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The Mysteries of Corporate Law: A Response to Brudney and Chirelstein

To the Editors:

In 1974, Professors Victor Brudney and Marvin Chirelstein published an article that suggested formulae for deciding whether minority shareholders of a subsidiary receive fair treatment in a controlled merger.¹ In 1977, in *Mills v. Electric Auto-Lite Co.*,² the Seventh Circuit relied on that article in concluding that the merger terms being reviewed were fair. As Professor Simon Lorne pointed out recently, "it is clear from the Seventh Circuit decision in *Mills* that the court did not fully understand the concepts set forth in the Brudney & Chirelstein article."³ "A least in stock mergers," he explained,

the Brudney & Chirelstein approach yielded an ascertainable, satisfying and simple solution. . . . In the context of non-stock mergers the advantages of certainty and simplicity are lost, and the intrinsic appeal of the analysis disappears. Thus, the value of the Brudney & Chirelstein approach may lie more in what it has provoked than in the solution it proposed—but the value of provocation is not inconsiderable.⁴

The analysis in the Lorne article wholly supports its criticisms of the limited relevance and applicability of the Brudney and Chirelstein thesis. It does not, however, adequately account for the persuasiveness of that thesis, which is evidenced by the fact that the Seventh Circuit decided a case by applying it. An analysis of what makes the Brudney and Chirelstein thesis persuasive seems especially necessary since they have recently applied it to the area of corporate freezeouts.⁵ Although the Lorne article recognizes that "[h]aving challenged the simple approach of the Brudney and Chirelstein analysis, it is perhaps incumbent upon the author to provide some guidance to the courts,"⁶ that guidance is limited to admonitions that recognition be given to the rights of all parties, that imprecision is inherent in any search for total fairness, and that the standards by which the fairness of business transactions are judged must be based on the information avail-

1. Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974).

2. 552 F.2d 1239 (7th Cir.), cert. denied, 434 U.S. 922 (1977).

3. Lorne, *A Reappraisal of Fair Shares in Controlled Mergers*, 126 U. PA. L. REV. 955, 956 (1978).

4. *Id.* at 987.

5. See Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978) [hereinafter cited as *Freezeouts*].

6. Lorne, *supra* note 3, at 988.

able to businessmen before the consummation of those transactions.⁷ In assuming the burden borne by critics of Brudney and Chirelstein, it is my hope that the following analysis of the persuasiveness of their thesis will provide more guidance than these three admonitions.

I

The recent expansion of the Brudney and Chirelstein thesis in this *Journal*, entitled *A Restatement of Corporate Freezeouts*, begins with a description of the 1977 decision by the Supreme Court of Delaware in *Singer v. Magnavox Co.*,⁸ a case involving the acquisition of Magnavox by North American Phillips Corporation. Later in their article, Brudney and Chirelstein note that

it is possible that the Delaware court was concerned about the compromise between the managements of North American and Magnavox, which included new employment contracts for the latter. Indeed, this may have been a crucial factor, for it raises the question whether the transaction was truly arm's length, or whether the Magnavox management had in fact received a personal consideration for its change of position. This may partly explain why the supreme court directed the court of chancery to reexamine the "entire fairness" of the transaction on remand. Just how such a re-examination is to be carried out remains something of a mystery.⁹

Since the original Brudney and Chirelstein article was entitled *Fair Shares in Corporate Mergers and Takeovers*,¹⁰ it seems clear that this confession concerning the mystery of the *Singer* remand raises basic questions as to the heuristic value of their thesis.

Brudney and Chirelstein agree that "an alert interest in the bona fides of the target's management in the takeover . . . is a welcome development," but attempt to limit the impact of their confession by concluding that, in the absence of the mystery presented by the "question [of] the bona fides of the target's management, the pattern of overhead tender plus merger at the tender price is one in which issues both of 'purpose' and of 'fairness' are beside the point."¹¹ In *Young v. Valhi*,¹² however, which Brudney and Chirelstein cite as possibly fitting one of the hypotheticals they use in analyzing the question of whether a merger is in fact the second step in an acquisition (rather than an independent transaction),¹³ the Chancellor explicitly stated that "it is unnecessary to pass on the overall fairness of the price per share offered to minority stockholders of Valhi," a determination based on what he believed "to have been the use of technically correct but

7. *Id.*

8. 380 A.2d 969 (Del. 1977).

9. *Freezeouts*, *supra* note 5, at 1364-65.

10. Brudney & Chirelstein, *supra* note 1.

11. *Freezeouts*, *supra* note 5, at 1365.

12. 382 A.2d 1372 (Del. Ch. 1978).

13. *Freezeouts*, *supra* note 5, at 1361 n.15.

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devious corporate action . . . for the purpose of accomplishing a merger designed to eliminate all minority stockholders of Valhi.”¹⁴ The short of the matter, then, is that the question of fairness cannot be separated from that of bona fides, and that the law, to be effective, must cope with mysteries inaccessible to devotees of the Brudney and Chirelstein thesis.

Brudney and Chirelstein suggest that “[t]he current upheaval in Delaware law [of which *Singer* is an example] may well be traceable to criticisms articulated in” Professor Cary’s article, *Federalism and Corporate Law: Reflections Upon Delaware*.¹⁵ They fail to point out, however, that the case in which the Supreme Court of the United States cited that article, *Santa Fe Industries, Inc. v. Green*,¹⁶ reversed a holding by the Second Circuit concerning a Delaware short-form merger transaction used by the majority shareholders of a corporation to eliminate the minority interest. The Second Circuit had held that a cause of action had been stated under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 by a complaint seeking to set aside the merger or recover what was claimed to be the fair value of the minority shares.¹⁷

In other words, whether or not *Santa Fe* led to the “welcome development in the jurisprudence” of Delaware of “an alert interest in the bona fides . . . of management,”¹⁸ the actual holding in that case was that values of federalism—the fact that corporate law is regarded in the United States as a matter of state rather than federal law—outweighed the desirability of a single uniform rule concerning the standards to be applied in determining the fairness of a short-form merger. For such a holding to be acceptable, there must exist considerations that outweigh the desirability of clear and uniform rules, considerations that distinguish the law from formulae such as those contained in the Brudney and Chirelstein thesis.

II

In the briefest terms, it is my contention that those considerations derive from the nature of human competitiveness and self-awareness. Thus, the clearer and more uniform a rule is, the more likely it is to be regarded as a formality that can justifiably be manipulated so long as compliance with its explicit formulation is maintained. Reference to the Internal Revenue Service should be sufficient to demonstrate the considerable social costs involved in enforcing any system of rules communicated solely in terms of clear formulae or uniform doctrine and allowing for no resort to judicial “mysteries.”

In more concrete terms, it is my argument that the economic formulae underlying the Brudney and Chirelstein thesis significantly underestimate the extent to which human competitiveness limits the effectiveness of any control device based solely on an economic description of behavior. Thus,

14. 382 A.2d at 1378.

15. *Freezeouts*, *supra* note 5, at 1354 n.2 (citing Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974)).

16. 430 U.S. 462 (1977).

17. *Id.* at 469.

18. *Freezeouts*, *supra* note 5, at 1365.

any sufficiently uniform formula will at some point be exploited by the development of an application not derivable from the regularities in terms of which the formula has historically been defined. If such economic formulae are defined as the law of the marketplace, entrepreneurs can be defined as individuals who develop successful variations and United States corporate law as a system of rules that attempts both to limit and to encourage entrepreneurial activity, while simultaneously refusing to distinguish rules applicable to entrepreneurs from those that govern the business activities of others.

*List v. Fashion Park, Inc.*¹⁹ seems to be proof that the preceding paragraph accurately describes the application of Rule 10b-5, since the court's sole basis for the refusal to allow recovery was List's status as "an experienced and successful investor."²⁰ Similarly, in Delaware, it is clear that corporate law involves potentially conflicting bases of decision rather than one clear set of formulae. In *Young v. Valhi, Inc.*, the Chancellor held that "it is unnecessary to pass on . . . whether or not reasons given for the proposed merger, namely tax savings and avoidance of future conflicts of interest, were largely contrived."²¹ Such a holding was necessary because of possible conflicts with earlier Delaware cases. In *Condec Corp. v. Lunkenheimer Co.*,²² in which the Chancellor ordered the cancellation of certain shares allegedly issued solely to block an attempt to gain voting control of the corporation, it had been contended that the corporation's shares were issued "in order to preserve [its] existence for tax purposes as well as to avoid a possible violation of the Delaware statutory voting requirement for a corporate dissolution."²³ The Chancellor characterized these alleged business purposes as "obscure."²⁴ No stronger holding was ventured because an earlier Delaware Supreme Court decision had reversed a recovery for improper use of corporate funds based on a finding by the Vice Chancellor that the actual purpose for purchasing company shares with such funds was the desire to maintain control of the corporation.²⁵

III

One consequence of this line of cases is the requirement that each decision be read narrowly to ascertain its precedential effect. The resultant doctrine, although lacking uniformity, constitutes a far more concrete law of corporations than that available in most jurisdictions. Consequently, one of the values of federalism promoted by the *Santa Fe* decision was that corporate lawyers in other states could continue to rely on the fact that sufficient litigation would occur in Delaware to give warning of the possibility of a shift in the need to comply with arguably conflicting legal re-

19. 340 F.2d 457 (2d Cir.), cert. denied, 382 U.S. 811 (1965).

20. *Id.* at 464.

21. 382 A.2d at 1378.

22. 230 A.2d 769 (Del. Ch. 1967).

23. *Id.* at 775.

24. *Id.*

25. See *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964), cited in *Condec Corp. v. Lunkenheimer Co.*, 230 A.2d 769, 776 (Del. Ch. 1967).

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quirements or, if necessary, to incorporate in Delaware itself to maximize the advantages of such judicial signals. Despite these advantages provided by the centralization of litigation within a single court system, however, the fact remains that federalism also affords the opportunity for evasion of rules intended to be applicable. In *SEC v. Transamerica Corp.*,²⁶ for example, the district court refused to order certain proposals to be submitted to shareholders for action at the next annual meeting on the basis that “nothing in the General Corporation Law of Delaware . . . requires [the corporation] to give stockholders notice of [a] by-law amendment.”²⁷ The Third Circuit reversed on this basis: “If this minor provision [of the corporation’s bylaws, which required the Board of Directors to approve any proposed bylaw amendment] may be employed as Transamerica seeks to employ it, it will serve to circumvent the intent of Congress in enacting the Securities Exchange Act of 1934. It was the intent of Congress to require fair opportunity for the operation of corporate suffrage.”²⁸ The Third Circuit’s decision in fact represented the use of federal law to check state regulation, an overriding of considerations of federalism accepted because it was perceived as procedural rather than substantive.

The extent to which necessary corporate reforms at the time of this decision were perceived in terms of process is evident from the nature of the bylaw amendments being proposed for shareholder action in *Transamerica*: a shift in the site of the annual meeting, the election of independent public auditors by the shareholders, and a requirement that a report of the annual meeting proceedings be sent to all shareholders.²⁹ During the past three decades, as such procedural reforms began to be perceived as inadequate, the focus of federal corporate litigation shifted to attempts to obtain redress under Rule 10b-5 for manipulations involving corporate securities.

*Blue Chip Stamps v. Manor Drug Stores*³⁰ called a halt to the promulgation of federal substantive corporate law by declaring that the Second Circuit had been right in *Birnbaum v. Newport Steel Corp.*³¹ when it held that section 10(b) “was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that Rule X-10B-5 extended protection only to the defrauded purchaser or seller.”³² Precisely what the Supreme Court’s holding means is, of course, a mystery, and the circuit courts are currently attempting to decide whether it mandates a return to the standing requirements delineated in *Birnbaum*, or simply draws to a halt the expansion of federal 10b-5 jurisdiction, by holding that the *Birnbaum* rationale should not further be eroded.

26. 67 F. Supp. 326 (D. Del. 1946), *modified*, 163 F.2d 511 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948).

27. *Id.* at 331.

28. 163 F.2d at 518.

29. *Id.* at 513 & n.1.

30. 421 U.S. 723 (1975).

31. 193 F.2d 461 (2d Cir. 1952).

32. *Id.* at 464; *see Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731 (1975).

IV

What has been suggested is that the persuasiveness of the Brudney and Chirelstein thesis inheres in the discomfort caused by mystery, in the need to believe that the courts can accomplish their task of judging the fairness of corporate transactions by imposing clear and uniform formulae on entrepreneurial activities. This argument is based on the proposition that a system of law conforming to such requirements entails expenditures such as those needed to administer effectively the rules of taxation: expenditures our society is thus far unwilling to make for the purpose of governing corporate behavior. In the context of the historical development of federal corporate law adumbrated above, *Mills v. Electric Auto-Lite Co.* provides an example of the gaps and inconsistencies necessarily involved in judicial decisions that attempt simultaneously to rationalize such a development and to administer effectively a system of rules governing competitive human behavior. The *Santa Fe* decision makes clear that an allegation that merger terms are unfair per se does not state a federal cause of action under Rule 10b-5. The result, as the Lorne article puts it, is

an inherent confusion between the nature of the wrong and the nature of the remedy in cases like *Mills*. The wrong claimed is not unfairness, but rather nondisclosure. After the fact, however, the nondisclosure wrong cannot be meaningfully remedied. The unfairness claim may be seen as a hybrid right of action that is developing under Section 14 [T]he potential remedy is not related to the wrong, but *Mills* creates one remedy for the combination of nondisclosure and unfairness where none other would be possible in the federal courts.³³

Perhaps the most striking example of the difficulties involved in promulgating a formula to govern competitive human behavior effectively is provided by the history of *Rosenfeld v. Fairchild Engine and Airplane Corp.*,³⁴ a decision that appears to represent a conscious judicial attempt to define the common law of corporate political competition. The question presented was that of the permissible uses of corporate funds in proxy contests. A majority of four refused to accept the three-person dissenting view that expenditures in excess of those "incurred in giving widespread notice to stockholders of questions affecting the welfare of the corporation" are ultra vires,³⁵ presumably because this formula failed to respond effectively to incumbent management's claim on corporate resources at least for the purpose of making the contest with insurgents an equal one in financial terms.³⁶ The fourth member of the majority, however, joined the three-person opinion delineating a distinction between "personal power" and "policy" contests in a concurring opinion that appeared to be restricted to a ruling on the technical question of allocating burden of proof.³⁷ The

33. Lorne, *supra* note 3, at 966 n.35.

34. 309 N.Y. 168, 128 N.E.2d 291 (1955).

35. *Id.* at 185, 128 N.E.2d at 300.

36. *Id.* at 173, 128 N.E.2d at 293.

37. *Id.* at 174-76, 128 N.E.2d at 293-95.

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final comment of that opinion, however, leaves open the possibility that there may exist situations in which campaign expenditures would be found to be “inherently unlawful,”³⁸ thus creating the mystery of precisely what it is that this decision means. Equally important, however, for purposes of the argument advanced here, is the fact that relatively few courts have applied the majority’s “personal power/policy” formula to the cases before them. The reason, as a California court recently put it, is that “[t]he rule is uncertain in application because every contest involves or can be made to involve issues of policy.”³⁹

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38. *Id.* at 176, 128 N.E.2d at 295.

39. *Braude v. Havenner*, 38 Cal. App. 3d 526, 532, 113 Cal. Rptr. 386, 389 (1974).

