DOCTRINES AND MARKETS

CONTROLLING CONTROLLING SHAREHOLDERS

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INTRODUCTION

The rules governing controlling shareholders sit at the intersection of the two facets of the core agency problem in United States public corporations law. The first is the familiar principal-agency problem that arises from the separation of ownership and control. With only this facet in mind, the presence of a large shareholder may better police management than the standard panoply of market-oriented techniques. The second is the agency problem that arises between controlling and non-controlling shareholders, which produces the potential for private benefits of control—benefits to the controlling shareholder not provided to the non-controlling shareholders. There is, however, a point of tangency between these facets. Because there are costs associated with holding a concentrated position and with exercising the monitoring function, some private benefits of control may be necessary to induce a party to play that role. Thus, from the public shareholders' point of view, the two facets of the agency problem present a tradeoff. The presence of a controlling shareholder reduces the managerial agency problem, but at the cost of the private benefits agency problem. Non-controlling shareholders will prefer the presence of a controlling shareholder so long as the

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benefits from reduction in managerial agency costs are greater than the costs of private benefits of control.[1]

The terms of this tradeoff are determined by the origami of judicial doctrines that describe the fiduciary obligations of a controlling shareholder. In this Article, we examine the doctrinal limits on the private benefits of control from a particular orientation. As we will show, a controlling shareholder may extract private benefits of control in one of three ways: by taking a disproportionate amount of the corporation's ongoing earnings, by freezing out the minority, or by selling control. Our thesis is that the limits on these three methods of extraction must be determined simultaneously, or at least consistently, because they are in substantial respects substitutes. We then consider a series of recent Delaware Chancery Court decisions that we argue point in inconsistent directions—on the one hand, reducing the extent to which a controlling shareholder can extract private benefits through selling control and, on the other, increasing the extent to which private benefits can be extracted through freezing out noncontrolling shareholders. While judicial doctrine is too coarse a tool to specify the perfect level of private benefits, we believe these cases get it backwards. The potential for overreaching by controlling shareholders is greater from freeze-outs than from sales of control, so a shift that favors freeze-outs as opposed to sales of control is a move in the wrong direction.

In Part I, we develop the simultaneity framework for controlling private benefits of control and describe briefly the general doctrinal structure. In Part II, we review and evaluate recent Delaware case law regarding sale of control and minority freeze-outs. In particular, we argue that the Delaware law of freeze-outs can be best reunified by giving "business judgment rule" protection to a transaction that is approved by a genuinely independent special committee that has the power to say "no" to a freeze-out merger, while also preserving what amounts to a class-based appraisal remedy for transactions that proceed by freeze-out tender offers without special committee approval. Part III concludes that, although some may disagree with our views concerning the appropriate levels of restriction governing techniques for extracting the private benefits of control, the terms of the debate will be more sharply focused if the rules governing these techniques are evaluated simultaneously.

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[1] RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 1229-31 (2d ed. 1995).

I. PRIVATE BENEFITS OF CONTROL: THE LINK BETWEEN EXTRACTING PRIVATE BENEFITS FROM OPERATING, SELLING CONTROL, OR FREEZE-OUTS

Imagine that a controlling shareholder can extract benefits from its ongoing operation of the company. For example, the controlling shareholder can take out significant benefits through cost-sharing arrangements that overpay the controlling shareholder for providing central services such as pension, accounting, or the like. Alternatively, the controlling shareholder can benefit through "tunneling"—that is, through contractual dealings with the company, like transfer pricing, that favor the controlling shareholder.[2] In either event, the controlling shareholder secures value from its control position that is not received by the non-controlling shareholders.

In turn, the controlling shareholder can extract the same value from control by selling it at a premium to the value of the non-controlling shares. The existence of an ongoing stream of private benefits increases the value of the controlling shares compared to the non-controlling shares by the present value of the future private benefits. A sale of control simply capitalizes the cash flow associated with private benefits of control.

The same private benefits can also be secured by freezing out the minority shareholders. In a public corporation, the trading price of shares in a corporation with a controlling shareholder reflects the value of a non-controlling share.[3] The price of a non-controlling share will have been discounted by the capitalized value of the controlling shareholder's private benefits. A freeze-out at the discounted price allows the controlling shareholder to capture the capitalized value of future private benefits.

The critical point is that, without more, we should expect doctrinal regimes of equivalent rigor to cover each of the three methods of extracting private benefits. While which technique a controlling shareholder resorts to will depend on the particular circumstances, as yet there is no reason to favor one method over another. In fact, the legal rules that govern the three methods are quite different. One set of legal rules specifies the boundaries for private benefits in the ongoing operation of the corporation.[4] A second addresses efforts by a

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[2] For one description of this strategy, see Simon Johnson et al., *Tunneling*, AM. ECON. REV., May 2000, at 22, 22.

[3] GILSON & BLACK, *supra* note 1, at 1234.

[4] *See infra* text accompanying notes 7-19 (discussing this particular set of rules).

controlling shareholder to sell control at a premium not shared with others. A third polices freeze-outs of non-controlling shareholders. As we will see, the rules controlling the level of private benefits from operations are the central determinant of the judicial doctrine that controls controlling shareholders; these rules set the level of private benefits that can be appropriately capitalized through sale of control or a freeze-out.

The rules governing a sale of control and those governing a freeze-out of non-controlling shareholders are quite different from one another. There is quite limited judicial intervention in the case of sales of control and quite intensive judicial intervention in the case of minority freeze-outs. In this Part, we argue that this pattern of judicial intervention represents the right relationship: more intense judicial review is appropriate in a freeze-out than in a sale of control. The objective of the legal rules in both the sale of control and freeze-out cases should be identical: to protect the controller's continuing claim to the permissible level of private benefits while limiting the controller's take to that level plus an appropriate share of the synergy gains. This is much easier to achieve in a sale of control, where continuing shareholders participate pro rata in synergy gains, than in a freeze-out, where the synergy gains must be priced and allocated as part of the freeze-out price. In the next Part, we argue that recent Delaware case law is moving in the wrong direction.

Getting it right is not a matter of indifference. A significant body of scholarship links capital market development and public shareholder protection.[5] As we will see, legal rules and the enforcement mechanisms for those rules affect the "minority discount"—that is, the value difference between the shares of equivalent cash flow rights held by public shareholders and by controlling shareholders.[6] The minority discount in turn affects the feasibility of "equity carve-outs," transactions in which a parent sells a minority interest in a subsidiary via an

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[5] The literature is summarized in Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000). *See also* Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998) (examining the legal rules protecting corporate shareholders in common law and civil law countries and hypothesizing that small, diversified shareholders are not likely to hold much influence in countries that do not protect their rights); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1131 (1997) (postulating that countries with poorer investor protections have smaller and narrower capital markets).

[6] *See* Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. (forthcoming 2004) (documenting cross-country differences in private benefits); Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. FIN. ECON. 325, 342 (2003) (same).

initial public offering (IPO), and also affects, generally, the value of control transactions where some shares remain in public hands.

A. *Private Benefits of Control in Operating the Company: The* Sinclair *Standard*

The legal rules governing private benefits of control in operating a company set the limits on the price of monitoring by a controlling shareholder. If these limits are effective, the presence of a controlling shareholder benefits the non-controlling shareholders because the reduction in managerial agency costs will exceed the level of private benefits.

Two basic legal rules police the level of private benefits that result from ongoing operations. First, if the controlling shareholder is a director, then any contract between the controlling shareholder and the corporation is an interested transaction and must meet the standards of statutes like Delaware General Corporation Law section 144,[7] which requires that the transaction be sanitized through either procedural techniques or substantive judicial review.[8] If the controlling

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[7] DEL. CODE ANN. tit. 8, § 144 (2001).

[8] Delaware General Corporation Law section 144 provides in pertinent part:

> (a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if:
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> (1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or
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> (2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or
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> (3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.

Id.; *see also* Oberly v. Kirby, 592 A.2d 445, 466 (Del. 1991) ("[W]here an independent committee is not available [to approve an interested transaction under § 144], the stockholders may either ratify the transaction or challenge its fairness in a judicial forum . . . .").

shareholder is not a director, then *Sinclair Oil Corp. v. Levien*[9] applies, which sets out the general standards for the conduct of controlled corporations.[10] For this purpose, the Delaware Supreme Court essentially divides sources of private benefits into two categories.

The first category concerns the business and strategic decisions of the corporation. In *Sinclair*, for example, a minority shareholder of Sinven Venezuelan Oil Company, a controlled corporation that operated primarily in Venezuela, claimed that Sinven's dividend policy favored the controlling shareholder, Sinclair Oil Corporation.[11] By paying out as dividends a large percentage of Sinven's profits, Sinven was alleged to favor the controlling shareholder, which apparently had attractive investment opportunities outside of the controlled corporation, and to disadvantage the non-controlling shareholders, who received equal dividends but lost the opportunity for the controlled corporation to reinvest its earnings.[12]

The second category concerns the core aspect of private benefits—the controlling shareholder's direct dealings with the controlled corporation. Here we are in the realm of true self-dealing—unfair transfer pricing, the transfer of assets from the controlled corporation to the controlling shareholder, and the use of the controlled corporation's assets as collateral for a controlling shareholder's debt.

The standards established for the two categories of private benefits are radically different. In general, courts treat business and strategic decisions that even-handedly affect the controlling and non-controlling shareholders essentially as business judgments. Thus, the Delaware Supreme Court handled the dividend decision in *Sinclair*, as well as the related claim that the controlled corporation's business was limited to the development of oil opportunities in Venezuela (presumably why the controlled subsidiary was in a position to pay such

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[9] 280 A.2d 717 (Del. 1971).

[10] *See id.* at 720 (invoking the intrinsic fairness standard when the fiduciary duty a parent owes its subsidiary "is accompanied by self-dealing—the situation when a parent is on both sides of a transaction with its subsidiary").

[11] *Id.* at 719-21.

[12] The dividend may also have had a differential tax impact on minority shareholders. Depending on whether the subsidiary was part of an affiliated group, at least eighty percent and as much as one hundred percent of the dividends received by the parent would not be taxed. *See* GILSON & BLACK, *supra* note 1, at 1239-41 (explaining the impact of dividend-received deductions on the decision to employ a minority freeze-out). Minority shareholders would be taxed on dividends received unless they were otherwise exempt.

large dividends), as business judgments, and thereby outside the realm of intrusive judicial review.[13]

In contrast, core self-dealing is held to a dramatically different standard. If the controlling shareholder appears to benefit at the expense of the controlled corporation (for example, when the controller disparately gains from contract terms or the enforcement of those terms where the two parties are on opposite sides), the intrinsic fairness standard—the most rigorous in corporate law jurisprudence—applies. In that situation, the controlling shareholder bears the burden of proving that the terms of the transaction were intrinsically fair, with the court making a de novo determination.[14]

These two standards thus allow some range of private benefits of control but, consistent with the minority shareholders' calculus, at a level that still may make the non-controlling shareholders better off.[15] What kind of private benefits remain? At the most benign, maintaining a publicly traded, majority-owned subsidiary may benefit the controlling shareholder by more effectively opening the controlled company's performance to public scrutiny, thereby assuring more accurate pricing of the controlled corporation's business than if it was bundled with that of the controlling shareholder. Reciprocally, the controlling shareholder may then make use of market signals to help assess its own and the controlled corporation's business prospects as well as the performance of the controlled corporation's management. Additionally, controlling shareholders may use market signals to devise more accurate incentive compensation for the management and employees of both corporations.[16] In these circumstances, the

[13] 280 A.2d at 722.

[14] *Id.* at 720.

[15] The efficacy of these standards is offered by Johnson et al., *supra* note 2, at 26, as an explanation for the absence of pyramidal structures in the United States: "Perhaps the reason that pyramidal group structures are relatively rare in the United States and the United Kingdom [yet ubiquitous elsewhere in Europe] is that many transactions inside a group would be challenged on fairness grounds by minority shareholders of subsidiaries, who would get a receptive hearing in court."

[16] These reasons are commonly offered as explanations for the efficiency of equity carve-outs. *See* Katherine Schipper & Abbie Smith, *A Comparison of Equity Carve-outs and Seasoned Equity Offerings: Share Price Effects and Corporate Restructuring*, 15 J. FIN. ECON. 153, 182 (1986) ("[T]he equity carve-out may improve public understanding of the subsidiary's growth opportunities."); *see also* Anand M. Vijh, *The Positive Announcement-Period Returns of Equity Carveouts: Asymmetric Information or Divestiture Gains?*, 75 J. BUS. 153, 189 (2002) ("[T]he market reacts positively to the announcement of carveouts because it thinks that carveouts create value by divesting unrelated businesses, enabling a complete spinoff or a third-party acquisition, providing new financing, undertaking new investments, and reducing stock complexity."). Announcement of such

non-controlling shareholders get more focused monitoring at a relatively low cost.[17]

Other conduct involving private benefits that does not involve core self-dealing may be more costly. Here we have in mind a variety of business decisions that, while not rising to the level of business opportunities, may provide the controlling shareholder a benefit that would not otherwise be available to it, even if the controlled corporation does not directly bear an offsetting cost. These decisions seem to us to have the character of real options: for example, where the activities of the controlled corporation may keep open a strategy for the controlling corporation.[18] Nonetheless, this source of private benefit remains limited, certainly when compared to core self-dealing.[19]

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transactions results in a slightly less than two percent positive abnormal return in the parent company's stock. *See* Schipper & Smith, *supra*, at 153 ("These gains are in contrast to the average abnormal loss associated with announcements of seasoned equity offerings."); *see also* Heather M. Hulburt et al., *Value Creation from Equity Carve-Outs*, 31 FIN. MGMT. 83, 99 (2002) (finding that empirical tests support the divestiture gains hypothesis because "rivals of parent firms exhibit negative stock price reactions to equity carve-out announcements"). Additional explanations for this gain include the signal that the parent company's stock is undervalued (otherwise the offering would have been of parent stock), *see* Vikram Nanda, *On the Good News in Equity Carve-Outs*, 46 J. FIN. 1717, 1733 (1991) ("[T]he choice of financing decision may provide information not just about the subsidiary's assets in place but also about the value of the assets in place of the rest of the corporation."), and the increased analyst coverage of both companies' stock, *see* Stuart C. Gilson et al., Information Effects of Spin-offs, Equity Carve-outs, and Targeted Stock Offerings 18 (June 1998) (unpublished manuscript) ("Investment bankers . . . often argue that the level and quality of analyst coverage significantly improves following these transactions."), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=42904. In the end, some controversy remains about the source of abnormal returns. *See* David Haushalter & Wayne Mikkelson, An Investigation of the Gains from Specialized Equity: Tracking Stock and Minority Carve-Outs 24 (May 29, 2001) (unpublished manuscript) (conjecturing that "the stock price effects do not reflect real benefits of specialized equity arrangements"), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=271691. For a more skeptical view of valuation creation by carve-outs and carve-out stability, see André Annema et al., *When Carve-outs Make Sense*, MCKINSEY Q. No. 2, at 13, 15 (2002) (finding that, two years after the carve-out, most carve-outs "destroy[ed] shareholder value" and warning that "[c]arving out even small stakes in subsidiaries will likely lead to complete and irreversible separation").

[17] This statement is consistent with empirical evidence indicating that carve-out subsidiary stocks do not underperform stock portfolio benchmarks, contrary to the usual findings of underperformance for IPOs or seasoned equity offerings. Anand M. Vijh, *Long-Term Returns from Equity Carveouts*, 51 J. FIN. ECON. 273, 275 (1999).

[18] For this purpose it is useful to consider two different kinds of controlling shareholders:

> One group has a *unidimensional* relation to their portfolio company—that is, the controlling shareholder's only connection with the company is its shareholdings. A second group, in contrast, has a *multidimensional* relation to their

Finally, there is a level of private benefits extraction that arises from non-actionable self-dealing. For example, a contract with a controlling shareholder at market prices will still impound market-level rents and will not reflect savings from reduced information asymmetries. The relationship may also entail "micro" self-dealing that in each instance is small but in the aggregate is significant.

What's important is that judicial doctrine effectively puts a ceiling on the private benefits of control associated with operating the corporation. Behavior that has the potential to transfer large amounts of value is subjected to intense judicial scrutiny, which is consistent with our hypothesis that controlling shareholders do not take markedly more from non-controlling shareholders than they provide.[20] Thus, the level of private benefits from operations provides a benchmark for assessing the standards governing alternative methods of securing private benefits.

B. *Sale of Control at a Premium*

The second method by which a controlling shareholder may extract private benefits of control is by selling its control for a premium that reflects the capitalized value of the private benefits of control available from operating the controlled corporation. Although the holding in *Perlman v. Feldmann*[21]—that a controlling shareholder cannot sell control at a premium that is not shared with non-controlling shareholders[22]—continues to amuse corporate law teachers (both because it provides the basis for an interesting class and because of the Second Circuit's Fantasia-like view of Indiana law), by the early 1990s,

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> portfolio—that is, in addition to the controlling shareholder's stock position, it also has an operational relation to the company, for example, as customer or supplier.
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> . . . A unidimensional controlling shareholder has few channels by which to appropriate private benefits [from the controlled corporation].

GILSON & BLACK, *supra* note 1, at 1233. For the unidimensional controlling shareholder, real options may be the primary source of private benefits. *Id.* at 1233-34.

[19] *Id.* at 1233-34.

[20] John Coates is more pessimistic with respect to the potential size of private benefits that controlling shareholders can secure through operations. *See* John C. Coates IV, *"Fair Value" as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions*, 147 U. PA. L. REV. 1251, 1314-27 (1999) (contending that controllers can readily shift value from controlled subsidiaries). However, much of Coates's focus is on whether value-reducing operational decisions that affect all shareholders can be transmuted into private benefits in a freeze-out as a result of valuation standards. *Id.*

[21] 219 F.2d 173 (2d Cir. 1955).

[22] *Id.* at 178.

the applicable legal rule was radically different. Whether one looks to Delaware case law[23] or to the American Law Institute's (ALI) *Principles of Corporate Governance*,[24] the rule is clear: in general, a controlling shareholder can sell control at a premium that is not shared with non-controlling shareholders.

Given the limits on private benefits of control from ongoing operations, it seems clear that non-controlling shareholders would prefer a rule that allows controlling shareholders the right to sell their shares at a price that reflects the net present value of the flow of private benefits from operating the company.[25] Correspondingly, a buyer of control presumably would not wish to acquire the controlled corporation at a price that reflects the capitalized value of private benefits unless it thought it could increase the value of its purchased interest. Because the amount of private benefits from operating the controlled corporation is capped by the legal rule applicable in that situation, the non-controlling shareholders will share any increase in value resulting from an increase in the common value of the controlled corporation.[26]

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[23] The court in *Harris v. Carter*, 582 A.2d 222, 234 (Del. Ch. 1990), stated that, "[w]hile Delaware law has not addressed this specific question, one is not left without guidance from our decided cases.... [It] is [a] principle [of Delaware law] that a shareholder has a right to sell his or her stock and in the ordinary case owes no duty in that connection to other shareholders when acting in good faith." *See also* Thorpe v. CERBCO, Inc., 676 A.2d 436, 442 (Del. 1996) (distinguishing the fiduciary relationship between directors and the corporation from the relationship between controlling shareholders and other shareholders); *In re* Sea-Land Corp. S'holders Litig., No. 8453, 1987 WL 11283, at *5 (Del. Ch. May 22, 1987) ("A controlling stockholder is generally under no duty to refrain from receiving a premium upon the sale of his controlling stock."); *cf.* Robert W. Hamilton, *Private Sale of Control Transactions: Where We Stand Today*, 36 CASE W. RES. L. REV. 248, 249 (1985) ("It is unlikely that any American court today would reject the general proposition that controlling shareholders may obtain a premium for their shares which they need not share with other shareholders.").

[24] PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.16 (1994).

[25] This discussion draws on GILSON & BLACK, *supra* note 1, at 1231-32, which in turn was informed by Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 711 (1982) (arguing that minority shareholders want a rule that increases the market value of shares in the corporation). *See also* Lucian Arye Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q.J. ECON. 957, 974-81 (1994) (comparing the market rule with the equal opportunity rule in the context of corporate control transfers); Marcel Kahan, *Sales of Corporate Control*, 9 J.L. ECON. & ORG. 368, 378 (1993) (analyzing the legal rules governing the sale of corporate control).

[26] An empirical study of *Perlman v. Feldmann* showed that the stock of Newport Steel, the controlled corporation, experienced abnormal returns of thirty-four percent during negotiations for sale of control and abnormal returns of seventy-seven percent

Next, assume that the new controller realizes certain synergies from its operation of the controlled corporation. Does this change the legal rule that non-controlling shareholders would choose? We think not. So long as the legal rules governing private benefits of control from operations do not allow all of the synergy to be captured by the controlling shareholder, the non-controlling shareholders will participate in the value increase resulting from the sale of control. This is a plausible assumption given that actually achieving synergy will require direct interaction between the controlling shareholder and the controlled corporation, an interaction that will be subject to *Sinclair*.[27]

There are exceptions to the permissive general rule, but these seem to fit well within the present analysis. Section 5.16 of the ALI *Principles of Corporate Governance* states these exceptions.[28] The general rule that a controlling shareholder can sell its shares at a premium is qualified in two circumstances: first, when the controlling shareholder acquires shares from non-controlling shareholders in anticipation of the contemplated sale of control without disclosure and, second, when it is apparent that the purchaser is likely to extract illegal levels of private benefits from operating the controlled corporation.[29]

(twenty-nine percent on an industry-adjusted basis) over the entire year during which control was sold. Michael J. Barclay & Clifford G. Holderness, *The Law and Large-Block Trades*, 35 J.L. & ECON. 265, 270-71, 270 n.7 (1992). Because market price measures the value of the public minority shares, the data suggest that the minority shareholders benefited from the sale of control. The experience of Newport's non-controlling shareholders seems to be a generalizable one.

On the other hand, it is also possible to see *Perlman v. Feldmann* as correctly decided on its own peculiar facts, namely the Korean War price controls that produced a valuation gap between the capped wholesale price of steel and the value of the steel to end-users, whose products were not price-capped. 219 F.2d at 175. To try to capture this difference, Newport had insisted that customers provide advances against future purchases, i.e., interest free loans. *Id.* at 177. Even if the end-users who acquired control of Newport continued to make these advances on their purchases, if the present value of the interest-rate differential was less than the steel-product valuation gap, then at least part of the control premium can be considered a form of special synergy gain that, because it was not ratably shared with the minority, was properly subject to recovery.

[27] *See supra* notes 9-14 and accompanying text for a discussion of the standards imposed by *Sinclair*.

[28] PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.16 (1994).

[29] Section 5.16 (a) and (b) restrict a controlling shareholder's right to sell control at a premium if:

> (a) The controlling shareholder does not make disclosure concerning the transaction to other shareholders with whom the controlling shareholder deals in connection with the transaction; or

The first exception operates merely as a form of insider trading regulation. The second backstops the rule, limiting the level of private benefits from operations. In circumstances of looting, the controlling shareholder may be judgment proof. The exceptions provide an alternative source of recovery when the seller of control should have known what was coming.

In short, the legal rule governing receipt of private benefits through sale of control fits nicely with the legal rule governing the level of private benefits from ongoing operations of the company. Except when there is reason to believe that the operating rules will be violated following the sale, there is no reason for a more restrictive rule. Put differently, if the stream of private benefits from operations is effectively controlled, there is no need to regulate the transfer of its capitalized value.[30]

C. *Freeze-out of Minority Shareholders*

The third method by which a controlling shareholder can extract private benefits of control is through freezing out minority shareholders at a market price that reflects a discount equivalent to the private benefits of control available from operating the controlled corporation. In contrast to the simple permissive rules governing the sale of control at a premium, the rules governing minority freeze-outs are both complex and restrictive.

The modern law of minority freeze-outs dates to the Delaware Supreme Court's decision in *Weinberger v. UOP, Inc.*[31] In that case, the

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> (b) It is apparent from the circumstances that the purchaser is likely to violate the duty of fair dealing . . . in such a way as to obtain a significant financial benefit for the purchaser or an associate.

Id. § 5.16(a)–(b) (citations omitted).

[30] Thus, one way to understand "mandatory bid" systems that are common to takeover practice in the European Union, see *infra* note 115 (last paragraph), which give public minority shareholders an exit right upon an acquisition of control, is in terms of the differential capacity of legal systems to articulate and enforce minority shareholder rights.

[31] 457 A.2d 701 (Del. 1983). The present historical account relegates Delaware's flirtation with a business purpose test as a precondition to a freeze-out—announced in *Singer v. Magnavox Co.*, 380 A.2d 969, 975-76 & n.5, 982 (Del. 1977) (apparently in response to pressure from the federal courts) and overruled in *Weinberger*, 457 A.2d at 715—to accounts more concerned with the impact of federalist considerations on the development of corporate law. For one such account, see GILSON & BLACK, *supra* note 1, at 1254-69. *See also* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 600 (2003) (asserting that Delaware's race is not with other states, but with the risk of federal preemption).

Signal Companies determined to acquire the 49.5% of UOP that it did not own through a merger in which the UOP shareholders would receive cash for their UOP stock.[32] Although Signal was prepared to pay up to $24 per share for the stock, the UOP board agreed to accept $21 per share, an approximately fifty percent premium over the market price of UOP stock.[33] The court treated the freeze-out transaction as a simple manifestation of the core self-dealing conduct that requires intensive judicial review of the transaction terms for fairness.[34] Because the lower the price Signal paid to UOP shareholders, the better off it was, and because Signal had benefited by its receipt of a feasibility study prepared by Signal's UOP directors to the detriment of the UOP minority, the transaction simply presented a variation of the typical scenario that triggers heightened review of operating transactions under *Sinclair*.[35] Consistent with the general principle that a controlling shareholder is cut no slack in its dealings with a controlled corporation, the court stressed that Signal-designated directors of UOP should be held to the same standard as non-Signal directors; conflicting loyalties had to be resolved in favor of the controlled corporation.[36]

Having established that a freeze-out triggered intensive judicial review of the transaction's fairness, the court went on to delineate the terms of that review. "Fairness," the court explained, consists of the process by which the transaction is negotiated: "fair dealing" together

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[32] *Weinberger*, 457 A.2d at 705.

[33] *Id.* at 705-06.

[34] *Id.* at 710.

[35] "Self-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary." Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

[36] *See Weinberger*, 457 A.2d at 710 (relying on "the long-existing principle of Delaware law that these Signal designated directors on UOP's board still owed UOP and its shareholders an uncompromising duty of loyalty"). In the post-*Weinberger* evolution of freeze-outs, the inherent tensions in a transaction proposed by a controller, who either has the necessary voting power to accomplish the transaction or, if the transaction is conditioned on a majority of minority approval, will remain in control even if the minority refuses, have led to the imposition of entire fairness review in all such freeze-outs; no explicit taking advantage of minority shareholders is required. *See* Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994) (requiring entire fairness review when a controlling or dominating shareholder stands on both sides of the transaction); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985) ("'[T]he requirement of fairness is unflinching . . . where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.'" (quoting *Weinberger*, 457 A.2d at 710)).

with "fair price."[37] With respect to fair dealing, the court stressed both the obligation of candor on the part of the parent[38] and the importance of a process that mirrors a real arm's-length transaction in which each party has the right to say "no."[39] As to fair price, the court adopted for this purpose the liberalized appraisal standard previously adopted by the Delaware legislature.[40]

Unfortunately, the court provided no real guidance as to how the two elements of fairness interacted. On the one hand, *Weinberger* can be read as suggesting that, if the parent allowed the subsidiary to establish an independent negotiating committee that had the right to say "no," the court could then infer that the price resulting from arm's-length bargaining was also fair. Alternatively, however, the court simultaneously and unhelpfully stressed that "the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness."[41]

The importance of this confusion cannot be overemphasized. For this purpose, it is important to keep in mind what is at stake. Controlled corporation shareholders already have a remedy if they believe the price to be paid in a cash-out merger is too low: an appraisal proceeding with precisely the same measure of value as that adopted by the *Weinberger* court.[42] The difference between the two remedies is technically procedural, but ultimately of enormous substantive consequence. Under the Delaware appraisal procedure, a shareholder must jump through a number of procedural hoops, including not

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[37] *Weinberger*, 457 A.2d at 711.

[38] *Id.*

[39] In an oft-cited footnote, the court stated that

> the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's length. 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.

Id. at 709 n.7 (citations omitted).

[40] *Id.* at 703-04; *see also* DEL. CODE ANN. tit. 8, § 262 (Supp. 1982) (current version at tit. 8, § 262 (2001)).

[41] *Weinberger*, 457 A.2d at 711. The court's reasoning is unclear. Suppose the price is entirely fair, but the process is faulty. To what else are shareholders entitled beyond a fair price?

[42] *Id.* at 703-04.

voting for the transaction and not accepting payment, in order to retain the right to bring an appraisal action.[43] More importantly, the Delaware corporate statute does not authorize a class appraisal procedure.[44] In contrast, a breach of fiduciary duty claim can be brought on behalf of all subsidiary shareholders regardless of how they voted or whether they accepted payment for their shares.[45] Thus, the economics of the litigation process mean that, if a fight about price is limited to appraisal, the controlling shareholder is exposed as to price only with respect to the number of shares for which appraisal rights are perfected, typically a quite small number. Moreover, the controller can manage its potential risk by conditioning its obligation to close the merger on a certain level of shareholder approval. In a class action under the *Weinberger* standard, however, the price exposure extends to all shares acquired through the freeze-out merger without the need for shareholders to take any action at all.[46]

Finally, if the freeze-out merger consideration is stock in the controller or stock in any publicly traded corporation, the minority shareholders have no right to appraisal.[47] Thus, without a cause of action for breach of fiduciary duty, the minority shareholders in such a transaction may have no remedy at all.

What remained open after *Weinberger*, then, was the procedural key. If the parent adopts an arm's-length negotiating structure, including an independent negotiating committee with a right to say "no," and receives the approval of a majority of the minority shareholders, does the standard of review shift to business judgment and therefore relegate shareholders to their appraisal rights as the

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[43] § 262(a).

[44] *Id.*

[45] *See* Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1111 (Del. 1994) (noting that the plaintiff brought a class action on behalf of all shareholders of the acquired company whose stock had been procured through the merger).

[46] *See* GILSON & BLACK, *supra* note 1, at 1266-69 (discussing the differences between appraisal actions and other claims). In *Andra v. Blount*, 772 A.2d 183, 183-84 (Del. Ch. 2000), Vice Chancellor Strine confronted the critical procedural consequence of a plaintiff's successfully invoking entire fairness review of a freeze-out merger in the context of applying standing as a barrier to entire fairness review. *See also* Clements v. Rogers, 790 A.2d 1222, 1225 (Del. Ch. 2001) (confronting a similar procedural consequence with respect to the acquiescence doctrine).

[47] § 262(b)(2). If, however, the controller owns at least ninety percent of the target's stock and uses the short-form merger procedure under DEL. CODE ANN. tit. 8, § 253 (2001), then the minority shareholders have appraisal rights irrespective of the consideration. § 262(b)(3).

Weinberger court suggested in footnote 7?[48] Alternatively, would the appraisal measure of value nonetheless be applied on a class basis because, as the *Weinberger* court also explained, "the test for fairness is not a bifurcated one as between fair dealing and price"?[49] This and related issues were more or less clearly worked out in two Delaware Supreme Court opinions, *Kahn v. Lynch Communications Systems, Inc.* (*Kahn I*)[50] and *Kahn v. Lynch Communications Systems, Inc.* (*Kahn II*),[51] involving Alcatel U.S.A. Corporation's freeze-out of non-controlling shareholders in Lynch Communication Systems, Inc.

Kahn I plainly resolved the issues at stake in structuring the approval process of a freeze-out merger. The court considered a perfectly sensible argument that entire fairness review should not apply, and therefore shareholders would be remitted to an appraisal remedy, if the negotiating structure plausibly protected their interests[52]—as, for example, where the merger terms met the approval of a fully empowered, independent negotiating committee and the merger was conditioned upon approval by the majority of the disinterested minority.[53] Where the procedure approximated an arm's-length negotiation, no special judicial review would be appropriate, and the business judgment standard would apply. Furthermore, it would follow that the frozen-out shareholders would be held to their decision regarding the pursuit of appraisal. Instead, the *Kahn I* court held that adopting such a negotiating structure served only to shift the burden of proof to the plaintiff on the issue of the freeze-out's fairness.[54] The court believed that the controlling shareholder retained the capacity to influence the minority that cannot be procedurally

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[48] 457 A.2d at 709 n.7. See *supra* note 39 for the footnote quotation.

[49] 457 A.2d at 711.

[50] 638 A.2d at 1117.

[51] 669 A.2d 79, 84 (Del. 1995).

[52] *See Kahn I*, 638 A.2d at 1115 (discussing the possibility that approval of a cash-out merger by a committee of interested directors "renders the business judgment rule the applicable standard of judicial review").

[53] *In re* Trans World Airlines, Inc. S'holders Litig., No. 9844, 1988 WL 111271, at *7 (Del. Ch. Oct. 21, 1988):

> Both the device of the special negotiating committee of disinterested directors and the device of a merger provision requiring approval by a majority of disinterested shareholders, when properly employed, have the judicial effect of making the substantive law aspect of the business judgment rule applicable and, procedurally, of shifting back to plaintiffs the burden of demonstrating that such a transaction infringes upon rights of minority shareholders.

[54] 638 A.2d at 1117.

dissipated.[55] In effect, the court envisioned an implicit threat that, if the non-controlling shareholders did not approve the freeze-out, the controlling shareholder would exercise its operating discretion to their disadvantage.[56] In *Kahn I* itself, the court found that Alcatel had coerced the independent negotiating committee set up by Lynch Communications by threatening to proceed with a tender offer at a lower price if the committee continued to resist.[57] The court remanded the case to the chancery court to determine the transaction's entire fairness.[58]

Kahn I left open two important issues. First, what happens if the transaction structure fails this initial fair-dealing inquiry and therefore does not operate to shift the burden of proof? If a transaction has to exhibit both fair dealing and fair price to be entirely fair, then how can the fairness standard ever ultimately be satisfied if, as in *Kahn I*, the fair-dealing component is not met? Second, why should a controlling shareholder allow the creation of a fully empowered negotiating committee if all it gets in return is a burden shift? Unless the evaluation of price is somehow different—even without the presumptions of business judgment review—as a result of procedural protections, what is in it for the controlling shareholder?[59]

On remand, the chancery court found that the transaction satisfied both the fair-dealing and fair-price components of the entire fairness review.[60] As has been suggested, finding that the fair-dealing component was satisfied, despite the controlling shareholder's coercion of the independent negotiating committee, required some fast-talking. On appeal, the supreme court's assessment of fair dealing took an unacknowledged but major shift. While in *Kahn I* the inquiry

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[55] *Id.* at 1116-17.

[56] "'The controlling stockholder relationship has the [sic] potential to influence, however subtly, the vote of [ratifying] minority stockholders in a manner that is not likely to occur in a transaction with a noncontrolling party.'" *Id.* at 1116 (quoting Citron v. E.I. DuPont de Nemours & Co., 584 A.2d 490, 502 (Del. Ch. 1990)). In making this statement, the court appears unaware that this "inherent coercion" can exist only to the extent that judicial review of the controlling shareholder's operating decisions fails to control private benefit extraction.

[57] *See id.* at 1118 (stating that the independent negotiating committee had "full knowledge of Alcatel's demonstrated pattern of domination" while considering Alcatel's proposal to purchase Lynch Communications).

[58] *Id.* at 1121-22.

[59] *See In re* Cysive, Inc. S'holders Litig., No. 20341, 2003 WL 21961453, at *15-16 (Del. Ch. Aug. 15, 2003) (concluding that burden-shifting, particularly on "fair value," is not generally material either at the pleading stage or at trial).

[60] *Kahn II*, 669 A.2d at 83.

was whether the independent negotiating committee had been coerced, in *Kahn II* the inquiry shifted to whether the non-controlling shareholders voting on the freeze-out merger were coerced.[61] Despite the finding that "the specter of coercion" had impaired the functioning of the independent negotiating committee, the court concluded that "[w]here other economic forces are at work and more likely produced the decision to sell," this coercion still

> may not be deemed material with respect to the transaction as a whole, and will not prevent a finding of entire fairness. In this case, no shareholder was treated differently . . . nor subjected to a two-tiered or squeeze-out treatment. . . . Clearly there was no coercion exerted which was material to this aspect of the transaction . . . .[62]

Putting *Kahn I* and *Kahn II* together, we are left with something like a two-tiered inquiry concerning the fair-dealing component of the entire fairness standard. With respect to whether the burden of proof on entire fairness has shifted to the plaintiff, the appropriate inquiry assesses the presence and true empowerment of an independent negotiating committee.[63] Fairly read, *Kahn I* holds that the burden of proof does not shift unless the independent negotiating committee has the right to prevent the transaction.[64] With respect to the ultimate determination of whether the transactional procedure satisfies the fair-dealing component, the inquiry shifts to whether the inherent coercion and the form of the transaction actually influenced the non-controlling shareholders' votes. Characterized somewhat less than sympathetically, is fair dealing satisfied despite an unfair, but not structurally coercive, procedure?[65]

That leaves the issue of the stakes associated with establishing an empowered special committee. Will the assessment of fair price be influenced by the extent to which the transaction structure attempts

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[61] *See id.* at 86 (holding that the coercion found by the court in *Kahn I* did not have a "material" influence on the shareholders' decision to sell and, therefore, was not indicative of unfair dealing).

[62] *Id.* (citation omitted).

[63] How to design a fully empowered, independent negotiating committee is itself an interesting issue. *See* GILSON & BLACK, *supra* note 1, at 1303-05 (speculating as to what negotiating procedures will satisfy the fair-dealing requirement after *Kahn I*).

[64] *See supra* text accompanying note 54 (describing the court's holding that an arm's-length negotiating structure shifts the burden of proof).

[65] By contrast, a violation of the duty of candor does appear to result in a per se failure of the entire fairness standard. *See* Ince & Co. v. Silgan Corp., No. 10941, 1991 WL 17171, at *5 (Del. Ch. Feb. 7, 1991) (stating that "entire fairness includes the obligation 'to disclose with entire candor all material facts concerning the merger'" (quoting Sealy Mattress Co. v. Sealy, Inc., 532 A.2d 1324, 1335 (Del. Ch. 1987))).

to dissipate the specter of coercion? The answer to that question remains opaque, largely because of the court's continued insistence on the "non-bifurcated standard of *Weinberger*."[66] There is, however, a specter of judicial coercion with respect to the link between procedure and price. Although *Weinberger* eliminated the free option that arose out of *Lynch v. Vickers Energy Corp.*,[67] which held that failing the entire fairness standard exposed the controlling shareholder to the equitable remedy of the monetary equivalent of rescission,[68] and the court in the seemingly endless *Cede & Co. v. Technicolor, Inc.*[69] litigation read the appraisal standard in section 262 to include significant elements of post-transaction value,[70] *Weinberger* continued to hold out the prospect of equitable relief beyond the appraisal standard.[71] Thus, the court has left room for a link between procedure and damages, with an appropriate incentive effect.

D. *Summary*

The doctrinal origami of the limits on controlling shareholders presents a clear but complex pattern. The rule governing the extraction of private benefits of control limits large wealth transfers from non-controlling to controlling shareholders by imposing rigorous judicial review of self-dealing transactions between the controlling shareholder and the controlled company, while still leaving room for a range of private benefits that may be more beneficial to the controlling shareholder than costly to the controlled company and that

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[66] *Kahn II*, 669 A.2d at 90. The court's reference to "a disciplined balancing approach" following its mention of the non-bifurcated standard in *Kahn II*, *id.*, appears to contemplate an undisciplined tradeoff between procedure and price that seems to assure the continued pattern of fully litigating every freeze-out transaction.

[67] 429 A.2d 497 (Del. 1981) (awarding the plaintiff rescissory damages for the controlling shareholder's breach of fiduciary duty in a tender offer, rather than the appraisal damages typically awarded to minority shareholders injured in sales to controlling parties); *see also* GILSON & BLACK, *supra* note 1, at 1269 (discussing the option-like effect of differing damage standards in appraisal and entire fairness proceedings).

[68] 429 A.2d at 501; *see also Weinberger*, 457 A.2d 701, 703-04, 714 (Del. 1983) (overruling *Lynch* by holding that appraisal, and not rescissory damages, is the appropriate remedy for minority shareholders in freeze-out mergers).

[69] 684 A.2d 289 (Del. 1996).

[70] *Id.* at 299-300.

[71] 457 A.2d at 714 ("While a plaintiff's monetary remedy ordinarily should be confined to the more liberalized appraisal proceeding herein established, we do not intend any limitation on the historic powers of the Chancellor to grant such other relief as the facts of a particular case may dictate.").

may support the more focused monitoring of the managerial agency problem available to a controlling shareholder.

In turn, the rule governing the extraction of the capitalized value of the private benefits from operations through the sale of control is both simple and permissive. Because of the restrictions on the extraction of private benefits from operations (which continue to allow a level of private benefits consistent with focused monitoring), an acquirer of control must ordinarily improve the performance of the controlled corporation in order to profit from its investment. Achieving this improvement requires two inputs: the capabilities of the new controlling shareholder and the existing business of the controlled corporation. Because the non-controlling shareholders remain participants in the controlled corporation, the gain that results from this bilateral monopoly is shared more or less proportionately. Judicial intervention is limited to those circumstances where either there is an observable risk that the purchaser of control will exceed the level of allowed private benefits from operation or there has been fraud in the interaction between the selling controlling shareholder and non-controlling shareholders in anticipation of the control sale.

In contrast, the rules that limit extracting the capitalized value of the private benefits of control through freezing out the non-controlling shareholders are both complex and restrictive. This difference emerges because, unlike with a sale of control, non-controlling shareholders will not automatically participate in any value increase as a result of the freeze-out. This discrepancy results in an incentive for controlling shareholders to manipulate the operation of the controlled corporation and the market price of its stock in anticipation of the transaction, subject to the limits imposed by the *Sinclair* standard.[72] It also can leave the non-controlling shareholders with no benefit from the post-transaction increase in value even though an input in which they have an interest is necessary to achieve that increase. Requiring an independent negotiating committee and more rigorous judicial review serves to ensure that the non-controlling shareholders receive some portion of the gain that would result from bargaining in a bilateral monopoly.[73]

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[72] *Sinclair*, 280 A.2d 717, 722 (Del. 1971), would not restrict poor decisions that reduce value generally. To the extent that the effects of such decisions may not be reversible, the potential for manipulation is real.

[73] There is no obvious reason to believe that giving all the gain to one side or another in a bilateral monopoly is necessary in order to achieve an efficient level of transactions. From the perspective of either participant, any value above the

II. DISTURBING THE SYMMETRY: THE *DIGEX* AND *SILICONIX* LINES OF CASES

To this point, we have argued that the Delaware doctrine seeking to control the level of private benefits enjoyed by controlling shareholders reflects a sensible symmetry between the three alternative methods by which these benefits can be extracted: through ongoing operations, by a sale of control, or by a freeze-out. As our discussion of the case law reflects, we do not assert that this symmetry is the result of grand design. Rather, we believe only that, when rules governing one or another alternative get out of line, transaction planners are quick to adjust their strategies to compensate, such that the Delaware Chancery Court sees the implications of its previous decisions quickly and is promptly given the opportunity to adjust the rules and restore balance.[74] We also do not assert that the pattern necessarily reflects a fully efficient equilibrium that can be reflected in complex equations. Rather, we suggest only that the pattern reflects a rough but workable solution, not necessarily any worse than the results of an effort to mathematically model the solution to three simultaneous equations under restrictive assumptions.

Our recognition of the overall structure's viability should not, however, imply that we believe the Delaware courts always get it

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reservation price is a rent. Lucian Bebchuk and Alan Schwartz discuss this issue as it pertains to the takeover context in an interesting, albeit lengthy, debate. For examples of their arguments, see Lucian Arye Bebchuk, *The Case for Facilitating Competing Tender Offers: A Last (?) Reply*, 2 J.L. ECON. & ORG. 253, 256 (1986); Lucian Arye Bebchuk, *The Sole Owner Standard for Takeover Policy*, 17 J. LEGAL STUD. 197, 228 (1988); Alan Schwartz, *Bebchuk on Minimum Offer Periods*, 2 J.L. ECON. & ORG. 271, 271 (1986); Alan Schwartz, *Search Theory and the Tender Offer Auction*, 2 J.L. ECON. & ORG. 229, 244 (1986); Alan Schwartz, *The Sole Owner Standard Reviewed*, 17 J. LEGAL STUD. 231, 234 (1988).

[74] Ronald Gilson and Bernard Black describe "[t]his drastic telescoping of the common law process" with respect to takeovers in the 1980s: "Each new decision was reflected in the tactics of the next transaction; the Chancery Court often had to confront the 'next case' on a motion for preliminary injunction soon after the initial decision." GILSON & BLACK, *supra* note 1, at 4. We do not intend this analysis as a strong claim for the efficiency of the common law of corporations. We do, however, think that the claim for efficiency is likely the strongest here, where the rules concern an ongoing pattern of transactions and where professionals view their role as involving continual adjustment of transactional structures to reflect new judicial decisions. This explicit interaction between case law and transaction structure is plainly visible in the latter line of cases we discuss in this Part. *See also* John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307, 328-37 (2000) (documenting the rapid shift from stock options to breakup fees in friendly mergers following an adverse Delaware Supreme Court ruling on stock options).

right. These are complicated and difficult matters with, as we have tried to show, a lot of moving parts. Moreover, the case law does not acknowledge the simultaneity of the three doctrinal lines, which makes maintaining their symmetry that much harder. Thus, mistakes happen. The role of commentary is to identify these glitches and offer suggestions as to how they can be rectified.[75]

In this Part, we focus on what we believe to be two such glitches that go to the center of the symmetry developed in Part I. The first, the chancery court decision of *In re Digex, Inc. Shareholders Litigation*,[76] deals with the rules governing private benefit extraction through the sale of control, and the second, the line of cases following *In re Siliconix Inc. Shareholders Litigation*,[77] deals with the rules governing private benefit extraction through freeze-outs. Recognition of the relationship between the three doctrinal areas that control controlling shareholders' extraction of private benefits suggests that, in each, the chancery court is moving in the wrong direction. More particularly, *Digex* threatens to interfere with the controller's right to retain a control premium in the sale of control, and the *Siliconix* line of cases threatens to reduce minority protections in freeze-out transactions in a way that will enhance the controller's take beyond the permitted level of private benefits.

A. Digex: *New Restrictions on Sale of Control at a Premium*

The controversy in *Digex* now seems terribly dated. The transaction began with a contest between WorldCom, Inc. and Global Crossing, Ltd. to acquire Intermedia Communications, Inc., a telecommunications company, and/or Digex, Inc., Intermedia's controlled subsidiary in the web hosting business, said to be "well positioned in one of the hottest segments of the technology sector . . . ."[78] WorldCom won the contest, having made clear "that WorldCom would outbid anyone for Digex."[79] The legal issues were posed by the conflict between Intermedia and Digex shareholders over which group would receive the WorldCom stock that would be the consideration in the acquisition.

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[75] This is a much easier job, we recognize, than trying to get the answer both right and written in the amount of time typically available to the chancery court.

[76] 789 A.2d 1176 (Del. Ch. 2000).

[77] No. 18700, 2001 WL 716787 (Del. Ch. June 19, 2001).

[78] *Digex*, 789 A.2d at 1181.

[79] *Id.* at 1184.

While the facts leading up to the transaction are complex, the central issue can be stated briefly. After initially considering a direct acquisition of Digex, WorldCom decided instead to acquire control of Digex indirectly, by acquiring Intermedia.[80] The two alternatives had dramatically different impacts on Intermedia and Digex, at least in the first instance. If WorldCom acquired Intermedia, Intermedia's shareholders would receive the control premium associated with Digex.[81] Alternatively, if WorldCom acquired Digex, the control premium would be shared between Intermedia and Digex's non-controlling shareholders.[82] After some initial uncertainty, WorldCom decided to acquire Intermedia, thereby succeeding to Intermedia's control of Digex.[83] Neither Digex nor its shareholders would be a party to the transaction.

There was, however, one complication. WorldCom wanted the Digex board of directors, composed of four Intermedia representatives and three independents, to grant WorldCom a waiver of section 203 of the Delaware General Corporation Law,[84] Delaware's business combination statute.[85] This provision prohibits an acquirer of more than fifteen percent of a target's shares from engaging in a range of interested transactions with the target, including a freeze-out merger, for a period of three years unless the target company's board

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[80] *Id.* at 1184-85.

[81] *Id.* at 1183.

[82] *Id.* This difference extended to the personal positions of Intermedia representatives who constituted a majority of Digex's board. All had significant ownership positions in Intermedia but comparatively small or no ownership interests in Digex. *Id.* at 1181 n.5.

[83] *Id.* at 1187. The plaintiffs claimed that, and the chancery court devoted substantial attention to determining whether, Intermedia had somehow usurped a Digex corporate opportunity by diverting WorldCom's initial interest in acquiring Digex to an acquisition of Intermedia. *Id.* at 1188-94. While the chancery court correctly held that Digex had no independent opportunity because of Intermedia's control, *id.* at 1189-92, we think the court made the issue harder than it needed to be. So long as no acquisition of Digex could occur without Intermedia's approval, the manner in which WorldCom expressed its preference for acquisition of Intermedia should be beside the point. While a properly scripted exchange would have referred WorldCom to the Digex board while also expressing Intermedia's position that it would not approve an acquisition of Digex, the outcome hardly should turn on invariably conflicting evidence regarding the terms of the actual conversation. Since Intermedia had the uncontested right not to approve a Digex acquisition, any further inquiry on this point should have been unnecessary.

[84] DEL. CODE ANN. tit. 8, § 203 (2001).

[85] *Digex*, 789 A.2d at 1185.

of directors preapproves the acquirer's initial share acquisition or another exemption applies.[86]

This account sets up the issue. There was no doubt that Intermedia was free to structure the transaction, so it could sell control of Digex without sharing the premium with non-controlling Digex shareholders. But what happens when Digex is asked to participate in the transaction by waiving the application of section 203?

At the Digex board meeting held to consider the waiver, the board voted four to three to approve the waiver, conditioned on the amendment of Digex's articles of incorporation to require that Digex independent directors approve any post-acquisition material transaction between WorldCom and Digex.[87] The vote broke down along party lines. The three independent directors voted against the waiver, while the four Intermedia-affiliated directors voted in its favor, after rejecting the position advanced by counsel to the independent directors that they recuse themselves due to conflicts of interest.[88]

Because the Intermedia-affiliated directors were hopelessly conflicted, the court treated the section 203 waiver as a straightforward interested transaction between a parent and subsidiary to which the entire fairness standard applied.[89] At this point the court's analysis got interesting. Although Intermedia could sell control of Digex without Digex's participation, it could not grant a waiver of section 203 without action by the Digex board.[90] This restriction changed the position of the parties. As the court put it, "[t]he waiver had value and granted some degree of bargaining leverage to Digex."[91] The failure on the part of the Intermedia-affiliated members of the Digex board to exert

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[86] § 203. Intermedia claimed that another exemption applied, one for acquisitions in which the acquirer went from owning less than fifteen percent to owning more than eighty-five percent of the target company's voting stock. *Digex*, 789 A.2d at 1197; *see also* § 203(a)(2) (detailing the exemption). The problem was that Intermedia held only fifty-two percent of Digex's equity but ninety-four percent of its voting power. *Id.* at 1181. Thus, if section 203's statutory term "voting stock" referred to voting power, then WorldCom's acquisition was exempt from section 203 and the issue of whether the Digex board properly waived section 203 was irrelevant. *Id.* at 1198. Alternatively, if the statutory percentage referred to ownership of the target's equity, a Digex board waiver would be necessary. *Id.* The chancery court held that the statute required an eighty-five percent equity position in order for the acquirer to be exempt, making the board waiver critical. *Id.* at 1199.

[87] *Digex*, 789 A.2d at 1209.

[88] *Id.* at 1187.

[89] *Id.* at 1206.

[90] *Id.* at 1214.

[91] *Id.* at 1205.

this leverage on behalf of Digex non-controlling shareholders was then held to violate the entire fairness standard.[92]

Without more, this is an unremarkable result. The Intermedia-affiliated directors were on both sides of a transaction between Intermedia and Digex. The facts hardly support a claim of fair dealing, and the fair-price inquiry is not much more complicated.[93] While there were acknowledged advantages to be gained by Digex from the substitution of WorldCom for Intermedia[94]—this was the prototypical transaction where sale of control resulted in an improvement for the non-controlling shareholders—it would have been hard for the court to conclude that the charter amendment was all that could have been extracted from WorldCom had the Digex board exerted itself.

Thus, if *Digex* stands for no more than the proposition that a corporation's board must bargain on behalf of minority shareholders when a statute requires the corporation's cooperation in connection with a sale of control by its controlling shareholder, then the result is unremarkable. For better or worse, the statute simply limits the control that the controlling shareholder can sell. If the acquirer does not care about section 203, then nothing changes. If it does, then the bargaining becomes three-way. This may be an unintended consequence of section 203, but in that event, the legislature is free to amend the statute.[95]

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[92] *Id.* at 1214.

[93] *See id.* at 1211-14 (examining the fair-price question and concluding that the behavior of the interested directors clearly disadvantaged the Digex shareholders).

[94] "[P]laintiffs do not dispute that WorldCom is a good fit in many respects, vastly superior to Intermedia in many ways, or that Digex strongly desired to be rid of Intermedia's restrictive presence." *Id.* at 1213.

[95] Indeed, the legislature in 2002 amended the Delaware Code's general definition of "voting stock" to clarify that, contrary to the *Digex* court's view, the relevant metric in section 203 (and elsewhere) should be "voting power." Act of June 20, 2002, secs. 4, 6-8, §§ 203(a)(2), 203(c)(8), 212(a), 223(c), 73 Del. Laws 298, 298 (2002). Section 203(c)(8) was amended to say, "Every reference to a percentage of voting stock shall refer to such percentage of the votes of such voting stock." *Id.* at sec. 6, § 203(c)(8). In addition, see DEL. CODE ANN. tit. 8, § 212(a) (2001), which was amended to say, "[E]very reference in this chapter to a majority or other proportion of stock, voting stock or shares shall refer to such majority or other proportion of the votes of such stock, voting stock or shares." Act of June 20, 2002, sec. 7, § 212(a), 73 Del. Laws 298, 298 (2002). *See generally* Act of June 20, 2002 (synopsis authored by Sen. Adams) ("The amendments to Sections 203(a)(2), 203(c)(8), 212(a) and 223(c) clarify that references to 'voting stock' or 'shares' therein and elsewhere in the title, including in Sections 203, 223 and 253, are intended to adopt the voting power concept reflected in Section 212(a).").

A more serious problem arises if *Digex* is something more than an artifact of section 203. A realistic look at sale of control transactions suggests that the controlled corporation often will be involved in the sale in some fashion. Two points on the continuum of corporate involvement in the controlling shareholder's sale illustrate the problem.

First, consider the problem of due diligence. The acquirer of control typically will wish to undertake its own investigation of the corporation whose control it is buying. This necessarily will include access to information that is not otherwise public. *Digex* itself reveals the transaction pattern. When Intermedia's investment banker was shopping Intermedia and Digex, all parties who were interested in going forward with discussions were required to sign a confidentiality and nondisclosure agreement,[96] surely an unnecessary condition if the relevant information was already public. This information, however, could come from only two sources: from the controlling shareholder who would have received such knowledge through its board representation or in its position as a controlling shareholder or directly from the controlled corporation itself.

The controlling shareholder's use of non-public information poses a *Digex* concern whatever the source of the information. The ALI's *Principles of Corporate Governance* frame the issue nicely. Section 5.11 on its face prohibits a controlling shareholder from using material, non-public information to secure a pecuniary benefit from trading in the controlled corporation's securities.[97] Alternatively, if the information is intended to come from hands-on investigation by the acquirer, access to information, records, and personnel is possible only with the approval of the controlled corporation. Approval of that access can be seen as posing the same opportunity for bargaining as approval of the section 203 waiver in *Digex*.

While one can imagine a range of accommodations by the controlled corporation—like facilitating due diligence—that are transactionally necessary or helpful to the sale of control, the problem is posed most starkly by another, more effective, spillover from the world of hostile takeovers. Section 203 is not, and was not intended to be, a showstopper. Unless the acquirer needs access to the controlled corporation's assets (for example, to provide security for the financing

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[96] *Id.* at 1182.

[97] PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.11 (1994).

needed in the takeover), the inability to do a freeze-out merger for a three-year period is not an insurmountable barrier.[98] In the hostile takeover environment, the roles of section 203 and other antitakeover statutes were largely marginalized by the poison pill, which stops a hostile transaction much earlier in the process than the second-step transaction.[99]

In the context of a sale of control, the poison pill can provide dramatically more than the "some degree of bargaining leverage"[100] that the chancery court found section 203 provided the Digex board. If the fiduciary obligation of the controlled corporation's board dictates that it take advantage of every bargaining lever for the benefit of the minority shareholders, then the board may also have the obligation to *create* a lever. The board can simply adopt a poison pill that covers all but the existing controlling shareholder, effectively reserving to the board a veto power (or whatever power the pill currently accords the board under Delaware law)[101] over the controlling shareholder's sale of control. Now *that* is leverage.

Analyzing the role of the controlled corporation's board is straightforward. If the directors have a fiduciary obligation to bargain, then a failure even to consider adoption of a poison pill would surely violate their duty of care. Once the board takes up the question, the directors associated with the controlling shareholder are hopelessly conflicted. Either they must appoint a special committee with the right to adopt and manage a pill, in which event at least the burden of proof would shift, or the decision not to adopt the pill would, under *Digex*, be subject to entire fairness review with the burden of proof on the directors. If failing to use the section 203 lever was likely to fail this standard, despite the acknowledged advantages to Digex of a

[98] For example, section 203 does not prohibit post-acquisition transactions with a third party, leaving the potential for a bust-up takeover in place.

[99] *See* GILSON & BLACK, *supra* note 1, at 1399 (asserting that "[s]tate takeover statutes should have no influence on companies that already have firm level defenses like . . . poison pills").

[100] *Digex*, 789 A.2d at 1205.

[101] See Ronald J. Gilson, *Lipton & Rowe's Apologia for Delaware: A Short Reply*, 27 DEL. J. CORP. L. 37, 37 (2002) [hereinafter Gilson, *A Short Reply*]; Ronald J. Gilson, Unocal *Fifteen Years Later (And What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 501 (2001) [hereinafter Gilson, Unocal *Fifteen Years Later*]; Martin Lipton & Paul K. Rowe, *Pills, Polls, and Professors: A Reply to Professor Gilson*, 27 DEL. J. CORP. L. 1, 2 (2002), which debate what power the pill gives a board under Delaware law.

WorldCom acquisition of Intermedia, then so, too, would failing to adopt and exert the leverage of a pill.[102]

It should be apparent that this rather straightforward analysis of the controlled corporation's post-*Digex* obligation to adopt a pill would effectively overturn the principle that controlling shareholders can sell control at a premium. In our analysis of the symmetry among the three doctrines that comprise the restraints on controlling shareholders, we argued that the permissive sale of control standard was appropriate.[103] Certainly nothing in *Digex* speaks to that issue, and our analysis counsels that the chancery court's *Digex* approach leads in the wrong direction. So what can be done about it?

While the *Digex* problem is surely catalyzed by the effectiveness of the poison pill, we do not think that the easy response of imposing context-specific restraints on the use of the pill is the right approach.[104] The poison pill makes the conflict between *Digex* and a permissive sale of control standard more pointed, but as illustrated by our analysis of *Digex*'s application to transactional due diligence,[105] that conflict is hardly limited to the pill.

In our view, the right way to disarm this conflict is to situate it in the symmetry of restraints on controlling shareholders. In Part I, we argued that, because the *Sinclair* standard should keep the price of focused monitoring within a range that non-controlling shareholders

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[102] While *Moran v. Household International, Inc.*, 500 A.2d 1346, 1356 (Del. 1985), speaks of the board's responsibility to defend against a hostile bid, we are not aware of a case that considers what standard of review would apply to a decision not to defend. Perhaps a decision not to defend converts the hostile bid to a friendly bid, in which event the standard of review—the intermediate standard or the more rigorous version of the business judgment rule that the chancery court has developed in connection with non-*Revlon* takeovers, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985)—depends on the *Revlon* trigger. In the sale of control setting, in contrast, the control relationship would seem to dictate entire fairness in all events.

[103] *See* discussion *supra* Part I.B (arguing that the permissive standard allows for both adequate control and value maximization).

[104] As we will see with the *Siliconix* line of cases, *infra* Part II.B, the specter of having to apply the poison pill in contexts other than defenses against hostile bids is not limited to the sale of control context. When the conformity of the poison pill with the structure of Delaware law was first debated in connection with *Household International*, the critics argued that it dramatically changed the allocation of authority between shareholders and management. The courts rejected that position. *See Household Int'l*, 500 A.2d at 1354 (finding that the case did not effect a "'fundamental transfer of power from the stockholders to the directors'" (quoting appellants)). The same structural concern is raised, however, by the role of the pill in the sale of control and freeze-out settings explored here.

[105] *See supra* p. 810 (utilizing due diligence to illustrate that information may also act as a bargaining lever).

would be willing to pay, a permissive sale of control standard is appropriate.[106] Encouraging control sales benefits non-controlling shareholders because, subject to the monitoring payment allowed by *Sinclair*, they participate ratably in any post-transaction value increases.[107] This assessment suggests that the *Sinclair* standard should be the touchstone of a principled resolution of the conflict between *Digex* and the sale of control standard.

Sinclair poses the triggering test[108] for heightened review as whether "the parent has received a benefit to the exclusion and at the expense of the subsidiary."[109] We think this is also the appropriate triggering test for the standard governing controlled subsidiary participation in a sale of control transaction. The distinction is between a setting where the non-controlling shareholders have something directly at stake in the transaction—that is, where non-controlling shareholders lose something as a result of the transaction—and one where the issue is only an effort to extract a payment by holding up the transaction.

Thus, controlled corporation participation in activities like acquirer due diligence does not come at the expense of the subsidiary; withholding participation serves only as a hold-up device for which the symmetry of doctrine provides no support. The same analysis would apply to the controlled subsidiary's decision to adopt a poison pill directed at the sale of control.[110]

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[106] *See supra* pp. 794-96 (advocating for a permissive sale of control in light of the *Sinclair* boundaries to which it would remain subject).

[107] *See supra* text accompanying note 26 (discussing data that suggest minority shareholders benefit from sales of control through higher share prices).

[108] Einer Elhauge originated this useful characterization of a legal rule whose application determines which of other competing legal rules apply. Einer Elhauge, *The Triggering Function of Sale of Control*, 59 U. CHI. L. REV. 1465, 1501-03 (1992).

[109] *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

[110] From a different perspective, an effort by the controlled subsidiary's board simply to assert hold-up value would seem to run afoul of the principle in *Mendel v. Carroll*, 651 A.2d 297, 306 (Del. Ch. 1994), which does not permit a board "to deploy corporate power against the majority stockholders, in the absence of a threatened serious breach of fiduciary duty by the controlling stock." In *Mendel* the board sought to dilute the controlling shareholders' position to allow an acquisition of the corporation at a price that was favorable to the minority shareholders but not to the controlling shareholders; in our circumstance, the board would be trying to block a transaction favorable to the controlling shareholder but not to the minority shareholder. *See, e.g.*, EAC Indus. v. Frantz Mfg. Co., No. 8003, 1985 Del. Ch. LEXIS 464, at *29-30 (Del. Ch. June 28, 1985) (enjoining the board's effort to dilute a controlling shareholder to allow an acquisition of the corporation to go forward).

At least one author of this Article is dismayed that the *Principles of Corporate Governance* are ambiguous on the conflict between section 5.11 (Use by a Controlling Shareholder of Corporate Property, Material Non-Public Corporate Information, or

Consistent with the permissive sale of control doctrine, some limitations apply. The controlling shareholder cannot sell control when it has reason to believe that the acquirer will extract private benefits in excess of the *Sinclair* standard and cannot deal with the non-controlling shareholders without first disclosing an anticipated sale of control.[111] Under the same circumstances, the board of the controlled corporation should have a *Digex*-like obligation to act; in these situations, the controlling shareholder does gain at the expense of the non-controlling shareholders. The symmetry between the exceptions is not coincidental.[112]

That leaves for assessment the precise issue posed in *Digex*: the application and waiver of section 203 in a situation that the legislature did not contemplate. Here, we think, the short answer is that we are stuck with what the legislature has done. Once the legislature has

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Corporate Position) and section 5.16 (Disposition of Voting Equity Securities by a Controlling Shareholder to Third Parties). PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 5.11, .16 (1994). While parsing the black letter of both sections would fairly give one pause, at least the commentary to section 5.11 is consistent with the primacy of sale of control principles over the more general principles governing actions by controlling shareholders:

> Certain acquisitions and dispositions of a corporation's securities involve the exercise or relinquishment of control, which is governed by § 5.16 . . . rather than § 5.11. Accordingly, § 5.11(a) [barring controlling shareholder use of non-public information or corporate power] does not preclude a controlling shareholder from selling shares of the corporation at a premium . . . if the standards of § 5.16 are met and no other conduct is present that would constitute a breach of the duty of fair dealing.

Id. § 5.11 cmt. c(1).

[111] *See supra* note 29 (quoting the ALI's limitations on sale of control).

[112] The doctrinal symmetry is completed by understanding that dilution would be allowed under the *Mendel* exception for "a threatened serious breach of fiduciary duty," 651 A.2d at 306, when the board believed the controlling shareholder was going to increase the level of private benefit extraction, the parallel to the similar exception to the permissive sale of control standard. *See supra* text accompanying notes 28-29 (explaining that the controlling shareholder cannot sell at a premium when it is apparent that the buyer will increase the level of private benefit extraction).

This is consistent with a recent unreported decision in which Chancellor William B. Chandler III refused to enjoin a poison pill put in place by a special committee that blocked the forty-four percent holder's plan to acquire sufficient additional stock for an absolute majority and that would have permitted the holder to block a higher third-party bid in favor of its own bid. Creo Inc. v Printcafe Software, Inc., No. 20164, at 11 (Del. Ch. Feb. 21, 2003) (ruling denying request for temporary restraining order); *see also* Memorandum of Law of Plaintiff Creo Inc. in Support of Its Motion for a Temporary Restraining Order, Creo Inc. v Printcafe Software, Inc., No. 20164 (Del. Ch. Feb. 21, 2003), 2003 WL 21665298 (presenting the plaintiff's account of the facts); David Marcus, *Cleaning Up Your Corporate Structure*, CORP. CONTROL ALERT, July 2003, at 20, 21 (describing the unreported bench ruling in *Creo*).

given the controlled corporation a bargaining lever, a *Sinclair* analysis dictates that it be used.[113] In our view, the application of section 203 to a sale of control by an existing controlling shareholder is an unnecessary spillover of the takeover defense apparatus into non-takeover contexts. Fixing the boundaries of section 203, however, is properly a chore for the legislature.[114] In the meantime, the limited range of post-acquisition transactions to which section 203 applies at least cabins the problem.[115]

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[113] *See supra* text accompanying notes 100-01 (discussing a corporate board's legal obligation to use and perhaps even create bargaining levers).

[114] We have some sympathy for the argument that the section 203 waiver in *Digex* was entirely fair to the public minority. The minority had no right to participate in the control premium, no right to impede the sale or to force a transactional alternative, and in exchange for the section 203 waiver, received a protective governance change and a parent with deeper pockets. Nonetheless, it is one thing to say that the minority received something substantial for their cooperation; it is quite another to conclude that they received what they would have in an arm's-length bargain.

[115] In light of the traditional concerns in a case like *Digex* about a controller's capturing a control premium that a merger would have shared with the minority, two recent Delaware Supreme Court cases strike us as odd. *McMullin v. Beran*, 765 A.2d 910, 916-17 (Del. 2000), presents the irony of potentially imposing a higher standard when the controlling shareholder allows the minority to participate ratably in a control sale than when the minority is excluded from such a sale. In *McMullin*, a controlling shareholder negotiated the sale of the entire corporation with all shareholders receiving the same price. *Id.* While recognizing that the board of the controlled subsidiary lacked the power to block or even influence the transaction, the court nonetheless held that the controlled subsidiary board had violated its fiduciary duty by failing to fully inform itself about whether the transaction price exceeded the subsidiary's going concern value. *Id.* at 919-20. Consequently, the subsidiary board could not discharge its disclosure obligation to minority shareholders who had to decide whether or not to seek appraisal. *Id.* at 920. While there is a real puzzle concerning why the directors could not reasonably rely on the judgment of the controlling shareholder given that the controlling shareholder had the same incentive to maximize price, the case is best understood as imposing a disclosure obligation which complicates, but does not restrict, a controlling shareholder's power to sell its control in the course of merger.

Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 918 (Del. 2003), limits the ability of a shareholder with majority voting power to irrevocably commit herself to support a merger as part of a transaction in which the board of the controlled corporation has consented to a "force the vote" provision in the merger agreement. In *Omnicare* the controlled corporation, NCS, sought to escape insolvency through a proposed merger with Genesis Health Ventures, Inc. *Id.* at 921. Genesis was unwilling to play a "stalking horse" role and sought to lock up the transaction. *Id.* at 920. The two dominant shareholders (who maintained sixty-six percent of the voting power but only twenty percent of the equity, *id.* at 935) displayed their commitment to the transaction by entering into a voting agreement with Genesis that committed them to vote for the merger. *Id.* at 926. At the time, the dominant shareholders knew that the NCS board had approved a compulsory shareholder vote on the merger and left no fiduciary "out" in the merger agreement. *Id.* at 924-25. All shareholders were to receive identical per share consideration. *Id.* at 925. A divided Delaware Supreme Court held that the

resulting lockup was both preclusive and coercive with respect to the shareholder right to consider transactional alternatives, notwithstanding the express desire of the controlling stockholders to bargain away that right in protecting the existing transaction. *Id.* at 939.

From a doctrinal perspective, the case illustrates the inconsistencies in *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1154-55 (Del. 1989), which applies proportionality to defensive measures in the context of a friendly merger, yet permits a particular defense—Time's tender offer for Warner—that, as a factual matter, was preclusive. The court dodged this problem with the assertion that, at least in principle, Paramount could bid for the merged company. *Time*, 571 A.2d at 1155. But if this theoretical possibility solves the preclusiveness problem in *Time*, why wouldn't it work equally well in *Omnicare*?

One way to understand *Omnicare* and *Digex* is as an inchoate effort to deal with the troubling mismatch between control rights and cash flow rights that emerges from dual class capital structures. In *Digex*, Chancellor Chandler was obviously troubled by the gap between Intermedia's ninety-four percent voting power and its fifty-two percent equity interest. 789 A.2d at 1181, 1203. According to the chancellor, such a disparity between ownership and voting power contradicted the legislative policy concern that tender offers should be curbed when they are not "sufficiently attractive to . . . a high percentage of the outstanding shares." *Id.* at 1203. Similarly, in *Omnicare*, the court noted with distaste that a decision by shareholders holding only twenty percent of the company's equity but sixty-five percent of the voting rights could bind the remaining public eighty percent to a decision that the latter contingent now could not oppose. *See* 818 A.2d at 936 ("[A]ny stockholder vote would have been robbed of its effectiveness by the impermissible coercion that predetermined the outcome of the merger without regard to the merits . . . ."). From this perspective, because the controlling shareholders in *Omnicare* could not have sold control other than through a corporate-level transaction like a merger (their voting control disappeared if they sold their shares), the NCS independent directors, like those in *Digex*, were conflicted about whether they should block the controlling shareholders' efforts to impose a control transaction. As suggested in *Mendel*, 651 A.2d at 306, a "true" majority shareholder might legitimately have received greater deference from the board.

Moreover, the mismatch between voting rights and cash flow rights is particularly problematic because the insolvency risk of the controlled corporation means that the payoffs from the two transactional alternatives could well have been evaluated quite differently by the public shareholders (who are diversified and therefore risk neutral) and the controllers (who are undiversified and therefore risk averse). *Cf.* Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991), *aff'd sub nom.* Solomon v. Pathe Communications Corp., 672 A.2d 35 (Del. 1996) (discussing the different incentives for creditors and shareholders in a company "operating in the vicinity of insolvency"). Of course, nothing in the *Omnicare* opinion directly turns on this distinction, although the facts clearly suggest it.

The current version of the European Union's proposed Thirteenth Directive on Takeovers reflects this uneasiness about voting rights that are disproportionate to equity, although the proposal would not extend to eliminating the kind of disproportionate voting rights present in *Omnicare*. Commission Proposal for a Directive of the European Parliament and of the Council on Cross-Border Mergers of Companies with Share Capital, COM(03)703 final; *see also* Jeffrey N. Gordon, *The International Relations Wedge in the Corporate Convergence Debate*, *in* CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE (Jeffrey N. Gordon & Mark J. Roe eds., forthcoming 2004) (discussing the Thirteenth Directive).

B. *The* Siliconix *Line of Cases: Relaxing the Standards Governing Freeze-outs*

In Part I, we justified the more restrictive standard governing judicial review of the fairness of a controlling shareholder's freeze-out of non-controlling shareholders because, unlike in a sale of control situation, non-controlling shareholders will not participate automatically in an increase in value that results from the freeze-out.

A number of recent chancery court opinions have loosened these standards, in our view inappropriately. The doctrinal symmetry governing limits on the extraction of private benefits by controlling shareholders suggests that the recent chancery court tightening of the standards for sale of control is ill-advised. In the case of the standards governing freeze-outs, the same symmetry suggests that the recent loosening of the standards is also misguided.

The loosening of the freeze-out standards came in response to a shift in transaction engineering. The tightness of the standard of review governing freeze-out mergers crystallized in *Kahn I.* The supreme court stated, in no uncertain terms, that even the creation of a special committee with the power to block the transaction would not eliminate entire fairness review.[116] Rather, the court held that establishing such a committee merely shifted the burden of proof.[117] In response, transaction planners began to look at a tender offer as the first step in a two-step freeze-out process.

The strategy builds on the supreme court's decision in *Solomon v. Pathe Communications Corp.*,[118] which held that a shareholder with voting control over 89.5% of a corporation's outstanding stock owed no obligation with respect to the fairness of the price offered in a tender offer for the stock of the controlled corporation, unless the offer was structurally coercive or disclosure concerning the offer was inadequate.[119] Suppose a controlling shareholder held eighty percent of the controlled corporation's outstanding stock and desired to freeze out the minority shareholders. If it proceeded in a straightforward manner with a one-step freeze-out merger, the transaction would be subject to entire fairness review under *Weinberger*, which, in effect, calls

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[116] Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994); *supra* text accompanying notes 50-58.

[117] *Kahn I*, 638 A.2d at 1117.

[118] 672 A.2d 35 (Del. 1996).

[119] *See id.* at 40 ("[I]n the absence of coercion or disclosure violations, the adequacy of the price in a voluntary tender offer cannot be an issue.").

for a class action appraisal process with respect to price.[120] An alternative approach would be to accomplish the freeze-out in two steps. First, the controlling shareholder would make a tender offer for all of the non-controlling stock with a majority-of-the-minority closing condition[121] and, perhaps, a commitment to take out any non-tendering shareholders in a short-form merger at the same price in order to insure that the offer is not coercive. *Solomon* is commonly read to dictate that this offer would be free from entire fairness review.[122]

Next, the controlling shareholder would effect a short-form merger under section 253, which requires neither a shareholder vote nor the approval of the controlled corporation.[123] Under *Glassman v. Unocal Exploration Corp.*,[124] appraisal is the exclusive remedy for allegations of price unfairness in a short-form merger.[125] The two-step freeze-out thus accomplishes something critical that a one-step freeze-out merger cannot: the elimination of entire fairness review of any step in the

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[120] Weinberger v. UOP, Inc., 457 A.2d 701, 703-04 (Del. 1983); *see also supra* text accompanying notes 31-41 (describing the *Weinberger* case and the standards adopted therein).

[121] In this hypothetical, satisfying a majority of the minority condition would assure that the controlling shareholder would reach the ninety percent level necessary to a short-form merger. If the controlling shareholder's pre-transaction holdings were less than eighty percent, an additional closing condition would be required; sufficient shares would have to be tendered so that the controlling shareholder would own ninety percent of the outstanding shares after the transaction closed.

[122] In fact, this reading of *Solomon* is itself an unacknowledged stretch. *Solomon* did not involve a tender offer that was part of a freeze-out transaction and, thus, could have been read as inapplicable in a freeze-out setting. Indeed, both the Delaware Supreme Court opinion, *Solomon,* 672 A.2d at 39, and the lower court opinion, No. 12563, 1995 WL 250374, at *5 (Del. Ch. Apr. 21, 1995), emphasize that the transaction was not a freeze-out. As the text that follows relates, *Solomon* was read broadly without acknowledgement or justification of the extension.

Moreover, the *Solomon* transaction was itself so unusual that it would be unwarranted to read the case broadly. The controller's tender offer was part of a series of transactions by which a secured lender took majority control in the process of realizing on its security interest in the stock of the parent's operating subsidiary. *Solomon,* 672 A.2d at 37. The Chancellor found that there was no valid basis to resist the foreclosure. *Solomon,* 1995 WL 250374, at *5-6. The tender offer to public minority shareholders—whose stock would be valueless after foreclosure of the subsidiary's stock—was, in effect, a means to buy off any potential hold-up value that the minority might conceivably have possessed. The Chancellor described the lawsuit as an "effort to leverage some additional money from the secured-creditor/new majority shareholder out of this 1992 mop-up operation." *Id.* at *6.

[123] DEL. CODE ANN. tit. 8, § 253 (2001).

[124] 777 A.2d 242 (Del. 2001).

[125] *Id.* at 243.

transaction, including especially the fairness of the price. The new transaction form makes appraisal exclusive for the entire transaction; the class appraisal proceeding provided by entire fairness review disappears. Of course, the change in standard suggests a change in bidder tactics. Short of a belief that non-controlling shareholders will not tender, a controlling shareholder should never offer more than the low end of her assessment of the appraisal standard. Even if her assessment proves to be less than fair value, any higher price resulting from an appraisal proceeding will be payable only to the small number of shareholders who both do not tender and otherwise perfect their appraisal rights.

The first clear test of this strategy came in *Siliconix*.[126] In that case, Vishay Intertechnology, Inc. sought to acquire the roughly twenty percent of Siliconix stock that it did not own.[127] After proposing a cash tender offer, perhaps to be followed by a freeze-out merger at the tender offer price, and establishing a special committee of allegedly disinterested Siliconix directors, Vishay ultimately lost patience when the special committee proved more independent than Vishay expected.[128] Vishay then substituted a stock-for-stock exchange with a majority of the minority condition and plainly stopped worrying about the special committee's views.[129] The special committee advised Vishay that it was unlikely to approve the terms of the exchange offer, but in its Schedule 14D-9, the special committee made no recommendation concerning the offer and did not ask its financial advisor for a fairness opinion.[130] The exchange offer was the issue before the court on a motion for preliminary injunction.[131]

The court quickly concluded that, following *Solomon*, a controlling shareholder had no obligation to demonstrate the entire fairness of a proposed tender offer without pausing over the fact that, unlike *Solomon*, the *Siliconix* transaction contemplated a freeze-out.[132] The court also held that the Siliconix directors did not breach a duty of care or loyalty to minority shareholders by failing to evaluate Vishay's offer

[126] *In re* Siliconix Inc. S'holders Litig., No. 18700, 2001 WL 716787 (Del. Ch. June 19, 2001).

[127] *Id.* at *1.

[128] *Id.* at *2-3.

[129] *Id.* at *3-4.

[130] *Id.* at *5.

[131] *Id.* at *1, *6.

[132] *Id.* at *8. See *supra* note 122 for a discussion of *Solomon*.

nor by failing to provide shareholders with their evaluation and recommendation.[133]

It was with respect to the court's treatment of Siliconix's directors that the analysis gets interesting. The court recognized that

> [i]t may seem strange that the scrutiny given to tender offer transactions is less than the scrutiny that may be given to, for example, a merger transaction .... From the standpoint of a Siliconix shareholder, there may be little substantive difference if the tender is successful and Vishay proceeds, as it has indicated that it most likely will, with the short-form merger. The Siliconix shareholders ... will end up in the same position as if he or she had tendered or if the transaction had been structured as a merger ....[134]

The reason for this discrepancy will have a familiar ring. The court focused on the different role corporate law assigns the board in mergers as opposed to tender offers:

> [U]nder the corporation law, a board of directors which is given the critical role of initiating and recommending a merger to the shareholders traditionally has been accorded no statutory role whatsoever with respect to a public tender offer .... This distinctive treatment of board power with respect to merger and tender offers is not satisfactorily explained by the observation that the corporation law statutes were basically designed in a period when large scale public tender offers were rarities .... More likely, one would suppose, is that conceptual notion that tender offers essentially represent the sale of shareholders' separate property and such sales—even when aggregated into a single change in control transaction—require no "corporate" action ....[135]

This account of the board's role in mergers and tender offers is plainly recognizable as the premise of those who argued in the early 1980s that defensive tactics by managers were inappropriate.[136] Now the court says that a conflicted target board violates no duty of loyalty by failing to act on behalf of minority shareholders in a freeze-out tender offer because the statute assigns them no explicit role.[137] In the 1980s, shareholder choice advocates argued that target management could not act—ostensibly on behalf of shareholders—to block a tender offer because the statute assigned them no explicit role.

[133] *Id.* at *6-8.

[134] *Id.* at *7.

[135] *Id.* (citation omitted).

[136] *See, e.g.*, Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 847 (1981) ("While control of the merger and sale of asset mechanisms is firmly ensconced in management, the tender offer mechanism generally is not even mentioned in the statute, let alone placed within management's control.").

[137] *Siliconix*, 2001 WL 716787, at *7-8.

Of course, the shareholder choice advocates lost that battle. In *Unocal Corp. v. Mesa Petroleum Co.*,[138] the Delaware Supreme Court held that a target board of directors "had both the power *and duty* to oppose a bid it perceived to be harmful to the corporate enterprise."[139] As the court put it, even in a tender offer "a board of directors is not a passive instrumentality."[140] The Delaware Supreme Court then went one step further in *Moran v. Household International, Inc.*[141] Making sure that the target board of directors had the means to act effectively in opposing a tender offer that the board perceived as a threat, the court approved the adoption of a poison pill that made it unthinkable for a bidder to go forward with a tender offer unless the board approved the offer or a court ordered the pill redeemed.[142]

Thus, there is a sharp disconnect between *Siliconix*'s characterization of the target board's role in responding to a freeze-out tender offer by a controlling shareholder and the Delaware Supreme Court's characterization of the target board's role in responding to a third-party tender offer. Rather perversely, only when the board is conflicted by the offer itself is it limited to an observer's role.

Indeed, if the extent of the board's role is to turn on whether the bidder is a controlling shareholder, the court in *Siliconix* seems to get the direction of the distinction exactly backwards. In a third-party tender offer, the potential for competitive bidding if the initial offer is too low will provide target shareholders some protection even if the board does not. In a controlling-shareholder tender offer, only the target board can act. The question that *Siliconix* should have confronted is what standard of review applies when the board of the controlled corporation either did not consider, or did not adopt, a poison pill that would have given it real bargaining power. Because the majority of the board was conflicted, the court would be required to determine whether it was entirely fair not to adopt a pill, a determination that, because the fair-dealing element necessarily drops out, turns on whether the court thinks either the price or the board's strategy is entirely fair.[143] This, of course, is precisely the determination a court

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[138] 493 A.2d 946 (Del. 1985).

[139] *Id.* at 949 (emphasis added).

[140] *Id.* at 954.

[141] 500 A.2d 1346, 1355 (Del. 1985).

[142] *Id.* at 1349, 1355.

[143] Experienced acquisitions practitioner Ted Mirvis suggested in conversation that the use of the pill in response to a hostile tender offer is quite different from its use in a freeze-out transaction precisely because a pill is designed to prevent a transfer in control, while with a freeze-out, control has transferred long before. While we cannot

has to make under *Weinberger*, which *Siliconix* says does not apply to freeze-out tender offers, a nice closing of a doctrinal Möbius strip.[144] In the end, what is most striking in *Siliconix*'s treatment of the target board's role is that the court at no point even evidences awareness of twenty years of doctrinal encouragement of a target board's non-statutory role in responding to tender offers.

The chancery court next took up the target board's role in a freeze-out tender offer in *In re Aquila, Inc. Shareholders Litigation.*[145] For doctrinal purposes, *Aquila* is largely a replay of *Siliconix.* The court again held that a controlling shareholder does not have a duty of entire fairness when making a freeze-out tender offer.[146] But *Aquila* does go somewhat further in approving a passive role for the target board. The conflicted directors (no independent directors existed) were allowed to discharge their duty of loyalty to the non-controlling shareholders by doing essentially nothing.[147] The board's effort on behalf of the non-controlling shareholders consisted solely of asking an independent financial advisor "to perform a financial analysis of the proposed exchange ratio and to publish a summary of that analysis in the company's Schedule 14D-9,"[148] presumably as a substitute for the board's decision not to make a recommendation themselves.

Strangely, the plaintiffs did "not argue that these three directors [named by the controlling shareholder] had a fiduciary duty to do more," and the court plainly shared this assessment.[149] Yet, the board's passivity left shareholders with neither a bargaining agent nor an information agent, conduct hardly consistent with the high standard set for conflicted directors in *Weinberger.*[150] Even where the controlling

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quarrel with this distinction, in our view the commonality that links the two settings is the board's obligation when it believes that shareholders may tender into an underpriced offer. From this perspective, differential control is a distinction without a difference; why should the board's duty to protect shareholders be lower when the threat is the misuse of control than when the threat is an unfavorable transfer of control?

[144] See *supra* text accompanying notes 34-40 for the *Weinberger* requirement in a freeze-out merger; *supra* text accompanying note 132 for the *Siliconix* rejection of that requirement in a freeze-out tender offer.

[145] 805 A.2d 184, 190 (Del. Ch. 2002).

[146] *Id.*

[147] *See id.* at 191 (holding that the target board's failure to make a recommendation on the tender offer or appoint independent directors was not a breach of fiduciary duty).

[148] *Id.*

[149] *Id.*

[150] *Weinberger* stressed "the long-existing principle of Delaware law that [the controlling shareholder] designated directors on [the controlled corporation's] board still

shareholder offers a price within a range of reasonableness, shareholders still have a big stake in getting the high end, rather than the low end, of the range. From this perspective, recall *Weinberger*'s stress on the fact that Signal believed the non-controlling shares of UOP were a "good investment" at a price up to $24 a share, but offered only $21.[151] The failure of UOP's board to bargain for a price at the higher end of the range plainly drove the result. Even if the controlling shareholder has no obligation of entire fairness in a freeze-out tender offer, *Aquila* offers no explanation for how *Van Gorkom*-like passivity (whether motivated by inattention or conflict) can satisfy the target board's fiduciary duty.[152]

As with *Siliconix*, however, the most interesting part of *Aquila* is the extent to which its discussion of the target board's role in freeze-out tender offers ignores the obvious overlaps between the doctrinal framework governing the target board's role in freeze-out tender offers and that governing the target board's role in hostile tender offers.[153] The target corporation in *Aquila* had a remarkably high percentage of institutional investors; ninety-four institutions held more than eighty percent of all publicly held shares, and twenty-two institutions accounted for a majority of such shares.[154] This distribution became relevant in connection with the court's assessment of irreparable harm and the balance of the equities in responding to the motion for preliminary injunction.[155] The alleged harm to the shareholders from the board's passivity was what has come to be called "substantive coercion" in hostile takeover doctrine—the concern that shareholders will mistakenly accept too low a price for their shares.[156] In the context of hostile tender offer doctrine, substantive coercion is offered as a justification for defensive action even against a structurally noncoercive

owed [the controlled corporation] and its shareholders an uncompromising duty of loyalty." 457 A.2d 701, 710 (Del. 1983).

[151] *Id.* at 705.

[152] *See* Smith v. Van Gorkom, 488 A.2d 858, 890 (Del. 1985) (holding that the passivity of the directors failed to satisfy the duty of care).

[153] 805 A.2d at 190-95.

[154] *Id.* at 187.

[155] *See id.* at 195 (finding that, in light of the extensive disclosure documents given to the stockholders, the absence of a recommendation from the target board "is not such an important omission as to justify an injunction [when] . . . the publicly owned shares are nearly all owned by sophisticated institutional investors").

[156] The Delaware Supreme Court first adopted this term in *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1153 n.17 (Del. 1989), from Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 267 (1989).

tender offer. Interestingly, when used to justify defensive tactics, substantive coercion appears to be a presumption, rather than a fact. Once alleged, factual inquiry into the sophistication of the target shareholders is unnecessary.[157]

In *Aquila*, by contrast, the court relies explicitly on the sophistication of institutional shareholders in concluding that the plaintiffs had failed to show irreparable harm—i.e., that there was not a significant risk of substantive coercion.[158] In particular, the absence of a 14D-9 statement was unlikely to increase the risk of shareholders mistakenly tendering "when, as here, the publicly owned shares are nearly all owned by sophisticated institutional investors."[159] As in *Siliconix*, the same element was treated differently in connection with a freeze-out tender offer than in connection with a hostile tender offer.

Our analysis to this point suggests that the chancery court has moved in the wrong direction in its recent treatments of the restrictions on controlling shareholders who extract private benefits of control through freeze-outs. The symmetry dictated by the functional links between the three methods of extracting private benefits draws no distinction based on the mechanical technique used to effect a freeze-out. *Siliconix* and *Aquila*, when coupled with *Glassman*, significantly reduce the constraints on benefit extraction through freeze-outs from the level we have argued is appropriate. Adding insult to injury, *Siliconix* and *Aquila* justify their results based entirely on doctrine, rather than function, yet as we have suggested, they do not confront the doctrinal inconsistencies and transactional incentives they in turn create.[160]

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[157] This presumed lack of sophistication was plainly the case in *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1382 (Del. 1995), where the court credited the target's characterization of a hostile offer as a threat because shareholders might tender based on a mistaken view of the target's intrinsic value without pausing over the facts that institutional investors held forty-two percent of Unitrin's stock and that thirty-three percent of Unitrin's stock was held by only twenty institutions. In contrast, the chancery court has on occasion treated the threat of substantive coercion as a fact that has to be proved, rather than merely alleged. *See, e.g.*, Chesapeake Corp. v. Shore, 771 A.2d 293, 333 (Del. Ch. 2000) ("The defendants have not persuaded me that they made an informed, good faith judgment that the [target] electorate would be confused about [the target's] value . . . .").

[158] 805 A.2d at 186.

[159] *Id.* at 195.

[160] The formal thinness of the distinction between the transactional forms is demonstrated by *Hartley v. Peapod, Inc.*, No. 19025, 2002 WL 31957458, at *2 (Del. Ch. Mar. 27, 2002), in which the court held that a merger structured as a two-step transaction—a tender offer followed by short-form freeze-out—is subject to the *Kahn* entire fairness regime. As a formal matter, the case follows *In re Unocal Exploration Corp. Shareholders*

The judicial disconnect between the conflicting lines of doctrine governing a controlling shareholder's obligations in freeze-out mergers and freeze-out tender offers and the similarly conflicting lines of doctrine governing the target board's role in freeze-out tender offers and in hostile tender offers was finally addressed in *In re Pure Resources, Inc. Shareholders Litigation.*[161] *Pure* presented another opportunity for the chancery court to consider the standards governing the tender offer, freeze-out alternative to a freeze-out merger. In *Pure,* however, two things were significantly different than in *Siliconix* and *Aquila:* plaintiffs who recognized the disconnect between the target board's role in freeze-out and hostile tender offers and a judge who was unwilling to ignore it. The plaintiffs' position explicitly claimed that the target board should have acted like a real board and adopted a poison pill to give itself some bargaining room. To be sure, the plaintiffs do not deserve all the credit; they were helped in making this claim by the brief but unusual spurt of independence by the target board's special committee.[162] For a short time—but, as far as we know, for the first time—this special committee asked for the authority to adopt a poison pill.[163] Once properly framed, and given the conspicuous opportunity to make some sense of an area where the combination of blatant doctrinal inconsistencies and the predictable planning response of transactions taking the form that results in the least constraints without affecting substance, a thoughtful judge would have found it difficult to turn a blind eye.

Thus, in *Pure,* the chancery court directly confronted the two doctrinal anomalies posed by the freeze-out, tender offer strategy: first, the tensions among *Solomon, Kahn I,* and *Kahn II* over the standards that apply to a controlling shareholder's freeze-out of non-controlling

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Litigation, 793 A.2d 329, 338 n.26, 347 (Del. Ch. 2000), *aff'd, Glassman v. Unocal Exploration Corp.,* 777 A.2d 242 (Del. 2001), which, in holding that appraisal was ordinarily the exclusive remedy for a short-form merger, distinguished the case of a two-step transaction. But notice the result: shareholders get more protection from subsequent judicial review in a transaction in which they may have the benefits of a bargaining agent than in one lacking such a bargaining agent.

[161] 808 A.2d 421 (Del. Ch. 2002).

[162] *See id.* at 433 (describing plaintiffs' argument that "[i]nstead of wielding the power to stop Unocal in its tracks and make it really negotiate, the Pure board has taken only the insufficient course of telling the Pure minority to say no").

[163] Unfortunately, the special committee backed down without explanation and, to the court's annoyance, declined to waive the attorney-client privilege, which would have allowed inquiry into what legal advice the committee was given on this issue. *See id.* at 431 n.8 ("[I]n general it seems unwise for a special committee to hide behind the privilege . . . .").

shareholders and, second, the conflict in the standards that apply to a target board's response to a freeze-out tender offer and to its response to a hostile tender offer. Properly understood, the *Pure* resolution is an important, yet still incomplete, step toward restoring a desirable coherence in this area. Our goal here is twofold: first, to highlight where that step leads, both in terms of the convergence of standards that govern the freeze-out tender offer and the freeze-out merger and in terms of the potential convergence of the target board's duties in a freeze-out tender offer and a hostile tender offer, and second, to identify what else is necessary to restore symmetry to the doctrine that controls controlling shareholders.

The convergence of the standards for freeze-out mergers and freeze-out tender offers is possible because the doctrinal breadth of the "get out of jail free" card—that *Solomon* is said to give freeze-out tender offers—has been, as *Pure* clearly recognized, significantly overstated. Despite its subsequent treatment in the case law, *Solomon* simply is not doctrinally determinative. Its limits become clear once we recognize that a freeze-out tender offer implicates the entire fairness standard in two different ways.[164] First, and the focus of the court's attention in *Solomon,* is the fiduciary duty of the controlling shareholder: is the controlling shareholder under an obligation of entire fairness in setting the terms of the tender offer? Second is the fiduciary duty of the target directors: are the target directors subject to a fiduciary duty to the non-controlling shareholders despite the existence of a controlling shareholder?

The only question addressed by *Solomon*'s statement that "courts do not impose any right of the shareholders to receive a particular price"[165] is that of the controlling shareholder's fiduciary duty. While the complaint in *Solomon* also alleged that the target company directors violated their duty of loyalty because they did not oppose the controlling shareholder's tender offer, the court disposed of that issue without challenging the applicability of the standard.[166] Thus, *Solomon*

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[164] We have noted earlier that *Solomon* itself did not involve a freeze-out tender offer, *supra* note 122. Thus, the doctrinal development of a distinction between freeze-out mergers and freeze-out tender offers is flawed at a stage earlier than we address in the text here.

[165] Solomon v. Pathe Communications Corp., 672 A.2d 35, 39 (Del. 1996).

[166] In dismissing the claim against the target directors, the court held:

> [The complaint] attempts to assert a breach of the duty of fair dealing by the directors because they did not oppose the tender offer. The asserted unfairness of the tender offer is based on its allegedly inadequate price. The Chancellor's holding that none of the facts cited by Solomon "can be said to arouse as

plainly leaves open the potential for convergence between the standards governing freeze-out mergers and those governing freeze-out tender offers along two dimensions: through a more careful explication of what *Solomon* actually holds with respect to, first, the obligation of a controlling shareholder in making a freeze-out tender offer and, second, the obligation of target directors in responding to one. *Pure* takes up the task along both fiduciary dimensions.

C. *Convergence in the Standards Governing Freeze-out Mergers and Freeze-out Tender Offers*

After expressing skepticism as to the substantive justifications for treating freeze-out tender offers and freeze-out mergers differently, *Pure* makes use of a small doctrinal sleight of hand to increase and make explicit a controlling shareholder's obligations in structuring a freeze-out tender offer.[167] Even under the chancery court's broad reading of *Solomon*, the *Solomon* "get out of jail free" card can be used only if the tender offer is noncoercive.[168] *Pure* imposes additional requirements on freeze-out tender offers by detailing and expanding the conditions that must be met for an offer to be deemed noncoercive.[169] A freeze-out tender offer by a controlling shareholder will be noncoercive, and therefore will satisfy the controlling shareholder's fiduciary obligations under *Solomon*, only if (i) the offer is subject to a nonwaivable majority of the minority tender condition, (ii) the controlling shareholder commits to consummate a short-form merger promptly after increasing its holdings above ninety percent, (iii) the controlling shareholder "has made no retributive threats,"[170]

> much as a fleeting doubt of the fairness of the foreclosure or the $1.50 tender offer" price is correct as a matter of law.

Id. (quoting Solomon v. Pathe Communications Corp., No. 12563, 1995 WL 250374, at *5 n.5 (Del. Ch. Apr. 21, 1995)). Whatever else may be buried in this passage, the court hardly holds that the legal standard governing the directors' obligation has been watered down; only controlling shareholders have had their burdens reduced. This reading is consistent with the cases cited by the *Solomon* court, *id.*, which focus only on the controlling shareholder's duties and predate the clarification of board duties in a takeover scenario that began with *Unocal*, *supra* text accompanying notes 139-40.

[167] *See* 808 A.2d at 445 ("The potential for coercion and unfairness posed by controlling shareholders . . . requires some equitable reinforcement . . . .").

[168] *See supra* text accompanying notes 121-22 (emphasizing that noncoercion is the key to the escape from entire fairness review allowed in *Solomon*).

[169] *See* 808 A.2d at 445 (noting that such conditions provide protections which "minimize the distorting influence of the tendering process on voluntary choice").

[170] *Id.* This condition reflects *Pure*'s interesting discussion of the difference between structural coercion, that is, coercion resulting from the terms of the tender offer, *id.* at

and (iv) the independent directors are given complete discretion and sufficient time "to react to the tender offer, by (at the very least) hiring their own advisors,"[171] providing a recommendation to the non-controlling shareholders, and disclosing adequate information to allow the non-controlling shareholders an opportunity for informed decision making.[172]

438, and inherent coercion, the power of the controlling shareholder—"the 800-pound gorilla," as the court terms it, *id.* at 436—to impose costs on non-controlling shareholders through its operation of the company if the non-controlling shareholders reject the freeze-out tender offer, *id.* Here, recognition of the extent to which *Sinclair*, 280 A.2d 717, 722 (Del. 1971), restricts a vengeful response to rejection would have been helpful.

[171] *Pure*, 808 A.2d at 445.

[172] *Id.* To be explicit, we read this open-ended invitation to action as arising from *Pure's* use of the parenthetical phrase "at the very least" to modify its list of what directors require the time and discretion to accomplish. *Id.*

The *Pure* court's insistence on detailed disclosure of the investment bank's valuation workup is one of the genuine innovations in the decision because it corrects for a lacuna in the federal disclosure pattern covering freeze-outs. Exchange Act Rule 13e-3, which was promulgated in 1979 to address an earlier wave of going-private transactions, excepted from its special disclosure requirements a transaction where the minority shareholders received parent stock (or any listed stock). *See* 17 C.F.R. § 240.13e-3(g)(2)(iii) (2003) (exempting listed securities from disclosure). This limitation in coverage to cash-out mergers was founded on the mistaken belief that recipients of parent stock were not really frozen out since they "are on an equal footing and are permitted to maintain an equivalent or enhanced equity interest." Going Private Transactions by Public Companies or Their Affiliates, Exchange Act Release No. 16,075, 44 Fed. Reg. 46,738 (Aug. 8, 1979) (to be codified at 17 C.F.R. pt. 240). This belief, of course, forgets that the exchange ratio in a controlling shareholder freeze-out where equity is used as the consideration is just as crucial—and just as subject to opportunism—as the amount of cash. The new wave of freeze-out tender offers has mainly involved exchange offers that can avoid the detailed disclosure requirements of the federal rule. Perhaps more crucially, exchange offers allow companies to avoid specific disclosure as to whether the parent "reasonably believes that the Rule 13e-3 transaction is fair or unfair to unaffiliated security holders," 17 C.F.R. § 229.1014(a) (2003), and to omit stating "in reasonable detail the material factors upon which [that] belief . . . is based," § 229.1014(b). So, unless the state fiduciary law is appropriately crafted, controlling shareholders will shift from mergers to exchange freeze-out tender offers, and "fairness" will drop out of such transactions altogether.

There is a parallel disclosure inconsistency in the context of the friendly arm's-length deal. In the case of a merger, disclosure under the federal securities laws must be made of the target's investment banker workup. See Schedule 14A, Item 14, 17 C.F.R. § 240.14a-101 (2003), which references Form S-4, *id.* § 239.25, which in turn references the disclosure required in Schedule 13E-3, Item 9, *id.* § 240.13e-100 (which in turn references Item 1015 of Regulation M-A, *id.* § 229.1015). No comparable disclosure need be made in the case of a tender offer—compare Recommendation or Solicitation by the Subject Company and Others, *id.* § 240.14d-9, and Schedule 14D-9, *id.* § 240.14d-101. This difference, which makes sense in a case of a hostile tender offer (why disclose the target's possible reservation price?), is not appropriate where the tender offer is part of a friendly transaction, for example, a tender offer followed by a

For purposes of a freeze-out tender offer, then, *Pure* says that robust engagement by a target board (i.e., a special committee) as a bargaining agent for the minority shareholders is necessary to avoid coercion.[173] This goal requires both the controller's permission for such activity and the target board's undertaking of it. In that sense, *Pure* substantially modifies *Siliconix* and *Aquila*, which would permit target board passivity.[174]

Pure's broad interpretation of "coercion" is consistent with Delaware jurisprudence in the hostile-bid area, where "substantive coercion"—bid pressure that might induce target shareholders to mistakenly accept a low-ball offer—constitutes a "threat" that in turn justifies a target board response much like "structural coercion"—bid pressure that arises from a structure exploiting shareholder collective-action problems.[175] In the freeze-out case, unless the target board is a vigorous bargaining agent for the minority shareholders, the controller's bid will be at the low end of the settlement range, a low-ball offer. So it makes perfect sense in a freeze-out tender offer both to place certain limits on the controller's behavior and to require the independent directors to act as genuine bargaining agents, including forming an opinion about the desirability of the controller's offer.

The measure of convergence, then, is how this standard for freeze-out tender offers compares operationally to the entire fairness review contemplated for freeze-out mergers under *Kahn I* and *Kahn II*. Start with *Kahn I*. If the freeze-out merger satisfies the fair-dealing

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freeze-out merger. Of course, a board informed by *Pure* might well decide to make such disclosure as a matter of state law fiduciary duty.

Note also that the interaction of the target board's disclosure requirements under Schedule 14D-9 and now under *Pure* in the case of a freeze-out tender offer could give the special committee a certain negotiating leverage. Presumably the special committee will not disclose the investment banker information until the end of the negotiating process, and the bidder would be hard-pressed not to extend the offer to permit the shareholder assimilation of the new disclosure, which will be filed as an amendment to Schedule 14D-9.

[173] 808 A.2d at 445-47.

[174] See *supra* text accompanying notes 137-60 for the *Siliconix* and *Aquila* discussions. *Pure*'s framework in this regard now seems established as the law of the Delaware Chancery Court. *See* Next Level Communications, Inc. v. Motorola, Inc., No. 20144, 2003 WL 549083, at *13 (Del. Ch. Feb. 25, 2003) ("[T]he court will apply the framework of analysis . . . most recently discussed in the *Pure Resources* case."). As a matter of practice, target boards are taking a more energetic role in freeze-out tender offers. For one description of this phenomenon, see Robin Sidel, *Takeover Targets Force Up Offers in 'Minority Squeeze-Out' Deals*, WALL ST. J., May 10, 2002, at C3.

[175] 808 A.2d at 438-40; *see also supra* note 170 (defining "structural coercion" and contrasting the concept with "inherent coercion").

component of *Weinberger*, the burden of proof shifts to the plaintiff with respect to fair price.[176] Most importantly, a fair reading of *Kahn I* seems to require that a special committee be given some substantial freedom to say "no" before the burden will shift.[177] Under *Pure*, in contrast, the court does not mention a right to say "no." *Pure* accepts the fact that the controlling shareholder may go to the minority shareholders over the special committee's objection.[178]

In assessing this difference, two points are important. First, we need to be a little clearer about just what the right to say "no" under *Kahn I* really means. In our view, this right amounts to the special committee's prerogative to reject the merger if it believes that the merger consideration is inadequate, meaning that the controlling shareholder who nevertheless wants to proceed must make a tender offer to the minority shareholders.[179] On the other hand, nothing in *Kahn I* suggests that the special committee rejecting the merger is obligated to try and block a subsequent tender offer.[180] Thus, if we think of the *Kahn I* right to say "no" as the equivalent of an *Interco* pill that buys the board time but not ultimate veto power,[181] *Pure* operates as

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[176] Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994). We recognize that this summary is operational shorthand for the murky statements in *Kahn I* and *Kahn II*. *See supra* text accompanying notes 61-71 (detailing the unresolved issues regarding the fairness standard left open by *Kahn I* and *Kahn II*).

[177] 638 A.2d at 1120-21. For an earlier discussion of *Kahn I*'s requirements, see *supra* notes 52-58, 61-65 and accompanying text.

[178] *See* 808 A.2d at 437 (implying that the support of the special committee is not required since "the tender offer takes place between the controlling shareholder and the minority shareholders[, and] . . . the short-form merger can be effected by the controlling shareholder itself").

[179] Conceivably, the controlling shareholder could use its power over the board to discharge the special committee and proceed with the merger. Such action, however, would appropriately trigger a high degree of judicial scrutiny and skepticism.

[180] From our perspective, this limitation on the special committee's role is appropriate since it would be even harder to justify giving independent directors in a controlled company the right to flatly "just say no"—in effect a *Unitrin* poison pill—than it would be to give independent directors such a right in the case of an uncontrolled company. At least in an uncontrolled company, affected shareholders who want to accept a hostile bid despite the board's objection actually elect the directors and have the power to replace them.

[181] In *City Capital Associates v. Interco, Inc.*, the chancery court limited a target board's defensive tactics to those necessary to evaluate the offer, communicate with shareholders, and seek or devise an alternative. 551 A.2d 787, 798 (Del. Ch. 1988). When those tasks were completed, the shareholders were then free to accept or reject the hostile offer. *Id.* at 798-800. By an *Interco* pill, we mean a poison pill that must be redeemed when these tasks have been completed. *See* Gilson, *A Short Reply*, *supra* note 101, at 47 (defining an *Interco* pill as a poison pill that "allows management time to

something of a functional alternative. In both cases the board can thoroughly examine the bid, propose alternatives, and advise shareholders, but ultimately the matter remains the shareholder's choice.

On this dimension, then, there is only a narrow gap between *Kahn I* and *Pure* with respect to the consequence of a board's decision to exercise this time-limited veto. In *Pure*, the controlling shareholder's fiduciary test is whether it can demonstrate, through satisfaction of the anticoercion litany, that the shareholders have not been "coerced."[182] *Kahn II* achieves a similar result in the freeze-out merger, at least as to the fair-dealing prong of the entire fairness analysis.[183] Because the *Kahn II* controlling shareholder could demonstrate that the minority *shareholders* were not, in fact, coerced, the fact that the *special committee* was coerced (via the threat to make a tender offer over their objections to the merger proposal) simply drops out of the fair-dealing case.[184]

We are then left only with what is a procedural, but very important, difference with respect to fair price in the two scenarios. We first note that there should not be a substantive difference between *Pure* and *Kahn I* and *Kahn II* with respect to fair price. *Weinberger* dictates that an appraisal measure of value be used in an entire fairness proceeding, including the potential for the award of equitable relief if appropriate.[185] The measure of value would be essentially the same under *Pure* because, if the anticoercion litany is satisfied, plaintiffs are relegated to their appraisal remedy; if it is not, then the entire fairness standard applies.

The procedural difference, however, is critical. As we have stressed, an entire fairness proceeding under *Weinberger*, *Kahn I*, and *Kahn II* provides the equivalent of a class appraisal proceeding without the

secure an alternative transaction and persuade shareholders that the bid price is too low, but does not allow management ultimately to block the offer").

[182] *See* 808 A.2d at 445-46 (noting that compliance with the anticoercion litany satisfies a board's fiduciary duty with respect to a tender offer). We believe it is a fair reading of the opinion to think that the burden of proof rests with the defendants regarding the anticoercion litany. Moreover, the *Pure* litany seems a pretty good metric for determining whether the shareholders are actually coerced.

[183] Kahn v. Lynch Communications Sys., Inc., 669 A.2d 79, 85-86 (Del. 1995).

[184] *See id.* at 86 (rejecting a finding of unfair dealing despite the controlling shareholder's coercion of the special committee since there was no coercion of the minority shareholders). Because the court fails to explain why it found that the shareholders were not coerced, one has to take the Delaware Supreme Court's finding largely on faith.

[185] Weinberger v. UOP, Inc., 457 A.2d 701, 714 (Del. 1983).

need for shareholders actually to perfect their appraisal rights.[186] In contrast, if the *Pure* anticoercion litany is met, shareholders must perfect their appraisal rights both informally, by not tendering their shares in the tender offer, and formally, by meeting the statutory requirements in connection with the mandated short-form merger.[187]

Thus, the treatment of freeze-out mergers and freeze-out tender offers after *Pure* pretty much converge with the still substantial exception of the difference between a class and non-class procedure for challenging value.[188] At this point, *Pure* makes apparent its preference for how to resolve the final discrepancy: "To the extent that my decision . . . causes some discordance between the treatment of similar transactions to persist, that lack of harmony is better addressed in the [*Kahn*] line, by affording greater liability-immunizing effect to protective devices such as majority of minority approval conditions and special committee negotiation and approval."[189] In particular, the opinion suggests business judgment protection when a transaction meets a high process standard.[190] Freeze-out mergers then would be treated the same way as freeze-out tender offers after *Pure*; if anticoercion standards were met, minority shareholders would be relegated to the appraisal remedy for challenging value.[191]

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[186] *Supra* text accompanying notes 42-46, 52-66.

[187] 808 A.2d at 446-47.

[188] We agree with Vice Chancellor Strine's conclusion in *In re Cysive, Inc. Shareholders Litigation*, No. 20341, 2003 WL 21961453, at *15-16 (Del. Ch. Aug. 15, 2003), that any potential difference on the burden-shifting question, particularly on "fair value," is not generally material either at the pleading stage or at trial.

[189] 808 A.2d at 444.

[190] *Id.* at 446. That result is roughly consistent with the approach recommended by the ALI's *Principles of Corporate Governance*, which makes appraisal the exclusive remedy in a freeze-out merger when the directors who approve the transaction for the controlled corporation "have an adequate basis, grounded on substantial objective evidence, for believing that the consideration offered to the minority shareholders in the transaction constitutes fair value for their shares." PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.25(a)(1) (1994).

[191] It is possible that the fallout from the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11 U.S.C.S., 15 U.S.C.S., 18 U.S.C.S., 28 U.S.C.S., 29 U.S.C.S.), may impose a harmonization of *Pure* and *Kahn I*, at least with respect to NASDAQ-listed companies. Under the proposed amendments to the NASDAQ rules following Sarbanes-Oxley, all companies are required to have a majority of independent directors and compensation, nomination, and audit committees made up only of independent directors. Rule Change and Amendments to NASD Rules 4200 and 4350 Regarding Board Independence and Independent Committees, Exchange Act Release No. 47,516, 68 Fed. Reg. 14,452-53 (proposed Mar. 17, 2003). In the case of a controlled corporation, the requirements for a majority of independent directors and independent-only compensation and nominating committees do not apply. *Id.* As the description of the proposed rules makes clear, however, the

We think it is important that the Delaware Supreme Court resolve the difference between the availability of a class appraisal remedy in freeze-out mergers and freeze-out tender offers,[192] but there is an alternative to reconsidering *Kahn I.* The court could instead harmonize the treatment of the two transaction forms by reconsidering *Solomon*, or at least the chancery court's extension of *Solomon* to freeze-outs (a result, we have noted, which the Delaware Supreme Court has

"controlled company exception does not extend to the audit committee requirements [only independent directors] under Rule 4350." *Id.* at 14,454 (emphasis omitted). Proposed Rule 4350(h), dealing with conflicts of interest, then requires that all related-party transactions "be approved by the company's audit committee or another [comparable] independent body of the board of directors." Rule Change and Amendment to Require an Issuer's Audit Committee or Another Independent Body of the Board of Directors to Approve Related Party Transactions, Exchange Act Release No. 48,137, 68 Fed. Reg. 42,152, 42,152 (proposed July 8, 2003) (alteration in original) (emphasis omitted). If a freeze-out merger is a related-party transaction, then the audit committee of a company listed on the National Association of Securities Dealers, Inc. (NASD) has the absolute right to block a freeze-out transaction. In other words, *Kahn II*'s assessment of the entire fairness of a freeze-out merger without the approval of a committee with blocking power will not be available. If this is correct, then pressure on the Delaware Chancery Court's handling of freeze-out tender offers will increase, and a reassessment of *Solomon* seems only more compelling.

[192] We do not make this suggestion simply for reasons of doctrinal coherence—Delaware has survived the functional inconsistencies arising from the equal dignity accorded to different statutory treatment of equivalent transactional techniques. *See, e.g.*, Hariton v. Arco Elecs., Inc., 188 A.2d 123, 125 (Del. 1963) (noting that the Delaware "sale-of-assets statute and the merger statute are independent of each other [and] . . . of equal dignity, and the framers of a reorganization plan may resort to either type of corporate mechanics to achieve the desired end"). Rather, the inconsistency between *Pure* and *Kahn* may leave a special committee on uncomfortable terrain, pressed to approve a merger it objects to because such a merger leaves shareholders in a better litigation position ex post. In *Kahn* redux, for example, the special committee would know that capitulation to the merger terms offers two advantages to the minority. First, the merger would preserve a class appraisal remedy, whereas the transactional alternative in which the special committee refuses the merger and the controlling shareholder proceeds by tender offer could leave only statutory appraisal. Second, shareholders are entirely free to express their preferences in a merger vote; the tendering decision may be influenced by calculations regarding the offer's probability of success and the time-value-of-money costs of waiting for the second step. Yet approval of the merger to better protect minority rights could require insincerity and misleading disclosure that could distort the shareholder merger vote. And applicable fiduciary law requires the board to withhold approval from a merger that it does not regard as "fair." *See* Kahn v. Lynch Communications Sys., Inc., No. 8748, 1993 WL 290193, at *4 (Del. Ch. July 9, 1993), *rev'd on other grounds*, 638 A.2d 1110 (Del. 1994) (criticizing one of the independent directors for voting in favor of the merger even though he did not believe that the price was fair by stating, "The fact that the alternatives to Alcatel's overture were limited does not mean that the Independent Committee should have agreed to a price that was unfair"). In other words, it is not simply that the *Kahn/Pure* inconsistency is unaesthetic, but also that it will whipsaw the target board and potentially deprive shareholders of relevant information.

not yet endorsed).[193] Harmonization would follow either from the elimination of the class appraisal remedy, where the controlling shareholder has demonstrated *Pure*-like process in a freeze-out merger, or from a declaration that the fair-price prong of the entire fairness standard applies in a freeze-out tender offer.

The arguments in favor of revisiting *Kahn I* are substantial. We are sympathetic to the *Pure* court's preference for a resolution to the treatment of freeze-outs that focuses on the court's assessing process, rather than determining value.[194] An appraisal proceeding puts the court in a quite difficult position. *Weinberger* instructed the chancery court to apply modern financial techniques in establishing the value of the controlled corporation's stock in a freeze-out to the end of eliminating the arbitrariness of the old Delaware block method.[195] As a practical matter, however, the result is likely to be one of dueling experts, each applying the tools of modern finance to end up at vastly different valuations. This situation, in turn, leaves the court to assess the validity of the experts' differing assumptions about risk measures, interest rates, and the myriad of other factors that drive the ultimate valuation—an assessment with which a judge should appropriately feel quite uncomfortable.[196] It is hardly surprising, then, that the *Pure* court favors giving the parties and the court a process-based alternative.[197]

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[193] *See supra* note 122 (pointing out the Delaware Supreme Court's emphasis on the fact that the *Solomon* transaction was not a freeze-out).

[194] 808 A.2d at 434.

[195] *See* Weinberger v. UOP, Inc., 457 A.2d 701, 712-13 (Del. 1983) ("[T]he standard 'Delaware block' or weighted average method of valuation . . . shall no longer exclusively control such proceedings.").

[196] In the market for firms, or large blocks of stock, "fair value" emerges as the endpoint of a bargaining process that may use various financial and non-financial metrics. The effort to reproduce this result in a judicial proceeding will necessarily produce diverse and contestable valuation methods that may leave the chancellor feeling like a judge in divorce court. *See, e.g.*, Rutherford B. Campbell, Jr., *The Impact of Modern Finance Theory in Acquisition Cases*, 53 SYRACUSE L. REV. 1, 18-37 tbls.1-18 (2003) (offering empirical evidence on diverse valuation methodologies).

[197] Former Chancellor, now Professor, William T. Allen made this point persuasively in a discussion during the Penn Symposium at which an earlier draft of this Article was presented. Since Professor Allen presided over the valuation process in *Cinerama, Inc. v. Technicolor*, 663 A.2d 1134 (Del. Ch. 1994), he plainly speaks from experience. Nonetheless, we wonder whether there are not techniques that might mitigate some of the problems associated with dueling valuation experts. For example, more frequent use might be made of a court-appointed expert. *See In re* Appraisal of Shell Oil Co., 607 A.2d 1213, 1223 n.3 (Del. 1992) (inviting the chancery court to appoint a neutral expert witness in "the hope that the use of such an expert will bring greater reason and clarity to the appraisal process"). We expect that the participation

The attraction of a process-based harmonization is buttressed by recent corporate governance developments that are likely to enhance the independence of the special committee. Section 301 of the Sarbanes-Oxley Act requires every listed company to establish an audit committee and requires that the committee be comprised solely of "independent" directors.[198] The New York Stock Exchange (NYSE) corporate governance proposal elaborates and strengthens this standard.[199] Although the proposed rule exempts controlled companies

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of such an expert would serve to reduce the distance between the experts' valuations much like "baseball," or "final offer," techniques do in arbitration. These techniques contemplate that the arbitrator has to select without adjustment whichever of the two parties' valuations is most reasonable in the arbitrator's judgment. *See* Mediators, Inc. v. Manney, 296 B.R. 89, 92-95 (S.D.N.Y. 2003) (considering the parties' positions on issues such as confession of judgment, accrual of interest, and quarterly payments before choosing one side's proposal); CPR INST. FOR DISPUTE RESOLUTION, 1 CPR MODEL ADR PROCEDURES AND PRACTICES SERIES: ADR GLOSSARY (1998) (defining private alternative dispute resolution processes such as "baseball," or "final offer," arbitration), *available at* www.cpradr.org/adrprivate.htm. A more extreme variation called "night baseball" simply requires the arbitrator to accept whichever of the parties' valuations is closest to that of the arbitrator. *See, e.g.*, Judith S. Kaye, *Business Dispute Resolution—ADR and Beyond: An Opening Statement*, 59 ALB. L. REV. 835, 840 n.14 (1996) (explaining the different variations of arbitration including "night baseball"). The point of the procedure is to eliminate the incentive for extreme valuations. While in the judicial context the judge must make her own determination, the parties may logically assume that the court-appointed expert is unlikely to credit extreme valuations and that the court will likely give more credence to the neutral expert. Thus, there will be substantial incentive to offer a valuation that the court-appointed expert will view as reasonable.

Moreover, a valuation procedure that comes after a special committee process is likely to be much more manageable than otherwise. The plaintiff class's expert will be constrained by the special committee's settlement range and by the substantial evidence on valuation that will already have been developed.

[198] Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C.S. § 78j-1(m)(3)(B) (Law. Co-op. Supp. 2003):

> In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee—
>
> (i) accept any consulting, advisory, or other compensatory fee from the issuer; or
>
> (ii) be an affiliated person of the issuer or any subsidiary thereof.

[199] Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Relating to Corporate Governance, 68 Fed. Reg. 19,051 (proposed Apr. 11, 2003) [hereinafter Rule Change and Amendment No. 1]. The NYSE proposal and the comparable NASD proposal have been approved, with minor subsequent amendment, by the Securities and Exchange Commission (SEC). Order Approving Proposed Rule Changes and Amendments No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval of Amendments Relating to Corporate Governance, Exchange

from the general listing requirement of a majority of independent directors, controlled companies must nevertheless establish an audit committee that consists of at least three independent directors.[200] The NYSE's "independence" standard would require a board determination that the director in question had "no material relationship" with the listed company and includes a three-year cooling-off period for many of the most common kinds of prior connections that might undermine independence.[201] The NYSE would also add special independence requirements for audit committee members that exclude any compensation for consulting, financial, or legal services; that require all audit committee members to be "financially literate"; and that require at least one member to "have accounting or related financial management expertise."[202] Thus, in most future parent-subsidiary, freeze-out situations, the special committee will almost certainly consist of directors with much greater independence and perhaps more financial sophistication than has been commonly the case in the past.[203]

Moreover, in light of the extensive experience with special committees in many contexts—including management buyouts, derivative litigation, as well as going-private transactions—we have a much better developed sense of the institutional structure that can make such committees more effective.[204] Hiring independent financial and legal advisors seems particularly important (and seems to be part of the *Pure*

Act Release No. 48,745, 68 Fed. Reg. 64,154 (Nov. 4, 2003) [hereinafter SEC NYSE Order].

[200] Rule Change and Amendment No. 1, *supra* note 199, at 19,052.

[201] SEC NYSE Order, *supra* note 199, at 64,157 (reiterating the "independence" standard and explaining that NYSE modified its original proposal to shorten the cooling-off period from five to three years).

[202] Rule Change and Amendment No. 1, *supra* note 199, at 19,055 (emphasis omitted).

[203] Similar standards have been proposed by the NASD for NASDAQ-listed companies. *See supra* note 191 (discussing proposed amendments following Sarbanes-Oxley). The potential impact of these new governance standards is apparent even in the small sample of freeze-out cases we discuss. None of the special committee members in *Siliconix* would have been "independent" under either the NYSE standards for the general board or audit committees or the Sarbanes-Oxley standard for audit committees. Similarly, the target board in *Aquila* had no independent members.

[204] *See, e.g.*, Gregory V. Varallo, William M. McErlean & Russell C. Silberglied, *From* Kahn *to* Carlton*: Recent Developments in Special Committee Practice*, 53 BUS. LAW. 397, 400 (1998) (arguing that rules are now reasonably well-developed). On the mixed early history of director independence in a prior cycle of going-private transactions, see William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 BUS. LAW. 2055, 2056 (1990).

anticoercion litany) not only because the specially retained advisors will have reputational capital at stake, but also because of the competitive dynamics between the special committee "team" and the management team.

At the same time, however, there is a powerful argument in favor of harmonizing the treatment of freeze-out mergers and freeze-out tender offers by reconsidering the extension of *Solomon* to freeze-outs. The logic of this approach is faithful adherence to the symmetry of rules that control controlling shareholders' extraction of private benefits. In a freeze-out, controlling shareholders can be expected to retain the prior level of private benefits (as already impounded in the pre-freeze-out price of minority shares);[205] the concern is to ensure that the minority receives a premium that reflects a fair share of the synergy gains. The gains that result from freezing out minority shareholders require the contribution of both the controlling and noncontrolling shareholders; the gains must then be fairly divided between them. Where a gain is created by the sale of control, pro rata sharing results automatically,[206] but in a freeze-out, the division of that gain parallels a self-dealing transaction covered by the *Sinclair* standard. Thus, a class-based appraisal remedy—the equivalent of a *Sinclair* remedy—is called for regardless of the transaction form, and the holding that the Delaware Supreme Court should reconsider is the chancery court's application of *Solomon* to freeze-out tender offers, rather than *Kahn I*'s provision of class-based appraisal.[207]

Moreover, this approach avoids what would be a troubling inconsistency in Delaware law: minority shareholders of a controlled company receiving less protection when faced with a hostile "internal" tender offer than when faced with a hostile "external" tender offer. In the "external" case, the board is fully empowered to resist the offer, with a *Unitrin* pill, to the point where even maximally sophisticated

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[205] See *supra* notes 12-15 and accompanying text for a brief explanation of the standards that limit the extraction of private benefits.

[206] *See supra* notes 26-29 and accompanying text (describing the results from a sale of control).

[207] It may also seem an odd time for the Delaware Supreme Court to make a move that, by reconsidering *Kahn I*, reduces the protection of public minority shareholders. The court's recent stress on minority protection in cases like *McMullin* and *Omnicare* certainly bespeaks increased concern for the interests of minority shareholders. A court that has historically shown sensitivity to general trends in political economy may be reluctant to embrace reduced shareholder protection in response to what looks like an end run around previously established fiduciary standards. *See supra* note 31 (discussing Delaware's sensitivity to federal competition in the establishing of fiduciary rules).

institutional investors cannot accept a bid in the face of the board's contrary judgment. The board's arm's-length bargaining power and a competitive takeover market protect the shareholders from a low-ball offer. By contrast, since an "internal" tender offer faces no competitive threat from a bust-up bidder, the controlling shareholder might exploit inside information and timing advantages that would be non-policeable; at best, the target board can use an *Interco* pill to protect itself. The harmonization choice—whether to relax judicial treatment of freeze-out mergers or to tighten the treatment of freeze-out tender offers—depends on an assessment of the controlling shareholder's incentives to make a low-ball offer in each scenario in light of the procedural burdens of statutory appraisal. From this perspective, leaving controlling shareholders more discretion with a freeze-out tender offer undermines the barriers to low-ball freeze-outs.

We find the choice between a reconsideration of *Kahn I* and a reconsideration of the extension of *Solomon* to freeze-outs a close question. In the end, the weight of the considerations on both sides leads us to prefer a hybrid approach that involves reconsideration of both *Kahn I* and *Solomon.* We share the *Pure* court's conclusion that a fully empowered special committee, including the *Pure* anticoercion litany and the right to say "no," affords sufficient process so that entire fairness review in a freeze-out merger can be eliminated.[208] Where independent directors have the power to block a freeze-out merger, but

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[208] We offer a friendly amendment to the *Pure* anticoercion litany to further advance a tender offer structure that would avoid certain elements of distorted shareholder choice. *Pure* requires the controller to make a tender offer with a mandatory majority-of-minority condition and the promise to consummate a short-form merger if the ninety percent threshold is achieved, but it does not require a ninety percent achievement condition. *Supra* text accompanying notes 170-72. Such an offer could force a tender decision from a shareholder otherwise opposed to the offer but also worried about the decreased liquidity and other disadvantages of being a minority shareholder in a company where, say, eighty-five percent of the stock is privately held. (Assume, for example, an offer made by a fifty-five percent shareholder that obtains another thirty percent of the company's stock, easily satisfying the majority-of-minority condition.) In other words, the ninety percent threshold for consummating a short-form merger is not the threshold of concern about being frozen in as a minority shareholder in a thinly traded stock. So the *Pure* anticoercion litany should be amended to require that, for an offer without a ninety percent achievement condition, where the majority-of-minority condition has been satisfied, the offer must be extended for a reasonable period to give shareholders who initially failed to tender a renewed opportunity to do so. In effect, for this special group of tender offers, this addition would, as a matter of state law, require bidders to offer a subsequent offering period under Rule 14d-11, 17 C.F.R. § 240.14d-11 (2003). *See* Grand Metro. P.L.C. v. The Pillsbury Co., 558 A.2d 1049, 1060 (Del. Ch. 1988) (imposing a comparable requirement in the bidder's offer as a condition for a grant of equitable relief).

do not, it is fair to assume that the process sufficiently tracks an arm's-length negotiation which fairly relegates shareholders to their appraisal remedy. To this extent, we favor revisiting *Kahn I.*

But what if the special committee rejects the proposed freeze-out merger and the controlling shareholder goes over the committee's head as in *Siliconix*? Here, the chancery court's extension of *Solomon* to freeze-out tender offers also should be reconsidered. If the controlling shareholder seeks to override the special committee's veto, the process no longer matches an arm's-length transaction—the minority shareholders lose the protection of their bargaining agent, and unlike in a hostile tender offer, the protection of the market for corporate control is not available. Under these circumstances, the transaction remains a *Sinclair*-like interested transaction, and entire fairness protection (here meaning "fair price") is appropriate—an outcome consistent with the symmetric controls governing the extraction of private benefits by controlling shareholders. One particular advantage of this hybrid approach is that it strengthens the bargaining position of the special committee by giving its "say 'no'" power more bite. As the special committee's "threat point"[209] shifts from statutory appraisal to class-based appraisal, the conditions of arm's-length bargaining are more nearly replicated. This outcome should appeal to the concerns that animate both the *Kahn I* and *Pure* courts.[210]

In summary, in harmonizing the *Kahn* and *Solomon* lines of cases to achieve convergence in the legal rules governing freeze-out mergers and tender offers, we think there are two critical factors: first, whether the special committee had the power to say "no," at least to the extent of an *Interco* pill, and the offer was otherwise noncoercive (i.e, whether the *Pure* anticoercion litany was complied with) and, second, whether the offer was in fact approved by the special committee. If both of these conditions are satisfied, then the business judgment rule should apply to the freeze-out transaction, whether merger or

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[209] The "threat" being the consequence to the controller of the special committee's non-agreement.

[210] We think the Delaware Supreme Court could also take account of developments since *Kahn I* that may additionally mitigate some concerns about the controller's "inherent coercion" of the minority, including the development of institutional practices and corporate governance rules that buttress the special committee's independence in fact. *See, e.g., supra* notes 198-203 (offering examples of recent corporate governance rules articulated by Congress and the NYSE). This resolution also has the benefit of effectively eliminating the often confusing process of non-bifurcated review that melds fair dealing and fair price in a way which diverts attention away from the economic judgments to be made.

tender offer, and the minority shareholders should be limited to statutory appraisal. The minority shareholders have received the benefits of a virtual arm's-length bargaining process over division of the gains associated with the freeze-out and have accepted a noncoercive offer. On the other hand, if the special committee does not approve the proposal but the controlling shareholder proceeds anyway, then the transaction should be subject to entire fairness review and minority shareholders should have a class-based appraisal remedy. This implies that, for a case like *Siliconix*, the special committee's rejection of the offer would leave the controlling shareholder with the burden of demonstrating that its tender offer to the public shareholders satisfies entire fairness review, per *Kahn II*. The further implication is that the terms of a freeze-out merger that result from an appropriate committee process and an uncoerced shareholder vote should be reviewed on a business judgment standard, not entire fairness.[211]

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[211] If the *Pure* anticoercion litany is not complied with, entire fairness review is, of course, appropriate. We think that controlling shareholders will have ample incentives to facilitate an active special committee process even in cases where the committee contemplates that non-agreement is likely and that a tender offer directly to the shareholders will be necessary. The special committee process is likely to set a valuation that would narrow the range a court might find in a subsequent entire fairness proceeding. The plaintiff class's expert would be limited by what the special committee was prepared to settle for in hard bargaining, and a lot of evidence would be generated on the valuation questions from a good faith bargaining effort. Without a special committee process, the expert would not be so constrained, and the controller would face greater risk of a high judgment. In any event we are puzzled by the suggestion in *Krasner v. Moffett*, 826 A.2d 277, 286-88 (Del. 2003), that an otherwise appropriate special committee process might be undercut by the fact that ultimately the entire board votes on the merger proposal that the special committee has negotiated.

We note that other commentators favor extending entire fairness protection to freeze-out tender offers while not necessarily adopting our hybrid approach. *See, e.g.*, Kimble Charles Cannon, *Augmenting the Duties of Directors to Protect Minority Shareholders in the Context of Going-Private Transactions: The Case for Obligating Directors to Express a Valuation Opinion in Unilateral Tender Offers After* Siliconix, Aquila *and* Pure Resources, 2003 COLUM. BUS. L. REV. 191, 240-52 (proposing several non-hybrid ways to protect minority shareholders faced with controlling-party tender offers, including changes in Delaware Code); Brian M. Resnick, Note, *Recent Delaware Decisions May Prove to be "Entirely Unfair" to Minority Shareholders in Parent Merger with Partially Owned Subsidiary*, 2003 COLUM. BUS. L. REV. 253, 282 (recommending that *Siliconix* be overturned or that the Delaware Supreme Court "impose a procedural fiduciary obligation on the board . . . of the subsidiary to negotiate with the parent as zealously as it would with a third-party bidder").

Experienced Delaware practitioner Frank Balotti and his coauthors agree with our general concerns, but would instead revisit *Glassman* to require a limited hearing on fair-price issues or a legislative revision of the appraisal statute to make the extra amount determined in an appraisal proceeding following a short-form merger payable to all shareholders in a freeze-out transaction. Bradley R. Aronstam, R. Franklin

D. *Convergence in the Standards Governing Target Board Duties in Responding to a Freeze-out Tender Offer and a Hostile Tender Offer*

Harmonizing the different standards that govern the controlling shareholder's obligation in freeze-out mergers and freeze-out tender offers still leaves a discrepancy between the standards governing the target board's duties in responding to a freeze-out tender offer, which *Siliconix* and *Aquila* implicitly eliminate, and the target board's duty to respond to a hostile tender offer, which the Delaware Supreme Court has taken quite seriously. The issue was posed starkly in *Pure* by the plaintiffs' claim (supported by the special committee's aborted effort to block the offer) that the target board should have adopted a poison pill.[212]

While it is hard not to share the *Pure* court's impatience with the claim that the board only has an obligation to stand up for shareholders when it is in management's interest to do so,[213] we also share the court's conclusion that there should be no blanket "duty on the part of the independent directors to seek blocking power"[214] through the right to adopt a pill. The explanation derives from the inherent tension between the board's role in protecting the shareholders and the shareholder's role in making the ultimate decision whether to accept or reject the tender offer.

In a "just say no" regime in which target directors—even after they have investigated, negotiated, communicated, and explored alternatives—have the right to prevent the shareholders from accepting a hostile tender offer by declining to redeem a pill, there is no coherent case for not demanding that target directors who confront a freeze-out tender offer have the same power at their disposal. As we have

Balotti & Timo Rehbock, *Delaware's Going-Private Dilemma: Fostering Protections for Minority Shareholders in the Wake of* Siliconix *and* Unocal Exploration, 58 BUS. LAW. 519, 548-58 (2003). The legislative proposal, in particular, has much to recommend it since it would provide a class-based appraisal remedy, but it may also inject the court into valuation disputes that could be better resolved by bargaining through the special committee process which we have outlined. For a contrary view that defends the present arrangements, see Jon E. Abramczyk et al., *Going-Private "Dilemma"?—Not in Delaware*, 58 BUS. LAW. 1351 (2003).

[212] *Supra* note 162 and accompanying text.

[213] The court referred to "the rough fairness of the goose and gander rule." *In re* Pure Resources, Inc. S'holders Litig., 808 A.2d 421, 446 (Del. Ch. 2002).

[214] *Id.* The court also held that, "[w]hen a controlling stockholder makes a tender offer that is not coercive in the sense I have articulated, . . . there is no duty on [that controlling shareholder's] part to permit the target board to block the bid through use of the pill." *Id.*

suggested, target shareholders need the protection even more in a freeze-out tender offer because the market for corporate control is not available to protect them. Alternatively, observance of the *Pure* anticoercion litany—after which target directors, having acted diligently on behalf of the shareholders step back and let the shareholders decide whether to accept a hostile tender offer—is a fair proxy for the *Interco* pill that a shareholder choice regime would dictate. This correspondence is especially tight if, as we propose for the freeze-out tender offer, the process is coupled with entire fairness review of price when the controlling shareholder goes over the head of an independent committee.

In the end, *Pure* stops short of complete convergence of the doctrine governing target board responses to hostile and freeze-out tender offers, openly expressing its preference for a shareholder choice regime in connection with freeze-out tender offers, rather than achieving complete convergence by requiring "the use of a device that our statutory law only obliquely sanctions and that in other contexts is subject to misuse, especially when used to block a high value bid that is not structurally coercive."[215] Indeed, the *Pure* court makes a not-so-veiled threat to achieve convergence by moving in the other direction: "If our law trusts stockholders to protect themselves in the case of a controlling stockholder tender offer that has the characteristics I have described, this will obviously be remembered by advocates in cases involving defenses against similarly noncoercive third-party tender offers."[216] Our hybrid harmonization, involving reconsideration of both *Kahn I* and *Solomon*, results in the equivalent of an *Interco* regime for freeze-outs consistent with the regime the *Pure* court properly and candidly favors.

From our perspective, then, *Pure* does an admirable, if not yet complete, job of restoring symmetry to the doctrinal constraints on controlling shareholder extraction of private benefits by reestablishing a rough convergence of the standards governing judicial review of the fairness of freeze-out mergers and freeze-out tender offers within the parameters imposed by prior case law. The broad reading of *Solomon* offered by *Siliconix* and *Aquila* threatened to upset the balance among different techniques for extracting private benefits of control by relaxing the restrictions on freeze-outs. *Pure* moves things in the right direction and correctly invites the Delaware Supreme

[215] *Id.*
[216] *Id.* at 446 n.50.

Court to finish the task of convergence. In our view, accomplishing that task requires reconsidering both *Kahn I* and *Solomon* with the desirable result of restoring symmetry to the law that controls controlling shareholders.

CONCLUSION

In this Article, we have argued that Delaware doctrine restricts the extent to which controlling shareholders can extract private benefits of control to a level at which it is plausible that the benefits to minority shareholders from reduction in managerial agency costs as a result of concentrated monitoring by a controlling shareholder exceed the costs of the controlling shareholders' private benefits of control. This result is accomplished by the mix of rules governing self-dealing transactions between the controlling shareholder and the controlled corporation, the sale of control, and the freeze-out of non-controlling shareholders. We then considered recent developments in the rules governing sales of control and freeze-outs, arguing that *Digex* threatened to tighten inappropriately the permissive rules governing sale of control and that *Siliconix* and *Aquila,* before the useful correction by *Pure,* threatened to loosen inappropriately the restrictive rules governing freeze-outs.

In the end, some may disagree with our evaluation of the appropriate levels of restriction governing different techniques for extracting private benefits of control. The terms of this debate, however, will be much more sharply focused if we have at least persuaded our readers that the rules governing the three methods of extraction should be evaluated simultaneously.

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