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There Is No Affirmative Action for Minorities, Shareholder and Otherwise, in Corporate Law

In *Minorities, Shareholder and Otherwise*, Anupam Chander argues that, unlike constitutional law, "corporate law places minorities at the heart of its endeavor."[1] Central to his project is an empirical claim that corporate law has an "elaborate framework" for "protecting minority interests in the corporation."[2] In Chander's view, it thus is corporate law, not constitutional law, that is truly equipped to deal with issues such as fairness, oppression, and power.

It is a very clever thesis, which is quite well executed. Most important, it is quite novel, which is what really counts. Academics do not get rewarded with tenure, promotions, or *The Yale Law Journal* slots for being right; they get rewarded for having smart and novel ideas. When Edmund Burke warned us to be wary of "sophisters, economists, and calculators,"[3] however, it doubtless was because there is a positive correlation between an idea's novelty and the likelihood it will prove wrong.[4]

Chander overstates the extent to which corporate law values principles like equal treatment. To the contrary, corporate law explicitly permits discrimination among shareholders. Consider, for example, the discriminatory

1. Anupam Chander, *Minorities, Shareholder and Otherwise*, 113 YALE L.J. 119, 119 (2003).

2. *Id.* at 123.

3. EDMUND BURKE, REFLECTIONS ON THE REVOLUTION IN FRANCE 238 (J.C.D. Clark ed., Stanford Univ. Press 2001) (1790).

4. My critique of Chander's analysis will focus mainly on the underlying premise or, to put it another way, on showing that his analysis of corporate law doctrine is fundamentally flawed.

self-tender offer validated in *Unocal*[5] or the discriminatory aspects of the poison pill validated in *Moran*.[6] In both cases, boards were permitted to discriminate amongst shareholders, treating one shareholder differently than the rest.

Likewise, corporate law permits boards of directors to discriminate amongst classes of stock so long as they do not breach the contractual duties owed to the class being discriminated against.[7] Chander claims "*Zahn v. Transamerica Corp*. shows how the obligations of controlling shareholders devolve on the board of directors, which must act disinterestedly with respect to the various classes of shareholders."[8] But that claim is simply wrong. Properly understood, *Zahn*[9] is a case about conflicts between classes, not about the duties of a controlling shareholder.[10] More importantly, however, the holding of the case is not that directors must "act disinterestedly" among various classes of stock. To the contrary, when viewed in context, the gist of the case is that the board had a duty to comply with the corporation's "contractual obligations to the Class A holders," but their "primary duty was to maximize the value of the Class B shares."[11]

An even more critical problem, however, which goes to the heart of Chander's project, is the extent to which he overstates corporate law's concern with protecting the interests of minority shareholders.

At the outset, we need to identify which body of corporate law is relevant to the project. Chander opines, for example: "Cases from California and Massachusetts go further still, demanding duties from controlling shareholders that mirror those typical of a partnership."[12] Those cases, however, are concerned with the relative rights and duties of shareholders of closely held corporations. For example, Chander cites *Donahue v. Rodd Electrotype Co.*[13] in

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5. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (upholding a defensive self-tender offer by the target of a hostile takeover bid that discriminated against the hostile bidder—which owned approximately thirteen percent of the target's stock—by precluding the bidder from tendering shares into the self-tender offer).

6. Moran v. Household Int'l., Inc., 500 A.2d 1346 (Del. 1985) (upholding a poison pill defense pursuant to which, inter alia, target company shareholders could buy additional target shares at a steep discount to market despite the fact that the pill discriminated against the hostile bidder by precluding it from buying stock at that favorable price).

7. *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 340-42 (2002) (discussing the *Transamerica* litigation).

8. Chander, *supra* note 1, at 139.

9. 162 F.2d 36 (3d Cir. 1947).

10. BAINBRIDGE, *supra* note 7, at 342.

11. *Id.* at 340-42.

12. Chander, *supra* note 1, at 139.

13. 328 N.E.2d 505 (Mass. 1975).

support of his claim, but the decision in that case expressly limited "the applicability of our holding to 'close corporations' . . . ."[14]

The *Donahue* precedent, moreover, subsequently was superseded and modified by *Wilkes v. Springside Nursing Home*,[15] which held that there must be a balance between the fiduciary duty of the majority to the minority and the majority's "*rights* to what has been termed '*selfish ownership*' in the corporation . . . ."[16]

In any case, the analogy between close corporations and the body politic seems weak, at best. Granted, close corporations are somewhat like the body politic because exit is costly in both, while secondary capital markets make exit from public corporations quite easy. Yet, because close corporations are often described as "incorporated partnerships,"[17] the analogy with the body politic breaks down quite quickly. Partnerships make decisions by consensus, which they can do because partners typically have comparable interests (profit maximization) and equal access to information. In a pluralistic body politic, those conditions do not hold, and decisionmaking must be effected through the exercise of authority. As such, the body politic most closely resembles the public corporation, where authority-based decisionmaking also prevails.[18]

This distinction is critical because fairness concerns—while admittedly still present—are far more attenuated in the law of public corporations than in that governing close corporations. In *Sinclair Oil Corp. v. Levien*,[19] the Delaware Supreme Court held that two standards of review are potentially applicable to transactions between a controlling shareholder and the dominated corporation, to wit: the business judgment rule and the intrinsic fairness standard. The latter, far more exacting, standard "will be applied only when the fiduciary

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14. *Id.* at 511.

15. 353 N.E.2d 657 (Mass. 1976).

16. *Id.* at 663 (emphasis added). Post-*Donahue* cases in Massachusetts also suggest that fiduciary duties in closely held corporations are subject to be trumped, albeit to an uncertain extent, by contract. *See, e.g.*, Blank v. Chelmsford OB/GYN, P.C., 649 N.E.2d 1102, 1105 (Mass. 1995) (holding that "questions of good faith and loyalty with respect to rights on termination or stock purchase do not arise when all the stockholders in advance enter into agreements concerning termination of employment and for the purchase of stock of a withdrawing or a deceased stockholder"). Chander's claim that "the contractarian victory is incomplete," Chander, *supra* note 1, at 123, is thus called into question.

17. Indeed, the *Donahue* court itself stated that "the close corporation bears striking resemblance to a partnership." 328 N.E.2d at 512.

18. *See* BAINBRIDGE, *supra* note 7, at 197-204 (explaining why public corporations rely on authority rather than consensus in making decisions).

19. 280 A.2d 717 (Del. 1971). In *Nixon v. Blackwell*, 626 A.2d 1366 (Del. 1993), the Delaware Supreme Court indicated that the *Sinclair Oil* precedent applies to both public and close corporations.

duty is accompanied by self-dealing . . . ."[20] Self-dealing, moreover, occurs only when the controlling shareholder receives some benefit "from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary."[21]

Chander cites *Sinclair* for the position that "the Delaware Supreme Court held that the parent corporation of a majority-owned subsidiary had violated its fiduciary obligation as a controlling shareholder by using its power to cause the subsidiary to fail to enforce a contractual right against another subsidiary of the parent corporation."[22] He fails to remind the reader, however, that in that case the plaintiff challenged three transactions between the controlling stockholder and the subsidiary. The Delaware Supreme Court held that two of those transactions were insulated from judicial review by the business judgment rule.

Chander's omission of the *Sinclair Oil* standard of review and the full outcome of the case is critical, because it is fatal to one of the key parts of his argument; namely, Chander's treatment of the sale of control cases. Chander focuses here on *Perlman v. Feldmann*.[23] He concedes *Perlman* is controversial.[24] It is more than just controversial, however. It is an outlier. The overwhelming weight of authority confirms that a controlling shareholder is free to sell at any price he or she can get, without having to share the premium with the minority or providing an alternative exit for the minority, absent usurpation of a corporate opportunity or sale to a looter.[25]

Perlman and its ilk do not, as Chander claims, ask "*which rule makes minority shareholders better off*?"[26] Nor does it adopt a "Rawlsian egalitarianism," under which unequal treatment is permissible only if "it benefits the least well off."[27] Instead of mandating that a controlling shareholder give minority shareholders an equal opportunity to sell their stock, *Perlman* simply held that a controlling shareholder may not usurp an opportunity that should have benefited all shareholders. One could have reached the same result under a

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20. Sinclair Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

21. *Id.*

22. Chander, *supra* note 1, at 139.

23. 219 F.2d 173 (2d Cir. 1955).

24. Chander, *supra* note 1, at 131.

25. For statements of the general rule, see Treadway Companies, Inc. v. Care Corp., 638 F.2d 357, 375 (2d Cir. 1980); Clagett v. Hutchison, 583 F.2d 1259, 1262 (4th Cir. 1978); Zetlin v. Hanson Holdings, Inc., 397 N.E.2d 387, 388 (N.Y. 1979); Tryon v. Smith, 229 P.2d 251, 254 (Or. 1951); Glass v. Glass, 321 S.E.2d 69, 74 (Va. 1984).

26. Chander, *supra* note 1, at 131.

27. *Id.* at 131.

standard *Sinclair Oil*-based analysis, since the controlling shareholder received a benefit "to the exclusion and at the expense" of the minority.

This is critical, because it goes to the heart of Chander's project. Early in the article, for example, he claims that: "At the same time that constitutional law moves to limit affirmative action for racial minorities and women, corporate law embraces affirmative action for minority shareholders."[28] As we see from both *Sinclair Oil* and *Perlman,* however, while corporate law ensures that the majority may not benefit itself at the expense and to the exclusion of the minority, corporate law does not require the majority affirmatively to benefit the minority at its own expense. There simply is no corporate law version of affirmative action.

As another example, consider former Delaware Chancellor William Allen's opinion in *Mendel v. Carroll*.[29] The Carroll family, which collectively controlled Katy Industries, Inc., proposed a freeze-out merger that would have cashed out the minority shareholders at about twenty-six dollars per share. Sanford Pensler made a competing offer at about twenty-eight dollars per share. The Carroll Family withdrew their merger proposal, but also announced that they had no interest in selling their shares. Their opposition to the Pensler proposal effectively precluded the minority shareholders from selling to Pensler and, thereby, getting a premium for their shares. The minority shareholders sued, alleging that the Carroll Family violated its fiduciary duties and the board of directors violated its fiduciary duties. Chancellor Allen held: "The board's fiduciary obligation to the corporation and its shareholders . . . does not authorize the board to deploy corporate power *against* the majority stockholders, in the absence of a threatened serious breach of fiduciary duty by the controlling stock."[30] *Mendel* thus illustrates the extent to which corporate law tolerates majority hegemony. The controlling shareholders had no obligation to renounce thought of self or to affirmatively benefit the minority.

In sum, Chander's theoretical construct rests on a doctrinal foundation of sand. He persistently overstates the extent to which corporate law protects minority shareholders, while understating the freedom that law gives majority shareholders.

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28. *Id.* at 110-120.

29. 651 A.2d 297 (Del. Ch. 1994).

30. Mendel v. Carroll, 651 A.2d 297, 306 (Del. Ch. 1994).

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