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THE CORPORATE FIDUCIARY DUTY DOCTRINE AND THE REQUIREMENT OF FAIRNESS IN PARENT-SUBSIDIARY RELATIONS

I. INTRODUCTION

It is a well established principle of law that those who dominate a corporation or assume the duties of handling corporate affairs owe a fiduciary duty to that corporation and its stockholders.[1] Though fiduciaries, corporate officers are not trustees in the true sense of the word.[2] The technical requirements of the trust relationship are missing,[3] but the stringent requirements of good faith and fair dealing remain undiminished.[4] Generally, management's duties are denominated as obedience, diligence, and loyalty.[5] Management encompasses officers, directors, and in a proper situation, controlling shareholders.[6] Management fulfills its duties when its acts *intra vires,* within its respective authority, by exercising due care and observing applicable fiduciary duties.[7]

This Comment will deal with the standards of fairness applied to corporate fiduciary dealings in the context of parent-subsidiary relations. The extent of and applicable standards for fiduciary duties have been the source of much litigation. It has been clearly recognized by the courts that "[t]he doctrine of the fiduciary relation is one of the most confused and entangled subjects in corpora-

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1. *See, e.g.,* Pepper v. Litton, 308 U.S. 295 (1939); Geddes v. Anaconda Mining Co., 254 U.S. 590 (1920); Twin-Lick Oil Co. v. Marbury, 91 U.S. 587 (1875); Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939); Lofland v. Cahill, 13 Del. Ch. 384, 118 A. 1 (1922); Billings v. Shaw, 209 N.Y. 265, 103 N.E. 142, 46 N.Y.S.2d 482 (1913); Bailey v. Jacobs, 325 Pa. 187, 189 A. 320 (1937).

2. Bovay v. H.M. Byllesby & Co., 27 Del. Ch. 33, 29 A.2d 801 (1943) (Officers and directors are fiduciaries but are not real trustees because they do not hold the legal title to the corporate property). Selheimer v. Manganese Corp. of America, 423 Pa. 563, 224 A.2d 634 (1966); Spering's Appeal, 71 Pa. 11, 10 Am. Rep. 684 (1872) (Directors are mandatories and not trustees, and thus were held to a standard of ordinary care due to lack of compensation. The holding in Spering's Appeal was later altered by statute: PA. STAT. ANN. tit. 15, § 1408 (1933), as amended, PA. STAT. ANN. tit. 15, § 1408 (1968)).

3. G. Bogert, Trusts and Trustees § 16 (2d ed. 1965).

4. *See, e.g.,* Lofland v. Cahill, 13 Del. Ch. 384, 118 A. 1 (1922); Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 123 N.E. 148 (1919).

5. H. HENN, LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES, at 451 (1961).

6. *Id.* at 450.

7. *Id.*

tion law."[8] A cursory review of recent cases commenting on this confusion reveals judicial opinion of the status of the doctrine of fiduciary relations.[9] The future of minority stockholder rights in parent-dominated subsidiaries depends solely on the strength of the applicable fiduciary standard. In light of recent judicial actions it appears that minority stockholders in a dominated subsidiary can no longer exact from parent corporations the scrupulous fairness previously required.[10] This possibility and the development, application and future of corporate fiduciary doctrines will be treated in this Comment.

II. The Corporate Fiduciary Duty Doctrine—Background, Meaning, and Application

A director of a corporation is held to the standards of a fiduciary in his dealings with and in behalf of the corporation.[11] He occupies a position of great trust and the law expects the highest degree of fidelity from him.[12] However, as long as the director acts within his authority, with proper diligence, in good faith and deals fairly, his actions are usually immune from judicial attack under the protection of the well established "business judgment rule."[13] The courts have continuously stated that it is not their place to pass judgment upon the sagacity or expediency of a decision of a corporation's board of directors.[14] Nevertheless, if there is a showing

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8. Geller v. Transamerica Corp., 53 F. Supp. 625, 629 (D. Del. 1943).

9. *See, e.g.,* Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Sup. Ct. 1970); Levien v. Sinclair Oil Co., 261 A.2d 911 (Del. Ch. 1970), *rev'd,* 280 A.2d 717 (Sup. Ct. 1971).

10. *See* Section V *infra.*

11. *See* cases cited in note 1 *supra.*

12. Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (1928). Justice Cardozo stated:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. *Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.* As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not be consciously lowered by any judgment of this court.

Id. at 464, N.E. at 546 (emphasis added).

13. H. Henn, Law of Corporations and Other Business Enterprises, at 451 (1961).

14. *See, e.g.,* United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917); Moskowitz v. Bantrell, 41 Del. Ch. 177, 190 A.2d 749 (Sup. Ct. 1963); Sandler v. Schenley Industries, 32 Del. Ch. 46, 79 A.2d 606 (1951); Bryan v. Aiken, 10 Del. Ch. 1, 82 A. 817 (1912), *rev'd on other grounds,* 10 Del. Ch. 446, 86 A. 674 (Sup. Ct. 1913); Edison v. Edison United Phonograph Co., 52 N.J. Eq. 620, 29 A. 195 (Ch. 1894); Selheimer v. Manganese Corp. of America, 423 Pa. 563, 224 A.2d 634 (1966).

of fraud or gross abuse of discretion, a court may be called upon to enter the challenged transaction and assert its legal and equitable powers.[15] In the area of parent-dominated subsidiary relations, however, there are additional factors which require greater safeguards than the business judgment rule can provide.[16]

Before a thorough examination of the inadequacy of the business judgment rule in the context of today's complex parent-subsidiary relations can be undertaken, the development and extension of the corporate fiduciary doctrine must be explained and put in its proper perspective. Although the extension of the corporate fiduciary doctrine has been multi-faceted, its thrust has always been the same: regardless of who controls a corporation or its subsidiary, a fiduciary duty is owed to any corporate entity or entities under its domination. The complexities of a corporate super-structure do not alter this basic premise of corporation law.[17]

The main outgrowth of the corporate fiduciary doctrine, and its application to the directors of a corporation, is the correlative doctrine that majority, controlling shareholders of a corporation also have a fiduciary duty toward the corporation and its minority stockholders.[18] Although this is the general rule, it must be noted that "a majority stockholder is not a fiduciary merely because of his majority, but only when he usurps powers of the directors."[19] However, when the controlling stockholders do assume power over the corporation as directors, the case law holds them to the duty of a fiduciary:

> [W]hen a number of stockholders combine to constitute themselves a majority in order to control the corporation as they see fit, they become for all practical purposes the corporation itself and assume the trust relation occupied by the corporation toward its stockholders.[20]

The case of *Allied Chemical & Dye Corp. v. Steel & Tube Co. of America*[21] exemplifies the approach of the courts to the fiduciary

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15. Evans v. Armour and Co., 241 F. Supp. 705 (E.D. Pa. 1965); Meyerson v. El Paso Natural Gas Co., 246 A.2d 789 (Del. Ch. 1967); Greenbaum v. American Metal Climax, Inc., 27 App. Div. 225, 278 N.Y.S.2d 123 (1967).
16. David J. Greene & Co. v. Dunhill Int'l Inc., 249 A.2d 427, 430-31 (Del. Ch. 1968).
17. *See, e.g.*, Pepper v. Litton, 308 U.S. 295, 306 (1939); Southern Pacific Company v. Bogert, 250 U.S. 483, 492 (1918).
18. *See, e.g.*, Southern Pacific Company v. Bogert, 250 U.S. 483 (1918); Ervin v. Oregon Ry. & Nav. Co., 27 Fed. 63 (S.D.N.Y. 1886); Helfman v. American Light & Traction Co., 121 N.J. Eq. 1, 187 A. 540 (1936); Weisbecker v. Hosiery Patents, Inc., 356 Pa. 244, 51 A.2d 811 (1947).
19. Cleary v. Higley, 277 N.Y.S. 63, 76, 154 Misc. 158 (Sup. Ct. 1937).
20. Ervin v. Oregon Ry. & Nav. Co., 27 Fed. 63, 76 (S.D.N.Y. 1886).
21. 14 Del. Ch. 1, 120 A. 486 (1923).

duty doctrine. In that case the Court of Chancery of Delaware issued a preliminary injunction restraining the defendant's proposed sale of corporate assets because the price did not appear to be fair and adequate. The complainants were minority stockholders of defendant corporation which was controlled by a group of majority stockholders. In issuing the injunction the court noted:

> The same considerations of fundamental justice which impose a fiduciary character upon the relationship of the directors to the stockholders will also impose, in a proper case, a like character upon the relationship which the majority of the stockholders bear to the minority . . . is beyond all reason and contrary, . . . to the plainest dictates of what is just and right, . . . to take any view other than that they are to be regarded as having placed upon themselves the same sort of fiduciary character which the law impresses upon the directors. . . . Unless the majority in such a case are to be regarded as owing a duty to the minority such as is owed by the directors to all, then the minority are in a situation that exposes them to the grossest frauds and subjects them to most outrageous wrongs.[22]

The court recognized the rationale underlying the application of the corporate fiduciary doctrine to all types of corporate control: a "fairness test" based on the dictates of fairness and justice in order to protect those who are beyond the inner circle of corporate authority.[23]

Another variation of corporate domination which requires the imposition of fiduciary duties is found in parent-subsidiary relations.[24] Once again, the directors must deal with the corporate subsidiary in fairness and utmost good faith.[25] Where there are dual directorships of parent and subsidiary, the directors owe the same duty of good management to both;[26] the additional directorship does not "dilute" the fiduciary duty owed either corporation.[27] The dual directorship will, however, alert the courts to the greatly enhanced possibility of a conflict between self-interest and duty.[28] The same considerations which apply to directors of the dominating parent also apply to majority stockholders of a parent which domi-

22. *Id.* at 12-13, 120 A. at 491.

23. *See also,* Farmer's Loan and Trust Co. v. New York and Norfolk Ry., 150 N.Y. 410, 44 N.E. 1043 (1896).

24. *See, e.g.,* Marcy v. Guanajuato Development Corp., 228 F. 150 (D.N.J. 1915); Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Sup. Ct. 1970); Cottrell v. Pawcatuck, 35 Del. Ch. 309, 116 A.2d 787 (1955); Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952); New York Central Ry. Co. v. Harlem Ry. Co., 275 App. Div. 604, 93 N.E.2d 451, 90 N.Y.S.2d 309 (1949).

25. Pepper v. Litton, 308 U.S. 295, 306 (1939).

26. *See, e.g.,* Warshaw v. Calhoun, 43 Del. Ch. 148, 156, 221 A.2d 487, 492 (1966); Abelow v. Midstates Oil Corp., 41 Del. Ch. 145, 149, 189 A.2d 675, 677 (1963); Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 123 N.E. 148, 261 App. Div. 975 (1919).

27. Levien v. Sinclair Oil Corp., 261 A.2d 911, 915 (Del. Ch. 1970).

28. Bailey v. Jacobs, 325 Pa. 187. 194, 189 A. 320, 324 (1937).

nates a subsidiary.[29] The essence of the entire matter is control, its exact form is inconsequential.[30] It is easy to state the obligation imposed by the corporate fiduciary doctrine: "[T]he power to control . . . should be considered in no lesser light than that of the power of a trustee to deal with the trust estate and with the beneficiary."[31] However, the real meaning of the doctrine depends on the specific test of fairness utilized by the courts. This test is the key to understanding the practical working of the corporate fiduciary doctrine. Nowhere is this reality more obvious than in parent-subsidiary dealings.

III. Main Areas of Application of the Corporate Fiduciary Doctrine in Parent-Subsidiary Relations

A. *Sale of Corporate Assets*

When the board of directors or the controlling shareholders of a corporation endeavor to sell corporate assets, either as total or partial liquidation, majority stockholder ratification is required.[32] In addition, an effective majority ratification requires that the terms of the sale are fair and that the sale itself is in the best interests of the corporation.[33] Not only must the statutory requirements as to the sale of corporate assets be satisfied, there must also be "equitable compliance with the prerequisites to a sale of the assets"[34] to protect the minority stockholders from loss.[35] The director must demand and secure an adequate price for the assets.[36] Equity will declare his conduct wrongful if the sale injures the beneficiary by "letting his equitable assets go for an unfair and inadequate price."[37] There need be no affirmative advantage to the director for his actions to be so condemned.[38]

These equitable safeguards are founded upon the fiduciary

29. *See, e.g.,* Farmer's Loan and Trust Co. v. New York and Norfolk Ry. Co., 150 N.Y. 410, 44 N.E. 1043 (1896).
30. Levien v. Sinclair Oil Co., 261 A.2d 911, 915 (Del. Ch. 1970).
31. Lattin, Corporations, Ch. 12, § 8 (1959).
32. *See, e.g.,* Allied Chemical and Dye Corp. v. Steel and Tube Corp. of America, 14 Del. Ch. 1, 120 A. 486 (1923).
33. *Id.*
34. Cottrell v. Pawcatuck Corp., 35 Del. Ch. 309, 316, 116 A.2d 787, 792 (1955). *See also* Weisbecker v. Hosiery Patents, 356 Pa. 244, 251, 51 A.2d 811, 814 (1947).
35. Allied Chemical and Dye Corp. v. Steel and Tube Corp. of America, 14 Del. Ch. 1, 120 A. 486 (1923).
36. *Id.* at 16, 120 A. at 494.
37. *Id.*
38. *Id.*

obligations borne by the controlling group of the corporation. In *Kavanaugh v. Kavanaugh Knitting Co.*[39] the plaintiff, a minority stockholder in the defendant corporation, sought a judgment enjoining the directors and majority stockholders from continuing to dissolve the corporation. Finding the corporation "exceedingly prosperous and making enormous net profits,"[40] the New York Court of Appeals held that the resolution to dissolve was a result of bad faith and dishonest motives. The sole purpose of the dissolution was to reduce the plaintiff's interest in the corporation so the directors could secure excessive salaries previously challenged in court by the plaintiff. In granting plaintiff his relief despite statutory authority allowing dissolution the court concluded:

> A court of equity will protect a minority stockholder against the acts or threatened acts of the board of directors or of the managing stockholders of the corporation, which violated the fiduciary relation and are directly injurious to the stockholders. . . . The courts cannot pass upon the question of the expediency of the dissolution; . . . They can however, and will, . . . demand, inflexibly uphold and enforce, . . . the obligations of the fiduciary relation. The good faith of the individual defendants is a proper and fundamental subject to be adjudged. Bad faith, fraud or other breach of trust constitutes a foundation for equitable relief.[41]

In a sale of corporate assets such protection of minority interests is paramount since the existence of the corporation is usually at stake.[42] Thus, the gravity of such a sale requires that the decision to sell or dissolve must be made "in good faith and through honest intention and endeavor."[43] Such action must be prudent in view of the welfare and advantage of the corporation and the stockholder. The fact that the decision to sell later proves unwise or incorrect does not strip it of its validity or integrity.[44] It is only a breach of the good faith or honesty requirements which prompt judicial intervention.[45]

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39. 226 N.Y. 185, 123 N.E. 148 (1919).
40. *Id.* at 188, 123 N.E. at 150.
41. *Id.* at 195, 123 N.E. at 153.
42. Allied Chemical and Dye Corp. v. Steel and Tube Corp. of America, 14 Del. Ch. 1, 120 A. 486 (1923):

> It is doubtless generally true of any going, money-making corporation that it would be not to its best interest to sell all of its assets. Indeed, is this not the consideration underlying the old rule . . . that the assets of a going, prosperous concern could not be sold except by consent of all the stockholders?

Id. at 11, 120 A. at 490.

43. *Id.* at 16, 120 A. at 494.
44. Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 123 N.E. 148, 261 App. Div. 975 (1919).
45. Cottrell v. Pawcatuck, 35 Del. Ch. 309, 316, 116 A.2d 787, 792 (This Comment does not deal with the effect of negligence on a director's fiduciary obligations; however it should be noted that lack of due diligence and care will also call for judicial action in corporate affairs).

B. Merger of Parent and Subsidiary

The merger of a parent and subsidiary corporation often has the same far-reaching ramifications as a sale of corporate assets since it entails the death of a corporate entity. Therefore, the same stringent requirements of fairness and good faith are required of corporate decision-makers in mergers.[46] Again, the rationale for this duty is the protection of the impotent minority.[47] Another parallel between a merger and a sale of corporate assets is the difficulty in determining what is a fair appraisal of the value of the corporate assets.[48] In the case of a parent-subsidiary merger there are many intangible elements in addition to bare statistical data which must be equated "in passing on the fairness of an exchange ratio."[49] "Fairness of the exchange ratio," however, does not require that the values exchanged be exactly equal. The market value and the liquidating value of both parent and subsidiary must be considered in light of the fact that "a merger effects an exchange of shares of stock in a going concern for shares in another going concern."[50] There are hidden intangibles such as good will, existing contracts, and diversity of activity which make an exchange of a subsidiary's stock for a parents' stock very difficult to evaluate. The subsidiary is not entitled to the liquidating value of its stock since it receives more from the parent than mere shares of stock. It should be noted that despite the similarities, a merger is really quite different from a sale of corporate assets.[51] Therefore, in order "to arrive at a judgment of the fairness of the merger, all of its terms must be considered."[52] Fairness requires "that upon a merger the minority stockholder shall receive the substantial equivalent of value of what he had before."[53] In determining if equivalent value has been exchanged, the weight placed on the

46. *See, e.g.*, Bastian v. Bourns, 256 A.2d 680, 682 (Del. Ch. 1969).
47. *Id.* at 681.
48. *See, e.g.*, Bastian v. Bourns, 256 A.2d 680 (Del. Ch. 1969); David J. Greene & Corp. v. Schenley Industries, Inc., 281 A.2d 30 (Del. Ch. 1971).
49. Bastian v. Bourns, 256 A.2d 680, 683 (Del. Ch. 1969).
50. Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 305, 93 A.2d 107, 113 (Sup. Ct. 1952).
51. *Id.* The court said:

> Plaintiff's attempt to push to extremes the analogy drawn from a sale of assets leads them to a wholly untenable position, viz., that upon a merger a stockholder of a subsidiary is entitled to receive securities equal in value of his stock . . . this proposition is unsound.

52. Porges v. Vadsco Sales Corp., 27 Del. Ch. 127, 134, 32 A.2d 148, 151 (1943).
53. Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 306, 93 A.2d 107, 114 (1952).

various factors involved will depend on the circumstances of each individual case which means that the fairness of the exchange ratio will always be decided on a flexible basis.

Although in substance a merger involves a sale of assets, the assets can not be valued in the same manner as they are on liquidation. Rather, as Chancellor Seitz concluded in *Sterling v. Mayflower Hotel Corp.*,[54] there are various factors to be considered, "e.g. going concern value, book value, net asset value, market value. . . ."[55] These were all found to be pertinent to the issue of the fairness of the merger plan. In *Sterling* the proposed merger was not enjoined because the Chancellor found the plan fair to the plaintiffs and the other minority stockholders. Further, the court found no inferences of fraud or bad faith. The court, in the process of reviewing the proposed transaction, emphasized the need for flexibility in its search for fairness.[56] At the same time it was made clear that fairness remained the rigidly enforced standard required by the corporate fiduciary doctrine.[57]

C. Filing of Consolidated Tax Returns

The opportunity to file consolidated tax returns by a parent and its dominated subsidiary presents another area in which the corporate fiduciary doctrine has significance.[58] Consolidated tax returns are permitted when a parent owns eighty per cent or more of a subsidiary's stock.[59] By filing jointly, one corporation may set-off the other corporation's tax losses against its profits and thereby save itself a great deal of money. This generally has been upheld where the agreement to file the consolidated return was consensual.[60] Nevertheless, the question of fiduciary obligations always arises when the dominant corporation retains all the tax savings made possible by the tax loss corporation. Again, fairness under the circumstances is the test to be applied.[61]

In the few decisions discussing this problem, the circumstances of each case controlled the outcome of the litigation. In the land-

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54. 33 Del. Ch. 20, 89 A.2d 862, *aff'd*, 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952).

55. *Id.* at 28, 89 A.2d at 867.

56. *Id*: "I conclude that all relevant value figures of both corporations may be examined and compared in order to arrive at a decision as to the fairness of the [merger] plan."

57. *Id.* at 26, 89 A.2d at 866. The court stated:

> [T]here are many cases where there is such a conflict between duty and self-interest and the court deals with it as here, by placing the good faith and fairness burden on those espousing the transaction.

58. *See, e.g.*, Case v. New York Central Railroad, 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965); Meyerson v. El Paso Natural Gas Co., 246 A.2d 789 (Del. Ch. 1967).

59. 26 U.S.C. § 1501-04 (1954).

60. *See* cases cited in note 58 *supra*.

61. Meyerson v. El Paso Natural Gas Co., 246 A.2d 789, 790 (Del. Ch. 1967).

mark decision of *Case v. New York Central Railroad Company*,[62] the New York Court of Appeals reversed the lower court's finding of unfairness in defendant's allocation of all tax savings resulting from filing the consolidated return. In so doing the Court of Appeals relied substantially on the fact that the defendant railroad's ability to continue paying rent and operating its lines was paramount to the plaintiff's interest. The solvency of the defendant was found to be of vital interest to the plainiffs, who were minority stockholders of the corporation which owned and leased lines to the defendant railroad. In addition, the court specifically found that the plaintiffs' corporation would have paid the Government $268,725 more in taxes than it paid defendant on being relieved of all tax liability.[63] Thus, the court concluded that the transaction was fair in light of the circumstances and that judicial intervention was unwarranted.

A similar situation arose in *Meyerson v. El Paso Natural Gas Co.*[64] where the Delaware Chancery Court found the parent's actions in allocating all tax savings to itself to be fair under the circumstances. The crucial fact was the subsidiary's status as a wasting asset corporation.[65] This status precluded any advantage to be gained by receipt of any tax savings. Therefore, the court found that the facts justified the parent corporation's outwardly selfish actions. No unfairness to the subsidiary was possible. In conclusion, although the fairness of the inter-corporate transaction is the main inquiry in upholding the appropriate fiduciary duties,[66] practicality has mooted the question in the area of consolidated tax returns. Although in the cases which have been litigated unfairness toward the subsidiary has been impossible under the facts, fairness remains the paramount criterion.[67]

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62. 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965).
63. *Id.* at 155, 204 N.E.2d at 647, 256 N.Y.S.2d at 609.
64. Meyerson v. El Paso Natural Gas Co., 246 A.2d 789 (Del. Ch. 1967).
65. FLETCHER, CYCLOPEDIA ON CORPORATIONS, Ch. 58, § 5347, at 704 (Rev. ed. 1959):

> The general rule that corporations may not pay dividends except out of net profits or surplus, is subject to a well-established exception in the case of "wasting asset" companies, that is to say, companies engaged in the exploitation of such assets as mines, oil wells, leases, patents and the like. In fact the wasting asset doctrine is recognized in most of the modern corporation acts which expressly permit corporations solely or principally engaged in the exploitation of "wasting assets" to distribute the net proceeds derived from exploitation of their holdings such as mines, oil wells, patents, and leaseholds, without allowance or deduction of depletion.

66. 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965).
67. *Id.* at 158, 204 N.E.2d at 647, 256 N.Y.S.2d at 612.

D. *Freeze-Out of Minority Stockholders*

As a fiduciary, the controlling corporate hierarchy may not use its power to employ corporate assets to perpetuate its domination of the corporation.[68] In the Delaware decision of *Bennett v. Breuil Petroleum Corporation*[69] the Chancery Court held that "action by majority stockholders having as its primary purpose the 'freezing out' of a minority interest is actionable without regard to the fairness of the price."[70] The importance of the case lies in the court's willingness to look past the facts to the motives of the controlling interest.[71] The *Bennett* case made it clear that the fiduciary duty owed by directors or majority shareholders is to deal fairly and justly. *Bennett* confirms that Chancery Court's rationale in *Yasik v. Wachtel*[72] which, although it dismissed the plaintiff's complaint, recognized the impropriety of issuing shares of stock to "maintain or obtain voting control."[73] In *Yasik* the plaintiff, who owned but a few shares of Diamond State Brewery, alleged that the issuance of 58,400 shares of defendant Diamond State Brewery's stock to defendant Wachtel was a scheme to wrest control from the former majority stockholder by giving Wachtel controlling votes. The court found, however, that the plaintiff never had control and therefore had suffered no injury. The court also found that the issuance was in good faith and to the benefit of the corporation. The decision did not foreclose protest by those actually deprived of control. These holdings, though divergent in results, demonstrate that the courts will condemn corporate manipulation by the controlling members via stock issuance for the sole purpose of guaranteeing domination.[74]

However, a corporation is not barred from purchasing, holding, selling or transfering shares of its own stock provided that the corporation's capital is no way impaired. In *Kors v. Carey*[75] the plaintiff alleged that defendant corporation and its directors abused their power by buying the corporation's own stock to retain firm control of the corporation. The court dismissed the complaint holding that the purchase of the stock was to preserve the corporation's business policies. No breach of fiduciary duties was found. The court asserted that "directors, while bound to deal with stock-

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68. *See* Condec Corp. v. Lunkenheimer Corp., 43 Del. Ch. 353, 230 A.2d 769 (1967); Macht v. Merchants' Mortgage and Credit Co., 22 Del. Ch. 74, 194 A. 19 (1937).

69. 34 Del. Ch. 6, 99 A.2d 236 (1953).

70. *Id.* at 11, 99 A.2d at 239.

71. *Id.*

72. 25 Del Ch. 247, 17 A.2d 309 (1941).

73. *Id.* at 256, 17 A.2d at 313.

74. *See, e.g.,* Kors v. Carey, 39 Del. Ch. 47, 158 A.2d 136 (1960); Anderson v. Albert & J.M. Anderson Mfg. Corp., 350 Mass. 343, 90 N.E.2d 544 (1950).

75. 39 Del. Ch. 47, 158 A.2d 136 *citing* DEL. CODE ANN. tit. 8, § 160 (1953), *as amended* (1970).

holders as a class with scrupulous honesty, may in the exercise of honest business judgment adopt a valid method of eliminating what appears to them a clear threat to the future of their business by any lawful means, ..."[76]

Other Delaware decisions have confirmed the *Kors v. Carey* holding. When the welfare and policies of a corporation are at stake certain insidious elements may be purged by "freezing out." In *Martin v. American Potash and Chemical Corporation*[77] the defendant's action in purchasing shares of its own stock at a private retirement sale was condoned because it eliminated shares of a stockholder who was at odds with management policy. In another representative case, *Hall v. Trans-Lux Daylight Picture Screen*,[78] the directors of the defendant corporation were allowed to expend corporate funds in order to defend corporate policy in a proxy fight.

This corporate privilege is quite naturally predicated on the absolute absence of fraud or unfairness.[79] The courts recognize that the elimination of a dissentient faction is far different from the purchase of stock strictly for control purposes.[80] In this situation the courts have recognized the often delicate balance that has to be struck between duty and self-interest.[81] In *Bennett v. Propp*,[82] the Supreme Court of Delware affirmed plaintiff's suit for accounting against the chairmen and president of the Noma Lites Corp. for their purchase of the corporation's stock in order to retain their position of control. In finding for the plaintiff the court stated:

> We must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult. . . . Hence, in our opinion, the burden should be on the directors to justify such a purchase as one primarily in the corporate interest.[83]

The directors can satisfy the burden of proof with a showing of good faith and a "sincere belief that the buying out of the dissi-

76. *Id.* at 55, 158 A.2d at 141, *citing* McPhail v. L.S. Starrett Corp., 257 F.2d 388 (1st Cir. 1958).
77. 33 Del. Ch. 234, 92 A.2d 295 (1952).
78. 20 Del. Ch. 78, 171 A. 26 (1933).
79. *See* note 77 *supra*.
80. Bennett v. Propp, 41 Del. Ch. 14, 21, 187 A.2d 405, 409 (Sup. Ct. 1962).
81. *Id.* at 22, 187 A.2d at 409.
82. 41 Del. Ch. 14, 187 A.2d 405 (1962).
83. *Id.* at 22, 187 A.2d at 409.

dent stockholder was necessary to maintain what the board believed to be proper business practices."[84] The "sincere belief" of the directors must be founded on a reasonable investigation of the purported threat to corporate policy and effectiveness.[85] Hindsight will not establish liability for an honest mistake of judgment, if at the time the decision was made the course of conduct appeared reasonable.[86] Therefore, manipulation to obtain or maintain corporate control is not permissible,[87] while similar action for the welfare of the corporation is allowed as being consonant with fiduciary obligations.[88]

E. Declaration of Dividends

The courts allow directors a wide range of discretion in dividend declaration.[89] In all jurisdictions statutes set the outer boundaries of permissible dividend declaration.[90] However, statutory compliance is not necessarily conclusive on the issue of the fairness or economic expediency of a dividend declaration.[91] Consequently it has been asserted that:

> Regardless of the status of the surplus or profit and loss account, dividends should not be declared when such action might endanger the ability of the corporation to meet its obligations as they fall due or curtail its operations by shortage of working capital. *Statutory limitations should be regarded as restrictions, not as permissions to declare dividends improvidently up to the statutory limit.*[92]

In no situation, except that of a wasting asset corporation, may dividends be declared which impair the capital of a corporation.[93] Dividends generally may only be declared on surplus or net profits.

Although the above mentioned facts are basic corporate dogma, stockholders rarely bring suits to enjoin excess dividends.[94] The

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84. Cheff v. Mathes, 41 Del. Ch. 494, 504, 199 A.2d 548, 554 (Sup. Ct. 1964).

85. *Id.* at 506, 199 A.2d at 555.

86. *See, e.g.,* Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964); Karasik v. Pacific Eastern Corp., 21 Del. Ch. 81, 180 A. 604 (1935).

87. *See* note 74 *supra.*

88. *See* notes 77-86 and accompanying text *supra.*

89. FLETCHER, CYCLOPEDIA ON CORPORATIONS, Ch. 68, § 9049, at 233 (Rev. ed. 1959).

90. *See, e.g.,* DEL. CODE ANN. tit. 8, § 170 (1953) (dividends declared from surplus or net profits); PA. STAT. ANN. tit. 15, § 751, 1702 (1913 and 1963, respectively) (dividends declared from earned surplus founded on actual earnings or net profits).

91. I. DEWING, FINANCIAL POLICY OF CORPORATIONS, Chapter 25 at 743 (5th ed. 1953).

92. Ballantine and Hills, *Corporate Capital and Restriction Upon Dividends Under Modern Corporation Laws,* 23 CALIF. L. REV. 229, 263 (1935) (emphasis added).

93. Bryan v. Aiken, 10 Del. Ch. 1, 82 A. 817 (1912), *rev'd on other grds.,* 10 Del. Ch. 446, 86 A. 674 (Sup. Ct. 1913).

94. *See, e.g.,* Levien v. Sinclair Oil Corp., 261 A.2d 911 (Del. Ch. 1970), *rev'd,* 280 A.2d 717 (Del. Sup. 1971).

typical case contesting a dividend declaration arises from the corporation's failure or refusal to declare a dividend, resulting in a stockholder's suit to have dividends declared under judicial compulsion. The stockholder generally fails due to the courts' great reluctance to delve into this delicate area of business judgment.[95] This hesitancy is illustrated in the Delaware decision of *Bryan v. Aikin.*[96] There the Chancery Court was faced with the difficult problem of determining whether a stock dividend should be added to the corpus of a testamentary trust for the remainderman or should be given to the holder of the life estate as income from the trust. In the process of passing on the ultimate issue the Chancellor propounded fundamental law on the disposition of corporate earnings. He stated that the power to distribute or withhold earnings from the shareholders was a decision for the board of directors. In withholding the earnings from the shareholders the board of directors could apply them toward expansion and improvement of the business facilities. The Chancellor concluded that "within the limits of good faith, the power of the company to so deal with the earnings of the company is not subject to judicial control."[97]

As evidenced by *Bryan v. Aikin,* there are many possible uses to which corporate earnings may be applied, only one of which is dividend distribution to the stockholders. When the alternative disposition of earnings via dividend declaration is to be utilized "rests in the honest discretion of the directors."[98] Nevertheless, the courts are not powerless to compel the declaration of a dividend. The criteria for judicial intervention to compel declaration of dividends is set forth in *Eshleman v. Keenan*[99] where plaintiff brought a derivative suit for redress of a wrong to the corporation by its directors. The defendant directors were ordered to make restitution to the corporation. The overriding problem was whether such recovery by the corporation should inure directly to the stockholders in the form of dividends. The Chancery Court held that the money should be paid to the corporation, and whether dividends were to result from the restitution by the defendants would be a matter for the honest judgment of the directors. However, in so holding the court did not foreclose the possibility of judicial intervention:

95. *E.g.,* Eshleman v. Keenan, 22 Del. Ch. 82, 194 A. 40 (1937); Bryan v. Aiken, 10 Del. Ch. 1, 82 A. 817 (1912), *rev'd on other grds.,* 10 Del. Ch. 446, 86 A. 674.
96. 10 Del. Ch. 1, 82 A. 817 (1912).
97. *Id.* at 8, 82 A. at 820.
98. Trevies v. Menzies, 37 Del. Ch. 330, 334, 142 A.2d 520, 552 (1958).
99. Eshleman v. Keenan, 22 Del. Ch. 82, 194 A. 40 (1937).

> That courts have the power in proper cases to compel the directors to declare a dividend is sustained by respectable authorities. But that they should do so on a mere showing that an asset exists from which a dividend may be declared, has never, I dare say, been asserted anywhere. In such a case the court acts only after a demonstration that the corporation's affairs are in a condition justifying the declaration of the dividend as a matter of prudent business management and that the withholding of it is explicable on the theory of an oppressive or fraudulent abuse of discretion.[100]

Thus, only upon a showing of fraud or oppression on the part of the directors in the exercise of their discretionary powers will a court intervene and compel a dividend to be declared.[101] The directors have the greatest possible leeway in furtherance of corporate goals;[102] yet, they may not overstep the bounds of fiduciary duty.

IV. Fiduciary Obligations in Parent-Subsidiary Relations and the Requirement of Fairness

A unique problem arises when one corporation controls another corporate entity and a fiduciary duty is owed to both by those in command. Such parental domination, and the normally ensuing interlocking directorates, are legally sanctioned.[103] Consequently, the duality of directorship creates fiduciary duties running to both corporations by the same individual.[104] As has been previously stated, the additional directorship is not a device "for diluting fiduciary duties."[105] The fiduciary obligation still demands good faith and fair dealing on the part of the directors. However, in this instance there is a crucial difference in presumptions, which causes a dramatic reversal in the role of the courts in involvement in corporate affairs.

In *David J. Greene & Co. v. Dunhill International Inc.,*[106] the Delaware Chancery Court asserted the rationale underlying the attitude of the courts where there is a parent-subsidiary or interlocking directorate relation. A preliminary injunction was issued against the proposed merger of defendants A.C. Spalding & Bros., Inc. and Dunhill. The plaintiffs were minority stockholders of the A.G. Spalding Corporation; the defendant corporation owned eighty per cent of Spalding's stock. In upholding the plaintiff's attack on the merger ratio as grossly unfair and inequitable the court said:

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100. *Id.* at 87-88, 194 A. at 43.
101. *Id.*
102. *See* text accompanying note 62 *supra.*
103. *See, e.g.,* DEL. CODE ANN. tit. 8, § 144 (1969).
104. *See, e.g.,* Warshaw v. Calhoun, 43 Del. Ch. 148, 221 A.2d 487 (Sup. Ct. 1966); Abelow v. Midstates Oil Corp., 41 Del. Ch. 145, 189 A.2d 675 (Sup. Ct. 1963).
105. *See* text accompanying note 27 *supra.*
106. 249 A.2d 427 (Del. Ch. 1967).

> In the absence of divided interests, the judgment of the majority stockholders and/or the board of directors, as the case may be, is presumed made in good faith and inspired by a bona fides of purpose. But when the persons, be they stockholders or directors, who control the making of a transaction and the fixing of its terms, are on both sides, then *the presumption and deference to sound business judgment are no longer present.* Intrinsic fairness, tested by all relevant standards, is then the criterion.[107]

This drastic reversal in judicial policy is self-explanatory in light of the ready opportunity for self-dealing.[108] Since the fiduciary duties of undivided and unselfish loyalty are owed both corporations, a conflict between duty and self-interest will not be tolerated by the courts.[109]

There is early precedent for the proposition that when one corporation deals with another corporation which it controls, it becomes incumbent on the dominant corporation to demonstrate "the entire fairness of the transaction."[110] In *Geddes v. Anaconda Copper Mining Co.*[111] the Supreme Court condemned the actions of interlocking directors in selling all the property of an unprofitable corporation directly to the dominant corporation. In so doing the Supreme Court found the price paid in shares of defendant's stock to be inadequate. The court felt the dissolution was justified due to business exigencies, but determined that the assets sold for cash at a public sale would be a far more realistic valuation of the corporate property. In so holding Justice Clark said that "the relation of directors to corporations is of such a fiduciary nature that transactions between boards having common members are regarded as jealously by the law as are personal dealings between a director and his corporation."[112] Justice Clark went further to say that in such a situation "where the fairness of such transactions is challenged the burden is upon those who would maintain them to show their entire fairness."[113]

The reaction of the Supreme Court to this delicate situation has been adopted by the states. However, despite similar state-

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107. 249 A.2d at 430-31 (emphasis added).
108. Gottlieb v. Heydon Chemical Corp., 33 Del. Ch. 82, 88, 90 A.2d 660, 663 (Sup. Ct. 1952).
109. Guth v. Loft, Inc., 23 Del. Ch. 255, 270, 5 A.2d 505, 510 (Sup. Ct. 1939).
110. Keenan v. Eshleman, 23 Del. Ch. 234, 243-44, 2 A.2d 904, 908 (Sup. Ct. 1938).
111. 254 U.S. 590 (1920).
112. *Id.* at 599.
113. *Id.* (citations omitted).

ments of the rule there are fundamental differences in the scope of the fiduciary obligation in parent-subsidiary and interlocking directorate situations. The difference lies not in the character of the fiduciary duty, but rather in the particular jurisdiction's method of determining the element of fairness. Most states assert that dealings between a parent and a subsidiary or between corporations with inter-locking directorates must be fair to all parties concerned.[114] This is particularly true respecting minority stockholders of a dominated corporation because they occupy a position of relative impotence. The following jurisdictional discussions are representative of the pervasiveness of the fairness doctrine and its subtle variations in application.

A. *Pennsylvania*

In Pennsylvania it is a statutory mandate that officers and directors stand in a fiduciary relation to their corporation.[115] In line with other jurisdictions, this requirement has been extended to make majority stockholders fiduciaries to the minority shareholders.[116] Furthermore, interlocking directorates are not unlawful,[117] and are often desirable where the interests of different corporations are "closely interwoven."[118] By reason of a parent's control of a subsidiary through interlocking directorates and majority stock ownership the parent owes the subsidiary the same fiduciary duties as are owed subsidiaries by their own directors.[119] Control, being the vital consideration, fixes the liability.[120]

Once dual control is established, it is the settled rule in Pennsylvania that transactions between the dependent corporations are open to careful judicial scrutiny.[121] If there is no abuse of trust relations and the transaction is fair, it will not be disturbed.[122] The utmost good faith of those in control must not only exist, it

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114. *See* discussion in Sections IVA through IVD *infra*.

115. PA. STAT. ANN. tit. 15, § 1408 (1968):

> Officers and directors shall be deemed to stand in a fiduciary relation to the corporation, and shall discharge the duties of their respective positions in good faith and with that diligence, care and skill which ordinarily prudent men would exercise under similar circumstances.

116. *See, e.g.*, Weisbecker v. Hosiery Patents, Inc., 354 Pa. 244, 51 A.2d 811 (1947).

117. *See* PA. STAT. ANN. tit. 15, § 1409.1 (1968).

118. Hirshhorn v. Mine Safety Appliances Corp., 106 F. Supp. 594, 600 (W.D. Pa. 1952).

119. *Id.*

120. Overfield v. Pennroad Corp., 42 F. Supp. 586, 607 (E.D. Pa. 1941).

121. *See* Bonini v. Family Theater Corp., 327 Pa. 273, 194 A. 498 (1937); South Side Trust Co. v. Washington Tin Plate, 252 Pa. 237, 97 A. 450 (1916); Merchantile Library Hall Co. v. Pittsburgh Library Ass'n, 173 Pa. 30, 33 A. 744 (1896).

122. South Side Trust Co. v. Washington Tin Plate, 252 Pa. 237, 241, 97 A. 450, 451 (1916).

must be manifest.[123] Thus, transactions between the parent and the dominated subsidiary are not void, but merely voidable on a showing of unfairness or fraud.[124] What is fair will depend upon the particular circumstances of each case.[125] The courts will probe the facts to determine if the welfare of the corporation was the primary motivation of the director in his decision-making.[126] His judgment must be "untrammeled by a hostile interest in himself or others."[127]

When the director or directors involved hold dual positions of trust and authority the existence of "hostility" becomes more than a possibility. In *Pennsylvania Knitting Mills v. Bayard*[128] the plaintiff corporation brought suit for an accounting against its former directors who had conceived of a plan for the issuance and sale of stock in a newly created subsidiary. The scheme was a failure and the plaintiff-corporation went into the hands of a receiver. In concluding that the common pleas court erred in dismissing plaintiff's complaint, it was stated that when two corporations have a majority of common directors, transactions between them are "presumptively fraudulent" absent stockholder ratification.[129] Therefore, the *Bayard* case made hostility a legal presumption rather than a mere possibility. Subsequent case law in Pennsylvania has not followed this extreme position.[130] Now the complaining stockholder is required to show the existence of a transaction which, on its face, *could* appear to be detrimental to the complaining stockholder's interest.[131] At this point the burden shifts to the director to come forward and prove the fairness of the challenged transaction.[132] Therefore, any agreement which is the product of the action of interlocking directors may not be of itself affirmative evidence of fraud, but it will be carefully examined by the court if challenged.[133] As stated in *Hirshhorn v. Mine Safety Appliances*

123. Merchantile Library Hall Co. v. Pittsburgh Library Ass'n, 173 Pa. 30, 41, 33 A. 744, 747 (1896).
124. *See, e.g.*, Bowman v. Gum, Inc., 327 Pa. 403, 410, 193 A. 271, 274 (1937).
125. Evans v. Armour and Co., 241 F. Supp. 705, 711 (E.D. Pa. 1965).
126. *In re* Philadelphia Rapid Transit Co., 16 F. Supp. 941 (E.D. Pa. 1936).
127. Evans v. Armour and Co., 241 F. Supp. 705, 711 (E.D. Pa. 1965).
128. 287 Pa. 216, 134 A. 397 (1926).
129. *Id.* at 221, 134 A. at 399.
130. Bowman v. Gum, Inc., 327 Pa. 403, 193 A. 271 (1937).
131. Evans v. Armour and Co., 241 F. Supp. 705, 711 (E.D. Pa. 1965).
132. *See, e.g.*, Hirshhorn v. Mine Safety Appliances Corp., 106 F. Supp. 594 (W.D. Pa. 1952); Robinson v. Brier, 412 Pa. 255, 194 A.2d 204 (1963).
133. *In re* Philadelphia Rapid Transit Co., 16 F. Supp. 941, 942 (E.D. Pa. 1936).

Company:[134] "[I]nterlocking directorates don't make transactions void or voidable per se. Such transactions are declared invalid only, where, in close scrutiny, fraud or unfairness was revealed."[135] In *Hirshhorn* the plaintiff was denied relief because he failed to prove that the subsidiary corporation in which he held stock was entitled to ownership of certain rebreather patents allegedly misappropriated by the parent corporation. Nevertheless, the court reiterated the fact that the burden of proving the ultimate question of "inherent fairness" was on the defendant because of its control of the subsidiary.[136]

In Pennsylvania fairness is the criterion for inquiry into fiduciary relations where there are transactions between corporations with interlocking directorates, parent and subsidiary corporations, and directors and their own corporations.[137] Absent dual control of corporations, the basic inquiry as to corporate fiduciary duties is the business judgment rule.[138] When the situation encompasses more intricate corporate structures, however, the courts must go beyond the scope of the business judgment rule.[139] The Pennsylvania courts demand the strictest accountability of a person occupying dual positions of control to avoid a collision between personal and fiduciary interests.[140] The directors must act in good faith and for the common interest.[141]

The test of fairness which has evolved in Pennsylvania requires the fiduciary to carry the burden of proof and show that he was in no way unjustly enriched.[142] The corporation does not have to suffer a loss to hold the fiduciary for a breach of his duties.[143] The Pennsylvania fairness test adopts the standard promulgated by the Supreme Court in *Magruder v. Drury*.[144] In *Magruder* a trustee was held to account for profits made when he invested the trust funds in a firm of real estate brokers of which he was a partner. The Court stated that "it makes no difference that the estate was not a loser in the transaction."[145] As will be later developed, this fairness test is contrary to that of other jurisdictions.[146]

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134. 106 F. Supp. 594 (W.D. Pa. 1952).
135. *Id.* at 601.
136. *Id.*
137. *See, e.g.*, Evans v. Armour and Co., 241 F. Supp. 705, 713 (E.D. Pa. 1965).
138. *See generally* Otis & Co. v. Pennsylvania Ry. Co., 61 F. Supp. 905 (E.D. Pa. 1945); Barnes Foundation v. Keely, 314 Pa. 112, 171 A. 267 (1934).
139. Evans v. Armour and Co., 241 F. Supp. 705, 713 (E.D. Pa. 1965).
140. Overfield v. Pennroad Corp., 42 F. Supp. 586, 608 (E.D. Pa. 1941).
141. Bailey v. Jacobs, 325 Pa. 187, 194, 189 A. 320, 324 (1937).
142. *Id.*
143. Lutherland, Inc. v. Dahlen, 357 Pa. 143, 53 A.2d 143 (1947).
144. 235 U.S. 106 (1914).
145. *Id.* at 119.
146. *See* sections IVB, IVC, and IVD *infra*.

As it now stands, the fairness test in Pennsylvania gives a complaining minority stockholder the right to litigate the issue of fairness simply by showing that a transaction *could* be detrimental to his interests.[147] It may be concluded that in Pennsylvania, contracts which are the result of intercorporate dealing are always open to investigation by the courts.[148] A parent or dominant corporation must prove that it was in no way unjustly enriched by its dealings with its subservient corporations.[149] A parent's actions must be in good faith and in the best interests of the subsidiary in order to qualify as being "inherently fair." Such stringent requirements afford an otherwise helpless minority stockholder a genuine weapon against the possible abuse of the awesome powers of a parent or a controlling corporation.

B. *New Jersey*

In New Jersey, as in other jurisdictions, the decision of a board of directors is generally immune from judicial revision or control.[150] This immunity is effective as long as the directors "keep within the scope of their powers, and act in good faith and with honest motives. . . ."[151] New Jersey courts have recognized, however, that dealings between corporate entities with common directors are a different type of corporate transaction.[152] This particular variety of dealing calls for the closest judicial scrutiny for fairness. New Jersey law also demands that the burden of proving the fairness of the transaction fall on the directors.[153] In *Helfman v. American Light and Traction Co.*,[154] the Chancery Court found that a parent corporation's bylaws may expressly authorize its contracting with other subsidiary corporations under the parent's control. More importantly, however, the court held that the authorization "does

147. *See* note 131 and accompanying text *supra*.
148. South Side Trust Co. v. Washington Tin Plate, 252 Pa. 237, 241, 97 A. 450, 451 (1916).
149. Bailey v. Jacobs, 325 Pa. 187, 189 A. 320 (1937); Pink Lady, Inc. v. William Penn Loan Co., 189 Pa. Super. 187, 150 A.2d 154 (1959).
150. *See, e.g.*, Edison v. Edison United Phonograph Corp., 52 N.J. Eq. 620, 625-26, 29 A. 195, 197 (1894).
151. *Id.*
152. *E.g.*, Bingham v. Savings Investment & Trust Co., 101 N.J. Eq. 500, 138 A. 659 (1927). The chancery court recognized the uniqueness inherent in the interlocking directorate situation when it said that: "The objection that the merger is unfair calls for careful judicial scrutiny of the plan, *in view of the interests in the merger of interlocking directorates, . . .*" Id. at 506, 138 A. at 662 (emphasis added).
153. Marcy v. Guanajunato Development Corp., 228 F. 150, 151 (D.N.J. 1915).
154. 121 N.J. Eq. 1, 187 A. 540 (1936).

not foreclose careful judicial scrutiny as to fairness."[155] Judicial intervention may not be barred or disclaimed by the dominant corporation.

Therefore, in New Jersey the rule has been formulated that dissenting stockholders of a dominated corporation have the right to subject a transaction to the equitable powers of the courts.[156] This places a heavy burden on the directors to show that the transaction was fair and free from fraud.[157] All the complaining stockholder need present in order to call the fairness test into operation are facts which *could* result in a finding of unfairness.[158]

To determine what is fair in the situation under investigation the New Jersey courts ask the threshold question: "What would have independent directors done under the circumstances?"[159] This test of fairness has been labelled the "arm's length bargaining" test.[160] It envisions an ideal bargain struck between disinterested parties of equal bargaining power. This test was first espoused by the Supreme Court in *Pepper v. Litton*[161] where defendant filed a claim against his bankrupt corporation for five years back salary. The Court, upon the plaintiff's prompting, found the defendant was the perpetrator of an intricate scheme which was a fraud on his corporation. The court held that defendant, as the dominant and controlling shareholder of the bankrupt corporation, had "not only to prove the good faith of the transaction but also show its inherent fairness from the viewpoint of the corporation and those interested therein."[162] More importantly, the Court stated that "the essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not equity will set it aside."[163] Some courts have recognized this test as the ideal in assuring fairness in intercorporate deals.[164]

New Jersey courts continue to exact scrupulous fairness of intercorporate transactions.[165] The "arm's length bargain" test is indicative of objective fairness. However, decisions in other juris-

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155. *Id.* at 17, 187 A. at 548.
156. Marcy v. Guanajunato Development Corp., 228 F. 150 (D.N.J. 1915).
157. Solimine v. Hollander, 128 N.J. Eq. 228, 276, 16 A.2d 203, 228 (1940).
158. Brundage v. The New Jersey Zinc Corp., 48 N.J. 450, 476, 226 A.2d 585, 599 (1967).
159. Marcy v. Guanajunto Development Corp., 228 F. 150, 156 (D.N.J. 1915).
160. *See, e.g.*, Pepper v. Litton, 308 U.S. 295 (1939).
161. 308 U.S. 295 (1939).
162. *Id.* at 306.
163. *Id.*
164. *See, e.g.*, Kors v. Carey, 39 Del. Ch. 47, 158 A.2d 136 (1960) (The transaction complained of was not set aside because the court found the earmarks of an arm's length bargain).
165. 48 N.J. 450, 476, 226 A.2d 585, 599 (Sup. Ct. 1965) (calling for proof by directors of entire fairness of the transaction).

dictions have demonstrated serious deficiencies as to its applicability in parent-subsidiary relations.[166] Its fatal defect is its inability to accommodate the realities of present day corporate structure, dealings, and goals. Despite these shortcomings the "arm's length bargain" test zealously protects minority stockholder interests. This is a boon to the small, public shareholder. By a showing of facts "which *could* lead to a showing of unfairness"[167] the small shareholder can obtain the assistance of equity. Once the complaining stockholder gets his complaint into an equity court the challenged transaction must meet the rigors of a truly "objective fairness" test. Recent statutory enactments in New Jersey have not curtailed the courts powers of careful scrutiny.[168] Objective fairness remains the pivotal question in intercorporate dealings.

C. New York

New York adheres to the business judgment rule and its rationale as do the previously discussed jurisdictions.[169] However, when the allegations of a complaint show intercorporate transactions with dual directors, the conduct is removed from the cloak of the business judgment rule. In intercorporate transactions, dual directors may be unable to exercise unprejudiced judgment, so the courts scrutinize the transaction with care.[170] Thus, the situation in New York is similar to that in New Jersey and Pennsylvania in respect to the invocation of judicial scrutiny in intercorporate and parent-subsidiary relations. Nevertheless, there is a fundamental difference in its test for fairness, the critical point in question. New York has applied a variety of tests to determine the fairness of a parent-subsidiary transaction.[171] Not until *Case v. New York Central Railroad Co.*[172] did New York seem to come up with a firm

166. *See specifically,* Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Del. Sup. 1970); Meyerson v. El Paso Natural Gas Co., 246 A.2d 789 (Del. Ch. 1967); Case v. New York Central Ry. Co., 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965).

167. *See* note 158 and accompanying text *supra.*

168. N.J. REV. STAT. § 14A:6-8 (1968) (no longer are contracts between corporations with common directors voidable at will by either corporation).

169. *See, e.g.,* Everett v. Phillips, 288 N.Y. 227, 43 N.E.2d 18 (1942).

170. Price v. Standard Oil Co., 77 N.Y.S.2d 687, 55 N.Y.S.2d 890 (Sup. Ct. 1945).

171. *See, e.g.,* Chelrob v. Barrett, 265 App. Div. 455, 39 N.Y.S.2d 625 (1943) (the court found no fraud, fault, overreaching, personal profit, or bad faith), *rev'd,* 293 N.Y. 442, 57 N.E.2d 825 (1944). In reversing the court said: "The test in each case is whether corporate action is the result of the exercise by the directors of their unbiased judgment in determining that such action will promote corporate interests." *Id.* at 460, 57 N.E.2d at 833.

172. 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965).

standard for testing fairness. Prior to *Case* the New York courts had interchangeably applied the "arm's length bargain" test, a fraud test, and a good faith test. Perhaps better than any other jurisdiction, New York epitomizes the confusion that has existed in applying the corporate fiduciary doctrine to parent-subsidiary and interlocking directorate situations.

In *Cleary v. Higley*[173] the court held that the subsidiary was not entitled to recover damages for the issuance of its stock by the command of the dominant parent. The court found that the sale of the stock was necessary since both the parent and the subsidiary faced receivership. The funds received from the sale of the subsidiary's stock were needed to avert liquidation. The court also found that the subsidiary sustained no loss by the issuance and sale of the new shares of stock. In so holding, the court laid down some basic premises which would create a prima facie case for shifting the burden of proof of fairness to the interested directors. Those criteria were: (1) loss to the subsidiary; (2) undue profit made by the parent at the expense of the subsidiary; (3) acts committed to secure or promote a selfish parental interest; and (4) a fraud on the part of the interested directors in carrying out the challenged transaction.[174] As in other jurisdictions, a foundation must be laid before the burden of proof will be shifted to the directors. The firmness of this foundation will vary by jurisdiction.[175] The criteria for shifting the burden of proof and for utilizing the fairness test are crucial; quite often they determine the outcome of the litigation.[176]

Although fairness has been tested by many methods in the New York courts, the Court of Appeals in *Case* impliedly rejected the standard tests of fairness as unsuited for present day corporate dealings. Applying a strictly factual test, the court held the questioned transaction to be valid in the *Case* decision. They found the results of filing consolidated tax returns were expected by all parties to the agreement. Furthermore, the complaining party was in a completely untenable position because there was no way it could have utilized the resultant tax savings. In addition, the life of the complaining corporation depended on the continued existence of the controlling corporation which desperately needed the tax savings to remain a viable corporate entity. This approach is realistic, but no more realistic than other jurisdictions which hold that fairness depends upon the circumstances of the case.[177]

The dramatic change lies in the dependence by the court on the expectations of the parties. Of course the expectations of the parties to a transaction are one of the circumstances to be considered in

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173. 277 N.Y.S. 63, 154 Misc. 158 (1937).
174. *Id.* at 76.
175. *See generally* sections IVA, IVB, and IVD.
176. *See* sections IVD and V *infra*.
177. *See* note 61 and accompanying text *supra*.

passing on the fairness of the transaction, however, if the court decides a case on that point alone it abdicates its traditionally held equitable powers.[178] Moreover, this test of fairness may very well work injustice when the complaining minority stockholders have not had any part in the decision. As to them, the "expectations" may be illusory, if not absolutely antithetical to their desires. Despite the possibility of working an injustice, the expectations test does have merit.[179] Its realistic approach to a troublesome legal-economic problem is a departure from the confusion of the past. The *Case* decision clearly recognizes that the parent-subsidiary or interlocking directorate presents a unique problem. Unfortunately, those who are meant to be protected by the fairness test may now be destroyed by it. The minority stockholder in a dominated corporation should not be left remediless when he feels his interests are being unfairly affected.

Since the *Case* decision there has been little litigation on the matter in New York. However, in *Greenbaum v. American Metal Climax, Inc.*,[180] the court upheld the defendant's motion for summary judgment. Relying on *Case*, the court found no "bad faith or undue advantage" on the part of the parent corporation.[181] This decision hints at the possibility of further equivocation in New York. Perhaps, as it now appears, *Case* will be narrowly restricted to its facts. Only one other jurisdiction has referred to the "expectations test," and in so doing dismissed it as untenable in an equity situation.[182]

Presently, New York appears to examine bad faith, undue advantage, unfair or selfish motives, etc. merely as part of the factual consideration of each case. As such, an initial judicial inquiry into the fairness of the challenged intercorporate transaction will precede this factual determination. Thus, what is fair will be primarily a factual determination in the traditional vein of judicial inquiry.

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178. Levien v. Sinclair Oil Corp., 261 A.2d 911 (Del. Ch. 1970):

> A theory of "reasonable expectations" may have a place in the ebb and flow of corporate life as it relates to investment, market appraisals, and the like. But it would go against the grain of our decisions to apply it in derogation of duties we have so long regarded as fiduciary.

261 A.2d at 916.

179. It should be noted that the test does give the parties what they bargained for and also gives the courts a solid foundation for a decision in an otherwise vague area of the law.

180. 27 App. Div. 225, 278 N.Y.S.2d 123 (1967).

181. *Id.* at 129.

182. Levien v. Sinclair Oil Corp., 261 A.2d 911 (Del. Ch. 1970).

D. *Delaware*

As the "corporate capital of the world" Delaware's test for fairness must be carefully studied because of its persuasive influence on other courts. The principles underlying Delaware's test for fairness are deeply entrenched in precedent. In *Sterling v. Mayflower Hotel Corporation*,[183] the Delaware Supreme Court reaffirmed the precedent of *Keenan v. Eshleman* that directors who stand on both sides of a transaction must etablish its entire fairness. However, in *Sterling* the court upheld a merger between parent and subsidiary. In affirming Chancery's holding the Delaware Supreme Court said:

> Plaintiffs invoke the settled rule of law that Hilton as majority stockholder of Mayflower and the Hilton directors as its nominees occupy, in relation to the minority, a fiduciary position in dealing with Mayflower's property. Since they stand on both sides of the transaction, they bear the burden of establishing its entire fairness, and it must pass the test of careful scrutiny by the courts. *Keenan v.. Eshleman*, 23 Del. Ch. 234, 2 A.2d 904; *Gottlieb v. Heyden Chemical Corp.*, 33 Del. Ch. 82, 90 A.2d 660.[184]

In a more recent case, *David J. Greene & Co. v. Dunhill International, Inc.*,[185] the applicable law was reiterated in unequivocal terms. The Delaware Chancery Court held that when a corporation stands on both sides of a transaction with its subsidiary, "it (a) has the burden of proof, (b) to show the transaction is fair, (c) after a careful scrutiny by the Court."[186] In so doing the court found the proposed merger to be unfair and thus issued an injunction.

This objective or intrinsic fairness test was developed out of the necessity for assuring that fiduciary duties were being honored when human frailties and shortcomings too often tempted abuse[187] and where the business judgment rule no longer had merit or validity.[188] Until recently, this demanding test was the safeguard afforded minority stockholders in dominated Delaware subsidiary corporations.[189] The great possibility of self-dealing on the part of

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183. 33 Del. Ch. 293, 93 A.2d 107 (1952).

184. *Id.* at 298, 93 A.2d at 109.

185. 249 A.2d 427 (Del. Ch. 1968).

186. 249 A.2d at 431.

187. *See, e.g.*, Gottlieb v. Heyden Chemical Corp., 33 Del. Ch. 82, 90 A.2d 660 (Sup. Ct. 1952):

> Human nature being what it is, the law, in its wisdom, does not presume that directors will be competent judges of the fair treatment of their company where fairness must be at their own personal expense.

Id. at 88, 90 A.2d at 663.

188. David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 430-31 (Del. Ch. 1968). Here the court concluded:

> [W]hen the persons, be they stockholders or directors, who control the making of a transaction and the fixing of its terms, are on both sides, then the presumption and deference to sound business judgment are no longer present.

189. *See, e.g.*, Levien v. Sinclair Oil Corp., 261 A.2d 911 (Del. Ch. 1970), *rev'd*, 280 A.2d 717 (1971).

the dominant corporation made this safeguard of fiduciary duties imperative.[190] The business judgment rule simply can not afford the protection needed under the aforementioned circumstances. Unfortunately, recent developments in the Delaware Supreme Court, specifically the Supreme Court ruling in *Sinclair v. Levien*, has altered that which has taken years to perfect.[191] The availability of the protective features of the intrinsic fairness test has been greatly curtailed.

V. THE FUTURE OF FIDUCIARY OBLIGATIONS IN PARENT-SUBSIDIARY RELATIONS FOLLOWING SINCLAIR V. LEVIEN

The Delaware Courts had faithfully applied the rigorous intrinsic fairness test.[192] This test was specially designed to meet the situation where human frailties were vulnerable to temptation.[193] But in *Sinclair Oil Corporation v. Levien*,[194] the Delaware Supreme Court retreated from its established position of applying the intrinsic fairness test. Intercorporate dealings previously scrutinized by the courts under the intrinsic fairness test may now pass unquestioned via the business judgment rule. In the *Sinclair* case the plaintiff-appellee brought suit for an accounting by defendant corporation which had caused its subsidiary, Sinclair Venezuelan Oil Company (Sinven), to declare and pay out $108,000,000 in dividends over a six year period. This amount was $38,000,000 in excess of Sinven's earnings during the same six year period. Defendant was able to compel the dividend declaration because it owned ninety-seven per cent of the Sinven stock. The plaintiff, a minority Sinven stockholder whose investment was being eaten up, alleged waste, denial of industrial development, and an overall breach of fiduciary duties. Applying the time-honored intrinsic fairness test the Delaware Chancery Court found Sinclair's actions exceedingly unfair, holding that Sinven appeared to be more like a corporation in partial liquidation rather than a going concern.[195] In reversing the holding of the Chancellor, the Delaware Supreme Court precluded use of the intrinsic fairness test by some subtle legal footwork.

The Supreme Court started its treatment of the *Sinclair* case

190. David J. Greene & Co. v. Dunhill Int'l Inc., 249 A.2d 427 (Del. Ch. 1968).
191. Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. Sup. 1971).
192. *See, e.g.*, Bastian v. Bourns, Inc., 256 A.2d 680 (Del. Ch. 1969); David J. Greene & Co. v. Dunhill, 249 A.2d 427 (Del. Ch. 1968); Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107 (1952).
193. *See* note 187 *supra*.
194. 280 A.2d 717 (Del. Sup. 1971).
195. Levien v. Sinclair Oil Corp., 261 A.2d 911, 919 (Del. Ch. 1970).

by boldly reiterating the established Delaware case law as authority:

> When a situation involves a parent and a subsidiary, with the parent controlling the transaction and fixing the terms, the test of intrinsic fairness, with its resulting shifting in the burden of proof, is applied. *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 225, 5 A.2d 503; *David J. Green & Co. v. Dunhill International, Inc.*, 249 A.2d 427 (Del. Ch. 1968); *Bastian v. Bourns*, Inc., 256 A.2d 680 (Del. Ch. 1969) *aff'd Per Curiam*, (unreported) (Del. Sup. 1970).[196]

The court then went on to acknowledge the fact that "the basic situation for the application of the rule is one in which the parent has received a benefit to the exclusion and at the expense of the subsidiary."[197] The opinion states that the intrinsic fairness test has been applied in the *basic* situation—the typical situation—where the parent has been guilty of self-dealing; this is illustrative not exclusive. From this general observation, the court proceeded one step further and assumed that self-dealing was a prerequisite, necessary before any case could come under the protective umbrella of the intrinsic fairness test.[198] The court relied on its recent decision in *Getty Oil Co. v. Skelly Oil Co.*[199] which held that the parent (Getty) did not have to allocate part of its oil import quota to is subsidiary. In so finding, the Supreme Court reversed the Chancery Court's finding of unfairness in failure to allocate. In *Sinclair* the Supreme Court concluded that in the *Getty* case the application of the intrinsic fairness test was precluded by the absence of self-dealing on the part of the parent corporation.[200] A close reading of the *Getty* case exposes the reason for the court's reliance on the business judgment rule rather than the intrinsic fairness test. The deciding factor was not the absence of self-dealing; rather, the crucial element in *Getty* was the intervention of a third party—the Federal Government's Oil Importation Board—in the decision-making process.[201] In *Getty* the court acknowledged that two tests were available to determine the fairness of a corporate transaction: the intrinsic fairness test and the business judgment rule.[202] In applying the business judgment rule the court stated:

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196. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. Sup. 1971).
197. *Id.*
198. *Id.* The court said:

> This standard [intrinsic fairness] will be applied only when the fiduciary duty is accompanied by self-dealing—the situation when a parent is on both sides of a transaction with its subsidiary. Self-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary.

199. 267 A.2d 883 (Del. Sup. 1970); *see* note 166 *supra*.
200. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. Sup. 1971).
201. 267 A.2d 883, 887 (Del. Sup. 1970).
202. *Id.*

> [T]he business judgment rule is used when the terms of a parent-subsidiary transaction are not set by the parent but by a third-party. The question is then one of business judgment with which the court should not interfere absent a showing of gross and palpable overreaching.[203]

Thus, *Getty* stands for the traditional approach that independent decision-making in parent-subsidiary relations is sufficient to take a particular transaction outside the jurisdiction of the intrinsic fairness test. The court found that the business judgment rule in these situations provided sufficient protection for minority stockholder rights, and absent a showing of a "gross and palpable overreaching"[204] the corporate decision will stand. Therefore, *Getty* actually stated a proposition that is inconsistent with that which the court used in *Sinclair* to buttress its decision. By making self-dealing an additional requirement to the invocation of the intrinsic fairness test in parent-subsidiary deals, the court has repudiated the rule of law which it so strongly endorsed in the opening remarks of the opinion.[205] It thereby espoused and destroyed the same fundamental rule of law in one breath.

By substantially controverting established case-law, the Supreme Court of the State of Delaware has done two things: (1) it has simplified a very complex area of corporate law, and (2) in the process of simplifying it has severely limited the access of an aggrieved minority stockholder in a parent-dominated subsidiary to the equitable powers of the courts through the intrinsic fairness test. The ramifications of a crippled intrinsic fairness test are far-reaching.[206] The test was developed through the years in response to the reality that one who controls a corporate entity owes it, "preemptorily and inexorably, the most scrupulous observance of his duty."[207] Coupled with this duty is the wise judicial recognition that conflicts of interest negate the presumed good faith:

> [W]hen the persons, be they stockholders or directors, who control the making of a transaction and the fixing of its terms, are on both sides, then the presumption and deference to sound business judgment are no longer present. . . .[208]

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203. *Id.*
204. Meyerson v. El Paso Natural Gas Co., 246 A.2d 789, 794 (Del. Ch. 1967).
205. *See* note 196 *supra.*
206. Basically, the *Sinclair* decision strips the courts of their equitable powers to scrutinize intercorporate transactions. Now, the less obvious forms of self-dealing and unfairness may very well pass unnoticed as unquestioned business judgment.
207. Guth v. Loft, Inc., 23 Del. Ch. 255, 280, 5 A.2d 503, 514 (Sup. Ct. 1939).
208. David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 430-31 (Del. Ch. 1968).

The possibility of a conflict between self-interest and duty had been recognized as so great as to preclude reliance on the business judgment of dual, interested or interlocking directors.[209]

The ramifications of *Sinclair v. Levien* are far-reaching. The most critical affect is the imposition of the requirement of self-dealing before the intrinsic fairness test can be utilized by an aggrieved minority stockholder in a parent-dominated subsidiary.[210] This self-dealing prerequisite destroys the effectiveness and fundamental purpose of the intrinsic fairness test, for it was the application of the test itself which was the mode of discovering the prevalence of self-dealing.[211]

CONCLUSION

An analysis of the corporate fiduciary doctrine has exposed a myriad of ideals and euphemistic concepts which purportedly exact of directors, controlling shareholders, and dominant parent corporations the utmost good faith and fair dealing when handling the affairs of the corporation, its stockholders, or its subsidiaries. However, this examination has also revealed a pervasive, yet quite understandable, hesitancy on the part of the courts to interfere with matters of genuine business judgment. Analysis reflects a broad overview of the spectrum of corporate life, both the ideal and the real, and the monumental task of balancing the two equities.

In order to balance fiduciary obligations with the realities of corporate life in a highly competitive economic world, the courts have relied on the business judgment rule. However, when a corporation dominates another corporation and controls its actions, the business judgment rule no longer has merit or validity. In this unique situation the courts are forced to deviate from the general rule of nonintervention and scrutinize intercorporate transactions with care. The purpose of this judicial inquiry is to assure that those who are outside the sphere of corporate control and decision-making are being treated fairly.

In the process of establishing the requisite fairness in intercorporate affairs various tests have evolved. The existence of many tests confirms the great amount of difficulty in defining fairness in the more intricate corporate structures and transactions. It is submitted that the most realistic test devised to date has been the "intrinsic fairness" test. It has best protected minority stockholder interests in subsidiary corporations. Unfortunately, in the

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209. See notes 188 and 189 *supra*.

210. See note 198 *supra*.

211. LATTIN, CORPORATIONS, 565, Ch. 12, § 8 (1959):

> Self-dealing in whatever form it occurs should be handled with rough hands for what it is—dishonest dealing. And, while it is often difficult to discover self-dealing in mergers, consolidations, sale of all the assets or dissolution and liquidation, the difficulty makes it even more imperative that the search be thorough and relentless.

wake of *Sinclair v. Levien*, the scrupulous fairness once exacted of a dominant parent corporation may no longer be required. With self-dealing a requirement for judicial inquiry, the small, public investor in a Delaware subsidiary may now find himself the victim of the subtle, yet insidious injustices which the intrinsic fairness test was created to detect. Under the guise of legitimate business judgment, parent corporations may be allowed to perpetrate the worst type of fraud, that which silently, yet implacably, erodes the foundations of a subsidiary corporation until it eventually caves in from its own weight.

Hopefully, other jurisdictions will not follow Delaware's lead and compromise their fairness tests. Such action should be condemned for it would reduce the already disadvantaged minority stockholder to a position of total impotence.

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