derivative context and only when the company was requesting some sort of shareholder action. For derivative actions implicating the duty of care, the universal presence of liability waiver provisions in the articles of incorporation meant that recovery of damages would have little likelihood of success.¹²⁵ Damages would only be possible in a meaningful sense in actions involving inadequate disclosure to shareholders asked to approve transactions involving the duty of loyalty.¹²⁶

III. Full Disclosure and the Duty of Loyalty

A. Materiality Defined

In ensuring adequate information, the doctrine of complete candor and honesty prohibits “[m]isleading partial disclosure”¹²⁷ and,

suffice. *Id.* With respect to individual actions for false disclosure, the court indicated that such a suit was possible, but with limitations. For an example of a cause of action brought on behalf of a single shareholder see *Jackson Nat'l Life Ins. Co. v. Kennedy*, 741 A.2d 377 (Del. Ch. 1999). Noting the traditional role of the federal securities laws in regulating disclosure to the market, the Court declined to permit an action based upon “fraud on the market.” *Malone*, 722 A.2d at 12–13. As a result, actual reliance would be the order of the day, eliminating the possibility of a large class action. Moreover, the shareholder would need to show a direct, rather than derivative, injury. See *Jackson*, 741 A.2d at 389 (enough to plead that omission was important to “consideration of its rights under the Certificate and that the communicating director or directors could not have reasonably concluded otherwise.”). In the case of the directors of Mercury Financial, the allegations involved the knowing dissemination of materially false information. See *id.* at 7, 9. The loss of “virtually all of its equity” seemed to “obliquely claim an injury to the corporation.” *Malone*, 722 A.2d at 14. Thus, the case appeared to be a derivative action, something that required pre-suit demand on the board. Plaintiffs would have to determine whether the cause of action was direct or derivative, an often subtle distinction. See *Parnes v. Bally*, 788 A.2d 131 (Del. 2001); *Grimes v. Donald*, 755 A.2d 388 (Del. 2000), *aff'd*, 784 A.2d 1080 (Del. 2001) (decision without published opinion). Alternatively, the case could be replead as an action on behalf of an individual or a properly recognizable class. To plead the matter as a class, the plaintiffs would have to overcome the language in *Gaffin v. Teledyne*, 611 A.2d 467, 474 (Del. 1992), that fraud cases were not properly brought as a class action because the element of justifiable reliance would “inevitably” predominate over common questions of law and fact.

125. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2001); see also *Arnold v. Sec'y for Sav. Bancorp*, 650 A.2d 1270, 1287 (Del. 1994) (“In the instant case, plaintiff’s claim that section 102(b)(7) does not extend to disclosure violations must be rejected as contrary to the express, unambiguous language of that provision.”). The provision applies to liability and does not preclude injunctive or other types of relief.

126. The Delaware Code specifically bars waiver of liability in the case of a breach of the duty of loyalty. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). See also *Emerald Partners v. Berlin*, 726 A.2d 1215, 1227 (Del. 1999); *Rosser v. New Valley Corp.*, No. 17272, 2000 Del. Ch. LEXIS 115, at *26 (Del. Ch. Aug. 15, 2000).

127. See *Weiss v. Samsonite Corp.*, 741 A.2d 366, 374 (Del. Ch. 1999).

in some cases, “literally true statements” if materially incomplete.¹²⁸ Although extending to common stockholders,¹²⁹ there still exists an issue about the applicability of the obligation of full disclosure to preferred shareholders, at least those without voting rights.¹³⁰ The duty does not apply to debt holders.¹³¹

128. See *Sonet v. Plum Creek Timber Co.*, No. 16931, 1999 Del. Ch. LEXIS 49 (Del. Ch. Mar. 18, 1999).

129. The materiality standard also applies to directors, although the difference in the decision making process means that the information necessary to make an informed decision will vary. See *Brehm v. Eisner*, 746 A.2d 244, 259 n.49 (Del. 2000).

The term “material” is used in this context to mean relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decisionmaking. In this sense, it is distinct from the use of the term “material” in the quite different context of disclosure to stockholders in which an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.

Id. (citations omitted).

130. See *Jackson Nat'l Life Ins. Co. v. Kennedy*, 741 A.2d 377, 389–90 (Del. Ch. 1999). Whatever uncertainty has been suggested by the courts, the duty to disclose honestly would seem to apply with equal vigor to non-voting preferred shareholders. First, the Delaware courts have long accepted that the duty applied in contexts not involving voting rights, such as the decision to tender or not tender shares. *Id.* at 390. Second, *Malone* clarified that the doctrine applied to any public disclosure. *Id.* at 389; *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998). In neither instance does the presence or absence of voting rights seem to matter.

131. See *Revlon v. MacAndrews & Forbes Holding*, 506 A.2d 173, 184 (Del. 1986). Doubt exists about the application of the doctrine to purchasers, at least those not already shareholders. In *SEC v. Dirks*, the Supreme Court made clear that insider trading was fundamentally premised upon fiduciary duty principles. 463 U.S. 646, 653 (1983). Thus, disclosure obligations did not extend to non-shareholder purchasers. Nonetheless, no court has been willing to dismiss insider trading cases due to the absence of a fiduciary duty to purchasers. See *Debartolo Group v. Jacobs Group*, 186 F.3d 157, 169 n.5 (2d Cir. 1999) (“For purposes of insider trading, it does not matter whether the insider is buying from an existing shareholder or selling to an entity who then becomes a shareholder.”). See also *Gratz v. Claughton*, 187 F.2d 46, 49 (2d Cir. 1951) (Hand, J.) (“It would be a sorry distinction to allow [an insider] to use the advantage of his position to induce the buyer into the position of a beneficiary, although he was forbidden to do so, once the buyer had become one.”). The two read in tandem suggest that fiduciary obligations apply to imminent shareholders, i.e., those about to purchase. Nonetheless, the approach is accidental and make-weight. Neither *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), nor *Dirks* explained how fiduciary duty principles could extend to non-shareholders. *Cady Roberts* is probably correct, therefore, in the holding that disclosure obligations under the antifraud provisions extend to purchasers. If no duty applied to purchasers, insiders could sell to them knowing that share prices would fall without breaching fiduciary obligations and violating the prohibitions on insider trading. It is the analysis in *Dirks*, which premises these obligations on fiduciary duty principles, that is suspect. The reasoning in this area is less a matter of compelling logic and more a matter of accident. Moreover, as a practical matter, courts are simply unwilling to exonerate fiduciaries in insider transactions with non-shareholder purchasers. Delaware courts will, therefore, need to address a similar concern. To the extent arising under fiduciary duty principals, the duty of honesty and completeness would not extend to purchasers who did not already own shares.

Delaware courts have expressly adopted the federal definition of materiality.¹³² Thus, information will be material under Delaware law where there is:

a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.¹³³

As under Rule 10b-5, Delaware courts have noted that materiality amounts to a mixed question of law and fact,¹³⁴ to be determined by objective standards.¹³⁵ Materiality is examined from the perspective of shareholders, not directors.¹³⁶

132. See *Smith v. Van Gorkom*, 488 A.2d at 858, 890 (Del. 1985). But see *In re Transworld Airlines S'holders Litig.*, No. 9844(con.), 1988 Del. Ch. LEXIS 139, at *27 n.2 (Del. Ch. Oct. 21, 1988) (noting that the standard for disclosure under state and federal securities laws is "essentially the same," but "[t]he similarity is not exact"). As one court noted, the test was comparable "to the test applied by federal courts when treating disclosure under the federal securities laws." *Lacos Land Co. v. Arden Group, Inc.*, 517 A.2d 271, 279 (Del. Ch. 1986). The federal definition appears in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

133. *Roberts v. General Instrument*, No. 11639, 1990 Del. Ch. LEXIS 138, at **29-30 (Del. Ch. Aug. 13, 1990); see also *Zirn v. VLI Corp.*, 621 A.2d 773, 779 (Del. 1993); *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985) ("Moreover, it is clear from the Delaware cases that the materiality standard of *TSC Industries, Inc. v. Northway, Inc.* . . . applies."); *Weiss v. Samsonite Corp.*, 741 A.2d 366, 374 (Del. Ch. 1999) (defining materiality standard as "substantial likelihood" that omitted facts would "significantly alter[] the 'total mix' of information" and would assume "actual significance in a reasonable stockholders' deliberations.").

134. See *Weinberger v. Rio Grande Industries*, 519 A.2d 116 (Del. Ch. 1986); see also *Zirn*, 621 A.2d at 778-79; *Glassman v. Wometco Cable TV*, No. 7307, 1989 Del. Ch. LEXIS 1, at *5 (Del. Ch. Jan. 6, 1989) ("The materiality of non-disclosed facts is a mixed question of law and fact and as such is not usually an appropriate issue for resolution by summary judgment." (citation omitted)).

135. See *Zirn*, 621 A.2d at 779. Materiality includes information mandated by statute. See *Nebel v. Southwest Bancorp*, No. 13618, 1995 Del. Ch. LEXIS 80, at *17 (Del. Ch. July 5, 1995) ("In my view, any argument that the erroneous inclusion of a page from another state's appraisal statute was 'immaterial' is foreclosed by the mandatory nature of the statutory requirement.").

136. *Zirn*, 621 A.2d at 779 ("[T]he focus is on what a reasonable investor would consider important in tendering his stock, not what a director considers important."); see also *Kahn v. Lynch Communication Sys., Inc.*, 669 A.2d 79 at 88 (Del. 1995) (noting that test for materiality is objective, "determined from the perspective of the reasonable shareholder, not that of the directors or other party who undertakes to distribute information").

B. Immaterial Material Information

Perhaps a majority of the reported cases in Delaware involving issues of complete candor and honesty have focused on two areas. One concerns the obligation to disclose conflicts of interest and illegal activity.¹³⁷ Courts routinely refuse to require such disclosure, likening the obligation to “self-flagellation.” The other involves information about alternative valuations.¹³⁸ Whether a merger, tender offer or other sale of the business, Delaware courts routinely refuse to require disclosure of information suggesting a higher valuation than the price offered.¹³⁹

To justify nondisclosure, courts have often relied on a balancing test that weighs the benefits of disclosure against the harm of inundating shareholders with unnecessary information.¹⁴⁰ Thus, materiality cannot be so broad as to bury “shareholders in an avalanche of trivial information” or otherwise cause investor confusion.¹⁴¹ Such an approach amounts to a tacit acknowledgment that investors would find the information useful but provides for exclusion because the harm outweighs the benefits. The test does not comport with usual notions of materiality, which merely focus on the significance of the information to investors.¹⁴²

137. See sources cited *supra* note 87.

138. *Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170, 1174 (Del. 2000); *In re Unocal Exploration Corp. S'holders Litig.*, 793 A.2d 329, 352 (Del. Ch. 2000).

139. Courts have refused to do so even where they have recognized that it might be “good policy.” *Lewis v. Vogelstein*, 699 A.2d 327, 332 (Del. Ch. 1997) (noting that while it might be “good public policy” to disclose to shareholders the value of options as compensation to officers and directors, “it does not follow that the fiduciary duty of corporate directors is the appropriate instrument to determine and implement sound public policy with respect to this technical issue”).

140. See, e.g., *Solomon v. Armstrong*, 747 A.2d 1098, 1128 (Del. Ch. 1999):

The determination of the materiality of an alleged omission or misstatement “requires a careful balancing of the potential benefits of disclosure against the resultant harm.” The theory goes that there is a risk of information overload such that shareholders’ interests are best served by an economy of words rather than an overflow of adjectives and adverbs in solicitation statements.

(citing *Arnold v. Sec’y for Sav. Bancorp*, 650 A.2d 1270 (Del. 1994) (footnotes omitted)).

141. 747 A.2d at 1130 (quoting *Behrens v. United Investors Mgmt.*, No. 12876, 1993 Del. Ch. LEXIS 217, at 33 (Del. Ch. Oct. 1, 1993)). The reference to an “avalanche of trivial information” also sometimes appears in federal cases. At least as used by the Supreme Court, however, the phrase is not a justification for excluding information important to reasonable investors, but instead has been used to determine the appropriate test for materiality. See, e.g., *TSC Indus., Inc. v. Northway, Inc.*, 426 US 438, 448 (1976) (rejecting lower court standard that held materiality encompassed information which “might” be important to a reasonable investor).

142. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 234 (1988) (“The role of the materiality requirement is not to ‘attribute to investors a child-like simplicity, an inability to grasp the probabilistic significance of negotiations,’ but to filter out essentially useless information

C. Self-flagellation

(1) State Regime

The duty of complete honesty does not require companies to characterize facts as acts of mismanagement or violations of the law.¹⁴³ Said another way, a company does not have to disclose “[m]ere speculation” or “a legal conclusion.”¹⁴⁴ Courts in Delaware have inartfully labeled this the “self-flagellation” doctrine.¹⁴⁵

In many respects, the doctrine is unremarkable. Courts agree that notions of materiality do not require that management pejoratively characterize circumstances.¹⁴⁶ Nonetheless, the doctrine traditionally did not absolve companies from disclosing underlying facts that suggested a conflict of interest or improper behavior, thereby enabling shareholders to draw their own conclusions.¹⁴⁷ Delaware courts, however, have broadened the ban on pejorative characterizations to encompass the surrounding facts.¹⁴⁸

that a reasonable investor would not consider significant, even as part of a larger ‘mix’ of factors to consider in making his investment decision.” (citations omitted)).

143. *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 143 (Del. 1997) (“The directors’ duty of disclosure does not oblige them to characterize their conduct in such a way as to admit wrongdoing.”); *Bragger v. Budacz*, No. 13376, 1994 Del. Ch. LEXIS 202, at *21 (Del. Ch. Dec. 7, 1994) (“Yet it is well settled that directors need not in their disclosure document admit plaintiffs’ claims to be true; they need not engage in confessions of contested positions.”).

144. See *Tuckman v. Aerosonic Corp.*, No. 4094, 1982 Del. Ch. LEXIS 452, at *34 (Del. Ch. May 20, 1982). The same approach applies to motivations. In general, they need not be stated affirmatively, although a misstatement may be actionable. This is largely the holding in *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991). See also *Herd v. Major Realty Corp.*, No. 10707, 1990 Del. Ch. LEXIS 211 (Del. Ch. Dec. 21, 1990).

145. Delaware courts apparently used the appellation for the first time in *Stroud v. Grace*.

We recognize the long-standing principle that to comport with its fiduciary duty to disclose all relevant material facts, a board is not required to engage in “self-flagellation” and draw legal conclusions implicating itself in a breach of fiduciary duty from surrounding facts and circumstances prior to a formal adjudication of the matter.

606 A.2d 75, 84 n.1 (Del. 1992). In fairness, the phrase was used even earlier by a federal court. See *Missouri Portland Cement Co. v. Cargill, Inc.*, 498 F.2d 851, 873 (2d Cir. 1974). With respect to the federal courts, however, the phrase has not become an appellation for the doctrine.

146. See *BROWN*, *supra* note 7, § 3.03[5][b] (Supp. 2000).

147. The doctrine first arose in *Stroud*, 606 A.2d 75. In that case, the court recognized that companies had no obligation to “engage in ‘self-flagellation’ and draw legal conclusions implicating itself in a breach of fiduciary duty from surrounding facts and circumstances prior to a formal adjudication of the matter.” *Id.* at 84 n.1. At the same time, however, they were obligated to “disclose[] all material facts relevant to the issue at hand.” *Id.*

148. Thus, for example, in *Loudon*, plaintiffs alleged that directors violated the duty of complete honesty by failing to reveal the facts surrounding the resignation of a director.

In *Wolf v. Assaf*, the court declined to find material information indicating that the chairman knew about improper accounting treatment.¹⁴⁹ Shareholders had filed a suit against the company alleging securities fraud based in part upon improper accounting practices. In the action, the chairman admitted that he had known about the accounting irregularities.¹⁵⁰ Plaintiff alleged that the chairman's awareness should have been disclosed in the proxy materials and that the failure to disclose violated his obligation of candor.¹⁵¹

In dismissing the allegations, the Court of Chancery characterized the claims as requiring management to engage in "self-flagellation" and require them to disclose facts that would arguably constitute a breach of fiduciary duty.¹⁵²

700 A.2d at 135. The proxy statement contained no information explaining the reasons for a director's resignation. *Id.* According to plaintiff, the director had resigned because of his opposition to perceived wrongdoing by the board. *Id.* Describing the approach as "a novel disclosure theory," the court declined to find the omitted information material:

To be sure, it might be "better practice" for directors of a public corporation to be more candid and forthcoming in their communications to stockholders when presenting a slate for election to the board. It is a leap of logic, however, for this Court, applying a form of "common law" of corporate disclosure, to fashion a rule that attempts to draw—in a liability context—a bright line of disclosure for directorial elections. How much information must be imparted to the stockholders concerning positions previously taken by directors who have been dropped from the management slate? When can it be said that omitted information about a former director's disagreement with management rises to the level of a "substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of a reasonable shareholder"? What is plaintiff's theory of causation and economic damage to him and other stockholders?

Id. at 144 (citations omitted). The court's use of rhetorical questions was odd. The same issues could be raised about any close question under the materiality standard. The very difficulty of the issue explains why the matter is typically left for the jury. Moreover, it was unclear what was "novel" about the claim. Facts surrounding the resignation of a director have long been recognized as potentially important information. Item 6 of Form 8-K under the Exchange Act requires companies to disclose any time a director has resigned as a result "of a disagreement with the registrant." Item 6, 17 C.F.R. 249.8-K. Moreover, cases have held that conflict at the board level can be material. See *Cooperman v. Individual Inc.*, 171 F.3d 43, 49 (1st Cir. 1999) (conflict at the board level over the future direction of the company could be material). *But see In re Frederick's of Hollywood S'holders Litig.*, No. 15944 (con.), 2000 Del. Ch. LEXIS 19, at *27 (Del. Ch. Jan. 31, 2000) (reasons for resignation of directors three months before approval of merger not material).

149. No. 15339, 1998 Del. Ch. LEXIS 101, at *16 (Del. Ch. June 16, 1998).

150. *Id.* at *11.

151. *Id.* at *6.

152. *Id.* at *14 ("A bright line rule demanding that all such facts be disclosed would suck management into a bottomless pit of self-flagellation worthy of the imagination of Dante.").

Plaintiff's artfully phrased siren song that he "didn't care how the disclosure was characterized so long as the facts were there" does not dissuade me from concluding it is no more than an artifice designed to camouflage an attempt at compelling self-flagellation. . . . Until a court has formally adjudicated the underlying allegation of wrongdoing, [the] board had no duty to disclose the Chairman's knowledge of mistakes in accounting practices in a manner which would force a statement to counter any inference its accounting practices could be characterized as wrongful.¹⁵³

The court seemed to suggest that facts creating an inference of wrongdoing did not have to be disclosed.¹⁵⁴

The analysis inappropriately equated the disclosure of the underlying facts with the obligation to characterize them in a pejorative fashion. An acknowledgement that the chairman knew of the accounting irregularities would not preclude the company from including an explanation and a context.¹⁵⁵ Nor would such disclosure automatically mean that the chairman had violated the law.¹⁵⁶

The prohibition on self-flagellation has, therefore, been used as an excuse to avoid disclosure not only of legal conclusions and pejorative characterizations but also of underlying facts. The doctrine has been used to treat, as immaterial, facts concerning the bidding process to purchase a company,¹⁵⁷ the valuation methodology used in a merger,¹⁵⁸ the failure to properly file reports required under the securities laws,¹⁵⁹ and the negotiations between a parent and an

153. *Id.* at *15.

154. Delaware courts have occasionally expressed discomfort with the doctrine. See *Brown v. Perrette*, No. 13531, 1999 Del. Ch. LEXIS 92, at *22 (Del. Ch. May 14, 1999) ("I find it troublesome that a board can escape disclosure of material information *precisely because* the materiality arises from the board's alleged misdeeds." (emphasis in original)).

155. In fact, the chairman acknowledged his awareness of the treatment but "believed that they were either done legitimately or did not affect the company's financial picture." *Wolf*, 1998 Del. Ch. LEXIS 101, at *11.

156. The Commission takes the position that the failure to adhere to GAAP creates a presumption that the financial statements were misleading. See *In the Matter of Advanced Medical Products, Inc.*, Exchange Act Release No. 37649 (admin. proc. September 5, 1996) ("Failure to present financial statements in conformity with GAAP results in a presumption that the statements are misleading and inaccurate."). Courts, on the other hand, tend to look at each instance of nonconformity, without creating any presumption. The issue tends to arise not under the rubric of materiality, but whether the false disclosure met the requirements for scienter. See *BROWN*, *supra* note 7, § 1.04[2].

157. *Brown*, 1999 Del. Ch. LEXIS 92, at *34 n.25.

158. *Citron v. E.I du Pont de Nemours & Co.*, 584 A.2d 490, 503 (Del. Ch. 1990).

159. In *Brody v. Zaucha*, 697 A.2d 749 (Del. 1997), plaintiffs alleged that the defendant had failed to disclose various violations of the securities laws, including the failure to file a complete Schedule 13D and a Form 4. The court rightfully concluded that the defendant did not have "to make self-accusatory statements." *Id.* at 754. On the other hand, a defendant trying to obscure the purchase of additional shares might, as part of that

independent board committee appointed by the target company.¹⁶⁰ Other facts not subject to disclosure under the self-flagellation doctrine include a decision to promote a merger in part to allow a controlling shareholder to avoid estate taxes¹⁶¹ and the failure to disclose shareholder opposition to a stock buy-back program.¹⁶²

The extension of this doctrine to surrounding facts has conflicted with general notions of full disclosure, something recognized by the Delaware courts. One decision expressly acknowledged the conflict, at least in the case of affirmative misrepresentations.¹⁶³ Nonetheless, on the whole, the courts have declined to impose any meaningful requirement that fiduciaries reveal facts suggesting a lack of integrity or conflict of interest.¹⁶⁴

(2) Federal Regime

Courts under the federal regime take a different approach. They agree with the ban on pejorative characterizations and admissions of legal wrongdoing.¹⁶⁵ Nonetheless, they have routinely found as

process, fail to file applicable disclosure documents. In these circumstances, the failure to file a Form 4 as an underlying fact may be material.

160. *Citron*, 584 A.2d at 503; *see also* *Weinberger v. United Fin. Corp.*, No. 5915, 1983 Del. Ch. LEXIS 443, at **28–29 (Del. Ch. Oct. 13, 1983).

161. *Weingarden & Stark v. Meenan Oil Co.*, Nos. 7291 & 87310 (con.), 1985 Del. Ch. LEXIS 374, at **6–7 (Del. Ch. Jan. 2, 1985).

162. *Seibert v. Harper & Row, Publr.*, No. 6639, 1984 Del. Ch. LEXIS 523, at *16 (Del. Ch. Dec. 5, 1984).

163. *See* *Brown v. Perrette*, No. 13531, 1999 Del. Ch. LEXIS 92, at *25 n.19 (Del. Ch. May 14, 1999) (noting that the “rule against self-flagellation might be waived if the corporation affirmatively declared that no violation occurred”); *see also* *Siegman v. Columbia Pictures Entm’t, Inc.*, No. 11152, 1993 Del. Ch. LEXIS 1, at *22 (Del. Ch. Jan. 15, 1993) (Once having spoken, defendants “had an obligation to speak truthfully.”).

164. The court seemed to make the proper distinction in *Wells Fargo & Co. v. First Interstate Bancorp*, No. 14696, 1996 Del. Ch. LEXIS 3, at **28–31 (Del. Ch. Jan. 18, 1996). Plaintiffs alleged that the bidder began repurchasing larger quantities of its own shares in an effort to boost stock prices following the announcement of a merger. *Id.* at *4. The court agreed that the purchases could be material and subject to disclosure but that the motivation for them was not. *Id.* at *15. Similarly, in *Siegman* the court agreed that the company had no affirmative obligation to disclose the possibility that the transaction violated a particular statute. *Siegman*, 1993 Del. Ch. LEXIS 1, at **21–22. Nonetheless, once the company represented that the statute “was not implicated in the transaction,” it had an obligation to explain completely the relevance of the provision. *Id.* at *22.

165. One court specifically noted that characterizations add nothing to the total mix and are not, therefore, material, as a matter of law. *See* *Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1277 (D.C. Cir. 1994):

We agree with the district court that many of plaintiffs’ allegations called for pejorative characterizations of disclosed factual matters. Since the use of a particular pejorative adjective will not alter the total mix of information available to the investing public, such statements are immaterial as a matter of law and cannot serve as the basis of a 10b-5 action under any theory.

material factual information surrounding the activity.¹⁶⁶ Essentially, the approach by the federal courts has been to require full disclosure but to leave the characterization to shareholders.

Facts suggesting a conflict of interest or improper motivation have routinely been found material.¹⁶⁷ The information would allow shareholders “to give more careful scrutiny” to the transaction.¹⁶⁸ As one court noted,

[T]he violation arising from the failure to disclose such a potential conflict of interest does not turn on the failure to disclose a director’s true motivations but rather stems from the failure to disclose a fact that puts the shareholder on notice of a potential impairment of the director’s judgment. Whether or not the director’s underlying action could give rise to liability for breach of fiduciary duty under state law is not relevant. The information by itself is material for the shareholder to place the director’s recommendation in perspective.¹⁶⁹

The line between underlying facts and characterizations is not always clear. In some cases, the underlying facts lead to an ineluctable conclusion about the inappropriateness of the behavior,

(citations omitted). *See also* *Recupito v. Prudential Sec.*, 112 F. Supp. 449, 457 (D. Md. 2000):

Additionally, CMI’s failure to describe the subordinated CMBS as “extremely illiquid” does not render the prospectus misleading. The prospectus clearly explains that there was a limited secondary trading market for the subordinated CMBS and warned of the potential consequences of this “illiquidity.” A prospectus ‘need not characterize a security or a risk in pejorative manner.’ Whether CMI used the adjective Plaintiff chooses is not the focus of the court’s inquiry.

(citation omitted).

166. *See, e.g.*, *Lessler v. Little*, 857 F.2d 866, 876 (1st Cir. 1988), *cert. denied*, 489 U.S. 1016 (1989). *See also* *Sea Containers Ltd. v. Stena AB*, 890 F.2d 1205, 1210 (D.C. Cir. 1989) (“Although the federal securities laws do not require a person to publicly confess to engaging in illegitimate or illegal conduct, the securities laws do require disclosure of material facts relating to a person’s action.”); *In re Metlife Demutualization Litig.*, 156 F. Supp. 2d 254, 268–69 (E.D.N.Y. 2001) (“Although the Securities Act did not require MetLife Co. to verbalize all negative inferences, it cannot be said as a matter of law that a reasonable policyholder would have been able to make the appropriate inference about the costs of elections from the facts disclosed.”). For a series of cases finding adequate disclosure of the underlying facts, see *Kas v. Financial General Bankshares, Inc.*, 796 F.2d 508 (D.C. Cir. 1986); *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1 (2d Cir. 1983), *cert denied*, 465 U.S. 1052 (1984); and *Valley National Bank v. Trustee for Westgate-California Corp.*, 609 F.2d 1274 (9th Cir. 1979), *cert denied*, 444 U.S. 1015 (1980).

167. As one court noted, “[F]acts of this nature have always been considered material.” *Kas*, 796 F.2d at 513.

168. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384 (1970).

169. *Kas*, 796 F.2d at 513. Thus, in *RMED International, Inc. v. Sloan’s Supermarket, Inc.*, the court held that the omission of an investigation by the FTC would be material. 185 F. Supp. 2d 389 (S.D.N.Y. 2002). The investigation indicated that the company’s acquisition of supermarkets in New York could potentially violate the antitrust laws. *Id.* at 395–97.

all but indistinguishable from the characterization itself. Nonetheless, the inevitability of the characterization does not constitute a justification for nondisclosure.

An example of the required disclosure of underlying facts under the federal securities laws occurred in *Par Pharmaceutical, Inc. Securities Litigation*.¹⁷⁰ There, plaintiff alleged that the company failed to disclose a scheme to bribe FDA employees to secure expedited approval of various drugs and to slow approval of competing products.¹⁷¹ Public disclosure documents revealed the number of drugs receiving approval and indicated that the company “led the industry in obtaining approvals.”¹⁷² In fact, Par had apparently obtained the quick approvals not from business acumen but from illegal payments.¹⁷³

The affirmative nature of the statements made the outcome straight-forward. Although acknowledging the general rule that companies had no obligation to disclose “uncharged criminal behavior, or to accuse itself of antisocial or illegal policies,” the court held that the approach did not eliminate the duty to make accurate and complete disclosure.¹⁷⁴ Having discussed the approval process, completeness dictated the disclosure of the payments:

A reasonable jury could find that, by extolling Par’s ability to obtain FDA approvals, by comparing Par’s success in this regard to other companies in the industry and to its own previous performance, and by projecting continued success in obtaining rapid approvals, the statements conveyed to a reasonable investor the false impression that Par had a particular expertise in obtaining FDA approvals constituting a legitimate competitive advantage over other companies and that this advantageous expertise was responsible for its success in obtaining FDA approvals.¹⁷⁵

Thus, defendants had a duty to disclose the payments, even though such disclosure effectively amounted to an admission of improper activity.¹⁷⁶

In other cases, courts have characterized omitted information as material because it suggested a motivation other than the best interests of shareholders. In *Mendell v. Greenberg*, a large

170. 733 F. Supp. 668 (S.D.N.Y. 1990).

171. *Id.* at 672–73.

172. *Id.* at 676.

173. *Id.* at 675.

174. *Id.*

175. *Id.* at 677–78.

176. See also *In re Sotheby’s Holdings Sec. Litig.*, 00 Civ. 1041 (DLC), 2000 U.S. Dist. LEXIS 12504 (S.D.N.Y. Aug. 30, 2000) (duty to disclose price fixing scheme where company stated that it was engaging in “intense competition” with its primary competitor).

shareholder died, creating a heavy estate tax burden.¹⁷⁷ Shortly afterwards, the company entered into a merger agreement.¹⁷⁸ The proxy statement said nothing about the tax obligations, information that may have suggested a possible motivation for the transaction.¹⁷⁹ The court conceded that the motivation for the merger did not have to be disclosed, only “objective material facts relating to the transaction.”¹⁸⁰ Nonetheless, the substantial estate tax liability represented a fact that was “not so inconsequential as to allow summary judgment.”¹⁸¹

Federal courts have consistently required that companies disclose facts indicating a conflict of interest or illegal activity.¹⁸² This includes the need to reveal personal indebtedness¹⁸³ and that a merger was motivated by a desire to eliminate two derivative suits.¹⁸⁴ The

177. 927 F.2d 667, 670 (2d Cir. 1991).

178. *Id.*

179. *Id.* Tax motivations were also an issue in *Maldonado v. Flynn*, 597 F.2d 789 (2d Cir. 1979). In that case, the directors approved a plan to allow senior officers to accelerate the exercise date of certain stock options. *Id.* at 792. According to plaintiffs, acceleration provided the officers with, and deprived the company of, certain tax benefits. *Id.* In agreeing that the omission of the tax consequences was actionable, the court noted that the matter raised concern about the integrity of management:

Since self-dealing presents opportunities for abuse of a corporate position of trust, the circumstances surrounding corporate transactions in which directors have a personal interest are directly relevant to determination of whether they are qualified to exercise stewardship of the company [I]t has been recognized that shareholders are entitled to truthful presentation of factual information “impugning the honest, loyalty or competency of directors” in their dealings with the corporation to which they owe a fiduciary duty.

Id. at 796 (citation omitted).

180. *Mendell*, 927 F.2d at 674.

181. *Id.* at 674. This case can be contrasted with *Weingarden & Stark v. Meenan Oil Co.*, Nos. 7291 & 87310 (con.), 1985 Del. Ch. LEXIS 374 (Del. Ch. Jan. 2, 1985), where the court held that the omission of a possible tax motive for the transaction was not material:

The first alleged omission is the failure to disclose that a purported purpose of the merger was to enable Kenny, Jr. to transfer his Meenan stockholdings to Kenny, III free of estate taxes. . . . However, even if plaintiffs were asserting this alleged improper purpose as a disclosure claim, it fails as a matter of law. Corporate officials are not required to engage in “self-flagellation” or speculate as to alleged improper motives.

Id. at **6-7.

182. See *Kas v. Financial General Bankshares, Inc.*, 796 F.2d 512 (D.C. Cir. 1986) (“[C]ase law recognize[s] a cause of action based on a failure to disclose that a member of management has a personal stake in a corporate decision or has some special relationship to another party to a bargain for which shareholder approval is sought.”).

183. See *SEC v. Parklane Hosiery Co.*, 558 F.2d 1083, 1086 (2d Cir. 1977).

184. See *Lichtenberg v. Besicorp Group Inc.*, 43 F. Supp. 2d 376, 389 (S.D.N.Y. 1999) (“The Proxy is replete with the Board’s purported justifications for the merger. Having thus undertaken to describe the motivation for structuring the transaction as they did, the Board was obligated to state all the important purposes of the merger, including that of extinguishing the . . . derivative suits.”).

requirement applies even where the fiduciary obtains no economic benefit as a result of the relevant transaction.¹⁸⁵ With the underlying facts, shareholders make their own determination. They decide whether the facts call into question the fairness of the transaction.

D. Valuations

(1) General

Another heavily litigated disclosure area concerns valuation-related data. For shareholders asked to vote on a merger or to tender their shares, few issues matter more than the expected consideration. In making an informed decision, shareholders would seemingly desire facts suggesting the possibility of a higher price. The information may result in non-approval or a decision to vote against the matter to preserve the right to challenge the fairness of the transaction.¹⁸⁶

Agreement exists among both Delaware and federal courts that materiality does not extend to speculative or highly unreliable data.¹⁸⁷ This would exempt valuations determined in a cursory or unreliable fashion or offers that lacked sufficient indicia of seriousness. Assuming an adequate degree of reliability, however, federal, but not state, courts, find as material information suggesting a higher value than the one presented to shareholders for approval. Delaware courts, in contrast, have been adamant, even hostile, toward shareholder allegations that information and data on alternate valuations should be required.¹⁸⁸

185. See *Kas*, 796 F.2d at 513.

186. See DEL. CODE ANN. tit. 8, § 262(a) (2002). Shareholders voting for a transaction forfeit their right to challenge its fairness. See *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 848 (Del. 1975) (“However, when an informed minority shareholder either votes in favor of the merger, or like Bershad, accepts the benefits of the transaction, he or she cannot thereafter attack its fairness.”).

187. See *Arnold v. Sec’y for Sav. Bancorp*, 650 A.2d 1270, 1280 (Del. 1994) (“Delaware law does not require disclosure of inherently unreliable or speculative information . . .”); see also *Rosser v. New Valley Corp.*, No. 17272, 2000 Del. Ch. LEXIS 115, at *12 (Del. Ch. Aug. 15, 2000).

188. See, e.g., *McMullin v. Beran*, No. 16493, 1999 Del. Ch. LEXIS 227, at *16 (Del. Ch. Dec. 1, 1999) (“Delaware law does not, however, require disclosure of unreliable or speculative information that would confuse shareholders or inundate them with an overload of information.”); see also *Van de Walle v. Unimation, Inc.*, No. 7046, 1991 Del. Ch. LEXIS 27, at *49 (Del. Ch. Mar. 6, 1991) (“To be the subject of a disclosure obligation, information relating to value must be considered reliable Neither set of figures was intended to serve as a valuation of the company [and the projections] were not sufficiently reliable evidence of value to be the subject of mandated disclosure to stockholders.”); *Goodwin v. Live Entm’t*, No. 15,765, 1999 Del. Ch. LEXIS 5, at **35–38 (Del. Ch. Jan. 22, 1999) (failure to disclose that target was “receiving a premium for its Series C stock over a hypothetical concluded market value” held not actionable where material to be disclosed was “inherently tentative” and “would not have contributed

More remarkable, state courts have used the very importance of the information to justify a finding of immateriality. Thus, in *In re Vitalink Communications Corp. Shareholders Litigation*,¹⁸⁹ the court refused to find material a range of possible values presented to the board and used in the deliberation process. In so doing, the court decided that the information would cause “enormous harm” by misleading investors into thinking that a higher price was possible.¹⁹⁰

(2) *State Law Regime*

The materiality of valuations often comes up in transactions that involve fairness opinions. These opinions attest to the adequacy of the offering price. They are used to fulfill the board’s fiduciary obligation to make an informed decision.¹⁹¹ Nothing in the fairness opinion process provides information that places the valuation in perspective. Typically stating that an offer is fair “from a financial point of view,” the opinion generally speaks only to the fairness of the offer at issue and does not address alternative valuations or consider the likelihood of a higher offer.¹⁹²

The opinion also does not usually disclose the range of possible fair prices or analyze fairness in non-financial terms.¹⁹³ Management may in fact have received other offers or have used other formulas that suggest a greater value. Presumably such information would be

meaningfully or reliably to the shareholders’ consideration of whether the price they were receiving for their common stock was fair Further disclosure therefore may have made the Proxy Statement less, not more, reliable.”)

189. No. 12085 (con.), 1991 Del. Ch. LEXIS 195, *40 (Del. Ch. Nov. 8, 1991).

190. *Id.* at *41 (“Disclosure of this analysis would have presented an enormous potential for harm to the shareholders. Even if the disclosure included a sentence why Kidder believed the analysis produced an inflated range, it could have mislead shareholders into believing that a higher price was attainable.”). This was true if the range had been accompanied by an explanation about changes in market conditions that made the range suspect. See also *Goodwin*, 1999 Del. Ch. LEXIS 5, at *45 (disclosure of asset valuations based on different assumptions would have been “confusing” to shareholders).

191. See *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985).

192. See *O’Reilly v. Transworld Healthcare*, 745 A.2d 902, 929 (Del. Ch. 1999):

[T]he duty of disclosure does not appear to require them, when they have received only one offer, to disclose information from which the stockholders could assess whether the offer represents the highest value reasonably available to the company’s stockholders, as opposed to whether the offer at issue represents fair value.

193. For a discussion of fairness opinions, see Lucian Arye Bebchuk & Marcel Kahan, *Symposium: Fundamental Corporate Changes: Causes, Effects, and Legal Responses: Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27 (1989).

important to shareholders in deciding whether to approve the transaction.¹⁹⁴

The issue of alternative values can arise in a number of different circumstances. The first concerns the existence of other offers. The second involves alternative valuations that vary depending upon the type of transaction. The third concerns values that change with the use of other formulas. Although sometimes relying on the unreliability of the data, the courts in Delaware have excluded all such information from the definition of materiality. They have done so despite the talismanic importance of investment banking opinions in the shareholder approval process.¹⁹⁵

a. Alternative Offers

Perhaps nothing could be more important to shareholders deciding whether to approve the sale of a business than information on the availability of other, higher-priced offers. Delaware courts have not, however, required disclosure of such information. In declining to do so, they have largely used an analysis and approach

194. Although Delaware courts on the whole have excluded the information from the definition of materiality, the first modern case in the area took exactly the opposite view. See *Lynch v. Vickers Energy Corp.*, 383 A.2d 278, 281 (Del. 1977):

Technically speaking, the language may be accurate; but that kind of generality is hardly a substitute for hard facts when the law requires complete candor. And when, as here, management was in possession of two estimates from responsible sources—one using a “floor” approach defining value in terms of its lowest worth, and the other a more “optimistic” or ceiling approach defining value in terms of its highest worth—it is our opinion that complete candor required disclosure of both estimates. If management believed that one estimate was more accurate or realistic than another, it was free to endorse that estimate and to explain the reason for doing so; but full disclosure, in our view, was a prerequisite.

195. In considering the blanket conclusion that the information supporting the opinion of investment bankers need not be disclosed to shareholders, one lower court characterized the approach as “intellectually unsatisfying.”

Fearing stepping on the SEC's toes and worried about encouraging prolix disclosures, the Delaware courts have been reluctant to require informative, succinct disclosure of investment banker analyses in circumstances in which the bankers' views about value have been cited as justifying the recommendation of the board. But this reluctance has been accompanied by more than occasional acknowledgement of the utility of such information, acknowledgement that is understandable given the substantial encouragement Delaware case law has given to the deployment of investment bankers by boards of directors addressing mergers and tender offers.

....

In my view, it is time that this ambivalence be resolved in favor of a firm statement that stockholders are entitled to a fair summary of the substantive work performed by the investment bankers upon whose advice the recommendations of their board as to how to vote on a merger or tender rely.

In re Pure Res., Inc. S'holders Litig., 808 A.2d 421, 449 (Del. Ch. 2002).

for determining materiality expressly rejected by the U.S. Supreme Court.¹⁹⁶

Rather than weigh probability against magnitude, the test employed at the federal level, Delaware courts have categorically concluded that other offers are not material.¹⁹⁷ They treat them as an invitation to negotiate and have determined that negotiations are immaterial as a matter of law absent agreement on price and post-merger structure. As a result, offers are little more than mere inquiries and “indications of interest from other potential buyers, and the handling of these inquiries need not be disclosed as they concern preliminary discussions to arrange a merger.”¹⁹⁸

*Wisconsin Investment Board v. Bartlett*¹⁹⁹ represents an example of the approach used in Delaware. The board of Medco Research authorized the chairman to negotiate a merger.²⁰⁰ In the event negotiations were successful, the chairman was to receive 0.75% of the aggregate value of any consideration paid in the transaction.²⁰¹ The chairman, therefore, had a financial incentive to ensure completion of a merger, even at an inadequate price. Ultimately, the company accepted a merger proposal from King Pharmaceuticals and submitted the matter to shareholders for approval.²⁰² Plaintiffs alleged that the proxy material omitted information on other offers.²⁰³ The opinion admitted that there was “substantial disagreement” between the parties over “the efforts taken” by the company’s board “to engage in discussions with other potential suitors.”²⁰⁴ Moreover, the court acknowledged that “not every potential suitor either became the subject of intense scrutiny or implicated mutual due

196. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 238–39 (1988).

197. See *McMullin v. Beran*, No. 16493, 1999 Del. Ch. LEXIS 227, at *16 (Del. Ch. Dec. 1, 1999) (“Moreover, preliminary discussions held in order to arrange mergers are immaterial.”). See also *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 847 (Del. 1975) (“We also find that the defendants were under no duty to disclose the substance of their discussions with Indian Head or any other casual inquiries they received about Dorr-Oliver. Efforts by public corporations to arrange mergers are immaterial under the *Rosenblatt v. Getty* standard, as a matter of law, until the firms have agreed on the price and structure of the transaction.”); *Krim v. Pronet, Inc.*, 744 A.2d 523, 528–29 (Del. Ch. 1999) (“Plaintiff offers only conclusory allegations about other ‘discussions or negotiations,’ and fails to plead any specific facts regarding potential suitors besides MetroCall. Moreover, even if such ‘discussions or negotiations’ did exist, they need not be disclosed.” (citations omitted)).

198. *McMullin*, 1999 Del. Ch. LEXIS 227, at *17 (internal punctuation omitted).

199. No. 17727, 2000 Del. Ch. LEXIS 42 (Del. Ch. Feb. 24, 2000).

200. *Id.* at **3–4.

201. *Id.* at *4n.1.

202. *Id.* at *4.

203. *Id.* at **15–16.

204. *Id.* at *15.

diligence,²⁰⁵ suggesting that in fact some had reached such a stage. Nonetheless, the court refused to find the other offers material, characterizing them as little more than “indications of interest;” offers that were “preliminary in order to explore the possibility of a business combination that might lead to a merger agreement, and little more.”²⁰⁶

Object characterizations of other offers as preliminary or as expressions of interest amounts to conclusions, not analysis. First, the court never explained why suitors given “intense scrutiny” or offers that were subject to board discussion failed to meet the materiality test. Second, labeling an offer as “preliminary” does not, perforce, equate with immateriality. Offers require negotiation. The mere receipt of a serious offer at an attractive price can constitute material information even without additional negotiations.

b. Alternative Transactions

Delaware courts oppose the disclosure of values arising out of alternative transactions, routinely finding the information immaterial.²⁰⁷ Courts sometimes characterize the data as uncertain and speculative, despite strong indications of reliability.²⁰⁸ Other times they disavow the need for shareholders to consider anything except the precise transaction placed before them. Finally, they often emphasize the possibility of investor confusion arising from multiple valuations.²⁰⁹

*Arnold v. Society for Savings Bancorp, Inc.*²¹⁰ involved an example of multiple valuations. Bancorp suffered severe financial

205. *Id.* at *16.

206. In another case, the court specifically found immaterial a statement that the company had received interest from other bidders “at a more attractive price” despite the fact that price had not been discussed at all. In *Golden Cycle v. Allan* the court rationalized that, given the ongoing hostile tender offer, shareholders could infer that those “who had expressed some interest” in fact “understood that a price in excess” of that offered by the bidder was necessary. No. 16301, 1998 Del. Ch. LEXIS 80 at *25.(Del. Ch. May 20, 1998).

207. See *Frank v. Arnelle*, No. 15642, 1998 Del. Ch. LEXIS 176, at *22 (Del. Ch. Sept. 16, 1998) (“Delaware courts do not require mandatory disclosure of valuation opinions prepared in connection with a board’s approval of a self-tender offer.”).

208. See *Barkan v. Amsted Indus.*, 567 A.2d 1279, 1289 (Del. 1989) (“Even the best estimate constitutes an exercise in enlightened speculation that may or may not be borne out by subsequent developments.”); see also *Van de Walle v. Unimation*, [1991] Fed. Sec. L. Rep. (CCH) ¶ 95,834 (Del. Ch. Mar. 6, 1991) (“[T]o be the subject of a disclosure obligation, information relating to value must be considered reliable.”).

209. See *Barkan*, 567 A.2d at 1289 (“We see no reason why candor would demand that shareholders be deluged with conflicting estimates of financial performance, many of which have been made stale by the passage of time.”).

210. 650 A.2d 1270 (Del. 1994).

difficulties.²¹¹ One of its subsidiaries, Fidelity Acceptance, however, remained profitable.²¹² Eventually, Bancorp retained Goldman Sachs to shop the company.²¹³ When no acquirors were forthcoming, Goldman proposed breaking up the company and solicited offers for each part, including Fidelity Acceptance.²¹⁴ Goldman eventually proposed to the board the sale of each separate piece of Bancorp, with all remaining assets placed in a “stub” bank.²¹⁵ Based on this approach, Goldman estimated the value of each share of Bancorp at \$19.26, although the value of the stub bank was considered highly uncertain.²¹⁶ The executive summary presented to the board disclosed that the stub required some cash, with the amount “subject to negotiations with various buyers.”²¹⁷ Further, the summary noted that “material deterioration” in the loan portfolio or the failure of the portfolio to meet “secondary market documentation” could have a negative affect on valuation.²¹⁸

By an eight-to-five vote, the board declined to approve the transaction.²¹⁹ Eventually, the board agreed to a merger with the Bank of Boston for \$17.30 per share.²²⁰ The proxy statement discussed the proposal by Goldman but stated that “the board was advised that, in light of uncertainties involving the value of certain assets, the value ultimately distributable to shareholders could only be estimated.”²²¹ Plaintiffs challenged the failure to disclose the break-up value presented to the board.²²²

In finding the information immaterial, the court noted that the board had to balance the benefits of disclosure against the harms.²²³ The harm came from the concern that shareholders might think a higher offer was possible. “Disclosing an overly optimistic per share figure may be harmful because it might induce stockholders to hold out for an elusive, higher bid.”²²⁴ The opinion, however, gave a second reason for finding the information immaterial. Relying on

211. *Id.* at 1274.

212. *Id.*

213. *Id.*

214. *Id.*

215. *Id.*

216. *Id.* at 1274–75.

217. *Id.* at 1283.

218. *Id.*

219. *Id.* at 1275.

220. *Id.*

221. *Id.* at 1278.

222. *Id.* at 1276.

223. *Id.* at 1282.

224. *Id.* at 1282–83.

conclusory affidavits produced by the defendants,²²⁵ the court held that the \$19.26 valuation was too speculative and unreliable and that disclosure could “under some circumstances, constitute material misrepresentation.”²²⁶ Thus, the court suggested that the company could commit fraud by disclosing the alternative valuation.

Several things make the analysis in the opinion suspect. First, the characterization that the estimates were unreliable lacked any sound basis. They were not back-of-the-envelope calculations that lacked credibility. Instead, they were used in a formal presentation to the board by a reputable investment banking firm. They amounted to reasoned prognostication. Moreover, the estimates were certain enough for presentation for board review and reliable enough to ensure that the board met its obligation to be informed under the business judgment rule.

Second, whatever uncertainty existed, the court nowhere explained how these concerns rendered the disclosure adequate for the board but inadequate for shareholders.²²⁷ The value of the stub bank may have been speculative but it was based upon the book value. The risk that the trading value could differ was commonplace and easy to explain in the proxy materials.

Finally, the opinion contained inherent contradictions. With the definition of materiality focusing on matters important to a reasonable shareholder, the court all but conceded that shareholders would rely on the information about the break-up value of the company. Indeed, the information might cause shareholders to oppose the transaction and hold out for an “elusive, higher bid.”²²⁸

225. Although the court placed considerable weight on the affidavits, they seemed conclusory and unpersuasive. They did little more than note that the use of book value and the possibility that the market would provide an alternative, lower value to the shares of the stub bank. As one affidavit noted: “Goldman made it clear to Board [sic] that the value was based on the book value of the stub assets, which is not reflective of the amount of their market or liquidation value.” *Id.* at 1283. Another stated that “[w]e told the Board that the \$3.32 per share value we attributed to the stub was simply its estimated book value and that stock in the stub was likely to trade for considerably less.” *Id.* Others described the stub value as “speculative.” *Id.* at 1279–80. The statements, therefore, did little more than disclose the obvious fact that it would be inherently difficult to predict market value in the aftermath of a break up of the company and the formation of a stub bank.

226. *Id.* at 1283.

227. See *Lynch v. Vickers Energy Corp.*, 383 A.2d 278, 281 (Del. 1977) (“If management believed that one estimate was more accurate or realistic than another, it was free to endorse that estimate and to explain the reason for doing so; but full disclosure, in our view, was the prerequisite.”).

228. *Arnold*, 650 A.2d at 1283. It is not entirely clear what the court meant by elusive. To the extent that it suggested the impossibility of the alternative, this was hard to understand. The alternative transaction—a break up of the company—was entirely within the power of the board to implement.

The opinion nowhere explained why this was inappropriate or why this was the only use for the information.

Perhaps the most extraordinary example of an unwillingness to require the disclosure of alternative transactions occurred in *Skeen v. Jo-Ann Stores, Inc.*²²⁹ In that case, House of Fabrics engaged in a second step merger to acquire the remaining 23% of the shares of Fabri-Centers.²³⁰ With 77% of the votes, House of Fabrics had the power to approve the transaction.²³¹ Minority shareholders, therefore, had little role in the transaction.²³² Plaintiffs alleged that the Information Statement circulated by House of Fabrics omitted material information.²³³ Among other things, they contended that they should have received a summary of methodologies and range of values used by the investment banker in deriving the fairness opinion.²³⁴ Particularly since the merger price was 20% below book value, shareholders contended that the information would have given them a better idea about the price they could have obtained had they chosen to exercise their appraisal rights.²³⁵

In finding the information immaterial, the court did not focus on reliability, nor did the court find an absence of a relationship between the ranges of value and the possible appraisal price.²³⁶ The court conceded that plaintiffs wanted the information to assist in valuing the company.²³⁷ Nonetheless, the court categorically excluded the information, characterizing the request as “a new disclosure standard” involving “helpful” but not material information: “They suggest that stockholders should be given all the financial data they would need if they were making an independent determination of fair value. Appellants offer no authority for their position and we see no reason to depart from our traditional standards.”²³⁸

In fact, however, shareholders did not request all of the financial information necessary to value the company. They simply asked for the range of values used by the investment banker. Unless unreliable or otherwise failing to meet the test for the materiality of speculative

229. 750 A.2d 1170 (Del. 2000).

230. *Id.* at 1171–72.

231. *Id.* at 1172.

232. *Id.*

233. *Id.* at 1173.

234. *Id.*

235. *Id.* at 1174.

236. *Id.* at 1173–74.

237. *Id.* at 1174.

238. *Id.* at 1174. See also *In re Staples, Inc. S'holders Litig.*, 792 A.2d 934, 954 (Del. Ch. 2001) (“duty did not require the directors to provide financial information that was merely ‘helpful’ or cumulative to other information that was provided, and the duty did not extend to the provision of information to permit stockholders to make “an independent determination of fair value”).

information, the valuation range would seem important to a shareholder asked to give up dissenters rights, at least where the price offered in the transaction was at the low end of the range.

Delaware courts have consistently refused to find this type of information material. They have refused to acknowledge the materiality of ranges in value developed by an investment banking firm and presented to the board of directors,²³⁹ valuations prepared by an investment banking firm in the context of a solvency opinion,²⁴⁰ calculations of liquidation value,²⁴¹ and valuations prepared for accounting purposes.²⁴² The courts have also been unwilling to require disclosure of alternative transactions, even in cases of affirmative misrepresentations.²⁴³ Despite occasional attempts to base

239. See *In re Vitalink Communications Corp. S'holders Litig.*, No. 12085 (con.), 1991 Del. Ch. LEXIS 195, **40-41 (Del. Ch. Nov. 8, 1991) (holding that omission of range of fair values determined by investment banking firm not material).

240. See *Klang v. Smith's Food & Drug Ctrs.*, 702 A.2d 150, 157 (Del. 1997).

241. See *Barkan v. Amsted Indus.*, 567 A.2d 1279, 1289 (Del. 1989).

242. See *Klang*, 702 A.2d at 157 (decision to render such information immaterial "was premised upon the sentiment that figures generated for purely accounting purposes are useless predictors of market value, and are at least as likely to mislead stockholders as to enlighten them").

243. In *Goodwin v. Live Entm't*, No. 15765, 1999 Del. Ch. LEXIS 5, at **8-11 (Del. Ch. Jan. 22, 1999), Bain Capital agreed to acquire Live Entertainment in a merger. Common shareholders were to receive a premium of approximately 50%. *Id.* at **8-9. Pioneer Electronics owned 637,844 shares of common stock and all of the shares of the Series C Preferred shares, with a total of 50.7% of the voting power. *Id.* at **5-6. The proxy materials indicated that Pioneer favored the merger despite the fact that the Series C Preferred shares would be purchased at a price "substantially less than the amount to which Pioneer would be entitled upon a liquidation of the Company." *Id.* at *30. The statement about Pioneer amounted to a representation that the price offered in the merger was fair. See *id.* at *30. Pioneer's willingness to sell the preferred shares at below liquidation value suggested that the price paid for the common was very attractive and compensated for any shortfall on the preferred. The language also seemed to eliminate any concern that Pioneer would accept a low price on the common stock (which had to be given to all shareholders) in return for a higher price for the preferred shares (which only Pioneer owned). See *id.* In fact, however, the preferred shares were not subject to redemption at their liquidation value. *Id.* at *32. Pioneer had no right to receive a price premised upon liquidation value. In assessing the market value of the preferred shares, internal valuations indicated that the price paid for the Series C Preferred Shares would involve a substantial premium over market value. See *id.* at *32. Thus, in direct contradiction to the statement in the proxy materials, Pioneer received a premium for the preferred shares, something that could have been compensation for an inadequate price paid for the common shares. Nonetheless, the court found the internal valuations of the preferred shares immaterial. See *id.* at **36-37. "The disclosure of a hypothetical—and therefore inherently tentative—concluded market value of the Series C would not have contributed meaningfully or reliably to the shareholders' consideration of whether the price they were receiving for their common stock was fair." *Id.* The court also emphasized that the plaintiff had presented no evidence of "improper motive." *Id.* at *40. "In the absence of any evidence that Pioneer received anything at the expense of the common stockholders, it is impossible to infer that Pioneer (or its affiliate directors), much

decisions on the speculativeness of the data, the courts have objected to this type of information rather than focusing its concern on reliability.

c. Alternative Formulas

The formula used to calculate price or determine valuation has also generated considerable litigation. Companies may use different formulas or assumptions in calculating value. Courts routinely refuse to require disclosure of the assumptions underlying,²⁴⁴ or the projections used in determining,²⁴⁵ valuations.²⁴⁶ Nor have they required disclosure of other information invariably suggesting that the price to be paid could have been higher.²⁴⁷

less the other directors or [the investment banker], were motivated by a desire to conceal material facts about the value of the Series C.” *Id.* at **40–41. Finally, the court went so far as to disavow the misleading nature of the disclosure, noting that the information was “literally true.” *Id.* at *38. In arriving at the remarkable conclusion, the court conflated notions of materiality with state of mind requirements. The court indicated that

the bargaining history regarding Pioneer’s Series C position is free from any hint that Pioneer attempted to obtain unreasonable consideration for its Series C position at the expense of the common stockholders. . . . In the absence of any evidence that Pioneer received anything at the expense of the common stockholders, it is impossible to infer that Pioneer (or its affiliate directors), much less the other directors . . . were motivated by a desire to conceal material facts about the value of the Series C.

Id. at **40–41. Moreover, materiality focuses solely on the information important to a reasonable investor. In this case, the fact that the largest shareholder in fact received a substantial premium for a class of shares only it held, in contrast to affirmative statements in the proxy indicating that the shareholder received less than the value of the shares, would seemingly be important to a reasonable investor. Rather than provide the information to shareholders and allow them to draw their own conclusion, the court decided to do it for them.

244. See *Goodwin*, 1999 Del. Ch. LEXIS 5, at *33 (no obligation to disclose “underlying analysis supporting a fairness opinion”). But see *In re Staples, Inc. S’holders Litig.*, 792 A.2d 934, 958 (Del. Ch. 2001) (suggesting that companies may sometimes have obligation to reveal projections provided by the company and used in determining fairness: “One suspects that the projections are the information that most stockholders would find the most useful to them.”).

245. See *McMillan v. Intercargo Corp.*, No. 16963, 1999 Del. Ch. LEXIS 95, at **20–21 (Del. Ch. May 3, 1999) (no obligation to disclose projections used in determining fairness opinion by investment banker).

246. See *Nebel v. Southwest Bancorp*, No. 13618, 1995 Del. Ch. LEXIS 80, at *17 (Del. Ch. July 5, 1995) (“The plaintiffs have cited no authority that requires a corporation to disclose to its shareholders all of the information that it furnished to its valuation advisors in connection with the transaction.”).

247. In *Weiss v. Samsonite Corp.*, the company made a self tender offer for 51% of its shares. 741 A.2d 366, 374–76 (Del. Ch. 1999). The \$40 price represented a 33% premium over market and would largely be financed through additional borrowing. *Id.* at 369. The proxy materials disclosed the price, the potential depressing effect on the post-tender market for the company’s shares, and the need for all stockholders to tender to ensure success of the plan. *Id.* at 370. More than 97% of all shares were tendered. *Id.* In the

In *In re Vitalink Communications Corp. Shareholders Litigation*, an acquiror offered \$10.50 per share, a 23% premium over market.²⁴⁸ The target's investment banking firm had conducted a financial analysis of the value of the company using a number of different formulas.²⁴⁹ Each resulted in a range of values greater than the offering price.²⁵⁰

In declining to find material the range of values based on the discounted cash flow analysis, the court did not focus on reliability. Instead, the court conducted a balancing test, weighing costs against benefits.²⁵¹ "[I]ts potential benefit was, at best, minimal: to act as a mere affirmance to the shareholders of the Board's message that this was a very good deal."²⁵² At the same time, the harm was deemed considerable.²⁵³ "Even if the disclosure included a sentence explaining why the analysis was overly optimistic, it could have misled shareholders into believing that a higher price was attainable."²⁵⁴

With respect to the investment banking firm's comparable transaction analysis, the range was "unreliable" and based upon

aftermath, however, prices of Samsonite fell by more than expected, with the result that shareholders lost \$2-\$3 in value compared with the pre-tender offer price. *Id.* at 375. Plaintiffs sued, alleging, among other things, that the company failed to disclose the methodology and "reasoning" behind the \$40 price offered in the tender offer and its calculation of "total value." *Id.* at 374. The court disagreed. Shareholders had enough information to determine whether to tender, sell into the market, or hold the shares. "How the \$40 number was arrived at in this circumstance, where the shareholders would retain their relative equity interest, would make no more difference than it would had the Board simply declared a \$40 extraordinary dividend." *Id.* at 375. The court's decision was true enough. Even had shareholders known about the methodology, they still had considerable incentive to tender. That arose not from the merits of the proposal but the coercive nature of the offer. Given the reality that post-tender offer share prices would be lower, all shareholders had an incentive to tender and take advantage of the attractive price on the front end. Nonetheless, it seems simplistic to suggest that a board could simply announce an offer above the current market price without discussing how the method used to determine the price. *See also* *Frank v. Arnelle*, No. 15642, 1998 Del. Ch. LEXIS 176, at **16-17 (Del. Ch. Sept. 16, 1998) (no duty to disclose how price range in Dutch auction tender offer determined). This is particularly true where the company suspects that the transaction might have a negative impact on the post-market price.

248. No. 12085 (con.), 1991 Del. Ch. LEXIS 195, at **8-9 (Nov. 8, 1991).

249. *Id.* at **23-30.

250. *Id.*

251. *Id.* at **12-13.

252. *Id.* at *40.

253. *Id.*

254. As one court explained:

That is, because the Board did not know the extent of the overstatement and, therefore, could not have disclosed the extent of the overstatement, the shareholders could have read the disclosure and reasonably believed that even if \$11.75 was not attainable, a price higher than \$10.50 was reasonably attainable when all of the circumstances indicated that this was not the case.

Id. at **40-41.

“market conditions that have changed drastically.”²⁵⁵ Disclosure would have harmed investors by having them believe “a price higher than \$10.50 per share was reasonably attainable when all of the circumstances indicated that this was not the case.”²⁵⁶ Finally, the range of valuations based upon comparable companies was also deemed immaterial. “[I]t is necessary to draw a line somewhere or else disclosures will become so voluminous that they no longer serve their purpose.”²⁵⁷

The court’s analysis all but admitted the importance of the information. Indeed, disclosure did not have to occur because of concern over excessive reliance by shareholders. In truth, the possibility of excessive reliance could have been tempered through cautionary language rather than non-disclosure. Finally, the importance of the information did not relate only to the availability of a higher offer, something deemed by the court to be ephemeral at best. Shareholders were asked to approve the sale at a given price. Assent could deny them the opportunity to contest the price under a state appraisal action.²⁵⁸

(3) *Federal Regime*

Valuation information at the federal level generally comes up in two circumstances. In the context of a merger proxy statement or tender offer documents, information suggesting a higher offer will constitute material information. Courts have characterized offers suggesting a higher price as inherently material. As one court noted, “[F]irm offers from other potential purchasers, if they are more favorable than the offer being endorsed by management, must be disclosed in proxy materials soliciting shareholder approval. . . .”²⁵⁹

The issue also comes up in the context of affirmative misrepresentations. Management often represents the price as fair, typically pointing to the opinion of an investment banker. Other methods of valuing the company or the existence of competing offers casts doubt on this conclusion. Non-disclosure of information about other offers can suggest that the company affirmatively

255. *Id.* at *41.

256. *Id.* at **41–42.

257. *Id.* at *43. *See also In re Dataproducts Corp. S’holders Litig.*, [1991] Fed. Sec. L. Rep.(CCH) ¶ 96,227 (Del. Ch. Aug. 22, 1991) (“Our law rejects the proposition that disclosure of the detailed facts and specific analyses underlying a financial advisor’s valuation methodology is automatically mandated in all circumstances.”).

258. *See supra* note 186.

259. *South Coast Serv. Corp. v. Santa Ana Valley Irrigation Co.*, 669 F.2d 1265, 1273 (9th Cir. 1982).

misrepresented the fairness of the price.²⁶⁰ This does not mean that all offers or alternative valuations automatically cross the threshold of materiality. With respect to alternative valuations, they must meet standards of reliability. With respect to other offers, they must reach a stage of probability that makes them something more than mere inquiries.²⁶¹ Nonetheless, assuming these tests have been met, federal courts generally presume that the information would be important to a reasonable shareholder in deciding how to vote on a merger or other sale of the business.

An example of the typical treatment of alternative valuations occurred in *Virginia Bankshares*.²⁶² In that case, the parent company engaged in a merger with Virginia Bankshares in an effort to eliminate the remaining 15% of the stock held by the public.²⁶³ The board received a fairness opinion describing the \$42 offering price as fair.²⁶⁴ The proxy materials also characterized the offer as fair and the price as high.²⁶⁵ The Supreme Court agreed that such terms could be actionable: “[S]uch conclusory terms in a commercial context are reasonably understood to rest on a factual basis that justifies them as accurate, the absence of which renders them misleading.”²⁶⁶

The Court went on to point out that a basis in the record existed for concluding that, in fact, the statements in this case were misleading:

Whereas the proxy statement described the \$42 price as offering a premium above both book value and market price, the evidence indicated that a calculation of the book figure based on the appreciated value of the Bank’s real estate holdings eliminated any such premium. The evidence on the significance of market price showed that [the investment bank] had conceded that the market was closed, thin, and dominated by [the parent], facts omitted from the statement. There was, indeed, evidence of a “going concern” value for the Bank in excess of \$60 per share of common stock, another fact never disclosed. However conclusory the directors’ statement may have been, then, it was open to attack by garden-variety evidence. . . .²⁶⁷

Thus, internal evidence in the company that challenged the \$42 price as fair was “garden-variety” evidence. This was true even though the

260. Little doubt exists about the ability to challenge these types of statements in the aftermath of *Virginia Bankshares*. See generally *Virginia Bankshares v. Sandberg*, 501 U.S. 1083 (1991).

261. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 238–39 (1988).

262. *Virginia Bankshares*, 501 U.S. at 1083.

263. *Id.* at 1088.

264. *Id.*

265. *Id.*

266. *Id.* at 1093.

267. *Id.* at 1094.

board had obtained an opinion attesting to the fairness of the actual price offered.²⁶⁸

With respect to alternative offers, the courts are even clearer. Admittedly, mere expressions of interest will not constitute material information.²⁶⁹ Nonetheless, more substantial indications of interest will often be important to a reasonable investor voting on the sale of the business.²⁷⁰ As one court noted: “management, when endorsing one offer, must inform stockholders of any better one.”²⁷¹

268. The approach also applies to other kinds of affirmative statements that go to the value of the company. See *In re Time Warner Sec. Litig.*, 9 F.3d 259, 268 (2d Cir. 1993). Failure to disclose alternative methods of raising capital contemplated by the company was material and

Time Warner’s public statements could have been understood by reasonable investors to mean that the company hoped to solve the *entire* debt problem through strategic alliances. Having publicly hyped strategic alliances, Time Warner may have come under a duty to disclose facts that would place the statements concerning strategic alliances in a materially different light.

Id. at 268 (emphasis in original).

269. See *South Coast Serv. Corp. v. Santa Ana Valley Irrigation Co.*, 669 F.2d 1265, 1273 (9th Cir. 1982) (“There is no duty to disclose inquiries or indications of interest that do not fall within the category of firm or definite offers.”). See also *Giardina v. Fertel, Inc.*, No. 00-1674 § “N,” 2001 U.S. Dist. LEXIS 13681, **16–17 (E.D. La. Aug. 29, 2001) (two phone calls between officers concerning possibility of merger constituted mere overtures and were not material).

270. *Flake v. Hoskins*, 55 F. Supp. 2d 1196 (D. Kan. 1999), illustrates the usual approach in this area. In that case, plaintiffs alleged that the proxy materials contained material omissions by failing to disclose other offers. *Id.* at 1221–22. In addition, they contended that the characterization of the merger as in the best interests of shareholders was misleading because the board had better alternatives, including a convertible stock offering. *Id.* at 1222. Defendants contested the materiality of the other offers, asserting that they were not “firm.” *Id.* In applying the probability-magnitude test in *Basic, Inc.*, the court first noted that an offer could be material even if not firm. “Instead, in determining whether information is so material as to require disclosure, the Court must evaluate the extent of negotiations and effect of the potential transaction.” *Id.* at 1222. The existence of material offers cast doubt on the board’s belief that the offer was in the best interest in shareholders. The court concluded that the other offers were “more than casual expressions of interest” and in fact included a price higher than the one offered in the merger. *Id.* at 1223. As a result, they constituted potential antifraud violations. One court even concluded that the nondisclosure of a withdrawn offer could be a material omission. In *Keyser v. Commonwealth National Financial Corp.*, 675 F. Supp. 238 (M.D. Pa. 1987), Meridian Bancorp made an offer to acquire Commonwealth. *Id.* at 241–42. Ultimately, however, the offer was withdrawn. *Id.* at 244. Shortly afterwards, Commonwealth agreed to a merger with another bank but omitted any mention of the Meridian offer in the proxy statement. *Id.* at 247. The court agreed that the withdrawn offer could be material. *Id.* at 253. “[T]he fact finder must decide whether, under all the circumstances, Meridian’s position as outlined was a sufficiently firm proposal reasonably available to Commonwealth so that disclosure of its existence to the shareholders was required.” *Id.*

271. *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1295 (2d Cir. 1973).

Unlike Delaware courts, cases under federal law do not speak categorically about the materiality of alternative valuations. Nor do they attempt to balance the “harm” of disclosure against the benefit. Instead, they focus on the inherent importance of the information and its reliability or probability.

Conclusion

Corporate law today imposes few absolute restrictions on managerial behavior. With management wielding broad decision-making authority, fiduciary obligations remain the only significant limitation on board discretion. In the case of the duty of care, the business judgment rule prevents substantive review of decisions. Only if a decision amounts to waste will the courts intervene.

The logic of this approach arises from the belief that, in the absence of a conflict of interest, management deserves great deference and latitude in decision-making. Under the approach, informed risk taking will not result in liability. The absolution rests on a single pillar: that management had no alternative motivation for making the decision and, although ultimately a bad decision, was motivated by true desire to benefit shareholders.

The duty of loyalty, in contrast, arises in the context of self-dealing. These transactions, therefore, raise the possibility that directors are motivated by self-interest rather than the best interests of shareholders. Even with this possible motivation, the law has traditionally done little more than require that the transaction be fair.

As with the duty of care, however, procedural mechanisms arose in an effort to lessen the burden on directors seeking to engage in self-dealing. Courts focused on the use of disinterested approval mechanisms to alter the analysis. In the case of disinterested approval by directors or shareholders, fairness disappeared entirely as an element of the analysis. Shareholders were left with a cause of action for waste, a difficult standard to meet.

Disney illustrates the consequences of this approach.²⁷² The company received shareholder approval of Michael Eisner’s compensation plan, which included stock options to buy 8 million shares, and an executive bonus plan, which permitted the payment of up to \$10 million a year.²⁷³ As a result of the approval, shareholders wanting to challenge the “fairness” of the transaction had to attack the procedures used in obtaining approval, particularly an absence of

272. *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342 (Del. Ch. 1999), *aff’d*, 746 A.2d 244 (Del. 2000).

273. Proxy Statement, Walt Disney Co. (Feb. 25, 1997), *available at* <http://www.sec.gov/Archives/edgar/data/1001039/0000898430-97-000058.txt>.

complete disclosure. Once this proved unavailing, shareholders were left with the impossible standard of proving waste, with the “fairness” of the compensation never examined.²⁷⁴

Courts eliminated fairness with little discussion or analysis. They did not examine the efficacy of the shareholder approval mechanism. In applying the business judgment rule, they did not examine the considerable difference between mismanagement and conflicts of interest. They did not make any effort to devise a system that eliminated or reduced interested influence on the disinterested voting process. Finally, they did not ensure that shareholders were informed at the time of ratification.

Analysis of the case law indicates that Delaware courts have construed the concept of material information narrowly, with the result that shareholders do not receive information of obvious importance. A comparison with the federal disclosure cases shows a marked difference in the interpretation of the materiality standard. Thus, the omission of tax motivations was material in *Mendell*, a Rule 10b-5 case, and immaterial in *Weingarden*, a state fiduciary duty case.²⁷⁵ The consequence is that the “informed” approval of a transaction is, in fact, not necessarily informed in the state context.

Admittedly it could be argued that the federal standard has it wrong and that federal courts have defined “materiality” too loosely. This interpretation, however, seems intuitively flawed. Shareholders asked to approve the sale of a business would logically want information suggesting the possibility of a higher price, either to oppose the deal or to preserve the right to seek an appraisal. The same is true of facts suggesting a conflict of interest.

The federal approach seems more rational for another reason. Disinterested approval eliminates fairness. It does so even for those

274. *In re Walt Disney Co. Derivative Litig.*, 731 A.2d at 368–69:

Therefore, our courts have treated fully informed shareholder ratification under § 144(a)(2) as validating the transaction and removing it from the purview of entire fairness review. The business judgment rule applies to the ratified transaction, and to rebut its presumption, the plaintiff must allege facts showing that no person of ordinary sound business judgment could view the benefits received as a fair exchange for consideration paid by the corporation, i.e., the transaction amounts to complete waste.

(footnotes omitted).

275. In *Weingarden & Stark v. Meenan Oil Co.*, Nos. 7291 & 87310, Del. Ch. LEXIS 374, at **6–7 (Del Ch. Jan. 2, 1985), the exclusion under the self-flagellation doctrine was categorical:

The first alleged omission is the failure to disclose that a purported purpose of the merger was to enable Kenny, Jr. to transfer his Meenan stockholdings to Kenny, III free of estate taxes . . . [i]t fails as a matter of law. Corporate officials are not required to engage in “self-flagellation” or speculate as to alleged improper motives.

shareholders who oppose the transaction. The significant consequences of disinterested approval dictate that courts err on the side of ensuring shareholders receive all necessary information. This suggests a need for a broad rather than narrow test for materiality.

The approach used by the Delaware courts needs to be rethought. Given all of the issues and problems surrounding disinterested approval, it seems inappropriate to use it to eliminate fairness from the analysis. At the same time, disinterested approval need not be ignored entirely. Sometimes the "disinterested" shareholders might actually be disinterested. Sometimes they may have adequate information. Allowing disinterested approval to shift the burden to shareholders to demonstrate the unfairness of the transaction, something already done when the transaction is between a controlling shareholder and the corporation, would balance these interests. It would recognize that disinterested approval had benefits but would leave open the possibility that the transaction still could be unfair.

Perhaps all of this is myopic. Maybe Delaware courts will change their approach and conclude that disinterested approval shifts the burden of proof rather than eliminates fairness altogether. At the same time, if they impose a standard for showing unfairness that is impossibly high, nothing will be different. It will be waste by another name. If that is the case, it is probably better to leave things as they are and call it by its true name.