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## Freeze-out Transactions the Pure Way: Reconciling Judicial Asymmetry between Tender Offers and Negotiated Mergers

Ely R. Levy  
*King & Spalding LLP*

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## **FREEZE-OUT TRANSACTIONS THE *PURE* WAY: RECONCILING JUDICIAL ASYMMETRY BETWEEN TENDER OFFERS AND NEGOTIATED MERGERS**

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*Ely R. Levy\**

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\* Associate, King & Spalding LLP; J.D., Hofstra University School of Law, 2003; B.A., New York University, 2000. The author would like to thank Professor Mark L. Movsesian for his thoughtful comments and suggestions. The author would also like to express his sincere gratitude and appreciation to Sara Levy for her constant encouragement and enduring support.

## I. INTRODUCTION

At the heart of the Delaware corporate common law is the notion that the actions of corporate management enjoy broad ranging deference in nonconflict transactions.<sup>1</sup> Directors and officers are relatively free to transact in furtherance of maximizing shareholder value without being second-guessed by courts.<sup>2</sup> In limited instances, however, where directors and officers are self-interested in a particular transaction, this deference disappears and the directors and officers are generally charged with proving the entire fairness of the self-interested transaction.<sup>3</sup> The Delaware courts have attempted to adapt this fiduciary duty paradigm to develop the contours of the relationship between controlling and minority shareholders, though the relationship has been dubbed “an aspect of Delaware law fraught with doctrinal tension.”<sup>4</sup> This traditional paradigm has been recently challenged.

Recently, the Delaware Court of Chancery has delivered several opinions that have dramatically affected the rights of minority shareholders in public corporations.<sup>5</sup> This Article will examine how this recent case law affects the

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<sup>1</sup> A “conflict transaction” is a transaction that is entered into by fiduciaries that have an interest in the transaction. Thus, fiduciaries, usually corporate management or controlling stockholders, are said to “stand on both sides” of the transaction. See *Williams v. Geier*, 671 A.2d 1368, 1379 (Del. 1996) (stating that these transactions are susceptible to shareholder challenges on fiduciary duty of loyalty grounds); *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 845 (Del. 1985) (describing a conflict transaction as one in which “a majority shareholder stands on both sides of a transaction”).

<sup>2</sup> See *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985) (stating that, absent self-interest, the decisions of corporate management will be shielded by the deferential business judgment rule). Under the business judgment rule, if directors can demonstrate that they made a business decision on an informed basis, in good faith, and without self-interest, the courts will respect the board’s decisions without holding the directors liable for unanticipated losses. See *id.* The business judgment rule promotes several identifiable policies. First, the rule encourages informed risk taking by directors because it shields them from personal liability for honest, good faith decisions. See, e.g., *Joy v. North*, 692 F.2d 880, 885-86 (2d Cir. 1982) (explaining that investors can diversify their portfolios to diminish their risks, and therefore an overly careful approach by directors seeking to minimize risk instead of maximizing gain is not in the best interests of investors). Second, the business judgment rule discourages courts from reviewing business decisions in hindsight. See *id.* at 886 (recognizing that an entrepreneur’s function is to make reasoned decisions with less than perfect knowledge). Lastly, the business judgment rule prevents courts from reviewing the substance of business decisions, a task for which they are not equipped. See *Weiss v. Temp. Inv. Fund, Inc.*, 692 F.2d 928, 941 (3d Cir. 1982), *vacated by* 465 U.S. 1001, *remanded to* 730 F.2d 939 (3d Cir. 1984).

<sup>3</sup> *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

<sup>4</sup> *In re Pure Res. S’holders Litig.*, 808 A.2d 421, 433 (Del. Ch. 2002).

<sup>5</sup> See *id.*; *Glassman v. Unocal Exploration Co.*, 777 A.2d 242 (Del. 2001); *In re Aquila, Inc. S’holders Litig.*, 805 A.2d 184 (Del. Ch. 2002) (refusing to enjoin tender offer on grounds that such offers were voluntary transactions and holding that no fairness duty is to be imposed on parent companies); *In re Siliconix Inc. S’holders Litig.*, No. 18700, 2001 WL 716787 (Del. Ch. June 19, 2001) (involving a challenge of an exchange offer by a controlling stockholder of Sili-

rights of minority shareholders under Delaware law,<sup>6</sup> particularly in the context of freeze-out and going private transactions.<sup>7</sup> Given the onslaught of regulation accompanying the Sarbanes-Oxley Act, the incidence of corporations going private will likely increase.<sup>8</sup> Thus, it is critically important for the Delaware

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conix); *In re Staples, Inc. S'holders Litig.*, 792 A.2d 934, 952 (Del. Ch. 2001) (holding that "[w]hen a board uses sufficient procedural protections — such as independent director approval or a stockholder vote — judicial review of the fairness of an 'interested' transaction may, as a general matter, be obviated").

<sup>6</sup> While cases from other jurisdictions will be discussed, the main focus will be on Delaware courts as Delaware has long been recognized as the leading jurisdiction in dealing with issues of corporate law. See DALE A. OESTERLE, *THE LAW OF MERGERS, ACQUISITIONS, AND REORGANIZATIONS* 41 (1991). Over 320,000 corporations, sixty percent of Fortune 500 corporations, and more than one-half of the thirty companies listed in the Dow Jones Industrial Average are incorporated in Delaware. See E. Norman Veasey, *The Role of the Delaware Courts in Merger and Acquisition Litigation*, 26 DEL. J. CORP. L. 849, 856 (2001) (citing to the spring 2001 Dole Foods, Inc., proxy statement: "[T]he development in Delaware over the last century of a well-established body of case law construing the Delaware General Corporation Law, which provides businesses with a greater measure of predictability than exists in any other jurisdiction . . ."). For a comparative study on minority shareholder rights that is not Delaware-specific, see generally Julian Javier Garza, *Rethinking Corporate Governance: The Role of Minority Shareholders — A Comparative Study*, 31 ST. MARY'S L.J. 613, 622 (2001).

<sup>7</sup> In this Article, the terms "freeze-out," "controlling stockholder buyout" and "going private transaction" will be used interchangeably. The term "going private transaction" can be defined as "any transaction in which a shareholder or group of shareholders obtains the entire common equity interest in a company, and other shareholders receive cash, debt or preferred stock in exchange for their shares." 1A MARTIN LIPTON & ERICA H. STEINBERGER, *TAKEOVERS & FREEZEOUTS* § 9.01 (2003). Commentators have used the term "freeze-out" in a different context, namely referring to tactics in which controlling stockholders attempt to disadvantage minority shareholders in close corporations. See generally A. Richard Blaiklock, *Fiduciary Duties Owed by Frozen-Out Minority Shareholders in Close Corporations*, 30 IND. L. REV. 763 (1997). In the close corporation context, controlling stockholders may withhold dividends from minority shareholders or dilute the shares of minority shareholders by issuing new stock and controlling the disposition of that stock. See Garza, *supra* note 6, at 622. A seminal work on the topic is F. O'NEAL & J. DERWIN, *EXPULSION OF OPPRESSION OF MINORITY SHAREHOLDERS* (1961). For a comprehensive description of the prevalence of freeze-outs in the corporate landscape, see John C. Coates, IV, "Fair Value" as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions, 147 U. PA. L. REV. 1253, 1253-54 n.2 (1999), discussing the prevalence of billion dollar freeze-outs.

<sup>8</sup> When a company goes private it is no longer obligated to comply with the costly reporting and disclosure requirements mandated by the Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C.A. §§ 78a-77mm (1997 & Supp. 2003)) ("Exchange Act") and the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.). For a discussion detailing the reasons for going private, see *infra* note 36 and accompanying text. Going private transactions are poised for a resurgence since their near extinction in the early 1990s. Indeed, as two experts have stated, "Given shareholder fatigue from the prolonged decline in public equity values, readily available private capital for equity investment in more mature companies and historically low interest rates, taking a company private may be the crack in the current economic wall." Michael J. Levitin & Steven S. Snider, *Going Public: Been There, Done That, "Going Private" Now*, WASH. BUS. J., Oct. 21, 2002, <http://washington.bizjournals.com/Washington/stories/2002/10/21/focus4.html>; see

judiciary to establish a coherent framework for transacting parties to rely upon in crafting the mechanics of these transactions.

While most publicly traded corporations are comprised of a dispersed ownership structure – a structure where no single shareholder owns control of the company – several corporations have a controlling shareholder.<sup>9</sup> This controlling shareholder plays an important role when the corporation undertakes a merger or freeze-out transaction. To consummate a freeze-out, most state corporate law statutes require the approval of both the corporation's board of directors and majority shareholder.<sup>10</sup> A controlling shareholder who moves to obtain the entire common equity interest can unilaterally set the price of the minority's stock as well as control the merger's approval.

While the controlling stockholder can legally freeze out the minority on his own terms, minority shareholders are generally afforded two remedies if they feel their stock is undervalued. First, pursuant to Delaware General Corporation Law section 262(b), the minority shareholder can obtain judicial appraisal of their stock.<sup>11</sup> This remedy allows the minority to receive the value of their stock as determined by the court, not the freeze-out price.<sup>12</sup> Second, minority shareholders can seek judicial review of the merger itself. Because the freeze-out merger is inherently a conflict transaction, courts will generally invoke the entire fairness standard of review, which may ultimately allow the minority damages if the court determines that the value of the stock exceeds the freeze-out purchase price.<sup>13</sup>

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also Frank Aquila & Jonathan Gluck, *Sarbanes-Oxley and the "Law of Unintended Consequences": Public Companies Opting to Go Private*, M&A LAW., Oct. 2002, at 16; Margaret Johnsson & Fran Wiechart, *New Regulations: Preparing for the Unplanned Costs*, FIN. EXECUTIVE, Jan. 2003, at 16-18 (estimating the costs of complying with Sarbanes Oxley to range from \$4 million to \$9 million for initial costs of average-sized Fortune 500 companies and annual costs from \$3 million to \$8 million); Clifford E. Neimeth, *One Step or Two? (Delaware's Going Private Dichotomy)*, J. INVESTMENT COMPLIANCE, Winter 2002/2003, at 30.

<sup>9</sup> Michael Barclay & Clifford Holderness, *Private Benefits from Control of Public Corporations*, 25 J. FIN. ECON. 371, 371-72 (1989) (stating that twenty percent of companies of a randomly chosen sample had a controlling shareholder). For an interesting, well-documented exploration into the intricacies of the dispersed ownership phenomenon, see generally Nicholas L. Georgakopoulos, *Corporate Defense Law for Dispersed Ownership*, 30 HOFSTRA L. REV. 11 (2001).

<sup>10</sup> See, e.g., DEL. CODE ANN. tit. 8, § 251 (LEXIS through 2003 Reg. Sess. legislation). It is important to note that "situations where a controlling shareholder has a majority interest and one where the controlling shareholder has an impregnable although non-majority interest are essentially the same from the point of view of their legal constraints." ARTHUR M. BORDEN & JOEL A. YUNIS, *GOING PRIVATE* § 102, at 1-3 (2002). Note, however, there is an important distinction made from the perspective of federal securities liability in this regard. See LIPTON & STEINBERGER, *supra* note 7, § 904[1][a][ii].

<sup>11</sup> DEL. CODE ANN. tit. 8, § 262(b) (2001).

<sup>12</sup> See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 713-15 (Del. 1983).

<sup>13</sup> See *id.* at 714. For a plenary discussion of the entire fairness standard, see *infra* notes 85-109 and accompanying text.

The premise underlying the assertion of entire fairness review is sound: “When a majority shareholder stands on both sides of a transaction, the requirement of fairness is ‘unflinching’ in its demand that the controlling stockholder establish the entire fairness of the undertaking sufficient to pass the test of careful scrutiny by the courts.”<sup>14</sup> The Delaware Court of Chancery in *In re Pure Resources Shareholders Litigation* recently undermined the “unflinching” and longstanding entire fairness protection afforded to minority shareholders in this context.<sup>15</sup>

In *Pure Resources*, the Delaware Court of Chancery addressed whether there was enough utility to justify continuing the stricter scrutiny of interested mergers that condition the transaction on a majority of the minority stockholder vote and/or where a special committee of independent directors is formed.<sup>16</sup> For reasons to be discussed in this Article,<sup>17</sup> courts have traditionally perceived these so-called “intra-corporate cleansing mechanisms” as inherently suspect.<sup>18</sup> For instance, the formation of a special committee of independent directors and conditioning the conflict transaction on approval of a majority of the minority vote did not displace entire fairness review.<sup>19</sup> However, this layer of protection to minority shareholders was removed in *Pure Resources* and several other recent decisions.<sup>20</sup>

This Article argues that the recent Delaware case law is misguided as it abrogates entire fairness review in a conflict transaction setting – a fundamental notion that has been endorsed and upheld as integral to Delaware’s merger review paradigm. Central to this argument is the longstanding notion that the *Pure Resources* court has expressly ignored – despite the employ of independent committees and the like – the entire fairness standard should still apply to self-interested transactions. This is because “the underlying factors which raise the

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<sup>14</sup> *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 845 (Del. 1985).

<sup>15</sup> 808 A.2d 421 (Del. Ch. 2002).

<sup>16</sup> *See id.* at 422-23. The author of the *Pure Resources* opinion, Vice-Chancellor Strine, along with his colleagues, former Chancellor William T. Allen, and Vice-Chancellor Jacobs, initially addressed this question in, William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1303 (2001). For a discussion on these purported cleansing mechanisms, see *infra* notes 55-63 and accompanying text.

<sup>17</sup> *See infra* Part VI.

<sup>18</sup> *See, e.g.*, *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110 (Del. 1994).

<sup>19</sup> *See id.* at 1117 (holding that approval of the transaction by a majority of the minority of shareholders and a majority on a committee of independent directors does not displace entire fairness review but “shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff”).

<sup>20</sup> *See Pure Res.*, 808 A.2d at 422-23; *see also* *Glassman v. Unocal Exploration Co.*, 777 A.2d 242 (Del. 2001); *In re Siliconix Inc. S’holders Litig.*, No. 18700, 2001 WL 716787 (Del. Ch. June 19, 2001).

specter of impropriety can never be completely eradicated.”<sup>21</sup> Moreover, for reasons to be discussed, the Court of Chancery’s erroneous departure from the application of entire fairness review will necessarily deal a debilitating blow to minority shareholders’ interests in the freeze-out context.

Part II of this Article briefly examines the mechanics of freeze-outs in the corporate landscape. The early literature on freeze-outs will form a revealing backdrop that will accommodate the current legal issues surrounding freeze-outs. This Part also explores the different ways controlling stockholders could effectuate a buyout of the minority, namely through either a negotiated merger or tender offer. As the court demonstrated in *Pure Resources*, the distinction between the two alternative ways of effectuating a buyout is an important one; the method employed to consummate the freeze-out will often govern the ex post judicial standard of review. The transaction mechanics of both methods as well as the intra-corporate cleansing mechanisms invoked by acquirors are discussed.

Part III discusses the legal relationship between controlling and minority shareholders. This Part discusses the specific duties arising out of freeze-out transactions prior to *Pure Resources* and the other related case law. Central to this discussion is an analysis of several recent Delaware cases that have addressed entire fairness review in the freeze-out context.<sup>22</sup> The doctrinal tension between *Kahn v. Lynch Communication Systems*<sup>23</sup> and its progeny and *Solomon v. Pathe Communications Corp.*<sup>24</sup> and its progeny is examined.

Part IV examines the *Pure Resources* decision. The underlying negotiations and mechanics of the transaction between Unocal and Pure Resources will be assessed. This Part focuses on Vice-Chancellor Strine’s departure from *Kahn* and his modification and endorsement of the *Solomon* standard of review—so long as the exchange offer is “structured in a manner that reduces the distorting effect of the tendering process on free stockholder choice and by ensuring minority stockholders a candid and unfettered tendering recommendation from the independent directors of the target board.”<sup>25</sup> The doctrinal problems with this opinion as well as the practical effects the decision will ultimately have on transacting parties and their counsel are discussed. Additionally, this Part dis-

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<sup>21</sup> *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997) (declining to defer to a decision made by special independent committee of directors).

<sup>22</sup> See *Unocal Exploration*, 777 A.2d 242 (limiting the application of entire fairness review and establishing that a parent corporation need not demonstrate fairness with respect to a short-form merger pursuant to section 253 of the Delaware Code); *In re Aquila, Inc. S’holders Litig.*, 805 A.2d 184 (Del. Ch. 2002) (refusing to enjoin tender offer on grounds that such offers were voluntary transactions and holding that no fairness duty is to be imposed on parent companies); *Siliconix*, 2001 WL 716787 (involving a challenge of an exchange offer by a controlling stockholder of Siliconix).

<sup>23</sup> 638 A.2d 1110.

<sup>24</sup> 672 A.2d 35 (Del. 1996).

<sup>25</sup> *Pure Res.*, 808 A.2d at 424.

cusses the requirement established in *Pure Resources* that requires a minority stockholder be given a “fair summary” of the investment bankers’ findings.<sup>26</sup>

Part V draws on the lengthy discussion of Vice-Chancellor Strine in *Pure Resources* regarding the justifications for treating tender offers and negotiated mergers differently.<sup>27</sup> Central to this discussion was the Vice-Chancellor’s finding that the same concerns exist when a controlling person seeks to acquire the minority’s stock irrespective of whether he or she employs a tender offer or negotiated merger to achieve his or her end.<sup>28</sup> The concerns arising out of *Kahn* that relate to the integrity of the special disinterested director committee process, the informational advantages of controlling stockholders and the minority shareholder’s fear of retributive threats in the event of a no vote are discussed in the context of both tender offer and negotiated merger transaction types. This part argues that these concerns persist in both transaction types and thus, the Delaware courts should treat them the same way.

Part VI argues that the exclusive application of entire fairness review to interested transactions is proper, particularly in light of the fact that a controlling party proposes and controls the transaction and its essential terms. Entire fairness review should apply irrespective of whether a tender offer or negotiated merger is employed. In both tender offers and negotiated mergers, the controlling stockholder will always have the potential to influence, however subtly, the vote of minority stockholders in a manner that would not be of concern in a transaction with a noncontrolling party. Consequently, full disclosure of material facts to ratifying minority stockholders is inadequate. Therefore, procedural protection via the entire fairness doctrine should have been upheld in *Pure Resources*.

Part VII explores the economic theory of freeze-outs. It assesses the social utility of freeze-outs and the social costs freeze-out transactions impose on society. Additionally, the transaction costs, incentives and externalities associated with freeze-outs and the entire fairness review are examined. While there may be benefits to freeze-outs, these transactions result in inefficiencies and diminish overall social welfare. Since freeze-out transactions appear to be socially sub-optimal under both the Pareto efficiency model and the Kaldor-Hicks efficiency model, enhancing scrutiny of these transactions may have the effect of reducing their incidence. Furthermore, entire fairness review potentially encourages fair dealing between the majority and minority shareholders.

After examining whether applying entire fairness review to freeze-outs is consistent with the Delaware corporate law paradigm, this Article argues that there is no policy-laden reason to depart from a longstanding framework that subjects conflict transactions to stricter scrutiny. Moreover, the judicial institution performing the review – the Delaware Court of Chancery – is doing so effi-

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<sup>26</sup> See *infra* Part IV.C.

<sup>27</sup> See *Pure Res.*, 808 A.2d at 441-43.

<sup>28</sup> See *id.* at 443.



ciently and expeditiously. Given the inadequacies of the appraisal remedy, it is necessary to protect minority shareholders when they are faced with the prospect of being frozen out.

Since nothing has occurred to change the court's perception of the tainted dangers inherent in conflict transactions since *Kahn*, the Article ultimately suggests that the Delaware Supreme Court should reexamine *Pure Resources* and Delaware's treatment of tender offers commenced by controlling parties and reinstate the functional balance it established in *Kahn* and its progeny.

## II. FREEZE-OUT TRANSACTIONS IN THEORY AND PRACTICE

### A. *Freeze-outs in Legal and Economic Literature*

There has been considerable commentary on freeze-out transactions.<sup>29</sup> There was much controversy surrounding freeze-outs as they became prevalent in the 1970s.<sup>30</sup> As a result of poor market conditions in the mid-1970s controlling stockholders and corporate management sought to realize control of corporations at relatively inexpensive prices.<sup>31</sup> After several controlling parties made large profits by taking companies public and then private, the Securities and Exchange Commission ("SEC") responded with Rule 13e-3 that sought to protect shareholders with disclosure requirements.<sup>32</sup> The SEC promulgated the rule because of conflict of interest concerns arising from these transactions.<sup>33</sup>

<sup>29</sup> See, e.g., Richard A. Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U. L. REV. 630 (1985); Arthur M. Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987 (1974); J. Robert Brown, Jr., *In Defense of Management Buyouts*, 65 TUL. L. REV. 57 (1990); Victor Brudney, *Efficient Markets and Fair Values in Parent Subsidiary Mergers*, 4 J. CORP. L. 63 (1978); Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974); Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978) [hereinafter Brudney & Chirelstein, *Corporate Freezeouts*]; Deborah A. DeMott, *Directors' Duties in Management Buyouts and Leveraged Recapitalizations*, 49 OHIO ST. L.J. 517 (1988); Jan G. Deutsch, *The Mysteries of Corporate Law: A Response to Brudney and Chirelstein*, 88 YALE L.J. 235 (1978); Edward F. Greene, *Corporate Freeze-out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487 (1976); Louis Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730 (1985); Dale Arthur Oesterle & Jon R. Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207 (1988); Elliott J. Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624 (1981).

<sup>30</sup> LIPTON & STEINBERGER, *supra* note 7, § 9.01[5].

<sup>31</sup> See *id.*

<sup>32</sup> 17 C.F.R. § 240.13e-3 (2003). Schedule 13E-3 disclosures focus on share valuation opinions and the fairness of the transaction. See *id.* § 240.13e-100, Item 9 on Schedule 13E-3.

<sup>33</sup> See John L. Graham & John J. Kelly III, *Tempted to Leave Wall Street: Old Economy Company Executives Examine Prospects of Going Private*, N.Y.L.J., May 1, 2000, at S4, available at LEXIS, Nexis Library, NYLAWJ File.

Several commentators perceived these transactions as harmful to minority stockholders because of the relatively unfettered ability of the controlling stockholder to displace the minority's interest.<sup>34</sup> Not surprisingly, they argued for per se bans of freeze-outs or for legal rules restricting them.<sup>35</sup> Conversely, other commentators argued that freeze-outs yield advantages to stockholders as they promote the efficient allocation of societal resources.<sup>36</sup> These commentators concluded that freeze-outs should be permitted – subject to disclosure and fairness rules.<sup>37</sup>

Quintessential to these debates was the debate over what legal standards should be applied to freeze-out transactions.<sup>38</sup> While this debate was overshadowed by the 1980's takeover controversy,<sup>39</sup> it has abruptly resurfaced once

<sup>34</sup> See Brudney & Chirelstein, *Corporate Freezeouts*, *supra* note 29, at 1359 (arguing that “pure going private transactions are of small value and high risk and hence should be prohibited”).

<sup>35</sup> See *id.*

<sup>36</sup> Indeed, freeze-outs have many benefits. These benefits include inter alia:

permitting control persons to acquire 100% ownership of assets undervalued in the stock market, whether because of short-termism or because control persons need not discount stock values to reflect agency risks, and so returning cash for investors to use in more highly valued investments; permitting control persons to obtain 100% upside in potential new, riskier projects or investments . . . , and encouraging control persons to devote “socially optimal” effort in such projects and investments; reducing agency costs and conflicts of interests by increasing ownership concentration and improving owner oversight; providing protection against or alternative to a hostile takeover; reducing the cost of capital by replacing high-cost equity capital with low-cost debt capital; reducing creditor apprehension and low employee morale resulting from poor stock performance; permitting corporate managers or other shareholders to convert illiquid investments into cash; eliminating competitively disadvantageous disclosure requirements; eliminating the costs of having public shareholders, including costs of shareholder relations and meetings, auditing and legal fees, transfer agents, stock certificates, and the like, and eliminating exposure to shareholder litigation; and increasing a company's “tax shield” by replacing non-deductible stock dividends with deductible interests payments.

LIPTON & STEINBERGER, *supra* note 7, § 9.01[2] (footnotes omitted). Additionally, another common argument for allowing freeze-outs is that they facilitate the capturing of synergistic value that, absent these transactions, would not be available. See Coates, *supra* note 7, at 1327. Relatedly, Professor Coates questions the notion that a ban on freeze-outs would have much social welfare. See *id.* at 1329.

<sup>37</sup> See, e.g., Borden, *supra* note 29, at 1006 (arguing for regulation of price); Oesterle & Norberg, *supra* note 29, at 243-45 (arguing for disclosure regulations). Other commentators have argued for legal rules ensuring a meaningful shareholder vote, e.g., Booth, *supra* note 29, at 659-60, and for mandated independent committees to represent shareholders. E.g., Oesterle & Norberg, *supra* note 29, at 241-43.

<sup>38</sup> See Greene, *supra* note 29, at 518; Lowenstein, *supra* note 29, at 782-84.

<sup>39</sup> For discussions on the illustrious hostile takeover frenzy of the 1970s and 1980s and the legal debates surrounding those events, see generally BRYAN BURROUGH & JOHN HELYAR, *Published by The Research Repository @ WVU, 2004*

again.<sup>40</sup> The Delaware courts have continually struggled to fashion a solution to this daunting problem.<sup>41</sup>

Initially, the entire fairness model was applied and courts modified the standard in light of the different factual circumstances they were confronted with.<sup>42</sup> Because of the potential abuse and conflicts in freeze-out transactions,

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BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO (1990); Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423 (1993); John C. Carter, *The Rights of Other Corporate Constituencies*, 22 MEM. ST. U. L. REV. 491 (1992); John C. Coffee, Jr., *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-ups*, 1988 WIS. L. REV. 435; Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) [hereinafter Easterbrook & Fischel, *Proper Role*]; Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Jeffrey N. Gordon, "Just Say Never?" *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffet*, 19 CARDOZO L. REV. 511 (1997); Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993); Thomas Lee Hazen, *State Anti-Takeover Legislation: The Second and Third Generations*, 23 WAKE FOREST L. REV. 77 (1988); Dale Arthur Oesterle, *Delaware's Takeover Statute: Of Chills, Pills, Standstills, and Who Gets Iced*, 13 DEL. J. CORP. L. 879 (1988); Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987); Mark A. Sargent, *On the Validity of State Takeover Regulation: State Responses to MITE and Kidwell*, 42 OHIO ST. L.J. 689, 712 (1981); Julian Velasco, *The Enduring Illegitimacy of the Poison Pill*, 27 IOWA J. CORP. L. 381, 384 (2002), describing the takeover environment of the mid-1980s as an "era of open corporate warfare."

<sup>40</sup> See generally Allen et al., *supra* note 16, at 1287 (discussing the need to address the doctrinal tensions relating to fiduciary standards of conduct under Delaware law). The question of what standard of review should be applied to directorial action in the mergers and acquisitions context has been raised in other areas. For instance, what standards of review to be applied to board-adopted defensive and protective measures have been prevalent in legal literature. See, e.g., Frederick H. Alexander, *Reining in Good Intentions: Common Law Protections of Voting Rights*, 26 DEL. J. CORP. L. 897, 899 (2001); Mark Lebovitch & Peter B. Morrison, *Calling a Duck a Duck: Determining the Validity of Deal Protection Provisions in Merger of Equals Transactions*, 2001 COLUM. BUS. L. REV. 1; Gregory V. Varallo & Srinivas M. Raju, *A Process Based Model for Analyzing Deal Protection Measures*, 55 BUS. LAW. 1609, 1615 (2000); E. Norman Veasey, *Law and Fact in Judicial Review of Corporate Transactions*, 10 U. MIAMI BUS. L. REV. 1, 12 (2002) (explaining the question of whether to apply the business judgment rule or a more substantive standard to deal protection provisions); Ely R. Levy, Note, *Corporate Courtship Gone Sour: Applying a Bankruptcy Approach to Termination Fee Provisions in Merger and Acquisition Agreements*, 30 HOFSTRA L. REV. 1361 (2002) (arguing for the application of a "best interests" standard where the shareholder franchise is constrained by provisions in merger agreements).

<sup>41</sup> See *In re Pure Res. S'holders Litig.*, 808 A.2d 421, 434-35 (Del. Ch. 2002).

<sup>42</sup> See *Tanzer v. Int'l Gen. Indus., Inc.*, 379 A.2d 1121 (Del. 1977) (establishing the entire fairness standard of review in conflict transactions), *overruled by* *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983). The test established in *Tanzer* was later modified in the seminal case of *Weinberger v. UOP, Inc.*, 457 A.2d 701. Prior to *Weinberger*, under *Singer v. Magnavox Co.*, the proponent of the conflict transaction was required to affirmatively demonstrate that a proposed transaction was in line with a legitimate business purpose. 367 A.2d 1349 (Del. Ch. 1976), *aff'd in part, rev'd in part*, 380 A.2d 969 (Del. 1977), *overruled in part by* *Weinberger v. UOP, Inc.*, <https://researchrepository.wvu.edu/wvlr/vol106/iss2/5>

courts felt that stricter scrutiny was warranted.<sup>43</sup> The doctrinal tensions that were prevalent, when freeze-outs became commonplace in the corporate landscape, have circled back to the forefront in Delaware's corporate jurisprudence. As will be demonstrated, this longstanding concern for minority interests in the freeze-out context has been challenged and undermined by recent Delaware case law.<sup>44</sup> These recent cases have coalesced to erode minority shareholder rights by allowing corporate planners to craftily evade the entire fairness standard.

### B. *The Tender Offer/Negotiated Merger Distinction*

Under Delaware law, a majority shareholder has a legal right to buyout the shares of minority shareholders.<sup>45</sup> Often, it is the corporation's officers and directors who are the controlling stockholders.<sup>46</sup> Controlling stockholder buyouts share several common characteristics. A controlling stockholder acquiror will structure the transaction in one of two ways: the acquiror will effectuate a

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457 A.2d 701 (Del. 1983). The *Weinberger* court abrogated the "business purpose" test; however, the test has survived in other jurisdictions. See, e.g., *Coggins v. New Eng. Patriots Football Club, Inc.*, 492 N.E.2d 1112, 1119 (Mass. 1986) (articulating the "business purpose" test under Massachusetts law).

The corporate directors who benefit from this transfer of ownership must demonstrate how the legitimate goals of the corporation are furthered . . . . Because the danger of abuse of fiduciary duty is especially great in a freeze-out merger, the court must be satisfied that the freeze-out was for the advancement of a legitimate corporate purpose. If satisfied that elimination of public ownership is in furtherance of a business purpose, the court should then proceed to determine if the transaction was fair by examining the totality of the circumstances.

*Id.* at 1118 (citations omitted).

<sup>43</sup> See *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 845 (Del. 1985) ("When a majority shareholder stands on both sides of a transaction, the requirement of fairness is unflinching in its demand that the controlling stockholder establish the entire fairness of the undertaking sufficient to pass the test of careful scrutiny by the courts.").

<sup>44</sup> See *infra* notes 133-60 and accompanying text.

<sup>45</sup> See DEL. CODE ANN. tit. 8, § 253 (2001); see also *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 43 (Del. 1994).

<sup>46</sup> This type of transaction is frequently referred to as an MBO (management buyout).

A management buyout is the purchase of a target company by a newly-formed company comprising the target's old management and new partners as majority equity holders. The management buyout gives rise to a conflict of interest. The old management and new partners use the new company to buy the old company, which is the target of the merger. Management has an incentive to make the merger succeed to the detriment of the old company. This merger raises questions of self-dealing and fairness because majority shareholders buy their old company along with the minority's interest.

Garza, *supra* note 6, at 624 (footnotes omitted).

negotiated single-step merger or, in the alternative, a two-step acquisition where the controlling stockholder conducts a tender or exchange offer for the public equity and subsequently completes a second-step merger. Despite the fact that both transactions effectively achieve the same result – the controlling stockholder owning all of the corporation’s outstanding equity as a concern – the method employed is crucial after the *Pure Resources* decision.<sup>47</sup>

In a tender offer, the controlling stockholder will offer to purchase the minority’s stock for a cash consideration.<sup>48</sup> If most of the stockholders tender into the offer, a second-step merger pursuant to section 253 of the Delaware General Corporation Law usually follows.<sup>49</sup> The need for a second-step merger following a successful tender is necessary because a tender offer “will never result in all outstanding stock being tendered.”<sup>50</sup> As a result of the successful tender offer, the controlling stockholder will have sufficient voting power to effectuate the second-step merger.<sup>51</sup> The second-step merger will subsequently

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<sup>47</sup> See *infra* notes 190–206 and accompanying text.

<sup>48</sup> If the consideration offered in return for the stock is something other than cash, i.e., stock bonds, debentures and the like, the offer is an exchange offer. See John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer’s Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1147 (1984). The Williams Act, part of the Exchange Act, principally regulates tender offers. See Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. § 78n(d)-(f) (2000)). The rules governing tender offers center on the offeror’s disclosure of his identity, funding and purpose. See 15 U.S.C. § 78n. Additionally, the Williams Act mandates that if an acquiror offers to purchase only a portion of the outstanding shares, and the holders tender more than the number that the bidder has offered to purchase, the acquiror must purchase in the same proportion from each stockholder. See 17 C.F.R. §§ 240.13e-4(f)(3), .14d-8 (2003). While the offer is required to be open for at least twenty business days, any increase in price before the expiration thereof requires such price to be increased to each stockholder whose shares were tendered prior to the increase. See *id.* §§ 240.13e-4(f)(3), .14e-1(a). These requirements are said to level the playing field between acquirors and tendering stockholders. There has been considerable commentary on the detrimental effects, burdensome costs, and inefficiencies resulting from regulating the market for corporate control. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982) [hereinafter Easterbrook & Fischel, *Corporate Control*]; Frank H. Easterbrook, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277 (1984); Easterbrook & Fischel, *supra* note 39; Gilson, *supra* note 39.

<sup>49</sup> DEL. CODE ANN. tit. 8, § 253 (2001).

<sup>50</sup> See David W. Leebron, *Games Corporations Play: A Theory of Tender Offers*, 61 N.Y.U. L. REV. 153, 162 n.33 (1986) (“Some shareholders may not be aware of the tender offer or even aware that they are shareholders.”). In his article, Leebron demonstrates that tender offers and negotiated mergers distribute gains differently, which subsequently influences the size and types of gains created. See *id.* at 215–16. He argues that tender offers should be regulated like mergers — through enabling statutes that establish default rules of minimal standards allowing for variation in the corporate charter. See *id.* at 218.

<sup>51</sup> See *In re Pure Res. S’holders Litig.*, 808 A.2d 421, 434–35 (Del. Ch. 2002). The court elaborated,

eliminate the non-tendering minority, thereby allowing the acquiror to achieve its purpose.<sup>52</sup> While the Delaware General Corporation Law does not address tender offers,<sup>53</sup> a tender offer by the controlling stockholder could potentially be subject to the disclosure requirements set forth in Rule 13e-3 of the Securities Exchange Act of 1934 (“Exchange Act”).<sup>54</sup>

The use of a tender offer carries with it certain benefits and drawbacks. Complete control of the corporation will probably be gained less expensively by using a tender offer, though this contention has been the subject of debate.<sup>55</sup>

As a matter of statutory law, this way of proceeding is different from the negotiated merger approach in an important way: neither the tender offer nor the short-form merger requires any action by the subsidiary’s board of directors. The tender offer takes place between the controlling shareholder and the minority shareholders so long as the offering conditions are met. And, by explicit terms of [title 28,] § 253 [of the Delaware Code], the short-form merger can be effected by the controlling stockholder itself, . . . .

*Id.* at 437.

<sup>52</sup> From the acquiror’s point of view this is essential because retaining even a small minority of stockholders may obstruct the goals of the acquiror, namely the avoidance of costly securities disclosure requirements.

<sup>53</sup> See generally DEL. CODE. ANN. tit., §§ 101-398 (2001 & Supp. 2002). “Tender offers are not addressed by the Delaware General Corporation Law, a factor that has been of great importance in shaping the line of decisional law addressing tender offers by controlling stockholders . . . .” *Pure Res.*, 808 A.2d at 437. In this respect the Vice-Chancellor Strine craftily described the judicial processes in molding the Delaware corporate common law:

Much of the judicial carpentry in the corporate law occurs in this context, in which judges must supplement the broadly enabling features of statutory corporation law with equitable principles sufficient to protect against abuse and unfairness, but not so rigid as to stifle useful transactions that could increase the shareholder and societal wealth generated by the corporate form. In building the common law, judges forced to balance these concerns cannot escape making normative choices, based on imperfect information about the world.

*Id.* at 434.

<sup>54</sup> Generally, Rule 13e-3 applies to transactions that have a “‘reasonable likelihood’ or ‘purpose’ of producing . . . a ‘Rule 13e-3 effect.’” LIPTON & STEINBERGER, *supra* note 7, § 9.04[1][a][iii]. A Rule 13e-3 effect has been defined as the termination of disclosure obligations under the Exchange Act “by virtue of causing a class of equity securities to be held of record by less than 300 persons or causing the equity security to be neither listed on a national securities exchange nor authorized to be quoted on the NASDAQ Stock Market.” *Id.* The Rule requires a series of disclosures as to the fairness of the transaction. These disclosures must prominently inform shareholders of the transaction’s purpose, the reasons for the transaction’s timing, any potential quantifiable detriments to shareholders, and other alternative transactions considered. See 17 C.F.R. §§ 240.13e-3(e)(1), .13e-100, Item 7 on Schedule 13E-3. Additionally, the Rule imposes waiting periods prior to consummation of such transactions as well as filing requirements. LIPTON & STEINBERGER, *supra* note 7, § 9.04[1].

<sup>55</sup> Compare Leebron, *supra* note 50, at 158 (arguing that “although tender offers and negotiated mergers serve essentially identical purposes, an acquirer may be able to pay less in a tender offer because of certain limitations on the stock market’s ability to fully value the acquired firm”), with Easterbrook & Fischel, *Proper Role*, *supra* note 39, at 1169 (stating that “a tender offer is by

Additionally, fairness of the tender offer price may be less subject to judicial scrutiny than in conventional negotiated mergers.<sup>56</sup> This derives from the theoretical presumption that each stockholder makes his or her own decision whether to tender into the offer. Put another way, no tendering stockholder of the acquired entity could plausibly claim that the board of directors approved an unfair offer. Therefore, courts have traditionally reviewed tender offers deferentially.<sup>57</sup>

Alternatively, tender offers often require the acquirer to offer a premium to attract an adequate number of tendering stockholders. This premium, coupled with the costs of publicizing the offer, can increase the cost of a tender offer above the market value of the shares before the offer is initiated.<sup>58</sup> The tender offer itself can be contested or subject to costly litigation as well. More importantly, the acquirer in the tender offer context may not have the opportunity to conduct sufficient due diligence exercises, whereas in a negotiated merger thorough due diligence prospects are increased.<sup>59</sup> Furthermore, the acquiror may not

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far the more costly device"). For a discussion on the transaction costs of tender offers, see Gilson, *supra* note 39, at 841 n.86.

<sup>56</sup> It is important to note, that while the Securities and Exchange Commission ("SEC") initially sought to regulate the substantive fairness of these transactions, *see* Going Private Transactions, Exchange Act Release No. 34-14185, 42 Fed. Reg. 60090 (proposed Nov. 23, 1977) (to be codified at 17 C.F.R. pt. 240), the Supreme Court in *Sante Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), held that the purpose of the securities laws was to "substitute a philosophy of full disclosure" and the fairness of the transaction was peripheral to this purpose. *Id.* at 477 (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 158 (1972)). Moreover, the Court stated that since state general corporation statutes already contemplate breaches of fiduciary duty in connection with securities transactions, it would be inappropriate for these duties to be federalized. *See id.* at 478. Since *Sante Fe*, the SEC has refrained from substantively reviewing freeze-outs thereby paving the way for the development of state court scrutiny. *See* Going Private Transactions, Exchange Act Release No. 33-6100, 44 Fed. Reg. 46736 (Aug. 8, 1979) (to be codified at 17 C.F.R. pt. 240).

With the passage of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections at 11, 15, 18, 28, and 29 U.S.C.), the *Sante Fe* framework may be challenged as the federal initiatives target conduct in the boardroom, behavior that has traditionally been under the purview of state laws and courts. For a discussion relating to these important issues, *see* generally Larry Cata Backer, *The Sarbanes-Oxley Act: Federalizing Norms for Officer, Lawyer, and Accountant Behavior*, 76 ST. JOHN'S L. REV. 897 (2002); Lisa M. Fairfax, *The Sarbanes-Oxley Act as Confirmation of Recent Trends in Director and Officer Fiduciary Obligations*, 76 ST. JOHN'S L. REV. 953 (2002); *see also* Lawrence Lederman, et al., *A Blow for States*, DAILY DEAL, Oct. 26, 2002, LEXIS, Nexis Library, DADEAL File.

<sup>57</sup> Whether this is solid judicial policy when a tender offer is commenced by a controlling fiduciary will be discussed *infra* in Part V. *See infra* notes 214-24 and accompanying text.

<sup>58</sup> *See supra* note 49 and accompanying text.

<sup>59</sup> *See* Committee on Negotiated Acquisitions, *Purchasing the Stock of a Privately Held Company: The Legal Effect of an Acquisition Review*, 51 BUS. LAW. 479, 489 n.42 (1996).

be able to realize as many representations and warranties from the acquired party.<sup>60</sup>

A controlling stockholder may opt for a negotiated merger that is a “bargaining transaction, the terms of which are negotiated by the managements of the merging firms.”<sup>61</sup> In the case of a controlling stockholder, the bargaining will ensue between the controlling stockholder who may be the corporation’s management, and the minority stockholders. To protect the minority stockholders, the controlling stockholder usually appoints a special committee of disinterested independent directors to represent the minority’s interests in the negotiations. Furthermore, the controlling stockholder may also condition the consummation of the freeze-out on approval of a majority of the outstanding minority stock.

These mechanisms are said to mitigate the potentially abusive effects of the controlling stockholder’s voting ability to approve the merger.<sup>62</sup> While incorporating these mechanisms does not ensure a litigation-free transaction, the risk of litigation is seemingly diminished.<sup>63</sup> As will be discussed, the evidentiary burdens in litigation concerning the transaction may potentially be affected because of the presence of these mechanisms – even more so after *Pure Resources*.<sup>64</sup>

While not required under Delaware law, a special committee of independent directors is quite routine in freeze-out transactions.<sup>65</sup> In its representation of the minority stockholders, the special committee will “negotiate with representatives of the parent company in an attempt to recreate the arm’s length bargaining process that would otherwise be absent in a parent/subsidiary transaction.”<sup>66</sup> Ideally, the special committee should have broad powers to engage counsel’s assistance, negotiate the price of the transactions, and prepare a recommendation to the board. These tasks should be performed in conjunction with the main function of the committee, namely “to aggressively seek to promote and protect minority interests.”<sup>67</sup>

<sup>60</sup> See *id.* at 486 n. 22.

<sup>61</sup> See Leebron, *supra* note 50, at 179.

<sup>62</sup> By the technique of making a nonwaivable majority of the minority vote condition to a merger, “the ability of the controlling stockholder to both offer and accept is taken away, and the sell-side decision-making authority is given to the minority stockholders.” *In re Pure Res. S’holders Litig.*, 808 A.2d 421, 442 (Del. Ch. 2002).

<sup>63</sup> See *infra* notes 125-40 and accompanying text.

<sup>64</sup> See *infra* notes 193-205 and accompanying text.

<sup>65</sup> See LIPTON & STEINBERGER, *supra* note 7, § 9.06[1].

<sup>66</sup> *Id.*

<sup>67</sup> *In re Trans World Airlines, Inc. S’holders Litig.*, No. 9844, 1988 Del. Ch. LEXIS 139 (Del. Ch. Oct. 21, 1988), reprinted in 14 DEL. J. CORP. L. 870, 884 (1988).



The majority of the minority provision is another mechanism used to protect the minority's interest. The consummation of the freeze-out transaction is conditioned on a majority of the stockholders that are unaffiliated with the controlling stockholder approving the transaction. This mechanism can be present in both the tender offer and negotiated merger contexts. The nonaffiliated majority of the minority shareholders would approve the transaction either by vote in a negotiated merger or by tender in a tender offer.<sup>68</sup>

The controlling stockholder seeking to acquire the entire outstanding common equity interests – by either tender offer or negotiated merger – must contemplate the likelihood of litigation. As will be discussed, the way in which the controlling stockholder structures the freeze-out *ex ante* will affect the rigorosity of the *ex post* review afforded to a particular transaction.

### III. THE MAJORITY/MINORITY SHAREHOLDER DYNAMIC

Minority ownership in a corporation generally refers to “any shareholder who owns stock representing less than fifty percent of a corporation’s capital.”<sup>69</sup> Notwithstanding, a shareholder who owns less than fifty percent of a corporation’s outstanding stock can be deemed to have controlling status if the shareholder exerts control through conduct or if the ability to dictate a transaction is demonstrated.<sup>70</sup> Thus, “a shareholder owes a fiduciary duty only if it owns a majority interest in *or* exercises control over the business affairs of the corporation.”<sup>71</sup>

Both directors as well as controlling stockholders owe fiduciary duties to minority shareholders.<sup>72</sup> Controlling shareholders are brought under the fiduciary duty paradigm because their inherent status as controlling persons is accompanied by voting power – voting power that facilitates decision-making authority, particularly in light of their ability to remove and elect corporate

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<sup>68</sup> The *Pure Resources* court noted in dicta that parties that have employment, severance, or other contractual agreements, with the controlling stockholder that create voting incentives are not considered unaffiliated. 808 A.2d 441, 446-47 (Del. Ch. 2002).

<sup>69</sup> See Garza, *supra* note 6, at 620.

<sup>70</sup> See *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 70 (Del. 1984) (stating that only stockholders with controlling status are fiduciaries).

<sup>71</sup> *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987) (emphasis added). It is important to note that the plaintiff is charged with the burden to adduce evidence demonstrating the control status of a stockholder, i.e., that the stockholder dictated the terms of the transaction. See *Gilbert v. El Paso Co.*, 490 A.2d 1050, 1055 (Del. Ch. 1984) (stating that a stockholder who owns less than fifty percent of a corporation’s outstanding equity does not, without plaintiff demonstrating more, become a controlling person); *Puma v. Marriott*, 283 A.2d 693, 695 (Del. Ch. 1971).

<sup>72</sup> See 2 JAMES D. COX ET AL., CORPORATIONS § 14.16 (Supp. 1998); see also *Ivanhoe Partners*, 535 A.2d at 1344 (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985)).

management.<sup>73</sup> Thus, subjecting controlling shareholders to the fiduciary rubric presumably deters or, at the very least, constrains self-dealing transactions.<sup>74</sup> The prospect of a minority shareholder action against the directors and/or controlling stockholders serves as a check on these fiduciaries.<sup>75</sup>

#### A. *Rights and Duties of the Majority Shareholder*

Under Delaware law, controlling shareholders have a legal right to “(a) elect directors; (b) cause a break-up of a corporation; (c) merge it with another company; (d) cash-out the public stockholders; (e) amend the certificate of incorporation; (f) sell all or substantially all of the corporate assets; or (g) otherwise alter materially the nature of the corporation and the public stockholders’ interests.”<sup>76</sup> The controlling stockholder’s exercise of these rights is subject to the fiduciary duties of care and loyalty owed by the majority to the minority stockholders.

The duty of care mandates that management and controlling stockholders act in good faith, with ordinary care, and “in a manner the director reasonably believes to be in the best interests of the corporation.”<sup>77</sup> This duty is interconnected with the business judgment rule defense – a management-friendly

<sup>73</sup> See *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 1116 (Del. 1994) (expressing concern over the voting rights of controlling stockholders and decision-making); *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490, 502 (Del. Ch. 1990) (describing a controlling stockholder’s inherent coercive voting authority).

<sup>74</sup> Several law and economics scholars have challenged the social and economic utility of regulating self-dealing transactions, corporate opportunities and the like. In this regard, the Chicagoans focus on how the fruits of insider trading and other corporate opportunities in the hands of corporate management would not harm shareholders, but rather such benefits would be offset by reductions in compensation. On this fascinating debate, see generally FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 *STAN. L. REV.* 857 (1983); Easterbrook & Fischel, *Corporate Control*, *supra* note 48, at 734-35; David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 *NW. U. L. REV.* 1449, 1461-62 (1986); Henry G. Manne, *Insider Trading and the Law Professors*, 23 *VAND. L. REV.* 547, 567 (1970); Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 *J. LEGAL STUD.* 801, 805 (1980). *But cf.* Lucian Arye Bebchuk & Christine Jolls, *Managerial Value Diversion and Shareholder Wealth*, 15 *J.L. ECON. & ORG.* 487 (1999) (arguing that the costs of managerial value diversion can conceivably outweigh the benefit to shareholders); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 *COLUM. L. REV.* 1403 (1985) (arguing against the aforementioned free market models and asserting that it is implausible to assume that the level of managerial pay is set by a disinterested agent seeking to maximize share value); Therese H. Maynard, *Spinning in a Hot IPO—Breach of Fiduciary Duty or Business as Usual?*, 43 *WM. & MARY L. REV.* 2023 (2002) (rejecting any and all law and economics rationales that the market will correct IPO spinning to corporate management).

<sup>75</sup> See Garza, *supra* note 6, at 620.

<sup>76</sup> See *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 43 (Del. 1994).

<sup>77</sup> See MODEL BUS. CORP. ACT § 8.30(a) (2002).

protective layer. Under the business judgment analysis, if controlling stockholders can demonstrate that they made a business decision on an informed basis, in good faith and without self-interest, the courts will respect the decision without holding the controlling person liable for unanticipated losses.<sup>78</sup> The business judgment rule in the freeze-out merger context contemplates deferential judicial examination of the substance of the controlling stockholder's decision, while focusing on the process the controlling person used in consummating the transaction.<sup>79</sup>

The duty of loyalty is perhaps more critical in the controlling stockholder buyout context. Where a controlling stockholder receives a direct or indirect personal benefit from a business decision or transaction, this may suggest a breach of the duty of loyalty.<sup>80</sup> Such self-dealing obviates the controlling stockholder's business judgment rule defense.<sup>81</sup> In the controlling stockholder buyout context, the controlling stockholder, by definition, stands on both sides of the transaction.<sup>82</sup> Controlling persons are able to propose the transaction, set the terms, and ultimately approve the transactions with their voting power.<sup>83</sup>

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<sup>78</sup> See *supra* note 2.

<sup>79</sup> In response to the seminal business judgment rule case of *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), where the court found a breach of the duty of care, the Delaware state legislature enacted DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). This section allows Delaware corporations to limit or eliminate director liability for duty of care breaches. Charter or bylaw provisions, however, cannot limit personal liability for breaches of the duty of loyalty. See *id.* § 102(b).

<sup>80</sup> The duty of loyalty contemplates a duty of candor or duty to disclose. This ancillary duty requires that a director disclose any potential conflicts of interest that the director may have with respect to any corporate matter on which the director will act. This duty applies to facts and circumstances that "would have assumed actual significance in the deliberations of the reasonable shareholder." *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). Recently, in *Turner v. Bernstein*, 776 A.2d 530 (Del. Ch. 2000), the Delaware Court of Chancery upheld a shareholder summary judgment motion where the directors provided the shareholders with cursory information that was considered material to merger approval. *Id.* at 541. Because the directors failed to provide the shareholders with sufficient financial information indicating why the merger was in their best interest, the court held they "defaulted on [their] affirmative obligation to disclose the information material to the decisions [they] [were] asking the GenDerm stockholders to make." *Id.* at 532.

<sup>81</sup> See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995) (holding that if a self-dealing fiduciary cannot demonstrate that the transaction was at an entirely fair price, the fiduciary will be liable and there is no business judgment defense); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986). A self-dealing transaction or decision is when the controlling stockholders transact when they have "a personal interest that might conflict with the interest of the party to whom she owes a fiduciary duty." JAMES E. CLAPP, *WEBSTER'S DICTIONARY OF THE LAW* 391 (2000). A self-dealing transaction can be sanitized if the "taint" of the underlying conflict transaction is removed by demonstrating that the transaction was approved by shareholders or by disinterested directors who were fully informed of the conflict. See DEL. CODE ANN. tit. 8, § 144 (2001 & Supp. 2002).

<sup>82</sup> See *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 1115 (Del. 1994).

<sup>83</sup> See *id.* at 1116.

The extensive role of the controlling stockholder in this process has impressed upon the courts the need for stricter scrutiny of these transactions.<sup>84</sup> This strict scrutiny is embodied in the rigorous entire fairness standard of review.

### B. Entire Fairness Review

The exacting entire fairness standard has proven to be an important procedural vehicle of minority stockholder protection under Delaware law.<sup>85</sup> Since the seminal 1983 case of *Weinberger v. UOP, Inc.*,<sup>86</sup> controlling stockholders seeking to freeze out the minority bear the burden of proving the entire fairness of the transaction. In *Weinberger*, directors who served on the boards of both the parent and subsidiary sought to buy out the minority interest at twenty-one dollars per share.<sup>87</sup> Plaintiff-stockholders challenged the elimination of the defendant corporation's minority shareholders by a freeze-out merger between the defendant corporation and its majority owner.<sup>88</sup> The Delaware Court of Chancery held that the terms of the merger were fair to plaintiff and the other minority shareholders of the defendant corporation.<sup>89</sup>

On appeal, the Delaware Supreme Court held that the transaction failed to satisfy any reasonable concept of "fair dealing."<sup>90</sup> This was due in part to the deficient disclosure of the defendant's directors' conflicts of interest.<sup>91</sup> Addi-

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<sup>84</sup> See *Williams v. Geier*, 671 A.2d 1368, 1379 (Del. 1996).

<sup>85</sup> While entire fairness has been an important procedural remedy, appraisal has also played an important role in protecting stockholders who are frozen out. Appraisal is a legislative creation that allows stockholders who are discontent with a transaction to sell their stock at a fair price determined by a court. See *Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182, 1186 (Del. 1988). Legislatures instituted this remedy to compensate for the abrogation of the common law right each stockholder had to prevent the consummation of the merger. See *Heilbrunn v. Sun Chemical Corp.*, 150 A.2d 755 (Del. 1959). For a comprehensive discussion of the statutory appraisal rights of shareholders in the freeze-out context, see Bradley R. Aronstam et al., *Delaware's Going Private Dilemma: Fostering Protections for Minority Shareholders in the Wake of Siliconix and Unocal Exploration*, 58 BUS. LAW. 519 (2003); Alexander Khutorsky, Note, *Coming in from the Cold: Reforming Shareholders' Appraisal Rights in Freeze-out Transactions*, 1997 COLUM. BUS. L. REV. 133; Michael R. Schwenk, Note, *Valuation Problems in the Appraisal Remedy*, 16 CARDOZO L. REV. 649 (1994).

<sup>86</sup> 457 A.2d 701 (Del. 1983).

<sup>87</sup> *Id.* at 707.

<sup>88</sup> *Id.* at 703.

<sup>89</sup> *Id.* In doing so, the court rejected the "Delaware Block" method of determining fair value in any stock valuation proceeding under Delaware law. See *id.* at 712-13. Under the Block method, traditional asset value, market value, and earnings value were each assigned a specific weight and the amounts were added to create a per share value. See *id.* at 713. The court felt the method was "outmoded" in that it excluded valuation methods that were prevalent in the financial community at the time. *Id.* at 712-13.

<sup>90</sup> *Id.* at 712.

<sup>91</sup> See *id.*

tionally, the minority shareholders were denied critical information, subsequently resulting in an uninformed minority shareholder vote.<sup>92</sup>

The *Weinberger* court elaborated on the central aspects of the entire fairness standard. The court stated,

[T]he concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness. However, in a non-fraudulent transaction price may be the preponderant consideration outweighing other features of the merger.<sup>93</sup>

Underlying the *Weinberger* court's entire fairness framework is the existence of conflicts of interest created by the controlling stockholders controlling both sides of the transaction – establishing the terms and voting in approval.<sup>94</sup> This conflict is precisely what obliges controlling stockholders to demonstrate the transaction was entirely fair.<sup>95</sup> Since *Weinberger*, Delaware courts have subsequently refined the “fair dealing” and “fair price” requirements of the entire fairness standard.<sup>96</sup>

While “fair price” was said to examine the economic and financial considerations relied upon when valuing the proposed purchase, the courts elaborated on what the fair price determination did not entail. In *Cinerama, Inc. v. Technicolor, Inc.*,<sup>97</sup> the Delaware Court of Chancery opined that the fair price determination

does not mean the highest price financeable or the highest price that fiduciary could afford to pay. At least in the non-self-dealing context, it means a price that is one that a reasonable

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<sup>92</sup> *See id.*

<sup>93</sup> *Id.* at 711 (citations omitted).

<sup>94</sup> *See id.* at 710.

<sup>95</sup> *See id.*

<sup>96</sup> *See infra* text accompanying notes 98-100.

<sup>97</sup> 663 A.2d 1134 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995).

seller, under all the circumstances, would regard as within a range of fair value; one that such a seller could reasonably accept.<sup>98</sup>

The fair dealing prong of the analysis examines “the process itself that the board followed, the quality of the result it achieved and the quality of the disclosures made to the shareholders to allow them to exercise such choice as the circumstances could provide.”<sup>99</sup>

An important corollary of the fair dealing requirement is the “complete candor” requirement set forth in *Lynch v. Vickers Energy Corp.*<sup>100</sup> In *Lynch*, minority stockholders tendered their shares in response to an offer between defendant corporations to purchase outstanding common stock.<sup>101</sup> The minority stockholder filed suit against the directors and corporations, alleging violations of their fiduciary duties by failing to make full disclosure in the tender offer regarding the value of net assets.<sup>102</sup> Further, the minority shareholders alleged that they were coerced into selling their shares for a grossly inadequate price.<sup>103</sup> The Delaware Supreme Court found that the failure to disclose the substance of an engineering report was a violation of the fiduciary duty of candor owed by defendants to the minority shareholders.<sup>104</sup> The court further held that minority shareholders had the right to that information and to make their own judgments about its significance before they were asked to tender their shares.<sup>105</sup>

The complete candor requirement established in *Lynch* charges Delaware courts with an obligation to

examine what information defendants had and to measure it against what they gave to the minority stockholders, in a context in which “complete candor” is required. In other words, the limited function of the Court [is] to determine whether defendants had disclosed all information in their possession germane to the transaction in issue. And by “germane” we mean, for present purposes, information such as a reasonable share-

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<sup>98</sup> *Id.* at 1143. For a discussion of the different valuation methodologies employed by state courts in fair price hearings, see generally LIPTON & STEINBERGER, *supra* note 7, § 9.07 discussing going concern value, earnings value, liquidation value, and net book value.

<sup>99</sup> *Cinerama*, 663 A.2d. at 1140.

<sup>100</sup> 383 A.2d 278 (Del. 1977).

<sup>101</sup> *Id.* at 279.

<sup>102</sup> *Id.*

<sup>103</sup> *Id.*

<sup>104</sup> *Id.* at 281.

<sup>105</sup> *Id.* at 282.

holder would consider important in deciding whether to sell or retain stock.<sup>106</sup>

The court noted that the duty of candor owed to a minority stockholder is essential because it prevents controlling persons from using their presumable informational advantages to their own advantage and to the detriment of the minority stockholders.<sup>107</sup>

While entire fairness review was generally invoked to critically assess the controlling stockholder's dealings in interested mergers, the effect, from a judicial review standpoint, of conditioning consummation of the transaction on approval by a majority of the minority of the stockholders and/or the approval vote of a special committee of disinterested directors was not, and is still not certain. There was the notion that these mechanisms would change the standard from entire fairness to business judgment, while other authority suggested the standard would remain the same subject to the burden shifting to the plaintiff to prove the unfairness of the transaction. This issue was brought to the forefront in diverging cases of *In re Trans World Airlines, Inc. Shareholders Litigation*,<sup>108</sup> and *Citron v. E.I. Du Pont de Nemours & Co.*<sup>109</sup>

### C. *The Pre-Kahn Split of Authority*

Before the Delaware Supreme Court decided *Kahn v. Lynch Communication Systems*,<sup>110</sup> lower courts were divided over what effect, if any, should be given to intra-corporate cleansing mechanisms in interested mergers. In *Trans World Airlines*,<sup>111</sup> the minority shareholders of Trans World Airlines ("TWA"), voted by an overwhelming majority to approve a proposed merger transaction by which entities controlled by TWA's dominating shareholder, Carl Icahn, would acquire all of the voting stock of the corporation.<sup>112</sup> In the proposed merger, each share owned by the shareholders would be converted into the right to receive \$20 per share in cash and \$30 in principal amount of a new 12% sub-

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<sup>106</sup> *Id.* at 281 (citations omitted).

<sup>107</sup> *See id.* For a discussion of the informational advantages and how controlling persons potentially use them to the detriment of minority stockholders, see generally LUCIAN ARYE BEBCHUK & MARCEL KAHAN, THE "LEMONS EFFECT" IN CORPORATE FREEZE-OUTS (Nat'l Bureau of Econ. Research, Working Paper No. w6938, 1999), at <http://www.nber.org/papers/w6938.pdf>.

<sup>108</sup> No. 9844, 1988 Del. Ch. LEXIS 139 (Del. Ch. Oct. 21, 1988), reprinted in 14 DEL. J. CORP. L. 870 (1988).

<sup>109</sup> 584 A.2d 490, 502 (Del. Ch. 1990).

<sup>110</sup> 638 A.2d 1110 (Del. 1994).

<sup>111</sup> 1988 Del. Ch. LEXIS 139, reprinted in 14 DEL. J. CORP. L. 870 (1988).

<sup>112</sup> *Id.* at \*2. Excepted from the ownership was a 10% stock interest that was to be owned by an Employee Stock Ownership Plan.

ordinated debenture due in 2008.<sup>113</sup> Icahn, who controlled 77% of TWA's common stock, committed to vote his shares in the same proportion as the public shares were voted.<sup>114</sup> Over 96% of the voting shares approved the transaction.<sup>115</sup>

Several minority stockholders sought a preliminary injunction to stop the merger on inadequate disclosure and breach of fiduciary duty grounds.<sup>116</sup> In determining the evidentiary burdens on the parties, the Delaware Court of Chancery held that when a special negotiating committee of disinterested directors is formed and a merger provision requiring approval by a majority of disinterested shareholders is present, the business judgment standard of review is invoked.<sup>117</sup> Put another way, the directors are not obligated to prove the entire fairness of the transaction; rather, the plaintiffs are required to demonstrate that the decision to enter into the transaction lacked rational business judgment.

Alternatively, a diverging view was developing in Delaware case law. In *Citron*,<sup>118</sup> Du Pont, the parent company, sought to acquire approximately 30% of its Remington subsidiary.<sup>119</sup> In the merger, Du Pont ultimately acquired all of Remington's common stock that it did not already own by exchanging .574 Du Pont share for each share of Remington.<sup>120</sup> The minority stockholder plaintiffs contended that Du Pont, as Remington's majority shareholder, breached its fiduciary duty of loyalty to Remington's minority shareholders by proposing a patently inadequate merger that it knew Remington's directors

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> *Id.*

<sup>116</sup> *Id.* at \*3. Plaintiffs complaint alleged that

(1) the price proposed is unfairly low; (2) that the transaction was timed to mask the upward trend of TWA's earnings; and (3) that a special two member committee of the TWA board that purported to represent the interests of the public shareholders in the negotiation process with Mr. Icahn, (a) misunderstood its responsibility to seek to negotiate the best available transaction, (b) as a result, was passive, and (c) relied entirely upon an investment banker who, as it knew, had a material conflict of interest, and who never proceeded with its own analysis of value far enough to reduce its view to a single range of fair value.

*Id.* at \*2-3.

<sup>117</sup> *Id.* at \*18-19.

<sup>118</sup> 584 A.2d 490 (Del. Ch. 1990).

<sup>119</sup> *Id.* at 493.

<sup>120</sup> *Id.* at 498.



would not be in a position to oppose.<sup>121</sup> Additionally, plaintiffs alleged that the merger was a product of self-dealing, unfair dealing, and gross negligence.<sup>122</sup>

The court rejected these arguments and ultimately held that the subsidiary stockholder vote approving the merger was fully informed and valid.<sup>123</sup> Furthermore, it held that the parent fairly proposed and negotiated the merger terms with plaintiff stockholders.<sup>124</sup> The merger committee understood its fiduciary obligations, discharged those obligations carefully, and produced a transaction that was fair to the minority stockholders.<sup>125</sup>

Of important interest is the *Citron* court's discussion regarding what standard of review should be applied to the conflict transaction. As in the TWA merger, the parent-subsidiary merger in *Citron* contained a minority of the majority provision as well as a special committee of disinterested directors.<sup>126</sup> The court reiterated the *Weinberger* mantra that "[t]o invoke the entire fairness review standard, all that is required is that the parent corporation has stood on both sides of the transaction."<sup>127</sup> Citing to *Rosenblatt v. Getty Oil Co.*,<sup>128</sup> the court held that because "the merger was ratified by a fully informed majority of Remington's minority stockholders . . . , the burden will shift to the plaintiff to prove that the merger was unfair."<sup>129</sup> The court refused to follow the case law suggesting the invocation of business judgment review in this context.<sup>130</sup>

The underlying rationale for the *Citron* court's refusal to alter the standard of review is compelling. In a merger between a controlling stockholder and the corporation it controls, "no court could be certain whether the transaction terms fully approximate what truly independent parties would have achieved in an arm's length negotiation" notwithstanding the negotiations of special committees of independent directors.<sup>131</sup> Even with a special committee and ratification of the merger by a majority of the minority shareholders, the court felt additional protection for minority stockholders was necessary. The

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> *Id.* at 503.

<sup>124</sup> *Id.* at 505.

<sup>125</sup> *Id.*

<sup>126</sup> *Id.* at 498.

<sup>127</sup> *Id.* at 500 n.13.

<sup>128</sup> 493 A.2d 929, 937 (Del. 1985).

<sup>129</sup> *Citron*, 584 A.2d at 500 (citation omitted).

<sup>130</sup> See *id.* at 501. "Rather, in a parent-subsidiary merger context, shareholder ratification operates only to shift the burden of persuasion, not to change the substantive standard of review (entire fairness). Nor does the fact that the merger was negotiated by a committee of independent, disinterested directors alter the review standard." *Id.* at 502.

<sup>131</sup> *Id.* at 502.

court provided this protection by adhering to the rigorous entire fairness standard and staunchly refusing to dilute the review process. The bi-polar outcomes reached in *Trans World Airlines* and *Citron* were resolved in the seminal *Kahn v. Lynch Communication Systems*<sup>132</sup> case.

#### D. *Kahn and its Progeny*

The Delaware Supreme Court attempted to reconcile the seemingly contradicting authority in *Citron*, *Rosenblatt*, and *Trans World Airlines*. In *Kahn*, 43.3% controlling stockholder, Alcatel, sought to acquire the remaining outstanding common equity interest in Lynch Communications.<sup>133</sup> In response to previous resistance from Lynch's management to acquire a subsidiary of Alcatel, Alcatel attempted to purchase the outstanding 56.7% of shares in Lynch that it did not own.<sup>134</sup> Pursuant to a supermajority provision, Alcatel previously thwarted two corporate combination attempts by Lynch.<sup>135</sup> By virtue of the voting provision, any combination necessarily required Alcatel's approval.

In response to a \$14 per share offer from Alcatel, Lynch's directors appointed a special committee of independent directors to assess the merits of the offer.<sup>136</sup> The committee considered the bid to be inadequate and instead sought \$17 per share.<sup>137</sup> After raising the price to \$15.50, Alcatel decided to launch a hostile offer for that amount.<sup>138</sup> With no other option, the directors ceded to the demands of Alcatel and approved the sale at a per share price of \$15.50.<sup>139</sup>

Subsequently, minority shareholders filed suit alleging that defendants breached their fiduciary duties to the shareholders. Plaintiffs contended that the Chancery Court erred when it found that "the tender offer and merger were negotiated by an independent committee" and then placed the burden of persuasion on plaintiffs.<sup>140</sup> Plaintiffs further alleged that the merger price was unfair and Alcatel's offer to purchase the stock was false and misleading.<sup>141</sup> The Delaware Supreme Court held that the hostile offer launched by Alcatel under-

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<sup>132</sup> 638 A.2d 1110 (Del. 1994).

<sup>133</sup> *Id.* at 1112.

<sup>134</sup> *Id.*

<sup>135</sup> *Id.* at 1113. The court deemed this important to its finding that Alcatel did, as a matter of fact, control the corporation.

<sup>136</sup> *Id.*

<sup>137</sup> *Id.* at 1118.

<sup>138</sup> *Id.* at 1119.

<sup>139</sup> *Id.* at 1113.

<sup>140</sup> *Id.* at 1111.

<sup>141</sup> *Id.* at 1112.

mined the authority of the special committee.<sup>142</sup> Any authority to “say no” was abrogated by the threat of the hostile offer.<sup>143</sup> Thus, the court held “[e]ntire fairness remains the proper focus of judicial analysis . . . irrespective of whether the burden of proof remains upon or is shifted away from the controlling or dominating shareholder, because the unchanging nature of the underlying ‘interested’ transaction requires careful scrutiny.”<sup>144</sup>

The court then qualified this framework by crafting a two-part test for determining whether burden shifting is appropriate in an interested merger transaction.<sup>145</sup> In the freeze-out context, the controlling shareholder proposing the transaction bears the burden of proving its entire fairness. If the controlling stockholder does not dictate the terms of the merger and the special committee has genuine bargaining power that it can exercise with the controlling stockholder at arm’s length, the burden of proof will be shifted.<sup>146</sup> The stringent burden will then be shifted to the plaintiff to prove the unfairness of the transaction.<sup>147</sup> The effect of this analysis was to provide incentives to transacting parties in the freeze-out context to employ special committees and include majority of the minority provisions *ex ante*, as these minority stockholder protections would facilitate the controlling person’s defense in *ex post* merger review.

What is clear from the *Kahn* analysis is that the use of these “intra-corporate cleansing mechanisms” does not *ipso facto* establish the procedural fairness of the conflict transaction.<sup>148</sup> Furthermore, as *Kahn* expressly suggested by reaffirming *Weinberger* and *Rosenblatt*, the correct standard of review in

<sup>142</sup> *Id.* at 1120.

<sup>143</sup> *Id.* The court explained that the

“power to say no is a significant power. It is the duty of directors serving on an independent committee to approve only a transaction that is in the best interests of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available. It is not sufficient for such directors to achieve the best price that a fiduciary will pay if that price is not a fair price.”

*Id.* at 1119 (citation omitted).

<sup>144</sup> *Id.* at 1116. For a discussion on the effect of this protection on the dispersed ownership structure of corporations, see Georgakopoulos, *supra* note 9, at 43.

<sup>145</sup> See *Kahn*, 638 A.2d at 1117.

<sup>146</sup> Note, however, that a condition precedent to burden shifting is a factual finding that the special committee was genuinely independent, informed, and had the ability to negotiate at arm’s length. See *id.* at 1120.

<sup>147</sup> See *id.* For a discussion on the burden of proving unfairness, see Park McGinty, *The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 EMORY L.J. 163, 235 n.185 (1997).

<sup>148</sup> *Kahn*, 638 A.2d at 1120. For a discussion of the effect of this holding on the statutory appraisal remedy, see John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 360, 389-90 (1996).

interested mergers is entire fairness and not business judgment. This framework was undermined in the context of a controlling stockholder tender offer to the minority in *Solomon v. Pathe Communications Corp.*<sup>149</sup>

*E. Diverging Standard: Tender Offers and the Solomon Line of Cases*

The Delaware courts have treated tender offers by controlling stockholders differently than negotiated mergers. While the tender offer and the negotiated merger essentially accomplish the same goal when commenced by a controlling shareholder, there has been recent commentary questioning the different treatment of transactional similarities.<sup>150</sup> Moreover, several recent cases adhering to the *Solomon* framework have solidified the less stringent judicial treatment of tender offers by controlling stockholders.<sup>151</sup>

In *Solomon*, minority stockholders challenged the fairness of a tender offer made by Credit Lyonnais Banque Nederland N.V. (“CLBN”) to purchase 5.9 million shares of the publicly traded common stock of Pathe Communications Corporation (“Pathe”).<sup>152</sup> CLBN, an 89% stockholder, launched a tender offer to buy out the remaining 11% minority.<sup>153</sup> The tender offer was proposed in conjunction with CLBN’s planned foreclosure on a security interest it held.<sup>154</sup> The minority stockholders asserted that the directors breached their duty of fair dealing because they failed to oppose the tender offer.<sup>155</sup> Furthermore, plaintiffs claimed the directors breached their duty of care for negligently failing to negotiate a sufficient tender price.<sup>156</sup>

In a succinct opinion, the Delaware Supreme Court held that when courts examine “totally voluntary tender offers,” such as the one in *Solomon*, “they do not impose any right of the shareholders to receive a particular price.”<sup>157</sup> The court reiterated and affirmed the “voluntariness” standard Dela-

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<sup>149</sup> 672 A.2d 35 (Del. 1996).

<sup>150</sup> See Allen et al., *supra* note 16, at 879-80.

<sup>151</sup> See, e.g., *In re Aquila, Inc. S’holders Litig.*, 805 A.2d 184 (Del. Ch. 2002) (refusing to enjoin tender offer on grounds that such offers were voluntary transactions and holding that no fairness duty is to be imposed on parent companies); *In re Siliconix Inc. S’holders Litig.*, No. 18700, 2001 WL 716787 (Del. Ch. June 19, 2001) (involving a challenge of an exchange offer by a controlling stockholder of Siliconix).

<sup>152</sup> 672 A.2d at 37.

<sup>153</sup> *Id.*

<sup>154</sup> *Id.*

<sup>155</sup> *Id.*

<sup>156</sup> *Id.*

<sup>157</sup> *Id.* at 39 (citing *Lynch v. Vickers Energy Corp.*, 351 A.2d 570, 576 (Del. Ch. 1976), *rev’d on other grounds*, 383 A.2d 278 (Del. 1977)). The court dismissed plaintiff’s complaint on procedural grounds, namely for failing to state a cause of action for a breach of the duty of care because it made only conclusory assertions and because there was no right to receive a particular price for

ware courts have applied to tender offers, namely “whether coercion is present or whether there is ‘materially false or misleading disclosures made to shareholders in connection with the offer.’”<sup>158</sup> Ultimately, the court concluded that in the absence of coercion or disclosure violations, the adequacy of the price in a voluntary tender offer is not an issue.<sup>159</sup>

More recently, in *In re Aquila, Inc. Shareholders Litigation*<sup>160</sup> and in *In re Siliconix Inc. Shareholders Litigation*,<sup>161</sup> the Chancery Court affirmed the principles expressed in *Solomon*. The facts of both cases are virtually the same. In *Siliconix*, the controlling stockholder parent company, Vishay International (“Vishay”), launched a cash tender offer of \$28.82 to acquire the outstanding 19.6% minority interest of its subsidiary.<sup>162</sup> Vishay agreed to pursue a second step short-form merger under section 253 of the Delaware General Corporation Law<sup>163</sup> at the same price if it acquired at least 90% of the outstanding Siliconix shares.<sup>164</sup> At the request of Vishay, Siliconix appointed a special committee of disinterested directors who subsequently sought financial advice regarding the adequacy of Vishay’s offer.<sup>165</sup> After negotiations with the special committee failed, Vishay unilaterally launched an exchange offer with a majority of the minority provision.<sup>166</sup> The Siliconix special committee neither recommended nor rejected the offer.<sup>167</sup>

A minority stockholder of Siliconix filed suit to enjoin the exchange offer on the grounds that Vishay could not demonstrate that the transaction was entirely fair.<sup>168</sup> The court held, notwithstanding the “conflicted status” of a majority of the directors of Siliconix, “unless coercion or disclosure violations can be shown, no defendant has the duty to demonstrate the entire fairness of [a] proposed tender transaction.”<sup>169</sup> In both *Aquila* and *Siliconix* the Delaware

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totally voluntary tender offers. *Id.* at 40.

<sup>158</sup> *Id.* at 39 (citing *Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051, 1056 (Del. Ch. 1987)).

<sup>159</sup> *Id.*

<sup>160</sup> 805 A.2d 184, 190 (Del. Ch. 2002).

<sup>161</sup> No. 18700, 2001 WL 716787 (Del. Ch. June 19, 2001).

<sup>162</sup> *Id.* at \*2.

<sup>163</sup> DEL. CODE ANN. tit. 8, § 253 (2001).

<sup>164</sup> *Siliconix*, 2001 WL 716787, at \*2.

<sup>165</sup> *Id.*

<sup>166</sup> *Id.* at \*4.

<sup>167</sup> *Id.* at \*17.

<sup>168</sup> *Id.* at \*3.

<sup>169</sup> *Id.* at \*7 (citing *In re Life Technologies, Inc. S’holders Litig.*, No. 16513, 1998 WL 1812280 (Del. Ch. Nov. 24, 1998)).

courts refused to apply entire fairness scrutiny to tender offers,<sup>170</sup> notwithstanding its application to negotiated mergers that achieve the identical result for the controlling party.

A recently settled case in the Delaware Court of Chancery, *Hartley v. Peapod, Inc.*,<sup>171</sup> sheds light on the scope of *Siliconix* and *Aquila*. In *Hartley*, Vice-Chancellor Lamb, in the context of a proposed class action settlement, addressed issues relating to tender offers commenced by controlling stockholders. In *Harley*, the controlling stockholder, Koninklijke Ahold N.V. (“Ahold”), entered into a merger agreement with the Peapod Corporation to acquire the remaining outstanding stock.<sup>172</sup> After intense negotiations between Ahold and the minority stockholders’ special committee, Ahold agreed to offer \$2.15 per share.<sup>173</sup> The transaction was structured as a tender offer followed by a second-step short-form merger.<sup>174</sup> Ahold and the special committee negotiated a merger agreement stating the terms and conditions of the offer.<sup>175</sup> The tender offer was not subject to a majority of the minority provision. As a result, even if no minority stockholders tendered into the offer, Ahold still intended to consummate the merger.

During the settlement hearing, plaintiff sought to justify the existing settlement on the basis that it would have been precluded from challenging the fairness of the tender offer price, given the recent *Siliconix* and *Aquila* holdings.<sup>176</sup> The plaintiff further contended that all the tendering stockholders did so with full disclosure by Ahold and that the Peapod board agreed to merge with Ahold.<sup>177</sup> Consequently, the tender offer would surely have been considered voluntary *ex post*. Vice-Chancellor Lamb disagreed with plaintiff’s contention and explained that the *Aquila* and *Siliconix* holdings were not applicable to *Hartley*.<sup>178</sup>

The *Hartley* case was distinguished from *Siliconix* and *Aquila* in that the tender offer was the first step of a two-step negotiated merger agreement between Ahold, the controlling stockholder, and a special committee of the board

<sup>170</sup> See *id.*

<sup>171</sup> Stipulation & Agreement of Settlement, *Hartley v. Peapod, Inc.*, No. 19025 (Del. Ch. 2002) (order approving proposed settlement entered March 8, 2002).

<sup>172</sup> *Id.* at 2-3.

<sup>173</sup> *Id.* at 3.

<sup>174</sup> See *id.*; Clifford E. Neimeth, *Mergers & Acquisitions*, J. INV. COMPLIANCE, Winter 2002/2003, at 29, 33.

<sup>175</sup> Stipulation & Agreement of Settlement at 3.

<sup>176</sup> See Neimeth, *supra* note 174, at 33.

<sup>177</sup> See *id.*

<sup>178</sup> *Id.*

of directors of Peapod.<sup>179</sup> As the Vice-Chancellor opined, “[a]bout this whole idea that this is a *Siliconix* transaction. It’s not. It’s a negotiated transaction between a majority stockholder and a special committee . . . .”<sup>180</sup> Since there was no majority of the minority provision in the merger agreement, the minority stockholders would not have been able to stop the transaction. The Vice-Chancellor noted that this case “was entirely different than *Siliconix* or *Aquila* where the transaction is entirely up to the minority acting as a block or a majority of them to determine whether the transaction will go forward at all.”<sup>181</sup>

Vice-Chancellor Lamb concluded that the transactional mechanics in *Hartley*, were the functional equivalent of negotiated mergers by controlling stockholders and special committees – mergers that are governed by the entire fairness standard under *Kahn*.<sup>182</sup> The *Hartley* case serves as a reminder that the very existence of a merger agreement – which enabled Ahold to consummate a section 251 long-form merger even if the tender offer was unsuccessful – was dispositive.

Similarly, in *Glassman v. Unocal Exploration Corp.*,<sup>183</sup> the Delaware Supreme Court addressed the uncertain question regarding whether a section 253 short-form merger with a controlling stockholder with its 90% owned subsidiary would be subject to entire fairness review. Section 253 of the Delaware General Corporation Law authorizes directors of a corporation that owns at least 90% of each of the outstanding classes of stock of a subsidiary that are entitled to vote on a merger, to merge the subsidiary into itself without any requirement for action to be taken by the board of directors of the subsidiary.<sup>184</sup> Plaintiffs, relying on the *Weinberger* and *Kahn* line of cases, challenged the fairness of the merger, arguing that mergers effected under section 253 should be reviewed under the entire fairness test – the same standard that is typically applied to freeze-out mergers effected by controlling stockholders under the long-form merger statutes, sections 251 and 252 respectively.<sup>185</sup>

The Delaware Supreme Court reasoned that section 253 creates a right in a 90% stockholder to freeze out minority stockholders. This statutory right “authorizes the elimination of minority stockholders by a summary process that does not involve the ‘fair dealing’ component of entire fairness.”<sup>186</sup> Thus, the

<sup>179</sup> *Id.*

<sup>180</sup> *Id.* at 40 n.26 (citing Hearing Transcript at 5, *Hartley* (No. 19025)).

<sup>181</sup> *Id.* at 40 n.27 (citing Hearing Transcript at 5, *Hartley* (No. 19025)).

<sup>182</sup> See *id.* at 33. Indeed, *Kahn* also involved a merger agreement providing for a front-end loaded tender offer followed by a second-step merger. See 638 A.2d 1110 (Del. 1994).

<sup>183</sup> 777 A.2d 242 (Del. 2001).

<sup>184</sup> *Id.* at 243; see DEL. CODE ANN. tit. 8, § 253 (2001).

<sup>185</sup> *Unocal Exploration*, 777 A.2d at 247.

<sup>186</sup> *Id.* at 247-48 (citations omitted). The court further elaborated:

short-form merger “effectively circumscribe[s] the parent corporation’s obligations to the minority in a short-form merger.”<sup>187</sup> Consequently, the court held the business judgment rule would be applied when a short-form merger is consummated.<sup>188</sup>

When read together, *Siliconix* and *Unocal Exploration* provide controlling stockholders with a roadmap for accomplishing a freeze-out of the minority without assuming the formidable burden of proving entire fairness. Moreover, the *Siliconix* court engaged in a discussion regarding the incongruence in the Delaware precedent that requires entire fairness review of interested mergers and alternatively, business judgment review to tender offers initiated unilaterally by controlling stockholders.<sup>189</sup> This incongruence was a central component of the *Pure Resources* opinion.

#### IV. THE *PURE RESOURCES* STANDARD

In *Pure Resources*, Vice-Chancellor Strine delivered an opinion that essentially illustrated the means for controlling stockholders to structure minority freeze-outs and simultaneously avoid entire fairness litigation. The Vice-Chancellor attempted to reconcile Delaware’s seemingly disparate treatment of negotiated mergers and tender offers followed by second-step mergers. As was discussed, under the *Kahn* benchmark, negotiated mergers by controlling stockholders are subject to entire fairness review.<sup>190</sup> Under the *Solomon* framework amplified by the *Siliconix* and *Aquila* holdings, a unilateral tender offer that serves the same purpose as the negotiated merger, namely to facilitate the controlling person’s purchase of all outstanding common equity interests, would be

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Under settled principles, a parent corporation and its directors undertaking a short-form merger are self-dealing fiduciaries who should be required to establish entire fairness, including fair dealing and fair price. The problem is that § 253 authorizes a summary procedure that is inconsistent with any reasonable notion of fair dealing . . . The equitable claim plainly conflicts with the statute. If a corporate fiduciary follows the truncated process authorized by § 253, it will not be able to establish the fair dealing prong of entire fairness. . . . In order to serve its purpose, § 253 must be construed to obviate the requirement to establish entire fairness.

*Id.* at 243. For a comprehensive discussion on the foundations of *Siliconix* and *Unocal Exploration* and the appraisal remedy, see generally Aronstam et al., *supra* note 85, at 536-48, arguing for an alternative “limited fairness” test to short-form merger transactions that would require controlling stockholders to demonstrate how the price was arrived at and whether the transaction takes advantage of the minority stockholders.

<sup>187</sup> *Unocal Exploration*, 777A.2d at 243.

<sup>188</sup> *Id.*

<sup>189</sup> See *In re Siliconix Inc. S’holders Litig.*, No. 18700, 2001 WL 716787, at \*7 (Del. Ch. June 19, 2001).

<sup>190</sup> See *supra* notes 133-48 and accompanying text.



subject to less stringent business judgment review.<sup>191</sup> This Part will analyze the *Pure Resources* decision focusing primarily on the judicial asymmetry in the review of controlling stockholder tender offers and negotiated mergers.

#### A. *Background and Underlying Negotiations*

In 2000, Unocal Corporation, Inc. (“Unocal”), a natural gas and exploration company, spun off its oil operations in western Texas and combined them with Titan Exploration, Inc., another oil company, to create Pure Resources.<sup>192</sup> Subsequently, Unocal held 65% of Pure Resources outstanding common stock.<sup>193</sup> The former shareholders of Titan Exploration, including several of its managers that remained to manage Pure Resources, held 34% of the residual outstanding common stock.<sup>194</sup> With the permission of Pure Resources’ management, in August of 2001, Unocal began investigating the prospect of acquiring the 34% minority interests.<sup>195</sup> In August of 2002, Unocal informed the Pure Resources board of directors of its intent to commence an exchange offer for the 34% remaining minority interest.<sup>196</sup>

After learning of Unocal’s intent to commence a tender offer, the Pure Resources board established a special committee that was comprised of a joint-appointee and one Unocal appointee who possessed no ties to Unocal.<sup>197</sup> This committee had the limited authority to engage independent advisors, advise the shareholders with respect to the offer in the required Schedule 14D-9, and negotiate the bid price with Unocal.<sup>198</sup> Unocal refused the special committee’s request that it be delegated plenary authority of the board under Delaware law, which would have empowered the committee, *inter alia*, to pursue alternative transactions and to adopt a poison pill to block the offer.<sup>199</sup>

Subsequent to the committee’s formation, Unocal formally commenced an exchange offer. The offer terms contained an exchange ratio of 0.6527 of a Unocal share for each Pure Resources share. The parties also included a non-waiveable majority of the minority provision, a waiveable condition that Unocal would obtain 90% of the outstanding common stock to enable a second-step

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<sup>191</sup> See *supra* notes 150-82 and accompanying text.

<sup>192</sup> See *In re Pure Res. S’holders Litig.*, 808 A.2d 421, 425 (Del. Ch. 2002).

<sup>193</sup> *Id.* at 426. The court spent considerable time unraveling the various agreements that were economically affected by the buyout transaction.

<sup>194</sup> *Id.* at 425.

<sup>195</sup> *Id.* at 427.

<sup>196</sup> *Id.* at 429.

<sup>197</sup> *Id.*

<sup>198</sup> *Id.* at 430.

<sup>199</sup> *Id.*

merger, and a statement of Unocal's intent to consummate a second-step merger at the same exchange ratio as the exchange offer.<sup>200</sup> The special committee opposed the offer on the ground that the price was inadequate.<sup>201</sup>

The plaintiff, a minority shareholder, sought to enjoin Unocal from making an exchange offer on several grounds. First, the plaintiff argued that Unocal's offer was coercive and further subject to entire fairness review under the *Kahn* framework.<sup>202</sup> Additionally, plaintiff alleged that the disclosure documents filed with the SEC did not provide minority stockholders with adequate disclosure of the material facts and financial information that was necessary for the stockholders to make an informed decision with respect to the exchange offer.<sup>203</sup> Unocal responded that, because it proceeded by way of an exchange offer and not a negotiated merger, its offer was subject to the standard under *Solomon* and its progeny.<sup>204</sup> To wit, Unocal's offer complied with the *Solomon* standard because the terms contained a majority of the minority provision and further Unocal intended to consummate a short-form merger with the minority shareholders receiving the same consideration as tendering stockholders in the first step.<sup>205</sup> In a lengthy opinion Vice-Chancellor Strine attempted to address the underlying dispute – a dispute fraught with doctrinal tension.

#### B. *The Modification of the Solomon Standard*

The court began its discussion by articulating the different routes transacting parties can pursue in consummating a buyout of the minority interests. In a negotiated merger, the court discussed the presence of “inherent coercion” as articulated in *Kahn*.<sup>206</sup> This inherent coercion that persists when a controlling stockholder purports to buy out the minority's stock via negotiated merger results from a fear that the controlling person will make retributive threats against the minority if they refuse to tender their stock.<sup>207</sup> Such threats include the prospect of threatening a squeeze-out merger at a less favorable price, withholding of dividends, and other retaliatory actions that could potentially influence the minority's vote.<sup>208</sup> The court noted the *Kahn* mandate of entire fairness review in such situations, while at the same time noting the business judgment

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<sup>200</sup> *Id.*

<sup>201</sup> *Id.* at 432.

<sup>202</sup> *Id.* at 433.

<sup>203</sup> *Id.* at 432.

<sup>204</sup> *Id.* at 433.

<sup>205</sup> *See id.*

<sup>206</sup> *Id.* at 433.

<sup>207</sup> *See id.*

<sup>208</sup> *See id.* (citing *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 1116 (Del. 1994)).

review of tender offers under *Solomon* – despite the prospect of inherent coercion in the latter transactional method as well.<sup>209</sup>

After engaging in a lengthy discussion with respect to the *Kahn* and *Solomon* asymmetry, the Vice-Chancellor refused to apply entire fairness review and concomitantly established standards for tender offers to be deemed noncoercive.<sup>210</sup> First, the tender or exchange offer should be subject to a nonwaivable condition that a majority of the shares not owned by the controlling stockholder must be tendered.<sup>211</sup> It is important to note, however, that the court emphasized that the definition of minority should be expressly defined to exclude shareholders who are connected to the controlling stockholder because they are directors, officers, or affiliates of the controlling stockholder.<sup>212</sup> Additionally, stockholders who have economic incentives by virtue of employment agreements, stock repurchase agreements, severance agreements, or any agreement that would be affected by the transaction should also be excluded.<sup>213</sup> In this regard, the court concluded that Unocal's offer was coercive because included within the definition of "minority" were several stockholders that were affiliated with Unocal by virtue of employment, severance, or put agreements.<sup>214</sup>

The second factor requires the offer to contain a promise by the controlling stockholder to promptly consummate a short-form merger at the same price as the exchange or tender offer if it obtains more than 90% of the minority's stock.<sup>215</sup> Lastly, the court warned that controlling stockholders must be cautious not to make any retributive threats against minority stockholders in an attempt to induce them into tendering their stock.<sup>216</sup> Thus, if a tender or exchange offer is "structured in a manner that reduces the distorting effect of the tendering process on free stockholder choice and by ensuring minority stockholders a candid and unfettered tendering recommendation from the independent directors of the target board" entire fairness review could be evaded.<sup>217</sup>

The court further noted in dicta that business judgment protections, not the entire fairness standard, should govern negotiated mergers that are negotiated by special committees and contain a majority of the minority provision, but the court noted such a decision would have to be made by the Delaware Supreme Court. This method of analysis, according to the court, "would help level

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<sup>209</sup> *Id.* at 438.

<sup>210</sup> *Id.* at 445.

<sup>211</sup> *Id.*

<sup>212</sup> *Id.* at 446.

<sup>213</sup> *See id.*

<sup>214</sup> *Id.* The offer was enjoined subject to amendment of this aspect of the exchange offer terms.

<sup>215</sup> *See id.* at 445.

<sup>216</sup> *Id.*

<sup>217</sup> *Id.* at 424.

the litigation risks posed by the different acquisition methods, and thereby provide an incentive to use the negotiated merger route.”<sup>218</sup> The court essentially attempted to restore shareholder confidence in the special committee, a confidence that contravenes the inherent suspicions articulated in the *Kahn* framework. This departure from *Kahn* will be discussed shortly.

### C. The “Fair Summary” Requirement

Essential to *Pure Resources* is the overall framework it established regarding the treatment of minority shareholders in freeze-outs. Along these lines, the court addressed a question of law that has always been uncertain, namely, what extent of disclosure is the controlling party required to provide to the minority. The court advocated for the removal of the substantive protective layer (entire fairness review) and strengthened the disclosure to minority shareholders by requiring the controlling party to provide a “fair summary” of investment banking analyses. For the court, this additional “fair summary” will protect minority interests and produce a more informed decision. Protecting minority shareholders by way of mandating additional disclosure, however, is inadequate because disclosure does not ensure fair dealing – a component that is quintessential to the entire fairness brand of scrutiny.

In addressing the inadequate disclosure claims of the minority stockholders, the court focused on the registration statement on form S-4 filed by Unocal with the SEC to support its offer and the Schedule 14D-9 filed in response to the offer.<sup>219</sup> The extent of which the underlying investment banker analyses and valuation methods required to be disclosed to stockholders was an uncertain question under Delaware law. There had been Delaware case law suggesting that valuation analyses are not material to the stockholder determination of whether to approve a transaction or exercise appraisal rights.<sup>220</sup> Alternatively, other case law suggested that valuation methodologies might indeed be material.<sup>221</sup>

In *McMullin v. Beran*,<sup>222</sup> plaintiff-minority shareholder filed a putative class action against ARCHO Chemical, Inc.’s management, alleging breach of their fiduciary duties in connection with the sale of their company to a third

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<sup>218</sup> *Id.* at 444 n.43.

<sup>219</sup> *Id.* at 448.

<sup>220</sup> *See, e.g.,* Skeen v. Jo-Ann Stores, Inc., 750 A.2d 1170, 1174 (Del. 2000) (holding that while investment banker analyses are helpful to stockholders, this information is not “material” as a matter of law).

<sup>221</sup> *See, e.g.,* McMullin v. Beran, 765 A.2d 910 (Del. 2000) (stating that the information provided to the investment bankers and the valuation methods they employ may indeed be material in certain circumstances).

<sup>222</sup> 765 A.2d 910.

party at the behest of 80% controlling stockholder.<sup>223</sup> The importance and precedential value of *McMullin* lies in its examination of the fiduciary responsibilities owed by directors to minority shareholders in evaluating a sale proposed by the controlling stockholders. The court found that the directors owed minority stockholders fiduciary duties of care, loyalty, and good faith in recommending the sale, notwithstanding the inability of the directors to negotiate or halt the sale given the controlling shareholder's majority holding status.<sup>224</sup>

Specifically, the court held that the directors had the duty to act on an informed basis to independently ascertain and communicate how the merger consideration compared to the corporation's value as a going concern.<sup>225</sup> In doing so, the court noted that directors are "obliged to disclose with entire candor all material facts concerning the merger, so that the minority stockholders are able to make an informed decision whether to accept the tender offer price or to seek judicial remedies such as appraisal or an injunction."<sup>226</sup>

The *McMullin* court also refused to subject shareholders to uncertainties when a proposal to merge a corporation with a third party is negotiated by its controlling shareholder. The court refused to allow management to abdicate its fiduciary obligations by leaving it to the stockholders to approve or disapprove the merger agreement without directorial guidance. The court emphasized that

[e]ffective representation of the financial interests of the minority shareholders imposed upon the Chemical Board an affirmative responsibility to protect those minority shareholders' interests. This responsibility required the Chemical Board to: first, conduct a critical assessment of the third-party Transaction with Lyondell that was proposed by the majority shareholder; and second, make an independent determination whether that transaction maximized value for all shareholders. The Chemical Directors have a duty to fulfill this obligation faithfully and with due care so that the minority shareholders will be able to make an informed decision about whether to accept the Lyondell Transaction tender offer price or to seek an appraisal of their shares.<sup>227</sup>

The *McMullin* court's campaign to safeguard the minority's decisional interests in the context of a sale negotiated by a controlling stockholder was based on the

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<sup>223</sup> *Id.* at 914.

<sup>224</sup> *Id.* at 921-25.

<sup>225</sup> *Id.* at 917.

<sup>226</sup> *Id.*

<sup>227</sup> *Id.* at 920.

ineluctable fact that the majority shareholder's voting power makes the outcome a "preordained" conclusion.<sup>228</sup>

The Delaware courts reached an inconsistent result in *Skeen v. Jo-Ann Stores, Inc.*<sup>229</sup> In *Skeen*, minority stockholders filed an action against board of directors of House of Fabrics, Inc. ("HOF"), alleging they were not provided adequate disclosures relating to a merger in which they were frozen out by a controlling stockholder.<sup>230</sup> HOF agreed to be acquired by Fabri-Centers of America, Inc., in a two-step transaction – a tender offer of the HOF shares at \$4.25 per share followed by a merger at the same price.<sup>231</sup> The former minority shareholders alleged that they were not provided adequate financial information to determine whether to accept the merger consideration of \$4.25 per share or pursue their statutory appraisal rights.<sup>232</sup> The shareholders contended that omitted information would have been important for them to determine how much value was added between the tender offer and the merger.<sup>233</sup> Additionally, the stockholders claimed the disclosures they were provided with lacked relevant material financial data.<sup>234</sup>

The *Skeen* court began its analysis by stating the definitive often cited standard governing whether disclosures are material. For a fact to be considered material "there must be 'a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable stockholder as having significantly altered the total mix of information made available.'"<sup>235</sup> The court further noted that the plaintiffs are required to provide a basis for the court to infer that the alleged disclosure deficiencies were material.<sup>236</sup> In commencing an action based on inadequate disclosure, the plaintiffs are required to allege that "'facts are missing from the [information] statement, identify those facts, state why they meet the materiality standard and how the omission caused injury.'"<sup>237</sup>

Strictly adhering to these pleading standards, the *Skeen* court held that the defendant directors offered no undisclosed facts concerning the supposed

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<sup>228</sup> *Id.* at 919.

<sup>229</sup> 750 A.2d 1170 (Del. 2000).

<sup>230</sup> *Id.* at 1171.

<sup>231</sup> *Id.*

<sup>232</sup> *Id.* at 1173-74.

<sup>233</sup> *Id.* at 1173.

<sup>234</sup> *Id.*

<sup>235</sup> *Id.* at 1172 (quoting *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 142 (Del. 1997)).

<sup>236</sup> *Id.* at 1173.

<sup>237</sup> *Id.* (alteration in original) (quoting *Loudon*, 700 A.2d at 140).

plan that would have been critical to the appraisal determination.<sup>238</sup> The complaint ultimately failed because plaintiffs neglected to aver facts suggesting that the undisclosed information was inconsistent with the disclosed information.<sup>239</sup> More importantly, as a precedential matter the court refused to provide its imprimatur on the notion that a summary of the methodologies used and ranges of values generated by investment bankers in reaching its fairness opinion should be considered material as a matter of law.<sup>240</sup> After *Skeen*, investment-banking methodologies underlying fairness opinions were considered immaterial and therefore not subject to mandatory disclosure under Delaware law.

In *Pure Resources*, the court attempted to narrow the doctrinal chasm resulting from the *Skeen* and *McMullin* decisions. Vice-Chancellor Strine declared that

it is time that this ambivalence be resolved in favor of a firm statement that stockholders are entitled to a fair summary of the substantive work performed by the investment bankers upon whose advice the recommendation of their board as to how to vote on a merger or tender rely.<sup>241</sup>

Supporting the court's reconciliation of this murky question, he stated "that disclosure of the banker's 'fairness opinion' alone without more provides stockholders with nothing other than a conclusion, qualified by a gauze of protective language designed to insulate the banker from liability."<sup>242</sup> Because the valuation methodologies are what "buttresses the result," the Vice-Chancellor held that a fair summary requirement was necessary.<sup>243</sup>

Additionally, the court ordered Unocal to reveal the restrictions that were placed on the special committee.<sup>244</sup> To this effect, the Vice-Chancellor stated that "no reasonable reader of the Pure proxy would know that the special committee sought to have the full power of the Pure board delegated to it – including the power to block an offer through a rights plan – and had been rebuffed."<sup>245</sup> These disclosure mandates contravene the Delaware judiciary's traditional reluctance to mandate prolix disclosures and overreach into a realm traditionally reserved for the SEC. Indeed, under SEC rules, Schedule 14D-9

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<sup>238</sup> *Id.* at 1174.

<sup>239</sup> *See id.*

<sup>240</sup> *See id.*

<sup>241</sup> *In re Pure Res. S'holders Litig.*, 808 A.2d 421, 449 (Del. Ch. 2002).

<sup>242</sup> *Id.*

<sup>243</sup> *Id.*

<sup>244</sup> *See id.* at 451.

<sup>245</sup> *Id.* at 452.

does not require the inclusion of the financial analyses of the target's investment bankers.<sup>246</sup> Ultimately, the court enjoined the exchange offer pending revisions to the registration statement and Schedule 14D-9.<sup>247</sup>

Is enhanced disclosure the proper focus in protecting minority interests in freeze-outs? Does abrogating entire fairness review in the freeze-out context in light of heightened disclosure adequately protect the minority shareholders? Augmented disclosure has been criticized as having little utility in other contexts relating to mandated SEC disclosures.<sup>248</sup> Several commentators compellingly assert that SEC mandated disclosure to lay-shareholders leads to inefficiencies, as lay people are not able to understand intricate disclosures and complex transactions.<sup>249</sup> As one commentator stated, "The SEC overestimates the average investor's ability to master the complexities of the financial picture of the typical issuer, and therefore has failed . . . to understand that its disclosure documents can be used effectively only by professionals."<sup>250</sup>

<sup>246</sup> See 17 C.F.R. § 240.14d-9(e)(2)(ii) (2003).

<sup>247</sup> *Pure Res.*, 808 A.2d at 452-53.

<sup>248</sup> For interesting perspectives on the great debate surrounding the social and economic utility of SEC-mandated disclosure, see generally RALPH F. DE BEDTS, *THE NEW DEAL'S SEC: THE FORMATIVE YEARS* (1964); FERDINAND PECORA, *WALL STREET UNDER OATH* (1939); Alison Grey Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 *HASTINGS L.J.* 311 (1973); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 *VA. L. REV.* 717 (1984); Roger J. Dennis, *Mandatory Disclosure Theory and Management Projections: A Law and Economics Perspective*, 46 *MD. L. REV.* 1197, 1199 (1987); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 *VA. L. REV.* 669 (1984); Harry Heller, *Disclosure Requirements Under Federal Securities Regulation*, 16 *BUS. LAW.* 300 (1961); Laylin K. James, *The Securities Act of 1933*, 32 *MICH. L. REV.* 624 (1934); Dennis S. Karjala, *Federalism, Full Disclosure, and the National Markets in the Interpretation of Federal Securities Law*, 80 *NW. U. L. REV.* 1473 (1986); Robert L. Knauss, *A Re-Appraisal of the Role of Disclosure*, 62 *MICH. L. REV.* 607 (1964); Bruce Alan Mann, *Prospectuses: Unreadable or Just Unread?—A Proposal to Reexamine Policies Against Permitting Projections*, 40 *GEO. WASH. L. REV.* 222 (1971).

<sup>249</sup> See, e.g., HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 14 (1979).

<sup>250</sup> *Id.* With respect to disclosure requirements in company prospectuses, Kripke stated, "The myth that it is the layman to whom the prospectus is addressed permeates the SEC's concept of disclosure. It limits the usefulness of disclosure to those who should be its proper objective, the sophisticated investor and professional through whom information ought to filter down to the layman." Homer Kripke, *The Myth of the Informed Layman*, 28 *BUS. LAW.* 631, 633 (1972). *But cf.* Panel Discussion, *New Approaches to Disclosure in Registered Security Offerings*, 28 *BUS. LAW.* 505, 527 (1972) ("With regard to Professor Kripke's obeisance to the so-called experts in securities investment, one can, I believe, with equal justification oppose his concept of the 'myth of the informed layman' with the 'myth of the 'expert' expert.'"). The so-called "myth of the 'expert' expert" theory is premised on the rationale that Kripke's informed layman theory incorrectly assumes that only experts can comprehend disclosure filings and all experts understand disclosure. *Id.* Therefore, the SEC should direct disclosure to "those persons who are capable of understanding the transactions being described." *Id.*



In relation to minority shareholders who are confronted with informational disadvantages vis-à-vis the controlling stockholder, the fair summary requirement may prove to be a boon to the minority's decisional interests when confronted with the prospect of a freeze-out. In the freeze-out context, minority interests that are confronted with accepting the freeze-out consideration or perfecting their appraisal rights will be aided by the fair summary mandate. However, this enhanced fair summary disclosure requirement alone, or coupled with the flawed appraisal remedy,<sup>251</sup> is not a sufficient exemplar of minority shareholder protection in the freeze-out context. Enhanced disclosure should complement rather than substitute entire fairness review in interested transactions.

#### D. *The Practical Effects of Pure Resources on Transacting Parties*

The *Pure Resources* decision has several practical consequences.<sup>252</sup> While the Delaware Supreme Court will ultimately be the final arbiter on the standard of review question, *Pure Resources*, *Siliconix*, and *Aquila*, collectively, suggest that a controlling stockholder seeking to buy out the minority will be able to avoid entire fairness review if the transaction takes the form of a tender or exchange offer with a properly structured majority of the minority provision as well as a promise to consummate a short-form merger on the same terms. Consequently, the negotiated merger route will less likely be used because the litigation threat in the tender offer context will likely be non-existent.<sup>253</sup>

Additionally, transacting parties will necessarily have to be more cognizant of appointing a special committee of independent directors and empowering such committee with plenary authority with respect to an offer. In addition to meeting SEC disclosure requirements, a fair summary of the investment bankers' analyses and detailed information with respect to the recommendation (or lack thereof) of the special committee must be provided to the minority stockholders. While the absence of these devices do not necessarily constitute a breach of fiduciary duty, compliance with these requirements will undoubtedly dispel the entire fairness burden on the proponent of the tender offer. This raises an important question: Is allowing transacting parties to evade fairness review in this manner sound public policy? After assessing the discussion on the judicial incongruity in *Pure Resources*, the answer will be more apparent.

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<sup>251</sup> The ineffectiveness of the appraisal remedy will be addressed *infra* at text accompanying notes 289-295.

<sup>252</sup> For a discussion of the corporate governance implications of *Pure Resources*, see the comments of Judge Tennille in *Lessons From Enron: A Symposium on Corporate Governance*, 54 MERCER L. REV. 683, 691 (2003), recorded in the symposium's morning session transcript.

<sup>253</sup> For more on the effects *Pure Resources*, *Siliconix*, and *Unocal Exploration* will have on transacting parties and their counsel, see Aronstam et al., *supra* note 85, at 521 n.16, referring to the "corporate blueprint" resulting from these opinions.

## V. RECONCILING THE JUDICIAL INCONGRUITY

The sixty-two million dollar question was posed by Vice-Chancellor Strine in *Pure Resources*: “Is there reason to believe that the tender offer method of acquisition is more protective of the minority, with the result that less scrutiny is required than of negotiated mergers with controlling stockholders?”<sup>254</sup> While the Delaware Supreme Court will be the ultimate arbiter of this question, the Vice-Chancellor provided an illuminating discussion.

The Delaware courts have long perceived tender offers as voluntary noncoercive transactions.<sup>255</sup> Unless “materially false or misleading disclosures were made to the shareholders in connection with the offer” or “by reason of its terms or the circumstances under which it was made, is wrongfully coercive” the Delaware courts consider the offer voluntary.<sup>256</sup> Alternatively, tender offers raise concerns of coerciveness as they have been likened to a prisoner’s dilemma,<sup>257</sup> they distort choice and create incentive for stockholders to tender into offers that they may believe are inadequate in order to subsequently avoid a worse predicament.<sup>258</sup>

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<sup>254</sup> *In re Pure Res. S’holders Litig.*, 808 A.2d 421, 441 (Del. Ch. 2002).

<sup>255</sup> *See Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051, 1056 (Del. Ch. 1987).

<sup>256</sup> *Solomon v. Pathe Communications Corp.*, 672 A.2d 35, 39 (Del. 1997) (citing *Eisenberg*, 537 A.2d at 1056).

<sup>257</sup> The prisoner’s dilemma can be understood from the following hypothetical:

Tanya and Cinque have been arrested for robbing the Hibernia Savings Bank and placed in separate isolation cells. Both care much more about their personal freedom than about the welfare of their accomplice. A clever prosecutor makes the following offer to each. “You may choose to confess or remain silent. If you confess and your accomplice remains silent I will drop all charges against you and use your testimony to ensure that your accomplice does serious time. Likewise, if your accomplice confesses while you remain silent, they will go free while you do the time. If you both confess I get two convictions, but I’ll see to it that you both get early parole. If you both remain silent, I’ll have to settle for token sentences on firearms possession charges. If you wish to confess, you must leave a note with the jailer before my return tomorrow morning.” The “dilemma” faced by the prisoners here is that, whatever the other does, each is better off confessing than remaining silent. But the outcome obtained when both confess is worse for each than the outcome they would have obtained had both remained silent.

Steven Kuhn, *Prisoner’s Dilemma*, THE STANFORD ENCYCLOPEDIA OF PHILOSOPHY (Zalta ed. 2003), at <http://plato.stanford.edu/archives/fall2003/entries/prisoner-dilemma/> (last modified Aug. 11, 2003). This philosophical problem has been applied to tender offers as an illustration of the conflict between individual shareholders and group rationality.

<sup>258</sup> *See, e.g.*, Lucian Arye Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1039-40 (1982); Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695, 1696-97 (1985); Robert A. Prentice & John H. Langmore, *Hostile Tender Offers and the “Nancy Reagan Defense”: May Target Boards “Just Say No”? Should They Be Allowed To?*, 15 DEL. J. CORP. L. 377, 442 (1990).

The Vice-Chancellor focused on the coercive potential of tender offers coupled with the same potential for retributive action by the controlling stockholders as in negotiated mergers. For the Vice-Chancellor, “nothing about the tender offer method of corporate acquisition makes the 800-pound gorilla’s retributive capabilities less daunting to minority shareholders.”<sup>259</sup> Accordingly, the Vice-Chancellor argued that, *ex ante*, minority shareholders would fear retributive action *ex post* if they vote no. This “inherent coercion” exists in both the tender offer and negotiated merger contexts with equal force. Thus, Strine was convinced that the disparate treatment of the two transactional methods under Delaware law is not warranted. Put another way, the substance of a transaction should govern how the transaction is reviewed by the court, not the form or mechanics of it.

Interestingly, there exists a theoretical basis to argue that the disparate treatment of tender offers and negotiated mergers under Delaware law is intentional. The *Siliconix* opinion itself acknowledges the intentional nature of the asymmetrical treatment of the two transaction types.<sup>260</sup> Vice-Chancellor Noble noted that as a policy matter the distinction is appropriate because tender offers are not transactions that are directed at the target company.<sup>261</sup> By definition, tender offers are made directly to the stockholders and therefore are not corporate-level transactions.<sup>262</sup> Furthermore, unlike in the negotiated merger, the stock interests of nontendering stockholders do not evaporate as a matter of law – at least not until the short-form merger is effectuated.<sup>263</sup> On the other hand, a merger is a corporate-level transaction by the board of directors that can be outcome determinative by the controlling stockholder who has sufficient voting power.

In adhering to the *Solomon/Siliconix* business judgment review framework, the Vice-Chancellor proposed a “slight easing” of the *Kahn* paradigm, for the purpose of providing incentive to use the negotiated merger route.<sup>264</sup> To that end, he advocated providing business judgment protection to negotiated mergers where a special committee and majority of the minority provision are present. Ultimately, for the Vice-Chancellor, affording a “greater liability immunizing effect” to special committee negotiations and majority of the minority provisions would ease the asymmetrical treatment of tender offers and negotiated mergers under Delaware law.<sup>265</sup>

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<sup>259</sup> See *Pure Res.*, 808 A.2d at 441.

<sup>260</sup> See *In re Siliconix Inc. S’holders Litig.*, No. 18700, 2001 WL 716787, at \*8 n.35 (Del. Ch. June 19, 2001).

<sup>261</sup> *Id.* at \*7.

<sup>262</sup> *Id.*

<sup>263</sup> See *id.*

<sup>264</sup> *Pure Res.*, 808 A.2d at 444 n.43.

<sup>265</sup> See *id.* at 444.

### A. Applying Entire Fairness Review to Both Transaction Types

For Vice-Chancellor Strine, the minor transactional difference should not heavily impact the policy-driven decision of what standard of review should be applied to these transactions *ex post*. In light of the fact that there is some basis to argue that the incongruence in Delaware's treatment of tender offers and negotiated mergers is intentional, is a "slight easing" of the *Kahn* benchmark appropriate in the negotiated merger context? Should these controlling stockholder transactions when accompanied by intra-corporate cleansing mechanisms be afforded business judgment deference as Vice-Chancellor Strine suggested in *Pure Resources*? To answer this important question requires a reassessment of the underlying policy concerns of the *Kahn* framework.

In *Kahn*, the Delaware Supreme Court was principally concerned with the controlling stockholder's ability to influence a special committee of independent directors and minority stockholders. The court expressly stated, "no court could be certain whether the transaction terms fully approximate what truly independent parties would have achieved in an arm's length negotiation."<sup>266</sup> Often, the only source of advice these committees have is from the controlling stockholder who is the proponent of the merger.<sup>267</sup> The integrity of the special disinterested director committee process necessarily requires an enhanced form of judicial scrutiny as most public corporations have a majority of independent directors, yet those directors are not hermetically sealed off from the inside directors.<sup>268</sup> These concerns that the *Kahn* court confronted remain prevalent in both tender offers and negotiated mergers – when commenced by controlling stockholders.

Additionally, *Kahn* was concerned with the ability of a controlling stockholder to take retaliatory actions in the wake of rejection by an independent board, a special committee or a minority stockholder.<sup>269</sup> Vice-Chancellor Strine argued that this concern is identical if not more prevalent in the tender offer context.<sup>270</sup> In a tender offer, a "stockholder could be one of the few who holds out, leaving herself in an even more thinly traded stock with little hope of liquidity and subject to a § 253 merger at a lower price or at the same price but at a later (and, given the time value of money, a less valuable) time."<sup>271</sup>

Beyond *Kahn*, the controlling stockholder who effectuates a freeze-out of the minority by way of either a tender offer or a negotiated merger will likely

<sup>266</sup> *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 1116 (Del. 1994).

<sup>267</sup> See Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 *FORDHAM L. REV.* 437, 453 (1993).

<sup>268</sup> See *id.* at 452.

<sup>269</sup> See *Kahn*, 638 A.2d at 1116.

<sup>270</sup> See *Pure Res.*, 808 A.2d at 442-43.

<sup>271</sup> *Id.* at 442.

be privy to private information relating to the corporation's value.<sup>272</sup> This presence of private information "enables a controlling stockholder to gain systematically at the expense of the minority shareholders."<sup>273</sup> Indeed, when the controlling stockholder's information indicates that the value of the minority's shares is above the market price, the profit maximizing controlling stockholder will not hesitate to exercise his or her freeze-out right at that very moment.<sup>274</sup>

The controlling stockholder's right to effectuate a freeze-out is therefore akin to the ultimate call option – a call option on the minority's interest that lasts for an indefinite duration and whose exercise price is determined by the option holder.<sup>275</sup> Because there are few, if any, cognizable differences between the *Solomon* and *Kahn* line of cases, and because the technical differences do not adequately account for the differences in policy emphasis, these transactions should be treated the same way. In light of the prevalence of the concerns of *Kahn* in both transaction types, the appropriate judicial response should contemplate the application of the entire fairness standard to both tender offers and negotiated mergers when the proponent is a controlling person, not the application of business judgment protection to the interested proponents of these transactions.

## VI. ENTIRE FAIRNESS, FREEZE-OUTS, AND ECONOMIC THEORY

Is the application of entire fairness review costly and economically inefficient so as to warrant abdicating this standard of review in the freeze-out context? Are freeze-out mergers socially optimal transactions? Is substantive review of freeze-out transactions consistent with Delaware's venerable corporate law model? Is the Delaware Court of Chancery – the court that will engage in entire fairness review – adequately equipped for handling entire fairness review expeditiously and efficiently? Addressing these questions is essential in assessing the costs associated with entire fairness review and offsetting these costs with potential benefits resulting from this brand of scrutiny. Moreover, delving into the social, economic, and transaction costs associated with freeze-outs will make it increasingly apparent that entire fairness review is necessary in freeze-outs – irrespective of whether the transacting parties accomplish the freeze-out goal via the tender offer or negotiated merger.

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<sup>272</sup> See *id.* at 442-43.

<sup>273</sup> BEBCHUK & KAHAN, *supra* note 107, at 4.

<sup>274</sup> See *id.*

<sup>275</sup> See, e.g., ZOHAR GOSHEN & ZVI WEINER, THE VALUE OF THE FREEZEOUT OPTION (Berkeley Olin Program in Law & Econ., Working Paper No. 13, 2000), at <http://repositories.cdlib.org/blewp/13/>.

### A. Transaction Costs, Externalities, and Incentives

Any party seeking judicial relief is certain to incur some form of transaction costs. In merger review those transaction costs can be extensive, and include, inter alia, legal fees, expert fees, lost executive time, and potential risk minimization on the part of management. When judicial scrutiny is most intense (entire fairness review), management's hands could be tied and elements of risk, which are part and parcel of corporate notions of wealth maximization,<sup>276</sup> can potentially be stifled.<sup>277</sup> This negative externality is arguably the most significant cost stemming from strict judicial review when corporate machinery is the focal point. As one commentator has suggested, "[a] legal regime that significantly impaired management's freedom to decide the corporation's regular affairs would destroy far more shareholder value than is destroyed by all the renegade managements that oppress minority shareholders."<sup>278</sup>

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<sup>276</sup> There has been a longstanding philosophical debate regarding whether shareholder wealth maximization is the fundamental purpose of the corporation. See, e.g., William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1067 (2002) [hereinafter Allen et al., *Great Takeover Debate*] ("the question is whether corporation law exists solely in order to facilitate shareholder economic welfare or whether the 'republican' form of corporate governance represents a partial commitment by the law to values in addition to implementing shareholder will"). Vice-Chancellors Strine and Jacobs and former Chancellor William Allen recently crystallized this great debate as follows:

Competing political and philosophic views of the nature and purpose of the corporation may yield rather different answers to the most basic and arguably most persistent controversy in corporation law: What is the core purpose of the corporation? Is it to achieve the best result for the current group of stockholders? That position is associated with what we call the "property model" of the corporation. Or is it to maximize the value that the corporation generates as an entity in the long term, regardless of whether that is in the best interests of the current stockholders? That view is associated with what has been called the "entity model" of the corporation.

The focal point of the ongoing debate between the adherents of these two schools for most of the last quarter-century has been fixed – almost obsessively – on the area of takeover proposals, and specifically, on the question of who has primacy to decide whether to accept an "all-shares" tender offer – stockholders or directors? The property modelists, who are viewed as advocates of shareholder choice, contend that the stockholders themselves must be permitted to accept or reject a tender offer once the directors have had the opportunity to negotiate for a higher price, to seek better deals, and to present a noncoercive alternative. By contrast, the entity modelists regard director decisionmaking as primary. When informed directors have made a good-faith decision that an all-shares tender offer is not in the long-run best interests of the corporation, this school advocates that directors must be permitted to "just say no" on the stockholders' behalf.

*Id.* at 1071-72 (footnotes omitted); see also William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 264-66 (1992).

<sup>277</sup> See McGinty, *supra* note 147, at 227.

<sup>278</sup> *Id.*

Alternatively, when courts engage in deferential adjudication (business judgment review) transactions costs are necessarily diminished as the burden of proof is on the challenging shareholders. When courts apply deferential review, directorial discretion is not threatened and management is able to “respond efficiently to a perpetually changing business environment . . . thereby creat[ing] significant enhanced discretion efficiencies.”<sup>279</sup> This increased discretion, which presumably constitutes a positive externality, is due to the rational basis type of adjudication<sup>280</sup> – if the directorial action is rationally related to a legitimate purpose it will almost always pass judicial scrutiny.

While the costs of entire fairness review can be insidious (and not merely from a pecuniary perspective) there are several positive externalities that result from this type of adjudication.<sup>281</sup> The mere potentiality that a freeze-out merger will face entire fairness review will unavoidably affect the planning and transactional mechanics of the business transaction. Transacting parties and their counsel, sentient that entire fairness review is a possibility, will have a powerful incentive to transact fairly with the minority shareholders. Moreover, removing entire fairness review potentially subjects minority interests to exploitation on behalf of overly opportunistic controlling persons. Entire fairness review, therefore, hovers over the controlling stockholder as a Sword of Damocles, ensuring fair and reasonable treatment of the minority. It is a facilitator of

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<sup>279</sup> *Id.* at 221.

<sup>280</sup> See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)).

<sup>281</sup> While entire fairness litigation can be costly, it is important to mention the overall institutional effectiveness of the Delaware courts. The Delaware Supreme Court and the Delaware Court of Chancery collectively have been efficient and effective forums of judicial review. Recently, Chief Justice of the Delaware Supreme Court, E. Norman Veasey, expounded on Delaware’s judicial review of corporate transactions:

The disposition rate of the Delaware Courts is rather prompt. The Supreme Court moves about ten cases per week. Since the Supreme Court usually sits in panels of three, this means that each of the five justices must function on the disposition of one case per day, every day of the year on average. We are able to average about 30 days from submission to disposition, though some cases may take 60-90 days, and a few take longer. As you all know, the Court of Chancery is famous for prompt dispositions and expedited cases. The foregoing is a glimpse at the quantitative dimension. Now for the qualitative analysis.

In recent years, over 90% of the business cases disposed of by the Court of Chancery were not appealed to the Delaware Supreme Court. There are various reasons for that phenomenon (the changing dynamics of individual corporate transactions, satisfaction with the Chancery decision, delay, costs, settlement, etc.). Nevertheless, I see it as a tribute to the expertise and prompt work of this very special trial court that has had a consistently distinguished record over its 209-year existence.

Chief Justice E. Norman Veasey, *Law and Fact in Judicial Review of Corporate Transactions*, 10 U. MIAMI BUS. L. REV. 1, 4-5 (2002).

transactions that have a greater potential and likelihood to stray from negotiation to exploitation.

*B. Social Costs of Freeze-out Mergers*

This Part will assess the social costs freeze-out mergers exact on society. It builds on economic analysis from the literature on freeze-out transactions and extends some of the theoretical constructs to support the notion of enhanced scrutiny. If entire fairness review is evadable, freeze-out transactions will likely become more attractive to controlling shareholders. A legal rule or set of rules enhancing scrutiny of these transactions may impact the number of freeze-out transactions undertaken by controlling parties. If freeze-outs do impose social costs on society, enhancing the scrutiny of these transactions may lead to less freeze-out incidences which would presumably be socially optimal.

In the absence of market failure, transactions by private parties are said to be socially optimal, largely because they are consensual. These market transactions are “Pareto improvements because the parties to the transaction value what they get more than what they have given up.”<sup>282</sup> Freeze-out mergers are not considered Pareto optimal because, by definition, the frozen-out minority shareholders did not consensually transfer their interests to the controlling party.<sup>283</sup> Furthermore, the minority shareholders were better off before they were frozen out than after the transaction occurred.

Nonconsensual freeze-outs are, to a large extent, unconstrained by legal rules as a freeze-out option can be exercised at any time for any amount the controlling shareholder chooses to offer. While reputation generally constrains market actors, in the freeze-out context, reputation only goes so far as to restrict controlling persons from “extreme forms of expropriation . . . and only when future participation in the capital or labor markets is expected.”<sup>284</sup>

Since in a good part of these freeze-outs the controlling person will take the entity private, this reputation concern does not serve as a restriction on the opportunistic tendencies of the controlling shareholder. Moreover, a controlling shareholder’s good reputation “may have the perverse effect of discouraging the investigation of or legal challenge to a given conflict transaction, even if the

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<sup>282</sup> Coates, *supra* note 7, at 1321. “A situation is said to be Pareto efficient or Pareto optimal if there is no change from that situation that can make someone better off without making someone else worse off.” A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 7 n.4 (1989). The concept originated in economist Vilfredo Pareto’s famous work, *Manuel D’economie Politique*. VILFREDO PARETO, MANUEL D’ECONOMIE POLITIQUE (2d ed. 1927).

<sup>283</sup> Compare ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 12-15 (2d ed. 1997) (discussing the benefits of Pareto optimality), with RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 12-17 (5th ed. 1998) (criticizing notions of Pareto efficiency). See also Christopher Avery et al., *The Market for Federal Judicial Law Clerks*, 68 U. CHI. L. REV. 793, 800 (2001) (noting that the Pareto optimality standard is “notoriously limited in its usefulness, for rarely can one make some people better off without making even a single person worse off”).

<sup>284</sup> Coates, *supra* note 7, at 1322.



transaction involves a clear wealth transfer from minority shareholders.”<sup>285</sup> Consequently, it is evident that there are little, if any, restrictions on these transactions and the recent Delaware case law discussed above seeks to further this unrestricted scheme, thereby facilitating increased freeze-out incidence.

While freeze-out mergers may not be Pareto efficient, these transactions may be considered socially optimal under the alternative efficiency model – Kaldor-Hicks efficiency. Under Kaldor-Hicks, a transaction is socially optimal if it results in a net increase in utility.<sup>286</sup> Thus, while the notion of freeze-outs expropriating wealth from minority shareholders in favor of controlling shareholders leads to sub-optimal Pareto results, under the Kaldor-Hicks efficiency, this may be socially optimal because of the overall increase in wealth – notwithstanding the potentiality of worsening conditions for the minority.<sup>287</sup>

Notwithstanding the fact that, under the Kaldor-Hicks theory freeze-outs should be encouraged, Professor Coates notes that that these transactions “may reduce social welfare ex post.”<sup>288</sup> This social welfare reduction is due to transaction costs (legal, banking, and printing costs) inherent in all conflict transactions. Additionally, the ex post social welfare reduction is due to the fact that “the value taken from minority shareholders may exceed the value received by the fiduciaries because of differences in valuation due to heterogeneous information or preferences.”<sup>289</sup> The costs freeze-outs impose on the minority shareholders – usually in the form of tax costs and reinvestment costs – are significant in warranting enhanced scrutiny.<sup>290</sup>

If freeze-out transactions yield sub-optimal results in terms of social welfare and utility, why then does the law tolerate them? Perhaps a per se ban on these transactions would be more optimal than invoking legal rules that would constrain these transactions? While some advocate for a general ban on

<sup>285</sup> *Id.* at 1322-23

<sup>286</sup> Kaldor-Hicks efficiency posits that an allocation of resources is efficient if the winner’s gains exceed the losses suffered by the losers, thereby making the aggregate better off. See POSNER, *supra* note 283, at 14. “A given transaction is Kaldor-Hicks efficient if the gainers could compensate the losers in *utiles* and all parties would be at least as well off as before the transaction took place.” Edward J. McCaffery, *Slouching Towards Equality: Gender Discrimination, Market Efficiency, and Social Change*, 103 YALE L.J. 595, 641 (1993).

<sup>287</sup> Along these lines, in their famous treatise, *The Economic Structure of Corporate Law*, Frank Easterbrook and Daniel Fischel liken interested transactions to a diversified portfolio where shareholders “would be on the winning side of some transactions and the losing side of others.” EASTERBROOK & FISCHEL, *supra* note 74, at 22.

<sup>288</sup> Coates, *supra* note 7, at 1324. While Professor Coates’ analysis addresses minority discounts in conflict transactions, this Article adapts the economic theory and attempts to apply it to notions of enhanced scrutiny specifically in freeze-out mergers.

<sup>289</sup> *Id.* (citing ROBERT CHARLES CLARK, CORPORATE LAW 505-06 (1986)).

<sup>290</sup> See, e.g., Bate C. Toms, III, *Compensating Shareholders Frozen Out in Two-Step Mergers*, 78 COLUM. L. REV. 548, 569 (1978).

freeze-outs,<sup>291</sup> economic theorists generally do not adhere to this view.<sup>292</sup> This is because freeze-outs do indeed have several supporting rationales. For instance, freeze-outs can potentially have the effect of encouraging control persons to devote socially optimal efforts into such projects and investments,<sup>293</sup> returning cash for investors to use in more highly valued investments, providing protection against or alternative to a hostile takeover, and permitting corporate managers or other shareholders to convert illiquid investments into cash.<sup>294</sup>

More commonly, freeze-outs “permit a controlling shareholder who owns 100% of one such asset but only a controlling stake in a second asset to capture all of the synergies from the combination by first eliminating the minority owners of the second asset.”<sup>295</sup> This capturing of synergistic value coupled with the rationale contending that freeze-outs are “necessary to the functioning of the market for corporate control”<sup>296</sup> leads to results that contravene any notion of banning freeze-outs altogether. Moreover, while an outright ban on freeze-outs may minimize self-dealing at the expense of minority shareholders, “additional transaction costs associated with substitute forms of self-dealing . . . would reduce social gains from the ban.”<sup>297</sup>

It has been demonstrated that freeze-outs exact both *ex ante* and *ex post* social costs, while concomitantly presenting seemingly sound rationales undermining the notion that a *per se* ban on freeze-outs produces social welfare. Under either the Pareto efficiency model or the Kaldor-Hicks model, freeze-outs involve wealth transfers that do not seem to increase social welfare and indeed may have a contra effect. Therefore, while it is not optimal to ban freeze-outs altogether, it may make economic sense to constrain freeze-outs. Doing so by enhancing the scrutiny of these transactions will reduce expropriation by the controlling fiduciary of the minority’s wealth. While there is no flawless solution to this dilemma, a compelling case can be made – based on the social costs imposed on society by freeze-outs – to reduce the incidence of these transactions by enhancing judicial scrutiny of them via entire fairness review. Even assuming the incidence of these transactions does not decline, at the very least, enhanced scrutiny will serve as an incentive for the fiduciary to deal fairly with minority shareholders.

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<sup>291</sup> See, e.g., Brudney & Chirelstein, *Corporate Freezeouts*, *supra* note 29, at 1367-70 (advocating a *per se* ban on pure going private transactions).

<sup>292</sup> See, e.g., CLARK, *supra* note 289, at 510-11; Coates, *supra* note 7, at 1327. See generally Deutsch, *supra* note 29.

<sup>293</sup> See Benjamin Hermalin & Alan Schwartz, *Buyouts in Large Companies*, 25 J. LEGAL STUD. 351, 358 (1996).

<sup>294</sup> LIPTON & STEINBERGER, *supra* note 7, § 9.01[2].

<sup>295</sup> Coates, *supra* note 7, at 1327.

<sup>296</sup> *Id.* at 1328.

<sup>297</sup> *Id.* at 1329.

## VII. CONSISTENCY IN DELAWARE'S DOCTRINAL PARADIGM

The negative externality of stifling directorial risk-taking and discretion, discussed previously, becomes relevant in the context of self-interested transactions. This is where the Delaware corporate law has drawn a proverbial line – nonconflict transactions enjoy broad discretion while conflict transactions are constrained by greater scrutiny. Thus, corporate management, by and large, enjoys unbridled discretion in almost every business transaction or decision they endorse. Since freeze-outs are by their very nature conflict transactions, they fit under the enhanced scrutiny side of the divide – a divide that has been central to the Delaware corporate law paradigm. There is no policy-laden reason to exempt freeze-out transactions from the traditional norms embraced by Delaware's corporate law model.

Moreover, the Delaware statutory scheme, like most other states, has shown a general distrust for self-interested transactions.<sup>298</sup> Judicial adjudication is most effective when it consistently aids in the accommodation of legislative ideals and goals.<sup>299</sup> “Policy development by adjudication is more comfortable

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<sup>298</sup> See DEL. CODE ANN. tit. 8, § 144 (2001), Delaware's interested director statute, which reads as follows:

(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.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.

<sup>299</sup> Allen et al., *Great Takeover Debate*, *supra* note 276, at 1070; see also Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1239 (2001). On the role of the Delaware courts in shaping Delaware's corporate law, see generally Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate* <https://researchrepository.wvu.edu/wvlr/vol106/iss2/5>

when the case at hand requires the jurist to flesh out the details necessary to create a workable framework to further a policy goal that can be found in the Delaware General Corporation Law – for example, the need to police self-dealing.”<sup>300</sup> Therefore, applying a heightened standard of review in a conflict setting would be consistent with the Delaware’s legislature’s general distrust for insider opportunism as well as the longstanding common law paradigm the Delaware courts have articulated over the years.

Additionally, the Delaware General Corporation Law,<sup>301</sup> like every state corporation statute, has demonstrated a need to protect shareholders in buyout circumstances.<sup>302</sup> Section 262 of the Delaware General Corporation Law<sup>303</sup> affords shareholders who dissent from fundamental corporate transactions the right to receive the appraised “fair value” of their shares.<sup>304</sup> The purpose of the

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*Charters*, 68 U. CIN. L. REV. 1061 (2000); Leo E. Strine, Jr., *Delaware's Corporation Law System: Is Corporate America Buying an Exquisite Jewel or a Diamond in the Rough?*, 86 CORNELL L. REV. 1257 (2001).

<sup>300</sup> See Allen et al., *Great Takeover Debate*, *supra* note 276, at 1070.

<sup>301</sup> DEL. CODE ANN. tit. 8, §§ 101-398 (2001).

<sup>302</sup> See ALA. CODE § 10-2B-13.02 (1999); ALASKA STAT. § 10.06.580 (West 2002); ARIZ. REV. STAT. ANN. § 10-1302 (West 1996); ARK. CODE ANN. §§ 4-27-1301 to -1331 (Michie 2001); CAL. CORP. CODE § 1300 (Deering Supp. 2003); COLO. REV. STAT. ANN. §§ 7-113-101 to -302 (West 2002); CONN. GEN. STAT. ANN. §§ 33-855 to -872 (West Supp. 2003); DEL. CODE ANN. tit. 8, § 262 (2001 & Supp. 2002); D.C. CODE ANN. § 29-101.73 (2001); FLA. STAT. ANN. §§ 607.1301 to .1331 (West 2001); GA. CODE ANN. §§ 14-2-1301 to -1331 (2003); HAW. REV. STAT. § 414-342 (Supp. 2001); IDAHO CODE §§ 30-1-1301 to -1331 (Michie 1999 & Supp. 2003); 805 ILL. COMP. STAT. ANN. 5/11.65 (West 1993 & Supp. 2003); IND. CODE ANN. §§ 23-1-44-1 to -20 (Michie 1999 & Supp. 2003); IOWA CODE ANN. §§ 490.1301 to .1331 (West 2003); KAN. STAT. ANN. § 17-6712 (Supp. 2002); KY. REV. STAT. ANN. § 271B.13-250 (Michie 1989 & Supp. 2003); LA. REV. STAT. ANN. § 12:131 (West 1994 & Supp. 2003); ME. REV. STAT. ANN. tit. 13-C, §§ 1301 to -1332 (West Supp. 2003); MD. CODE ANN., CORPS. & ASS’NS § 3-202 (1999 & Supp. 2003); MASS. GEN. LAWS ANN. ch. 156B, § 85 (West 1996 & Supp. 2003); MICH. COMP. LAWS ANN. § 450.1762 (West 2001 & Supp. 2003); MINN. STAT. ANN. § 302A.473 (West 1985 & Supp. 2003); MISS. CODE ANN. §§ 79-4-13.01 to .31 (2001 & Supp. 2003); MO. ANN. STAT. § 351.875 (West 2001); MONT. CODE ANN. § 35-1-827 (2001); NEB. REV. STAT. § 21-20,138 (LEXIS through 2003 Reg. Sess.); NEV. REV. STAT. 78.3793 (LEXIS through all 2002 Legis.); N.H. REV. STAT. ANN. §§ 293-A:13.01 to .31 (1999); N.J. STAT. ANN. § 14A:11-1 (West 2003); N.M. STAT. ANN. § 53-15-4 (Michie 2001); N.Y. BUS. CORP. LAW § 910 (McKinney 2003); N.C. GEN. STAT. §§ 55-13-01 to -31 (LEXIS through 2002 Sess.); N.D. CENT. CODE § 10-19.1-87 (2001 & Supp. 2003); OHIO REV. CODE ANN. § 1701.85 (Anderson 2001); OKLA. STAT. ANN. tit. 18, § 1091 (West 1999); OR. REV. STAT. §§ 60.551 to .594 (2001); PA. CONS. STAT. ANN. §§ 15-1571 to -1580 (West 1995 & Supp. 2003); R.I. GEN. LAWS § 7-1.1-74 (1999); S.C. CODE ANN. §§ 33-13-101 to -103 (Law. Co-op. 1990 & West Supp. 2002); S.D. CODIFIED LAWS § 47-6-23 (Michie 2003); TENN. CODE ANN. §§ 48-23-101 to -103 (2002); TEX. BUS. CORP. ACT ANN. art. 5.11 (Vernon 2003); UTAH CODE ANN. §§ 16-10A-1301 to -1331 (2001); VT. STAT. ANN. tit. 11A, §§ 13.01 to .31 (2003); VA. CODE ANN. §§ 13.1-729 to -741 (West 2001); WASH. REV. CODE ANN. §§ 23B.13.020 to .310 (West 1994 & Supp. 2003); W. VA. CODE §§ 31D-13-1301 to -1331 (2003); WIS. STAT. ANN. §§ 180.1301 to .1331 (West 2002); WYO. STAT. ANN. §§ 17-16-1301 to -1331 (Michie 2003).

<sup>303</sup> DEL. CODE ANN. tit. 8, § 262.

<sup>304</sup> *Id.*

appraisal remedy is to provide minority shareholders liquidity as an alternative to remaining as an owner/investor of an entity that was fundamentally altered from the original entity.<sup>305</sup> A court will value the minority shareholder's interest as a going concern,<sup>306</sup> compare it to the merger or tender offer price, and award monetary damages to the minority.<sup>307</sup> The valuation consists of an assessment of a firm's net asset value, earnings value, and market price.<sup>308</sup>

Much has been written on the gross inadequacies of the appraisal remedy, particularly regarding minority shareholder rights following a freeze-out.<sup>309</sup> The appraisal right has been said to be inadequate mainly because among other reasons, appraisal statutes generally forbid the inclusion of post-merger gains as an element of value. The appraisal remedy may also be inadequate for determining fair value of shares when reliance is placed, as it often is, on market price. Indeed, in some states appraisal is not available for widely traded stock on the theory that the market price is the most reliable indicator of value. Emphasis on market price, which by definition does not take into account the premium that a minority could always command in a face-to-face negotiation, is clearly damaging to minority interests. Ultimately, this is simply another way in which appraisal precludes any award of post-merger gains.<sup>310</sup>

Additionally, controlling persons can withhold compensation without paying interest over the potentially protracted litigation.<sup>311</sup> As commentators recently noted, "this system forces dissenting shareholders to extend majority shareholders below-market loans resulting in a complete windfall to the company."<sup>312</sup> Furthermore, knowing that minority shareholders rarely exercise appraisal rights, controlling fiduciaries have an "incentive to discount merger consideration offered to minority shareholders based on an approximation of the number of shareholders who will not opt in."<sup>313</sup>

Given these particularly egregious deficiencies with the appraisal remedy, courts should use their equitable authority to further protect minority shareholders in the freeze-out context. Any method of protecting minority shareholder rights necessarily differs depending on the number of shareholders, the

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<sup>305</sup> See Barry M. Wertheimer, *The Purpose of the Shareholders' Appraisal Remedy*, 65 TENN. L. REV. 661, 666-67 (1998).

<sup>306</sup> See, e.g., *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137, 1144 (Del. 1989); *Tri-Continental Corp. v. Battye*, 74 A.2d 71,72 (Del. 1950).

<sup>307</sup> See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 712-13 (Del. 1983).

<sup>308</sup> See *id.* at 712.

<sup>309</sup> See, e.g., *Booth*, *supra* note 29, at 650-54.

<sup>310</sup> *Id.* at 650-51.

<sup>311</sup> Aronstam et al., *supra* note 85, at 548.

<sup>312</sup> *Id.*

<sup>313</sup> *Id.*

number of minority shareholders and many other factors. Entire fairness review facilitates this predicament as it allows for ad hoc determinations that protect minority shareholder rights with the necessary flexibility. Moreover, the very prospect of entire fairness review will impress upon controlling parties to deal fairly with the minority. Downgrading minority shareholders to the sole remedy of appraisal will place little, if any, equitable limitation on the will of controlling persons – particularly in freeze-outs where the controlling fiduciary is on both sides of the transaction.

## VIII. CONCLUSION

The informational advantages of controlling stockholders, coupled with *Kahn*'s inherent suspicions of independent committees and the potential for retributive actions, justify a policy-driven application of entire fairness review to both negotiated mergers and tender offers commenced by controlling stockholders. Moreover, there has been no evidence to suggest that the underlying concerns of *Kahn* and its progeny have been alleviated. Additionally, if these concerns exist in both the tender offer and negotiated merger context, as the court stressed in *Pure Resources*, the appropriate judicial response should be to apply entire fairness to both transaction types, not to cloak both transaction types with deferential business judgment review.

The time has come for the Delaware Supreme Court to reassess the policy foundations of *Solomon*, *Siliconix*, and *Aquila* in light of Vice-Chancellor Strine's discussion in *Pure Resources*. The court should realize that the *Kahn* concerns have not evaporated. Affording business judgment protection to controlling stockholder freeze-out transactions – in either tender offers or negotiated mergers – ignores the fundamental concerns arising out of conflict transactions. The fact that a negotiated merger or tender offer is employed ex ante to achieve the controlling shareholder's objective should not be what determines the ex post standard of review applied by the Delaware courts. What should be dispositive is the fact that the "underlying factors which raise the specter of impropriety can never be completely eradicated."<sup>314</sup> The application of entire fairness review will effectively incentivize fairness in controlling party transactions and level the playing field between controlling and minority shareholders.

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<sup>314</sup> *Kahn v. Tremont*, 694 A.2d 422, 422 (Del. 1997).

