Defining the Future: Personal Influence and United States Corporate Law

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EDITOR’S NOTE

In the following article, Professor Deutsch considers the processes by which the common law of corporations has developed. Both personal and institutional factors are discussed in an effort to account for the development of the concept of corporate fiduciary duty. It is left for the reader to resolve the intricate ambiguities raised by Professor Deutsch’s hypothetical characters.

M: I’m beginning to think it was a mistake to take law courses in night school. Now that I’ve finished introductory corporate law, I understand less than ever how you lawyers can respond so smugly to the current news of corporate bribery, criticizing what you call excesses on the part of administrative agencies, and simply taking for granted that the judicial system—the common law—will produce better results.

S: The one thing you cannot accuse me of is smugness. I do what you pay me to do, which is to manipulate the mysteries of law, but the one thing that process does not permit is smugness. Since the mysteries of the common law are judicial opinions, those opinions are relevant only insofar as they are treated as precedents in future judicial decisions, and such future decisions can only occur if two lawyers believe that divergent results are sufficiently likely on the basis of the existing precedents to justify taking fees from the clients who want those divergent results.

As to the recent reports concerning corporate bribery, several things, it seems to me, must be taken into account. Almost all the corporate executives involved argue both that it was being done to maximize profits and that it had to be done because their competitors were engaging in such practices. Both of those statements are, of course, factual assertions which in any given situation may or may not be true, but I think you will agree it is objectively true that the standards in terms of which corporate behavior is judged have risen, and that the question that is now being answered is whether given corporations were too laggard in acknowledging that higher standard. If you agree with this analysis, what we are facing is a classic instance of the application of the

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general legal standard known as the fiduciary principle, and *Meinhard v. Salmon*\(^1\) is, of course, regularly cited as the precedent embodying that principle.

M: That's exactly the case that started me wondering about you lawyers, since it is indeed constantly being cited to justify the application of the fiduciary principle to corporate behavior, while the decision itself was not only concerned with real estate, but—more to the point—involved the question of what behavior was required by the law from a partner, not a corporate executive.\(^2\)

S: I don't see what's puzzling about that. Business is increasingly utilizing the corporate structure, and the principle of *Meinhard* is therefore being applied to that situation.

M: But the one thing I kept learning in my corporate law course was the significance of formal requirements, and I simply do not understand why the differences between partnership and corporate structures are so totally ignored in the application of fiduciary principle.

S: Since your study of law surely also taught you that formal requirements may or may not be determinative of the result in any given legal dispute, I in turn am puzzled by your insistence upon the application of such requirements.

M: In the end, I suppose my preference is rooted in the fact that prediction is the basis on which we attempt rationally to control the future, and that accurate prediction is the result of sound theory.

S: But why is that related to formality?

M: Because sound theory requires clear and precise definition of terms, and that process ultimately results in formal distinctions or classifications.

S: I accept the human need for theoretical structures as a way of feeling in control of future events, but if the point is to gain accurate knowledge about such events, it seems yet more important to recognize that, insofar as those future events are intimately involved with human behavior, theoretical structures are as likely to mislead as to be successful in forewarning us what to expect.

Indeed, if you are willing to treat economics as a theoretical structure, I would say that the success of *Meinhard v. Salmon*—its reiterated citation in situations different from that involved in the case before the court—is due precisely to its recognition of this insight. Don't forget that the passage of the opinion most frequently cited specifically argues that:

1. 249 N.Y. 458, 164 N.E. 545 (1928).
2. A managing coadventurer appropriating the benefit of such a lease without warning to his partner might fairly expect to be reproached with conduct that was underhand, or lacking, to say the least, in reasonable candor, if the partner were to surprise him in the act of signing the new instrument. Conduct subject to that reproach does not receive from equity a healing benediction. *Id.* at 468, 164 N.E. at 548.
Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of 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.3

M: As I now understand your argument, it is that law is more successful than the marketplace in controlling human behavior.

S: I'm not certain I could argue that the law is more successful in each and every case; what I claim is that the marketplace is necessarily inadequate, and that the law is therefore necessarily required, not because it is a better theory, but precisely because the case-by-case development of the common law reminds us that there are limitations to the applicability of any given rule.

M: I, of course, understand that the rules in given precedents may conflict; but how does that relate to the fact that the concepts in terms of which those rules are developed may ultimately be definable in formal terms?

S: The point is that as soon as such concepts become sufficiently precise to be defined in such terms, they become inadequate descriptions of human behavior.

Perhaps I can illustrate my point more concretely by demonstrating that any attempt to formulate a theory concerning power inevitably ends either by denying the existence of influence or minimizing its significance. For this purpose, I define power as something demonstrated by the ability to control external events in accordance with one's desires and influence as control over other actors.

M: I agree that power is a concept that would be relevant to our discussion if all we were discussing was control over future events. But since what we are discussing is the law governing corporate behavior, I fail to see why the definitions of power and influence are matters we should consider.

S: I assume you agree that Perlman v. Feldman4 is an important case in corporate law, and that it can fairly be described as attempting to develop a theory concerning the power of corporate control. If so, I would argue that Essex Universal Corp. v. Yates5—in which the three opinions on the question of the percentage of stock ownership necessary to bring into play the fiduciary standards delineated in Perlman agreed only that a full trial should be had—demonstrates the necessary imprecision of the concept of power in corporate law.

3. Id. at 463-64, 164 N.E. at 546.
4. 219 F.2d 173 (2d Cir. 1955).
5. 305 F.2d 572 (2d Cir. 1962).
M: Since no trial was held, I'm not sure I agree that the lack of precision is unavoidable, but even if I accepted the fact that power was an imprecise concept, I fail to see what influence has to do with our discussion.

S: Influence is the power a leader exercises over his followers. In the broadest theoretical terms, I suppose it works because of the peculiarly human trait of self-consciousness, which I call peculiarly human because I assume humans are the only animals who spend time thinking about themselves from an outside point of view. By this I mean from a point of view that could be designated as neutral, value-free, and objective. It is because of this self-consciousness that the psychological process called identification can take place, in that a human can behave as though some other human knew better than himself what was good for him. Such behavior, of course, is what we observe when we say that someone is under the influence of a leader.

M: If we define the value of law as providing the opportunities for "sober second thoughts," and the value of economics as a theory whose terms are capable of sufficiently precise definition to permit calculations of rationality that are independent of purely personal preferences, then I think I can say that the behavior you are describing should be called political rather than legal or economic, and that it is properly designated either hasty or irrational.

S: I think the case that demonstrates that your distinction between political and economic behavior is untenable is Berwald v. Mission Development Co., in which the Supreme Court of Delaware refused to liquidate a holding company and distribute its assets. The sole significant asset of the holding company was a block of stock in an operating company in which there was an announced policy of declaring neither cash nor stock dividends. Since, when this policy was announced, shareholders in the holding company were offered an opportunity to exchange their shares for shares in the operating company, I suggest that, in your terms, it was irrational for them not to do so. The legal argument plaintiffs were making in Mission Development was that "There is an inherent conflict of interest between the controlling stockholder of Mission, Mr. J. Paul Getty, and the minority stockholders." What I am arguing is that the behavior of the minority stockholders can equally well be described as that of persons acting under the influence of J. Paul Getty.

M: I will agree that my attempt clearly to separate political from economic behavior in terms of the law fails to account for Berwald. Since the decision about which we disagree is Meinhard v. Salmon, however, I remain unconvinced that law cannot fairly be judged by the rigorous standards inherent in formal theoretical concepts. Salmon itself, after all, was phrased in terms of the legal duties imposed on the formal sta-

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7. Id. at 512, 185 A.2d at 482.
tus of co-venturer rather than a description of the consequences derived from a finding that Salmon exercised influence over Meinhard.

S: I'm afraid your formal reading of the Meinhard v. Salmon precedent, lawyer-like as it is, omits certain facts. Thus, in January 1917, Meinhard transferred to his wife his interest in the agreement made between himself and Salmon, and although she transferred it back on June 22, 1922 (after all the acts complained of in the lawsuit had occurred), on July 21, 1919, Meinhard requested Salmon to make all checks payable to Carrie W. Meinhard, enclosing a letter from himself to the Commissioner of Internal Revenue, in which he said, "You have doubtless mistaken me as having received moneys as agent or landlord, but I have simply acted as agent and attorney for Carrie W. Meinhard, who has a half interest in the net earnings of the Bristol Building, 500 5th Avenue."9

M: That may well be, but the New York Court of Appeals held for Morton H. Meinhard, and what you are citing in an attempt to demonstrate that Meinhard had given up his interest in the transaction was not found by the referee on the ground that the "evidence [was] not ultimate fact."10

S: I don't disagree with what you say. It just seems to me either that the precedent disregards the formal fact of a transfer of interest or that you are agreeing that the mechanisms of the legal process—which produced the referee's cryptic evidentiary finding—were more effective in this instance than non-legal theoretical analysis. Theoretical analysis, after all, if it were identifying the actor in economic partnership with Salmon, would have to designate Carrie rather than Morton, since the Cardozo opinion itself notes that Meinhard's participation in the transaction was restricted to the giving of "money, but neither time nor labor. . . ."11

M: I accept your argument that formal analysis alone cannot account for the power of Salmon v. Meinhard as a precedent. Nevertheless, I refuse to accept the proposition that the rhetoric which justified the application of the fiduciary principle, in disregard of the formal fact of a transfer of interest, is to be considered a legal principle simply because it is so regularly cited. Given the age of the Salmon precedent, however, I think our disagreement about the need for precision might be clarified by focusing on more recent decisions.

My point about what I regard as needless imprecision is perhaps best made by the recent Delaware decision in Tanzer v. International General Industries, Inc.12 Justices Duffy begins that opinion by noting that:

In *Singer v. Magnavox Company*, . . ., 380 A. 2d 969 (1977), we held that a merger of a Delaware corporation caused by a majority stockholder solely for the purpose of cashing-out minority stockholders is a violation of a fiduciary duty owed by the former to the latter. We reserved for another day the question of whether a merger made primarily to advance the business purpose of the majority stockholder is a violation of that duty.\(^\text{13}\)

He concludes that:

Since IGI's purpose in causing the Kliklok merger was a proper exercise of its voting power under the rule announced herein, we affirm the order of the Trial Court denying plaintiff's motion for a preliminary injunction.\(^\text{14}\)

This ruling, however, does not terminate the litigation because, given the fiduciary duty owed in any event by IGI to the minority stockholders of Kliklok, the latter are entitled to a fairness hearing under *Singer*. The Chancellor's opinion, announced at the preliminary injunction stage of this proceeding, discussed fairness only in terms of the price offered for the stock, but that was too restrictive. The test required by *Singer*, which applied the rule of *Sterling*, involves judicial scrutiny for "entire fairness" as to all aspects of the transaction.\(^\text{15}\)

I think my objections to *Tanzer* are best put by noting that Justice McNeilly concurred in *Singer* because, although he "agree[d] with the holding of the majority that a § 251 merger, made for the sole purpose of freezing out minority stockholders, is an abuse of the corporate process [and] also agree[d] with the learned and eloquent analysis of the Delaware case law on the subject of mergers made by Justice Duffy in his opinion, [he was] inclined to think . . . that the [Duffy] opinion waffles in its attempt to establish guidelines for future merger litigation with emphasis on the coined phrase 'business purpose', which standing alone connotes nothing magic or definitive."\(^\text{16}\)

The extent to which the majority regarded McNeilly's criticism as telling is indicated by the fact that the *Singer* opinion, although handed down before *Tanzer*, in fact appears in a later volume of the Reporter. Even in terms of the *Tanzer* opinion itself, moreover, which held that "[t]he test required by *Singer*. . . applied the rule of *Sterling*"\(^\text{17}\) it seems significant that, in *Singer*, it was Justice McNeilly in concurrence and not the majority, who held that "In these cases of going private, be they mergers under § 251 or § 253, it is my opinion that *Sterling v. Mayflower*, 93 A.2d 107 (1952), establishes an avenue for judicial

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13. *Id.* at 1122.
14. *Id.* at 1125.
15. *Id.*
16. 380 A.2d 969, 982 (Del. 1977).
17. 379 A.2d 1121, 1125 (Del. 1977).
scrutiny with a firm foundation based upon factual determinations of fundamental fairness and economic reasonableness which should be our guideline for future cases.”18

S: Your analysis indicates that what separates us is not a disagreement about the nature of common-law precedent, but rather about the style in terms of which the opinions embodying such precedents are crafted; although I am now uncertain whether our disagreement represents anything other than two ways of perceiving the same reality.

You noted, while we were discussing Salmon, that the clarity required by sound theory represents a need that the law must meet because theory is the only way in which we feel in control of the future. It now seems to me that what you are arguing is that the entire legal community either does or should share your preference.

Nor are you alone in making that argument. Grant Gilmore’s recent lectures on The Death of Contract argued that what was striking about “the formal system of the classical theorists”19 of contract law—given that they based their theory on a limited selection of cases, that many of those cases were English, and that even those cases were often open to conflicting interpretations—was that it enjoyed such rapid and widespread success. I now see that you are accounting for precisely that phenomenon.

M: I am of course delighted to hear that you understand my argument, but must point out that I think I can focus both on corporate rather than contract law and on judicial style rather than the concept of precedent. Thus, in the very lectures to which you refer, Gilmore draws the following contrast:

On its own terms. . . the theory of contract, as formulated by Holmes and Williston, seems to have gone into its protracted period of breakdown almost from the moment of its birth. I have credited Holmes and Williston with the design and execution of the great theory. It is tempting to set Cardozo and Corbin over against them as the engineers of its destruction. Tempting and by no means untrue. Cardozo’s attack was subtle, evasive, hesitant—it is by no means easy to know how far that master of judicial ambiguity meant us to go with the cryptic hints which he provided for our delectation and bewilderment. But it is certain that the outlines of the law of contract that emerged from the opinions of the New York Court of Appeals during the period of Cardozo’s dominance of that court had little enough to do with the law of contract as it was taught at Harvard during the same period.20

The extent to which that characterization of the author of Meinhard v. Salmon is accurate seems to me to be demonstrated by an analysis of

18. 380 A.2d 969, 982 (Del. 1977).
20. Id. at 57.
his opinion in *Globe Woolen Co. v. Utica Gas & Electric Co.*,\(^{21}\) which involved a suit by plaintiff corporation to compel specific performance of contracts to supply electric current to its mills. The facts, as stated in the opinion, are that "Greenidge . . . superintendnt and later the general manager of the defendant's electrical department, suggested to Mr. Maynard [who was a director of both plaintiff and defendant corporations] the substitution of electric power. . . . Maynard was fearful that the cost. . . . would be too great unless the defendant would guarantee a saving. . . . [F]rom time to time the subject was taken up anew [and after] investigation[s] by Greenidge. . . . a contract was closed [in] the form of letters exchanged between Greenidge and Maynard."\(^{22}\) What had happened was that "Greenidge had miscalculated the amount of steam that would be required to heat the dye houses [because] changes in the output of the mills had not been foreseen by Greenidge, and Maynard had not warned of them."\(^{23}\)

The answer to the question why Maynard was held responsible for having failed to warn Greenidge about possible future developments, despite the facts that "plaintiff's books were thrown open to Greenidge"\(^{24}\) and that "[Maynard] may have trusted to the superior technical skill of Mr. Greenidge,"\(^{25}\) is phrased in terms of general rules: "A beneficiary, about to plunge into a ruinous course of dealing, may be betrayed by silence as well as by the spoken word. The trustee is free to stand aloof, while others act, if all is equitable and fair. He cannot rid himself of the duty to warn and to denounce, if there is improvidence or oppression, either apparent on the surface, or lurking beneath the surface, but visible to his practised eye,"\(^{26}\) and "[A] finding that there was [a relation of trust reposed, of influence exerted, of superior knowledge on the one side and legitimate dependence on the other] has evidence to sustain it. A trustee may not cling to contracts thus won, unless their terms are fair and just,"\(^{27}\) leading to the conclusion that "The contracts before us do not survive these tests. The unfairness is startling, and the consequences have been disastrous."\(^{28}\)

The difficulty with this precedent is the lack of clarity as to what made the contract voidable: that Maynard was Greenidge's superior in terms of the corporate hierarchy, that "As a result of [defendant's contractual guarantee], it has supplied the plaintiff with electric current for nothing, and owes, if the contract stands, about $11,000 for the privilege,"\(^{29}\) or that Maynard was a director of both corporations. Theories

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22. Id. at 486, 121 N.E. at 378-79.
23. Id. at 488, 121 N.E. at 379.
24. Id. at 486, 121 N.E. at 380.
25. Id. at 491, 121 N.E. at 380.
26. Id. at 489, 121 N.E. at 380.
27. Id. at 490, 121 N.E. at 380.
28. Id. at 491, 121 N.E. at 380.
29. Id.
may often ignore differences regarded as significant by some in arriving at the formal uniformity necessary to achieve an acceptable level of consistency. One is more comfortable with the exercise of judicial power, however, when one is certain as to the justification for the imposition of liability.

S: I agree with you that *Globe Woolen* can be cited as authority for the designation of Cardozo as a "master of judicial ambiguity." Indeed, given Cardozo's concession that "It is not important...whether the trustee foresaw the precise evils that developed,"\(^{30}\) what seems crucial to justifying the voiding of the contract is the extent to which its one-sided nature was not fairly to be regarded as Greenidge's responsibility; and the answer to that inquiry must be based on an assessment of the extent to which Maynard would have been justified in "trust[ing] to the superior technical skill of Mr. Greenidge" for more than "comput[ation] with approximate accuracy [of] the comparative cost of steam and electricity."\(^{31}\)

I agree that the general rules enunciated by Cardozo do not in any way resolve this inquiry, and that, insofar as those rules constitute the *Globe Woolen* precedent, its application in any given case is no less mysterious than the rationale for its result. I note, however, that attempts will always be made to evade any test enunciated in any opinion, that the applicability of any precedent whose application would have significant impacts on human behavior will be disputed, and that such disputes will be resolved in terms of the facts determined upon in the course of judicial proceedings. It is the uncertainty inherent in this process that I find necessary and that you seem to be disputing.

M: How does that procedural uncertainty relate to our disagreement?

S: My argument is that it is precisely that uncertainty that constitutes the law's recognition of the necessary limits of formal theory. Thus, given the date of *Globe Woolen*, and the extent to which electricity represented a revolutionary technological innovation, the inquiry I have postulated as necessary seems to me to have been addressed in theoretical terms by the two judges in the Appellate Division who found "that the contracts were made in good faith and that the fact that Maynard was a director in the defendant company did not influence them or have anything to do with their making or affect their validity; that the contracts, however, resulted solely from a mutual mistake of fact, and the defendant should [therefore] be allowed to rescind...."\(^{32}\)

If you agree with this theoretical analysis, you surely remember *Raffles v. Wichelhaus*,\(^{33}\) in which a ship Peerless carrying the goods in question sailed from port at a time different from that at which another

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30. *Id.* at 492, 121 N.E. at 381.
31. *Id.* at 491, 121 N.E. at 380.
33. 159 Eng. Rep. 375 (Ex. 1864).
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ship Peerless sailed. Commenting on the *Raffles* decision, Holmes noted that:

> It is commonly said that such a contract is void, because of mutual mistake as to the subject matter, and because therefore the parties did not consent to the same thing. But this way of putting it seems to be misleading. The law has nothing to do with the actual state of the parties' minds. . . .

As a footnote to this passage, Holmes cites "CF. *Kyle v. Kavanaugh,*" which involved a seller offering to convey land located on one of two Prospect Streets in Waltham, Massachusetts, whereas the buyer intended to buy land located on the other Prospect Street. Since the *Kyle* contract involved the land itself, and the *Raffles* contract goods carried on the ship. Peerless, it is clear, if one is concerned with objective fact rather than "the actual state of the parties' minds," that *Kyle* is more directly in point than *Raffles* as authority for Holmes' analysis.

M: I agree with your theoretical analysis, but how does *Kyle*'s superiority as legal authority demonstrate the necessary limits of theory?

S: Because insofar as law is itself a theoretical structure, and therefore based on reasonably precisely defined concepts, what must be recognized as important is the theoretically inescapable conclusion that the "CF." citation is formally incorrect. As Gilmore puts it: "It is one of the mysteries of the legal literature that every English-speaking lawyer knows *Raffles v. Wichelhaus* while no one has even heard of *Kyle v. Kavanaugh.*"

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