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JORDAN v. DUFF & PHELPS

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Not-so-ordinary Judges in Ordinary Courts:  
Teaching Jordan v. Duff & Phelps

By J. Mark Ramseyer*

Abstract: By juxtaposing at-will employment with corporate fiduciary duties, Jordan v. Duff & Phelps creates something of a classroom brain-twister. Yet the exchange between Frank Easterbrook (writing for the majority) and Richard Posner (dissenting) also illustrates two fundamental but seldom recognized principles of real-world courts. First, the bench is properly a place for honest jurists of moderate talent (ideally, monitored for their work). It is not a place for men and women with the independence and sophistication of Posner and Easterbrook. Such judges can muddy the law by trying to fix bad precedent, and worsen the law by setting interventionist examples for their far less talented peers.

Second, by basic second-best principles, the right legal rule for a substantial fraction of contractual disputes is not a rule designed to facilitate efficient deals. It is a rule that dismisses a plaintiff’s claim forthright. We live in a world with imperfect judges, costly and dishonest attorneys, and only moderately intelligent juries. As Posner implicitly recognizes in Jordan (but other judges rarely do), many cases are simply beyond the capacity of such real-world courts to handle cost-effectively.

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Not-so-ordinary Judges in Ordinary Courts:
Teaching *Jordan v. Duff & Phelps*

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I.

Everyone loves a brawl.

And all the more so when the brawlers are smart, biting, literate debaters who routinely take wildly out-of-fashion positions. For a casebook editor trying to maximize adoptions, that makes *Jordan v. Duff & Phelps, Inc.*\(^1\) an easy call.

Writing for the Seventh Circuit majority, Frank Easterbrook claims fellow panelist Richard Posner is effectively telling the plaintiff that the defendant could have declared:\(^2\)

> In a few weeks we will pull off a merger that would have made your stock 20 times more valuable. It’s a shame you so foolishly resigned. But even if you hadn’t resigned, we would have fired you, the better to engross the profits of the merger for ourselves. So long sucker.

Replies Posner (448):

This is the kind of legal half-truth that should make us thankful that our opinions are not subject to Rule 10b-5.

Easterbrook (438) quotes Posner’s classic treatise for the proposition that:

> The fundamental function of contract law ... is to deter people from behaving opportunistically toward their contracting parties, in order to encourage the optimal timing of economic activity and to make costly self-protective measures unnecessary.

Posner (449) will have none of it:

> The inroads that the majority opinion makes on freedom of contract are not justified by its quotation from my academic writings ... or (my favorite one-liner from the whole casebook),

by the possibility that corporations will exploit their junior executives, which may well be the least urgent problem facing our nation.

Easterbrook (432) characterizes Jordan’s decision to quit Duff & Phelps as driven by in-law tensions:

> Jordan’s family lived near Chicago, the headquarters of Duff & Phelps, and Jordan’s wife did not get along with Jordan’s mother. The strain between the two occasionally left his wife in tears. ... Concluding that it was time to choose between his job and his wife, Jordan chose his wife and started looking for employment far away from Chicago.

In discussing Jordan’s damages, he (442) then adds:

> To compute Jordan’s “loss,” therefore, we must subtract the difference between his salary in Houston ($110,000) and his salary in Chicago ($67,000), or $43,000 per year, from the value of his stock ....

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\(^1\) 815 F.2d 429 (7th Cir. 1987), cert. denied, 485 U.S. 901 (1988).

\(^2\) 815 F.2d at 437. All parenthetical references are to the 7th Circuit opinion in *Jordan*. 
Maybe, responds Posner (451). But if so:

the emotional cost to Jordan of remaining in Chicago must be monetized and subtracted from the award of damages. It is a cost that he avoided by going to Houston; hence it is a benefit that [Duff & Phelps] confirmed on him by failing to disclose the information about the firm’s prospects.

“The case on remand,” he (451) concludes, “will be a soap opera.”

The third judge on the panel? Richard Cudahy seems to have watched bemused from the sidelines. His colleagues “argue lucidly and cogently (and ingeniously) their respective points of view,” he writes. “The case is not easy,” but he (443) will vote with Easterbrook.

II.

The facts. -- James Jordan worked as a securities analyst at Duff & Phelps. In taking the job, he signed no employment contract. By Duff & Phelps policy, however, he could regularly invest in the closely held firm’s stock. By late 1983, he owned about a one-percent stake.

When buying the stock, Jordan signed a shareholders’ agreement. Through it, he (446) acknowledged that “nothing herein contained [would] confer on [him] any right to be continued in the employment of the Corporation.” If he left the firm for any reason, he agreed to resell it for its book value at the end of the last calendar year.

During the early 1980s, CEO Claire Hansen had an affair with Carol Franchik. Upon its discovery, the firm fired her. She threatened to sue, and the board then (in 1983) adopted a resolution letting anyone fired keep his or her stock.

As Easterbrook notes (Section I, above), Jordan’s wife and mother did not like each other. To placate his wife, Jordan decided to look for work elsewhere. In November 1983, he obtained an offer from Underwood Neuhaus in Houston. He took the job, and tendered his resignation to Hansen. Hansen accepted it, but let Jordan work until the end of the year to take the higher book value.

On January 10, 1984, Duff & Phelps announced a merger with Security Pacific at a price that would have earned Jordan at least $450,000, and possibly as much as $650,000. What is more, it explained that Hansen had preliminarily tried to negotiate a merger earlier that summer. Those initial talks had collapsed, but Hansen had renewed negotiations in December and this time finalized the deal’s price and structure.

Jordan refused to cash his $23,000 check from Duff & Phelps for the stock's book value. Instead, he sued. While the suit was pending the merger collapsed (again), this time because the Federal Reserve placed on it conditions too onerous. In December, 1985, however, Duff & Phelps' senior managers decided to acquire the firm through an ESOP in a leveraged buy-out. Had he stayed at Duff & Phelps and sold his stock to them, Jordan claims he could have cleared $500,000.

Jordan argues Hansen violated Rule 10b-5. When he offered his resignation, explains he, Hansen should have told him about the summer merger talks. If Hansen had done so, he never would have resigned. Instead, he would have stayed through 1985 and sold his stock for $500,000. By repurchasing his stock on the firm's behalf at book value without disclosing the talks, Hansen violated the “abstain or disclose” rule at the heart of 10b-5.
The District Court. -- The District Court apparently thought it an simple case. Duff & Phelps was closely held, it noted, but Security Pacific was not. The law did force closely held firms to disclose any material information about pending merger talks when they repurchased stock. Yet it required public firms to do so only if they had reached an “agreement in principal” (sic) on the merger's terms. Here, the firms had not yet agreed when Jordan tendered his resignation to Hansen, and one of the firms was public. Accordingly, reasoned the district judge, Hansen owed no duty to disclose his merger discussions to Jordan.  

Easterbrook. -- Yet simple the case was not meant to be. Easterbrook (431) granted that public firms need not disclose pending merger talks before they agree “on the price and structure of the deal.” But closely held firms must disclose all material information even before they reach that agreement, and even if they merge with a public firm. As a result, the District Court’s quick-and-dirty resolution simply did not apply. Easterbrook then reversed. Reasoned he:

(1) The merger talks were material to Jordan. He had to decide whether to sell his stock to Hansen, and for that the possibility of a high-priced merger mattered.

(2) Although Jordan could not hold his stock if he quit, he did not need to quit. He could instead choose to stay at Duff & Phelps and keep his stock.

(3) Even though the Security Pacific deal eventually collapsed, Jordan might rationally have stayed at the firm in hopes that another buyer would eventually offer lucrative terms -- as indeed it did.

(4) Jordan did not have a right to stay at the Duff & Phelps, but Duff & Phelps showed no inclination to fire him. What is more, it could not have fired him just to increase senior management’s gains in the buy-out anyway (what Easterbrook calls an "opportunistic" firing). It could not, as Easterbrook inimitably put it, have told him that “even if you hadn’t resigned, we would have fired you, the better to engross the profits of the merger for ourselves. So long sucker.”

Hence the conclusion: Jordan had the option of staying at Duff & Phelps and keeping his stock; in order to decide whether to exercise that option, he needed information Hansen had but did not disclose; Hansen and Duff & Phelps stood in a fiduciary relation to Jordan as shareholder; and in repurchasing Jordan’s stock without disclosing the information Jordan needed to decide whether to keep his stock (and stay) or sell it (and go), Hansen and Duff & Phelps violated the abstain-or-disclose rule of Rule 10(b)-5.  

Posner. -- Posner focused on Easterbrook’s point (4):

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(A) As an employee at will, Jordan had no legally recognizable right to stay at Duff & Phelps. And if he had no right to stay, he had no right to keep his stock. Although Rule 10(b)-5 mandates disclosure, it mandates it only when an investor can respond to any information he obtains. Without a right to hold stock, Jordan lacked a right to respond to any news of a merger.

(B) Although Duff & Phelps showed no inclination to fire Jordan, the law should not penalize firms for being nice. It could have fired him, and for any reason whatever. And if it had, then Jordan could not have kept his stock -- and could not have sold it at the higher buy-out price.

(C) Even if corporate law imposes on directors (along with senior officers and majority shareholders) fiduciary duties toward minority shareholders, Jordan waived any such duties relevant here. Through the shareholders’ agreement, he specifically agreed that “nothing herein” would “confer on [him] any right to be continued in the employment of the Corporation.” He had a right to the information only if he had a right to stay at Duff & Phelps; as an at-will employee he had such a right only if he obtained it as an adjunct to any right he might acquire as a minority shareholder; and through the shareholders’ agreement he waived all such rights.

But what of the "Franchik Resolution"? Suppose Jordan wanted to stay, and refused to quit. To induce him to leave, the firm would have needed to fire him. Yet if it fired him, by the terms the resolution he acquired a legal right to keep his stock. Would that not destroy Posner’s argument? Apparently, the resolution was a red herring. The requirement that departing employees sell their stock stemmed from the shareholders’ agreement, and the agreement was subject to change only by unanimous shareholder vote. As a result, the "Franchik Resolution" was invalid on its face.

III.

So did Posner “get it right”? More specifically, (a) as a federal judge ruling on a state law issue did he apply the rule a state court judge would have applied, and (b) even if not, did he take an approach that made sense? To my mind, the answer to the first is straightforwardly no, and shows the risk inherent in appointing judges too creative and independent for the job. The answer to the second is yes, and in turn illustrates the second-best principles that ought to determine the rules real-world courts apply.

Smart judges in an Erie world. -- Typically, I teach Jordan two-thirds of the way through the semester. By then, I find it hard to claim Posner applied anything close to the rule a typical state-court judge would have applied. Usually, I teach it after Wilkes v. Springside Nursing Home.

In Wilkes, the Massachusetts Supreme Judicial Court faced a conflict among four 25 percent shareholders to a nursing home in Springside, Massachusetts. According to

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5 Note that the “opportunistic” firing to which Easterbrook objects is opportunistic only because it lets Duff & Phelps force Jordan to sell his stock at book value and abandon the gains attributable to the merger. Firing him is “opportunistic,” in other words, only because it forces him to sell his stock -- not because it takes away his job.

the court, three of them violated their fiduciary duty toward the fourth (Wilkes) when they fired him from his job as the home’s maintenance man. Shareholders traditionally hold no fiduciary duties toward each other, it explained, but partners do. Yet close corporations are much like partnerships. As a result, shareholders in close corporations should hold duties similar to those of partners. Granted, the four Wilkes shareholders deliberately chose the corporate form. Notwithstanding that fact, under the opinion they incurred fiduciary duties close to those they would have owed had they chosen a partnership instead.

In effect, the Wilkes court faced investors who could have selected strict fiduciary duties but opted for laxer duties instead, and then imposed on them rigid and demanding duties anyway. It faced investors who deliberately tried to waive fiduciary duties, in other words, and refused to let them. This is not just Massachusetts. Both the Indiana and Illinois courts have explicitly adopted the Wilkes formula as well.7

As a result, if the Wilkes court had faced the Jordan facts I find it hard to believe it would have dismissed Jordan’s claim. To be sure, Jordan worked on an at-will contract -- but then so did Wilkes. Posner would have let Hansen fire Jordan as stock analyst. The Wilkes court refused to let the ruling trio to fire Wilkes as maintenance man.

Fundamentally, both Posner and Easterbrook explicitly treat corporate law (and its constituent fiduciary duties) as a waivable default contract.8 In part because of pioneering work by Easterbrook and Daniel Fischel, their approach has become the law & economic orthodoxy.9 Indeed, it constitutes the basis from which most modern corporate legal scholarship proceeds. It does so for good reason: it makes sense.

Yet this scholarly enthusiasm for the fiduciary-duties-as-default approach is not one state court judges share. As in Wilkes, most state judges instead treat fiduciary duties as sacrosanct and recoil from any attempt to loosen them. Benjamin Cardozo immortalized that reverence in Meinhard v. Salmon with his famous purple prose:10

Not honesty alone, but the puntilio of an honor the most sensitive, is then the standard of behavior [for fiduciaries]. ... Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. ... [This standard for fiduciaries] will not consciously be lowered by any judgment of this court.

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8 Similarly, see Nagy v. Riblet Products Corp., 79 F.3d at 576 (Easterbrook, J): “the corporate charter is a species of contract, and selecting a state of incorporation then is no different from putting a choice-of-law clause in a complex commercial contract.”


Although now nearly 80 years old, Meinhard embodies a reverence state judges routinely still share. According to a simple Lexis search, over the five years from 2001 to 2005 judges cited Meinhard 80 times, the majority of those in state courts. Indeed, in another opinion arising out of the same Duff & Phelps sale, the Eleventh Circuit claimed it "a violation of fiduciary principles to require employees to contract away their right to make a return on their investment."11 Hence the dilemma: state judges emphatically reject the Easterbrook-Posner framework toward corporate law, and apply instead a distinctly moralistic approach; *Erie* requires Easterbrook and Posner to apply state law; and they in turn recoil at the idea of doing so.

Let me suggest the locus of the problem: judging is not a job for unconstrained, innovative minds. Judges are government bureaucrats. Their job is to be honest, to unravel a set of facts, to decide what law applies, and not to think too hard about it all.12 Despite our attempts to cow first-year students over the ambiguities involved, applying legal rules to facts is rarely rocket science.

Consider a parallel from the other legal system I know best, Japan. By all accounts, Japanese judges are relentlessly honest. They are also among the smarter members of the bar. Yet they work within a judicial bureaucracy that rigidly rewards conformity. And conform they do.

Hired in their late 20s, Japanese judges are regularly evaluated by senior judges in the judicial personnel office. Those senior judges then decide which judges to promote, which to stall, and when necessary (it rarely is) which to fire. Judges who work hard, who clear their dockets quickly, and who do not make waves earn regular promotions. They climb the pay scale quickly, and obtain postings in the most desirable cities. The heterodox wallow in undesirable posts at low pay.

The result is not an institution that works brilliantly -- and but it does facilitate dispute resolution more effectively than the American. The institution does not attract or encourage creative minds, but that is the point. In the vast majority of real and potential disputes, the law that applies could be easy to predict -- so long as judges did not try too hard to improve the world. And if parties could predict it, they could and would settle their disputes out of court in its shadow and pocket the fees they would otherwise pay their lawyers. If parties to contractual arrangements did not like the rule, they could simply adjust the contractual terms and price accordingly ex ante.

Under *Erie*, the job of a federal judge applying state law is similarly mechanical: mimic the state court. The federal judge is not to reinvent corporate law on a more sensible plane. Indeed, he is not to reinvent any law at all. He is to apply it. If voters want their world to go to hell, Oliver Wendell Holmes memorably remarked, a judge’s job is to help them. And if state courts want to send it there too, under *Erie* a federal judge’s job is to help them as well. Fundamentally, designing better legal rules is not a judge’s job.

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11 Smith, 891 F.2d at 1575.

Judges may enjoy creating better rules, but judicial experimentation necessarily makes it harder for disputants to predict what judges will do. An efficient legal system, however, is one disputants can avoid through settlement. For them to do so, the courts need to operate rigidly and mechanically -- judges need to abandon their intellectual ambition and work as lower-level bureaucrats. For that to happen reliably, they need to suffer career penalties for deviating from established rules. We lack ways to impose such penalties in the U.S. But appointing judges with the intelligence and creativity of Easterbrook and Posner is -- not to mince words -- exactly what we should not be doing. As judges, they simply do too much: they muddy the law in trying to fix it, and they worsen the law by encouraging (through example) their less talented peers to do so as well.

The world of second-best. -- On the second question, I find it easy to sympathize. Again, consider the Japanese parallel. Japanese judges routinely dismiss claims that American judges would entertain. For many legal wrongs that American courts would hear, they simply send the plaintiff's home. They recognize, in effect, that real-world courts do not handle some disputes well. Rather than try to right every wrong, they understand that for many wrongs in this world, the courts cannot reasonably provide a remedy -- and should not try.

An approach that recognizes the inherent limitations of the court has much to say for it. Scholars generally prefer legal systems that try to fix every problem, of course. On that score, the Japanese professoriate matches the American measure for measure. But the more limited approach has its roots in the basic distinction between first- and second-best legal rules.

Legal scholars typically start by asking whether the plaintiff suffered a loss. They then ask -- depending on the policy preferences of the writer -- (i) whether making the plaintiff bear the loss seems unfair, (ii) whether the defendant has the resources to bear the risk more easily, or (iii) whether judicial intervention would facilitate more efficient economic decisions. If they answer yes to the question they ask, they reason that a court should entertain the case. As we all know, the resulting disasters to the first two approaches are the stuff on which the young Professor Posner made his name.

After forty years of law & economics, we now opt routinely for approach (iii) instead. In torts, for example, the plaintiff should collect if but only if the defendant could have avoided the loss more cheaply than the plaintiff. In contracts, courts imply a term if but only if (as Easterbrook put it; 438) "the parties would have bargained for [it] if they had signed a written agreement."

Like the other two approaches, this law & economics formula rests on a first-best approach. Suppose, however, that lawyers are expensive and often dishonest; that courts are slow and cumbersome; that judges (other than the panel here) are only modestly intelligent, frequently wrong, badly harried, and in the pockets of the lawyers who funded their reelection campaigns; or that juries only randomly determine the facts correctly. Suppose, in short, that we live in the world that we do. If so, then the right legal rule may

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not be the one that places the loss on the least-cost-avoider. It may be the one that
forthrightly dismisses the claim.

In a second-best world, the right legal rule is not one that tries to get the "right
result" every time.\textsuperscript{14} It is the rule Richard Epstein attributes to Walter Blum: a simple,
easily implementable rule that gets the right result 95 percent of the time. In fact, of
course, even that approach may overestimate the abilities of real world courts. In our
badly flawed legal system, perhaps the right legal rule is not one that tries to get the right
result 95 percent of the time. Perhaps it is a rule that leaves courts satisfied with a decent
result 60 or 70 percent of the time. In any case, the easiest rule to implement is the one
Posner adopts here: tell the plaintiff to get lost.

Because Jordan waived any right to stay based on the shareholders' agreement,
Easterbrook relies heavily on what he sees as the limitations on Duff & Phelps' ability to
fire him. More particularly, he argues that the firm should not be allowed to fire him for
opportunistic reasons -- to prevent his obtaining the higher market price for his stock.
Necessarily, though, this takes courts into the business of asking why firms fire their at-
will employees, and whether those reasons are "opportunistic." Ex ante, Easterbrook's
rule plausibly encourages parties to avoid devious strategies and behave honestly.
Presumably, such is what most (or virtually all) parties would want of their partners,
whether or not they drafted a contract. In a first-best world, the rule makes eminently
good sense.

But we do not live in a first-best world, or anything close to it. In our world,
perhaps the right approach asks whether Jordan negotiated a contractual right to keep his
job. If he did not -- if he accepted an at-will contract -- then he had no right to continued
employment. Given that he could keep his stock only if he kept his job, he had no right
to hold his stock either. And if he had no right to hold his stock, he had no claim to
assert. End of story: if firms and employees dislike the result, they can write a contract
to the contrary at the outset.

Such is the opinion Posner writes. Harsh perhaps, it makes no attempt either to
encourage "fair" deals (as earlier generations urged), or to discourage "opportunistic"
behavior (as Easterbrook urges). Given our badly imperfect legal system, however,
perhaps those are precisely aims to which we should not aspire.

\textsuperscript{14} Richard A. Epstein, Simple Rules for a Complex World (Cambridge: Harvard University Press,
1995). If the judicial process involved no transactions costs, of course, a rule that "plaintiffs always win" a
given type of case would be every bit as efficient as a rule that "plaintiffs always lose." Real world judicial
processes are never free.