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Controlling Controlling Shareholders

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Ronald J. Gilson[*] and Jeffrey N. Gordon[**]

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ABSTRACT

The rules governing controlling shareholders sit at the intersection of the two facets of the agency problem at the core of 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, 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. 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 point of view of public shareholders, 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 benefits from reduction in managerial agency costs are greater than the costs of private benefits of control.

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. 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 symmetrical 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 non-controlling 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 efficiency gains are greater from sale of control than from freeze outs, so that a shift that favors freeze outs as opposed to sales of control is a move in the wrong direction. 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 offer without a special committee approval.

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Controlling Controlling Shareholders

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The rules governing controlling shareholders sit at the intersection of the two facets of the agency problem at the core of 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 point of view of public shareholders, the two facets of the agency problem present a tradeoff. The

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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 develop, 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 non-controlling 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 efficiency gains are greater from sale of control than from freeze outs, so that 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 control of private benefits of control and describe briefly the general doctrinal structure. In Part II, we review and

[1] Ronald J. Gilson & Bernard S. Black, The Law and Finance of Corporate Acquisitions 1229-31 (2d ed. 1995).

evaluate recent Delaware case law in the areas of sale of control and minority freezeouts. 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 offer without a special committee approval. Part III concludes.

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 like 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.

[2] See, e.g., Simon Johnson et al, Tunnelling, 90 Am. Econ. Rev. 22 (2000).

The same private benefits can also be secured by freezing out the minority. In a public corporation, the trading price of shares in a corporation with a controlling shareholder reflects the value of a non-controlling share. 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 covering 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, however, the legal rules that govern the three methods are quite different. One set of legal rules set the boundaries for private benefits in the ongoing operation of the corporation. A second addresses efforts by a 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 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 is the right relationship; more intense judicial review is appropriate in a freeze out than in a sale of control. In the next, 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.[3] As we will see, legal rules and the related enforcement mechanisms affect the "minority discount," that is, the value difference between the shares of equivalent cash flow rights held by public shareholders versus controlling shareholders.[4] This in turn affects the feasibility of "equity carveouts," transactions in which a parent sells a minority interest in a subsidiary via an IPO,[5] and the valuation generally of transactions in control 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 in effect set the limits on the price of monitoring by a controlling shareholder. If these limits are effective, the presence of a controlling shareholder is beneficial to the non-controlling shareholders: the reduction in managerial agency costs exceed the level of private benefits.

[3] The literature is summarized in LaPorta el al, Investor Protection and Corporate Governance, 58 J. Fin. Econ. 3 (2000). See also LaPorta el al, Law and Finance, 106 J. Pol.. Econ. 1113 (1998); LaPorta et al, Legal Determinants of External Finance, 52 J. Fin. 1131 (1997).

[4] Tatiana Nenova, The Value of Corporate Voting Rights and Control: A Cross-Country Analysis, 68 J. Fin. Econ. 325 (2003); Alexander Dyck & Luigi Zingales, Private Benefits of Control: An International Comparison (NBER W.P. 8711 2202), available on SSRN.

[5] There were approximately 224 equity carveouts raising more than $20 million during the 1980-1996 period. In a busy year for IPOS, 1998, 32 of 373 IPOs were equity carveouts, raising $15.5 billion, or approximately 45% of the $35.5 billion raised from all IPOs that year. See Eric A. Powers, Deciphering the Motvies for Equity Carve-Outs, 26 J. Fin. Res. 31 (2003). Between a quarter and third of these carveouts are followed by a spinoff of the parent's remaining stock.

Two basic legal rules police the level of private benefits from ongoing operations. First, if the controlling shareholder is a director, 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 § 144, which require that the transaction be sanitized through either procedural techniques or substantive judicial review.[6] If the controlling shareholder is not a director, then we are in the realm of Sinclair Oil Corp. v. Levien,[7] which sets out the general standards for the conduct of business for controlled corporations. 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, the non-controlling shareholder claimed that the controlled corporation's dividend policy favored the controlling shareholder. By paying out as dividends a large percentage of its profits, the corporation was said to favor the controlling shareholder who apparently had attractive investment opportunities outside of the controlled corporation, and disadvantage the non-controlling shareholders who

[6] DGCL § 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:

(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
(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
(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.

[7] 280 A.2d 717 (Del. 1971).

received equal dividends but lost the opportunity for the controlled corporation to reinvest its earnings.[8]

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, transfer of assets from the controlled corporation to the controlling shareholder, the use of the controlled corporation's assets as collateral for a controlling shareholder debt, and the like.

The standards established for the two categories of private benefits are radically different. In general, decisions relating to business and strategic decisions that affect the controlling and non-controlling shareholders even handedly are treated essentially as business judgments. Thus, the dividend decision in *Sinclair*, as well as the related claim that the controlled corporation's business was limited to development of oil opportunities in Venezuela (presumably why the controlled subsidiary was in a position to pay such large dividends), were treated as business judgments outside the realm of intrusive judicial review.

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, as, for example, where the controller disparately gains from contract terms or enforcement of those terms when the two are on the opposite sides of a transaction, the intrinsic fairness standard – the most rigorous in corporate law jurisprudence – applies. In that situation,

[8] 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 80 percent and as much as 100 percent of the dividends received by the parent would not be taxed. Minority shareholders would be taxed on dividends received unless they were otherwise exempt. See Gilson & Black, supra note 1, at 1239-41.

the controlling shareholder must bear the burden of proving that the terms of the transaction were intrinsically fair, with the court making a *de novo* determination.

The result of these two standards is to 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.[9] 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 can 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, and to devise more accurate incentive compensation for both corporations' management and employees.[10] Here the non-controlling shareholders get more focused monitoring at a relatively low cost.[11]

[9] The efficacy of these standards are offered by Johnson et al, supra note 2, 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 U.S. and U.K. [yet ubiquitous 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." 90 Am. Econ. Rev. at 26.

[10] These reasons are commonly offered as explanations for the efficiency of equity carveouts. 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 (1986).; accord, Arnand M. Vijh, The Positive Announcement-Period Returns of Equity Carvouts: Asymmetric Information or Divestiture Gains?, 75 J. Bus. 153 (2002). Announcement of such transactions results in a two to three percent positive abnormal return in the parent company's stock. See id at 153; Heather Hurlburt, James A. Miles & J. Randall Woolridge, Value Creation from Equity Carve-outs, 31 J. Fin. Mgmt 83 (2002). 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), Vikram Nandi, On the Good News in Equity Carve-Outs, 46 J. Fin. 1717 (1991), and the increased analyst coverage of both companies' stock. Stuart C. Gilson, Paul M. Healy, Christopher F. Noe & Krishna G. Palepu, Information Effects of Spin-Offs, Equity Carve-outs, and Targeted Stock Offerings, Harvard Business School Working Paper (1998), available at http://papers.sssrn.com/sol3/papers.cfm?abstract_id=42904. In the end, some controversy remains about the source of abnormal returns. See David Haushalter & Wayne H. Mickelson, An Investigation of the Gains from Specialized Equity: Tracking Stock and Minority Carve-Outs, working paper (2001), available at http://papers.ssen.com/sol3/papers.cfm?abstract_id=271691 (conjecture that "the stock price effects do

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 a business opportunity, 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 by the controlling shareholder.[12] Nonetheless, this source of private benefit also remains limited, certainly compared to core self-dealing.

In sum, judicial doctrine effectively puts a ceiling on the private benefits of control associated with operating the corporation. Behavior that is capable of transferring large amounts of value is subjected to intense judicial scrutiny, which is consistent with the surmise that controlling shareholders do not take markedly more from non-controlling shareholders than they provide.[13] As such, the level of private benefits from operation provides a benchmark for assessing the standards governing alternative methods of securing private benefits.

not reflect real benefits of specialized equity arrangements"). For a more skeptical view about valuation creation by and stability of carve-outs, see Andre Annema et al., When Carve-outs Make Sense, McKinsey Quarterly (No. 2, 2002) at 13-15.

[11] This is consistent with empirical evidence that carve-out IPOs do not underperform stock portfolio benchmarks, contrary to the usual evidence of underperformance for IPOs or seasoned equity offerings. Arnand M. Vijh, Long-term Returns from Equity Carveouts, 51 J. Fin. Econ. 273 (1999).

[12] For this purpose it is useful to consider two different kinds of controlling shareholders. One has a *unidimensional* relation to the corporation – its only connection to the corporation is through its stockholdings. A second has a *multidimensional* relation – in addition to its stock holdings, the controlling shareholder also has operational ties to the corporation, say as a customer or supplier. A unidimensional controlling shareholder has few direct means to extract private benefits of control from the controlled corporation. See Gilson & Black, supra note 1, at 1233-34. For this type of controlling shareholder, real options may be the primary source of private benefits.

[13] John Coates is rather more pessimistic with respect to the potential for the size of private benefits that can be secured through operations. John C. Coates, IV "Fair Value" as an Avoidable Rule of Corporate Law: Minority Discounts in 'Conflict Transactions, 147 U.Pa. L. Rev. 1251 (1999). However, much of his focus is on whether value reducing operational decisions that affect all shareholders can be transmuted into private benefits in a freezeout because of valuation standards.

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 reflecting the capitalized value of the private benefits of control available from operating the controlled corporation. Although the holding in Perlman v. Feldmann[14] that a controlling shareholder cannot sell control at a premium that is not shared with non-controlling shareholders continues to amuse corporate law teachers, both because it provides an interesting class and because of the Second Circuit's Fantasia-like view of Indiana law, by at least the early 1990s the applicable legal rule was radically different. Whether one looks to Delaware law[15] or to the American Law Institute's Principles of Corporate Governance,[16] 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 operating the controlled corporation, 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.[17] A buyer of control presumably would not wish to acquire the controlled corporation at a price that

[14] 219 F.2d 173 (2nd Cir. 1954).

[15] In re Sea-Land Corp. Shareholders Litigation, 1987 WL 11283, *5 (Del. Ch. 1987)("A controlling stockholder is generally under no duty to refrain from receiving a premium upon the sale of his controlling stock."); Harris v. Carter, 582 A.2d 222, 235 (Del.Ch. 1990) ("It is a principle of Delaware law that a shareholder has the right to sell his or her stock and in the ordinary course owes no duty in that connection to other shareholders when acting in good faith.") See also Thorpe v. CERBCO, Inc., 676 A.2d 436 (Del. Sup. 1996) . See Robert W. Hamilton, Private Sale of Control Transactions: Where We Stand Today, 36 Case Wes. Res. L. Rev. 248 (1985).

[16] American Law Institute, Principles of Corporate Governance: Analysis and Recommendations §5.16 (1994).

[17] This discussion draws on Gilson & Black, supra note 1, at 1231-2, which in turn was informed by Frank Easterbrook & Daniel Fischel, Corporate Control Transactions, 91 Yale L.J. 698 (1982); Lucian Bebchuk, Efficient and Inefficient Sales of Corporate Control, 109 Q.J. Econ. 957 (1994); Marcel Kahan, Sales of Corporate Control, 9 J. L. Econ. & Org. 368 (1993).

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. [18]

Next assume that the buyer acquiring control also sees the opportunity for synergy between the new controlling shareholder and 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 operating the controlled corporation do not allow all of the synergy to be captured by the controlling corporation, the non-controlling shareholders will participate in the increase in value 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, interactions that will be subject to *Sinclair*.

There are exceptions to the permissive general rule, but these seem to fit well with the analysis. Section 5.16 of the ALI Corporate Governance Project states these exceptions. The general rule that a controlling shareholder can sell its shares at a

[18] An empirical study of *Perlman v. Feldmann* showed that the stock of Newport Steel, the controlled corporation, experienced abnormal returns of 32% during negotiations for sale of control and abnormal returns of 77% (29% on an industry-adjusted basis) over the entire year which control was sold. Because market price measures the value of the public minority shares, the data suggests that the minority shareholders benefited from the sale of control. The experience of Newport's non-controlling shareholders seems to generalize. See Michael Barclay & Clifford Holderness, The Law and Large Block Trades, 35 J.L. & Econ. 265, 270 (1992).

On the other hand it is also possible to see *Perlman v. Feldmann* as correctly decided on its own peculiar facts, namely, 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. To try to capture this difference, Newport had insisted that customers provide advances against future purchases, i.e., interest free loans. 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 seen as a form of special synergy gain that, because it was not ratably shared with the minority, was properly subject to recovery.

premium is qualified in two circumstances: when the controlling shareholder acquires shares from non-controlling shareholders in anticipation of the contemplated sale of control without disclosure; and when it is apparent that the purchaser is likely to extract illegal levels of private benefits from operating the controlled corporation.[19] The first exception operates merely as a form of insider trading. 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 exception provides 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 operating 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.

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 sale of

[19] 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

(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."

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.[20] In that case, the Signal Companies determined to acquire the 49.5 percent of UOP that it did not own through a merger in which the UOP shareholders would receive cash for their UOP stock. 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 50 percent premium over the market price of UOP stock. The court treated the freeze out transaction as a simple manifestation of the core self-dealing setting that requires intensive judicial review of the transaction terms for fairness. Because the lower the price paid to UOP shareholders, the better off was Signal and because Signal had been benefited because of its receipt, to the detriment of the UOP minority, of a feasibilty study prepared by Signal's UOP directors, the transaction presented simply a variation of what triggers heightened review of operating transactions under *Sinclair*.[21] 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

[20] 457 A. 2d 701 (Del. 1983). This division of history relegates Delaware's flirtation with a business purpose test as a precondition to a freeze out, announced in Singer v. Magnavox, 380 A.2d 969 (Del. 1977), apparently in response to pressure from the Federal courts, and overruled in *Weinberger*, to accounts more concerned with the impact of federalist concerns on the development of corporate law. For one view of that history, see Gilson & Black, supra note 1, at 154-169. See also Mark Roe, Delaware's Competition, working paper, 116 Harv. L. Rev. __ (forthcoming 2003) (Delaware's race is not with other states, but with the risk of federal preemption).

[21] "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 shareholders of the subsidiary." 280 A. 2d at 720.

of UOP were held to the same standard as non-Signal directors; conflicting loyalties had to be resolved in favor of the controlled corporation.[22]

Once having established that a freeze out triggered intensive judicial review of the fairness of the transaction, 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" in the court's terms – together with " fair price." With respect to fair dealing, the court stressed both the obligation of candor on the part of the parent, and the importance of a process that mirrors a real arm's length transaction where each party had the right to say no.[23] As to fair price, the court adopted for this purpose the liberalized appraisal standard adopted by the Delaware legislature. 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, the court also unhelpfully stressed that "the test for fairness is not a

[22] The court explicitly referred to "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." 457 A.2d at 710. In the post-*Weinberger* evolution of freezeouts, the inherent tensions in a transaction proposed by controller who either has the necessary voting power to accomplish the transaction, or if the transaction is conditioned on majority of minority approval, will remain in control even if the minority refuses, has led to the imposition of entire fairness review in all such freezeouts. See Rosenblatt v. Getty Oil Co., 493 A.2d 929 (1985); Kahn v. Lynch Communications System, Inc., 638 A.2d 1110 (Del. 1994). No explicit taking-advantage of is required.

[23] In an oft-cited footnote, the court stated that "[T]he 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." 457 A.2d at 709, n.7.

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."[24]

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 the court adopted in *Weinberger*. The difference is procedural but of enormous substantive consequence. Under the Delaware appraisal procedure, a shareholder must jump through a number of procedural hoops, including not voting for the transaction and not accepting payment, in order to retain the right to bring an appraisal action. More important, the Delaware corporate statute does not authorize a class appraisal procedure. In contrast, a claim of breach of fiduciary duty can be brought on behalf of all subsidiary shareholders regardless of how they voted or whether they accepted payment for their shares. Thus, the economics of the litigation process means 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 as to which appraisal rights are perfected, typically a quite small number. Moreover, the controller can control its potential risk by conditioning its obligation to close the merger on a certain level of shareholder approval. In contrast, in a class action under the *Weinberger* standard, the price exposure extends to all shares acquired through the freeze out merger without the need for shareholders to take any action at all.[25]

[24] 457 A. 2d at 711. Suppose the price is entirely fair, but the process is faulty. To what else are shareholders entitled beyond a fair price?

[25] See Gilson & Black, supra note 1, at 1266-1269. In Andra v. Blount, 772 A.2d 183 (Del.Ch. 2000), Vice-Chancellor Strine confronted the critical procedural consequence of successfully invoking entire

Finally, if the freezeout merger consideration is stock in the controller or stock in any publicly-traded corporation, the minority shareholders have no right to appraisal.[26] 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 a majority of the minority shareholder approval requirement, does the standard of review shift to business judgment and therefore relegate shareholders to their appraisal rights as the *Weinberger* court suggested in footnote 7? 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"?[27] This and related issues were more or less clearly worked out in two Delaware Supreme Court opinions in Kahn v. Lynch Communication Systems, Inc.,[28] 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. There was a perfectly sensible argument that entire fairness review would not apply and shareholders therefore would be remitted to an appraisal remedy if the negotiating structure plausibly protected their interests, as for example, if the merger

fairness review in a freeze out merger in the context of the application of standing as a barrier to entire fairness review. See also Clements v. Rogers, 790 A.2d 1222 (Del.Ch. 2001) (same with respect to acquiescence doctrine).

[26] Del. Corp. Code 262(b)(2). If, however, the controller owns at least 90 percent of the target's stock and uses the shortform merger procedure under Del. Corp Code 253, then the minority shareholders have appraisal rights irrespective of the consideration. Del. Corp. Code 262(b)(3).

[27] 457 A.2d at 711.

[28] Kahn v. Lynch Communications Systems, Inc., 638 A.2d 1110 (Del. 1994)("Kahn I"); Kahn v. Lynch Communications Systems, Inc., 669 A.2d 79 (Del. 1995)("Kahn II").

terms met the approval of a fully empowered independent negotiating committee and if the merger were conditioned upon approval by the majority of the disinterested minority.[29] Where the procedure approximated an arm's length negotiation, no special judicial review would be appropriate, the business judgment standard would apply, and it would follow that the frozen out shareholders would be held to their decision whether to pursue appraisal. Nonetheless, the *Kahn I* court held that adopting such a negotiating structure served only to shift to the plaintiff the burden of proof on the issue of the fairness of the freeze out. The court made clear its belief that the controlling shareholder retains a capacity to influence the minority that cannot be procedurally dissipated – in effect, the implicit threat that if the non-controlling shareholders do not approve the freeze out, the controlling shareholder will exercise its operating discretion to their disadvantage.[30] In *Kahn I* itself the court held that Alcatel coerced the independent negotiating committee set up by Lynch Communications by threatening a tender offer at a lower price if the committee continued to resist, and remanded to the Chancery Court to determine the transaction's entire fairness.

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

[29] See, e.g., In re TransWorld Airlines, Inc. Shareholders Litigation, 1988 WL 111271 (Del. Ch. 1988), rerpinted in 14 Del. J. Corp. L. 870, 883 (1989) (Allen, Ch.).

[30] "The controlling stockholder relationship has the 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." 638 A.2d at 1116. 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.

allow the creation of a fully empowered negotiating committee if all it gets is a burden shift? Unless the evaluation of price is somehow different – though now not subject to business judgment review – as a result of procedural protections, what is in it for the controlling shareholder?

On remand, the Chancery Court found the transaction satisfied both the fair dealing and fair price components of the entire fairness review. 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 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. 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 . . . ."[31]

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 is to the presence and true empowerment of an independent

[31] 669 A.2d at 86.

negotiating committee.[32] 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. 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 – to put the matter somewhat less than sympathetically, is fair dealing satisfied despite an unfair but not structurally coercive procedure?[33]

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 to dissipate the specter of coercion? Here the answer remains opaque, largely because of the court's continued insistence on the "non-bifurcated standard of *Weinberger*."[34] There is, however, a specter of judicial coercion with respect to the link between procedure and price. Although *Weinberger* eliminated the free option associated with the prospect held out in Lynch v. Vickers Energy Corp.[35] that failing the entire fairness standard exposed the controlling shareholder to the equitable remedy of the monetary equivalent of rescission,[36] and the court in the seemingly endless *Technicolor* litigation read the appraisal standard in §262 to include significant elements of post-transaction value,[37] *Weinberger* continued to hold out the

[32] How to design a fully empowered independent negotiating committee is itself an interesting issue. See Gilson & Black, supra note 1, at 1304.

[33] A violation of the duty of candor does appear to result in a per se failure of the entire fairness standard.

[34] 669 A.2d at 90. The court's reference to "a disciplined balancing approach" in the following paragraph appears to contemplate an undisciplined trade off between procedure and price that seems to assure the continued pattern of full litigation of every freeze out transaction.

[35] 429 A. 2d 497 (Del. 1981). See Gilson & Black, supra note 1 at 1268-69 (option like effect of differing damage standards in appraisal and entire fairness proceedings).

[36] 457. A2d at 703-04, 714.

[37] Cede & Co. v. Technicolor, Inc., 684 A.2d 289 (Del. 1996).

prospect of equitable relief beyond the appraisal standard.[38] 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 extraction of private benefit 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 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 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 there is either an observable risk that the purchaser of control will exceed the level of

[38] 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."

allowed private benefits from operation or where 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 governing the extraction of the capitalized value of the private benefits of control through freezing out the non-controlling shareholders are both complex and restrictive. This is because, unlike a sale of control, non-controlling shareholders will not automatically participate in any increase in value as a result of the freeze out. This results in an incentive 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.[39] It also can leave the non-controlling shareholder 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 assure that the non-controlling shareholders receive some portion of the gain that would result from bargaining in a bilateral monopoly.[40]

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

[39] *Sinclair* would not restrict poor decisions that reduced value generally. To the extent the effects of such decisions are reversible, the potential for manipulation is real.

[40] There is no obvious reason to believe that giving all the gain to one side or another in a bilateral monopoly is necessary to achieve the efficient level of transactions. From the perspective of either participant, any value above the reservation price is a rent. Lucian Bebchuk and Alan Schwartz discuss this issue in the takeover context in an interesting, albeit lengthy, debate. See Alan Schwartz, Search Theory and the Tender Offer Auction, 2 J.L. Econ. & Org. 229 (1986); Lucian Bebchuk, The Case for Facilitating Competing Tender Offers: A Last (?) Reply, 2 J.L. Econ. & Org. 253 (1986); Alan Schwartz, Bebchuk on Minimum Offer Periods, 2 J.L. Econ. & Org. 271 (1986); Lucian Bebchuk, The Sole Owner Standard for Takeover Policy, 17 J. Legal Stud. 197 (1988); Alan Schwartz, The Sole Owner Standard Reviewed, 17 J. Legal Stud. 231 (1988).

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 the other alternatives begins to get out of line, transaction planners move quickly in that direction, so that the Delaware Chancery Court sees the implications of its previous decisions quickly and are promptly given the opportunity to adjust.[41] We also do not assert that the pattern necessarily reflects a fully efficient equilibrium that can be reflected in complex equations. Rather, we believe 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 viability of the overall structure should not, however, suggest that we believe the Delaware courts always get it 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 make suggestions as to how they can be rectified.[42]

[41] Gilson & Black describe "this 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 had to confront the 'next case' on a motion for preliminary injunction soon after the initial decision." Gilson and 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. As we will see, this explicit interaction between case law and transaction structure is plainly visible in the *Siliconix* line of cases we discuss in this Part.

[42] 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.

In this Part, we focus on what we believe are two such glitches that are central to the symmetry we developed in Part I. The first, the Chancery Court decision in In re Digex, Inc. Shareholders Litigation,[43] deals with the rules governing private benefit extraction through the sale of control, and the second, the *Siliconix*[44] line of cases, 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 suggest that, in each, the Chancery Court is moving in the wrong direction. In particular, *Digex* threatens to interfere with the controller's right to hold on to a control premium in the sale of control, and *Siliconix et al* threatens to reduce the minority's protections in freeze out transactions.

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 and Global Crossing to acquire Intermedia Communications, Inc., a telecom 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. …"[45] WorldCom won the contest, having made clear "that WorldCom would outbid anyone for Digex."[46] The legal issues were posed by the conflict between Intermedia shareholders and Digex shareholders over which group would receive the WorldCom stock that would be the consideration in the acquisition.

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

[43] In re Digex Shareholders Litigation, 799 A.2d 1176 (Del. Ch. 2000).
[44] In re Siliconix Inc. Shareholders Litigation, 2001 WL 716787 (Del. Ch. June 2001).
[45] 789 A.2d at 1181.
[46] 789 A.2d at 1184.

decided to acquire control of Digex indirectly by acquiring Intermedia. The two alternatives had dramatically different impacts on Intermedia and Digex, at least in the first instance. If WorldCom acquired Intermedia, its shareholders received the control premium associated with Digex. Alternatively, if WorldCom acquired Digex, the control premium would be shared between Intermedia and Digex's non-controlling shareholders.[47]

After some initial uncertainty, WorldCom decided to proceed by acquiring Intermedia, thereby succeeding to Intermedia's control of Digex.[48] Neither Digex nor its shareholders would be a party to the transaction.

There was, however, one rub. WorldCom wanted the Digex board of directors, composed of four Intermedia representatives and three independents, to grant WorldCom a waiver of Del. Gen. Corp. Law § 203, Delaware's business combination statute. This provision prohibits an acquirer of more than 15 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 of directors preapproves the acquirer's initial share acquisition or another exemption applies.[49]

[47] 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 a comparatively small or no ownership in Digex. 789 A.2d at 1181 n.5.

[48] The plaintiffs claimed, and the Chancery Court devoted substantial attention to determining whether, Intermedia had somehow taken a Digex corporate opportunity by diverting WorldCom's initial interest in acquiring Digex to an acquisition of Intermedia. While the Chancery Court correctly held that Digex had no opportunity because of Intermedia's control, we think the court made the issue harder than it need be. So long as no acquisition of Digex could occur without Intermedia's approval, the manner in which it 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 should hardly turn on invariably conflicting evidence of the terms of the actual conversation. Since Intermedia had the uncontested right to decline to go along with a Digex acquisition, any further inquiry on this point should be unnecessary.

[49] Intermedia claimed that another exemption applied, for acquisitions in which the acquirer went from less than 15 percent to more than 85 percent of the voting stock of the target company. Del. Gen Corp.L. § 203(a)(2). The problem was that Intermedia held only 52 percent of Digex's equity but 94 percent of its

This 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 §203?

At the Digex board meeting held to consider the waiver, the board voted 4 to 3 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.[50] The vote broke down along party lines. After the four Intermedia-affiliated directors rejected the position advanced by counsel to the independent directors that they not participate in the discussion and not vote on the waiver due to their conflict of interest, they voted in favor of the waiver, while the three independent directors voted against.

Because the Intermedia-affiliated directors were hopelessly conflicted, the court treated the §203 waiver as a straightforward interested transaction between a parent and subsidiary to which the entire fairness doctrine applied. It was at this point that the analysis got interesting. Although Intermedia could sell control of Digex without Digex's participation, it could not grant a waiver of §203 without action by the Digex board. This changed the position of the parties. As the court put it, "the waiver had value and granted some degree of bargaining leverage to Digex."[51] The failure on the

voting power. Thus, if the statutory term "voting stock" referred to voting power, then WordCom's acquisition was exempt from §203 and the issue of whether the Digex board properly waived § 203 was irrelevant. Alternatively, if the statutory percentage referred to ownership of the target's equity, a Digex board waiver would be necessary. The Chancery Court held that the statute required the acquirer to reach an 85 percent equity position to be exempt, making the board waiver central.

[50] 789 A.2d at 1209.

[51] *Id*. at 1205.

part of the Intermedia members of the Digex board to exert this leverage on behalf of Digex non-controlling shareholders was then held to violate the entire fairness standard.

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 easier. While there were acknowledged advantages to Digex from substituting WorldCom for Intermedia – this was the prototypical transaction where sale of control resulted in an improvement for the non-controlling shareholders[52] – it would have been hard 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 §203, then nothing changes. If it does, then the bargaining becomes three-way. This may be an unintended consequence of §203, but in that event the legislature is free to amend the statute.

A more serious problem arises if *Digex* is something more than an artifact of §203. A realistic view of the transactional realities of selling control 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.

[52] "Plaintiffs do not dispute that WorldCom is 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." 789 A.2d at 1213.

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 non-disclosure agreement,[53] surely an unnecessary condition if the information whose disclosure was necessary to the transaction moving forward was public. This information, however, could come from only two sources: from the controlling shareholder who would have received it 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 American Law Institute's Corporate Governance Project frames 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.[54] 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 §203 waiver in *Digex*.

While one can imagine a range of accommodations made by the controlled corporation, like facilitating due diligence, that are transactionally necessary or helpful to

[53] 789 A.2d at 1182.
[54] Principles of Corporate Governance, supra note 16, §5.11.

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, as a showstopper. Unless the acquirer needs access to the controlled corporation's assets, for example to provide security for the financing to acquire the takeover, the inability to do a freeze out merger for a three-year period is not an insurmountable barrier.[55] In the hostile takeover environment, the role of § 203 and other anti-takeover statutes were largely marginalized by the poison pill,[56] which stops a hostile transaction much earlier in the process than the second-step transaction.

In the context of a sale of control, the poison pill can provide dramatically more than the "some degree of bargaining and leverage"[57] that Chancery Court found §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, than it 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)[58] over the controlling shareholder's sale of control. Now that is leverage.

Analysis of 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

[55] For example, §203 does not prohibit any post-acquisition transaction with a third party, leaving the potential for a bust up takeover in place.

[56] See Gilson & Black, supra note 1, at 1399.

[57] 789 A.2d at 1205.

[58] See Ronald J. Gilson, Unocal Fifteen Years Later (And What We Can Do About It), 26 Del. J. Corp. L. 491 (2001); Martin Lipton & Paul K. Rowe, Pills, Polls and Professors: A Reply to Professor Gilson, 27 Del. J. Corp. L. 1 (2002); Ronald J. Gilson, Lipton & Rowe's Apologia for Delaware: A Short Reply, 27 Del. J. Corp. L. 37 (2002).

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 the failure to use the §203 lever was likely to fail this standard, despite the acknowledged advantages to Digex of a WorldCom acquisition of Intermedia, then so too would the failure to adopt and exert the leverage of a pill.[59]

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 shareholder, we argued that the permissive sale of control standard was appropriate. Certainly nothing in *Digex* speaks to that issue, and our analysis counsels that the Chancery Court's approach in *Digex* is leading 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.[60] The poison pill makes the conflict between *Digex*

[59] While *Household International* (Moran v. Household International, Inc., 500 A.2d 1346 (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 the Chancery Court has developed in connection with non--*Revlon* takeovers – 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.

[60] As we will see in our discussion of the *Siliconix* line of cases, the specter of having to apply the poison pill in contexts other than in defending against a hostile bid 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

and a permissive sale of control standard more pointed but, as illustrated by our analysis of the application of *Digex* to transactional due diligence, 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 would be willing to pay, a permissive sale of control standard is appropriate. Encouraging control sales benefits non-controlling shareholders because, subject to the monitoring payment *Sinclair* allows, they participate ratably in any post-transaction increases in value.[61] This 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[62] for heightened review as whether the "parent has received a benefit to the exclusion and at the expense of the subsidiary."[63] 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

between shareholders and management. That position was rejected. The role of the pill in sale of control and freeze out settings that we explore here illustrates that structural concern in two additional contexts.

[61] See TAN 17-19 supra.

[62] 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 (1992).

[63] 280 A.2d at 720.

holdup device for which the symmetry of doctrine provides no support. The same analysis would apply to the controlled subsidiary's decision whether to adopt a poison pill directed at the sale of control.[64]

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 disclosing an anticipated sale of control.[65] 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.

That leaves for assessment only the precise issue posed in *Digex*: the application and waiver of §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 given the controlled corporation a bargaining lever, a *Sinclair* analysis dictates that it be used. In our view, the application of §203 to a sale of control by an existing controlling shareholder is an unnecessary spillover of the apparatus of takeover

[64] 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 of Mendel v. Carroll, 651 A.2d 297 (Del. Ch. 1994).

To at least one of the author's dismay, the Corporate Governance Project is ambiguous on the conflict between §5.11 (Use by a Controlling Shareholder of Corporate Property, Material Non-Public Corporate Information, or Corporate Position) and §5.16 (Disposition of Voting Equity Securities by a Controlling Shareholder to Third Parties). While parsing the black letter of both sections would fairly give one pause, at least the commentary to §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."

[65] See TAN 19 supra.

defenses into non-takeover contexts, but fixing the boundaries of §203 is properly a chore for the legislature.[66] In the meantime, the limited range of post-acquisition transactions to which §203 applies at least cabins the problem.[67]

[66] We have some sympathy for the argument that the §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 §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.

[67] 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 (Del. 2000) poses the irony of a potentially higher standard when the controlling shareholder allows the minority to participate ratably in a control sale than when the minority is excluded. In *McMullin*, a controlling shareholder negotiated the sale of the entire corporation with all shareholders receiving the same price. 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 concerning whether the transaction price exceeded the subsidiary's going concern value and thereby not being in a position to discharge its disclosure obligation to minority shareholders who had to decide whether to seek appraisal. While there is a real puzzle concerning why the directors could not reasonably rely on the judgment of the controlling shareholder given that the controlled 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 v. NCS Healthcare, Inc., 818 A.2d 914 (2003) limits the ability of a shareholder with majority voting power to irrevocably commit itself 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 financial distress, indeed, insolvency, through a proposed merger with Genesis Health Ventures, Inc. Genesis was unwilling to play a "stalking horse" role and sought to lock-up the transaction. The two dominant shareholders (66 percent of the voting power but only 20 percent of the equity) displayed their commitment to the transaction by entering into a voting agreement with Genesis committing them to vote for the merger while knowing that the NCS board had approved a compulsory shareholder vote on the merger and left no fiduciary "out" in the merger agreement. All shareholders were to receive identical per share consideration. A divided Supreme Court held that the resulting lock-up 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 to protect the existing transaction

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 emerge from dual class capital structures. In *Digex* Chancellor Noble was obviously troubled by the gap between Intermedia's 94% voting power but its 52% equity interest. Similarly in *Omnicare*, the Court noted with distaste that a decision by holders of 20% of the company's equity, albeit 66% of the voting rights, could bind the remaining public 80% to a decision that they now could not oppose. 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 were, like those in *Digex,* conflicted concerning whether they should block the controlling shareholders' efforts to impose a control transaction. As suggested in Mendell v. Carroll, 651 A.2d 297 (Del. Ch. 1994), a "true" controlling shareholder might have received greater deference

Moreover, the mismatch 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

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 shareholders' freeze out of non-controlling shareholders because, unlike in a sale of control situation, non-controlling shareholders will not automatically participate 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 recent Chancery Court tightening of the standards governing sale of control is ill-advised; in the case of the standards governing freeze outs, the same symmetry suggests that 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 stating 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; all that shifted was the burden of proof. In response,

quite differently by the public shareholders (diversified, therefore risk neutral) and the controllers (undiversified, therefore risk averse). Cf. Credit Lyonais Bank Nederland, N.V. v. Pathe Communications Corp. 1991 WL 277613, *34 n.55; 17 Del. J. Corp. Law 1099, 1155 n.55 (Del. Ch. 1991) (creditor vs. shareholder decisionmaking on the brink of insolvency).

Of course, nothing in the Supreme Court's opinion directly turns on this distinction, although the facts clearly suggest it. Such uneasiness about voting rights that are disproportionate to equity is reflected in the current version of the European Union's proposed Thirteenth Directive on Takeovers, although the proposal would not extend to eliminating the kind of disproportionate voting rights present in *Omnicare.* See The International Relations Wedge in the Corporate Convergence Debate, in Jeffrey N. Gordon & Mark J. Roe, eds, CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE (forthcoming 2004).

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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 holding in Solomon v. Pathe Communications[68] that a shareholder with voting control over 89.5 percent 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.[69] Suppose a controlling shareholder held 80 percent of the controlled corporation's outstanding stock, and desired to freeze out the minority. If it proceeded straightforwardly with a one-step freeze out merger, the transaction would be subject to entire fairness review under *Weinberger*, in effect a class action appraisal process with respect to price. 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[70] and, perhaps, a commitment to take out any non-tendering shareholders in a short form merger at the same price, to insure the offer was not coercive. *Solomon* is commonly read to dictate that this offer would be free from entire fairness review.[71]

[68] 672 A.2d 35 (Del. 1995).

[69] "[I]n the absence of coercion or disclosure violations, the adequacy of the price in a voluntary tender offer cannot be an issue." 672 A.2d at 40.

[70] In this hypothetical, the satisfaction of a majority of the minority condition would assure that the controlling shareholder would reach the 90 percent level necessary to a short form merger. If the controlling shareholder's pre-transaction holdings were less than 80 percent, then an additional closing condition would be required: that sufficient shares be tendered that the controlling shareholder would own 90 percent of the outstanding shares after the transaction closed.

[71] 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 Supreme Court opinion, 472 A.2d 35,39, and the lower court opinion, 1995 WL 250374, *5 (Del. Ch. 1995) (Allen, C), emphasize that the transaction was not a freezeout. As the text that follows relates, *Solomon* was read broadly without acknowledgement or justification of the extension.

Next, the controlling shareholder effects a short-form merger under §253, which requires neither a shareholder vote, nor the approval of the controlled corporation. Under Glassman v. Unocal Exploration,[72] appraisal is the exclusive remedy for allegations of price unfairness in a short-form merger. 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 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 its assessment of the appraisal standard. Even if its 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 In re Siliconix Incorporated Shareholders Litigation.[73] In this case Vishnay Intertechnology, Inc. sought to acquire the roughly 20 percent of the stock of Siliconix Incorporated that it did not own. 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

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. The Chancellor found that there was no valid basis to resist the foreclosure. The tender offer to public minority shareholders – whose stock would be valueless after foreclosure of the sub's stock – was in effect a means to buy off any potential holdup 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.

[72] 777 A.2d 242 (Del. 2001).

[73] 2001 WL 716787 (Del. Ch. 2001).

directors, Vishnay ultimately lost patience when the special committee proved more independent than Vishnay expected. It then substituted a stock for stock exchange, with a majority of the minority condition, and plainly stopped worrying about the special committee's views. The special committee advised Vishany that it was unlikely to approve the terms of the exchange offer, but in its Schedule 14d-9 made no recommendation concerning the offer and did not ask its financial advisor for a fairness opinion. It was the exchange offer that was before the court on a motion for preliminary injunction.

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 freezeout. The court also held that the Siliconix directors did not breach a duty of care or loyalty to minority shareholders by failing to evaluate Vishnay's offer and by failing to provide shareholders with their evaluation and recommendation.

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 Vishnay 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… .[74]

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

[74] 2001 WL 716787, *7 (Del. Ch. 2001).

> "[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 … .[75]

This account of the role of the board 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.[76] 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; then shareholder choice advocates argued that target management could not act, ostensibly on behalf of shareholders, to block a tender offer, because the statute assigns them no explicit role.

Of course, the shareholder choice advocates lost that battle. In *Unocal*, 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."[77] As the court put it, even in a tender offer "a board of directors is not a passive instrumentality."[78] The Supreme Court then went one step further in *Household International*.[79] Making sure that the target board of directors had the means to act effectively in opposing a

[75] Id.

[76] 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.").

[77] Unocal Corp. v. Mesa Petroleum Co, 493 A.2d 946, 949 (1985) (emphasis added).

[78] 493 A.2d at 954.

[79] Moran v. Household International, Inc., 500 A.2d 1346 (1985).

tender offer the board thought 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.

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 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 does not consider, or does 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.[80] This, of course, is precisely the determination a court has to make under

[80] Ted Mirvis has suggested 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 in a freeze out control had transferred long before. While we cannot quarrel with the 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?

Weinberger, which *Siliconix* says does not apply to freeze out tender offers, a nice closing of a doctrinal Moebus strip. 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 20 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.[81] 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. But *Aquila* does go somewhat further in approving a passive role for the target board. The conflicted directors (there were no independent directors) were allowed to discharge their duty of loyalty to the non-controlling shareholders by doing essentially nothing. 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,"[82] 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,"[83] and the court plainly shared this assessment. 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

[81] 805 A.2d 184 (Del. Ch. 2002).
[82] 805 A.2d at 191.
[83] *Id*.

conflicted directors in *Weinberger*.[84] Even where the controlling 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 that the court in *Weinberger* stressed the fact that Signal believed the non-controlling shares of UOP were a "good investment"[85] at a price up to $24 a share, but offered only $21. 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*[86] like passivity (whether motivated by inattention or conflict) can satisfy the target board's duty of loyalty.

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. The target corporation in *Aquila* had a remarkably high percentage of institutional investors. Ninety-four institutions held more than 80 percent of all publicly held shares and 22 institutions accounted for a majority of such shares. 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. 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

[84] Weinberger stressed "the long-existing principle of Delaware law that [the controlling shareholder] *designated* directors on [the controlled corporation's] board still owed [the controlled corporation] and its shareholders an uncompromising duty of loyalty. 457 A.2d at 710.
[85] 457 A.2d at 705.
[86] Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

accept too low a price for their shares.[87] In the context of hostile tender offer doctrine, substantive coercion is offered as a justification for defensive action even against a structurally non-coercive 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.[88]

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. 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."[89] As in *Siliconix*, the same element was treated differently in connection with a freeze out tender offer than it would be in a hostile tender offer, at least by the Delaware Supreme Court.[90]

[87] The Delaware Supreme Court first adopted this term in Paramount Communications v. Time, 571 A.2d 1140, 1157 (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).

[88] This was plainly the case in Unitrin, Inc. v. American General Corp., 651 A.2d 1361 (Del. S.Ct. 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 fact that institutional investors held 42 percent of Unitrin's stock and that 33 percent of Unitrin's stock was held by only 20 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 Chesapeake Corporation 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….")

[89] 805 A.2d at 195.

[90] The formal thinness of the distinction between the transactional forms is demonstrated by Hartley v. Peapod, Inc., C.A. No. 19025 (Del. Ch. Feb. 27, 2002), in which the court held that a merger structured as a two step transaction – a tender offer followed by short form freezeout – is subject to the Kahn v. Lynch entire fairness regime. . As a formal matter, the case follows In re Unocal Exploration Corp. S'holders Litig., 793 A.2d 329, 339, n. 26 (Del. Ch. 2000), *aff'd*, Glassman v. Unocal Exploration, supra, 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 one without such a bargaining agent.

Our analysis to this point suggests that the Chancery Court's recent treatments of the restrictions on controlling shareholders extracting private benefits of control through freezeouts have moved in the wrong direction. 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, without confronting the doctrinal inconsistencies and transactional incentives the two cases create.

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, were finally addressed in the Chancery Court's opinion in In re Pure Resources, Inc. Shareholders Litigation.[91] *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

[91] 2002 WL 31304145 (Del. Ch. 2002)

board's special committee. 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.[92] Once properly framed, and given the conspicuous opportunity to makes 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, it would have been difficult for a thoughtful judge 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: that between *Solomon* and *Kahn I* and *Kahn II* over the standards that apply to a controlling shareholder's freeze out of non-controlling shareholders; and that between the standards that apply to a target board responding to a freeze out tender offer and to a hostile tender offer. Properly understood, we think the *Pure* resolution is an important, but still incomplete, step toward restoring a desirable coherence in this area. Our goal here is two fold: first, to highlight where that step leads, both in terms of the convergence of elements of the freeze out tender offer and the freeze out merger standards, and in the potential convergence of the target board's duties in the face of 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 potential for convergence of the standards for freeze out mergers and freeze out tender offers arises from the simple fact that 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 treatment in earlier cases, *Solomon*

[92] Unfortunately, the special committee backed down without explanation and, to the court's annoyance, declined to waive the attorney-client privilege to allow inquiry into what legal advice the committee was given on this issue. 808 A.2d at 431-32.

simply is not doctrinally determinative. *Solomon*'s limits become clear if we recognize that a freeze out tender offer implicates the entire fairness standard in two different ways.[93] 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"[94] is the fiduciary duty of the controlling shareholder. 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.[95] Thus, *Solomon* plainly leaves open the potential for convergence between the standards governing freeze out mergers and freeze out tender offers along two dimensions: through a more careful explication of what *Solomon* actually holds with respect to the obligation of a controlling shareholder in

[93] We have noted earlier that *Solomon* itself did not involve a freeze out tender offer. See note 71 supra. 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.

[94] 672 A.2d at 39.

[95] 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 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." 672 A.2d at 39. 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, 672 A.2d at 39, which focus only on the controlling shareholder's duties and which predate the clarification of board duties in a takeover scenario that began with *Unocal.*

making a freeze out tender offer, and of the obligation of target directors in responding to one. *Pure* takes up the task along both fiduciary dimensions.

A. Convergence in the Standards Governing Freeze Out Mergers and Freeze Out Tender Offers.

After expressing skepticism of the substantive justifications for treating these two freeze out techniques differently, *Pure* makes use of a small doctrinal slight of hand to increase and make explicit a controlling shareholder's obligations in structuring a freeze out tender offer. 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 non-coercive. *Pure* imposes additional requirements on freeze out tender offers by detailing – and expanding—the conditions that must be met for an offer to be non-coercive. A freeze out tender offer by a controlling shareholder will be non-coercive, and therefore will satisfy the controlling shareholder's fiduciary obligations under *Solomon*, only if (i) the offer is subject to a non-waivable majority of the minority tender condition, (ii) the controlling shareholder commits to consummate a short form merger promptly after increasing its holdings above 90 percent, (iii) the controlling shareholder has made no "retributive threats,"[96] and (iv) the independent directors are given complete discretion and sufficient time "to react to the tender offer, by (at the very least)"[97] hiring their own advisors,

[96] 808 A.2d at 445. This condition reflects *Pure*'s interesting discussion of the difference between structural coercion – coercion resulting from the terms of the tender offer – and yet another species of coercion: inherent coercion, the power of the controlling shareholder, the 800-pound gorilla is the court's term, to impose costs on non-controlling shareholders through its operation of the company if the non-controlling shareholders reject the freeze out tender offer. Here recognition of the extent to which *Sinclair* restricts a vengeful response to rejection would have been helpful.

[97] *Id.*

providing a recommendation to the non-controlling shareholders, and disclosing adequate information to allow the non-controlling shareholders to make an informed decision [98]

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. This requires both the controller's permission for such activity and the target board's undertaking of it. In this sense *Pure* substantially modifies *Siliconix* and *Aquila*, which would permit target board passivity.[99] *Pure*'s broad interpretation of "coercion" is consistent with Delaware jurisprudence in the hostile bid area, in which "substantive coercion" – bid pressure that might induce target shareholders mistakenly to accept a low-ball offer – constitutes a "threat" that justifies a target board response much like "structural coercion" – bid pressure that arises from a structure that exploits shareholder collective action problems. In the freeze out

[98] To be explicit, we read this open-ended invitation to action as arising from *Pure*'s use of the parenthetical phrase "at least" to modify its list of what directors require the time and discretion to accomplish. 808 A.2d at 438.

The *Pure* court's insistence on detailed disclosure of the investment bank's valuation work-up 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 Rule 13e-3(g)(2). 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…" Sec. Exch. Act. Rel. No. 16075 (Aug. 2, 1979), reprinted in Gilson & Black, supra, note 1, at 1310. This 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 have mainly been exchange offers to avoid both the detailed disclosure requirements of the federal rule but perhaps more crucially, specific disclosure as to whether the parent "reasonably believes that the Rule 13e-3 transaction is fair or unfair to unaffiliated security holders" and "in reasonable detail, the material factors upon which [that] belief is based." Schedule 13E-3, Item 8(a),(b). So unless the state fiduciary law is appropriately crafted, conrolling shareholders will shift from mergers to exchange freeze out tender offers, and "fairness" will drop out of such transactions altogether.

[99] Pure's framework in this regard now seems established as the law of the Delaware Chancery Court. See Next Level Communications, Inc., 2003 WL 549083 (Ch. Feb. 2003) (acceptance by the *Aquila* judge). As a matter of practice, target boards are taking a more energetic role in freeze out tender offers. See Robin Sidel, "Takeover Targets Force Up Offers in 'Minority Squeeze-Out' Deals, Wall St. J., May 10, 2002, at C.23.

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 as to 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 component of *Weinberger*, the burden of proof shifts to the plaintiff with respect to fair price.[100] Most important, 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. Under *Pure*, in contrast, there is no mention of a right to say no. *Pure* accepts the fact that the controlling shareholder may go over the special committee's objection to the minority shareholders.

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 refuse to approve 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.[101] On the other hand, nothing in *Kahn I* suggests that the special

[100] We recognize that this is operational shorthand for the murky statements in *Kahn I* and *Kahn II*. See TAN 28-38 supra.

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

committee that rejects the merger is obligated to try to block a subsequent tender offer.[102] 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,[103] *Pure* operates as something of a functional alternative. In both cases the board can thoroughly examine the bid, propose alternatives, advise shareholders, but ultimately the matter is for shareholder choice.

On this dimension, then, there is only a narrow gap between *Kahn* and *Pure* in the consequence of board exercise of this time-limited veto. In *Pure,* the controlling shareholder's fiduciary test is whether it can demonstrate, through satisfaction of the anti-coercion litany, that the shareholders have not been "coerced."[104] *Kahn II* achieves a similar result in the freeze out merger, at least as to the "fair dealing" prong of entire fairness. Because the *Kahn* 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.[105]

We are then we are 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

[102] 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* pill, than in the case of an uncontrolled company. At least in an uncontrolled company, the 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.

[103] In *Interco*, 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. When those tasks were completed, the shareholders were then free to accept or reject the hostile offer. By an *Interco* pill, we mean a poison pill that must be redeemed when these tasks have been completed. See Gilson, Lipton and Rowe's Apologia for Delaware, supra note 58, at 47.

[104] We think it is a fair (but admittedly not the only) reading of the opinion to think that the burden of proof is on the defendants with respect to the anti-coercion litany. Moreover, the *Pure* litany seems a pretty good metric for determining whether the shareholders are actually coerced.

[105] Because of the dearth of description of why the shareholders were not coerced, one has to take the Supreme Court's finding largely on faith.

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.[106] The measure of value would be essentially the same under *Pure* since, if the anti-coercion litany is satisfied, plaintiffs are relegated to their appraisal remedy, and if it is not, then the entire fairness standard applies in any event.

The procedural difference, however, is critical. As we have stressed, an entire fairness proceeding under *Weinberger* and *Kahn I* and *Kahn II* provides the equivalent of a class appraisal proceeding, without the need for shareholders actually to perfect their appraisal rights.[107] In contrast, if the *Pure* anti-coercion litany is met, shareholders have to 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.

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. At this point, *Pure* makes apparent its preference for how to resolve this 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."[108] In particular, the opinion suggests

[106] 457 A.2d at 714.
[107] See TAN 24-25.
[108] 808 A.2d at 444.

business judgment protection when a transaction meets a high process standard.[109] Freeze out mergers then would be treated the same way as freeze out tender offers after *Pure*: if anti-coercion standards were met, minority shareholders would be relegated to the appraisal remedy to challenge value.[110]

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,[111] but there is an alternative to reconsidering *Kahn I*. The court could

[109] That result, we note, is roughly consistent with the approach recommended by the ALI Corporate Governance Project which makes appraisal exclusive 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." Corporate Governance Project, supra note 16, §7.25(a).

[110] It is possible that the fall out from Sarbannes-Oxley may impose a harmonization of *Kahn I*, at least with respect to NASDAQ listed companies. Under the proposed amendments to the NASDAQ rules following Sarbannes-Oxley, all companies are required to have a majority of independent directors and compensation, nomination and audit committees made up only of independent directors. SR-NASD-2002-141: Amendments to Rules 4200 and 4350 Regarding Board Independence and Independent Committees (Oct. 9, 2002). In the case of a controlled corporation, the requirements of a majority of independent directors and independent only compensation and nominating committees do not apply. However, as the description of the proposed rules makes clear, the "controlled corporation exception does not extend to the audit committee requirement [only independent directors] under Rule 4350." The proposed Rule 4350(h), dealing with conflicts of interest, then requires that all related party transactions "must be approved by the company's audit committee or another independent body of the board of directors." SR-NASD-2002-80, Amendment No. 1 (Dec. 30, 2002). If a freeze out merger is a related party transaction, then the audit committee of a NASD listed company has the absolute right to block a freeze out transaction; i.e., *Khan 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 Chancery Court's handling of freeze out tender offers will increase, and a reassessment of *Solomon* seems only more compelling.

[111] This is not simply a matter 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 Electronics, Inc., 188 A.2d 123 (Del. 1963). Rather, this inconsistency between P*ure* 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 refused the merger and the controlling shareholder proceeded 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 of 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, 1993 WL 29013 (Del. Ch. 1993), reversed on other grounds, 638 A.2d 1110 (Del. 1994) (Chancery Court opinion in *Kahn I*) (sharply criticizing one of the independent directors for voting in favor of the merger even though he did believe that the price was fair: "The fact that the alternatives to Alcatel's overture were

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, that the supreme court has not yet endorsed.[112] 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 entire-fairness 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. An appraisal proceeding puts the court in a quite difficult position. *Weinberger* instructed the Chancery Court to apply modern financial techniques to establishing the value of the stock in a freeze out to the end of eliminating the arbitrariness of the old Delaware block method. 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, 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.[113] It is hardly surprising,

limited does not mean that the Independent Committee should have agreed to a price that was unfair," id. at *4.) In other words, it is not simply that the *Kahn/Pure* inconsistency is unaesthetic, but that it will whipsaw the target board and potentially deprive shareholders of relevant information.

[112] See note 71 supra and TAN 92-95 supra.

[113] 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 or Vice 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 (2003)(empirical evidence on diverse valuation methodologies).

then, that the *Pure* court favors giving the parties and the court a process based alternative.[114]

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 companies to establish an audit committee and requires that the audit committee be comprised solely of "independent" directors.[115] The proposed NYSE corporate governance proposals elaborate and strengthen this standard. Although the proposed rules exempt controlled companies from a 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. The NYSE's "independence" standard would require

[114] Former Chancellor, now Professor, William T. Allen made this point persuasively in a comment at the symposium at which an earlier draft of this article was presented. Since Professor Allen presided over the valuation process in the *Technicolor* litigation, 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 the Matter of the Appraisal of Shell Oil Co., 607 A.2d 1213, 1222-23, 1223n.3 (Del.S.Ct. 1992)(inviting 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 of such an expert would serve to reduce the distance between the experts' valuations much as does "baseball" or "final offer" arbitration. These techniques contemplate that the arbitrator has to select without adjustment whichever of the two parties' valuation is in the arbitrator's judgment most reasonable. See Mediators, Inc. v. Manney, 2003 WL 203186*2 (S.D.N.Y. 2003); 1 CPR MAPP 2:2 (CPR Model ADR Procedures and Practices (MAPP) series 1008 Vol. 1. ADR Glossary Private ADR Processes. 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. The point of the procedure is to eliminate the incentive for extreme valuations. While in the arbitration context the judge must make her own determination, it is reasonable that the parties will assume that the court appointed expert is unlikely to credit extreme valuations and that the court likely will 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.

[115] "In order to be considered 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."

Section 10A(m) of the Securities Exchange Act of 1934, 15 U.S.C. 78f(m), as added by Section 301 of the Sarbanes-Oxley Act of 2002.

a board determination that the director in question had no "material relationship" with the listed company and includes a 5 year cooling off period for many of the most common kind of prior connections that might undermine independence.[116] The NYSE would also add special independence requirements for audit committee members that exclude any compensation for consulting, financial, or legal services, that require "financial literacy" by all audit committee members, and that require at least one member to have "accounting or financial management expertise."[117] Thus in most future parent-subsidiary freeze out situations, the special committee is almost certain to consist of directors of much greater independence in fact and perhaps more financial sophistication, that has been commonly the case in the past.[118]

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.[119] The hiring of independent financial and legal advisors seems particularly important (and seems to be part of the *Pure* anti-coercion litany), because the specially-retained advisors will have reputational capital at stake and because of the dynamics of competition between the special committee "team" and the management team.

[116] Proposed NYSE Rule 303A(2)

[117] Proposed NYSE Rule 303A(6) and comments.

[118] Similar standards have been proposed by the NASD for NASDAQ-listed companies. See note 110 supra. The potential impact of these new governance standards is apparent even in the small sample of freeze out cases we are discussing. None of the special committee members in *Siliconix* would have been "independent" on either the NYSE standards for general board or audit committee or the Sarbanes-Oxley standard for audit committee. There were no independent board members on the target board in *Aquila.*

[119] See, e.g., Gregory Varallo et al, From Kahn to Carlton: Recent Developments in Special Committee Practice, 53 Bus. Lawyer 397 (1998) (rules are now reasonably well-developed). On the mixed early history of director independence in a prior cycle of going private transactions -- management buyouts -- see William T. Allen, Independent Directors in MBO Transactions: Are They Fact or Fantasy, 45 Bus. Lawyer 2055 (1990).

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 through reconsideration of 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. The gains that result from freezing out minority shareholders require the contribution of both the controlling and non-controlling shareholders, which must be fairly divided between them.[120] Where gain is created by sale of control, pro rata sharing results automatically,[121] 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 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.[122]

Moreover, this approach avoids what would be a troubling inconsistency in Delaware law: that minority shareholders of a controlled company receive less protection when faced with a hostile "internal" tender offer than shareholders 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 institutional investors cannot accept a bid in the face of the board's contrary judgment. The board's

[120] See TAN 8-9 supra.

[121] See TAN 18-19 supra.

[122] It may also seem an odd time for the Delaware Supreme Court to take 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 *McMullen* and *Omnicare* certainly bespeaks increased concern for the interests of minority shareholders. A court that historically has shown sensitivity to general trends in political economy (for example, *Singer v. Magnavox* following *Santa Fe v. Green,* see note – supra*)* may be reluctant to embrace reduced shareholder protection in response to what looks like an end run around previously established fiduciary standards.

arm's length bargaining power and a competitive takeover market protects the shareholders from a low-ball offer. By contrast, an internal tender offer faces no competitive threat from a bust-up bidder, the controlling shareholder might well exploit inside information and timing advantages that would be non-policeable, and at best the target board has an *Interco* pill. 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 in each scenario to make a low ball offer 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 reconsideration of *Kahn* I and 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* litany and the right to say no, is sufficient process that entire fairness review in a freeze out merger can be eliminated. Where independent directors have the power to block a freeze out merger but do not, it is fair to assume that the process sufficiently tracks an arm's length negotiation that shareholders are fairly relegated 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*? This is where 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 its 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 is appropriate (meaning here, "fair price"), 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"[123] shifts from statutory appraisal to class-based appraisal, the conditions of arm's length bargaining are more nearly replicated. This should appeal to the concerns that animate both the *Kahn* court and the *Pure* court.[124]

In summary, this dual reconsideration means that if the *Pure* litany is met and the special committee with the power to "say no" approves, then the business judgment rule applies to the freeze out transaction and minority shareholders are limited to statutory appraisal. If the controlling shareholder chooses to go forward without the special committee's approval, then the transaction is subject to entire fairness review, and minority shareholders have a class based appraisal remedy.[125]

[123] That is, the consequence to the controller of the special committee's non-agreement.

[124] We think the supreme court could also take account of developments since *Kahn I* that may also mitigate some of its concerns about the controller's "inherent coercion" of the minority, including the development in institutional practices and corporate governance rules that buttress the special committee's independence in fact. See TAN 115-118 supra. 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 that diverts attention from the economic judgments to be made.

[125] If the *Pure* litany is not complied with, then entire fairness review is also of course appropriate. We think that controlling shareholders will have ample incentives to facilitate an active special committee process even in cases where it 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 bound that

B. 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 governing the controlling shareholder's obligation in freeze out mergers and freeze out tender offers still leaves the 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) that the target board should have adopted a poison pill.

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 that it do so,[126] we also share the court's conclusion that there should be no

would narrow the range that 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 there would be a lot of evidence on the valuation questions generated from a good faith bargaining effort. Without a special committee process the expert would not be so constrained and thus the controller would face more risk of a high judgment.

We note that other commentators favor extending entire fairness protection to freeze out tender offers although not necessarily adopting our hybrid approach. See Kimble Charles Cannon, Augmenting the Duties of Directors to Protection Minority Shareholders in the Context of Going-Private Transactions, 2003 Colum Bus. L. Rev. 191 (2003); Brian Resnick, Recent Delaware Decisions May Prove to be "Entirely Unfair" to Minority Shareholders in Parent Merger with Partially Owned Subsidiaries, 2000 Colum. Bus. L. Rev. --- (2003).

Experienced Delaware practitioner Frank Balotti and coauthors agree with our the general concerns but would instead revisit *Glassman v. Unocal Exploration* 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 Balotti, and Timo Rehbock, Delaware's Going-Private Dilemma: Fostering Protections for Minority Shareholders in the Wake of Siliconix and Unocal Exploration, 58 Bus. Law. 519 (2003). The legislative proposal in particular has much to recommend it, since it would provide a class-based appraisal remedy, but it may inject the court into valuation disputes that could be better resolved by bargaining through the special committee process that we have outlined.

[126] The court referred to "the rough fairness of the goose and gander rule." 808 A.2d at 446.

blanket “duty on the part of the independent directors to seek blocking power”[127] 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 a tender offer.

In a “just-say-no” regime in which target directors, even after they have investigated, negotiated, communicated, and explored alternatives, still have the right to prevent the shareholders from choosing to accept a hostile tender offer by declining to redeem a pill, there is no coherent case for not demanding that target directors confronting a freeze out tender offer have available the same power. As we have suggested, if anything 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* anti-coercion litany, after which target directors, having acted diligently on behalf of the shareholders, then 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 if 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 response 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

[127] *Id*. The court also holds 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 [a controlling shareholder] to permit the target board to block the bid through use of the pill.” *Id*.

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."[128] Indeed, the 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 non-coercive third-party tender offers."[129] 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 the symmetry of 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 constraints 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 supreme court to finish the task of convergence. In our view, accomplishing that task requires reconsidering both

[128] 808 A.2d at 446.
[129] *Id.* at 446 n.50.

Kahn I and *Solomon*, with the desirable result of restoring the symmetry of the law that controls controlling shareholders.

III. 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 exceeds the costs of the controlling shareholder's private benefits of control. This 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 inappropriately tighten the permissive rules governing sale of control, and that *Siliconix* and *Aquila*, before the useful correction by *Pure*, threatened to inappropriately loosen the restrictive rules governing freeze outs.

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