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GAMING DELAWARE

WILLIAM W. BRATTON*

I. TRANSACTIONAL GAMING UNDER THE DOCTRINE OF INDEPENDENT LEGAL SIGNIFICANCE

Back in 2000, at the World Trade Center in Portland, Oregon, Time Belden and other Enron electricity traders carefully studied the regulations governing California's new electricity market. Belden thought that the complex rules were "prone to gaming."¹ And game them he did. Under one strategy, Enron filed imaginary transmission schedules, creating nonexistent congestion, so as to draw on the rules' provision of payment to alleviate congestion.² They called it "Death Star."³ Then there was "Ricochet," or megawatt laundering, under which Enron circumvented price caps by exporting power out of California, only to bring the power back later, when the State, desperate for supply, had to pay a premium price.⁴ Eventually, with an energy-starved California up in arms and the Federal Energy Regulatory Commission investigating energy sales to the State, Enron's lawyers paid the traders a visit. The traders walked the lawyers through the transactions, demonstrating legality under what must have been highly technical applications of the rules. The lawyers, expecting litigation, said, "Alright, but is it too late to change the names? Can't you just call the strategies "Puppy Dog" and "Mama's Cooking"?"⁵

Enron's North American trading desk made a profit of \$2.2 billion in 2000, much of it due to activities in Western region electricity and natural gas.⁶ The crisis in California implied political scrutiny of

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1. BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* 266 (2003).

2. *Id.* at 269-70.

3. *Id.*

4. *Id.* at 270.

5. *Id.* at 274.

6. *Id.* at 282.

Enron's results, and the firm did not want the public to see the extent of its profits. So, still gaming the system, it booked \$1 billion of profit as a reserve against potential liability, without actually showing the reserve in its published financials.⁷

In a legal regime of form without substance, an opportunistic actor can exploit the system in much the same way as Enron's traders and accountants. In such a world, all law is rules-based and literally interpreted, and there are no backstop interpretive controls in the form of principles⁸ (to use the accountants' term) or standards (to use the lawyers' term).⁹

There is a family resemblance between these tales from Enron and the terms and operation of Delaware's bedrock doctrine of independent legal significance (ILS). ILS also elevates form over substance and invites gaming. In its classic form, where ILS operates as a rule of statutory interpretation,¹⁰ it is almost unique in its disavowal of substance. With ILS, the state court effectively announces that no body of substantive principles informs certain applications of the legislature's corporate code, inviting transaction planners to exploit the literal word at will. As with Enron and power provision to California, the gamers are those in a position to invest in expertise. As at Enron,

7. *Id.*

8. See Sarbanes-Oxley Act of 2002, Pub. No. 107-204 § 108(d), 116 Stat. 745 (calling on the Securities Exchange Commission to conduct a study of "principles-based" accounting in response to dissatisfaction with gaming of rules-based treatments in recent years).

9. For the classic description of the interplay of rules and standards in American jurisprudence, see Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976).

10. *Hariton v. Arco Elec. Inc.*, 182 A.2d 22 (Del. 1962), *aff'd*, 188 A.2d 123 (Del. 1963), is the classic case. There Delaware rejected the doctrine of de facto merger. Under the doctrine, a sale of assets followed by a liquidation that leaves the shareholders of the selling firm in the same place that a conventional merger would have left them, is treated as a merger de facto, with the result that the shareholders of the selling firm receive statutory appraisal rights as if the transaction had been structured as a merger. The operative notion is that technical provisions in the State's corporate code are undergirded by substantive policies, so that similarity of transactional result means that rights provided in one section of the code apply by implication under other sections. Such a substantive approach reduces room for transactional gaming. *But see* *Farris v. Glen Alden Corp.*, 143 A.2d 25 (Pa. 1958); *Rath v. Rath Packing Co.*, 136 N.W.2d 410 (Iowa 1965). In *Hariton*, Delaware rejected the doctrine, drawing on ILS, and quoting Judge Leahy in *Langfelder v. Universal Lab. D.C.*, 68 F. Supp. 209, 211 (D. Del. 1940): "The rationale is that a merger is an act of independent legal significance, and when it meets the requirements of fairness and all other statutory requirements, the merger is valid and not subordinate or dependent upon any other section of the Delaware Corporation Law." 182 A.2d at 26-27. In this affirmative statement, the rule can be described as one of "equal dignity" for the various sections of the Code. The effect is to open the door for transactional gaming.

the gamer wins; and if it does not necessarily take all, it does take quite a bit at the expense of actors disadvantaged by the game. The victims of ILS usually are minority shareholders, whether dissenters in a control transaction or a class of preferred holders whose preferences have been stripped. They bear a familial resemblance to California's hapless energy consumers. Both groups sacrifice wealth to empowered parties wielding the literal word of the law to their own advantage. They are distant cousins, admittedly, but cousins.

This author supplements Professor Smith's able discussion of ILS¹¹ with some additional thoughts on the question of why Delaware has made this extraordinary commitment to a form-over-substance jurisprudence. Upon reflection, ILS turns out to be less bad than it looks, at least in its statutory version. Three significant (and substantive) differences distinguish Delaware law gamers from the gamers at Enron.

First, when a firm relies on ILS to plan a transaction that exploits provisions of the corporate code, it games with the sanction of case law. And, in classic, statutory ILS cases, the courts' literal interpretation of the statute has the benefit of being correct: When Delaware's legislature enacted the corporate code's sections on charter amendments, mergers, and asset sales,¹² it intended whatever transaction structures the courts and the corporate bar later deemed appropriate.¹³ Enron's gamers played form over substance on riskier regulatory turf: They would "take the position" that form trumps substance without advance regulatory endorsement of their legal theories. As they did so, they incurred significant enforcement risks.¹⁴ Their counsel and auditor might have curbed the abuses, but neither proved willing to take responsibility for the exercise of judgment implied when sub-

11. See D. Gordon Smith, *Independent Legal Significance, Good Faith, and the Interpretation of Venture Capital Contracts*, 40 WILLAMETTE L. REV. 825, 827 (2004).

12. DEL. CODE ANN. tit. 8, §§ 242, 251, 271 (2001).

13. The statement in the text extrapolates from the documented relationship between the Delaware legislature and the State's corporate bar. The keeper of Delaware's code in reality is not the legislature, which acts as a rubber stamp, but the bar's corporate law section. See Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 888-92 (1990).

14. The most famous case of this did not concern electricity trading but sham swaps entered into between Enron and special-purpose entities formed by the LJM1 and LJM2 limited partnerships controlled by its CFO, Andrew Fastow. These transaction structures went through an exhaustive planning process with the participation of Enron's outside counsel and auditor. See William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1305-20 (2002).

stance intervenes over form.¹⁵

Second, Delaware's regime of form over substance is not absolute. Delaware law holds out a possibility of ex post substantive scrutiny for some of the transactions that game its code under ILS. Breaches of fiduciary duty remain a possibility even where ILS formalizes the statutory framework and prevents statutory policies from constraining gaming. A minority shareholder fobbed out of appraisal rights in a case like *Hariton v. Arco Electronics*¹⁶ still may be able to package a process complaint in the framework of majority-to-minority fiduciary duty.¹⁷

Third, statutory ILS and Delaware transactional gaming should be distinguished from the more extreme versions at Enron because, historically, statutory ILS has held a central place in Delaware's competitive position in the charter market. *Federal United Corp. v. Havender*,¹⁸ in which ILS made its first appearance, was more than just a preferred stock case in which the Delaware Supreme Court used ILS to open a loophole for rights stripping.¹⁹ The case also signaled that Delaware would not subscribe to the antimanual approach outlined in Berle and Means' *The Modern Corporation and Private Property*.²⁰ Berle and Means' book was still a recent publication in 1940, having first appeared in 1932. But it already was famous, having had a visible impact on Congress in the enactment of the federal securities laws.²¹ Berle and Means, in addition to advocating a mandatory disclosure regime, advocated a state law program in which management power would be curbed by a substance-over-form doc-

15. In recent years, we have seen widespread compliance problems stemming from gaming, and the consequent demand for bright line rules coming from legal and accounting professionals. The trend stems in part from the fact that the professionals are unwilling to say "no" to their clients absent the support of the clear rule. Without the rule, saying "no" requires a judgment call that jeopardizes the client relationship. See William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023, 1049-51 (2003).

16. 182 A.2d 22 (Del. 1962), *aff'd*, 188 A.2d 123 (Del. 1963).

17. See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (requiring a negotiating committee on behalf of minority shareholders in a cashout merger).

18. 11 A.2d 331, 337 (Del. 1940).

19. This loophole simultaneously extricated Delaware law from the then-current vested rights doctrine, to which it had subscribed a few years earlier in *Keller v. Wilson & Co.*, 190 A. 115 (Del. 1936).

20. ADOLPH A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (rev. ed. 1991).

21. *Id.* at 264-85 (showing the importance of full disclosure for the functioning of the stock market).

trine of fiduciary protection of minority shareholders.²² *Havender*, in effect, said that Berle and Means' antimanagement program would not influence the policy of the state of Delaware. Berle and Means had singled out the courts, including those of Delaware, as a redoubt of equitable intervention that protected against laxity in the drafting of corporate codes and charters and subsequent transactional gaming. *Havender*, in containing judicial discretion to police transactions for unfairness, falsified that description.²³

Delaware's move to form over substance paid dividends in the post-war charter market. Roberta Romano's study of firms reincorporating to Delaware during the period 1960-1982 shows that firms moved to Delaware in search of a cost-reductive, stable legal regime, and were about to either go public, promulgate antitakeover measures, or position themselves as actors in the mergers and acquisitions market.²⁴ The stability on offer did not come from a state-of-the-art statute—Delaware always has preferred to stick with its old form of code, changing it incrementally as the need arises. Nor, in those days, before the blockbuster merger and acquisition cases of the 1980s,²⁵ did Delaware offer a thick case law on mergers and takeovers. What the firms preferred was Delaware's formalism. Under Delaware's early case law, a reincorporating firm concerned about takeover defense found a nearly bulletproof zone of discretion: Defensive tactics could be sustained on a formal showing of a threat to company policy with no further judicial review.²⁶ Firms planning activities as acquirers, in turn, preferred ILS and Delaware's emphatic rejection of the de facto merger doctrine: ILS assured them that the courts would not disturb cost-effective reverse triangular acquisition structures.²⁷ Of course, fiduciary law regarding mergers and takeovers changed rapidly in the late 1970s and 1980s, limiting management's zone of discretion. Takeover defenses came under *Unocal* review;²⁸ cases like *Singer*²⁹

22. *Id.* at 196-203.

23. William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 766-67 (2001).

24. ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 32-35 (1993).

25. *See, e.g.*, *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985) (instituting duty-of-care scrutiny of boardroom merger decisions); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (instituting proportionality scrutiny of tender offer defense).

26. *See* *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964).

27. It should be noted that by the time a reverse triangle was attacked in a de facto merger jurisdiction, the de facto doctrine had run out of steam and the transaction was sustained. *See* *Terry v. Penn Cent. Corp.*, 668 F.2d 188, 192-94 (3d Cir. 1981).

28. *Unocal Corp.*, 493 A.2d at 946.

and *Weinberger*³⁰ brought protection for minority shareholders in cash-out mergers. But as everyone realized at the time, Delaware made the concessions only to deflect congressional attention from its management protection operation.³¹

Summing up, to the extent the charter competition system is desirable as a matter of economic welfare, statutory ILS is a defensible formalism.

29. *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977) (imposing strict fiduciary standards on parent firms in cashout mergers).

30. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (overruling *Singer* and relaxing inspection to process scrutiny).

31. In the mid-1970s, there was a cognizable threat that much conduct covered by state fiduciary law would be found fraudulent or manipulative under section 10(b) of the Securities Exchange Act of 1934. *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977), defused that threat. Later threats came from the Congress, in which preemptive legislation was introduced. See S. 2567, 96th Cong., 2d Sess. (1980).