FAIRNESS AND TRUST IN CORPORATE LAW

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INTRODUCTION

Why has corporate fiduciary law abandoned trust? How does this abandonment affect fiduciary relations? In this Article, I will argue that courts and legislatures unwittingly have destroyed the fiduciary fabric of corporate law by developing doctrine for the convenience of those in power without regard to the fundamental integrity of the corporate enterprise. They have done so by disregarding the essential role of trust in corporate law.

Trust is the glue that binds corporate relationships. No matter how strong the legal rules requiring fiduciary loyalty are, no matter how successfully the market aligns a fiduciary's self-interest with corporate interest, trust is essential for corporate survival. In the absence of some measure of trust between those who invest their money and those who manage it, the corporation cannot succeed as an efficient business entity. This basic fact, virtually ignored in the corporate law literature, gives rise to a number of questions, not the least of which is: Trust in what? The answer given by fiduciary doctrine is trust in the corporate fiduciary's fairness; that is, that in dealing with the corporation in his own behalf, the fiduciary will treat the corporation fairly.

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Fairness is an odd concept in fiduciary law. The traditional view of fiduciary obligation was that self-dealing by the fiduciary was itself wrongful. The idea was that the fiduciary worked in the beneficiary's interests and that this arrangement was possible only if the fiduciary was precluded from thinking of himself while dealing with matters within the scope of the fiduciary relationship. Fairness, a bi-polar concept, could not enter into the picture because the traditional fiduciary relationship ran only one way: from fiduciary to beneficiary.

By replacing traditional fiduciary rules with the concept now known as the fairness test, courts opened up the examination of self-dealing transactions to consider the fiduciary's interest as well.¹ Fairness, as defined by and as used throughout our legal system, is a concept of balance, of proportionality among the parties to a transaction or proceeding. It is a concept that largely has developed in connection with questions of the justice of contractual and procedural arrangements.² It is a concept that, in our society, focuses on process, rather than substance.³ As such, fairness is a concept that has little need for trust; it is a concept that attempts to replace trust.⁴

In developing the fairness test, courts have replaced the central notion of trust in fiduciary relationships with this process-oriented concept of fairness. Although in doing so they have retained the rhetoric of fiduciary obligation, they have stripped it of meaning. The fairness test, which has been applied to directors and officers⁵ as well as to controlling stockholders,⁶ has been de-

1. See *infra* Section V(B).

2. See, e.g., John W. Chapman, *Justice and Fairness*, in JUSTICE: NOMOS VI 147, 155-56 (Carl J. Friedrich & John W. Chapman eds., 1963) (discussing fairness as an inherently procedural concept); Michael Rosenfeld, *Contract and Justice: The Relation Between Classical Contract Law and Social Contract Theory*, 70 IOWA L. REV. 769 (1985) (discussing the formal, process-oriented concept of contractual justice as the foundation of liberal society).

3. Chapin, *supra* note 2, at 155-56.

4. Cf. NIKLAS LUHMANN, TRUST AND POWER (1979) (analyzing concepts functionally equivalent to trust). For further exploration of this point, see *infra* notes 205-22 and accompanying text.

5. See, e.g., *Spach v. Bryant*, 309 F.2d 886, 888-89 (5th Cir. 1962) (applying Florida law and finding that stockholders or officers must show the "inherent fairness and good faith" of the transaction); *Fleigler v. Lawrence*, 361 A.2d 218, 221 (Del. 1976) (where officers and directors stood on both sides of a transaction between two corporations, they must meet the burden of showing "intrinsic fairness" of such transaction); *Underwood v. Stafford*, 155 S.E.2d 211, 212-13 (N.C. 1967) (officers and directors possess fiduciary

scribed as strict and searching.⁷ At the same time, courts generally have acknowledged that fairness contemplates a range of values and fiduciary conduct that properly is analyzed within the totality of a transaction's circumstances.⁸ Predictably, in light of the fairness test's bi-polarity and focus on process, the circumstances in which a fiduciary has been found to violate this fairness standard are relatively few; overreaching or misconduct of the grossest variety has become the touchstone.⁹

Perhaps this result is as it should be. Courts and commentators have widely recognized the substantial discretion required of directors and officers in the conduct of a corporation's business as well as the practical reality that self-dealing sometimes may be unavoidable and even beneficial.¹⁰ Some believe that the various

obligation toward corporation, and must show "full disclosure and fair dealing" when a conflict of interest arises).

6. See, e.g., *Perlman v. Feldman*, 219 F.2d 173, 175 (2d Cir.) (applying Indiana law and finding that a controlling stockholder owes a fiduciary obligation to minority stockholders and the corporation), *cert. denied*, 349 U.S. 952 (1955); *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464, 472-73 (Cal. 1969) (finding that controlling stockholders owe a duty of "inherent fairness" to minority stockholders and the corporation); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (finding that a parent corporation owes a fiduciary duty to its subsidiary when the parent is represented on both sides of transaction); *Case v. New York Cent. R.R.*, 204 N.E.2d 643, 645-46 (N.Y. 1965) (finding that a majority stockholder is required to engage in "fair dealing" with minority stockholders).

7. See, e.g., *Mayflower Hotel Stockholders Protective Comm. v. Mayflower Hotel Corp.*, 193 F.2d 666, 671 (D.C. Cir. 1951) (applying District of Columbia law and describing the test as requiring "careful scrutiny"); *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66, 74 (Cal. Dist. Ct. App. 1952) (same); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (describing the fairness test as "unflinching in its demand" that the proponent of a conflict-of-interest transaction prove "utmost good faith" and "the most scrupulous inherent fairness"); *Johnson v. Witkowski*, 573 N.E.2d 513, 521 (Mass. App. Ct. 1991) (referring to vigorous scrutiny).

8. See 3 MODEL BUSINESS CORP. ACT ANN. § 8.61, official cmt. (1993) ("It has long been settled that a 'fair' price is any price in that broad range which an unrelated party might have been willing to pay or willing to accept . . .").

9. See, e.g., *Chesapeake Constr. Corp. v. Rodman*, 261 A.2d 156, 158 (Md. Ct. Spec. App. 1970) (finding that an officer and owner of 75% of corporation's stock who sold property to corporation significantly above market value, failed to show "fairness, adequacy, and equity" of the transaction); *Bentz v. Vardaman Mfg. Co.*, 210 So. 2d 35, 40-41 (Miss. 1968) (finding that a corporate vice president, who tortiously influenced the corporation's failure to conform to an agreement with another corporation of which he was a director, failed to establish fairness of the transactions).

10. See, e.g., MODEL BUSINESS CORP. ACT ANN. subch. F, introductory cmt. ("[I]n many situations, the corporation and the shareholders may secure major benefits . . . despite the presence of a director's conflicting interest."); *Swafford v. Berry*, 382 P.2d 999, 1002 (Colo. 1963) (noting that a director's fiduciary duty does not prevent that director from doing business with the corporation for a profit); *Marciano v. Nakash*, 535

markets that revolve around the public corporation create sufficient incentives for corporate fiduciaries to act in the corporation's interest.¹¹ Others have relied on a vigorous plaintiffs' bar, together with federal disclosure requirements, to discipline errant managers.¹²

Perhaps this confidence is appropriate, but I doubt it. Although fairness defines the concept of the corporate fiduciary, it is itself one of the great unexplained mysteries of corporate law. One searches the cases in vain for any explanation of the meaning of fairness or of the propriety of using a fairness test to evaluate fiduciary conduct. The modest amount of scholarly commentary that exists focuses mainly on the circumstances in which the fairness test applies and on allocations of burdens of proof.¹³ Little time has been spent considering exactly what fairness means, whether any conception of fairness is even an appropriate measure of fiduciary conduct, and whether preferable, workable measures of fiduciary obligation exist.

A.2d 400 (Del. 1987) (finding that a director's self-interested loans to corporation were fair because loans were not available elsewhere).

11. See, e.g., Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

12. See, e.g., James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984).

13. What little literature there is on fairness is mostly limited to an examination of the concept in specific contexts. Among the more thoughtful examples are Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974) (focusing on mergers, although suggesting an extension of the analysis to other areas); Diedre A. Burgman & Paul N. Cox, *Reappraising the Role of the Shareholder in the Modern Public Corporation: Weinberger's Procedural Approach to Fairness in Freezeouts*, 1984 WIS. L. REV. 593 (analysis in context of freeze-out mergers); Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351 (1989) (arguing that fairness primarily is substantive fairness but detecting an evolution towards a new duty of independence); David M. Phillips, *Managerial Misuse of Property: The Synthesizing Thread in Corporate Doctrine*, 32 RUTGERS L. REV. 184 (1979) (discussing fairness generally); Michael B. Goldberg, Note, *The Fiduciary Duty of Parent to Subsidiary Corporation*, 57 VA. L. REV. 1223 (1971) (focusing on parent-subsidiary transactions); Robert D. Kodak, Comment, *The Corporate Fiduciary Duty Doctrine and the Requirement of Fairness in Parent-Subsidiary Relations*, 76 DICK. L. REV. 237 (1972) (same); Note, *Corporate Fiduciary Duty in the Context of Parent-Subsidiary Relations*, 74 YALE L.J. 338 (1964) (same); Comment, *"Interested Director's" Contracts—Section 713 of the New York Business Corporation Law and the "Fairness" Test*, 41 FORDHAM L. REV. 639 (1973) (analysis of fairness in context of interested directors of corporation); Note, *Review of Board Actions: Greater Scrutiny for Greater Conflicts of Interest*, 103 HARV. L. REV. 1697 (1990) (focusing on boards of directors in takeovers).

My answers to these questions center around the essential need for trust in corporate relationships and the potential for fiduciary duties to serve the function of establishing the basis for such trust.¹⁴ I hope to demonstrate the complete judicial failure to recognize this potential and to show the way in which the fairness test replaces meaningful, trust-reinforcing concepts of fiduciary duty with superficial procedures that easily mask disloyalty. I also hope to demonstrate the economic inequity of the fairness test by showing that it gives the corporate fiduciary an unwarranted, undisclosed, and self-determined financial interest in the corporation's assets.

In Part I, I analyze the concept of trust and its potential and actual roles in corporate law. I outline the circumstances under which the fairness test applies as well as judicial articulations of its content in Part II. Part III plumbs the depths of decisional and statutory law to prove that the fairness test provides a very weak procedural check, and virtually no substantive check, on fiduciary self-dealing. I turn to the fairness test and examine it within the framework of a trust model of fiduciary relationships to conclude in Part IV that the test is at best misapplied and at worst misconceived. Finally, I depart from the trust model in Part V to consider the economic effect of the fairness test after rationalizing its different applications into a typology of conflicts of interest.

Ultimately, the application of any form of fairness test to the vast majority of conflicts creates in the fiduciary a secret and unwarranted financial interest in the corporation's assets. Nonetheless, in a small number of conflicts involving controlling stockholders, a fairness test appropriately accounts for the fiduciary's legitimate financial interest in the corporation. I propose eliminating the fiduciary's interest when it is undeserved, thereby helping to restore the basis for trust, while retaining a procedural fairness approach in the cases in which the fiduciary has a legitimate financial interest.

14. My concern in this Article is with the fairness test as a general concept. I make no distinction between close and public corporations because the conclusions I reach herein are, I believe, equally applicable to both types of corporations. One might decide on policy grounds, however, to react differently to these conclusions based on the type of corporation at issue.

I. TRUST: THE FOUNDATION FOR CORPORATE EXISTENCE

A. *Why Fiduciary Relationships?*

Courts and scholars typically take for granted that the relationships among directors, officers, and, to a lesser extent, controlling stockholders and their corporations are fiduciary in nature. As a consequence, they rarely explore the reasons for treating these relationships as fiduciary. Therefore, it may be helpful to start by reflecting on the reasons for recognizing fiduciary relationships at all and by considering the role of fiduciary law in helping to maintain them. I will focus on the power disparities giving rise to fiduciary relationships¹⁵ and consider one role of fiduciary law that has been almost entirely ignored in corporate law. This is the role of fiduciary law in shoring up the trust necessary to induce stockholders to enter into the corporate relationship in the first place.

Fiduciary relationships are, characteristically, relationships of trust and dependency in which the dependent party (the beneficiary) has ceded control over some portion of her life to the power-holding party (the fiduciary) with the expectation that the power-holding party will exercise that control for her benefit.¹⁶ Corporate relationships obviously reflect this essential characteristic: directors have largely unlimited power over the corporation and its affairs, and controlling stockholders easily can override the will of minority stockholders on the few occasions when stockholder action is required. Most commonly, this power is reflected in the election of directors, but it also can be used in such occasional transactions as mergers, sales of control, sales of significant assets, and the dissolution of the corporation.

The power and control that are present in all fiduciary relationships are exaggerated in the corporation because the indeterminate length of the enterprise and the practically infinite array of investment opportunities for the corporation make any possibility of specified limitations on directors' power or ongoing control by the stockholders unrealistic. Legislatures and courts both have recognized this fact, the former in narrowly limiting the circum-

15. These power relationships also are usefully explored in Bernard Williams, *Formal Structures and Social Reality*, in *TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS* 3 (Diego Gambetta ed., 1988).

16. This definition of fiduciary relationships is further developed in Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675, 1684-87 (1990).

stances in which stockholder voting is required, and the latter in developing doctrines that generally preclude stockholders from using the judicial process to inquire into the merits of business decisions.¹⁷ In effect, once a stockholder invests her money in a corporation, she loses all control over the use, disposition, and return of that money, except for the possibility of recovering her investment by selling it on the market for what she can get (and sometimes that option is limited or unavailable).¹⁸

Given these realities, why would anybody invest money in a corporation, an entity over which she has no control? The obvious answer is that she expects to receive something in return, presumably in the form of increased wealth.¹⁹ Coupled with this expectation is the stockholder's trust that corporate fiduciaries will act in her interest to achieve that goal. Stockholders trust that corporate fiduciaries will use their funds to provide a desirable return at an acceptable level of risk and thus are willing to put their money into a corporation, rather than, say, treasury bills. To recognize that stockholders exhibit such trust fails to answer the important questions: Why do they exhibit such trust, and how is it maintained? In particular, how does the trust stockholders exhibit relate to the fiduciary obligations corporate law imposes? To address these questions, we must begin with an understanding of the nature and function of trust.

17. For a discussion of the limited nature of stockholders' voting rights, see ROBERT C. CLARK, *CORPORATE LAW* § 3.1.1 (1986). For a discussion of the principal judicial doctrine, known as the business judgment rule, see *infra* notes 34-35 and accompanying text.

18. One important limitation on this option is fiduciary misconduct's potential effect on value. The option is largely unavailable in close corporations. See, e.g., *Donahue v. Rodd Electrotape Co.*, 328 N.E.2d 505, 515 (Mass. 1975) (noting the practical difficulties faced by close corporation shareholders who want to sell their shares).

19. The traditional view of a corporation's purpose is to increase stockholder wealth. See, e.g., *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919); see also AMERICAN LAW INSTITUTE, *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 2.01 (Proposed Final Draft 1992) [hereinafter ALI, *PRINCIPLES*] (stating that the corporation's purpose is "corporate profit and shareholder gain"). Although there have always been challenges to the view of corporate profit as the sole measure of corporate existence, recently there has been significant challenge to the view that stockholders ought to be the exclusive beneficiaries of increased corporate wealth. For a discussion of some of these challenges, see David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223 (1991); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579 (1992). See also Symposium, *New Directions in Corporate Law*, 50 WASH. & LEE L. REV. (forthcoming March 1994).

B. *The Nature and Function of Trust*

Surprisingly, little has been written directly on the subject of trust.²⁰ Only recently have moral philosophers and sociologists attempted to define the concept and understand its role in our society.²¹ Among those who have addressed the issue, one general point of agreement appears to be that by definition, trust is concerned with the intentions of the trusted.²² Another point of agreement is that a major function of trust is to help reduce the uncertainty and complexity of life in society.²³ The limits of individual knowledge are such that we need mechanisms to help us extrapolate from our experiences when we encounter new situations. Trust is such a mechanism. Without trust, we would be overwhelmed by the world around us.

Seen in this light, trust serves a largely organizing function. As the sociologist Niklas Luhmann puts it, "[A] complete absence of trust would prevent [a man] even from getting up in the morning."²⁴ The destruction of trust, then, would be the destruction of

20. See BERNARD BARBER, *THE LOGIC AND LIMITS OF TRUST* 3 (1983) (observing the more broad-based failure of scholars in various fields to define and deal with the concept of trust); Annette Baier, *Trust and Antitrust*, 96 *ETHICS* 231, 232 (1986) (noting the paucity of literature on trust in moral philosophy); see also Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 *CORNELL L. REV.* 899, 929-30, 954-57 (1993) (discussing trust and noting the paucity of academic discussion of the subject). Extensive searches in various indices, textbooks, encyclopedias, and digests reveal little more on the subject than what is cited here.

21. See e.g., SISSELA BOK, *LYING: MORAL CHOICE IN PUBLIC AND PRIVATE LIFE* (1978); VIRGINIA HELD, *RIGHTS AND GOODS: JUSTIFYING SOCIAL ACTION* (1984); LUHMANN, *supra* note 4; Annette Baier, *Trust and Its Vulnerability*, 13 *TANNER LECTURES ON HUMAN VALUES* 109 (1992); Annette Baier, *Sustaining Trust*, 13 *TANNER LECTURES ON HUMAN VALUES* 136 (1992); Peter H. Kahn, Jr. & Elliot Turiel, *Children's Conceptions of Trust in the Context of Social Expectations*, 34 *MERRILL-PALMER Q.* 403 (1988).

22. The only discrete and explicit definition of trust I was able to find is Annette Baier's: "Trust . . . is reliance on another's good will . . ." Baier, *supra* note 20, at 234; see also *id.* at 240 (refining the definition of trust); cf. HELD, *supra* note 21, at 65 ("Persons who trust one another agree somehow not to take advantage of one another, not to advance their own interests at the expense of the other's interests."). More characteristic is Luhmann's approach to trust, which functionally (as opposed to conceptually) defines trust. See LUHMANN, *supra* note 4. I have largely followed that approach here.

23. LUHMANN, *supra* note 4, at 15; see also JOHN DUNN, *Trust and Political Agency*, in *INTERPRETING POLITICAL RESPONSIBILITY* 26, 26 (1990) (trust is "concerned with coping with uncertainty"); cf. HELD, *supra* note 21, at 65-66 (same).

24. LUHMANN, *supra* note 4, at 4; see also BOK, *supra* note 21, at 18-19 (emphasizing the importance of trust in the context of truth); *id.* at 31 (arguing that trust in verac-

the possibility of social relations, an objective that has had an elevated place in Western thought at least since Aristotle.²⁵ This realization leads to a final observation: that the centrality of trust in creating the possibility of society, by itself, gives trust a significant moral dimension.²⁶

Starting from this consensus on its key functions, recent studies have attempted to refine our understanding of the concept of trust by making two principal distinctions within it: the distinction between trust and truth, and the distinction among different types of trust. The first distinction is a clarification between trust and truth, a distinction that turns out to be critical for evaluating fiduciary obligation. The fact that one may trust another does not necessarily lead to the conclusion that the result of that trust will in some sense be the "true" or "right" result or the result that one would have chosen for herself. In other words, one can be mistaken yet trustworthy. This distinction is suggested by the accepted definition of trust, which, as I have indicated, speaks in terms of the trusted's intentions and trust's function of reducing complexity and uncertainty. Sissela Bok has recognized an analogous distinction between intention and result in separating truth from truthfulness, the former concept focused on epistemological questions, and the latter aimed at the intentions and motivations of a speaker.²⁷ Just as one can be truthful while uttering statements that in fact are false, so one can justifiably and rationally trust another despite her errors. The trustworthy weather forecaster does not betray our trust in her simply because it rains when she forecasts sun, nor do we necessarily accuse the teacher who gives a wrong answer of breach of trust.²⁸ Again, as Luhmann reminds us, "Trust is not concerned with knowing the essential truth about a matter but with the success of the reduction of complexity...."²⁹

ity is a "foundation of relations among human beings; when this trust shatters or wears away, institutions collapse").

25. See ARISTOTLE, *The Politics*, in 2 THE COMPLETE WORKS OF ARISTOTLE 1986-88 (Jonathan Barnes ed., 1984).

26. See HELD, *supra* note 21, at 62 ("For cooperation among persons to be sustainable, trust must be present."); Kahn & Turiel, *supra* note 21, at 416 (discussing the importance of the moral component of trust).

27. See BOK, *supra* note 21, at 6-13.

28. If this type of mistake were to occur repeatedly, one might have cause to distrust the forecaster's technical competence, but this observation suggests a different kind of trust, which I discuss *infra* notes 30-32 and accompanying text.

29. LUHMANN, *supra* note 4, at 69.

The second major distinction concerns the nature of entrusted matters. Trust is not a unitary concept. Bernard Barber has identified as separate concepts trust in technical competence and trust in fiduciary loyalty.³⁰ Alasdair MacIntyre, in his reading of Aristotle's *Nichomachean Ethics*, notices a somewhat similar distinction between ability and loyalty in separating the type of offenses resulting from an individual's technical inability to make a significant contribution to a communal project and offenses that "destroy the bonds of community in such a way as to render the doing or achieving of good impossible in some respect at least for some time."³¹ John Dunn also remarks on this distinction in the political context by distinguishing between trust in the good intentions of politicians and trust in their practical capabilities.³² It may well be that certain decisions are worthy of one kind of trust but not another.

C. *The Relationship Between Fiduciary Principles and Trust*

Although not acknowledged by the courts on a doctrinal level, the legal treatment of corporate fiduciaries' conduct implicitly reflects both of these refinements of trust. After all, courts do recognize the enormous complexity and indeterminacy of the corporate enterprise. To put it in the context of trust and truth, they recognize that the "truth" about corporate decisions is often unknowable, certainly in advance and possibly in retrospect.³³ At the same time, decisions need to be made in order for business to function. In recognition of these facts, courts apply a doctrine known as the business judgment rule when evaluating stockholder challenges to the actions of corporate fiduciaries. Under the business judgment rule, a court will not evaluate board decisions made in good faith, with due care, and with regard to the best interests of the corporation, nor will it impose liability for errors on the

30. See BARBER, *supra* note 20, at 14-15. Barber describes the first type of trust as involving faith in the competent technical performance of the trusted and the second, fiduciary trust, as a moral responsibility instilled by society to help control the exercise of power or use of expertise by the trusted. See *id.*

31. ALASDAIR MACINTYRE, *AFTER VIRTUE* 151 (2d ed. 1984); see *id.* at 151-52.

32. See DUNN, *supra* note 23, at 43. Dunn favors emphasizing the former type of trust. See *id.*

33. See, e.g., *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982) ("[A] reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge."), *cert. denied*, 460 U.S. 1051 (1983).

directors.³⁴ In other words, the business judgment rule suggests that as long as decisions are made in this manner, those decisions are justified in the context of the fiduciary relationship. Put simply, they are deserving of trust.

Courts also, again without acknowledging it, implicitly recognize the different types of trust. The distinction is inherent in the business judgment rule's requirements that directors fulfill both the duties of care and loyalty, the former going more or less to the board's technical competence, their abilities in managing the corporation, and the latter focused on their fealty to the corporation's interests.³⁵

Notwithstanding the courts' apparent implied recognition of these refinements of the concept of trust on a doctrinal level, their formal application of fiduciary law fails to carry forward these distinctions. As applied, corporate law, as reflected in the fairness test, confuses these important distinctions between trust and truth and between competence and loyalty. When fiduciary decisions fail to reward the beneficiary's trust because they are undertaken in bad faith or in the fiduciary's self-interest, they are not disregarded. Rather, if the fiduciary has satisfied the conditions of trust in technical competence, what we call the duty of care, she is subjected to an examination of whether she, in reality, has fulfilled the obligations of fiduciary trust *despite her apparent untrustworthiness*. The result is that we do not punish the breach of trust or the failure of the fiduciary to maintain the conditions of trustworthiness. Rather, we shift the legal analysis from an examination of whether the fiduciary has destroyed the conditions necessary for *trust* (which of course she has) to an epistemological-like search for *truth*. Although trust undoubtedly has been damaged, we forgive the fiduciary for causing that damage as long as we are satisfied that the truth, which we define as the fair result of the conduct, is the same as it would have been had the fiduciary acted in a trustworthy manner. In theory, this inquiry is embodied in the fairness test. Yet the inquiry is fatally flawed because the "truth"

34. A good statement of the business judgment rule is provided in *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (stating that the business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company") (citations omitted).

35. For a discussion of the duties of care and loyalty and their relationship to the business judgment rule, see CLARK, *supra* note 17, §§ 3.4-5.

is unknowable. As courts have come to recognize this reality in the course of applying the fairness test, they have shifted the fairness inquiry from substance to process. The result is to make the fairness test meaningless.³⁶ I now turn to an examination of the development of that test and, in the process, demonstrate the refocusing, and misfocusing, of this inquiry.

II. GETTING TO FAIRNESS

It is helpful to have an overview of the circumstances under which the fairness test applies before examining its substance and its propriety and utility as the measure of fiduciary conduct.³⁷ Although variations in doctrinal articulation occur among jurisdictions, the categories of cases that lead to fairness analysis are

36. See *infra* Part IV.

37. Except to the extent relevant to my analysis, I will use the generic phrases "fiduciary" or "corporate fiduciary" to include officers, directors, and controlling stockholders (including parent corporations) of the subject corporation. Although distinctions often are made among the range of duties owed by various types of fiduciaries, I conclude in this Article that the substance of the duty fundamentally is the same. See, e.g., ALI, PRINCIPLES, *supra* note 19, pt. 5 (making such distinctions).

One preliminary matter bears mentioning because of the potential confusion created by the varied expressions of fiduciary doctrines. That is the identification of when a fiduciary has breached her duty. At one time, the various forms of conduct now giving rise to fairness analysis were, in and of themselves, breaches of fiduciary duty that led directly to the imposition of remedies. See Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36-38 (1966) (describing the evolution of the legal treatment of self-dealing transactions). Today, it is fair to say that regardless of the conduct alleged and proved, a fiduciary will not have breached her duty to the corporation or its stockholders unless the result of that conduct is demonstrably unfair to the plaintiff. See *Twin-Lick Oil Co. v. Marbury*, 91 U.S. 587 (1875); *Shlensky v. South Parkway Bldg. Corp.*, 166 N.E.2d 793 (Ill. 1960); *Romanik v. Lurie Home Supply Ctr.*, 435 N.E.2d 712 (Ill. App. Ct. 1982); *Winchell v. Plywood Corp.*, 85 N.E.2d 313 (Mass. 1949); *Knudsen v. Burdett*, 287 N.W. 673 (S.D. 1939); *Gall v. Cowell*, 190 S.E. 130 (W. Va. 1937). But see *Box v. Northrop Corp.*, 459 F. Supp. 540, 546 n.9 (S.D.N.Y. 1978) (applying Maryland law), *aff'd*, 598 F.2d 609 (2d Cir. 1979). Thus, as Chancellor Allen has observed with respect to Delaware law, "Self-dealing transactions by corporate officers, directors or controlling shareholders are not prohibited." *Merritt v. Colonial Foods, Inc.*, 505 A.2d 757, 763-64 (Del. Ch. 1986); see also *Swafford v. Berry*, 382 P.2d 999 (Colo. 1963) (finding that a fiduciary relationship does not prohibit a director from doing business with corporation); *Oberly v. Kirby*, 592 A.2d 445, 467 (Del. 1991) (same). Although this statement is itself quite significant (I will analyze its implications in Part IV), I shall begin my discussion with the premise that the law does not regard self-dealing as intrinsically wrongful.

universal.³⁸ Consequently, I will pause to examine jurisdictional distinctions only when they significantly affect fiduciary analysis.

The fairness test applies only in cases of potential fiduciary misconduct.³⁹ The traditional (for want of a better word) form of potential fiduciary misconduct occurs when the fiduciary engages in a business transaction with the corporation. Such transactions include both ordinary business transactions, for example when the fiduciary buys property from or sells property to the corporation, and financial transactions in which the fiduciary deals with the corporation in a context involving its securities. Because, as I shall later demonstrate, these two types of transactions involve quite

38. *Box*, 459 F. Supp. at 547 (applying Maryland law to challenged recapitalization but noting that "it appears that there is no conflict of state laws with respect to the legal relations and liabilities of fiduciaries"); see also *infra* note 41 and accompanying text. *But cf.* *Delano v. Kitch*, 542 F.2d 550, 554 (10th Cir. 1976) (noting that Kansas has higher standard of fiduciary duty than other jurisdictions).

My statement in the text is a bit of an overstatement. As this Article was in the process of being edited, the Delaware Supreme Court delivered its opinion in *Cede & Co. v. Technicolor, Inc.*, Nos. 336,1991, 337,1991, 1993 WL 437646 (Del. Oct. 22, 1993), in which it held that breach of the duty of care, like breach of the duty of loyalty, would lead to an application of the fairness test with the burden of proof of fairness on the defendant directors. *Id.* at *77. Although the court asserted that this treatment was entirely consistent with Delaware law, it is fair to suggest that it came as a surprise to many corporate experts, see, e.g., DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE* 29 (3d ed. 1989) (stating that in duty of care cases, plaintiff has to prove causation and damages). Whether other jurisdictions will follow the Delaware approach remains unclear. See, e.g., *Francis v. United Jersey Bank*, 432 A.2d 814 (1981) (requiring proof of causation and damages by plaintiff in action for breach of the duty of care, although in the arguably distinct context of omission, rather than affirmative business judgment).

39. In the absence of fiduciary misconduct, courts refuse to inquire into the merits of a given business decision and to impose fiduciary liability regardless of the outcome of that decision under the doctrinal rubric of the business judgment rule. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (characterizing the business judgment rule as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company"). When misconduct is characterized as a breach of the duty of care, the business judgment rule's presumption is overcome and liability is imposed on the fiduciary without further inquiry beyond the amount of damages. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). *But see Technicolor*, 1993 WL 437646 (requiring defendant to prove fairness following breach and treating breach of duty of care as having only the limited effect of shifting the burden of proof and altering the standard of review, rather than concluding the substantive case). When the fiduciary's misconduct is characterized as a breach of the duty of loyalty, courts do not typically impose liability on the fiduciary automatically but rather evaluate the transaction to determine whether it is fair to the corporation. If so, liability is not imposed. *Burton v. Exxon Corp.*, 583 F. Supp. 405 (S.D.N.Y. 1984) (applying Delaware law). It is the latter type of fiduciary misconduct involving the duty of loyalty with which this Article is concerned.

different fiduciary problems,⁴⁰ I will concentrate on the first type of transaction, the more doctrinally cabined problem of fiduciaries engaging in ordinary commercial transactions with their corporations.

This form of self-dealing can lead to the application of the fairness test in two principal ways. The first, the common law approach, requires the fiduciary who transacts business with her corporation to prove that the transaction is fair to the corporation.⁴¹ In some jurisdictions, full and frank disclosure to the cor-

40. See *infra* Part V.

41. This common law approach, or some close variant thereof, is followed in all fifty states. See, e.g., *Spach v. Bryant*, 309 F.2d 886 (5th Cir. 1962) (applying Florida law; fair and not fraudulent); *Nelson v. Gammon*, 478 F. Supp. 630 (W.D. Ky. 1979) (applying Kentucky law; fair and reasonable), *aff'd*, 647 F.2d 710 (6th Cir. 1981); *In re Specialty Plastics, Inc.*, 113 B.R. 915 (Bankr. W.D. Pa. 1990) (applying Pennsylvania law), *vacated in part sub nom. Committee of Unsecured Creditors of Specialty Plastic v. Doemling*, 127 B.R. 945 (W.D. Pa.), *aff'd*, 952 F.2d 1391 (3d Cir. 1991); *In re Anchorage Boat Sales, Inc.*, 29 B.R. 275 (Bankr. E.D.N.Y. 1983) (applying New York law; fair and in good faith); *Tovrea Land and Cattle Co. v. Linsenmeyer*, 412 P.2d 47 (Ariz. 1966) (en banc) (fair); *Horne Bros., Inc. v. Ray Lewis Corp.*, 731 S.W.2d 190 (Ark. 1987) (fair and made in good faith); *Tenzer v. Superscope, Inc.*, 702 P.2d 212 (Cal. 1985) (en banc) (fair and reasonable); *Swafford v. Berry*, 382 P.2d 999 (Colo. 1963) (fair, not fraudulent, and accompanied by full and fair disclosure of the facts); *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976) (officers and directors on both sides of transactions between two corporations must show intrinsic fairness); *Bloodworth v. Bloodworth*, 169 S.E.2d 150 (Ga. 1969) (fair and made in good faith); *Weatherby v. Weatherby Lumber Co.*, 492 P.2d 43 (Idaho 1972); *Romanik v. Lurie Home Supply Ctr.*, 435 N.E.2d 712 (Ill. App. Ct. 1982); *Schemmel v. Hill*, 169 N.E. 678 (Ind. Ct. App. 1930) (en banc) (director must be fair and not secure an unjust advantage); *Holi-Rest, Inc. v. Treloar*, 217 N.W.2d 517 (Iowa 1974) (fair, honest, and in good faith); *Newton v. Hornblower, Inc.*, 582 P.2d 1136 (Kan. 1978) (fair and in good faith); *Chesapeake Constr. Corp. v. Rodman*, 261 A.2d 156 (Md. 1970) (fair, adequate, and equitable); *Johnson v. Witkowski*, 573 N.E.2d 513 (Mass. App. Ct. 1991) (fair and accompanied by adequate consideration); *Fill Bldgs., Inc. v. Alexander Hamilton Life Ins. Co. of Am.*, 241 N.W.2d 466 (Mich. 1976) (applying *Baker v. Hellner Realty Co.*, 251 N.W. 793, 795 (Mich. 1933)) (fair and in the interest of the corporation); *Fountain v. Oreck's, Inc.*, 71 N.W.2d 646 (Minn. 1955) (director must be fair and not take advantage of her position); *Rettinger v. Pierpont*, 15 N.W.2d 393 (Neb. 1944) (fair and not fraudulent); *Schoff v. Clough*, 380 P.2d 464 (Nev. 1963) (fair and not fraudulent); *Abeles v. Adams Eng'g Co.*, 173 A.2d 246 (N.J. 1961) (fair, honest, and reasonable); *Underwood v. Stafford*, 155 S.E.2d 211 (N.C. 1967) (fair and accompanied by full disclosure); *American Tumber & Trading Co. v. Niedermeyer*, 558 P.2d 1211 (Or. 1976) (fair, on close scrutiny); *Knudsen v. Burdett*, 287 N.W. 673 (S.D. 1939) (fair, in good faith, open, and "above board"); *Tennessee Dressed Beef Co. v. Hall*, 519 S.W.2d 805 (Tenn. Ct. App. 1974) (fair and equitable); *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963) (fair and not fraudulent); *Branch v. Western Factors, Inc.*, 502 P.2d 570 (Utah 1972) (fair and in good faith); *Rowland v. Kable*, 6 S.E.2d 633 (Va. 1940) (open, fair, and honest); *Washington ex rel. Hayes Oyster Co. v. Keypoint Oyster Co.*, 391 P.2d 979 (Wash. 1964) (fair); *Claus v. Farmers & Stockgrowers State Bank*, 63 P.2d 781 (Wyo. 1936) (open, fair, and honest, and directors have secured no advantage

porate decisionmaker is a prerequisite to permitting the fiduciary to demonstrate fairness.⁴² In the absence of such disclosure, the transaction is voidable by the corporation regardless of its fairness.⁴³

The second way this form of self-dealing will lead to application of the fairness test is through application of a jurisdiction's

to the detriment of the corporation).

Although other jurisdictions do not require that the transaction be fair per se, they seem to place similar restrictions on transactions between a fiduciary and her corporation. *See, e.g.,* *Duncan Shaw Corp. v. Standard Mach. Co.*, 196 F.2d 147 (1st Cir. 1952) (applying Rhode Island law; transaction must be made in good faith and approved or ratified by a majority vote of the board of directors); *Stuart v. Larson*, 298 F. 223 (8th Cir. 1924) (applying North Dakota law; made in absolute good faith); *National Union Life Ins. Co. v. Ingram*, 154 So. 2d 666 (Ala. 1963) (transaction must not be fraudulent); *Hadden v. Krevit*, 442 A.2d 944 (Conn. 1982) (made in good faith with adequate consideration); *Groves v. Rosemound Improvement Ass'n, Inc.*, 490 So. 2d 348 (La. Ct. App. 1986) (made without violation of fiduciary duty); *Knox Glass Bottle Co. v. Underwood*, 89 So. 2d 799 (Miss. 1956) (corporation must be represented by disinterested agents free from control of interested officer); *O'Rourke v. Grand Opera House Co.*, 133 P. 965 (Mont. 1913) (made in good faith and not to the detriment of other stockholders); *Johndahl v. Columbus Trotting Ass'n*, 147 N.E.2d 101 (Ohio Ct. App. 1956) (transaction open and free from blame); *Cardin Bldg. Co. v. Smith*, 258 P. 910 (Okla. 1927) (made in good faith and with adequate consideration); *Talbot v. James*, 190 S.E.2d 759 (S.C. 1972) (officer must make full disclosure of all relevant facts); *Lash v. Lash Furniture Co. of Barre, Inc.*, 296 A.2d 207 (Vt. 1972) (made in utmost good faith and loyalty); *Gall v. Cowell*, 190 S.E. 130 (W. Va. 1937) (made in good faith).

42. The burden of proof is always on the fiduciary absent some demonstrated approval or ratification of a disinterested corporate body. *See, e.g.,* *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490, 500 (Del. Ch. 1990); *Fliegler*, 361 A.2d at 221; *Hayes Oyster*, 391 P.2d at 986. The fiduciary has the burden of showing such disinterested approval before the ultimate burden of proof shifts back to the plaintiff. *See* *Michelson v. Duncan*, 407 A.2d 211 (Del. 1979); *Gottlieb v. Heyden Chemical Corp.*, 91 A.2d 57, 59 (Del. 1952); *ALI, PRINCIPLES, supra* note 19, at 309-10. Informal ratification is relevant to the defendant's proof of fairness, *Hadden v. Krevit*, 442 A.2d 944 (Conn. 1982), and may be sufficient to establish independent approval, *Robert A. Wachsler, Inc. v. Florafax Int'l, Inc.*, 778 F.2d 547 (10th Cir. 1985) (applying Delaware law).

43. *See* *Ohio Drill & Tool Co. v. Johnson*, 498 F.2d 186, 195 (6th Cir. 1974) (applying Ohio law; shifting the burden of proving a breach of fiduciary duty to the defendant due to non-disclosure); *Kapushion v. Colorado W. Packers, Inc.*, 701 P.2d 625, 627 (Colo. Ct. App. 1985) (listing the full and fair disclosure of all material facts as one requirement for a director contracting with the corporation); *Arrigoni v. Adorno*, 31 A.2d 32, 34-35 (Conn. 1943) (stating that directors have a duty to make full and fair disclosure); *Shlensky v. South Parkway Bldg. Corp.*, 166 N.E.2d 793, 802 (Ill. 1960) (listing disclosure as one factor to be considered in determining fairness); *Angelus Sec. Corp. v. Ball*, 67 P.2d 158, 160 (Cal. Dist. Ct. App. 1937); *Romanik*, 435 N.E.2d at 719 (same); *Schemmel*, 169 N.E. at 683; *Talbot*, 190 S.E.2d at 759; *Knudson*, 287 N.W. at 674-75; *Dowdle v. Texas Am. Oil Corp.*, 503 S.W.2d 647, 651 (Tex. Civ. App. 1973); *Kessler v. Commonwealth Doctors Hospital, Inc.*, 185 S.E.2d 43, 47 (Va. 1971); *Hayes Oyster*, 391 P.2d at 986.

"interested director" statute, now in force in forty-six states.⁴⁴ Although these statutes provide a number of variations,⁴⁵ their basic theme is constant. Under these statutes, the purpose of which is to countermand the early common law rule that interested director transactions were per se voidable,⁴⁶ voidability is abrogated if the fiduciary proves that the transaction in question was approved by an informed body of independent directors,⁴⁷ approved by stockholders, or is fair to the corporation. Perhaps because of their origins in the common law rule of voidability, those jurisdictions that have considered the matter have held that these statutes are not the exclusive means of validating interested director transactions; common law fairness is available as an additional test.⁴⁸

The second large category of cases to which the fairness test applies involves transactions between parent corporations (or controlling individual stockholders) and their partially-owned subsidiaries.⁴⁹ The problem these cases present is somewhat different from that which the classic interested director transaction presents because the subsidiary's board of directors is dominated (because

44. See *infra* notes 113-31 and accompanying text. Codifications also exist in the ALI Principles of Corporate Governance, see ALI, PRINCIPLES, *supra* note 19, § 5.02, and the Model Business Corporation Act, see 3 MODEL BUSINESS CORP. ACT ANN. §§ 8.60-63. For a useful comparison of the various statutory approaches, see ALI, PRINCIPLES, *supra* note 19, § 5.02 reporter's notes, at 300-12. For an attempt to evaluate early interested director statutes in light of common law fiduciary duties, see Ahmed Bulbulia & Arthur R. Pinto, *Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards?*, 53 NOTRE DAME L. REV. 201 (1977).

45. See ALI, PRINCIPLES, *supra* note 19, at 300-12; MODEL BUSINESS CORP. ACT § 8.61, at 1142.42-1 to 1142.43.

46. See Bulbulia & Pinto, *supra* note 44, at 202-05.

47. Judicial treatment of the concept of independent directors poses its own problems which are beyond the scope of this Article. For discussions of the concept see Grobow v. Perot, 539 A.2d 180 (Del. 1988); Puma v. Marriott, 283 A.2d 693 (Del. Ch. 1971). Only one statute, the Model Business Corporation Act, attempts to define interested directors. See MODEL BUSINESS CORP. ACT ANN. § 8.60 (1991); see also ALI, PRINCIPLES, *supra* note 19, § 1.23 (defining interested directors).

48. See Robert A. Wachslser, Inc. v. Florafax Int'l, Inc., 778 F.2d 547, 551 (10th Cir. 1985) (applying Delaware law); Marciano v. Nakash, 535 A.2d 400, 404 (Del. 1987); Merritt v. Colonial Foods, Inc., 505 A.2d 757, 764 (Del. Ch. 1986); Holi-Rest, Inc. v. Treloar, 217 N.W.2d 517, 525 (Iowa 1974). But see Matteson v. Wm. S. Sweet & Son, Inc., 193 A. 171, 173 (R.I. 1937) (holding the predecessor to current Rhode Island statute to be the exclusive method of validating interested director contracts).

49. Parent corporations do not owe fiduciary duties to their wholly-owned subsidiaries. *E.g.*, Anadarko Petroleum Corp. v. Panhandle E. Corp., 545 A.2d 1171, 1174 (Del. 1988).

it is selected) by the parent and because the parent or controlling stockholder typically owns sufficient shares to effect its will in all stockholder voting. Consequently, the independent approval procedures of the interested director statutes generally are inapplicable, and the common law fairness test is applied.

The problem also is different for a more important reason. The typical interested director transaction involves a "one-shot deal" in which the fiduciary attempts to profit through ordinary commercial dealings with the corporation.⁵⁰ In the parent-subsidiary context, the fiduciary has a continuing financial interest in the corporation, with the consequence that any given corporate decision has the potential to inure principally to the fiduciary's benefit. It is obvious that this fact alone cannot lead to the pervasive application of the fairness test without significantly damaging the efficacy of our existing model of the corporation.⁵¹ Consequently, courts have developed contextual rules to govern the application of the fairness test.

The first set of rules, pioneered by the Delaware and New York courts, addresses the situation in which the parent and subsidiary engage in commercial relations or have competing business interests. In this context, courts will apply the fairness test only when the parent (or controlling stockholder) has received a benefit to the detriment of the subsidiary (or minority stockholders).⁵² For example, in the leading Delaware case of *Sinclair Oil Corp. v.*

50. The notable exception is in the area of compensation, which provides the fiduciary with an ongoing financial stake in the corporation and which has received somewhat different doctrinal treatment, with directors receiving very broad latitude in setting compensation and judicial review often limited to a standard of waste. See ALI, PRINCIPLES, *supra* note 19, § 5.03, at 322-23; HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 245 (3d ed. 1983).

51. Courts have recognized this difficulty most clearly in the close corporation context, in which a similar structural problem exists. See, e.g., *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 663 (Mass. 1976) (establishing a pragmatic test for evaluating conflicts between controlling and non-controlling stockholders); *Schwartz v. Marien*, 335 N.E.2d 334, 338-39 (N.Y. 1975) (same).

52. *Burton v. Exxon Corp.*, 583 F. Supp. 405 (S.D.N.Y. 1984) (applying Delaware law); *Sinclair Oil Co. v. Levien*, 280 A.2d 717 (Del. 1971); *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883 (Del. 1970); *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584 (Del. Ch. 1986); cf. *Alliegro v. Pan Am. Bank*, 136 So. 2d 656, 661-62 (Fla. Dist. Ct. App. 1962), *cert. denied*, 149 So. 2d 45 (Fla. 1963); *Case v. New York Cent. R.R.*, 204 N.E.2d 643 (N.Y. 1965). For a more detailed examination of this test, see *infra* notes 184-89 and accompanying text.

Levien,⁵³ a parent corporation was held not to have engaged in self-dealing by causing its subsidiary to declare large dividends in excess of earnings, allegedly because of its need for money, when the subsidiary's minority stockholders received their share of the dividends.⁵⁴ It was held, however, to have engaged in self-dealing when it breached a contract between another wholly-owned subsidiary and the subsidiary and failed to cause the subsidiary to seek damages.⁵⁵

The second set of rules applied in the parent-subsidary context has produced the most prominent type of fairness analysis in recent years. These rules address the situation in which a parent corporation (or controlling stockholder) acquires the minority interests in its subsidiary, typically, although not always, by way of merger.⁵⁶ In these cases, the financial interest of the parent in the transaction is quite obvious, and its opportunity to take advantage of the minority interests is most direct.⁵⁷ As in the commercial context, a disinterested board is, by definition, unavailable.⁵⁸ Due to the inherent self-dealing nature of the transaction, the intrinsic fairness test always is applied.⁵⁹ Several jurisdictions have

53. 280 A.2d 717 (Del. 1971).

54. *Id.* at 721-22; see also *Burton*, 583 F. Supp. at 416 (applying an intrinsic fairness test when parent caused subsidiary to declare dividends on class of preferred stock owned by it but not on junior class of preferred stock owned by minority); cf. *Alliegro*, 136 So. 2d at 659-62 (holding that parent breached its fiduciary duty by retaining all tax benefits from filing consolidated tax return with subsidiary, which court found to be a preferential dividend); *Grinnell*, 306 N.Y.S.2d at 210 (dismissing action in part because director's conduct in voting for dividends did not rise to such a level as to warrant interference with the internal affairs of the organization).

55. *Sinclair Oil*, 280 A.2d at 723.

56. Again, the Delaware cases have been predominant. See *infra* note 59.

57. This last fact was noted by Vice Chancellor Jacobs in *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490, 501-02 (Del. Ch. 1990), in explaining why Delaware's interested director statute did not apply in the context of parent-subsidary mergers.

58. Although, as in the commercial context, approval by a fully informed and disinterested majority of the minority stockholders will shift the defendant fiduciary's burden of proving fairness to the plaintiff to prove unfairness. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 703 (Del. 1983). Some question exists as to whether this approval must be by an absolute majority of the minority or by a majority of the minority actually voting. *Susnan v. Lincoln Am. Corp.*, 578 F. Supp. 1041, 1061 (N.D. Ill. 1984) (reading *Weinberger* as requiring a majority of the minority actually voting).

59. See *Howing Co. v. Nationwide Corp.*, 927 F.2d 263, 268-69 (6th Cir.) (applying Ohio law), *vacated*, 112 S. Ct. 39 (1991); *Landy v. Amsterdam*, 815 F.2d 925, 929-30 (3d Cir. 1987) (interpreting Pennsylvania law); *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 845-46 (Del. 1987); *Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1107 (Del. 1985); *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937-38 (Del. 1985); *Weinberger*, 457 A.2d at 711-14; *Sornberger v. Chesapeake & O. Ry.*, 566 A.2d 503, 509 (Md. Ct. Spec.

required that the party challenging the merger first provide some evidence of self-interested behavior to demonstrate a basis for invoking the fairness obligation, possibly limiting the test's applicability.⁶⁰

In summary, it is fair to say that the fairness test applies whenever fiduciaries engage in transactions that create significant conflicts of interest between them and their beneficiaries. One clear conclusion is that courts and legislatures have made some preliminary decisions about the types of conflicts that are sufficiently suspect to result in heightened judicial scrutiny.⁶¹ A sec-

App. 1989), *cert. denied*, 570 A.2d 864 (Md. 1990); *Berkowitz v. Power/Mate Corp.*, 342 A.2d 566, 574 (N.J. 1975); *Dermody v. Sticco*, 465 A.2d 948, 949 (N.J. Super. Ct. Ch. Div. 1983); *Alpert v. 28 Williams St. Corp.*, 473 N.E.2d 19, 26 (N.Y. 1984); *Beloff v. Consolidated Edison Co. of New York*, 87 N.E.2d 561, 564 (N.Y. 1949); *cf. Coggins v. New England Patriots Football Club, Inc.*, 492 N.E.2d 1112 (Mass. 1986) (stating that the fairness test applies to freeze-out merger affected by controlling stockholder only if controlling stockholder first demonstrates a business purpose for the merger; otherwise, the merger is *per se* invalid).

Interestingly, however, the fairness test does not appear to apply as such to a tender offer by a parent for its subsidiary's minority shares. *Joseph v. Shell Oil Co.*, 482 A.2d 335, 343-44 (Del. Ch. 1984) (although stating that entire fairness test applies, identifying its content simply as requiring full disclosure); *cf. Abbey v. Montedison S.P.A.*, 539 N.Y.S.2d 862 (Sup. Ct. 1989) (stating that it is not clear that majority stockholder is required to offer fair price in making tender offer for minority's shares). Moreover, one pre-*Weinberger* court held that Delaware's interested director statute, and not the intrinsic fairness test, applied when a subsidiary's board of directors approved the sale of its assets to its parent to be followed by the subsidiary's dissolution. *Northway, Inc. v. TSC Indus., Inc.*, 361 F. Supp. 108, 114 (N.D. Ill. 1973) (applying Delaware law), *aff'd in part*, 512 F.2d 324 (7th Cir. 1975), *rev'd*, 426 U.S. 438 (1976).

60. *See, e.g., Landy v. Amsterdam*, 815 F.2d 925 (3d Cir. 1987) (holding that "proving the prospectus and rest" rule was unduly likely to produce nuisance litigation); *see also Radol v. Thomas*, 772 F.2d 244, 257 (6th Cir. 1985) (applying Ohio law; stating that the general rule that directors have burden of showing fairness only after plaintiff has made a *prima facie* case that "directors have acted in bad faith or without requisite objectivity"), *cert. denied*, 477 U.S. 903 (1986); *Box v. Northrop Corp.*, 459 F. Supp. 540, 548 (S.D.N.Y. 1978) (approximating Maryland law; holding that plaintiff had come forward with sufficient evidence of self-dealing to shift burden of proving fairness to defendants), *aff'd*, 598 F.2d 609 (2d Cir. 1979); *Puma v. Marriott*, 283 A.2d 693 (Del. Ch. 1971) (stating that the fact that the controlling stockholder owned 46% of corporation's stock was insufficient to demonstrate that it dominated outside directors so as to invoke the intrinsic fairness test).

61. I have chosen not to discuss conflicts between fiduciaries and their corporations arising from the fiduciary's usurpation of corporate opportunities, *see, e.g., Klinicki v. Lmdgren*, 695 P.2d 906, 912-15 (Or. 1985) (en banc) (discussing various tests for determining the existence of a corporate opportunity), the fiduciary's competition with the corporation, *see, e.g., Master Records, Inc. v. Backman*, 652 P.2d 1017, 1020-21 (Ariz. 1982) (describing and applying test of liability for competition with the corporation); *Lincoln Stores v. Grant*, 34 N.E.2d 704, 707 (Mass. 1941) (same), and the compensation

ond, equally clear, conclusion is that when such conflicts exist, the fairness test always applies, regardless of the nature of the conflict at issue. I will analyze the implications of these conclusions in Parts IV and V. First, however, I will examine the meanings of fairness in corporate law.

III. FAIRNESS

The attempt to identify and articulate the content of the fairness test is, predictably, frustrating. Courts and commentators long have decried the ephemeral nature of the standard, but efforts to make the test more determinate either themselves have dissolved into indeterminacy⁶² or largely have been disregarded in favor of the traditional standard.⁶³ Nonetheless, an examination of the origins of the fairness test and the ways in which courts talk about fairness may provide some insight into its meaning.

The enterprise is important. One could dismiss the project by resorting to trite comments about equity in general⁶⁴ or by ratio-

of officers and directors, *see, e.g.*, *Michelson v. Duncan*, 407 A.2d 211, 216-22 (Del. 1979) (dealing with the problem of compensation of officers and directors). These types of conflicts pose distinct problems to which the fairness test does not truly apply, regardless of the courts' occasional use of the term "fairness" in the cases. *See, e.g.*, *Miller v. Miller*, 222 N.W.2d 71, 80-81 (Minn. 1974) (applying "fairness" test in combination with the "line of business" test to evaluate corporate opportunities). The principal concern in corporate opportunity cases is with the determination of whether a particular opportunity is corporate and thus whether it is related to the corporation's business, rather than with exchange with the corporation (although concerns similar to fairness apply in this context as well). The problem of fiduciary competition with the corporation focuses on theft of corporate information and non-disclosure of the competition, as well as the fiduciary's intent. *See Master Records*, 652 P.2d at 1020. The question of compensation tends to focus on the issue of corporate waste. *See Michaelson*, 407 A.2d at 217. Although each of these conflicts implicates conceptions of fairness, none of them are evaluated directly in terms of the overarching fairness concept and are therefore beyond the scope of this Article.

62. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 92 (1991) (arguing that fiduciary duty should be interpreted to reflect what the parties would have bargained for had they bargained but failing to identify in a reasonably determinate way how one would go about discerning this fictitious result).

63. *See* Brudney & Chirelstein, *supra* note 13, at 325-30 (advocating a proportional sharing rule in parent-subsidiary transactions); Burgman & Cox, *supra* note 13 (discussing the abandonment of business purpose test in Delaware cash merger cases in favor of fairness test).

64. John Selden's reference to "the chancellor's foot" is the most famous example. *See* JOHN SELDEN, *THE TABLE TALK OF JOHN SELDEN* 61-64 (Edinburgh, Thomas Constable & Co. 1854).

nally placing confidence in the judgment and "case feel" of courts long accustomed to dealing with such matters.⁶⁵ That approach, however, would ignore what is most significant about the fairness principle: it not only is a judicial test of the legality of behavior but is also a standard of conduct. As a test applied in litigation, it may appropriately set forth circumstances in which legal liability will be imposed. As a test in litigation, it also establishes a standard of conduct for fiduciaries in the mass of cases that never will be litigated. Consequently, what courts say and do about fairness plays a central role in corporate governance.

An examination of the development of the fairness test is important for another reason. Precisely because every alleged fiduciary breach is measured by this standard called fairness, it is easy to assume that fairness should mean the same thing wherever applied. This conclusion is not true, as courts sometimes acknowledge.⁶⁶ Fairness is a standard the satisfaction of which very much depends upon context. Nonetheless, for a variety of possible reasons, courts have come to apply essentially the same fairness standard in all contexts.⁶⁷ By separately examining the several possible fairness standards and the different conflict of interest situations to which they might apply, we can gain further insight into the propriety of fairness as the measure of fiduciary conduct and the available alternatives.

The fairness test consists of two components, fair price and fair dealing. Fair price is concerned with the substantive terms of the transaction⁶⁸ and is satisfied by proof that the financial aspects of the transaction fall within a range that would be acceptable to unrelated parties. Fair dealing focuses on the process by which these terms are reached and is satisfied by proof that the

65. See, e.g., BENJAMIN N. CARDOZO, *THE NATURE OF THE JUDICIAL PROCESS* 164 (1921) ("Of the cases that come before the court in which I sit, a majority, I think, could not, with semblance of reason, be decided in any way but one. The law and its application alike are plain."); Joseph C. Hutcheson, Jr., *The Judgment Intuitive: The Function of the "Hunch" in Judicial Decision*, 14 CORNELL L.Q. 274 (1929) (discussing the importance of instinct in adjudication); see also KARL N. LLEWELLYN, *THE COMMON LAW TRADITION* 24-25 (1960) (discussing decisionmaking processes in easy and harder cases); *id.* at 59-61 (discussing the role of "situation sense").

66. See, e.g., *Joseph v. Shell Oil Co.*, 482 A.2d 335, 341 (Del. Ch. 1984) (suggesting that full disclosure is enough to satisfy the fairness required in the limited context of a parent's tender offer for subsidiary's minority shares).

67. See *infra* Section III(D).

68. I use the term "fair price" and "substantive fairness" interchangeably.

negotiations surrounding the transaction were structured to replicate those that would take place between unrelated parties.⁶⁹

Although recent caselaw has brought these two discrete aspects of fairness together under the rubric of "entire fairness,"⁷⁰ fair price and fair dealing each have different sources. One source of fairness, concerned largely with fair price, is appraisal statutes, from which has developed a standard of fair price that is applied in parent-subsidary merger cases as well as to directorial decisions to merge the corporation with, or permit it to be taken over by, third parties.⁷¹ Under this standard, and consistent with its origins, the goal of the fairness test is to compensate stockholders for that which has been taken from them.⁷² As I will discuss later in this Part,⁷³ this standard of fair price may well be at odds with the fair dealing component of the fairness test, which looks to the replication of arm's-length bargaining as its measure, and this disjuncture may have been recognized by those jurisdictions that recently have modified the fair price component to provide stockholders with a portion of merger gain. Nonetheless, in articulation and in concept, this measure of fair price largely is compensatory.

The second source of fairness is a series of late nineteenth- and early twentieth-century U.S. Supreme Court cases in which corporate law questions were pendant to questions of antitrust and bankruptcy law. These cases, in particular *Geddes v. Anaconda Copper Mining Co.*⁷⁴ and *Pepper v. Litton*,⁷⁵ are consistently cited sources for the fairness test as applied in self-dealing transactions.⁷⁶ *Geddes* establishes a standard for fair price, or substantive

69. *Oberly v. Kirby*, 592 A.2d 445, 470 (Del. 1991).

70. The recent leading case is *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

71. See *infra* notes 137-52 and accompanying text.

72. *Id.*; see also *Weinberger*, 457 A.2d at 713 ("The basic concept of value under the appraisal statute is that the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern.") (quoting *Tri-Continental Corp. v. Battye*, 74 A.2d 71, 72 (Del. 1950)); *Brudney & Chirelstein, supra* note 13, at 305.

73. See *infra* notes 163-65 and accompanying text.

74. 254 U.S. 590 (1921).

75. 308 U.S. 295 (1939). Both *Geddes* and *Pepper* were unanimous decisions, except that in *Geddes*, Justice McReynolds concurred without opinion. A third case, *Twin-Lick Oil Co. v. Marbury*, 91 U.S. 587 (1875), is also frequently cited but is less clear on the meaning of fairness, although it is cited in both *Pepper* and *Geddes*. See *Pepper*, 308 U.S. at 306, 307 n.14; *Geddes*, 254 U.S. at 599.

76. See, e.g., *Perlman v. Feldman*, 219 F.2d 173, 177 (2d Cir.), *cert. denied*, 349 U.S.

fairness. *Pepper*, on the other hand, appears to set the standard for fair dealing. It is, in part, the courts' failure to recognize that these cases deal with distinct types of fairness, each with different consequences for the fiduciary relationship, that is responsible for the failure of the contemporary entire fairness test. To make this clear, I will first examine the origins of fairness in the self-dealing context, then the origins of fairness in the parent-subsidary merger context and will then examine several recent cases dealing with each context to demonstrate the way in which the separate doctrines have blended in articulation and application.⁷⁷

952 (1955) (applying Indiana law); *First Trust & Sav. Bank v. Iowa-Wisconsin Bridge Co.*, 98 F.2d 416, 425 (8th Cir.) (quoting *Geddes* test at length), *cert. denied*, *Phoenix Fin. Corp. v. Iowa-Wisconsin Bridge Co.*, 305 U.S. 650 (1938); *Tenzer v. Superscope, Inc.*, 702 P.2d 212, 220 (Cal. 1985); *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464, 471 (Cal. 1969); *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66, 75 (Cal. Dist. Ct. App. 1952); *Weatherby v. Weatherby Lumber Co., Inc.*, 492 P.2d 43, 46 (Idaho 1972); *Newton v. Hornblower, Inc.*, 582 P.2d 1136, 1146 (Kan. 1978); *Winchell v. Plywood Corp.*, 85 N.E.2d 313 (Mass. 1949); *Knox Glass Bottle Co. v. Underwood*, 89 So. 2d 799, 813 (Miss. 1956), *cert. denied*, 353 U.S. 977 (1957); *Ramacciotti v. Joe Simpkins, Inc.*, 427 S.W.2d 425, 432 (Mo. 1968); *Marian v. Mariami*, 84 N.Y.S.2d 335, 338 (Sup. Ct. 1948), *modified*, 276 A.2d 205 (1949); *Intertherm, Inc. v. Olympic Homes Sys., Inc.*, 569 S.W.2d 467, 471-72 (Tenn. Ct. App. 1978); *Gall v. Cowell*, 190 S.E. 130, 138 (W. Va. 1937); *Davies v. Meisenheimer*, 37 N.W.2d 93, 97 (Wis. 1949).

Three days of Shepardizing *Geddes* and *Pepper* confirmed that these cases are ritually cited, separately or together, as the foundational fairness cases. Thorough review of the cases equally demonstrated, however, that little or no discussion of the meaning of fairness generally accompanies these citations. Rather, courts seem to treat the meaning of fairness as self-evident.

The indirect impact of these cases, although difficult to measure, is profound. Many cases, for example, rely on cases that have established the basis of fairness from *Geddes*, *Pepper*, and *Twin-Lick*. See, e.g., *International Controls Corp. v. Vesco*, 490 F.2d 1334, 1346 (2d Cir.) (quoting *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971) (quoting *Pepper*, 308 U.S. at 307)), *cert. denied*, 417 U.S. 932 (1974); *McKay v. Wahlenmaier*, 226 F.2d 35, 45 (D.C. Cir. 1955) (quoting *Central Ry. Signal Co. v. Longden*, 194 F.2d 310, 318 (7th Cir. 1952) (citing *Pepper*, 308 U.S. at 311)).

77. I organize the following discussion around self-dealing cases and parent-subsidary merger cases as separate and discrete categories because the cases themselves seem to make this distinction. This categorization probably is due to the fact that although fair dealing is a constant concept, the meaning of fair price varies depending on whether the transaction at issue is self-dealing or a parent-subsidary merger. I will later demonstrate that these categories are inappropriate and that a more rational typology of conflict transactions would create vertical and horizontal classifications. See *infra* Part V.

A. *Fairness in the Self-Dealing Context*

In *Geddes v. Anaconda Copper Mining Co.*,⁷⁸ Alice Gold & Silver Mining Company sold all its assets to Anaconda, a subsidiary of the Amalgamated Copper Company that originally had been organized as a holding company to acquire the properties of a number of mining companies operating in and around Butte, Montana. John D. Ryan, president of Anaconda and a director of Amalgamated, acquired an option to purchase a majority of Alice's stock and assigned the option to Butte Coalition Company, an Amalgamated subsidiary of which he was also a director. After acquiring the stock, Butte voted in favor of selling Alice's assets to Anaconda in exchange for Anaconda stock. Subsequently, the stockholders of Alice (including Butte) voted to dissolve Alice and distribute its assets (which now included the Anaconda stock).⁷⁹

Among the issues raised by the Alice minority stockholders who sued to rescind the sale were the fact that Alice and Anaconda had common directors and the alleged inadequacy of the price. As to the first issue, the Court applied the contemporary common law rule requiring that defendants demonstrate the entire fairness of the transaction "and where a sale is involved the full adequacy of the consideration."⁸⁰ The Supreme Court declined to disturb the district court's finding that the price was inadequate and focused instead on the remedy.⁸¹ Because that remedy was inextricably tied to the concept of fairness, I will first focus on the way in which the lower court dealt with the fairness concept and then on the remedy it granted.

The district court looked to the adequacy of price as the measure of fairness.⁸² Notwithstanding expert testimony from both sides as to the value of Alice's known and suspected reserves, the court quite frankly determined that the price was arbitrarily set,⁸³ although it conceded Ryan's good faith.⁸⁴ The fact

78. 254 U.S. 590 (1921).

79. The facts are described in detail in the court of appeals opinion. See *Geddes v. Anaconda Copper Mining Co.*, 245 F. 225, 229-31 (9th Cir. 1917), *rev'd*, 254 U.S. 590 (1921).

80. *Geddes*, 254 U.S. at 599.

81. *Id.* at 600-02.

82. *Geddes v. Anaconda Copper Mining Co.*, 222 F. 129, 131-33 (D. Mont. 1915), *aff'd*, 245 F. 225 (9th Cir. 1917), *rev'd*, 254 U.S. 590 (1921).

83. *Id.* at 132.

84. *Id.* at 133. That good faith is no defense to unfair fiduciary dealing had been

that the price was arbitrary did not seem, in and of itself, to trouble the court, which acknowledged the lack of market value for properties such as Alice's and their inherently speculative nature.⁸⁵ Given these factors, as well as the known facts about the Butte mining district, the court wrote,

[T]he price was not so large that it can be said it is clear there was no reasonable prospect of a larger price. Anaconda could afford to pay more than any other, but the question is: *Did* it pay more than any other *would* have paid? And in view of the common directors of vendor and vendee the minority stockholders were entitled to have this question answered by the acid test of a public sale in open market, whereat Anaconda might have purchased if the highest bidder.⁸⁶

Although the test was articulated in terms of adequacy of price and entire fairness, the court defined these terms as meaning the highest price the Alice directors could attain by auctioning the property.⁸⁷ The court's remedy was consistent with this standard. Alice's property was to be marketed for resale, and only if no bid higher than Anaconda's appeared would the sale be undisturbed.⁸⁸

The U.S. Court of Appeals for the Eighth Circuit agreed with the law that the district court applied as well as with its finding of inadequate price (to which it added, as an independent fact, Ryan's failure fully to disclose Anaconda's information regarding Alice to Alice's minority stockholders).⁸⁹ A majority of the court, recognizing the majority stockholders' right to retain the benefits of sale in the absence of a higher bidder, affirmed the district court's remedy.⁹⁰ One judge, however, argued that the sale should be rescinded.

How a sale of all of the property of a private corporation, for an inadequate price and which is otherwise unfair and wholly illegal . . . can be subsequently rendered legal by offering the prop-

long established. *See, e.g., Gibson v. Jeyes*, 31 Eng. Rep. 1044 (Ch. 1801).

85. *Geddes*, 222 F. at 132.

86. *Id.* at 132-33.

87. *Id.* The court also mentioned "methods of sale" as another factor in voiding the transaction. *Id.* at 131.

88. *Id.* at 135.

89. *Geddes v. Anaconda Copper Mining Co.*, 245 F. 225, 236-39 (9th Cir. 1917), *rev'd*, 254 U.S. 590 (1921).

90. *Id.* at 244.

erty at public sale, to see if at such sale it will bring more, I am unable to understand.⁹¹

The Supreme Court agreed with this dissent.⁹² As I earlier noted, it left undisturbed the lower courts' conclusions as to inadequacy of price. The Court evidently believed, however, that the market test contemplated by the lower courts was sufficiently unreliable that in a matter of doubt as to value, the minority stockholders of Alice should be permitted to retain the assets and reap the benefit of their actual value, instead of a value determined by artificial means. Consequently, the Court remanded the case to the district court with instructions to invalidate the sale.⁹³

Geddes tells us much about fairness. In the first place, despite the overtones of procedural fairness contained in the Eighth Circuit opinion, it is a case very much about the fairness of price. More particularly, the Supreme Court opinion appears to indicate that fair dealing will not be a cure for a price that is less than the highest possible price, implying that even had an auction of Alice's properties occurred *prior* to Anaconda's purchase, the resulting rescission of the sale still would have been ordered. Recognizing the inherent indeterminacy of valuation procedures, the Court resolved the problem by ensuring that the minority retained what, by definition, was the *actual* value of their assets: the assets themselves. In light of this outcome, *Geddes* might well be read as a case that prohibits self-dealing entirely, rather than one that permits self-dealing when fair price is demonstrated. This is not the rule the Court articulates, however, nor is it representative of the way subsequent courts have treated it. As a matter of doctrine, *Geddes* clearly stands for the proposition that self-dealing is permitted when the corporation shows that it has obtained the best price.

Although *Geddes* involved a sale of all of a corporation's assets and thus might be seen more appropriately as setting the standard for parent-subsidiary combinations, in fact the case has had its principal direct impact in self-dealing cases.⁹⁴ Illustrative

91. *Id.* at 242 (Ross, J., dissenting in part).

92. *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 601-02 (1921).

93. *Id.* at 602.

94. See, e.g., *Perlman v. Feldman*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955); *First Trust & Sav. Bank v. Iowa-Wisconsin Bridge Co.*, 98 F.2d 416 (8th Cir.), *cert. denied*, 305 U.S. 650 (1938); *Tenzer v. Superscope, Inc.*, 702 P.2d 212 (Cal. 1985); *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464 (Cal. 1969); *Remillard Brick Co. v. Remillard-Dandini*, 241 P.2d 66 (Cal. Dist. Ct. App. 1952); *Weatherby v. Weatherby*

of this impact is the Illinois Supreme Court's opinion in *Shlensky v. South Parkway Building Corp.*,⁹⁵ in which the court reaffirmed and explained Illinois's acceptance of the *Geddes* standard.⁹⁶ In so doing, it principally accepted *Geddes* as a case about fair price, although it recognized elements of fair dealing as well.

While the concept of "fairness" is incapable of precise definition, courts have stressed such factors as whether the corporation received in the transaction full value in all the commodities purchased; the corporation's need for the property; its ability to finance the purchase; whether the transaction was at the market price, or below, or constituted a better bargain than the corporation could have otherwise obtained in dealings with others; whether there was a detriment to the corporation as a result of the transaction; whether there was a possibility of corporate gain siphoned off by the directors directly or through corporations they controlled; and whether there was full disclosure—although neither disclosure nor shareholder assent can convert a dishonest transaction into a fair one.⁹⁷

The *Shlensky* application of fairness, although consistent with the *Geddes* focus on fair price as best price, establishes a checklist for corporate fiduciaries to enable them, in their quotidian business conduct, to determine whether their self-dealing transactions are fair. If courts in fact demanded this approach, they would go a long way towards establishing a meaningful substantive standard of fairness to guide both fiduciaries and courts themselves. In fact, this substantive approach is not generally followed,⁹⁸ in its place,

Lumber Co., 492 P.2d 43 (Idaho 1972); *Newton v. Hornblower, Inc.*, 582 P.2d 1136 (Kan. 1978); *Winchell v. Plywood Corp.*, 85 N.E.2d 313 (Mass. 1949); *Knox Glass Bottle Co. v. Underwood*, 89 So. 2d 799 (Miss. 1956), *cert. denied*, 353 U.S. 977 (1957); *Ramacciotti v. Joe Simpkins, Inc.*, 427 S.W.2d 425 (Mo. 1968); *Marian v. Mariani*, 84 N.Y.S.2d 335 (Sup. Ct. 1948), *modified*, 276 A.2d 205 (1949); *Intertherm, Inc. v. Olympic Homes Sys., Inc.*, 569 S.W.2d 467 (Tenn. Ct. App. 1978); *Gall v. Cowell*, 190 S.E. 130 (W. Va. 1937); *Davies v. Meisenheimer*, 37 N.W.2d 93 (Wis. 1949).

95. 166 N.E.2d 793 (Ill. 1960).

96. *Id.* at 801. *Shlensky* exemplifies this approach to fairness. However, it should be noted that it is exceedingly rare for a court to discuss the meaning or content of fairness at all.

97. *Id.* at 801-02 (citations omitted).

98. See *infra* notes 98-136 and accompanying text. Cases citing *Geddes* generally provide little or no discussion defining fairness. Rather, they typically rely on long quotations from or paraphrasings of the Supreme Court's *Geddes* opinion. See, e.g., *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 723 (5th Cir. 1984); *Fidelity and Deposit Co. of Md. v. USAFORM Hail Pool, Inc.*, 523 F.2d 744, 760 (5th Cir. 1975), *cert. denied*,

courts apply a procedural concept of fairness arising out of a distinctly different Supreme Court case.

That case is the famous *Pepper v. Litton*.⁹⁹ *Pepper* involved an action by a judgment creditor against the controlling stockholder, Litton, of the debtor corporation, Dixie Splint Coal Company. After Litton filed a claim against Dixie Splint for back salary, he transferred its assets to another corporation and placed Dixie Splint in bankruptcy. The plaintiff sued to have Litton's claim declared void.¹⁰⁰

Although the context of the case was fraud (in contrast to *Geddes*, in which the interested director's good faith was conceded), Justice Douglas engaged in a wide-ranging discussion of the obligations of corporate fiduciaries.¹⁰¹ In so doing, he cited *Geddes* for the proposition that self-dealing fiduciaries have the burden of proving "the good faith of the transaction" as well as "its inherent fairness from the viewpoint of the corporation and those interested therein."¹⁰² He then offered his own definition of the test, which largely contemplates fairness as fair dealing: "The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."¹⁰³ He went on to examine the application of equitable

425 U.S. 950 (1976); *DeMet v. Harralson*, 399 F.2d 35, 39 (5th Cir. 1968); *Hellier v. Baush Mach. Tool Co.*, 21 F.2d 705, 707 (1st Cir. 1927); *Scott v. Multi-Amp Corp.*, 386 F. Supp. 44, 67 (D.N.J. 1974); *Johnson v. American Gen. Ins. Co.*, 296 F. Supp. 802, 811 (D.D.C. 1969); *Schmitt v. Jacobson*, 294 F. Supp. 346, 348 (D. Mass. 1968); *In re Brunner Air Compressor Corp.*, 287 F. Supp. 256, 263 (N.D.N.Y. 1968); *In re Custom-Built Homes, Inc.*, 214 F. Supp. 806, 808 (M.D.N.C. 1963); *Austrian v. Williams*, 103 F. Supp. 64, 75 (S.D.N.Y.), *rev'd*, 198 F.2d 697 (2d Cir.), *cert. denied*, 344 U.S. 909 (1952).

The only context in which courts have clearly followed a best price model is when the sale of a corporation has become inevitable. *See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 (Del. 1985). However, the circumstances in which this test is applicable appear limited. *See Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1150-51 (Del. 1989) (finding sale not inevitable when board had long planned strategic merger); *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 844-45 (Del. 1987) (finding majority stockholder has no "Revlon duty" to auction corporation for highest price when contemplating cash-out merger of minority stockholders).

99. 308 U.S. 295 (1939).

100. *Id.* at 297-301.

101. *Id.* at 306-11.

102. *Id.* at 306.

103. *Id.* at 306-07. Although this formulation of the fairness test is followed by a footnote quoting *Twin-Lick Oil Co. v. Marbury*, 91 U.S. 587, 590 (1875), it is clear from the quotation that *Twin-Lick* had overtones both of substantive and procedural fairness and provided no real definition of the concept of fairness. *Pepper*, 308 U.S. at 307 n.14. Rather, the formulation is entirely of Justice Douglas's creation.

principles in a variety of contexts, including the equitable subordination of fiduciaries' claims in bankruptcy, piercing the corporate veil to impose corporate liability on a dominant stockholder, invalidation of transactions in which the fiduciary manipulates corporate process or utilizes inside information, and general violation by the fiduciary of "rules of fair play."¹⁰⁴ Of course, all this discussion is consistent with the subject of the case, which involved not the value of Litton's services or the appropriate amount of his claimed salary¹⁰⁵ but rather the manner in which he abused corporate process to defeat the claims of creditors. The focus on this problem is entirely procedural.

By its very nature, the concept of arm's-length bargaining looks not to the outcome of the bargain but to the process of bargaining itself. This, in fact, is the way that subsequent courts generally have treated the concept.¹⁰⁶ Such treatment is consistent with the common law rule, which shifts the burden of proving unfairness to the plaintiff when independent board or stockholder approval has been obtained.¹⁰⁷ It is further consistent with the recent emphasis courts have given, particularly in Delaware, to

104. *Pepper*, 308 U.S. at 307-11.

105. Justice Douglas does mention, however, the question of that value. *Id.* at 312 (noting it was "at best merely Litton's appraisal of the worth of [his] services over the years").

106. See, e.g., *Gearhart Indus., Inc. v. Smith Int'l Inc.*, 741 F.2d 707, 723-24 (5th Cir. 1984); *Bellis v. Thal*, 373 F. Supp. 120, 123-24 (E.D. Pa. 1974), *aff'd*, 510 F.2d 969 (3d Cir. 1975); *In re Brunner Air Compressor Corp.*, 287 F. Supp. 256, 262-66 (N.D.N.Y. 1968); *MacEwen v. Star-Kist Foods, Inc.*, 251 F. Supp. 33, 35-36 (E.D.N.Y. 1966); *Austrian v. Williams*, 103 F. Supp. 64, 75-76 (S.D.N.Y.), *rev'd*, 198 F.2d 697 (2d Cir.), *cert. denied*, 544 U.S. 909 (1952). *Tenzer v. Superscope, Inc.*, 702 P.2d 212, 220-21 (Cal. 1985). Courts sometimes talk about arm's-length fairness as requiring an outcome similar to that revealed by arm's-length bargaining. See, e.g., *Alpert v. 28 Williams St. Corp.*, 473 N.E.2d 19, 27 (N.Y. 1984) (noting that independent appraisal "may be a good means of demonstrating the price which would have been set by arm's length negotiations"). A particularly prominent example is Judge Learned Hand's opinion in *Ewen v. Peoria & E. Ry.*, 78 F. Supp. 312 (S.D.N.Y. 1948), in which he cited the master's report quoted in *International Radio Tel. Co. v. Atlantic Communication Co.*, 290 F. 698, 702 (2d Cir.), *cert. denied*, 263 U.S. 705 (1923), which that court relied on without further citation, describing the rule of fairness as being determined by "whether the proposition submitted would have commended itself to an independent corporation." *Ewen*, 78 F. Supp. at 316. This test does not appear to be widely accepted today and in fact has been harshly criticized. See, e.g., *Western Pac. R.R. Corp. v. Western Pac. R.R. Co.*, 206 F.2d 495, 499-500 (9th Cir. 1953) (applying California law); *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789, 791 (Del. Ch. 1967); *Case v. New York Cent. R.R.*, 243 N.Y.S.2d 620, 624 (App. Div. 1963), *rev'd*, 204 N.E.2d 643 (N.Y. 1965).

107. See *supra* note 42.

independent director approval as insulating a wide range of transactions from fairness scrutiny.¹⁰⁸ It is also consistent with those interested director statutes that, either expressly or by judicial interpretation, shift the burden of proving unfairness to the plaintiff after independent board or stockholder approval,¹⁰⁹ consistent with the common law rule.

Obviously these approaches are closely related, a relationship that the Delaware Supreme Court expressly acknowledged: "The key to upholding an interested transaction is the approval of some neutral decision-making body."¹¹⁰ Fairness in the arm's-length sense, therefore, is about attempting to replicate structurally and procedurally the circumstances of independent bargaining as a means of ensuring a fair outcome.¹¹¹ By emphasizing this type of fairness, *Pepper* clearly establishes the lower limits on the conduct of a corporate fiduciary, in contrast to *Geddes's* focus on the result of that conduct.¹¹²

108. See *infra* notes 157-59 and accompanying text; see also *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1989); *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1287 (Del. 1988) ("In the absence of self-interest, and upon meeting the enhanced duty mandated by *Unocal*, the actions of an independent board of directors in designing and conducting a corporate auction are protected by the business judgment rule.") (citations omitted), *appeal dismissed*, 548 A.2d 498 (1988); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1343 (Del. 1987) (noting that proof that board satisfied first prong of *Unocal* test is "materially enhanced" when majority of directors were independent); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 176 n.3 (Del. 1985) (refusing to apply "certain presumptions that generally attach to the decisions of a board whose majority consists of truly outside independent directors" when evidence was at best unclear as to directors' independence); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985) (noting that proof that directors satisfied *Unocal* standards is "materially enhanced" when "a majority of the board favoring the proposal consisted of outside independent directors" who otherwise acted in accordance with those standards).

109. See *infra* notes 116-22 and accompanying text.

110. *Oberly v. Kirby*, 592 A.2d 445, 467 (Del. 1991); see also *Marciano v. Nakash*, 535 A.2d 400, 404 (Del. 1987); *Merritt v. Colonial Foods, Inc.*, 505 A.2d 757, 765 (Del. Ch. 1986).

111. The concept of process as fairness hardly is new to our law. It forms the basis of Lon Fuller's attempt to explain the morality of law, see LON L. FULLER, *THE MORALITY OF LAW* (1964), and is critically important in validating the principles of justice John Rawls sees as undergirding the ideal society, see JOHN RAWLS, *A THEORY OF JUSTICE* (1971); see also Chapman, *supra* note 2, at 155-56 (criticizing Rawls's equation of justice with fairness as inherently procedural). I will further discuss the pervasiveness of the process-oriented approach to fairness *infra* Section III(D).

112. Obviously, one of the "earmarks" of an arm's-length bargain is its result, and in distinguishing the two approaches to fairness, I do not mean to disregard this fact. My point simply is one of emphasis and, as I will later demonstrate, the predominance of

Although courts have tended to emphasize aspects of procedural fairness far more heavily than a best price notion of fairness, they generally have not so neatly categorized these aspects of fairness and, not surprisingly, Justice Douglas's rhetoric has served many such courts in masking the need to analyze the meaning of this fiduciary obligation. Nonetheless, the distinction is vitally important because it is the failure to appreciate the distinctiveness of the two tests that has led to the weakness of the fairness test.

The trend towards a procedural conception of fairness is exacerbated by the largely recent enactment of state statutes dealing with interested director transactions¹¹³ and, even more recently, by the adoption of Subchapter F of the Revised Model Business Corporation Act.¹¹⁴ Although relatively little caselaw exists interpreting such statutes,¹¹⁵ the cases that have been decided, as well

one form of fairness over the other. *See infra* notes 126-29 and accompanying text.

113. Forty-six states have enacted such statutes. *See* ALA. CODE § 10-2A-63 (1987); ALASKA STAT. § 10.06.478 (1989); ARIZ. REV. STAT. ANN. § 10-041 (1990); ARK. CODE ANN. § 4.27-831 (Michie 1991); CAL. CORP. CODE § 310 (West 1990); COLO. REV. STAT. § 7-5-114.5 (1986 & Supp. 1992); CONN. GEN. STAT. ANN. § 33-323 (West 1987); DEL. CODE ANN. tit. 8, § 144 (1991); FLA. STAT. ANN. § 607.0832 (West 1990); GA. CODE ANN. §§ 14-2-860 to -864 (Michie 1989); HAW. REV. STAT. § 415-41 (1988); IDAHO CODE § 30-1-41 (Supp. 1993); ILL. COMP. STAT. ANN. ch. 805 § 5/8.60 (West 1993); IND. CODE ANN. § 23-1-35-2 (Burns 1987); IOWA CODE ANN. § 490.831 (West 1991); KAN. STAT. ANN. § 17-6304 (1988); KY. REV. STAT. ANN. § 271B.8-310 (Baldwin 1989); LA. REV. STAT. ANN. § 12:84 (West 1969); ME. REV. STAT. ANN. tit. 13A, § 717 (West 1981); MD. CODE ANN., CORPS. & ASS'NS § 2.419 (1993); MICH. COMP. LAWS ANN. § 450.1545a (West 1990); MINN. STAT. ANN. § 302A.255 (West 1987 & Supp. 1993); MISS. CODE ANN. §§ 79-4-8.60 to -8.63 (Supp. 1992); MO. ANN. STAT. § 351.327 (Vernon 1991); MONT. CODE ANN. §§ 35-1-461 to -464 (1992); NEV. REV. STAT. ANN. § 78-140 (Michie Supp. 1991); N.H. REV. STAT. ANN. § 293-A:41 (1987); N.J. STAT. ANN. § 14A:6-8 (West Supp. 1993); N.M. STAT. ANN. § 53-11-40.1 (Michie 1993); N.Y. BUS. CORP. LAW § 713 (McKinney 1986); N.C. GEN. STAT. § 55-8-31 (1990); N.D. CENT. CODE § 10-19.1-51 (1985); OHIO REV. CODE ANN. § 1701.60 (Baldwin Supp. 1992); OKLA. STAT. ANN. tit. 18, § 1030 (West 1986); OR. REV. STAT. § 60.361 (1987); R.I. GEN. LAWS § 7-1.1-37.1 (1992); S.C. CODE ANN. § 33-8-310 (Law. Co-op. 1990 & Supp. 1992); TENN. CODE ANN. § 48-18-302 (1986); TEX. BUS. CORP. ACT ANN. art. 2.35-1 (West Supp. 1993); VT. STAT. ANN. tit. 11, § 1888 (1984); VA. CODE ANN. § 13.1-691 (Michie 1993); WASH. REV. CODE ANN. §§ 23B.08.700-730 (West 1989); W. VA. CODE § 31-1-25 (1988); WIS. STAT. ANN. § 180.0831 (West 1992); WYO. STAT. § 17-16-831 (1989).

114. 3 MODEL BUSINESS CORP. ACT ANN. §§ 8.60-.63 (1991). Subchapter F of the Model Act, or statutes like it, have been adopted in four states. *See* GA. CODE ANN. § 14-2-860 to -864 (1990); MISS. CODE ANN. §§ 79-4-8.60 to -8.63 (Supp. 1992); MONT. CODE ANN. §§ 35-1-461 to -464 (1992); WASH. REV. CODE ANN. §§ 23B.08.700-.730 (West Supp. 1993).

115. An examination of the annotations following each state's statute revealed very little caselaw. Leading cases are *Marciano v. Nakash*, 535 A.2d 400 (Del. 1987) and

as the texts of the statutes themselves, demonstrate their overwhelmingly procedural orientation.¹¹⁶

Although the statutes do vary, the typical statute provides several methods by which a transaction involving an interested director can be insulated from attack on the grounds of conflict of interest or fairness.¹¹⁷ In fact, most statutes on their face provide alternative methods of achieving this result.¹¹⁸ They include approval by disinterested directors or stockholders (who sometimes statutorily are required to be disinterested, although sometimes not) following some form of disclosure, the specifics of which are

Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66 (Cal. 1952); *see also* Cohen v. Ayers, 596 F.2d 733 (7th Cir. 1979) (interpreting New York statute as shifting burden of proving fairness, rather than removing fairness requirement on compliance with approval provisions); Nelson v. Gammon, 478 F. Supp. 630 (W.D. Ky. 1979) (interpreting Kentucky statute as relying on disinterested director or stockholder approval when transaction is "not manifestly unfair to the corporation"), *aff'd*, 647 F.2d 710 (6th Cir. 1981); Scott v. Multi-Amp Corp., 386 F. Supp. 44 (D.N.J. 1974) (interpreting New Jersey statute); Aronoff v. Albanese, 446 N.Y.S.2d 368 (1982) (dealing with statute in the context of corporate waste); Hadden v. Krevit, 442 A.2d 944 (Conn. 1982) (holding that loans to corporation by directors were fair); Holi-Rest, Inc. v. Treloar, 217 N.W.2d 517 (Iowa 1974) (requiring director to prove reasonableness of compensation); Tennessee Dressed Beef Co. v. Hall, 519 S.W.2d 805 (Tenn. App. 1974) (finding transaction to be fair in the absence of disinterested director or stockholder approval).

116. *See, e.g.*, Oberly v. Kirby, 592 A.2d 445, 467 (Del. 1991) (stating that the key to upholding interested director transactions is some form of disinterested approval); Marciano, 535 A.2d at 405 n.3 (suggesting that disinterested approval would give rise to business judgment review). *But see, e.g.*, Scott, 386 F. Supp. at 67-69 (interpreting disjunctive text of New Jersey statute as conjunctive and requiring demonstration of fairness, although with a lesser quantum of proof, notwithstanding disinterested approval). The New Jersey legislature revised the New Jersey statute in 1988 specifically to overrule Scott. *See* N.J. STAT. ANN. § 14A:6-8, commissioners cmt. (West Supp. 1993). At the same time, it specified that the sole purpose of the New Jersey statute was to abrogate the common law rule of voidability, not to validate all conflict-of-interest transactions. *Id.*

I found no cases dealing with the question of fairness after disinterested approval. Although some cases talk about a continuing requirement of fairness notwithstanding such approval, *see* Cohen, 596 F.2d at 740-41; Aronoff, 446 N.Y.S.2d at 370-71, their circumstances make these statements unreliable. For example, both Cohen and Aronoff deal with questions of corporate waste, which are subject to higher standards than other types of fiduciary breach, such that it is more difficult to prove waste than breaches of other fiduciary duties. *Cf.* HENN & ALEXANDER, *supra* note 50, § 245, at 668 n.16 (discussing fairness in the context of executive compensation).

117. The Delaware statute appears to be typical. *See* DEL. CODE ANN., tit. 8, § 144 (1953); *see also* ALI, PRINCIPLES, *supra* note 19, § 5.02, reporter's note 1. The California statute served as the model for most later statutes, including Delaware's, although it has since been amended. Bulbulia & Pinto, *supra* note 44, at 204-05.

118. The majority of the statutes are written in the alternative, with fairness provided as a defense only in the event that procedural mechanisms have not been used. *But see infra* note 121 (citing statutes not written in the alternative).

set forth in the statute.¹¹⁹ Failing such approval, almost all of the statutes provide insulation for the transaction on a showing that it is fair, with statutory and interpretive variations existing as to the burden of proof.¹²⁰ A small minority of statutes requires fairness in addition to director or stockholder approval,¹²¹ as does a small minority of cases interpreting other statutes.¹²²

Although a significant minority of states requires that disinterested director approval be given in good faith,¹²³ it is doubtful that this requirement is meant to impose a standard of substantive fairness in addition to disinterested director or stockholder approval. In the first place, good faith always is required for directors to receive the benefits of the business judgment rule,¹²⁴ and it

119. For a table comparing these statutory disclosure requirements, see ALI, *PRINCIPLES*, *supra* note 19, § 5.02, reporter's note 1.

120. *See, e.g., supra* notes 116, 119.

121. Alabama and Illinois expressly require fairness, notwithstanding approval by disinterested directors or stockholders. *See* ALA. CODE § 10-2A-63 (1987); ILL. COMP. STAT. ANN. ch. 805, § 5/8.60 (West 1993). Connecticut requires that a transaction approved by disinterested directors be "not unfair" (and, as to transactions merely involving interlocking boards, that they not be "manifestly unfair"). CONN. GEN. STAT. ANN. § 33-323 (West 1987). Both Alaska and California require that transactions approved by disinterested directors be "just and reasonable" to the corporation. ALASKA STAT. § 10.06.478 (1989); CAL. CORP. CODE § 310 (Deering 1990). The Legislative Committee Comment to the California statute states that this requirement "is intended to codify . . . [Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66 (Cal. 1952),] indicating that the courts in any event will review the transaction for fairness." CAL. CORP. CODE § 310, legislative comm. cmt. The same is presumably true of the Alaska statute.

122. The leading case taking such a position interpreted California's statutory requirement of good faith directorial approval to require fairness. *Remillard*, 241 P.2d at 74-75. California's statute was later amended specifically to include a fairness component in the section sanitizing conflict transactions made with board approval. *See* CAL. CORP. CODE § 310 (Deering 1990). *Aronoff v. Albanese*, 446 N.Y.S.2d 368, 371 (1982), which suggests a fairness requirement in dictum, notes that New York's statute was based on the California statute. Although California's statute was amended after *Remillard* to include a fairness requirement, New York's statute continues only to require good faith in disclosure by the interested director, but not in board approval. N.Y. BUS. CORP. LAW § 713 (McKinney 1986); *see also* *Scott v. Multi-Amp Corp.*, 386 F. Supp. 44, 67-68 (D.N.J. 1974) (interpreting New Jersey statute to require fairness as well as disinterested approval, with approval merely lessening the standard of proof). *But see supra* note 116 (noting that the New Jersey legislature subsequently amended this statute to overrule *Scott*).

123. ALASKA STAT. § 10.06.478 (1989); CALIF. CORP. CODE § 310 (Deering 1990); COLO. REV. STAT. § 7-5-114.5 (1986); DEL. CODE ANN. tit. 8, § 144 (1953); KAN. STAT. ANN. § 17-6304 (1988); LA. REV. STAT. ANN. § 12:84 (West 1969); MINN. STAT. ANN. § 302A.255 (West 1985); MO. ANN. STAT. § 351.327 (Vernon 1991); NEV. REV. STAT. ANN. § 78.140 (Michie 1991); N.D. CENT. CODE § 10.19.1-51 (1985); OHIO REV. CODE ANN. § 1701.60 (Baldwin 1986); TEX. BUS. CORP. ACT ANN. art. 2.35-1 (West Supp. 1993); VT. STAT. ANN. tit. 11, § 1888 (1984).

124. *See, e.g., Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (stating that the

therefore would seem that courts would require good faith even when they do not apply the fairness test. In addition, the reporter's notes accompanying the Minnesota statute, which is in the standard form of this type of statute (based on the old Model Business Corporation Act), expressly describe the fairness requirement as alternative to disinterested approval: "If the standards set forth in [the statute] are met, the fairness of any transaction so approved is conclusively presumed."¹²⁵

In light of the similarity of these statutes, and in the absence of contrary interpretation, it seems reasonable to conclude that most jurisdictions would follow this approach, including jurisdictions that lack any statutory good faith requirement. The ordinary standard of fiduciary behavior remains procedural, therefore, with substantive fairness serving only as a default standard in case such procedures have not been followed. This standard not only suggests the relative unimportance of substantive fairness but also clearly casts it as a defense in litigation, rather than as a standard of fiduciary conduct. In other words, the question of substantive fairness is irrelevant unless the fiduciary has failed to protect herself by complying with procedural fairness and finds herself in the position of defending a lawsuit.

The simple act of describing these statutes reveals their overwhelmingly procedural focus.¹²⁶ Reinforcing this focus is recent

business judgment rule presumes that directors acted in good faith). Fairness, however, generally is not required. See *supra* notes 38-39.

125. MINN. STAT. ANN. § 302A.255, reporter's notes-1981 (West 1985). This description appears to be unchanged by the 1987 amendments to the Minnesota statute. See MINN. STAT. ANN. § 302A.255 (West Supp. 1993).

126. The conclusion that the standard interested-director statutes' focus is largely procedural is strongly reinforced by a recent article, written by members of a Committee of the Litigation Section of the American Bar Association, which evaluates the ALI Principles of Corporate Governance. See Charles Hansen et al., *The Role of Disinterested Directors in "Conflict" Transactions: The ALI Corporate Governance Project and Existing Law*, 45 BUS. LAW. 2083 (1990). The authors harshly criticize the ALI project as going beyond existing law. They also criticize the chief reporter's assertions that § 5.02 of the ALI project (imposing a duty of fair dealing) is largely consistent with existing law in incorporating a threshold fairness standard into disinterested director approval. *Id.* at 2093-97; cf. Melvin A. Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 1009 (1988) (Professor Eisenberg was Chief Reporter for the project from 1984 to its completion.). Hansen and his co-authors argue strongly that procedural sanitization without regard to fairness is all that is required under existing law. Hansen et al., *supra*, at 2089. Based on the statutes and the available cases, I believe that they are correct in their conclusion that existing law does not require both procedural and substantive fairness. Professor Dooley reaches the same conclusion. See Michael P. Dooley, *Two*

Delaware caselaw clarifying the interpretation of Delaware's statute as insulating interested director transactions without regard to fairness when the board complies with the statutory procedures.¹²⁷ This procedural emphasis is made irrefutably clear by Subchapter F of the Revised Model Business Corporation Act, which attempts to create an exclusive, bright-line approach completely insulating conflict-of-interest transactions that comply with the statutory requirements from attack in a manner designed to provide certain and predictable guidance for directors and to preserve efficient corporate operations.¹²⁸ Under the Model Act, fairness is clearly a last-ditch defense, available when directors have failed to avail themselves of the statutory procedures, rather than a standard of fiduciary conduct. Although different from other statutes in the degree to which it provides validation of interested director transactions, it is similar in its reliance on internal corporate procedures to protect the corporation and its stockholders.¹²⁹

Although few cases have been decided under these statutes, the statutes' influence is significant, as evidenced by judicial opinions using them by analogy in situations in which, by their terms, they do not apply.¹³⁰ Their influence is further evidenced by Part

Models of Corporate Governance, 47 BUS. LAW. 461, 486-95 (1992).

The procedural emphasis of these statutes is further suggested by Bulbulia & Pinto, *supra* note 44, at 209-10, who argue that the alternative fairness defense might best be construed in the context of these statutes as contemplating a form of procedural fairness, rather than substantive fairness.

127. *Marciano v. Nakash*, 535 A.2d 400, 404-05 (Del. 1987).

128. 3 MOD. BUS. CORP. ACT ANN. subch. F, introductory cmt. (1985). Subchapter F does not apply to business transactions between parent and subsidiary corporations, *id.*, an approach that I will demonstrate is wrong, *see infra* Part V.

129. The reporter's notes to the ALI Principles of Corporate Governance note that the Model Act's commentary states that when the terms of a transaction approved under Subchapter F are "manifestly unfavorable," the good faith of the approving directors may be called into question, and analogizes this to the ALI requirement that a transaction approved by disinterested directors must reasonably be concluded to have been fair. ALI, PRINCIPLES, *supra* note 19, § 5.02(a)(2)(B) reporter's note 13. Given the contingent nature of the Model Act requirement, this comment seems to diminish the fairness component of the ALI requirement, rather than to suggest a strong substantive component to the Model Act. *See also* A.A. Sommer, Jr., *The Duty of Loyalty in the ALI's Corporate Governance Project*, 52 GEO. WASH. L. REV. 719, 730 (1984) (noting that the ALI's requirement of reasonable belief as to fairness is quite modest and not meant to be equated with the test requiring a judicial determination of whether the transaction was fair).

130. *See, e.g., Oberly v. Kirby*, 592 A.2d 445 (Del. 1991) (applying Delaware statute by analogy to review conflict-of-interest transactions in not-for-profit corporation); *Citron*

V of the American Law Institute's *Principles of Corporate Governance*, which embodies a similar approach to a variety of types of conflict-of-interest transactions.¹³¹ It is hard not to conclude that these statutes both reflect and encourage the trend towards a dominant procedural conception of fairness.

Beyond the limited construction of procedurally focused interested director statutes, the most commonly articulated common law standard of fairness in the self-dealing context is the arm's-length bargain test.¹³² Although some courts have rejected this standard as a measure of substantive fairness because of its obvious artificiality and indeterminacy in control situations,¹³³ most courts accept it as a procedural inquiry, preferring to analyze the objective circumstances surrounding the transaction in question, rather than the transaction itself, to satisfy themselves that there were, in fact, the "earmarks of an arm's length bargain" and thus that the standard of fairness has been met. Exemplary of this approach is the court's advice in *Johnson v. Witkowski*.

Directors and officers who choose to run the risk of playing on both sides of the fence with their corporation are—or should be—advised to conduct their business as openly as possible, to avoid even the appearance of impropriety, and to structure the

v. E.I. DuPont de Nemours & Co., 584 A.2d 490 (Del. Ch. 1990) (applying principles analogous to the Delaware statute and discussing the Delaware statute in parent-subsidiary merger case); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981) (using statutory procedure as analogy to establish procedures of judicial review of the actions of independent litigation committees).

131. ALI, *PRINCIPLES*, *supra* note 19, pt. V. One might have thought that the fairness requirement in § 5.02(a)(2)(B) went some way towards reintroducing a notion of substantive fairness, and indeed some commentators have so claimed. *See, e.g.*, BLOCK ET AL., *supra* note 38, at 81; Dooley, *supra* note 126, at 492; Hansen et al., *supra* note 126, at 2091-92. In light of the reporter's note, however, this claim simply seems wrong. *See supra* note 129.

132. *See, e.g.*, *Tenzer v. Superscope, Inc.*, 702 P.2d 212, 220 (Cal. 1985); *Smith v. Tele-Communication, Inc.*, 184 Cal. Rptr. 571, 574 (1982) (citing *Jones v. H.F. Ahnanson & Co.*, 460 P.2d 464 (Cal. 1969)); *Osborne v. Locke Steel Chain Co.*, 218 A.2d 526 (Conn. 1966); *Marciano v. Nakash*, 535 A.2d 400, 405 (Del. 1987); *Groves v. Rosemound Improvement Ass'n*, 490 So. 2d 348, 351 (La. 1986); *Winchell v. Plywood Corp.*, 85 N.E.2d 313, 317 (Mass. 1949); *Alpert v. 28 Williams St. Corp.*, 473 N.E.2d 19, 29 (N.Y. 1984).

133. *See, e.g.*, *Western Pac. R.R. Corp. v. Western Pac. R.R. Co.*, 206 F.2d 495, 499-500 (9th Cir. 1953) (applying California law); *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789, 791 (Del. Ch. 1967); *Case v. New York Cent. R.R.*, 243 N.Y.S.2d 620, 624 (App. Div. 1963), *rev'd*, 204 N.E.2d 643 (N.Y. 1965).

deal so that it resembles as much as possible an arm's-length transaction.¹³⁴

This approach appears to be followed equally by courts when evaluating business dealings between parent and subsidiary corporations as when examining transactions between directors and their corporations.¹³⁵

For the moment, it is reasonable to conclude that fairness in self-dealing transactions contains strong roots in tests of both substantive and procedural fairness and that the former, at least historically, requires that the fiduciary ensure that her corporation receive the best deal possible.¹³⁶ For a variety of reasons, however, this substantive component has taken a back seat to the procedural component, which not only has become the governing standard but, to the extent price is relevant, has led to a reinterpretation of that component to require only a price within a fair range, rather than the best price. Perhaps a major influence on this transformation is the treatment of fairness in parent-subsidiary mergers, to which I now turn.

B. *Fairness in Parent-Subsidiary Mergers*

In dealing with the meaning of fairness in the parent-subsidiary merger context, I deal with terrain that is more travelled than that in the self-dealing context.¹³⁷ Nonetheless, a reexamination of the meaning of fairness in this type of transaction not only is essential in evaluating the propriety of fairness as the fiduciary

134. *Johnson v. Witkowski*, 573 N.E.2d 513, 521 (Mass. App. Ct. 1991); *see also Spach v. Bryant*, 309 F.2d 886, 889 (5th Cir. 1962) (discussing fairness in terms of process).

135. For a discussion of the propriety of applying a procedural fairness concept to both types of transactions, *see infra* Part V.

136. For cases articulating a best price standard, *see Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590 (1921); *Veaser v. Robinson Hotel Co.*, 266 N.W. 54 (Mich. 1936); *Rettinger v. Pierpont*, 15 N.W.2d 393 (Neb. 1944); *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577-78 (Tex. 1963); *cf. Chesapeake Constr. Corp. v. Rodnan*, 261 A.2d 156, 158 (Md. 1970) (test articulated in terms of best interests of corporation). The best price standard in fiduciary self-dealing cases can be traced back to early English cases. *See, e.g., Gibson v. Jeyes*, 31 Eng. Rep. 1044 (ch. 1801); *Fox v. Mackreth*, 29 Eng. Rep. 224 (1788).

137. *See, e.g., Brudney & Chirelstein, supra* note 13; *Burgman & Cox, supra* note 13. It should be noted that in parent-subsidiary mergers, the question of fairness concerns fairness to minority stockholders, in contrast to self-dealing transactions, in which the question of fairness is directed to the corporation. Although the cases do not treat this distinction as important, it becomes critical to my analysis in Part V.

standard but also helps to clarify the influence the cases in this area have had on the fairness concept in the self-dealing context.

As Professors Brudney and Chirelstein explained, the measure of fairness in parent-subsidary mergers derives largely from appraisal statutes, which give stockholders dissenting from their corporation's decision to undertake certain types of structural transactions the right to demand the fair value of their shares in a judicially-conducted valuation proceeding.¹³⁸ Fairness is statutorily enshrined as the lowest common denominator in this context and has received the judicial gloss that dissenting stockholders are entitled to receive the equivalent value of that which has been taken from them.¹³⁹ Were there any doubt as to the correctness of Brudney and Chirelstein's conclusion, that doubt was erased when the Delaware Supreme Court decided *Weinberger v. UOP, Inc.*,¹⁴⁰ in which it held the appraisal remedy generally to be exclusive in parent-subsidary merger cases.¹⁴¹ In addition, the *Weinberger* court articulated a fiduciary standard of entire fairness, consisting of both fair dealing and fair price. The *Weinberger* articulation of fair dealing is consistent with the concept of fiduciary behavior as traditionally applied to require arm's-length dealing. I will therefore focus on the fair price component and, importantly, its relationship to fair dealing.

The *Weinberger* court affirmed the idea that fair value under the appraisal statute requires the dissenting stockholder to be paid the equivalent value of that which has been taken from her.¹⁴² As the court read the Delaware appraisal statute, it required not only that the dissenter be paid the current value of her shares but that such value be determined considering elements of the corporation's future value "known or susceptible of proof as of the date of the merger."¹⁴³ Thus, fair price recognizes that stockholders are being deprived of an interest in a going concern

138. Brudney & Chirelstein, *supra* note 13, at 305.

139. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 703-04 (Del. 1983).

140. 457 A.2d 701 (Del. 1983).

141. *Id.* at 703-04. Although *Weinberger* left open the possibility of actions for fraud and breaches of fiduciary duty, the remedy to be applied in such cases was analogous to the appraisal remedy. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985) (remanding for determination of fair value of shares in accordance with *Weinberger*, after holding that the directors had breached their duty of care in approving a third party merger).

142. *Weinberger*, 457 A.2d at 713-14.

143. *Id.* at 713.

and should be compensated for the full value of that going concern.

At the same time, and significantly for the substantive component of the fairness test, the court recognized the difficulty of establishing fair value.¹⁴⁴ Acknowledging this difficulty, the court departed from its traditional method of valuation, the Delaware Block Method, in favor of other techniques generally accepted and recognized in the financial community.¹⁴⁵ Taking a directly opposite approach to the court in *Geddes* (and, admittedly, faced with different realities),¹⁴⁶ the court chose to rely on valuation technology to determine the equitability of fiduciary conduct.

More important than the *Weinberger* court's definition of fair price, however, is its articulation of the relationship between the two components of the entire fairness test: fair price and fair dealing. Although the court stated that the test of entire fairness was not bifurcated, it further acknowledged that "price may be the preponderant consideration outweighing other features of the merger."¹⁴⁷ Notably, however, the court lamented the absence of a committee of independent directors to negotiate on behalf of the subsidiary and concluded,

Since fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered nor pursued. Particularly in a parent-subsidiary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness.¹⁴⁸

Despite the apparent preponderance of price as the key to fiduciary conduct, therefore, the difficulty of determining a fair price leads fair process, at least when provided, to appear as the predominant factor.¹⁴⁹ Any doubt as to this emphasis on fair price

144. See *id.* at 712-13.

145. *Id.*

146. The major difference in reality is that at the time of *Weinberger*, fiduciary self-dealing on a showing of fairness had become an entrenched legal concept.

147. *Id.* at 711.

148. *Id.* at 710 n.7 (citation omitted). Ironically, the court cites as support for this proposition *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883, 887-88 (Del. 1970), in which the court declined to apply the fairness test due to the absence of self-dealing.

149. See also Richard Buxbaum, *The Internal Division of Powers in Corporate Gover-*

was erased in the analogous area of derivative litigation¹⁵⁰ by the Delaware Supreme Court in *Grobow v. Perot*,¹⁵¹ in which the court wrote, "Approval of a transaction by a majority of independent, disinterested directors almost always bolsters a presumption that the business judgment rule attaches to transactions approved by a board of directors that are later attacked on grounds of lack of due care."¹⁵²

Clearly, procedural fairness is the critical component. This procedural emphasis on fairness largely has been picked up by the courts following *Weinberger*, to the point that judicial evaluation of the fairness of price in a transaction that otherwise meets the fair dealing standard really turns on whether the manner in which the price was determined was fair.¹⁵³ In *Citron v. E.I. Du Pont de Nemours & Co.*,¹⁵⁴ Vice Chancellor Jacobs interpreted and applied *Weinberger's* approach to fairness. Although he rejected the proposition that arm's-length negotiating alone led to business judgment analysis, rather than to fairness analysis,¹⁵⁵ he determined that such arm's-length dealing had occurred and that it satisfied the fair dealing component of *Weinberger*.¹⁵⁶ He then examined fair price. In beginning his discussion of this issue he noted, "Before considering the specific evidence relating to value, the Court notes preliminarily that the merger terms were negotiated at arm's-length That fact is significant, and our Supreme Court has so recognized"¹⁵⁷ Not surprisingly, the court went on to determine that the merger price was fair.¹⁵⁸ Although

nance, 73 CAL. L. REV. 1671, 1723 (1985) ("'Fairness' . . . is basically a matter of full and fair disclosure (and perhaps of creating a simulated negotiation process); it is not a matter of constraint on the substantive terms of the merger.").

150. That the independence requirement in derivative litigation is closely related to that in self-dealing transactions is obvious. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 786 & n.14 (Del. 1981) (quoting DEL. CODE ANN. tit. 8, § 144 (1991)); *Merritt v. Colonial Foods, Inc.*, 505 A.2d 757 (Del. Ch. 1986) (evaluating legality of using cash-out merger to terminate pending derivative litigation).

151. 539 A.2d 180 (Del. 1988).

152. *Id.* at 190.

153. See, e.g., *Landy v. Amsterdam*, 815 F.2d 925, 931 (3d Cir. 1987) (applying Pennsylvania law); *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 939-40 (Del. 1985).

154. 584 A.2d 490 (Del. Ch. 1990).

155. *Id.* at 501-02.

156. *Id.* at 504-05.

157. *Id.* at 505 (quoting *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709-10 n.7 (Del. 1983)) (recognizing that arm's-length dealing is strong evidence of fairness).

158. *Id.* at 510.

the court's discussion of fair price is extensive, its emphasis on the effect of fair dealing suggests that at a minimum, evidence of arm's-length dealing will significantly lessen the burden of demonstrating fair price.¹⁵⁹

This conclusion is reinforced by the frequently-observed fact that the outcome of fairness analysis largely is dependent on whom the burden of proving fairness or unfairness is placed.¹⁶⁰ As a general matter, the burden of proof is placed on defendant fiduciaries whenever the transaction at issue involves unsanitized conflicts of interest—in other words, when procedural fairness has not been satisfied. One commentator has observed, although from a small sampling of cases, that defendants tend to lose fairness cases when the burden is placed on them.¹⁶¹ My own impressions, based on reading dozens of cases, bear out this observation.¹⁶² It seems that satisfying the test of procedural fairness is critical, if not determinative, in satisfying the fairness test.

In addition, parsing the entire fairness test reveals an ambivalence about the content of fiduciary obligation. Although this ambivalence may be merely semantic in the parent-subsidiary

159. See also *Landy v. Amsterdam*, 815 F.2d 925, 930–31 (3d Cir. 1987) (applying Pennsylvania law, which the court noted would follow *Weinberger*, and stating that “[u]nder Pennsylvania law, reliance on an independent opinion is a defense to a charge of unfairness”); *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 843 n.4 (Del. 1987) (stating that because the board included a majority of inside directors, “we, therefore, cannot conclude that the foregoing action is entitled to the presumptions that generally attach to decisions of a board whose majority consists of truly outside independent directors”) (citing *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986)); *Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1106 n.7 (Del. 1985) (noting that “the use of an independent negotiating committee of outside directors may have significant advantages . . . in defending suits of this type”); *Walter J. Schloss Assocs. v. Chesapeake & O. Ry.*, 536 A.2d 147, 154 (Md. App. 1988) (noting that successful cases for injunction or rescission in freeze-out mergers involve either no legitimate business purpose, *ultra vires* activity, unfair procedures, or fraud or other extreme violation of fiduciary duty going “beyond merely the price”). But see, e.g., *Susinan v. Lincoln Am. Corp.*, 578 F. Supp. 1041, 1062 (N.D. Ill. 1984) (quoting *Weinberger* to the effect that fairness of price may be the preponderant consideration in a non-fraudulent transaction and finding that fair dealing was satisfied in a merger “completely unlike an arms-length transaction” when the defendants had fulfilled the duty of candor).

160. See, e.g., *Goldberg*, *supra* note 13, at 1226–30.

161. *Id.* at 1229 n.33; see also *Bulbulia & Pinto*, *supra* note 44, at 225–26 (noting that allocation of the burden of proof may often be determinative of the litigation itself in close cases).

162. See, e.g., *Taussig v. Wellington Fndd, Inc.*, 313 F.2d 472 (3d Cir.), *cert. denied*, 374 U.S. 806 (1963); *Keenan v. Eshleman*, 2 A.2d 904 (Del. Ch. 1938); *David J. Greene & Co. v. Dunhill Int'l, Inc.*, 249 A.2d 427 (Del. Ch. 1968).

merger context, it has the potential to further weaken the standard of conduct fiduciaries apply in their ordinary dealings. The ambivalence, or rather the disjunction, is this: In describing the fair dealing component of the entire fairness test, the *Weinberger* court looked to the arm's-length bargain concept.¹⁶³ This concept, of course, theoretically contemplates that both parties will negotiate to achieve the mutually most advantageous deal. On the other hand, the fair price component, deriving as it does from the appraisal statute, seeks to compensate the minority stockholders for that which they have lost in the merger. It seems obvious that unrelated parties bargaining in their own self-interest will not simply want compensation for what was lost. As the legal economists tell us, they would in such case incur a loss due to the unavoidable presence of transaction costs.¹⁶⁴ Moreover, it would make little sense to sell stock for no gain, especially when the consideration is cash and the stock is publicly listed, so that the stockholder could liquidate her holdings at will.¹⁶⁵ In a true arm's-length bargain, the seller logically expects to receive a gain on the transaction, and thus the compensatory price component of fairness fails to mesh with the process component.

In the case of parent-subsidary mergers, the distinction may be semantic, at least in Delaware, where the appraisal statute has been interpreted to require that minority stockholders receive compensation for future value.¹⁶⁶ To the extent that the fairness test sets a standard of conduct, however, the articulation of the fair price standard, if more generally applied (or even if it is accepted, as it is, that price is a range), tends to diminish the force of a fair

163. The court thus described fair dealing as "embrac[ing] questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approval of the directors and the stockholders were obtained." *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983); see also *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490, 504 (Del. Ch. 1990) (finding fair dealing when the process by which merger terms were set tended "to approximate what independent parties would have arrived at in an arm's length bargain").

164. Transaction costs are the costs of identifying and bargaining with the parties to a contract as well as the costs of enforcing the bargain. A. MITCHELL POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* 12 (2d ed. 1989). An equivalent exchange, less transaction costs, will result in a net loss.

165. There is unlikely to be any significant difference in transaction costs in a merger and individual sale of stock on the market. Richard A. Booth, *Junk Bonds, the Relevance of Dividends and the Limits of Managerial Discretion*, 1987 COLUM. BUS. L. REV. 553, 560-61.

166. See *supra* note 143 and accompanying text.

dealing component that looks to real bargaining to set the outcome. In other words, if process is meant to ensure fairness, the likelihood of achieving fairness is diminished because the stated requirement is a very modest goal.

Some courts and commentators have described the arm's-length bargain test of fairness not as procedural but rather as substantive, requiring that the bargain result in that arrangement that would have been reached in an arm's-length bargaining process. This view is obsolete or mistaken.¹⁶⁷ In the first place, it ignores the emphasis that courts that apply the test give to process. In the second place, such a view of fairness is inconsistent with *Weinberger's* definition of the fairness test because it makes the fair dealing component redundant.

These limitations do not mean that substantive fairness is irrelevant but that its importance arises only in cases of default, that is, when no independent bargaining took place and, until litigation, no independent agent reviewed the terms of the transaction on behalf of the corporation or its minority stockholders. Thus, in *Marciano v. Nakash*,¹⁶⁸ a 50% stockholder group persuaded the court of the fairness of loans to the corporation by demonstrating both the unavailability of financing elsewhere and that the terms of the loans replicated commercial terms previously negotiated by the corporation.¹⁶⁹ Similarly, in *Tovrea Land & Cattle Co. v. Linsenmeyer*,¹⁷⁰ the court was convinced of the fairness of certain self-dealing transactions when the terms on which the director dealt with the corporation yielded the corporation a significant profit.¹⁷¹ In contrast, in cases in which the fiduciaries

167. See, e.g., *Ewen v. Peoria & E. Ry.*, 78 F. Supp. 312, 316 (D.N.Y. 1948) (stating that the test is "whether the proposition submitted would have commended itself to an independent corporation") (quoting *International Radio Tel. Co. v. Atlantic Communication Co.*, 290 F. 698, 702 (2d Cir.) (citation omitted in original), *cert. denied*, 263 U.S. 705 (1923)), *cert. denied*, 336 U.S. 919 (1949); *Burgman & Cox*, *supra* note 13, at 628-29 & n.196 (relying on *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976), a pre-*Weinberger* Delaware case, and *Shlensky v. South Parkway Bldg. Corp.*, 166 N.E.2d 793 (Ill. 1960), which I have found is not generally followed in analyzing fairness); see also *Goldberg*, *supra* note 13, at 1226 (relying in part on *Treas. Reg. § 1.482-1(d)(3)* (1970), which I have seen cited in no cases, and on older substantive fairness cases that do not appear to be generally followed in contemporary fairness analysis).

168. 535 A.2d 400 (Del. 1987).

169. *Id.* at 405.

170. 412 P.2d 47 (Ariz. 1966).

171. *Id.* at 58.

have been careful to structure independent negotiating committees or have relied on clearly independent outside agents (including most recent parent-subsidiary merger cases), substantive fairness has been of little significance.¹⁷² Substantive fairness or fair price, then, is not a standard of conduct that directs fiduciaries towards the highest fulfillment of their responsibilities but rather a defense to be resorted to in litigation. As a litigation defense, it provides a standard that merely compensates the complaining corporation for any demonstrated loss, rather than one that ensures the pursuit of the corporation's best interests.

C. *Fairness United*

I have analyzed separately the development of the fairness test in both the self-dealing and parent-subsidiary merger contexts because of the possibility that the different sources of the fair price component applied in each context might lead to different observations about the application of the fairness test in each context. In fact, I have observed that in both cases the analysis of fairness is largely procedural. More to the point, whatever has been the case historically, it is now clear that the fairness test applied in each context is one and the same and that it centers on process.

*Oberly v. Kirby*¹⁷³ is a 1991 Delaware case in which former directors of a charitable corporation and the Delaware Attorney General mounted a variety of challenges to certain actions of the incumbent members and directors, including a stock exchange between the charitable corporation and a business corporation in which the defendant was influential. Although the court noted that Delaware's interested director statute did not expressly apply to charitable corporations, it held that analogous principles applied.¹⁷⁴ Because all the charity's directors were interested in the

172. The business purpose test, which some jurisdictions apply to invalidate parent-subsidiary mergers without regard to fairness, *see, e.g.*, *Albright v. Bergendahl*, 391 F. Supp. 754, 756-57 (D. Utah 1974) (applying "legitimate corporate purpose" test); *Gabhart v. Gabhart*, 370 N.E.2d 345, 356 (Ind. 1977) (applying corporate purpose test); *Coggins v. New England Patriots Football Club, Inc.*, 492 N.E.2d 1112, 1117-18 (Mass. 1986) (applying "legitimate corporate purpose" test); *Alpert v. 28 Williams St. Corp.*, 473 N.E.2d 19, 28-29 (N.Y. 1984) (applying corporate purpose test), is not a fairness test, although it is evidently grounded in the notion that certain types of transactions are *per se* unfair.

173. 592 A.2d 445 (Del. 1991).

174. *Id.* at 467.

transaction and because, as a non-stock corporation, stockholder ratification was unavailable, the court applied the intrinsic fairness test, noting that, "[t]he standard for intrinsic fairness is the searching test announced in *Weinberger*."¹⁷⁵ Thus, the two-part fair dealing/fair price analysis is the standard equally applicable to self-dealing transactions and parent-subsidary mergers. Given the influence of the Delaware Supreme Court and of *Weinberger* itself, it seems likely that this unified fairness standard will be widely applied.

In evaluating the transaction under the fairness test, the *Oberly* court recognized that although no arm's-length negotiating occurred, the directors were fully informed as to the alternatives available to them and imposed no restrictions on their negotiating agent. Because of these facts, as well as evidence that the negotiations appeared vigorous, the court held the defendants to have met their obligation of fair dealing.¹⁷⁶ Having done so, it examined whether the Vice Chancellor had correctly concluded that the defendants met their burden of proving fair price. Although the evidence was limited, and largely presented by the plaintiffs,¹⁷⁷ the court affirmed the Vice Chancellor's holding.¹⁷⁸ This outcome further demonstrates the heavy process orientation of entire fairness, even in the self-dealing context.

The conclusion that courts treat fairness largely as procedural fairness is also supported by an examination of those conflict-of-interest transactions to which the entire fairness test does not apply. Those transactions I will discuss are tender offers by parents for the subsidiary's minority shares and cases in which self-dealing is not found.

The tender offer context is illustrated by the post-*Weinberger* case of *Joseph v. Shell Oil Co.*,¹⁷⁹ which involved minority stockholders' preliminary injunction motion against the controlling parent's tender offer. Although granting the injunction because the defendants had failed to prove that they had fulfilled their duty of candor, the court acknowledged its agreement with the general rule articulated by the defendants: The duty of a majority

175. *Id.* at 469 (citing *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983)).

176. *Id.* at 470-71.

177. The burden of proof was on the defendants. *Id.* at 469.

178. *Id.* at 472-73.

179. 482 A.2d 335 (Del. Ch. 1984).

stockholder in making a tender offer does not include offering a fair price but only requires a minimal fair procedure in the form of full disclosure.¹⁸⁰ The reason for this rule is that the stockholder is free to accept or reject the tender offer, presumably making her own determination as to the fairness of the offered price.¹⁸¹ Although this reasoning was indirectly challenged in a subsequent Delaware Chancery Court case,¹⁸² the Vice Chancellor found support for it in prior caselaw,¹⁸³ and it has not been rejected as a proposition of law. In limiting its focus to process, the *Joseph* opinion reinforces the procedural treatment of fiduciary breaches.

Another context in which the fairness test does not apply is when no self-dealing exists. Although this observation seems self-evident, the key is in how self-dealing is defined. The prevailing test¹⁸⁴ defines self-dealing as occurring when the parent corpora-

180. *Id.* at 341; see *Abbey v. Montedison S.P.A.*, 539 N.Y.S.2d 862 (Sup. Ct. 1989).

181. *Joseph*, 482 A.2d at 341.

182. See *Citron v. E.I. DuPont de Nemours & Co.*, 584 A.2d 490, 499-502 (Del. Ch. 1990). The Chancellor in *Citron* explained the universality of the fairness test's application in parent-subsidary mergers, in contrast with the purely procedural validation available under DEL. CODE ANN. tit. 8, § 144, as plausibly resting on the pervasive influence of the parent corporation that might lead minority stockholders to fear parent retaliation were they to vote against the proposed merger, a potential fear that never could procedurally be eliminated. *Id.* Surely the same problem exists with respect to parent tender offers.

183. *Joseph*, 482 A.2d at 341; see also *Northway, Inc. v. TSC Indus., Inc.*, 361 F. Supp. 108 (N.D. Ill. 1973) (applying Delaware law) (applying § 144 to support board approval of a transaction in which the subsidiary sold its assets to its controlling parent and then dissolved), *aff'd in part*, 512 F.2d 324 (7th Cir. 1975), *rev'd* 426 U.S. 438 (1976). Notably, however, the *Northway* court seemed to limit application of § 144 to abrogation of the common law voidability rule, rather than to eliminate the question of fairness. *Id.* at 114-15.

184. The test is most clearly articulated in *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971); see also *Case v. New York Cent. R.R.*, 204 N.E.2d 643, 645-46 (N.Y. 1965) (describing same test.) The test traces at least as far back as *Pepper v. Litton*, 308 U.S. 295 (1939), when the Supreme Court stated that

[a fiduciary] cannot use his power for his personal advantage and to the detriment of the stockholders For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis*.

Id. at 311.

The significance of *Levien* is not in articulating the test, which has long been applied as a means of evaluating fairness, but in applying it as a threshold test to determine whether the fairness test or the business judgment rule is to be applied. Some commentators have misunderstood the *Levien* test as itself a measure of fairness. See, e.g., Goldberg, *supra* note 13, at 1237-39.

tion (or controlling stockholder) receives a benefit to the detriment of the subsidiary corporation or the minority stockholders.¹⁸⁵ This test is exclusively procedural. As long as the fiduciary has been careful to maintain proportional treatment between itself and the minority, the court will not inquire into fairness. Nevertheless, gross unfairness might occur.

For example, a parent corporation might cause its partly-owned subsidiary to declare large dividends to its stockholders at a time when the parent needs cash, leaving the subsidiary without funds for growth. Alternatively, a parent corporation might enter into a contract to provide services to its subsidiary as a means of obtaining the subsidiary's cash. The second situation is evaluated under the fairness test; the first is not.¹⁸⁶ Although in each situation a parent corporation uses its subsidiary for its own purposes, in the first situation the dividend is paid to all stockholders pro rata, whereas in the second situation the parent receives something (cash) that the subsidiaries give up. The difference in the form of consideration (cash or services) leads to application of the fairness test in the second case.¹⁸⁷ Yet the potential for the parent opportunistically to use the subsidiaries is the same in each case.¹⁸⁸ The fact that the test relies on a procedural notion to

Proof of self-dealing to invoke the intrinsic fairness test is unnecessary in cases of interested director transactions to which statutory validation procedures are applicable. See *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976).

185. *Sinclair*, 280 A.2d at 721. The test appears to apply only to parent-controlling stockholder transactions with subsidiaries or the corporation and not to interested director or common director transactions. The apparent reason for this distinction is that the latter two types of transactions were prohibited at common law and the others were unaddressed. See *Marsh*, *supra* note 37, at 36-39.

186. *Sinclair*, 280 A.2d at 720-22.

187. Since any transaction will involve different forms of consideration on each side, it appears that self-dealing, as defined by the court, will always exist in transactions between a manager and the corporation. See, e.g., *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594-96 (Del. Ch. 1986) (applying intrinsic fairness test when controlling stockholder allocated different forms of merger consideration to himself and non-controlling stockholders); cf. *Summa Corp. v. Trans World Airlines, Inc.*, 540 A.2d 403, 406-07 (Del.) ("It is well established . . . that one who stands on both sides of a transaction has the burden of proving its entire fairness. In the absence of arms length bargaining, . . . this obligation inheres in, and invariably arises from the parent-subsidiary relationship.") (citation omitted), *cert. denied*, 488 U.S. 853 (1988); *Trans World Airlines, Inc. v. Summa Corp.*, 374 A.2d 5, 13 (Del. Ch. 1977) (holding that the intrinsic fairness test applied when parent deprived subsidiary of power to bargain over contracts with third parties). But cf. *In re Reading Co.*, 711 F.2d 509, 518 (3d Cir. 1983) (stating that whether an arrangement constitutes self-dealing depends on the proportionality of burdens and benefits).

188. These situations, of course, implicate questions of motive, from which courts shy

determine whether the fairness test even applies, despite the obvious potential for injustice, reinforces the importance of procedure in evaluating fiduciary conduct.¹⁸⁹

D. *Why Procedure Over Substance?*

There remains the question of why courts and legislatures largely have adopted a procedural approach to fairness in preference to a best price or other, more rigorous, substantive fairness approach. The reasons, of course, are speculative since the evolution of this procedural orientation has not itself been judicially noted or discussed. In addition, legislative commentary seems limited to discussion of the need for clear rules.

One reason might well be the consistent preference that late twentieth-century courts have shown for relatively objective forms of analysis.¹⁹⁰ In particular, the forms of procedural fairness are much more recognizable and identifiable than those of substantive fairness. Courts readily can identify when independent directors are available and independent committees used, when relatively dispassionate legal and financial advisors and appraisers have been retained, and when full disclosure has been made to independent

away. *Merritt v. Colonial Foods, Inc.*, 505 A.2d 757, 764 (Del. Ch. 1986) (finding directors' good faith was not curative); cf. *Lacos Land Co. v. Arden Group, Inc.*, 517 A.2d 271, 278 (Del. Ch. 1986) (invalidating stockholder approval of charter amendment offering recapitalization when controlling stockholder, presumably acting in good faith, coerced minority vote); see also *Palmiter*, *supra* note 13, at 1364 ("Significantly, throughout the loyalty regime's history, the interested person's subjective integrity or honor has always been irrelevant."). Professor Dooley discusses the Delaware courts' focus on motives, but he clearly means by this presumed motives in a category of transactions involving fiduciary conflicts of interest (hostile takeovers). See Dooley, *supra* note 126, at 518-19. Courts, however, generally avoid analyzing fiduciaries' motives in specific cases.

189. Of course if, as I suggest, see *supra* note 187, differences in the form of consideration lead to a conclusion of disproportionality and thus of self-dealing, the test will widely apply to self-dealing transactions and the category of cases in which it will be problematic will be limited.

190. See George C. Christie, *Objectivity in the Law*, 78 YALE L.J. 1311 (1969) (evaluating the possibility of judicial objectivity in light of scholarly instance that it exists); Duncan Keunedy, *The Structure of Blackstone's Commentaries*, 28 BUFF. L. REV. 205, 263 (1979) (arguing that "liberal legal thought" is obsessed with judicial objectivity). But see Catherine A. MacKinnon, *Feminism, Marxism, Method, and the State: Toward Feminist Jurisprudence*, 8 SIGNS: J. WOMEN CULTURE & SOC'Y 635 (1983) (challenging the concept of objectivity as intrinsically male). For an excellent study of the development of this objectivity obsession in American thought generally (including legal thought), see EDWARD A. PURCELL, JR., *THE CRISIS OF DEMOCRATIC THEORY* (1973); see also *Auerbach v. Bennett*, 393 N.E.2d 994 1002 (1979) (noting that courts are "well equipped" to evaluate procedure in contrast to substance).

directors or stockholders.¹⁹¹ In contrast, it is far more difficult to see when a "best" or "fair" price has been received.¹⁹² When the object dealt in is fungible and traded on reasonably efficient markets, at least there is an apparent starting point for evaluating the fairness of price.¹⁹³ Even this measure is elusive in the relatively rare cases where it is available. For example, the classic commodity that meets this description is the common stock of a widely traded corporation. Stock prices, however, are most likely to matter in evaluating the fairness of parent-subsidary mergers, in which the very presence of the parent as controlling stockholder is likely to affect the trading price of the stock in a manner that is difficult to calculate. As a standard, therefore, stock prices do little to cure the difficulty of identifying the best or a fair price.¹⁹⁴

Related to this preference for objective forms of analysis are our own perceptual difficulties. We can readily imagine and construct a model in which perfect procedural fairness exists, a paradigm against which to compare actual cases. Boards of directors then would have clear guidance in how to protect conflict-of-interest transactions from stockholder attack. Courts also then could determine easily, based on this model, whether the goal of procedural fairness was fulfilled. We have no perfect models for identi-

191. Although the point seems self-evident, it is also worth pointing out that the ideal of procedural fairness bears a striking resemblance to the economist's perfectly efficient market. For a description of market perfection, see Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. BUS. 411, 412-15 (1961).

192. Again, this point seems self-evident. Nonetheless, the indeterminacy of financial valuation often has been noted. The very fact that fair price universally is accepted to be a range is clear proof of such indeterminacy.

193. That is, by definition, the price of such a commodity should be "correct" in some sense. For a thorough discussion of the consequences of market efficiency, see Ronald A. Gilson & Renier Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

194. Much debate exists, for example, over the importance to fair valuation of applying a minority discount in determining value. In some cases, courts refuse to apply a minority discount. *See, e.g.,* Walter S. Cheesman Realty Co. v. Moore, 770 P.2d 1308, 1312-13 (Colo. Ct. App. 1988) (reversing trial court's application of a minority discount); Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1144 (Del. 1989) (affirming Vice Chancellor's refusal to apply minority discount); Thomas D. Hall, Comment, *Valuing Closely Held Stock: Control Premiums and Minority Discounts*, 31 EMORY L.J. 139 (1982) (arguing that minority discounts should not be applied in valuing close corporation shares). In other cases, however, courts have applied a minority discount. *See, e.g.,* Estate of Clarence J. Grootemaat, 48 T.C.M. (P-H) ¶ 79,049 (1979); Minette Hermelin, 46 T.C.M. (P-H) ¶ 77,094 (1977); Stanley A. Revzin, 46 T.C.M. (P-H) ¶ 77,068 (1977); Clark v. United States, 75-1 T.C. (CCH) ¶ 13,076 (1975).

ying a best or fair price. Although we can theoretically define these terms, even the tools of financial valuation that experts currently use are recognized as imperfect in application and variable in outcome.¹⁹⁵ Consequently, no court can even conceive of a best price or fair price model that provides the helpful comparison that the model of procedural fairness provides. So it seems natural for courts to look more to procedural fairness in applying an inherently indeterminate and necessarily more subjective test.

There may be a further reason why courts rely principally on procedural, rather than substantive, notions of fairness. Substantive fairness is a concept that is relatively unfamiliar in our political and social system. The major constitutional "fairness" claims involve liberty and equality,¹⁹⁶ which are presented as abstract concepts and as interpersonally related, rather than as tied to goods or services of any particular type or quantity. These are shored up by procedural aspects of due process, which look to the manner in which one is deprived of life, liberty, or property, rather than to the question of whether one can be deprived of such rights at all.¹⁹⁷ Attempts to introduce substantive ideals of fairness into our system have met, overwhelmingly, with failure, and even the philosophers who have tackled the question, from Aristotle¹⁹⁸ to John Rawls,¹⁹⁹ have looked to questions of consent, volition, and equality, rather than to rights to anything in particular.²⁰⁰ The one public area of fairness that comes to mind as analogous to the corporate situation, and indeed has been analogized to freeze-out

195. A nice discussion of this point is presented in *Cede & Co. v. Technicolor, Inc.*, Civ. A. No. 7129, 1990 WL 161084 (Del. Ch. Oct. 19, 1990), in which Chancellor Allen discusses valuation technology as well as the difficulty of combining the testimony of different experts.

196. See U.S. CONST. amends. V, XIV.

197. See, e.g., *Goldberg v. Kelly*, 397 U.S. 254 (1970). Although certain substantive rights are guaranteed by the Due Process Clause of the Fourteenth Amendment, *Planned Parenthood of S.E. Pa. v. Casey*, 112 S. Ct. 2791 (1992), these rights typically are rights to be free from certain governmental interferences, rather than rights to certain benefits.

198. ARISTOTLE, *NICHOMACHEAN ETHICS* bk. E (Hippocrates G. Apostle trans., 1975).

199. RAWLS, *supra* note 111, at 342-50; see H.L.A. Hart, *Are There Any Natural Rights?*, 64 PHIL. REV. 175, 185 (1955) (expressing a similar notion of fairness); see also ROBERT NOZICK, *ANARCHY, STATE AND UTOPIA* 93-95 (1974) (criticizing Hart's and Rawls's approaches but largely on consensual and volitional grounds and maintaining procedural focus). Cf. ELIZABETH H. WOLGAST, *THE GRAMMAR OF JUSTICE* ch. 6 (1987) (questioning whether justice can be conceived of as an ideal).

200. That the fairness concept, used to inform justice, is inherently process-oriented has been noted elsewhere. See Chapinan, *supra* note 2.

mergers,²⁰¹ is the Constitution's Takings Clause, in which the deprived property owner is guaranteed just compensation.²⁰² Even this analogy fails to provide an appropriate model because although the Constitution, like the fairness test, does not promise a "best" price,²⁰³ it contemplates a taking in the public interest by the very government by virtue of whose existence the property is protected (if not created).²⁰⁴ Corporations are neither created nor is their existence protected by corporate fiduciaries but rather by the state, yet the self-dealing to which the fairness test applies is self-dealing by corporate fiduciaries. The strangeness of substantive fairness notions to our legal and political system in general may well be a factor in courts' and legislatures' clear preference for the more familiar procedural concept of fairness.

IV. TRUST AND FAIRNESS: ASKING THE RIGHT QUESTION

The bedrock of corporate relationships is, I believe, trust. I have argued that fiduciary duty ideally helps to establish the circumstances in which trust between stockholders and managers can exist. I have further suggested that the appropriate question to ask in evaluating alleged breaches of fiduciary duty is whether the fiduciary has damaged that trust.

The fairness test disregards these concerns and, in so doing, asks a question that not only misses the point of fiduciary duty but also is inherently flawed. In asking whether a transaction was fair to minority stockholders, the fairness test looks not at trust but at the issue of truth. As I have tried to show,²⁰⁵ this epistemological-like inquiry is fatally flawed, either because we cannot identify with certainty a fair result or because we currently lack the tools to identify that fair result.²⁰⁶ The consequence of

201. Buxbaum, *supra* note 149, at 1722 (characterizing a freeze-out merger as a "private right of eminent domain").

202. See U.S. CONST. amend. V.

203. See generally JACQUES B. GELIN & DAVID W. MILLER, *THE FEDERAL LAW OF EMINENT DOMAIN* § 3.1 (1982) ("in practice the property owner has not been entitled to full indemnification for his loss"); 4 JULIUS L. SACKMAN & PATRICK J. ROHAN, NICHOLS' *THE LAW OF EMINENT DOMAIN* § 12.01 (3d ed. 1990) (discussing methods of valuation used in eminent domain proceedings).

204. See Morris R. Cohen, *Property and Sovereignty*, 13 CORNELL L.Q. 8 (1927) (arguing that all property is created by the state).

205. See *supra* Section III(D).

206. It is beyond my purpose here to engage in an analysis of the meaning of truth as an abstract concept. See generally 2 *THE ENCYCLOPEDIA OF PHILOSOPHY* 130 (Paul

this flawed inquiry is to lead courts to refocus the analysis to the proper question of whether the conditions for trust exist, that is, whether procedural fairness has been satisfied. It should now be clear that this inquiry too is misconceived because it is occasioned precisely by the determination that the conditions for trust do not exist, that fiduciary loyalty has not been satisfied because the fiduciary has favored herself in a conflict of interest with the beneficiary. The determination of procedural fairness, then, is meaningless. It is a judicial determination that reality belies appearances, that despite the failed conditions of fiduciary trust, fiduciary trust was appropriate after all.

Against this backdrop, the fairness test, as now applied, does nothing to sustain the conditions of trust necessary to encourage stockholders to part with their money and enter into fiduciary relationships as powerless parties. In this failing, the law disregards the centrality of trust in favor of a model that looks only to the form of action. Incredibly, such analysis centers on whether formal *appearances* have been maintained in the face of an obvious conflict of interest without regard to any more systemic damage to the ongoing relationship that such conflict might cause. The test provides no assurance that when fiduciary and beneficiary interests conflict, the latter will triumph. Rather, it acts to protect the fiduciary's conduct from attack by the beneficiary as long as the fiduciary can make her conduct *appear* fair, regardless of whether she actually pursues the beneficiary's interest. Hence, the fairness test benefits only the fiduciary, leaving the beneficiary largely unprotected.

Some scholars have suggested that the common law of contract arguably provides an alternative method of providing stockholders with the assurance that their investments will be managed

Edwards ed., 1967) (discussing the coherence theory of truth); *id.* at 223 (discussing the correspondence theory of truth); 6 *id.* at 88 (discussing the performative theory of truth); *id.* at 427 (discussing the pragmatic theory of truth). It is, nonetheless, implicit in the fair price component of the entire fairness test that fairness is a Platonic ideal, an implication reflected in such articulations as "intrinsic value." *See, e.g.,* Smith v. Van Gorkom, 488 A.2d 858, 893 (Del. 1985) (remanding for determination of intrinsic value in accordance with Weinberger); *cf.* Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1, 4 (1985) (bemoaning court's use of phrase "intrinsic value" as anachronistic and unrealistic). Nonetheless, whether fair price exists as an absolute truth, a relative truth, or something in between, it is clearly more difficult for a court to undertake the determination of fair price than it is to evaluate the fairness of process. *See supra* Section III(D).

faithfully and carefully.²⁰⁷ In principle, contract eliminates the need for trust by specifying the rights and obligations of the parties and, in so doing, creates a separate basis for determining their claims. The establishment of a satisfactory contract makes irrelevant the question of whether a person has "discharged his obligations on grounds of trust."²⁰⁸

Although a number of competing contractual models exist,²⁰⁹ the model of contract law I mean is the market model of contract developed by law and economics scholars and judges in the corporate law context.²¹⁰ This model looks at the corporation as a series of bilateral contracts among the various factors of production and output, including capital suppliers such as stockholders and bondholders, suppliers of labor, management, raw materials suppliers, and customers. It attributes to that organization a relatively efficient structure arising from the various parties' using their market-driven bargaining power and knowledge to negotiate efficient contracts in their respective self-interest.

I concede that trust might be unimportant in its functional capacity if it were possible in advance to detail the corporate contract. In that case, the ideal contract would itself eliminate the complexity and indeterminacy of corporate life, and trust would be unnecessary. To make this observation is itself to establish why even an ideal contract is insufficient: corporate complexity and indeterminacy are too great to permit the creation of any contract that will satisfactorily fulfill the role of trust.²¹¹ More importantly, a strict regime of contract would fail to replace the important value structure underlying a regime of trust.²¹²

207. See, e.g., EASTERBROOK & FISCHEL, *supra* note 62, at 92. Easterbrook and Fischel refer to this method as fiduciary duty, a characterization with which I disagree. See Lawrence E. Mitchell, *The Cult of Efficiency*, 71 TEX. L. REV. 217, 235-38 (1992) (reviewing FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991)).

208. LUHMANN, *supra* note 4, at 34; see also BARBER, *supra* note 20, at 101 (stating that in a market economy, trust is limited to trust in technical competence and does not include fiduciary trust).

209. See generally IAN R. MACNEIL, *THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS* (1980) (discussing relational model of contract); Rosenfeld, *supra* note 2 (discussing classical and social contract theory).

210. A good exposition and critique of this model is provided in Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

211. Bernard Barber also identifies lack of trust as a species of transaction cost. BARBER, *supra* note 20, at 128. The presence of such costs argues in economic terms against excessive reliance on contract to the exclusion of trust.

212. Although a complete exposition of the values underlying trust is beyond the

It will not suffice to answer, as do law and economics scholars, that the contract terms the parties would choose are easy to identify because they would choose those terms that produce the most efficient outcomes.²¹³ In the first place, efficiency is itself far too vague and open-ended a concept to serve adequately in reducing complexity and indeterminacy.²¹⁴ In the second place, the attempt to ground fiduciary loyalty in such an explanation misses both the nature and importance of trust; as Niklas Luhmann puts it, "Trust is . . . something other than a reasonable assumption on which to decide correctly, and for this reason models for calculating correct decisions miss the point of the question of trust."²¹⁵

Trust is not entirely teleological, a means to an end, nor is it a prediction.²¹⁶ Rather, in its character as a condition for societal relations, trust exists as a necessary foundation for permitting individuals to acquire goods or achieve other goals, and in this sense resembles Aristotle's concept of the virtues that, like trust, are only partly teleological and partly significant for their own sake as part of a conception of substantive goods.²¹⁷ In this sense, trust has somewhat of a universal character, an observation that is important in recognizing its place in the law and its utility as a foundation for doctrinal development.

Trust as a principle for achieving certain goals, however, also transcends the limitations of other methods. Luhmann notes that techniques such as optimization, means-ends analysis, and predic-

scope of this Article, it is provided in a forthcoming essay. See Lawrence E. Mitchell, *Trust. Contract. Process*, (on file with author). There, I argue for the concept of trust as a virtue in the Aristotelian tradition both because of its intrinsic value and because of its role in making societal relations possible.

213. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1433 (1989); POLINSKY, *supra* note 164, at 27.

214. See generally Jules L. Coleman, *Efficiency, Exchange, and Auction: Philosophic Aspects of the Economic Approach to Law*, 68 CAL. L. REV. 221 (1980) (discussing the concept of economic efficiency); *Symposium On Efficiency as a Legal Concern*, 8 HOFSTRA L. REV. 485-972 (1980) (same); see also Mitchell, *supra* note 207, at 235-38 (criticizing the contractual view of fiduciary duty).

215. LUHMANN, *supra* note 4, at 88.

216. *Id.* There is a teleological component to trust in a broad sense in that only through trust is the establishment and maintenance of community possible. Trust is not entirely teleological, however, in that its use can lead one to a particular good or provide a means of achieving a goal. Mitchell, *supra* note 212.

217. ARISTOTLE, *supra* note 198, at 36-37.

tion can eliminate the need for trust as far as they extend,²¹⁸ but the substantial uncertainties of economics suggests that they do not extend terribly far, especially when applied to answer hypothetical questions about the way in which rational persons act. Moreover, such analysis disregards the emotional, non-rational aspects of human behavior that play an important role in human relationships and the construction of communities.²¹⁹ In other words, as a practical matter, trust at some level is not a matter of choice; to live in society, we require some trust.

My conclusion as to the failure of the fairness test to support corporate trust is not belied by the fact that trading volumes on the organized exchanges continue to be high, demonstrating continued public faith in corporate management. On the contrary, the overwhelming proportion of corporate equities is today held by large financial institutions that may have a greatly diminished need for the protections of the fiduciary relationship because of the power they possess over corporate fiduciaries.²²⁰ The increased

218. LUHMANN, *supra* note 4, at 88.

219. The manner in which the infiltration of economic theory into a variety of disciplines has corrupted our concept of human nature by limiting it to rational economic man is explored in BARRY SCHWARTZ, *THE BATTLE FOR HUMAN NATURE: SCIENCE, MORALITY AND MODERN LIFE* (1986). Robert Frank has explored the ways in which emotions help people solve cooperation problems. See ROBERT H. FRANK, *PASSIONS WITHIN REASON: THE STRATEGIC ROLE OF THE EMOTIONS* (1988). Annette Baier has explored some of the emotional aspects of trust. See Baier, *supra* note 20.

220. Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135, 1152-56 (1991); Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1, 22 (1991); Roberta S. Karmel, *Is It Time for a Federal Corporation Law?*, 57 BROOK. L. REV. 55, 68-69 (1991); *Victories of Governance Proposals Rose By Significant Margin in 1990, Study Says*, 6 Corp. Couns. Wkly. (BNA) No. 43, Oct. 30, 1991, at 2. .

Some of the flavor of this activism is provided in Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991). On October 4, 1991, the Chief Executive Officer of the California Public Employees' Retirement System (CalPERS), "[t]he nation's largest institutional investor," announced that CalPERS would abandon the use of stockholder proposals to influence corporate governance and instead seek direct negotiations with individual corporations in order to avoid public scrutiny. *CalPERS to Drop Shareholder Proposals as Means of Forcing Management Change*, Sec. Law Daily (BNA) (Oct. 7, 1991).

Institutions also have exerted significant pressures on legislators in order to increase their voice in corporate governance. Both the United Shareholders Association and CalPERS have petitioned the Securities Exchange Commission to change the current proxy regulations in favor of greater stockholder participation. See *Regulation of Securityholder Communications*, Exchange Act Release No. 34-29315, 17 C.F.R. pt. 240 (June 11, 1991). Other institutional action has been aimed at preventing diminution of stockholder voices. As a result of the enactment of Pennsylvania's new anti-takeover law

influence of these institutional stockholders over corporate management has been extensively observed, as has their diminished need for fiduciary protection.²²¹ The enormous growth in institutional stockholders as a market force compels the conclusion that individual stockholders, on whom the fiduciary model was based, are increasingly reluctant to own individual stocks. Thus, if anything, current market conditions reinforce the conclusion that adequate trust in fiduciary loyalty is lacking.

Fiduciary duty, then, is an important contribution to establishing the conditions for the trust necessary to permit the corporation to exist and function,²²² and fairness is the measure of fiduciary obligation. Having explained why the fairness test as currently applied is inadequate to serve this function, I now turn to a reconceptualization of corporate conflicts to evaluate the economic effects of the fairness test and to consider available alternatives.

V. FAIRNESS IN CONTEXT: A REANALYSIS AND RECOMMENDATION

Courts frequently talk about the contextual nature of the fairness test. In light of my conclusion that the fairness test universally seems to contemplate a concept of procedural fairness, it is difficult to accept these assertions at face value. Reading the cases, however, one gets the sense of a distinction, despite the unrelieved uniformity of doctrinal articulation and analysis. I will attempt to identify this distinction by classifying the types of conflict of interest at issue in the various cases and analyzing the way in which

diminishing the effect of stockholder pressure on directors of Pennsylvania corporations, several institutional investors expressed doubts as to whether they would continue to invest in Pennsylvania companies. Diana B. Henriques, *A Paradoxical Anti-Takeover Bill*, N.Y. TIMES, Apr. 8, 1990, § 3, at F15; Gregory A. Robb, *SEC Chief Criticizes Bill to Thwart Takeovers*, N.Y. TIMES, Apr. 3, 1990, at D2; Leslie Wayne, *Takeovers Face New Obstacles*, N.Y. TIMES, Apr. 19, 1990, at D1; *Foe Studying Takeover Act*, N.Y. TIMES, Aug. 24, 1990, at D4.

221. See, e.g., Barnard, *supra* note 220, at 1154-56; Buxbaum, *supra* note 220, at 22-23; Karmel, *supra* note 220, at 66-76; Rock, *supra* note 220, at 448-50; see also Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1525 (S.D.N.Y. 1989) (suggesting that the sophistication of institutional investors is a reason for denying relief).

222. Cf. LUHMANN, *supra* note 4, at 33-35 (discussing the relationship between law and trust but cautioning against excessive reliance on law to establish trust); BARBER, *supra* note 20, at 15-16 (stating that trust as a fiduciary mechanism is essential but insufficient); see also Baier, *supra* note 20, at 255 (proposing moral decency test of trust relationships that continuation of relationship of trust "need not rely on successful threats held over the trusted, or on her successful cover-up of breaches of trust").

the fairness doctrine does or does not account for the distinctions among conflicts in resolving cases and giving guidance for fiduciary conduct. My ultimate conclusion is that applying the fairness test to the majority of self-dealing transactions gives the fiduciary a concealed financial interest in the corporation, the extent of which is determined largely by the fiduciary herself. There are some cases of conflict, however, in which the fiduciary does have a legitimate financial interest in the corporation. This observation leads me to argue that two quite distinct tests are appropriate, one substantive and one procedural, embodying quite different concepts of fiduciary loyalty that are applicable to different types of situations. Recognizing these distinctions goes a long way towards establishing meaningful, workable, and consistent standards of fiduciary conduct and tools for resolving cases.

A. *Vertical and Horizontal Conflicts*

Although fiduciary doctrine is employed over a wide-ranging variety of conflicts of interest in corporate law, these conflicts reduce down to two basic types. The first type is exemplified by what I have heretofore referred to as "self-dealing," that is, when corporate fiduciaries engage their corporations in business relations of a type that normally would involve a third party. Examples of this type of conflict include situations in which the fiduciary sells property to or buys property from the corporation, loans money to the corporation,²²³ or appropriates to herself a corporate opportunity. The hallmark of this type of conflict is that the conflict does not derive from the fiduciary's interest in the corporation itself, but rather from her interest in another business venture. It is only her position as a corporate power holder that gives her the opportunity to use the corporation to gratify this other interest. Like a third party, the corporate fiduciary in such a context has independent business interests that she is attempting to serve in transacting with the corporation. Such transactions with third parties ordinarily take place at arm's-length in the ordinary course of business on terms available in the market or as the product of negotiations.

223. I do not include conflicts in which a fiduciary *borrow*s money from the corporation because that situation is more like a preferential distribution of corporate assets and thus more properly treated as a horizontal conflict. See *infra* note 227 and accompanying text.

Ordinarily, no third party has the right to deal with the corporation and only succeeds by presenting competitive terms. When the transacting party is, instead, a corporate fiduciary, she has positional and informational advantages over third parties that may cause the corporation to prefer to do business with her or give her insights into corporate weaknesses. This position may give her bargaining advantages with the corporation over other competitors. In addition, this type of situation creates the possibility that the corporation will not be represented as vigorously in negotiations with the fiduciary as it would be with an unrelated party. I refer to this type of conflict of interest as a "vertical" conflict of interest because it presents a conflict between the power-holding fiduciary and the corporation over which she has power.²²⁴

The second type of conflict of interest is illustrated by the facts of *Sinclair Oil Co. v. Levien*,²²⁵ in which the controlling stockholder caused a dividend to be declared to serve its own financial needs. As with vertical conflicts, this type of case presents a situation in which the fiduciary attempts to satisfy other business interests by dealing with the corporation. Unlike the case of vertical conflicts, however, in this type of conflict the fiduciary attempts to satisfy this interest by means of a facially proper use of her legitimate financial interest in the corporation itself. The most typical situation in which this use of power occurs is when the fiduciary is a corporate stockholder.²²⁶ In such cases, the fiduciary not only has power over the corporation to be used in its management but also shares the benefits of that management in coin-

224. I first introduced the concepts of vertical and horizontal conflicts of interest to distinguish situations in which the principal role of fiduciary standards is to prevent or regulate self-dealing (vertical context) from cases in which fiduciary principles have been used to identify an exclusive beneficiary of the duty (horizontal context). Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1189-1215 (1990); see also Mitchell, *supra* note 19, at 590-94 (further applying this distinction). I will also use this distinction to determine the propriety of applying the fairness test in these disparate contexts. See *infra* Section V(B).

225. 280 A.2d 717 (Del. 1971).

226. It is possible to imagine cases in which the fiduciary has a different financial interest in the corporation, for example, a major relational debtholder of a corporation in bankruptcy or nearing bankruptcy. See, e.g., LAWRENCE E. MITCHELL & LEWIS D. SOLOMON, *CORPORATE FINANCE AND GOVERNANCE* 95 (1992) (discussing lenders' acquisition of corporate fiduciary duties). A similar situation is presented when the controlling and minority stockholders own different classes of stock. See, e.g., *Burton v. Exxon Corp.*, 583 F. Supp. 405, 408 (S.D.N.Y. 1984) (applying Delaware law); *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 587 (Del. Ch. 1986).

mon with the other stockholders. This type of conflict, which I refer to as "horizontal," occurs when the stockholding fiduciary attempts, by virtue of her position, to gratify her own financial interests through her ownership of shares at the expense, or to the detriment,²²⁷ of other holders of the same class of shares. Examples include cases involving not only declarations of dividends but also capital restructurings and reorganizations and selective redemptions.²²⁸ The critical determinant of horizontal conflict is that it presents a case in which the fiduciary uses her legitimate, preexisting financial interest in the corporation in a manner that may lead her to realize a benefit disproportionate to those who own the same type of interest.

Although there are contexts in which courts recognize this distinction, that recognition is not consistent and does not extend to the application of the fairness test. Perhaps the clearest acknowledgment of the difference between these types of conflicts is in the area of derivative litigation.²²⁹ The general rule is that cases are to be brought derivatively when the injury alleged is one that is shared in common with all other stockholders and directly when the representative stockholder plaintiff alleges injury that is unique.²³⁰ For example, cases alleging that fiduciaries usurped a

227. The cases applying the benefit-detriment test seem to equate detriment and expense. See, e.g., *Burton*, 583 F. Supp. at 416; *Sinclair Oil*, 280 A.2d at 720; *Jedwab*, 509 A.2d at 595. I mean to recognize that these concepts are different.

228. See Mitchell, *supra* note 19, at 599 n.99 (describing "classic" cases of horizontal conflict). In that description, I included dealings in corporate control, from which I now would exclude mergers. For the reasons behind this exclusion, see *infra* note 234 and accompanying text.

229. See, e.g., *Sax v. World Wide Press, Inc.*, 809 F.2d 610, 613 (9th Cir. 1987) (applying the general proposition that a shareholder can enforce a corporate right in a derivative action "if the gravamen of the complaint is injury to the corporation . . . without any severance or distribution among individual holders") (quoting 12B WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5911 (perm. ed. rev. vol. 1984)); *Seidel v. Allegis Corp.*, 702 F. Supp. 1409, 1411 (N.D. Ill. 1989) (holding that the stated claim was derivative because the wrongs alleged affected all shareholders by depressing the value of the stock); *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1070 (Del. Ch.) (explaining that the plaintiff in a direct action must allege a separate and distinct injury or assert a shareholder right that "exists independently of any right of the corporation"), *aff'd*, 500 A.2d 1346 (Del. 1985); *Hajdik v. Wingate*, 753 S.W.2d 199, 201 (Tex. Ct. App. 1988) (observing that a stockholder cannot bring an action "on his own behalf against one who has injured the corporation," despite a loss in value of his shares), *aff'd*, 795 S.W.2d 717 (Tex. 1990). See generally WILLIAM L. CARY & MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 622-24 (6th ed. 1988).

230. See *Elster v. American Airlines, Inc.*, 100 A.2d 219, 222 (Del. Ch. 1953) (holding

corporate opportunity or sold property to the corporation at inflated prices are derivative in nature because the alleged harm, if proved, damages the corporation, and thus the stockholders' interests, proportionately. On the other hand, cases involving dividend declarations or recapitalizations of controlled subsidiaries are brought directly because the alleged injury, if proved, is to the minority stockholders of the subsidiary and the benefit inures to the parent corporation or controlling stockholder. Occasionally, courts even will recognize the distinction in garden-variety cases dealing with an assortment of alleged fiduciary breaches.²³¹ In no cases, however, do courts fail to apply the fairness test as a consistent measure of fiduciary conduct.

B. *Fairness: A Gift to the Fiduciary*

Once the distinction between vertical and horizontal conflicts is recognized, the case for applying the fairness test in all situations, or at least the same concept of fairness in all situations, becomes questionable as an alternative to either the traditional, outright prohibition of such transactions or a best price standard. The transactions at issue in cases of vertical conflict either are transactions that the corporation may not have to undertake at all or, if necessary or desirable, could be consummated with a third party. The simple fact that such transactions do not occur with a third party, but rather with a fiduciary, creates the conflict and the possibility that the transaction may not best serve the corporation's interests. The issue in such cases is whether the corporation has in fact been well-served by the transaction or, to put it differently, whether the fiduciary's obligation of loyalty to the corporation has been compromised.

Cases of horizontal conflict present a different problem, a problem not only of degree, but of type. The difference arises because the fiduciary in such cases has made an investment in the corporation for the purpose of furthering her own financial inter-

that a stockholder may have an individual claim if she has suffered an injury distinct from the harm to the corporation); *Harden v. Eastern States Pub. Serv. Co.*, 122 A. 705, 707 (Del. Ch. 1923) (holding that when "the corporation itself [will not] . . . redress the wrongs done to it [and] the stockholders are permitted to proceed, . . . [t]heir right is strictly a derivative one").

231. See, e.g., *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963) ("Two classes of cases in the area of fiducial [sic] responsibility of officers and directors of a corporation are present here.").

ests, just as have the other stockholders. In such cases, unlike the vertical conflict cases, the fiduciary is legally entitled to receive the same benefits from stock ownership as are the other stockholders. The difficulty in these cases is determining when the fiduciary has exceeded her preexisting rights and benefitted in a manner disproportionate to the other stockholders.

Applying the fairness test to cases of vertical conflict instead of prohibition or a best price standard creates a right of the fiduciary to benefit from the corporation's assets when none existed before. This right is easily demonstrated by referring back to *Geddes* and the cases that follow it in applying a concept of fairness as best possible price. The term fairness as applied to this concept is a misnomer because the very term fairness implies a bilateral notion.²³² Fairness implicitly acknowledges the other party to the transaction by recognizing that the difference between the best deal and a fair deal goes to the contracting party, not the corporation. Implicit recognition of this fact can be found in the commentary to Subchapter F of the Revised Model Business Corporation Act, which, despite that statute's procedural orientation, acknowledges that fairness is a range.

[T]he width of that range is only a segment of the full spectrum of the directors' discretion associated with the exercise of business judgment That is to say, the scope of decisional discretion that a court would have allowed to [the board in the absence of a director's conflicting interest] is wider than the range of "fairness" contemplated for judicial determination where [the statute] is the governing provision.²³³

The fact that board discretion as to fairness narrows in the context of an interested director transaction offers clear support for the conclusion that determining fairness on the basis of any range of outcomes benefits the self-dealing fiduciary. Even more, when the concept of fairness is shifted from one of substance to one pre-

232. This implicit bilateral character of fairness may be illustrated by the court's description of the concept in *Colorado Management Corp. v. American Founder's Life Ins. Co. of Denver*, 359 P.2d 665 (Colo. 1961): "The rule is deemed necessary to the end that in the absence of arm's length bargaining the scales may not be unfairly tipped to one side or the other even through mistake or inadvertence." *Id.* at 668 (emphasis added).

233. MODEL BUSINESS CORP. ACT ANN. § 8.61, official cmt. (1993); *see also* Buxbaum, *supra* note 149, at 1725 (interpreting fairness test similarly).

dominately of procedure, the range of fair outcomes necessarily widens, thus giving the fiduciary a greater opportunity to gratify her interests at the possible expense of the corporation. In contrast to a true fairness test that accepts a range of outcomes as legitimate, the best price notion of fairness disregards the benefits and advantages of the fiduciary and looks only to the interests of the corporation. It seems that applying the fairness test to vertical self-dealing transactions necessarily leads to the conclusion that the fiduciary has a financial interest in the corporation.

By contrast, the application of a procedurally-oriented concept of fairness in cases of horizontal conflict seems to recognize both the fact of the fiduciary's legitimate, preexisting financial interest and the difficulty of balancing the fiduciary's and the beneficiary's rights. Frequently the fiduciary will be put in a position in which the interests of the corporation will be served in a stock-oriented transaction, such as the declaration of dividends or a selective repurchase or redemption of stock. In such situations, the fiduciary deals with the minority stockholders not only as a fiduciary but as a stockholder as well. In the former capacity, the fiduciary is proscribed from taking advantage of the minority; in the latter, the fiduciary is entitled to benefit from stock ownership. It is in this context that separating the legitimate from the illegitimate is most difficult, precisely because of the inherent legitimate interest, a problem that does not exist in the vertical conflict cases. Utilizing some measure of procedural fairness recognizes the difficulty in analyzing these interests and provides a reasonable measure of protection for minority stockholders.

Application of a procedurally-focused fairness test to cases of vertical conflict seems to equate the role and rights of the fiduciary in both vertical and horizontal conflict cases, by giving the fiduciary in the vertical conflict case an implied financial interest in the corporation that in fairness analysis is treated like the explicit financial interest of the fiduciary in the latter case. The difficulty is that this equation has occurred invisibly and under the guise of fulfilling the fiduciary's obligations. Moreover, because it is invisible and unacknowledged, it requires no consideration from the fiduciary to enable her to receive financial benefits solely because of her position, nor does it permit stockholders to evaluate and challenge the desirability of such a situation. In contrast, the horizontal conflict context presents a situation in which the fiduciary's financial interest is understood by all to be part of the game, and

the reason why is telling: it is because the fiduciary comes to the party first as a stockholder, having invested in the corporation, and only as a consequence of her stockholdings does she become a fiduciary. To put the matter slightly differently, the controlling stockholder becomes a fiduciary in consideration of her right to make and hold a given investment. By contrast, the non-stockholding director is a fiduciary solely by virtue of having been elected or appointed to that position, and application of the fairness test to her dealings with the corporation gives her the right to benefit from that position as if she had made an investment.

Although these observations would apply to any form of fairness test, the situation is aggravated by the strong tendency to treat fairness largely as a procedural test. It might be one thing to permit vertical self-dealing if the fiduciary were obligated rigorously to demonstrate that she paid, or the corporation received, the best price, or at least a price at the top of the range of fair prices. Not only is her burden now lessened to a demonstration of a range of fairness in which her transaction is included, however, but it largely can be satisfied on a showing that the negotiations surrounding the transaction were structured in a manner that replicated independent negotiations, with full disclosure or outside advice sometimes serving to discharge the burden entirely in the absence of patently fraudulent consideration. Although this procedure may lead to a fair result, it is the fiduciary, not the corporation, that is benefitted by the use of a fairness test, rather than a more rigorous analysis of outcome. Moreover, to the extent that the satisfaction of the duty of fair dealing or compliance with interested director statutes returns the burden of proof to plaintiff, the fiduciary's potential range of profit increases. The fairness test thus shifts any risk of harm from self-dealing to the corporation from the fiduciary and consequently reverses the traditional conception of the fiduciary relationship. In sum, it seems that the fairness test is inappropriate in vertical conflict situations and that its evolution has made its use even more questionable.

What I have said about the fairness test and vertical and horizontal self-dealing should make clear that parent-subsidary business dealings are a form of vertical conflict. Transactions in which the parent contracts to provide services to the subsidiary, to sell or buy property to or from the subsidiary, or to loan money to the subsidiary, are not transactions arising from the parent's ownership of stock but, like other vertical conflict cases, are trans-

actions that normally would be undertaken by third parties. So are parent-subsidiary mergers, in which the parent corporation, for its own purposes, seeks to unify its control over the subsidiary.²³⁴ In this context, the controlling stockholder stands on no different footing than any other person and consequently should have no greater opportunity to deal with the corporation. Like other cases of vertical conflict, such self-dealing enhances the fiduciary's economic interest in the corporation. The fact that *Levien* applies the fairness test to all such transactions, but not to transactions in which pro rata distributions are made to the controlling and minority stockholders, is a clear judicial recognition of this enhanced interest.

C. *Restoring Fiduciary Obligation*

Analyzing conflicts of interest in this manner suggests two conclusions. First, as to vertical conflicts, it suggests that self-dealing in such situations ought flatly to be prohibited. Second, it suggests that in horizontal conflict situations, any test that is applied must recognize the controlling stockholder's interest in the corporation as a stockholder, while further recognizing the pervasive conflicts her control creates.

The theoretical and practical difficulties of evaluating substantive fairness support the desirability of abolishing self-dealing in vertical conflict situations. Because application of the fairness test disproportionately benefits the fiduciary, both by giving the fiduciary a financial interest in the corporation in the first place and by grounding that interest in a standard—fairness—that is incapable of precise calculation, it cannot be supported on grounds of trust or equity. The cleanest way of eliminating the problem is to return to rules prohibiting fiduciary self-dealing entirely. Such prohibition also would accomplish the goal of substituting a higher standard of fiduciary conduct for the current approach, which treats fairness as a defense, rather than an aspiration. Abolition

234. Sales of control, on the other hand, present horizontal conflicts because, by definition, they cannot be undertaken by third parties and because they create the possibility that the controlling stockholder will receive disproportionate benefits solely from his ownership of stock. See, e.g., *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464, 476 (Cal. 1969) (en banc) (holding that controlling stockholders breached their fiduciary duty by taking advantage of a market opportunity to increase the value of their shares while denying same opportunity to minority stockholders); *Perlman v. Feldmann*, 219 F.2d 173, 178 (2d Cir.) (holding sale of control for premium unlawful), *cert. denied*, 349 U.S. 952 (1955).

might be undesirable, however, if there are good arguments supporting self-dealing.

Some legal economists have argued that an outright ban on self-dealing surplus would diminish corporate efficiency by removing incentives that fiduciaries have for increasing corporate gain.²³⁵ Even if one were to accept the idea that permitting fiduciaries to take advantage of such surplus is desirable, the use of the fairness test to accomplish this result is not. Because the amount and timing of the creation of such surplus is both secret and determined by fiduciaries (who, although independent in a given transaction, may want to obtain similar benefits one day), they are completely removed from market forces except in the very gross sense that the market generally acknowledges that self-dealing occurs. Because of this secrecy, such self-dealing is inefficient. The creation and appropriation of self-dealing surplus through the use of the fairness test cannot be defended on economic grounds.

Self-dealing may be necessary to the corporation's survival, however, as exemplified by *Marciano v. Nakash*,²³⁶ in which a 50% stockholder group was the lender of last resort. Such a case is likely to be exceptional.²³⁷ Nonetheless, an outright ban on self-dealing would leave those who are most interested in such a corporation unable to help it survive. Accepting this possibility leads to a compromise that permits necessary self-dealing but eliminates the potential use of self-dealing transactions as a form of secret fiduciary compensation. That compromise is a return to the best price standard of substantive fairness articulated in *Geddes*. Under this approach, if a fiduciary wishes to deal with the corporation in a transaction of a type that normally would be undertaken with third parties, the board of directors or a reviewing court (using evidence put forward by the board of directors) must determine that the corporation has received the best price possible under the circumstances or the transaction would be voidable by the corporation. This approach not only removes a large portion of the incentives for a fiduciary to engage in self-dealing

235. Compare, for example, Easterbrook & Fischel's argument with respect to the distribution of merger gains. See EASTERBROOK & FISCHEL, *supra* note 62, at 110-24.

236. 535 A.2d 400 (Del. 1987).

237. Obviously, this situation is unlikely ever to arise in the context of public corporations.

by eliminating the possibility that she can receive undetected or undetectable financial benefits from the corporation,²³⁸ but also goes a long way towards actually replicating the results of an arm's-length transaction by requiring the board to ensure that the corporation receives all it realistically can from the deal.²³⁹ The aspect of the test that looks to the circumstances of the transaction is designed to take account of those situations in which the fiduciary is the party of last resort, as in *Marciano*, and thus to acknowledge that in some circumstances, fiduciary self-dealing might actually be necessary to ensure the corporation's health or survival. In this manner, the role of the fiduciary to serve only the corporation's interests will be restored without requiring a radical change in legitimate business practices.

Horizontal conflict cases are more difficult. Dividends have to be declared, restructurings sometimes are desirable, and controlling stockholders have the right to sell control. It is impossible to separate the fiduciary's legitimate ownership interests from its right to control the corporation's business affairs. Nonetheless, analyzing conflict situations in terms of vertical and horizontal conflict leads to the conclusion that the circumstances in which true horizontal conflicts will occur are relatively few, involving as they do the fiduciary's interest as a stockholder. They will be limited to issues of distribution, control sales, and restructurings. Imposing the vertical conflict requirement that the minority stockholders receive the best deal possible would be unfair to the controlling interests since it would deprive them of the opportunity that is otherwise available to stockholders to act in their own interest. Unlike the vertical context, in which such a requirement restores the fiduciary to a position of having no financial interest in the corporation, imposing this requirement in the horizontal context would deprive the controlling stockholder of a legitimate property interest. In such a situation, perhaps the best that boards and courts can do is to pursue a rigorous requirement of procedural fairness similar to that now employed. Although this approach, as I have discussed,²⁴⁰ has its defects, it seems to provide the best practical

238. The best deal for the corporation must be the worst deal for the fiduciary.

239. Of course, the best price test shares the same epistemological flaw as the fairness test. Nonetheless, it is a narrower inquiry and one that is weighted in the corporation's favor. Consequently, it is likely to go a long way towards rectifying the problems of the fairness test.

240. See *supra* Part III; see also Mitchell, *supra* note 16, at 1714 (arguing that the bal-

solution short of abolishing controlling stockholder relationships, an approach that not only would be unfeasible but that might create problems far more severe than the cure. Nonetheless, limiting the application of the procedural fairness approach to the very narrow class of cases properly described as involving horizontal conflicts would go a long way towards ensuring the use of a meaningful fairness test in fiduciary conflict-of-interest situations and would significantly raise the level of fiduciary conduct.

VI. CONCLUSION

Would you entrust your money to people who you were told had the power, practical ability, and legal right to take some of it for themselves? Of course not. You might, however, if you were told instead that they had to treat you fairly. As I have demonstrated, the fairness test in corporate law enhances fiduciaries' power to self-deal with the practical ability and legal right to do so. The fairness test is neither fair nor much of a test. It is, instead, a fraud to the extent that it gives stockholders confidence in placing their trust in corporate governance. Recognizing this characterization goes a long way towards understanding how far fiduciary obligation has fallen from its potential to support trust. It is time to restore fiduciary principles and, in so doing, to restore trust.

ancing test applied in the close corporation context leads to upholding the fiduciary's actions).