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ARTICLES

TOWARDS A FEDERAL FIDUCIARY STANDARDS ACT

MARVIN A. CHIRELSTEIN*

I. INTRODUCTION

VIEWED FROM A DISTANCE, THERE IS SOMETHING SURPRISING about the fact that the legal standards that govern the conduct of corporate managers—directors, officers and controlling stockholders—differ in their source and origin depending on whether one is speaking of relations with the company itself or of relations with its security holders. At the security holder level, it is of course the federal securities statutes that have primary effect. Federal proxy and insider trading rules, together with federal disclosure requirements, are the prevailing constraints where relations between managers and investors are concerned. At the company level, by contrast, it is the statutory and common law of the state of incorporation that chiefly governs. Fiduciary limitations on dealings between the company and those who manage or control the disposition of its property have long been reserved to the states, of which Delaware, being the principal state of incorporation, is the most important. In effect, then, despite the economic identity that exists between the firm and its security holders, fiduciary obligation is at present dichotomized between federal and state legal systems which have no very close connection to one another; the federal system dominates the security holder level while the various state systems dominate at the firm level.

The reason for the dichotomy just described is in part historical. The common law of fraud and deceit—with its requirements of privity, reliance, and so on—was, or was thought to be, too restrictive to cope with problems of false disclosure or nondisclosure in transactions taking place on an impersonal stock exchange between anonymous parties.[1] Both the 1933 Act,[2] with its registration requirement and its broadened framework of liability, and the insider trading and proxy rules of the 1934 Act,[3] were responsive to the need to adapt the law of fraud and

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[1] L. LOSS, SECURITIES REGULATION 20 (2d ed. 1961).

[2] Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976).

[3] Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78jj (1976).

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deceit to contemporary conditions. These statutes obviously had to be national in scope—state blue-sky laws, like state antitrust laws, would never have been adequate to the task of policing and constraining the issuance and trading of securities on national stock exchanges.

But there was no such perception in New Deal days of the need for national fiduciary standards, except to some extent in the case of insolvency reorganizations and public utility holding companies. The relationship between the corporation itself and its managers or insiders—though of course constrained by fiduciary obligation—was thought properly left to state law. Insolvencies and public utilities aside, the problems involved were apparently not felt to be especially serious or perhaps were somehow viewed as local in character because they did not entail trading on a securities exchange. Whatever the reasons, the Supreme Court in the recent *Santa Fe Industries, Inc. v. Green*[4] case was almost certainly correct in holding that rule 10b-5[5] was *not* designed to provide a foundation for the erection of federal fiduciary standards, and in confirming that fiduciary rules remained a matter of state law. In the same spirit, many commentators questioned what appeared to be an attempt by the Securities Exchange Commission (SEC) to use the federal disclosure requirements to create substantive fairness standards in the going-private area, and the Commission, apparently recognizing the force of those criticisms, substantially moderated its position in its final regulations.[6] The essential point of the *Santa Fe* decision is clear, after all—disclosure rules are not to be converted into a federal law of fiduciary duty without congressional action, and until there is such action, state law governs.

The question now is whether Congress *should* act in the field of managerial conduct, or whether state law should be allowed to retain its preeminence. As is well known, many writers hold the view that the time has indeed come for legislation at the federal level on fiduciary responsibility and related problems.[7] A subcommittee of the Senate Judiciary Committee, chaired by Senator Metzenbaum, has introduced a bill on the subject,[8] and Professor Cary's influential article[9] on the need

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[4] Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).

[5] SECURITIES EXCHANGE COMMISSION, Rule 10b-5, 17 C.F.R. § 240.10b-5 (1981).

[6] *Compare* Rule 13e-3, 44 Fed. Reg. 46,736, 46,471 (1979) *with* Proposed Rule—Going Private Transactions by Public Companies or Their Affiliates, 42 Fed. Reg. 60,090, 60,101 (1977).

[7] *E.g.*, Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Henning, *Federal Corporate Chartering for Big Business: An Idea Whose Time Has Come*, 21 DEPAUL L. REV. 915 (1972); Schwartz, *Towards New Corporate Goals: Co-existance with Society*, 60 GEO. L.J. 57 (1971).

[8] Protection of Shareholders' Rights Act of 1980, S. 2567, 96th Cong., 2d Sess. (April 16, 1980).

[9] Cary, *supra* note 7.

for a federal minimum standards act, though far from commanding universal assent, continues to be discussed by both scholars and practitioners.

The position argued for in this article is favorable to the idea of federal legislation, but my approach, in the main, is more instrumental than philosophic. It seems clear to me that the fiduciary problems of major interest are problems that can only be solved legislatively, and that the appropriate solutions are both specific and various. No single and no general solution will handle all the problems that arise. Put differently, the evolution of a common law "fairness" standard is inadequate to the task of actually *achieving* fairness—a conclusion that somewhat resembles the one that inspired those who drafted the securities laws of the 1930's. While it is possible that such specific solutions might be left for the states to adopt, the case for uniformity and certainty becomes overwhelming once we know just what it is we want to do. If we think we have the answers, or can get them, then it is very hard to see why legal standards that would affect national corporations with national investor constituencies should not be national in application. The "state laboratory" concept may be valid to some extent, but the metaphor itself implies that experimentation will some day come to an end.

In Part II, next following, I try—using the freezeout of minority shareholders as my main illustration—to develop the idea of specific solutions for fiduciary problems and to show why nothing short of legislative action will meet the current need. In Part III, I argue the case for *federal* legislation a bit further, and I offer some suggestions about the administration of the federal statute that might emerge and the role of the SEC. My conclusion, overall, is that the adoption of a federal fiduciary standards act would be a progressive development in the field of company law, and that the time to begin working on the shape and substance of such a statute is now.

II. THE NEED FOR LEGISLATION

I think it would be agreed by many that the urgent concerns that inspired the federal investor protection laws of the 1930's have a near counterpart at the present time in the phenomenon of the takeover. Mergers, stock swaps, cash tender offers and other forms of corporate acquisition—far more than stock flotations—have become central to the corporate practice and now substantially engage the attention of lawyers, courts, administrators and investors. The legal problems that have arisen out of the takeover movement are almost too numerous to catalogue, but for the immediate purpose of this discussion—which, as I have said, is to illustrate the need for uniform statutory solutions to fiduciary problems—it is the so-called minority stockholder freezeout that I wish to highlight. The *Santa Fe* case is a good example. There, a parent corporation owned ninety-five percent of an operating sub-

sidiary, with the balance of the subsidiary's shares being held in small lots by public stockholders. Wanting to eliminate the minority interest, the parent, on its own motion, merged the subsidiary into itself under the Delaware short-form merger statute and paid off the public stockholders in cash at a price that it had previously determined to be fair. The Second Circuit Court of Appeals held this freezeout merger to be a fraudulent practice within the meaning of rule 10b-5,[10] but the Supreme Court reversed on the ground that the 1934 Act was solely concerned with disclosure, which was conceded to have been adequate and complete.[11] Issues of fairness and fiduciary responsibility, said the Court, were not properly raised under the federal statute, but were instead to be resolved by state law. Towards the end of his opinion Justice White virtually invited Congress to take notice of the freezeout problem;[12] until it did, however, the question remained a matter for state jurisprudence to grapple with.

To be sure, freezeouts are only one part of a much larger legal scene; yet it is accurate, I think, to say that the treatment of minority shareholders in mergers is a major subject for stockholder suits at the present time, and that it is almost impossible to achieve a freezeout without a court contest, actual or threatened. This may sound all to the good since the term "freezeout" has a pejorative ring, but, as I hope to show, the fact is that *some*—*perhaps most*—freezeouts are actually useful features of bona fide takeover transactions and often function as a necessary element in a business acquisition. On the one hand (in my view), there is far too much litigation over the rights of minority stockholders in this context; on the other hand (also in my view), the results that are reached in the decided cases are often wrong or at least inadequately explained by the courts. One has the impression that the freezeout problem is too actively litigated at present, or to put it differently, that the litigation that is going on at such a great rate is not resolving anything, and is not producing rules of general application which lawyers can use effectively in planning legitimate transactions. As a body of doctrine, the field appears to be disintegrating rather than coming together—much to the profit of one section of the bar, to be sure, but with a correspondingly heavy cost to everyone else.

Why is there such a chaotic legal structure, and why such uncertainty? The answer, at least in part, is that the prevailing *common law* principles of fiduciary duty—chiefly "fairness" and "business purpose"—are too weak, too clumsy and ill-focused to cope with the complexities and subtleties of a case like *Santa Fe*. It is not enough, quite obviously, to say that managers and controlling stockholders have

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[10] Green v. Santa Fe Industries, Inc., 533 F.2d 1283 (2d Cir. 1976).

[11] Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).

[12] *Id.* at 479.

a fiduciary duty to the public stockholders. This only begins the analysis, as Justice Frankfurter observed;[13] the hard question is just what concrete legal obligations the fiduciary should be asked to meet. The answer, at present, is altogether uncertain, deriving as it does from the common law as developed in the state courts, or perhaps common law buttressed by some vague statutory extrapolation. One goes from case to case (and it is best, I think, to read these cases with one's eyes half closed) searching for doctrine. The process is that curious inferential one that we all become familiar with in law school when, reading the old-time torts and contracts cases, we try our best to locate the rules of decision by slightly altering the fact patterns or by speculating about the court's "true intent." This is a process we know and love, but whatever its values elsewhere, I do not think it works well in resolving issues of high finance.

The courts *have* made an effort to give content to fiduciary duty in the field of freezeouts by emphasizing a requirement of "fairness." To be accepted or tolerated as a legitimate use of majority power in dealing with a minority, the deal must be shown (the burden being on the defendant-proponent) to be "fair" to the corporation's public stockholders.[14] Prompted, perhaps, by Justice White's observations in *Santa Fe*, the Delaware court has recently added to the fairness requirements a further condition, namely, that the freezeout have a demonstrable "business purpose," meaning, presumably, a commercial justification over and above the mere elimination of the minority stockholders.[15] Fairness and business purpose, then, represent the affirmative content of fiduciary duty with respect to freezeout transactions, and it is to be said in advance that the Delaware courts have, on a few recent occasions, struck down several merger transactions on the ground that these criteria of legitimacy had not been met.[16]

From my standpoint, however, the complaint is *not* the one that Professor Cary and others have made over the years, namely, that the state courts (Delaware especially) have been inattentive to minority interests and have allowed majorities to run roughshod over the rights of the public stockholders. This may be true, but I find it hard to be very clear in particular cases that the minority is entitled to anything beyond fair treatment. Fairness evidently refers to price. But price of what? What are the property interests that belong to the minority in the first place—what is it that the law recognizes to be *theirs*? That this ques-

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[13] SEC v. Chenery, 322 U.S. 194 (1947).

[14] *See* Tanzer v. Int'l General Industries, Inc., 379 A.2d 1121 (Del. Ch. 1979); Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 20, 89 A.2d 862 (Del. 1952).

[15] Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977).

[16] *E.g.*, Roland Int'l Corp. v. Najjar, 407 A.2d 1032 (Del. 1979); Tanzer v. Int'l General Industries, Inc., 402 A.2d 382 (Del. 1979).

tion of entitlement can be a difficult one will be evident if one thinks back to the early development of Chapter X of the National Bankruptcy Act;[17] it was very much an open question—until the Supreme Court resolved it[18]—whether the "fairness" requirement in Chapter X meant that senior security holders in an insolvency reorganization could be paid off with new securities having a value less than the face amount of their old claims, whether they could be asked to engage in a little give-and-take with the juniors, or whether "fair" meant that the seniors had to be compensated in full before juniors would be allowed to participate in the reorganized firm. The Court resolved this issue in favor of absolute priority for seniors, but until it did there was great uncertainty about what the seniors really owned in the way of "property" and hence what price would, as a matter of *theory*, be considered fair.[19] Congress has recently acted to overthrow the absolute priority standard[20]—seniors can now accept less than full face amount if a majority of their class consents, so that the rule of give-and-take is once again acceptable. The obvious point is that "fairness," even taken to refer solely to price and excluding other possible elements, very much depends on what the law regards the affected party as owning to begin with. There is nothing self-evident about this. Entitlements need to be defined before they can be compensated and, if a definition is lacking, then what is "fair" cannot be known.

Just as there was for a time under old Chapter X, there is uncertainty now about entitlements in the freezeout field. Take the *Santa Fe* situation as an illustration once again. A parent owns ninety-five percent (95%) of the stock of a subsidiary and acts to eliminate the minority by paying them cash—in this instance $150 a share—for their stock. Was $150 fair? Delaware law holds the price to be fair if and only if it is equal to what the minority stockholders would have received in an arm's length deal with the majority. This sounds all right, but a moment's thought suggests a good many ambiguities. Thus, who are the presumed parties to this hypothetical arm's length transaction? The parent corporation is clearly on one side, but who is on the other? Is it the minority stockholders acting one by one, limited as to information and limited also in their willingness to incur costs and engage in prolonged bargaining? Or is it the minority as a group acting as if they were represented by bargaining agents just as skilled and knowledgeable as those who represent the parent? One could easily imagine that a different "arm's length price" would emerge if the minority were regarded as "unionized" than if they were viewed as scattered and relatively powerless.

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[17] Bankruptcy Act of 1898, 11 U.S.C. §§ 1 *et seq.* (1979).

[18] Consolidated Rock Products Co. v. DaBois, 312 U.S. 510 (1941).

[19] *See, e.g., In re* Atlas Pipeline Corp., 39 F. Supp. 846 (D.C. La. 1941).

[20] The Bankruptcy Reform Act of 1978, 11 U.S.C. § 1 *et seq.* (1979).

Other ambiguities can be mentioned. Given the statutory power of the majority to eliminate and in other ways to disfavor the minority, might it not be expected that the value of the public shares would fall to a discount once majority control had been acquired by the parent? Is it "fair" to reflect this discount in the price ultimately paid in the freezeout, or should the minority shares be priced as if there were no controlling majority? There is a type of circularity about this question that makes it hard to deal with. To its credit (or blame), the Delaware court in the past has sought to break out of the circle by stating frankly that since minority stockholders have *got* to expect a certain amount of oppression from the majority, their stock should be discounted accordingly.[21] It is, perhaps, not likely that the same bald assertion would be made today, but that really does not mean that it was wrong, then or now.

Perhaps not always, but at least sometimes, the merger of an operating subsidiary into its parent results in a higher overall value for the combined entity than the sum of the values of the parent and subsidiary as separate corporations, as illustrated by *Santa Fe*. Stock market multipliers, operating economies or tax savings may in a given instance result in synergy, with a more valuable economic aggregate actually emerging by reason of the act of combination. Perhaps this would be an example of the "business purpose" on which the Delaware court now insists. But in any event, who gets the increase? How is it shared? Do minority stockholders have a claim, and if so, to how much? The Delaware courts have rejected the argument that there should be a division of synergistic gains between parent and minority;[22] on the other hand, the Seventh Circuit Court of Appeals has held that any post-merger appreciation must be divided so as to produce an equal percentage return for the stockholders of *both* corporations.[23] Who is right? Once again, the question is one of how "property" is defined and of what ownership rights are said to attach to the minority (or majority) shares to begin with. As might be expected, the issue has been debated in the law reviews.[24] I doubt, however, whether this and other aspects of the fairness question will ever be resolved satisfactorily by courts operating under the constraints of precedent. My doubt is supported, as I have said, by the observable fact that the litigation over freezeouts rages on

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[21] Greene & Co. v. Schenley Industries, Inc., 281 A.2d 30 (Del. 1977).

[22] Tanzer v. Int'l General Industries, Inc., 379 A.2d 1121 (Del. Ch. 1979).

[23] Mills v. Electric Auto-Lite Co., 552 F.2d 1239 (7th Cir.), *cert. denied*, 434 U.S. 922 (1977).

[24] *See* Brudney and Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974). *See also* Lorne, *A Reappraisal of Fair Shares in Controlled Mergers*, 126 U. PA. L. REV. 955 (1978); Deutsch, *The Mysteries of Corporate Law: A Response to Brudney and Chirelstein*, 88 YALE L.J. 235 (1978).

and on, with no indication that reliable principles have begun to emerge.

In the end, I think it altogether unlikely that the solutions to the issues that arise will be found within the ambit of fiduciary theory *at all.* And in any case, it may be that the establishment of a "fair price" for the minority's stock is *not* the optimum way every freezeout case should be decided. In effect, "fair price" may not always be the means by which fairness can best be achieved. There are, after all, many other devices that are known to the law for accomplishing a fair outcome—disclosure, for example, or majority vote—and one or another or these procedures may be deemed more practical and appropriate in a given context than the long-standing price test. But if so—and I hope to demonstrate that it is so—then, clearly, a legislative initiative is called for. More refined devices—those especially that entail procedural remedies—are not within the reach of common law development. They are likely to be too specific and detailed for a court to create even when armed with powers of equity, and in any event would require statutory authorization just as the securities reforms of the 1930's did.

Though I will not win friends by drawing this analogy, it does seem to me that many of today's fiduciary problems—those, especially, that involve recapitalizations and reorganizations—are just as complex as certain of the problems that the federal income tax has had to deal with over the years. Everyone desires the simplification of the tax law, but there is recognition also that if we wish, as most do, to *solve* complex tax problems, statutory amendment and not common law evolution is required in many instances. A great many examples can be given, but perhaps Subchapter C itself, which contains the tax treatment of corporations and shareholders, comes most readily to mind. Common law efforts—including *Eisner v. Macomber*[25]—to distinguish between dividend and nondividend distributions ultimately failed and were displaced by statutory provisions.[26] The reason for this is that the issues were both complex and technical and were as urgent as the need for government revenues. Looking back, the notion that those questions could have been left to chance judicial action seems foolish, and no one now would be likely to suggest that the system should have been allowed to simply "evolve."

My conviction is that the same is true of many contemporary fiduciary issues. Whatever may have been acceptable in a simpler time, the problems of fair dealing that today beset the field of corporate finance require a legislative effort. This is true, as I have said, because the old principles—chiefly fair price, arm's length dealing and business purpose—are not adequate, are too clumsy and indiscriminate. We can do better, I think, and indeed one of the most appealing things about the

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[25] 252 U.S. 189 (1920).

[26] *E.g.*, I.R.C. §§ 302, 305, 306.

idea of a federal fiduciary standards act is that it would provide us with the opportunity to actually solve problems in the way we think is right. As I will try to show, the "right" solutions may very well *vary* from problem to problem, so that the legal techniques that are relevant in one context may not be the best in another. If we legislate, however, we are obviously free to use more than a single means or device for meeting difficulties, and this to me is a particularly attractive feature of the present proposal.

I can illustrate all this by returning to the freezeout issue once again. Really, the word should be "issues," because freezeouts are not a single or a unitary phenomenon, although the courts—mistakenly, in my view—often appear to suppose that all freezeouts can be lumped together. As I have argued elsewhere,[27] these transactions are actually amenable to a threefold classification. So classified, each *type* of freezeout presents a different fairness issue, and it seems likely that each should be dealt with differently. A simple "fair price" solution—even if we could agree on who owns what—will not work as well as other devices that can be thought of, but these entail and would require specific legislation.

The following, then, is an effort to break freezeouts down into three classes, and then to supply an appropriate solution for each. Having done this, I want to add yet a fourth problem—namely, how to cope with transactions resulting in the elimination of dividend arrearages on preferred stock. This of course is an old-time, familiar and much-deplored issue in the finance field; and it is a freezeout of a sort (sometimes, in fact, accomplished through a merger).[28] I include this fourth problem not because it has so much contemporary relevance but for the light it throws on the other three issues. It seems to me the one area in which "fair price" is indeed the best solution, whereas the others are better approached by less traditional means.

A. *Parent-Subsidiary Mergers*

One quite common setting for a freezeout transaction is that illustrated by *Santa Fe*: A parent corporation owning a controlling interest in a subsidiary decides to eliminate the publicly held minority shares by merging the subsidiary into itself. The public stockholders are paid off in cash or debt at a price determined by the parent to be fair. In today's climate, as I have said, such freezeout mergers are very often contested by someone who is prepared to argue that the price set by the parent is far too low. Before the Delaware Supreme Court's decision in

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[27] Brudney and Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978).

[28] Bove v. The Community Hotel Corp. of Newport, R.I., 105 R.I. 36, 249 A.2d 89 (1969).

Singer v. Magnavox,[29] the sole test appeared to be the one just stated—adequacy of price—with the litigating process chiefly involving the presentation of competing views by the parties' hired financial experts. In *Singer*, the Delaware court added a further requirement that the parent have a business purpose for the merger other than the mere elimination of the minority shares.[30]

Are these tests—fair price and business purpose—the right ones? I strongly doubt it. As noted already, the merger of parent and subsidiary may very well result in an increase in the value of the combined entity, and it is at least arguable that the subsidiary's stockholders should get some share of the increase. Just what share is a debatable question, but the idea that they should be limited to the pre-merger value of their interest—with the entire increase going to the parent—seems quite unjustifiable. Beyond this, however, I doubt whether a "business purpose" requirement is really as wholesome and desirable as it sounds. The elimination of minority interests in controlled subsidiaries is probably a good thing in and of itself. Allocation of overhead costs, of tax benefits, of opportunities for growth and diversification, etc., between the two entities often presents management with hard and time-consuming choices, and especially with respect to corporate opportunities, the fiduciary dilemma may really be impossible to resolve even by a management that wants to meet the highest standard of fair dealing.[31] It is not only on the occasion of a merger, but also in many other day-to-day situations, that the parent-subsidiary relationship creates conflicts and uncertainty. Indeed, merger may be the best and only way of resolving such conflicts once and for all. Hence, I think it can be argued that *Santa Fe*-type transactions are *inherently* desirable—that the elimination of actual and potential fiduciary conflict is an entirely adequate "purpose," and that no further justification need be called for.

If you agree with these conclusions—namely, that the merger of parents and partly owned subsidiaries is a healthy way of reducing legal and formal complexities, but also that "fairness" requires some sort of sharing of economic benefit between the two sets of stockholders—then perhaps the best solution would be (a) to permit such mergers *without* a showing of business purpose, but (b) to limit the *form* of the consideration permitted to be paid to the minority to the parent's common shares.[32] In effect, the merger of parent and subsidiary would be treated

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[29] 380 A.2d 969 (Del. 1977).

[30] *Id.*

[31] *See* David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427 (Del. 1968).

[32] Compare the SEC's rule 13e-3(g)(2), which provides an exception from the general disclosure requirements imposed by rule 13e-3 on going-private transactions for mergers in which the public stockholders are offered an equity interest of the same class in the acquiring parent. "The Commission believes that such

as acceptable on its face, but the use of debt or cash to pay off the minority would be prohibited. The merger would be "fair" under my standard if the minority stock in the subsidiary were exchanged for stock of the parent at a ratio which reflected the respective values of the two securities prior to the announcement of the merger. The effect would be to cause an equal sharing of post-merger benefits, if any; valuation problems would be minimized; and the subsidiary's stockholders would enjoy the same tax-free treatment on the exchange as the parent's do.[33]

This "solution," which bears some relationship to the Second Circuit's approach in *Santa Fe*, would of course override those state statutes which expressly or impliedly permit cash-out transactions. The underlying judgment that I am making is that it is improper to exclude the subsidiary's stockholders from continued participation in the combined entity. Hence the *only* permissible consideration is the parent's common shares. At the same time, it is inherently desirable that the two sets of stockholders be unified. Hence there is to be no additional business purpose requirement. I should add that if these features were adopted, I would eliminate appraisal rights entirely.

B. *Going Private*

The merger of an operating parent and subsidiary seems to me distinguishable from so-called going private transactions of the classic *Power/Mate* variety.[34] Parent-subsidiary mergers are aimed at homogenizing the public stock ownership of the enterprise by eliminating one of two sets of public stockholders. This move seems desirable in itself as a way of reducing conflict-of-interest problems, and it may also produce scale-economics or other corporate level business gains. Provided it is carried out without impairing the minority stockholders' interests, I would make no effort to deter it. By contrast, going-private transactions are aimed exclusively at returning the corporation to a closely-held status by liquidating the publicly held shares and leaving the inside stockholders in whole possession. A good deal has been written and said about the alleged unfairness of going private,[35] and without repeating all the arguments that have been made, I will simply state that I entirely agree with the view that a procedure aimed solely or primarily at forcing out the public stockholders because the insiders find it advantageous to increase their own percentage interest is violative of the insiders' fiduciary obligations.

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transactions are . . . outside the purpose of rule 13e-3 since all holders of that class of security are on an equal footing and are permitted to maintain an equivalent or enhanced equity interest." SEC Release No. 16,075 (Aug. 8, 1979).

[33] *See, e.g.*, Rev. Rul. 57-278, 1957-1 C.B. 124.

[34] *See* Berkowitz v. Power/Mate Corp., 135 N.J. Super. 36, 342 A.2d 566 (1975).

[35] *E.g.*, Note, *Going Private*, 84 YALE L.J. 903 (1975).

Assuming all agreed to this, the question is: what remedy? In this area, I think, an appropriate legislative solution might be to adopt a "best interest" test. In effect, going private—whether attempted by tender offer or merger into a new company or both—would be enjoinable unless shown to be in the "best interest" of the public stockholders. This test could not be met merely by showing that there was adequate disclosure, nor even that the tender offer or merger was fair from the standpoint of the price paid to the public stockholders. To sustain the transaction, its proponents would have to demonstrate that the elimination of public stock ownership was in the best interest of the public stock-owners themselves, that circumstances had arisen which made public investment undesirable to the public investors. If, for example, a company had sold its major operating divisions and was left with a single division whose operation was too small to justify public participation, then liquidation of the public shares might be sustained as being in the best interest of the public stockholders.

Not fairness nor disclosure by itself, therefore, but a demonstration that public stock ownership had grown onerous *to* the public stockholders, would be required to justify the effort to return the company to private ownership.

C. *Two-Step Mergers*

Yet another situation involving the elimination of a minority stock interest is a business acquisition which takes place in two discrete but related steps.[36] X Corporation desires to acquire sole ownership of Y Corporation. Unable to arrange a consensual merger, X tenders (or privately negotiates) for a controlling proportion of Y's shares. Having succeeded in acquiring control, X promptly merges Y into itself or its wholly owned subsidiary and in effect obtains one hundred percent (100%) ownership of Y's assets. This situation obviously differs from "going private" because the acquiring party, X, is an outsider which evidently thinks it can do better with Y's business than the existing management. It also differs from the merger of a parent-subsidiary which have been separately operated for an extended period. In the latter case, as I have tried to suggest, management has an equal obligation to the stockholders of both entities, which it is obliged to honor on the occasion of the merger. But in a case where merger is merely the second step in a unitary acquisition of the target company's assets, no equivalent burden or restraint should be imposed, and the acquiring company should be free to complete its acquisition plan by buying out the interest of the nontendering stockholders. In effect, the transaction should be treated the same as a straightforward asset purchase in

[36] *See, e.g.*, Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977).

which approval by a majority of Y's stockholders is binding on the minority.

In these circumstances, I would not impose a best-interest test, and I would not limit the form of consideration to the acquiring corporation's shares. Viewing the transaction as an asset acquisition by an outsider, I would allow X in effect to purchase a voting majority and then follow that purchase with an acquisition of the remaining shares for cash, if that is the form of consideration X prefers.

There is, however, one important constraint that I would impose on X—a constraint which follows naturally, I think, from the perception that tender-plus merger is really equivalent to a unitary asset acquisition. Very briefly, I would require that the intention to merge be announced at the time of the tender offer, and I would further require that the price paid in the merger be the same as (*i.e.*, no less than) the price previously paid in the tender.[37] All stockholders would then have received a pro rata distribution of the sale proceeds—just as in an asset sale followed by a liquidation—and all would have been made aware that acceptance of the tender offer was equivalent to a disposition of the entire company. If these requirements were met—with emphasis on the equal price condition—I would permit the nontendering stockholders of the target company to be forced out by the decision of a majority of their own cohort.

D. *Preferred Dividend Arrearages*

A very long-standing issue in the corporate finance field is what standard of fairness applies (if any) where the common stockholders of a company propose a plan of recapitalization to the preferred stockholders whose aim is the elimination of dividend arrearages on the preferred stock.[38] In some cases, perhaps, the elimination of arrearages can be defended on the ground that the company needs new equity capital to survive or expand. The difficult question, however, is whether the degree of sacrifice being proposed to (really, imposed on) the preferred stockholders is "fair." No fixed standard exists under Delaware or other state law, and the outcomes in the decided cases have seriously offended, and even outraged, many impartial observers.[39]

Several alternative fairness tests can easily be imagined, largely through analogy of Chapter X and other insolvency or quasi-insolvency

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[37] *See* rule 13e-3(g)(1), containing similar requirements. *But see* Toms, *Compensating Shareholders Frozen Out in Two-Step Mergers*, 78 COLUM. L. REV. 548 (1978).

[38] The best known decision on the subject is Federal United Corp. v. Havender, 24 Del. Ch. 318, 11 A.2d 331 (1940). *See also* Bove v. The Community Hotel, 105 R.I. 36, 249 A.2d 89 (1969).

[39] *See, e.g.*, Dodd, *Fair and Equitable Recapitalizations*, 55 HARV. L. REV. 780 (1942).

systems. The so-called investment value doctrine, which has been used to measure the claims of senior security-holders in corporate simplifications under the Public Utility Holding Company Act,[40] is an alternative which I myself find plausible because it appears to balance the interests of seniors and juniors in a way that recognizes the claims of each class.[41] Other commentators, however, have favored the stricter absolute priority approach of Chapter X.[42] Still others have suggested that the arrearages be treated as "funded," that is, as entitling the preferred stockholders to receive dividends on the arrearages themselves as if the latter represented additional preferred shares.[43]

The several alternatives could certainly be debated, but from my standpoint any one of them is superior to the present system, under which the terms of a recapitalization plan are almost entirely within the discretion of those who represent the common stock. In contrast to the first three problems, the solution here is not procedural but substantive. A fair price means the deal is fair. But the question of *what* is a fair price is not left wholly to judicial intuition.

Looking back over the "solutions" I have proposed to these four illustrative fiduciary problems, it appears that the best solution (at least *my* best) is a different one in each case. The parent-subsidiary merger, in my view, should be subject to a requirement that only common stock (not debt or cash) be used to take out the minority shares of the subsidiary. Going private might be policed by a "best interests" test under which the transaction would be prohibited unless supported by a showing that termination of public stock ownership (and not merely fairness of price) was in the interest of the public stockholders. Two-step mergers would be burdened with an advance disclosure and an equal price requirement. Preferred stock arrearage recapitalizations would have to meet a *specific* fair price standard, whether the investment value standard or some other.

One may, of course, disagree with these solutions, and I am far from denying the possibility that better answers might be fashioned with more thought and study. My very strong hunch, though, is that when the problems have been thought through, it will be found that concrete and specific solutions—rather than a vaguely framed fairness test—are desirable, and that different problems are best handled in very different

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[40] Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79-79z6 (1971).

[41] Eastern Gas & Fuel Assoc., 30 S.E.C. 834 (1950). *See* Note, *A Standard of Fairness for Compensating Preferred Shareholders in Corporate Recapitalizations*, 33 U. CHI. L. REV. 97 (1965).

[42] Brudney, *Standards of Fairness and the Limits of Preferred Stock Modifications*, 26 RUTGERS L. REV. 445 (1973).

[43] Latty, *Fairness—The Focal Point in Preferred Stock Arrearage Elimination*, 29 VA. L. REV. 1 (1942).

ways, sometimes by focusing on procedure, sometimes on disclosure, sometimes on price, and so on.

All of this, I believe, points clearly to the desirability of legislation in this area. The exercise of judicial intuition about what is fair will not suffice, because the problems are too complicated and various to be dealt with by common law analogizing. We need a Code of fiduciary standards, just as we have needed a securities code, a tax code and commercial code. On the dimension of complexity and variety, the problems in all these fields are pretty nearly on a par.

III. CHARACTER OF THE STATUTE

I am aware that I have, in a sense, argued my case backwards. I have tried to show how useful and necessary it is to have legislative solutions to current fiduciary problems, and I have assumed, without debate, that if we decided we wanted extensive legislation, we would naturally want it to be at the federal level and not at the state. But the matter is certainly not beyond argument, and although federal action seems clearly appropriate to me, it is desirable (very briefly) to mention the reasons that I find persuasive.

First, and most obviously, we are dealing here with phenomena that are not only national (or international) in scope, but that have no primary connection at all in most instances with the state of incorporation. As we all know, the decision to incorporate in Delaware (or wherever) is nothing more than a decision on the part of management to make applicable the company law of that state. Presumably, that law contains the rules that management wants to operate under, with the choice quite naturally reflecting a preference for rules that are least onerous and least likely to impose liabilities and other constraints on directors and officers. This is not by definition bad or evil. It does, however, confirm the very well known point that the state of incorporation has no interest in its charters that is vital to the integrity of its own policies. People who dwell within its borders are not more intimately affected by its company law than people dwelling elsewhere—speaking, of course, of public companies—and the lives that its citizens live, including the privileges and protections they enjoy, are uninfluenced thereby. In effect, though it sounds legally paradoxical, the state of incorporation has no significant claim to regulatory power other than by default of a proper exercise of federal authority. In purely jurisdictional terms, then, it appears to make no sense whatever for the laws of state X to govern intracorporate relationships of a firm that has offices and operations and, even more importantly, has stock and bondholders in every state of the Union and perhaps in almost every foreign country.[44]

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[44] Lorne, Book Review, 128 U. PA. L. REV. 1261, 1270 (1980).

It has been contended by a few, however, that the jurisdiction issue is not important anyway, and that the virtue of having *diverse* state company laws lies precisely in the freedom thereby afforded to companies to *choose* the law they wish to live by—and as a corollary, to give investors the same choice.[45] The capital markets are said to be at work in all of this. Companies that can give their investors a higher expected return under the less-confining law of Delaware will want to incorporate there; those who do better for their shareholders by accepting the stricter limits of California law will send their charters west. Companies that fail to "maximize" in this respect will see their shares fall in value and may be threatened by takeover (assuming, of course, that state law does not unduly impede takeovers in the first place). Hence, a company that incorporates in Delaware does so, in effect, because this is really best for its stockholders. Investors, in turn, will choose those securities whose issuer's goals are best adapted to their individual portfolio needs. Presumably, conservative investors will buy shares of companies incorporated in California, while those who prefer more risk and less restrictive laws will look for Delaware firms. Still others will diversify.

But though interesting and even ingenious, this approach, in my view, is simply too unrealistic to be taken seriously. Experience and observation suggest that investors operate on gross (though not unreasonable) assumptions about how insiders will behave, and that few, if any, investors—including sophisticated ones—are capable of anticipating decisions like *Levien v. Sinclair*,[46] *Cheff v. Mathes*,[47] or *Barrett v. Denver Tramways*.[48] At the least, it would require the most determined and costly sort of educational process to enable the market to assimilate those cases into the probabilistic calculation that determines stock prices. Perhaps one of the reasons for this is that the decisions are altogether counter-intuitive. Thus, common stockholders expect pro rata treatment—the investment contract implies as much. They do not expect valuable corporate opportunities to be taken over by the majority stockholder, and they do not expect corporate assets to be used by insiders for the purpose of retaining control. Likewise, preferred stockholders expect to come ahead of common stockholders with respect to dividends—again, the investment contract seems to say so. They do not expect their back dividend claims to be eliminated merely because the common stockholders foresee that profits will presently become available for distribution, and wish to elbow the preferred stockholders aside.

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[45] Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

[46] 280 A.2d 717 (Del. 1977).

[47] 41 Del. Ch. 494, 199 A.2d 548 (1964).

[48] 53 F. Supp. 198 (D. Del. 1943), *aff'd*, 146 F.2d 701 (3d Cir. 1944).

Security-holders do indeed expect to be treated "fairly," but they have no accurate perception about the limits placed on fiduciary conduct by the states in which their issuers are incorporated, and of course not one investor in a thousand would be likely to be sure which state that was. In effect, fiduciary risks are not and probably cannot be anticipated. As to the company's alleged search for a "best" system from the standpoint of business efficiency, moreover, the relationship between business goals and rules of fiduciary obligation is remote if it even exists. While some have argued that corporate managers would work harder if they were freed of various fiduciary restraints,[49] I believe that conventional salaries, stock options and other prearranged bonus plans furnish adequate incentives. Freedom to choose among available systems of fiduciary regulation relates to the separate self-interest of the fiduciary—usually his interest in retaining his position—and to little else.

It seems virtually self-evident to me that problems that are national in scope, and that have no unique relationship to the welfare of the citizens of any particular state, should be solved at the national level. Equally as obvious, the solutions should be uniform. The participants in the process—insiders and their advisers, on the one side, and casual investors on the other—are not equal in their bargaining positions, and hence the rules of the game need to be established externally. The customary social advantage of pluralism and "freedom to choose" do not exist in this context any more now than when the New Deal securities statutes were enacted. The present diversity of company laws simply adds up to uncertainty for investors, and very often to surprise and defeated expectations.

Yet despite my fairly strongly held views on this subject, I would proceed cautiously and on a step-by-step basis towards the adoption of federal fiduciary standards. As I have said, the great appeal for me is in having a chance to *solve* problems and to do so in specific ways. I am not really interested in substituting a federal common law of fairness for state common law. While such a substitution might lead to greater uniformity, there is no reason to think that it would lead to correct solutions and not much reason to think that the problems would be better handled than they are now. Once again, I think that specific rules are needed—rules that lawyers can apply in the planning stage—and if this approach is taken, it seems reasonable to go forward, but on a limited basis. As noted, the freezeout area seems to be a promising place to begin. The issues are well understood, and one would suppose that a consensus of some sort could now be reached by the experts. There are plenty of cases on the merger of affiliates; the SEC has in the past few years devoted much effort to the going private phenomenon and could

[49] H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966).

undoubtedly make useful legislative proposals at this time. Our typology of freezeouts is pretty well in hand at present; there has been extensive debate in the law reviews and elsewhere; and I think many lawyers and their clients would welcome a resolution of the problem.

Speaking of the SEC, I would not give the agency any more than an advisory role in respect to the new statute. Enforcement of the new standards would be through the conventional medium of private law suits, and the SEC would not be given its customary rule-making authority. In this respect the new statute (as I conceive it) would have much less of an administrative component than the present securities laws. I am not, after all, proposing a disclosure statute—where perhaps a monitoring authority is necessary—but a "company law," whose enforcement and interpretation, like the company laws of the states, would be left to the courts.

One final, but I think important, observation: Any new federal law in the fiduciary field should be fully preemptive. This is consistent with my notion that there are, indeed, correct solutions for fiduciary problems, and that other solutions, even if apparently more rigorous, should be barred. State takeover laws are, of course, an obvious illustration. These laws weight the scales in favor of incumbent management; they are disruptive—Senator Metzenbaum has called the Ohio law "an abomination"[50]—and cannot be justified on investor protection grounds. The only rational response is federal preemption, and I would take the same approach in the other areas in which a federal policy is developed.

IV. CONCLUSION

A federal fiduciary act is not the only legislative possibility in the company law field. A bill calling for outside directors and other uniform rules for public companies has been proposed by Senator Metzenbaum's subcommittee; Professor Cary has proposed a *minimum* standards act; other reformers have sought to revive the old federal incorporation idea. I have no great enthusiasm for any of these proposals, as it happens, but I do not pretend to have analyzed them in detail. It does seem to me that they are either not ambitious enough, or else go too far in the direction of federal intervention. By contrast, I think that a cautious move towards uniform fiduciary standards—after so many years of "experimentation" at the state level—would be an important and predictable, but also a suitably limited, way of improving the nation's company laws. Litigation, as I have said, is far too active in this field. The need is for reliable rules of uniform application, and I think we are in a position now to make a good beginning.

[50] *The Role of the Shareholder in the Corporate World: Hearings Before the Subcomm. on Citizens and Shareholders Rights and Remedies of the Comm. on the Judiciary*, 95th Cong., 1st Sess. 142 (1977). *See also* Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 287-89 (1977).