

HARVARD LAW REVIEW

FAIR SHARES IN CORPORATE
MERGERS AND TAKEOVERS*Victor Brudney ***Marvin A. Chirelstein ***

Professors Brudney and Chirelstein urge a new approach to judicial supervision of mergers between parent and subsidiary corporations. They argue that a fair merger requires that gains generated by the combination should be shared by the two corporations rather than wholly absorbed by either, and they posit a sharing formula to provide fair treatment to all parties to the merger. Rather than attempting to intuit or deduce the result of an arm's-length bargain that does not and cannot exist in the parent-subsidiary context, the authors emphasize the joint obligation of management to the public stockholders of both companies. The sharing formula for mergers may be used to determine the fairness of other decisions made by the parent during the period of affiliation. Finally, the authors suggest a somewhat different sharing formula for mergers which are the contemplated second step following an acquisition of control.

WHAT legal standards should the courts apply in testing the "fairness" of a merger between a parent corporation and a subsidiary, where the parent owns a controlling interest in the subsidiary's stock and the remaining shares are held by public stockholders? This problem, which is one of long standing in the field of fiduciary obligation, has gained importance in recent years because of the increasing incidence of partial takeovers of public companies by other firms. Typically, the takeover process begins with a corporation's acquiring (by public tender offer, market purchases, private negotiation, or a combination of these) a controlling, but not a 100 percent, stock interest in what is then the target company. In some instances partial ownership is merely a transitory step towards full ownership; acquisition of control is followed within a short time by merger of the new subsidiary into the acquiring company. In others, the status of parent and subsidiary is preserved for an extended period; the parent operates the subsidiary as such through a board of directors composed of the parent's nominees, but ultimately elects to

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merge the subsidiary into itself, thereby obtaining direct ownership of all of the subsidiary's assets. Under either circumstance, the public stockholders of the merging subsidiary receive stock or other securities of the parent, or cash, in exchange for their minority shares.

The purchase price or exchange rate for the public stockholders' interest is necessarily determined unilaterally by the parent's management, rather than through arm's-length bargaining. The parent's proposal of the merger is virtually, and perhaps actually, equivalent to its approval by the requisite statutory majority of the subsidiary. To be sure, unilateral decision is unavoidable in this context and could not of itself constitute a violation of fiduciary duty. But given the evident, and indeed quite natural, tendency of management to view its obligation to the parent and its stockholders as primary, and to regard the subsidiary's public stockholders as outsiders, the value placed on the subsidiary's assets will often be as low as reasonable pessimism will allow.

For this reason, and because of the visible conflicts of interest they generate, mergers between parents and partly-owned subsidiaries are a favorite target for legal challenge by dissenters. It is generally agreed that the parent stands in a fiduciary relationship to the subsidiary's public stockholders, which creates a special obligation to deal fairly with them when acquiring their interest. Indeed, unilateral action by the parent — in setting the merger price and consenting to it on behalf of the subsidiary — poses the classic self-dealing problem which equity courts have traditionally resolved through the enforcement of fiduciary standards. However, in the present context, those standards lack the clear contractual or statutory basis which they have, for example, in insolvency reorganizations. Possibly for that reason, in determining whether the parent's treatment of the subsidiary's stockholders is truly fair, courts rarely have been able to extend fiduciary safeguards beyond the point of simple fraud.

Our overall goal in this Article is to consider what role a substantive requirement of fairness ought to play in providing additional protection to the public stockholders of a merging subsidiary. More particularly, our objectives are, first, to see whether fairness is a necessary or suitable element of merger regulation; and second, to consider what specific quantitative content such a fairness requirement might appropriately have. Although the two questions tend to run together somewhat, we deal with the first in Part I by examining and evaluating the other major protective devices provided by the corporate law — namely, ratification and appraisal rights. The second of our concerns is taken up in Part

II, in which we attempt to develop a sharing formula for mergers which occur after an extended period of affiliation between parent and subsidiary. Finally, in Part III we examine mergers which take place immediately, or shortly, after control of the subsidiary has been acquired by the parent — that is, prior to any substantial intervening period of combined operations.

By way of limitation, we emphasize that our aim is to explore investor protection schemes — that is, to examine and reformulate certain aspects of the corporate law of merger — and not to decide whether corporate combinations are desirable from an antitrust standpoint or whether consumers and others are well served by the creation of ever larger financial aggregates. Further, we cover only one important feature of merger regulation — many others are left untouched or mentioned only in passing. Finally, our interest is solely in publicly-held corporations — that is, in companies whose shares are owned by an appreciable number of investors not actively involved in management — and only in mergers between parents and subsidiaries.

I. RATIFICATION AND APPRAISAL

The traditional legal safeguards against the exploitation of public stockholders by management or by a controlling group in mergers have been stockholder approval and the statutory appraisal right. Whether or not the combination of “voice” and “exit” was institutionalized in deference to a perceived need for protection of the public stockholders against the insiders,¹ those two procedures are the principal modes provided by statute for stockholder self-defense. In our view, neither is sufficient.

A. Ratification

The inadequacy of stockholder approval as a protective procedure has been discussed elsewhere at length.² Whatever its value as a protective device in a merger between unrelated enter-

¹ It has been suggested that the role given to stockholders originated in an effort to mask, rather than to check, the power of management to effect mergers, and in any event serves the former function. See Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 228-29 (1962). But see Flarsheim v. Twenty Five Thirty Two Broadway Corp., 432 S.W.2d 245, 252 (Mo. 1968); Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decision Making*, 57 CALIF. L. REV. 1, 76-79 (1969); Levy, *Rights of Dissenting Stockholders to Appraisal and Payment*, 15 CORNELL L.Q. 420, 421 (1930).

² See, e.g., SEC, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL, AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES pt. VII, at 555-56 (1940) [hereinafter cited as SEC PROTECTIVE COMMITTEE STUDY]; Eisenberg, *supra* note 1; Manning, *supra* note 1, at 226-27.

prises, it affords no protection when a parent combines with a subsidiary and the parent owns the amount of the subsidiary's stock required to approve the transaction. Where the parent owns less than the statutory requirement, there is at least a technical possibility that the public stockholders might reject the merger plan; but the ability of the stockholders to exercise their voting rights with real effect even in that situation is slight.³ Indeed, even if the merger plan were made effective only when approved by a majority of the public stockholders, as if the latter were a separate class, the barriers to concerted stockholder action in the context of management's exclusive control of the proxy machinery would almost always assure a favorable vote. The atomized nature of the company's stockholdings, together with the easy salability of shares, means that stockholders cannot rely on group action to reject what they see as a mistaken decision to merge, particularly when the decision was made by a parent holding a large block of stock. Moreover, ratification gives dissatisfied stockholders only the limited option of rejecting the merger; they do not generally either initiate the merger discussion or participate in formulating its terms. They are confined to approving or disapproving a transaction, the terms of which are defined by management and can rarely be modified by stockholders during, or after, the bargaining process.⁴ Finally, since the timing and context for seeking approval of the merger are also dictated by management⁵ which controls, and has unlimited access to, the proxy apparatus, the process of seeking stockholder approval is skewed in favor of a vote for approval.

Voting rights do serve, however, as a conceptual premise on which to build a requirement of disclosure. Thus, notwithstanding the inadequate protection which the suffrage affords public stockholders in mergers involving combinations of parents and subsidiaries, recent cases suggest that, even when the parent owns two-thirds or more of the subsidiary's stock, the existence of the right to vote imports an obligation on the part of the subsidiary corporation and those who control it to make adequate disclosure to stockholders of the terms and consequences of the merger.⁶

³ See, e.g., Eisenberg, *supra* note 1, at 23-43; Manning, *supra* note 1, at 229.

⁴ While a kind of stockholder participation occurs when management consults with the holders of large blocks of stock, such participation is apt at best to set limits on management's initiative, but is not likely to impel management to initiate transactions.

⁵ Cf. *American Hardware Corp. v. Savage Arms Corp.*, 37 Del. Ch. 59, 136 A.2d 690 (Sup. Ct. 1957).

⁶ See, e.g., *Schlick v. Penn-Dixie Cement Corp.*, [Current] CCH FED. SEC. L. REP. ¶ 94,853 (2d Cir., Oct. 31, 1974); *Swanson v. American Consumer Indus., Inc.*, 415 F.2d 1326 (7th Cir. 1973); *Voegel v. Ackerman*, 364 F. Supp. 72

That obligation, embodied primarily in federal law,⁷ may offer two kinds of protection to public stockholders against an overreaching parent. First, disclosure of the terms and consequences of the merger exposes insiders to the glare of publicity. The knowledge that any disadvantageous or unequal treatment which they impose on public stockholders will be exposed to the full view of investors may impel the insiders to treat the public stockholders more generously than otherwise. Second, even when the voting power of public shareholders is arithmetically useless, a detailed understanding of the terms and import of the merger may incline a greater number of them to seek appraisal, or even, on grounds of unfairness, to attempt to enjoin the merger or obtain a larger share of its proceeds.⁸

Of course, the protection afforded by disclosure depends in considerable measure on what management is required to reveal. Recent judicial interpretation of disclosure requirements in mergers, particularly in parent-subsidary mergers, has expanded the categories of disclosable information substantially.⁹ But while the broadening base for liability of directors and officers will undoubtedly impel more significant disclosure of conflicting interests,¹⁰ the central problems of valuation are not likely to be solved by disclosure requirements. Longstanding prohibitions on disclosures of future earnings estimates are only now beginning to be relaxed,¹¹ but neither the case law nor the SEC rules re-

(S.D.N.Y. 1973); *Laurenzano v. Einbender*, 264 F. Supp. 356 (E.D.N.Y. 1966), *aff'd*, 448 F.2d 1 (2d Cir. 1971). Compare *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972) (complaint under rule 10b-5 did not make out cause of action if no allegation of misrepresentation as to merger), *with Popkin v. Wheelabrator-Frye, Inc.*, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,091 (S.D.N.Y. 1973) (even when parent controls subsidiary, failure to disclose leads to liability under proxy rules).

⁷ See, e.g., Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970) (registration of securities offerings); Securities and Exchange Act of 1934 §§ 13(d), 14(d), 15 U.S.C. §§ 78m(d), 78n(d) (1970) (filing requirements); 17 C.F.R. § 240.10b(5) (1973), implementing Securities and Exchange Act of 1934 § 10b, 15 U.S.C. § 78j(b) (1970) (antifraud provision); 17 C.F.R. §§ 240.14a-1 to 14a-10 (1973), implementing Securities and Exchange Act of 1934 § 14, 15 U.S.C. § 78n(a) (1970) (proxy rules).

⁸ See cases cited note 6 *supra*.

⁹ *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384 (1970); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 262-66, 269 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972); *Swanson v. American Consumer Indus., Inc.*, 415 F.2d 1326 (7th Cir. 1969); *Beatty v. Bright*, 318 F. Supp. 169 (S.D. Iowa 1970); *Colonial Realty Co. v. Baldwin-Montrose Chem. Co.*, 312 F. Supp. 1296 (E.D. Pa. 1970).

¹⁰ See, e.g., Metz, *An Unusual 'Go-Private' Plan*, N.Y. Times, Oct. 18, 1974, at 58, cols. 3-4.

¹¹ Although the Securities and Exchange Commission has indicated that it proposes to permit, if not to require, forecasts of earnings, see SEC Securities Act

quire an adequate presentation of alternatives to the proposed merger,¹² although such information is crucial for stockholders to evaluate the merits of the proposed merger and to determine the advisability of exercising appraisal or other legal rights. Moreover, even if disclosure were adequate in terms of categories covered, a well-informed electorate is insufficiently protected

Release No. 5362 (Feb. 2, 1973), judicial imposition of liability for misleading prediction may deter management from taking advantage of the opportunity to make such forecasts even when so inclined. See *Beecher v. Able*, [Current] CCH FED. SEC. L. REP. ¶ 94,450 (S.D.N.Y., Mar. 4, 1974). But see *Dolgow v. Anderson*, 53 F.R.D. 664, 686-90 (E.D.N.Y. 1971), *aff'd*, 464 F.2d 437 (2d Cir. 1972). See also Skovsen, Sharp, & Toulman, *Corporate Disclosure of Budgetary Data*, 133 J. ACCOUNTANCY 50 (1972). Possibly Rule 145, 17 C.F.R. § 230.145 (1973), will be interpreted to require statements of the earnings projections of both parties to the merger, on both a premerger and a postmerger basis, cf. *Schneider, Nits, Grits, and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254, 261 n.20 (1972), but the case law is far from clear on the question of communicating earnings projections or current values of fixed assets, see *Sunray DX Oil Co. v. Helmerich & Payne, Inc.*, 398 F.2d 447 (10th Cir. 1968); *Mader v. Armel*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,027, at 90,796 (S.D. Ohio 1971), *aff'd*, 461 F.2d 1123 (6th Cir. 1972), *cert. denied*, 409 U.S. 1023 (1973); *Feit v. Leasco Data Processing Equip.*, 332 F. Supp. 544, 549-75 (E.D.N.Y. 1971); *SEC v. Bangor Punta Corp.*, 331 F. Supp. 1154 (S.D.N.Y. 1971), *aff'd in relevant part sub nom. Chris-Craft Indus. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973), *cert. denied*, 414 U.S. 924 (1974); *Kohn v. American Metal Climax, Inc.*, 322 F. Supp. 1331 (E.D. Pa. 1970), *modified*, 458 F.2d 255 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972); *Gerstle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66 (E.D.N.Y. 1970), *aff'd in relevant part*, 478 F.2d 1281 (2d Cir. 1973). See also Note, *Disclosing Current Values of Fixed Assets in Corporate Reorganizations*, 55 CORNELL L. REV. 285 (1970); Comment, *The Use of Appraisals in SEC Documents*, 122 U. PA. L. REV. 138 (1973).

¹² The cases increasingly suggest that not merely firm offers but other possibilities which have some minimum probability of realization must be disclosed and explained in the material which solicits mergers or recapitalizations. See, e.g., *Swanson v. American Consumer Indus., Inc.*, 415 F.2d 326 (7th Cir. 1969); *Levin v. Marder*, 343 F. Supp. 1050, 1057-58 (W.D. Pa. 1972); *United States Smelting Refining & Mining Co. v. Clevite Corp.*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,691, at 99,051-54 (N.D. Ohio 1968); cf. *Moses v. Burgin*, 445 F.2d 369, 376 (1st Cir.), *cert. denied*, 404 U.S. 944 (1971); *Robinson v. Penn Central Co.*, 336 F. Supp. 655 (E.D. Pa. 1971); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971); *Kohn v. American Metal Climax, Inc.*, 322 F. Supp. 1331 (E.D. Pa. 1970), *modified*, 458 F.2d 255 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972). These suggestions, however, are vague and their implementation is difficult, in view of the uncertainty of the terms of the alternative possibilities and the even larger uncertainty of their realization. See, e.g., *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir. 1974); *Nanfito v. Tekseed Hybrid Co.*, 341 F. Supp. 240 (D. Neb. 1972), *aff'd*, 473 F.2d 537 (8th Cir. 1973); *Alameda Oil Co. v. Ideal Basic Indus., Inc.*, 337 F. Supp. 194 (D. Colo. 1972); cf. *Prettner v. Aston*, 339 F. Supp. 273 (D. Del. 1972); *McConnell v. Lucht*, 320 F. Supp. 1162 (S.D.N.Y. 1970). See generally Goolrick, *Some Disclosure Problems In Acquisition Proxy Statements and Prospectuses*, 28 BUS. LAW. 111, 119-121 (1972). See also cases cited note 84 *infra*.

against illegal diversion unless it is further armed with a standard of fair conduct which is enforceable by the courts.¹³ Indeed, the end result which disclosure is said by the courts to serve in parent-subsidary mergers — to trigger the exercise of appraisal rights or challenges for unfairness — may require judicial intervention to provide some norm of fairness for protection of the public stockholders. And it is not merely when disclosure requirements are complied with that a fairness standard ultimately must be invoked in order to offer adequate protection to public stockholders. As recent cases have made clear,¹⁴ failure to comply with disclosure requirements also implicates the fairness question. If, as frequently happens, the merger has been consummated by the time the inadequacy of disclosure is adjudicated, the only relief available turns on some measure of the adequacy of the price — which poses the fairness question in another format.¹⁵ The remedy

¹³ If, as has been suggested, rule 10b-5 requires full disclosure, but will not support a challenge for unfairness when such disclosure has been made, see *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972); *Lewis v. Bogin*, 337 F. Supp. 331, 337-38 (S.D.N.Y. 1972). *But cf.* *Knauf v. Utah Constr. & Mining Co.*, 277 F. Supp. 564, 570, 577, 579 (D. Wyo. 1967), *aff'd in relevant part*, 408 F.2d 958, 964 (10th Cir.), *cert. denied*, 396 U.S. 831 (1969), the disclosure requirements remain an incomplete remedy for alleged unfairness. See generally *Jacobs, The Role of Securities Exchange Act Rule 10b-5 in The Regulation of Corporate Mismanagement*, 59 CORNELL L. REV. 27, 89-91 (1973). Notwithstanding the Second Circuit's retreat in *Popkin v. Bishop*, *supra*, from its language in *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969), such challenges under rule 10b-5 are not yet precluded. *Schlick v. Penn-Dixie Cement Corp.*, [Current] CCH FED. SEC. L. REP. ¶ 94,853 (2d Cir., Oct. 31, 1974); *Dasho v. Susquehanna Corp.*, 461 F.2d 11, 26 (7th Cir.), *cert. denied*, 408 U.S. 925 (1972); *Levine v. Biddle Sawyer Corp.*, [Current] CCH FED. SEC. L. REP. § 94,816 (S.D.N.Y., Oct. 7, 1974); *Bryan v. Brock & Blevins Co.*, 343 F. Supp. 1062, 1070 (N.D. Ga. 1972), *aff'd on other grounds*, 490 F.2d 563 (5th Cir. 1974).

¹⁴ See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970) (fairness not a defense to nondisclosure liability); *Dasho v. Susquehanna Corp.*, 461 F.2d 11 (7th Cir.), *cert. denied*, 408 U.S. 925 (1972) (fairness as a means of measuring damages); *Swanson v. American Consumer Indus., Inc.*, 415 F.2d 1326 (7th Cir. 1969); *Gould v. American Hawaiian S.S. Co.*, 351 F. Supp. 873 (D. Del. 1973); *Lewis v. Bogin*, 337 F. Supp. 331 (S.D.N.Y. 1972); *Grestle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66 (E.D.N.Y. 1969), *aff'd in relevant part*, 478 F.2d 1281 (2d Cir. 1973).

¹⁵ Even a timely and successful challenge to a merger based solely upon the inadequacy of the disclosure of its terms and import may indirectly implicate the fairness question. While a successful challenge may only delay the merger until adequate disclosure is made, it is also possible that a requirement of full disclosure will induce a modification of the transaction which eliminates all reasonable grounds for challenging fairness or will result in a settlement at a somewhat better price for stockholders than was originally proposed in the merger. *Cf. In re Brown Co. Securities Litigation*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,751 (S.D.N.Y. 1973).

for failure to disclose thus becomes revision of the transaction by application of a fairness standard.¹⁶

B. Appraisal Rights

The statutory right of appraisal provides shareholders dissenting from a decision to merge with the option of receiving a cash payment from the merged company equal to the "value" of their shares. Appraisal has been called "a remedy of desperation," "technical . . . expensive . . . uncertain . . . and, in the case of a publicly held corporation, . . . unlikely to produce a better result than could have been obtained on the market."¹⁷ But even with these deficiencies in view, many writers have supported the continued availability of the appraisal right as a last-ditch check on management improvidence or as a countervailing force against abuse of discretion by insiders.¹⁸ Whether appraisal otherwise should be continued or eliminated, the question of interest in our inquiry is what specific relationship the right of appraisal bears to the conflict-of-interest problems afflicting parent-subsidiary mergers. If the law affords appraisal rights, should it also provide a fairness test, or does appraisal render fairness superfluous as a device for protecting the subsidiary's public stockholders' interests?

In answering that question, it is important to remember that the object of appraisal is to give dissident stockholders an opportunity to avoid the consequences of merger, not to undo the merger or to press directly for better terms. Appraisal statutes generally make explicit that the claim for which the dissenter is to be compensated in cash is the value of his shares "exclusive of any element of value arising from the expectation or accomplishment of the merger or consolidation."¹⁹ Drawing generally on the

¹⁶ But compare the notion articulated by the Supreme Court in *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970), that a showing of fairness will not save an inadequate disclosure from the necessity for corrective action. See also *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 270 (3d Cir. 1972); *Popkin v. Wheelabrator-Frye, Inc.*, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,091, at 94,371 (S.D.N.Y. 1973); *Colonial Realty Corp. v. Baldwin-Montrose Chem. Co.*, 312 F. Supp. 1296, 1299 (E.D. Pa. 1970).

¹⁷ See Eisenberg, *supra* note 1, at 85.

¹⁸ See *id.* at 81, 86; Lattin, *Remedies of Dissenting Stockholders Under Appraisal Statutes*, 45 HARV. L. REV. 233 (1931); Note, *Valuation of Dissenters Stock Under Appraisal Statutes*, 79 HARV. L. REV. 1453, 1455-56 (1966); Note, *Corporation Law — Dissenting Stockholder's Right of Appraisal — Determination of Value*, 28 N.Y.U. L. REV. 1021 (1953); Comment, *Valuation Problems Created by the Dissenting Stockholder*, 5 U.C.L.A. L. REV. 295 (1958).

¹⁹ DEL. CODE ANN. tit. 8, § 262(b) (1953); see N.Y. BUS. CORP. LAW § 623(n)(4) (McKinney 1963); ABA-ALI MODEL BUS. CORP. ACT § 81 (1969). See

premerger market price of the acquired company's stock, but in many jurisdictions also looking to such factors as previous years' earnings, dividends, and asset values,²⁰ the appraisal process is thus designed to generate a claim on behalf of dissenting stockholders equal to the value of their shares in the old firm, just as if it had continued on its customary course without the intervention of a merger bid. Hence, where the merger is perceived as producing gains for the combined enterprise,²¹ the appraisal price by itself is inadequate to permit the subsidiary's stockholders to receive any part of those gains. By the same token, it is not the object of the appraisal proceeding to require an overreaching parent to redistribute any portion of the merger gains among the subsidiary's public stockholders.²² Moreover, even if premerger share value is accepted as the proper measure of minority rights, in practice appraisal often seems inadequate as a valuation process. The valuation reached in an appraisal proceeding is usually based on existing data, that is, on whatever information has been made public about the corporation at the merger date. But the

also Beechwood Sec. Corp. v. Associated Oil Co., 104 F.2d 537, 540 (9th Cir. 1939); Jeffrey v. American Screw Co., 98 R.I. 286, 201 A.2d 146 (1964).

²⁰ The manner in which the value of the old stock is determined and particularly the weight given to market value varies among jurisdictions. See, e.g., authorities cited note 18 *supra*; Comment, *Valuation of Dissenting Minorities' Shares Under Section 21 of the New York Stock Corporation Law*, 17 *FORD. L. REV.* 259 (1948). Some legislatures have effectively made market price the conclusive test of value by permitting elimination of appraisal where the stock has a public market. See, e.g., DEL. CODE ANN. tit. 8, § 262(k) (Supp. 1970); ABA-ALI MODEL BUS. CORP. ACT § 80 (1969); N.J. REV. STAT. § 14A:11-1 (Supp. 1968); PA. STAT. ANN. tit. 15, § 1515L (Supp. 1974).

²¹ See note 33 *infra*.

²² The appraisal remedy might prevent overreaching of the public stockholders if the price offered in the merger were actually less than the premerger market price of the target company's shares, or if the dissenters could demonstrate that premerger market price did not accurately reflect the "intrinsic" value of the firm. Generally, however, the merger arrangements, at least between previously unrelated enterprises, will award the stockholders some premium over market — though presumably no more than necessary to attract approval from a statutory majority. See, e.g., L. DELLENBARGER, *COMMON STOCK VALUATION IN INDUSTRIAL MERGERS* 76-78 (1966); G. MCCARTHY, *ACQUISITIONS AND MERGERS* 96-102 (1963); Halpern, *Empirical Estimates of the Amount and Distribution of Gains to Companies in Mergers*, 46 *J. BUS.* 554, 555-57 (1963). Similar premiums, although possibly smaller in amount, see L. DELLENBARGER, *supra*, at 141; Piper & Weiss, *The Profitability of Multi-Bank Holding Company Acquisitions*, 29 *J. FIN.* 163, 173 (1974), may also be payable in parent-subsidiary mergers where public stockholder approval is necessary for the merger. Thus, a comparison of the offering price with the premerger market price will generally be pointless. And while a demonstration might conceivably be made that "intrinsic" worth exceeds market price at the merger date, nothing in the decided cases suggests that the fair value sought or awarded in appraisal proceedings purports to include amounts attributable to fiduciary violations in the merger process.

timing of the decision to merge may be based on the parent's anticipation of a substantial increase in the subsidiary's earnings. That anticipation may result from data known only to management which is not ripe for disclosure and which in many instances, therefore, will not have been reflected in the market price of the subsidiary's stock. Hence, judicial emphasis on the market price²³ or on past earnings as the basis for projecting future earnings,²⁴ is likely to result in underestimating the future earnings properly attributable to the old enterprise. Thus, the parent is in a position to induce appraisal at a time when the outsiders seeking the appraisal have little or no capacity to ascertain, let alone to demonstrate, the likelihood that the enterprise is currently worth more than its past record suggests.

To this limitation — which we concede is not unique to appraisal valuation — can be added the shadow cast by the overhang of the parent's control on the current market value of the subsidiary's shares.²⁵ The resultant depressed price may be a function merely of the inability of new groups to acquire control on the market, but it may also be a function of the likelihood of exploitation such as an unfair merger, which would be too costly for disarranged minority stockholders to challenge. In any event, any reliance upon market price to measure appraisal value visits upon the subsidiary's public stockholder the cost of the parent's control in determining appropriate compensation.

In summary, our view is that the individual right of appraisal is not directly responsive to the problem of fiduciary abuse in mergers between parents and subsidiaries. Appraisal is predicated more on the conception of managerial incompetence in valuing the old enterprise and negotiating a price for it than on the notion of a conflict of interest which results in a diversion of a portion of the merger proceeds to a controlling parent.²⁶ Moreover, it neither imposes its cost solely on the stockholders of the acquiring company nor seeks to reimburse all the victims of the inadequate merger price, that is, *all* the public stockholders of the acquired

²³ See, e.g., *Gallois v. West End Chem. Co.*, 185 Cal. App. 2d 765, 774, 8 Cal. Rptr. 596, 600-01 (Dist. Ct. App. 1960); *Prall v. United States Leather Co.*, 6 N.J. Misc. 967, 143 A. 382 (Sup. Ct. 1928), *aff'd per curiam*, 105 N.J.L. 646, 146 A. 916 (Ct. Err. & App. 1929); *Jones v. Healy*, 184 Misc. 923, 936, 55 N.Y.S.2d 349, 359-60 (Sup. Ct. 1945), *aff'd mem.*, 270 App. Div. 895, 62 N.Y.S.2d 605 (1946).

²⁴ See, e.g., *Francis I. duPont & Co. v. Universal City Studios, Inc.*, 312 A.2d 344, 348 (Del. Ch. 1973); *Application of Delaware Racing Ass'n*, 42 Del. Ch. 406, 413-15, 213 A.2d 203, 211-12 (Sup. Ct. 1965).

²⁵ Cf. *Talley Indus., Inc.*, SEC Investment Company Act Release No. 5953, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. § 77,774, at 83,792 (Jan. 9, 1970); *David J. Greene & Co. v. Schenley Indus., Inc.*, 281 A.2d 30 (Del. Ch. 1971).

²⁶ Cf. *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 116-18, 460 P.2d 464, 477-78, 81 Cal. Rptr. 592, 605-06 (1969).

company.²⁷ Finally, appraisal is merely an option-out alternative, and as such it focuses on the premerger value of the acquired company's shares. In short, it neither serves nor is designed to serve as a remedy for the fiduciary misbehavior at which the fairness challenge is directed.²⁸

II. STANDARDS OF FAIRNESS IN PARENT-SUBSIDIARY MERGERS

As we have noted, the occasion for judicial imposition of fairness constraints upon the terms of parent-subsubsidiary mergers arises because the terms are unilaterally imposed by the parent, rather than freely bargained at arm's length. Given the reason for judicial intrusion, the standard of fairness which the courts impose might most appropriately be a proxy for the bargain which the parent's power made impossible — the price at which the merger would have been arranged in a hypothetical free market by parties bargaining at arm's length.²⁹ It might also be argued — as we shall do in section B of this Part — that the requisite standard of fairness should be derived from analogy to a fiduciary (such as an investment adviser with multiple accounts) allocating investment opportunities among beneficiaries; the parent's management would be the fiduciary and the parent's stockholders and subsidiary's public stockholders would be the respective sets of beneficiaries. In either case, however, the standard of fairness

²⁷ Cf. *Raynor v. LTV Aerospace Corp.*, 317 A.2d 43 (Del. Ch. 1974).

²⁸ The usefulness of the appraisal remedy is as limited when it is invoked in ordinary arm's-length mergers between unrelated enterprises as when invoked in parent-subsubsidiary mergers. In the former type of merger, the fiduciary violation generally imputed to management is that some portion of the purchase price which the acquiring company was presumably willing to pay has been withheld from the acquired company's stockholders and either absorbed by management itself or else divided between it and the acquiring firm — with the result that the acquired company's stockholders receive less, in some unidentified amount, than they would have received had their management been devoted solely to their interests. If appraisal rights are to serve as an appropriate corrective, the valuation reached in an appraisal proceeding would have to be one which somehow restored that amount by hypothesizing a negotiated bargain or a competitive auction for control of the acquired company's shares. In any such competition or bargain, the management of the selling corporation, assuming it were uncorrupted, would hold out for and would receive, either from the other bargaining party or from the competitive bidders, some part of the selling corporation's contribution to the gains which are anticipated from the combined operation, and those gains would be apportioned ratably among the seller's stockholders. But such an element has never been included in valuation in appraisal proceedings, and indeed would be altogether contrary to their purpose.

²⁹ See *International Radio Tel. Co. v. Atlantic Communication Co.*, 290 F. 698, 702 (2d Cir.), *cert. denied*, 263 U.S. 705 (1923); *Ewen v. Peoria & E. Ry.*, 78 F. Supp. 312, 317 (S.D.N.Y. 1948), *cert. denied*, 336 U.S. 919 (1949).

would differ significantly from that which now generally prevails when courts are called upon to assess the fairness of mergers.

To put the matter in context, suppose that the merger of a parent and subsidiary is expected to generate an increment in the combined value of the two companies. In effect, the value of the merged entity is seen to exceed the sum of the premerger values of parent (*P*) and subsidiary (*S*) taken separately. We do not assert that this is always or even necessarily often true, but we think that it is likely to occur in more than a trivial number of cases for at least three reasons. First, there may be operating economies to be achieved through the elimination of duplicated functions or the like. Those opportunities for cost-saving may have existed but not been perceived by *P* before control was acquired, or they may have arisen subsequently. Although most economies can be largely realized merely through the parent-subsidiary affiliation, some may not be fully realizable short of complete ownership.³⁰ Second, merger may generate tax savings. Third, there may be stock market or financial benefits of a sort which became familiar to investors during the merger wave of the 1960's. Recent experience supports the expectation that merger may sometimes lead to a higher market multiplier for the portion of the subsidiary's income stream not owned by the parent. If the subsidiary's earnings are discounted more heavily than the parent's, a mere shift in ownership may change the rate at which those earnings are capitalized by investors. Even when combined total earnings are unchanged, there is, as Lintner has noted, "an automatic increase in the earnings *per share* of the acquiring company whenever its price-earnings ratio is higher than that of the acquired firm."³¹ Whether wisely or not, "many investors judge growth and growth prospects in terms of earnings per share," so that the merger may actually result in a higher aggregate value for the merging companies.³²

Whatever the reason for the increase in value when parent and subsidiary are merged,³³ the question that arises from the

³⁰ See *Grimes v. Donaldson, Lufkin & Jenrette, Inc.* [Current] CCH FED. SEC. L. REP. ¶ 94,722 (N.D. Fla., July 15, 1974) (absorption of subsidiary to avoid expenses of recordkeeping and inhibition against self-dealing and to eliminate duplication).

³¹ See Lintner, *Expectations, Mergers and Equilibrium in Purely Competitive Securities Markets*, 61 AM. ECON. REV. 101, 110 (1971).

³² *Id.*

³³ Mergers between previously unrelated enterprises occur, presumably, because at least the acquiring party, and generally both parties, believe that gains will result. See, e.g., W. ALBERTS & J. SEGALL, *THE CORPORATE MERGER* (1966); FTC, *ECONOMIC REPORT ON CORPORATE MERGERS* (1969), G. MCCARTHY, *ACQUISITIONS AND MERGERS* (1963). The hope of capturing the difference between the amount the acquiring party is willing to pay and some larger amount which it assigns to

standpoint of corporate law is whether the resulting increment must be divided among all the participants. Put otherwise, the issue is whether the parent as fiduciary should be compelled to share the increased value with the public stockholders of the subsidiary on some basis, or may instead appropriate that increase entirely to itself.

A. The Present Law

It is commonly said by courts and commentators that the fiduciary norm in this situation is one of arm's-length dealing; a fair price for the minority stock is that which an arm's-length bargain in a free market would have produced. In attempting to determine the fair arm's-length price, however, judicial opinions have concentrated on procedural matters³⁴ and have left the

the acquired enterprise or to gains from the combination of the two enterprises is presumably one stimulus to the merger. That difference may be the result of the stock market's misperception of the value of the acquired company, the possibilities of increased efficiency or product market dominance resulting from the merger, changes in financial structure, or stock market synergy or the like. See, e.g., Gort, *An Economic Disturbance Theory of Mergers*, 83 Q.J. ECON. 624 (1969); Halpern, *Empirical Estimates of the Amount and Distribution of Gains to Companies in Mergers*, 46 J. BUS. 554 (1973); Lewellen, *A Pure Financial Rationale for the Conglomerate Merger*, 26 J. FIN. 521 (1971); Lintner, *Expectations, Mergers and Equilibrium in Purely Competitive Securities Markets*, 61 AM. ECON. REV. 101 (1971); Mueller, *A Theory of Conglomerate Mergers*, 83 Q.J. ECON. 643 (1969). There is a considerable body of literature which questions whether mergers produce greater efficiency or profits over the long run. See, e.g., FTC, ECONOMIC REPORT ON CONGLOMERATE MERGER PERFORMANCE: AN EMPIRICAL ANALYSIS OF NINE CORPORATIONS (1972); E. KELLY, PROFITABILITY OF GROWTH THROUGH MERGERS (1967); S. REID, MERGERS, MANAGERS AND THE ECONOMY (1968); A. SINGH, TAKEOVERS: THEIR RELEVANCE TO THE STOCK MARKET AND THE THEORY OF THE FIRM (1971); Austin & Fishman, *The Tender Takeover*, 4 MERGERS AND ACQUISITIONS 4 (1969); Hogarty, *Profits from Mergers: The Evidence of Fifty Years*, 44 ST. JOHN'S L. REV. 378 (spec. ed. 1970); Piper & Weiss, *supra* note 22. See also, *Hearings Pursuant to S. Res. 40 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 91st Cong., 1st Sess., pt. 8A, at 69-95 (1969). While the gains expected from mergers between previously unrelated enterprises may be based upon more varied expectations, parent-sub-sidiary mergers are not exercises in altruism. Whatever the cause, we may assume that the parent will rarely acquire the subsidiary's assets unless it perceives — and reasonably expects — a gain from the transaction.

³⁴ Thus, the location of the burden of proof (which appears to mean the burden of justifying the fairness of the merger) is said to be on the defenders of the merger in parent-sub-sidiary mergers, rather than on the challengers as in arm's-length mergers. Compare *David J. Greene & Co. v. Dunhill Int'l, Inc.*, 249 A.2d 427, 432 (Del. Ch. 1968), and *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 298, 93 A.2d 107, 110 (Sup. Ct. 1952), with *Gomberg v. Midvale Co.*, 157 F. Supp. 132, 137 (E.D. Pa. 1955), *Muschel v. Western Union Corp.*, 310 A.2d 904 (Del. Ch. 1973), and *Baron v. Pressed Metals of America, Inc.*, 35 Del. Ch. 325, 332, 117 A.2d 357, 361 (Ch. 1955). But the impact of ratification by a majority of the

substantive formula ambiguous. Such formulas as the opinions disclose appear generally to focus on whether the value of what is surrendered by the public stockholders of the subsidiary is equivalent to the value of what they receive in exchange.³⁵ While occasionally the cases suggest that fairness requires a sharing of the gains resulting from the merger,³⁶ the test that is most often

disinterested minority stockholders upon the courts' assessment of fairness is not entirely clear. *Compare* Bastian v. Bourns, Inc., 256 A.2d 680 (Del. Ch. 1969), *aff'd*, 278 A.2d 467 (Sup. Ct. 1970), *with* David J. Greene & Co. v. Dunhill Int'l, Inc., *supra*. See also Alcott v. Hyman, 40 Del. Ch. 449, 184 A.2d 90 (Ch. 1962), *aff'd*, 42 Del. Ch. 233, 240, 208 A.2d 501, 505 (Sup. Ct. 1965); Brundage v. New Jersey Zinc Co., 48 N.J. 450, 226 A.2d 585 (1967).

³⁵ The standard of equivalence between the "get" and the "give" as the test of fairness was adopted in early cases involving sales of assets for cash in transactions between unrelated enterprises, which were challenged by alleging that side benefits awarded to those in control affected their judgment. See, e.g., Allied Chem. & Dye Corp. v. Steel & Tube Co., 14 Del. Ch. 1, 18-20, 120 A. 486, 494-95, *preliminary injunction dissolved after trial*, 14 Del. Ch. 64, 122 A. 142 (Ch. 1923); *cf.* Marks v. Wolfson, 41 Del. Ch. 115, 188 A.2d 680 (Ch. 1963); Alcott v. Hyman, 40 Del. Ch. 449, 184 A.2d 90 (Ch. 1962), *aff'd*, 42 Del. Ch. 233, 208 A.2d 501 (Sup. Ct. 1965); Robinson v. Pittsburgh Oil Ref. Corp., 14 Del. Ch. 193, 126 A. 46 (Ch. 1924). When the transaction was accomplished by merger, the courts continued to apply an equivalence test on the analogy to cash sales. No distinction appears to have been made between mergers of unrelated enterprises, see, e.g., Jackson Co. v. Gardiner Inv. Co., 200 F. 113 (1st Cir. 1912) (*preliminary injunction*), *on appeal after decision on the merits*, 217 F. 350 (1st Cir. 1914), *appeal dismissed*, 239 U.S. 628 (1915); Cole v. National Cash Credit Ass'n, 18 Del. Ch. 47, 56, 156 A. 183, 187 (Ch. 1931), and mergers between parent and subsidiary, see, e.g., Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952); David J. Greene & Co. v. Schenley Indus., 281 A.2d 30 (Del. Ch. 1971); Bastian v. Bourns Inc., 256 A.2d 680 (Del. Ch. 1969), *aff'd*, 278 A.2d 467 (Sup. Ct. 1970); David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427 (Del. Ch. 1968); Stryker & Brown v. Bon Ami, Civil No. 1945 (Del. Ch., Mar. 16, 1964), *reprinted in* PLI THIRD ANNUAL INST. ON SEC. REG. 573 (1972). See also Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66, 104-05 (E.D.N.Y. 1969), *damages determined*, 332 F. Supp. 644 (E.D.N.Y. 1971), *aff'd*, 478 F.2d 1281 (2d Cir., 1973); Hill v. St. Louis Coke & Iron Corp., 9 F. Supp. 69, 74 (D. Del. 1934) (*sale for cash*), *aff'd sub nom.* Anderson v. St. Louis Coke & Iron Corp., 79 F.2d 336 (3d Cir. 1935), *cert. denied*, 296 U.S. 656 (1936); Abelow v. Symonds, 40 Del. Ch. 462, 184 A.2d 173 (Ch. 1962) (*sale for cash*), *aff'd sub nom.* Abelow v. Midstates Oil Corp., 41 Del. Ch. 445, 189 A.2d 675 (Sup. Ct. 1963); Homer v. Crown Cork & Seal Co., 155 Md. 66, 141 A. 425 (1928) (*sale for cash*); Willcox v. Stern, 18 N.Y.2d 195, 219 N.E.2d 401, 273 N.Y.S.2d 76 (1966). The complaint by dissenters that they have received less than equivalent value, rather than any claim that equivalence was an inadequate test, has tended to define the issue for the courts on the question of fairness.

³⁶ Jones v. Missouri-Edison Elec. Co., 199 F. 64 (8th Cir. 1912), *cert. denied*, 229 U.S. 615 (1913); Ervin v. Oregon Ry. & Navig. Co., 27 F. 625 (C.C.D.N.Y. 1886), *appeal dismissed*, 136 U.S. 645 (1890). The sharing requirement is sometimes found in opinions of the Securities and Exchange Commission dealing with the fairness of mergers under the Investment Company Act, 15 U.S.C. § 80a (1970). LaSalle St. Capital Corp., SEC Investment Company Act Release No. 6693 (Aug. 23, 1971); Talley Indus. Inc., SEC Investment Company Act Release No. 5953,

decipherable³⁷ is one which merely echoes the appraisal standard

[1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,774 (Jan. 9, 1970); Townsend Corp. of America, SEC Investment Company Act Release No. 4045, at 35-39 (Sept. 2, 1964); Atlas Corp., SEC Investment Company Act Release No. 2920 (Oct. 19, 1959). Compare Burco Inc., 15 S.E.C. 828, 832-33 (1944), with Iowa Interests Corp., 40 S.E.C. 927 (1961). It also appears in the arguments made and acknowledged (but not accepted on the facts) in many judicial decisions, generally involving either arm's-length or two-step mergers. See, e.g., Levin v. Great W. Sugar Co., 406 F.2d 1112 (3d Cir.), cert. denied, 396 U.S. 848 (1969); Mitchell v. Highland-Western Glass Co., 19 Del. Ch. 326, 167 A. 831 (Ch. 1933) (arm's-length transaction); Brundage v. New Jersey Zinc Co. 48 N.J. 450, 226 A.2d 585 (1967).

Where the merger involves payment for the subsidiary's assets in cash or the parent's senior securities, the equivalence formula effectively precludes any sharing of gain since giving equivalent value in such currency at the time of the merger deprives the seller's stockholders of any possibility of sharing in the benefits of the combination. Where, however, the merger involves payment in the parent's common stock, sharing in the gains occurs if both enterprises are valued on a premerger basis and the parent's stock, so valued, is the currency in which the subsidiary's public stockholders are paid. Cf. Dasho v. Susquehanna Corp., 461 F.2d 11 (7th Cir.), cert. denied, 408 U.S. 925 (1972); Bragalini v. Biblowitz, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,371 (S.D.N.Y., Jan. 23, 1974); Muschel v. Western Union Corp., 310 A.2d 904, 909 (Del. Ch. 1973) (arm's-length merger). If the parent's stock is valued on a postmerger basis (i.e., including the gains) while the subsidiary's stock is valued on a premerger basis, no such sharing occurs.

³⁷ See generally Note, *The Fiduciary Duty of Parent to Subsidiary*, 57 VA. L. REV. 1223 (1971). The uncertainty as to the standard actually applied by the courts stems in part from the fact that market prices are almost uniformly found inadequate to measure either the contributions of the parties to the merger or the premises on which they should be deemed to have bargained. Instead, courts have tended to rely on expert testimony concerning the value of the shares and securities exchanged in the merger. The assumption is that in a bargain at arm's length the values so attested would have been recognized, and equivalents would have been exchanged by the parties. See Bastian v. Bourns, Inc., 256 A.2d 680 (Del. Ch. 1969), aff'd, 278 A.2d 467, (Sup. Ct. 1970); David J. Greene & Co. v. Dunhill Int'l. Inc., 249 A.2d 427 (Del. Ch. 1968); Stryker & Brown v. Bon Ami., Civil No. 1945 (Del. Ch., Mar. 16, 1964), reprinted in PLI THIRD ANNUAL INST. ON SEC. REG. 573 (1972); Abelow v. Symonds, 40 Del. Ch. 462, 470, 184 A.2d 173, 178 (Ch. 1962), aff'd, 41 Del. Ch. 145, 189 A.2d 675 (Sup. Ct. 1963). The courts have focused on reconciling disagreements between presumably independent experts partly by resolving the numerical differences on their "merits," and partly by taking into account as offsets to numerical differences such nonquantifiable factors as they deem significant. As a result, the opinions concentrate less on devising a substantive standard of fairness than on determining a permissible disparity between values and the significance of the intangibles. See Levin v. Great W. Sugar Co., 406 F.2d 1112 (3d Cir.), cert. denied, 396 U.S. 848 (1969); David J. Greene & Co. v. Schenley Indus., 281 A.2d 30 (Del. Ch. 1971); Bastian v. Bourns, Inc., 256 A.2d 680 (Del. Ch. 1969), aff'd, 278 A.2d 467 (Sup. Ct. 1970); Brundage v. New Jersey Zinc Co., 48 N.J. 450, 226 A.2d 585 (1967); Colby v. Equitable Trust Co., 124 App. Div. 262, 108 N.Y.S. 978, aff'd, 192 N.Y. 535, 84 N.E. 1111 (1908). Even in that determination, however, the courts have been ambiguous, referring either to a requirement of "careful scrutiny" in parent-subsidiary mergers, Sterling v. Mayflower

itself; the transaction is considered fair if the public stockholders of the absorbed subsidiary receive cash or other consideration equal merely to the premerger value of the subsidiary's shares. In many, perhaps most, cases, the arm's-length standard is thus evidently expected to generate no more for the minority stockholders (though of course no less) than might be realized through sale of individual shares to another investor in an ordinary brokerage transaction at the premerger market price.

With this version of a fairness standard in view, it is easy to understand why the availability of appraisal rights under state law has led some courts and legislatures to regard fairness as an unnecessary element of protection for minority stockholders. The statutory right of appraisal has often been interpreted either to foreclose fairness challenges altogether³⁸ or to limit their permissible scope,³⁹ whether the challenge is presented in a suit to enjoin a proposed merger, to unscramble a completed transaction, or to obtain money damages. These restrictive interpretations may be appropriate if the fairness challenge raises the question only of how much *S* is worth apart from the merger; under that limited view, an injunction, rescission, or a damage award to all stockholders may well be too harsh a form of relief where appraisal is available for dissatisfied individual stockholders. The more fundamental issue, however, is whether the fairness challenge implicates so narrow a question.

Hotel Corp., 33 Del. Ch. 293, 298, 93 A.2d 107, 110 (Sup. Ct. 1952), or to the need to find a disparity "so gross as to indicate bad faith," *Cole v. National Cash Credit Ass'n*, 18 Del. Ch. 47, 59, 156 A. 183, 188 (Ch. 1931), or "fraud," *Mitchell v. Highland-Western Glass Co.*, 19 Del. Ch. 326, 330, 167 A. 831, 833 (Ch. 1933), in mergers between unrelated enterprises. *Cf. Skelly v. Dockweiler*, 75 F. Supp. 11 (S.D. Cal. 1947).

³⁸ See Lattin, *A Reappraisal of Appraisal Statutes*, 38 MICH. L. REV. 1165 (1940); Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189, 1207 (1964).

³⁹ Some authorities indicate that although appraisal rights do not preclude a challenge for fairness, see Vorenberg, *supra* note 38, at 120-23; Note, *Interplay of Rights of Stockholders Dissenting from Sale of Corporate Assets*, 58 COLUM. L. REV. 251, 255 (1958), their existence should increase the challenger's burden of demonstrating that the terms are unfair, or might even alter the definition of fairness, so that a merger price which would be unfair in the absence of an appraisal remedy might be fair because of its availability. See Lattin, *supra* note 38, at 1169-70, 1172-74; Vorenberg, *supra* note 38, at 1215-16. This view is to be contrasted with the notion, early articulated but not often accepted, that the appraisal remedy was designed as an alternative only to a legal, and equitably fair proposal and not to an unlawful or inequitable proposal. See, e.g., *Colgate v. United States Leather Co.*, 73 N.J. Eq. 72, 98, 67 A. 657, 668 (Ch. 1907), *rev'd on other grounds*, 75 N.J. Eq. 229, 72 A. 126 (Ct. Err. & App. 1909). If the remedy of appraisal were fashioned as an alternative to a valid merger proposal, it is incongruous to use its availability as the basis for diluting the protection provided by the requirement of an equitable merger. See Lattin, *supra* note 18, at 247-51; Weiner, *Payment of Dissenting Stockholders*, 27 COLUM. L. REV. 547, 557 (1927).

Our own view is that broader issues are involved and that the relevant fiduciary norm merits basic reexamination, at least in the case of parent-subsidary mergers. As indicated below, we think that the existing standard of fairness — essentially, an appraisal standard which focuses on the premerger value of the subsidiary — is insufficient and inequitable in those cases in which the merger itself is a valuable transaction, that is, where merger generates a larger aggregate value than the sum of *P* and *S* taken separately. Such a possibility, moreover, suggests that appraisal and fairness challenges can have independent functions, so that the availability of the former need not in any way affect the availability or application of the latter.

B. Alternative Fairness Standards

In considering alternatives to the existing law, our effort will be to contrast the fiduciary premises which seem to underlie each such alternative with those of present law, and then to show in specific terms how the contrasting conceptions of fiduciary obligation lead to differences in actual result. As indicated, the situation to be considered is one in which *P* acquires a controlling stock interest in *S* (by whatever means) and then proceeds to operate *S* as a subsidiary. Ultimately, after a more or less extended period of affiliation, *P* elects to merge *S* into itself, paying off *S*'s public stockholders in stock, debt or cash or some combination of the three. In these circumstances, what constitutes fair treatment of the public stockholders?

To focus our inquiry, let us assume that the stock of *P* (which owns 50.01 percent of *S*) sells at 10 times current earnings of \$12 a share, or \$120, just prior to the announcement of the merger, and *S* stock sells at 10 times current earnings of 50 cents a share, or \$5. *P* has 1 million shares outstanding; *S* has 2 million-plus shares outstanding, of which the public owns 1 million and *P* owns the balance. *P*'s total income and stock value are thus \$12 million and \$120 million. *S*'s public shares earn \$500,000 and are worth \$5 million; and the sum of the separate values of the publicly owned shares of *P* and *S* is \$125 million. Let us further assume that a merger between *P* and *S* will produce an enterprise worth \$135 million; for whatever reason — cost economies, tax savings, or other benefits which are realized solely by virtue of the merger — *P*'s decision to merge with *S* has produced an increment of \$10 million in the expected combined value of the two corporations.⁴⁰ The obvious issue of fairness is how this

⁴⁰ The example could also be framed in what may be more familiar terms. If prior to acquisition of a 50% interest in *S*, *P*'s price-earnings ratio were 30, and *S*'s were 10, and if *P*'s multiplier were to remain unchanged, then the acquisition would produce a gain of \$10 million arising from the application of *P*'s multiplier

increment should be divided between *P* and the public stockholders of *S*.

The solution to this sharing problem depends entirely on what the concept of fiduciary obligation — which *P* is uniformly said to owe *S* — should be understood to mean in this context. In making a bargain between parent and subsidiary, is management free to consider that its primary duty is to one entity — presumably the parent — and that its duty to the other is of a secondary order? Or does fiduciary obligation imply an equal standard of responsibility, with neither entity having a superior claim to management's best efforts?

As we have noted, the answer generally given in the past has been that the subsidiary's public stockholders are entitled to no less, but no more, than the value of what they are asked to surrender in the merger — in effect, the usual “give-get” test of a simulated arm's-length bargain applies. Since the value of the “give” side of the equation is taken to be the value of *S*'s publicly held stock apart from the merger, the consequence is that the \$10 million increment is allocated exclusively to *P*. The *S* stockholders would therefore be entitled to no more than \$5 million in value if paid in bonds or cash for the 1 million shares of *S* surrendered. If paid in common stock, they would receive roughly 38,462 shares of *P* on the exchange. *P*'s stock after merger would be worth \$130 per share, and the *S* stockholders would then hold *P* shares with a total value of \$5 million. *S*'s outside stockholders would thus be fully compensated for the premerger value of their shares, but they would receive no portion of the gain resulting from the merger transaction itself.

The premises which underlie this outcome seem to be that the *S* stockholders have lost their bargaining rights and rights to independent representation in negotiating with *P*, and that management's duty “to do its best” is an obligation that runs principally, if not exclusively, to the parent corporation. To be sure, management has a duty to the subsidiary and its stockholders as well, since the merger transaction is effectively self-dealing. But that duty appears to require only that management refrain from paying less than the appraisal price for the public's shares. It does not embrace an obligation to seek for *S* or its public stockholders any portion of the merger gains, notwithstanding its

of 30 to the portion of *S*'s income stream (\$500,000) attributable to *P*'s ownership, which we may assume would be distributed to *P* in dividends. That increment would be reflected in the premerger value of *P*. A subsequent merger would produce an additional \$10 million increase in the capitalized value of the two companies, resulting from the application of *P*'s multiplier to the \$500,000 income stream it acquires through the merger from *S*'s public shareholders.

formulation as an obligation to engage in the equivalent of arm's-length bargaining. One can characterize both of management's obligations — to parent and subsidiary — as “fiduciary,” but it seems quite clear that they entail different levels of fidelity, at least in outcome.⁴¹

Indeed, this version of arm's-length may well assume (though without saying so) that the parties to the bargain are really *P* and the *individual* minority stockholders of *S*, rather than *S* itself. If the negotiation is viewed as involving *P* and the scattered *S* stockholders, it is perhaps understandable why the prevailing fiduciary standard should entitle the latter to no more than they would get through the sale of their individual holdings on the market. But perhaps the question of “parties,” or at least the identity of the selling party should be reconsidered. Instead of a bargain between *P* and the individual stockholders of *S*, perhaps the arm's-length concept should be taken to imply a transaction between the two firms, much as if the absorption of *S* by *P* were really an ordinary merger in which neither company owned a controlling interest in the other. One would then be led to picture two independent bargaining agents negotiating with each other over an acceptable price or exchange rate for *S*'s assets, both fully aware that the combination will result in an increase in aggregate value⁴² and that the consent of each bargainer is equally necessary to the realization of that increment. In effect, under this version the two entities are assumed to be dealing at arm's length, each represented by a manager who is duty bound to bargain diligently before consenting to submit the merger plan to his own stockholders.⁴³

⁴¹ A comparable difference is implicit in the notion, suggested by a growing body of Delaware cases, that where the public security holders of the subsidiary are formally accorded the same treatment as the parent (*e.g.*, dividend payments which are pro rata), the transaction is not to be regarded as a “self-dealing” transaction to be assessed by the test of “intrinsic fairness,” but rather is to be regarded like an arm's-length transaction, to be evaluated by the business judgment test. *See, e.g.*, *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 721–22, (Del. 1971); *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883, 887 (Del. 1970); *Singer v. Creole Petroleum Corp.*, 297 A.2d 440, 442 (Del. Ch. 1972), *modified on other grounds*, 321 A.2d 859 (Sup. Ct. 1973); *Chasin v. Gluck*, 282 A.2d 188, 192 (Del. Ch. 1971). To regard similarity of formal treatment as inhibiting the inquiry into whether there is substantive inequality of treatment has even less basis in fiduciary theory than does the denial of a sharing obligation in mergers.

⁴² To assume complete independence of the parties implies disparities in information which would pose a problem in valuation proceedings — what information or plans of one company should be deemed to be known to the other? If all the buyer's knowledge and plans are imputed to the seller, the buyer will be deprived of legitimate discovery values. If less than full knowledge is imputed, the question arises as to how much, or what items of knowledge should be imputed.

⁴³ For an acute analysis of the difficulties confronting courts in making such

Even this version of the arm's-length standard presents problems, however. Although the concept of a bargain between two companies calls for a sharing on some basis of the gain expected to result from the merger, it leads to no unique solution to the problem of fair division. Any sharing of the expected gain which leaves both parties better off is conceivable, but the actual outcome would depend on relative negotiating skills, individual expectations, adequacy of information, and other indeterminate variables. Moreover, while a solution based on the difference in size between *P* and *S* — perhaps through comparing stock values or income streams — has some appeal,⁴⁴ the relevance of a size factor in an arm's-length bargain is presumably slight where each party has (or is deemed to have) an absolute veto over the merger proposal.⁴⁵

In the end, a mediator might decide that the only feasible outcome is one which divides the merger gain equally between the two firms by awarding \$5 million to each.⁴⁶ While that result is no more likely than any other to be the outcome of a real negotiation, from the mediator's standpoint it does at least give an appearance of neutrality and evenhandedness. If we adopt this notion as our fiduciary premise, *P* would ultimately receive \$7.5 million of the \$10 million gain — \$5 million directly, and, because of its 50 percent ownership of *S*, \$2.5 million of the \$5 million allocated to *S*. The *S* public shareholders, if paid in bonds or cash, would receive \$7.5 million for surrendering their 1 million shares — \$5 million for the premerger value of the shares and \$2.5 million as their share of the increment. If paid in common stock, they would receive roughly 58,823 shares of *P* on the exchange. *P*'s stock after merger would be worth \$127.50 per share, and the *S* stockholders would hold *P* shares with a

assumptions see *Ewen v. Peoria & E. Ry.*, 78 F. Supp. 312, 316-17 (S.D.N.Y. 1948) (L. Hand, J.), *cert. denied*, 336 U.S. 919 (1949).

⁴⁴ Studies of mergers of listed companies suggest that the ratio in which they share in the merged enterprise has tended to correlate with the ratio of the market prices of the stocks of the two enterprises (during the period preceding the announcement of the merger) more closely than with the ratios of any other relevant variables. Compare L. DELLENBARGER, *COMMON STOCK VALUATION IN INDUSTRIAL MERGERS* 73-83 (1966), with Bosland, *Stock Valuation in Recent Mergers*, 94 *TRUSTS AND ESTATES* 516, 518-24, 583-90, 662-69 (1955). But cf. Halpern, *supra* note 22, at 568-73 (equal division between larger and smaller firms). Reference to the results of apparently arm's-length transactions to set a norm for the imputed bargain is limited by the qualification that side payments may in fact be concealed in the price. See note 92 *infra*.

⁴⁵ Cf. *Dravosburg Land Co. v. Scott*, 340 Pa. 280, 281-83, 16 A.2d 415, 416-17 (1940).

⁴⁶ See Halpern, *supra* note 22, at 573; Mossin, *Merger Agreements: Some Game-Theoretic Considerations*, 41 *J. BUS.* 460, 466 (1968).

total value of \$7.5 million. Thus, the dollar value of the merger would be \$2.50 per share to the public shareholders of *S* and \$7.50 per share to *P*. By contrast, under the appraisal standard which is supported by many of the decided cases, the dollar value of the merger to the *P* stockholders would be \$10 per share, and to the *S* stockholders zero.

Which of the two outcomes just compared should be adopted? It seems plain that a rule which allocates nothing to the minority interest in respect to the merger gain is unfair; surely *S* makes some contribution to the increase in total value which entitles the public stockholders to a share of the return. But we also think it arbitrary to insist that the uncertainties which would attach to a true arm's-length bargain between independent managers be resolved by an equal division of the gain. Since the outcome of an actual negotiation could fall at any point on a wide range, the equal division rule merely pretends to find a determinate solution where none exists.

At all events, the plain fact is that *P* and *S* are not at arm's length and it seems incongruous to treat them as if they were. Thus, if the two companies were truly unaffiliated, each management's knowledge of the other enterprise and its possibilities would be limited, and in particular the subsidiary's insight into the plans of the parent and the uses it contemplates for the subsidiary's assets would be merely speculative. Any valuation resting upon an imputed arm's-length bargain would therefore have to reflect an assumed disparity in information between the two companies.⁴⁷ But such a simulated solution would be inconsistent with the actuality that *P* and *S* are jointly managed. Moreover, any effort to impute to *P* an undisclosed perception about the gains to be derived from combining the two entities is presumably contrary to existing rules on insider trading.⁴⁸ Hence, although

⁴⁷ See Heyman, *Implications of Rule 145 Under the Securities Act of 1933*, 53 B.U. L. REV. 785, 812-13 (1973).

⁴⁸ The two companies have been operated as part of a single controlling group, so that the management of each enterprise must be deemed to know everything about the other. If the enterprises are not in fact being operated as a common pool of assets, they are at least the beneficiaries of a common pool of information about each other. And those in control owe as much obligation to the one enterprise as to the other to disclose all relevant information. To allow the parent to make an exchange on the basis of knowledge it has about the subsidiary which it acquired by reason of its control and does not disclose to the public is, therefore, to permit insider trading. *Gerstle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66 (E.D. N.Y. 1969), *aff'd in relevant part*, 478 F.2d 1281 (2d Cir. 1973). In contrast, any knowledge about the acquired company which the acquiring company learns in an arm's-length transaction comes, presumably, from its own efforts, and it is entitled to the benefit of its discovery of those values. *Cf. Heyman, supra* note 47, at 813; *Schneider & Manko, Rule 145*, 5 REV. SEC. REG. 811, 815 (1972). *But cf. Feit v.*

the arm's-length bargain concept is inequitable if it leads to an appraisal standard of fairness, if used to support an equal division of merger benefits or any other determinate formula, it is arbitrary both in theory and in application.⁴⁹

The shortcomings of the arm's-length bargain analogy suggest that it may be more appropriate to emphasize the joint character of management's responsibility to the stockholders of the two entities than to postulate a fictional bargain at arm's length. What ought to be stressed, we think, is not the idea of a make-believe bargain between strangers, but the fact that a

Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 549, 563-66 (E.D.N.Y. 1971).

⁴⁹ In addition to the indeterminacy in theory implicit in any effort to ascertain how two independent negotiators would divide the gain, there are indeterminacies in application whenever any effort is made to simulate an arm's-length bargain over assets or services for which there is no readily ascertainable market price. Thus, to determine the fairness of merger terms not fixed by arm's-length bargaining, the courts rely on the testimony of experts of uncertain independence, who can only provide approximations, and must attribute to each enterprise a wide range of values, at any one of which an exchange would be fair. Thus, the stock of Enterprise A, valued at between 20 and 23, which is being merged into Enterprise B having stock values between 40 and 44, may be exchanged "fairly" on the basis of a value of 20 for Enterprise A and 44 for Enterprise B (approximately 1 for .45 shares). The transaction would be equally fair if the respective values were 23 and 40 (approximately 1 for .57 shares). And courts are unable — either theoretically or practically — to determine where, if anywhere, within these ranges prices cease to be acceptable. See *Ewen v. Peoria & E. Ry.*, 78 F. Supp. 312, 316-17 (S.D.N.Y. 1948), cert. denied, 336 U.S. 919 (1949); cf. *Dasho v. Susquehanna Corp.*, 461 F.2d 11, 28 (7th Cir.), cert. denied, 408 U.S. 925 (1972) (use of market values to establish "a tolerable range of fairness"). If the merger parties are assumed to be unrelated, the acceptable range of values is limited only by the "business judgment" of the bargainers — a judgment seldom questioned by the courts. See, e.g., *Gimbel v. Signal Cos., Inc.*, 316 A.2d 599, 610 (Del. Ch.), aff'd, 316 A.2d 619 (Sup. Ct. 1974); *Fidanque v. American Maracaibo Co.*, 33 Del. Ch. 262, 279-80, 92 A.2d 311, 321 (Ch. 1952); *Mitchell v. Highland-Western Glass Co.*, 19 Del. Ch. 326, 330-31, 167 A. 831, 833 (Ch. 1933); *Cole v. National Cash Credit Ass'n*, 18 Del. Ch. 47, 56, 156 A. 183, 187-88 (Ch. 1931); cf. *Vorenberg*, supra note 38, at 1215-16. The "presumption [of] . . . sound business judgment" (which is rebutted only by apparently fraudulent conduct) has been held inapplicable when parent-subsidiary mergers are challenged; instead the test becomes "intrinsic fairness," which is determined by "careful scrutiny." *David J. Greene & Co. v. Dunhill Int'l, Inc.*, 249 A.2d 427, 431 (Del. Ch. 1968). However, no specific criteria have been offered for determining the "intrinsic fairness" of a merger price. See Comment, *The Corporate Fiduciary Duty Doctrine and the Requirement of Fairness in Parent-Subsidiary Relations*, 76 DICK. L. REV. 237, 250-65 (1971). The results of the cases suggest that the difference between the two standards is not significant, although it is possible that judicial articulation of the difference inhibits those who negotiate parent-subsidiary mergers more than those who corrupt "independent" management with side payments. Certainly the judicial valuation proceeding produces a "fair" price which is at best only a crude approximation of the arm's-length bargain for which it purports to be a proxy.

single management team is in charge of both enterprises, and that its ultimate responsibility is to the individual investors who own those companies' shares.⁵⁰ Taking that view, a more fitting analogy is to the legal responsibility of a trustee who undertakes to manage two (or more) trust accounts on behalf of separate beneficiaries having similar financial objectives. Where a profitable opportunity has been discovered — here the merger — the question that arises would not be one of improper self-dealing on the part of the fiduciary, for which an arm's-length standard might indeed be appropriate. Rather, the issue to be resolved would be how, or whether, a single fiduciary acting on behalf of multiple beneficiaries should be required to apportion among them the tangible benefits which his management skills produce. Suppose — to use a somewhat fanciful illustration — that a trustee has discretionary authority to manage two accounts: the first, belonging to beneficiary *A*, has assets of \$100; the second, belonging to beneficiary *B*, has assets of \$50. The trustee determines that a cost-saving of \$10 can be realized if both accounts are joined in a single administrative unit. The question is how that saving should be apportioned by the trustee so as to comply with his fiduciary obligations to *A* and *B*.

It is too plain for argument that the \$10 saving must be shared on some basis between *A* and *B*, and cannot be allocated solely to either — at least in the absence of agreement or demonstrable expectations to the contrary. Each beneficiary has a claim on the trustee's management skill, a claim which is entitled to recognition in some amount; neither can be wholly excluded from participation in the gain from the combination. On the other hand, a 50-50 apportionment of the expected gain is unwarranted because such a division would produce for *B* twice the percentage return on his investment account that *A* would get on his. Thus, if each account were credited with \$5, *B* would earn a 10 percent return while *A* would earn only 5 percent. To be sure, the dollar return to both would be the same, but such an outcome seems to be unreasonable when *A* has twice as many dollars under management as *B*. The only sensible view of the trustee's obligation, we

⁵⁰ Even if different persons occupy decision making roles in the parent and in the subsidiary, the parent's management is as much the loyal and dedicated representative of the subsidiary's public stockholders as it is of the parent's. *Cf.* Jones v. A.F. Ahmanson & Co., 1 Cal. 3d 93, 115 n.14, 460 P.2d 464, 476 n.14, 81 Cal. Rptr. 592, 604 n.14 (1969) (parent owes same fiduciary duty to own shareholders as to those of subsidiary). *But cf.* Warshaw v. Calhoun, 43 Del. Ch. 148, 157, 221 A.2d 47, 492-93 (Sup. Ct. 1966). *See generally* Note, *Corporate Fiduciary Doctrine in the Context of Parent-Subsidiary Relations*, 74 YALE L.J. 338 (1964). *See also* Ewen v. Peoria & E. Ry., 78 F. Supp. 312, 315-17 (S.D.N.Y. 1948) (L. Hand, J.), *cert. denied*, 336 U.S. 919 (1949).

think, is one which promises each beneficiary the same return per dollar of resources managed, and this in turn requires that the administrative saving⁵¹ be allocated on the basis of relative account size. Thus *A* should receive \$6.67, and *B*, \$3.33, of the anticipated \$10 gain, each thereby obtaining a 6 percent return on his investment. That indeed is the principle which determines the allocation of investment opportunities in the administration of common trust funds.⁵²

⁵¹ Such an allocation of the saving is unaffected by the different risk preferences of the investors. This may be seen if we assume the case of an investment manager with two discretionary accounts. Account *A* has assets of \$100 and the owner wants a relatively safe 6% return. Account *B* has assets of \$80 and *B* seeks a relatively risky 10% return. The manager accordingly has fashioned different sets of stocks in each account in an effort to meet the owner's goal. The question is: how should the \$10 saving, posited in the illustration in the text, be divided between *A* and *B*? One possible answer is that since *B* (\$80) wants a 10% return, *B* should get \$8 with the balance of \$2 to *A*. Or, since *A* (\$100) wants a 6% return, *A* should get \$6 and *B* the remaining \$4. The two answers are equally plausible. But the fact that *A* is a 6% financier while *B* is a 10% financier really has no bearing on their relative claims to the windfall. Once the windfall has been identified, it is simply the equivalent of cash. Each party is entitled to some share of it, and each has an equal claim per dollar of resources entrusted to management. Hence *A* should get \$5.55 (5/9 of \$10) and *B*, \$4.45 (4/9 of 10). Neither risk classes nor rates of return become relevant in determining the propriety of the division of a determinate saving, however relevant they may be in determining the allocation of future investment opportunities. See note 66 *infra*.

⁵² See, e.g., Collective Investment Regulations of Comptroller of the Currency, 12 C.F.R. § 9.18(3) (1973); TRUST DIV. AM. BANKERS ASS'N, COMMON TRUST FUNDS: A HANDBOOK ON THEIR PURPOSES, ESTABLISHMENT AND OPERATION 79-82 (2d ed. 1948) (App. D, Suggested Plan Art. V); cf. INT. REV. CODE OF 1954 § 584(c) (taxable income includes proportionate share of income from common trust fund whether or not distributed).

Professional investment advisers are confronted with a similar problem in determining how to allocate fairly among their advisees investment information, purchases of securities which are desirable but scarce, sales of undesirable securities, or purchases or sales of investments which can only be purchased or sold at different prices. Although authoritative answers have not been spelled out in detail, see, e.g., 2 SEC, INSTITUTIONAL INVESTORS STUDY REPORT OF THE SECURITIES & EXCHANGE COMMISSION, H.R. DOC. NO. 92-64, 92d Cong., 1st Sess. 372-73 (1971) [hereinafter cited as INSTITUTIONAL INVESTORS STUDY]; 1 SEC, REPORT OF SPECIAL STUDY OF SECURITIES & EXCHANGE COMMISSION, H.R. DOC. NO. 95, 88th Cong., 1st Sess. 371-74 (1963) [hereinafter cited as SPECIAL STUDY]; Henderson, *Conflicts of Interest for the Money Manager*, PLI THIRD ANNUAL INST. ON SEC. REG. 293, 299 (1972); Herman & Safanda, *Allocating Investment Information*, 1973 FIN. ANAL. J. 23; Lybecker, *Regulation of Bank Trust Department Activities*, 82 YALE L.J. 977, 992-94 (1973); Lybecker, *Regulation of Bank Trust Department Activities; Seven Gaps, Eight Remedies*, 2 SEC. REG. L.J. 122, 149-54 (1974), the Securities and Exchange Commission has indicated that a wide variety of allocation practices are used. See SPECIAL STUDY, *supra*, at 330-87; INSTITUTIONAL INVESTORS STUDY, *supra*, at 348-59. A predominant but far from exclusive practice is to allocate the investment (or disinvestment) opportunities in proportion either to the amounts ordered, or to the sizes of the various accounts. See, e.g., INSTITUTIONAL

If the same considerations which govern (or ought to govern) the duty of the trustee in the illustration above are allowed to control in our parent-subsidary merger example, the effect will be to divide the merger gain equally — not on a dollar basis, as already noted, but as a percentage of premerger values. With *S* shares worth \$5 prior to merger and *P* shares worth \$120, the rule of “proportionate sharing” that we have just described would entitle the *S* stockholders to receive the premerger value of their *S* shares (\$5 million) plus $5/125$ ths of the \$10 million of appreciation expected to result from the merger itself, or \$400,000. The *S* stockholders would thus receive \$5.4 million in value if paid in bonds or cash. If paid in common stock, they would receive roughly 41,667 shares of *P* on the exchange. With 1,041,667 shares of *P* outstanding after the merger, each *P* share would be worth \$129.60, and the *S* stockholders would then hold *P* shares with a total value of \$5.4 million.

On this approach, \$9.6 million of the \$10 million merger increment is allocated to the *P* stockholders and \$.4 million to the *S* minority. The result is that both sets of stockholders earn an 8

INVESTORS STUDY, *supra*, at 348–55, 782. In the case of mutual fund complexes a proportionate allocation formula for purchases is used often enough to be characterized as “typical.” See Glazer, *A Study of Mutual Fund Complexes*, 119 U. PA. L. REV. 205, 237–38 (1970); Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. PA. L. REV. 179, 236 (1971). But cf. Glazer, *supra*, at 219–26. Similar formulas have been suggested for banks. Herman & Safanda, *supra*, at 23, 90.

Although some authorities point to a fiduciary standard which precludes systematic allocation or denial of investment opportunities to particular accounts, at least in the absence of agreement, demonstrable expectation or other relevant basis for distinguishing among advisees, see, e.g., *Courtland v. Walston & Co.*, 340 F. Supp. 1076, 1082–85 (S.D.N.Y. 1972); 3 L. LOSS, SECURITIES REGULATION 1516 & n.122 (2d ed. 1961), discussing *SEC v. Todd*, 15 SEC ANNUAL REPORT 161 (D. Mass. 1946), neither authority nor practice yet points to a single sharing formula for the allocation of investment opportunities among several constituencies. Much of the prevailing ambiguity stems from uncertainties inherent in the need to consider individual variations among accounts, differing risk and return preferences, and promises or expectations of favorable treatment. See Henderson, *supra*, at 293–314; Leiman, *Conflicts of Interests and Related Problems of Broker Dealers and Investment Advisers*, PLI FIRST ANNUAL INST. ON SEC. REG. 323, 330–40 (1970). Because of the scope of variations in individual accounts and the uncertainty as to whether any particular opportunity can be said to “fit” any particular investor, no single investment decision can be said to operate fairly or unfairly or to depart from a rule of proportionality, since it may be justified on grounds peculiar to the investment and account involved at the time of decision. Moreover, it may be possible to compensate in a later transaction for impossibility or failure in sharing an advantage in an earlier transaction. Hence, in order to determine whether allocation is being appropriately executed in accordance with a proportionate division formula, it is necessary to examine the adviser’s behavior in a large number of cases over a fairly long period of time. Cf. Henderson, *supra*, at 308; Leiman, *supra*, at 332.

percent return on their investment as a result of the merger — \$0.60/\$120 for *P*'s owners, and \$0.40/\$5 for the public stockholders of *S* — so that an equal dollar investment in either stock will generate the same return. The outcome is thus a fair one in the respect that all investors to whom management has an obligation of trust are treated alike.

In summary, the fiduciary obligation may be envisioned in the present setting in three possible forms. The first — which reflects the prevailing body of law — apparently assumes direct arm's-length dealings between *P* (the entity) and the individual minority stockholders of *S*. Such dealings are considered fair if the price paid for the minority shares is equal to their premerger value — \$5 per share in our illustration — even though a gain results from the merger itself which is retained in full by *P*. The second alternative assumes that the dealings are between *P* and an uncontrolled *S*, with each entity being represented by an independent bargaining agent. On that assumption a wide range of outcomes is possible, and no single outcome seems to be dictated. If a fair bargain would entail an equal dollar division of the merger gain, the *S* stockholders would receive \$7.50 per share, which represents the premerger value of their stock in *S* plus their share of the half of the merger increment allocated to *S*. Finally, the third version of fiduciary duty (and the one here urged) entirely discards the idea of dealings between *P* and *S* or its stockholders. What is emphasized instead is the duty of management to treat all stockholders alike by giving each an equal return on his investment, whether that investment is in the shares of *P* or the shares of *S*.⁵³ Under this formulation the allocation of values is fair if the *S* stockholders receive the premerger value of their shares (\$5) plus 5/125ths of the gain attributable to the merger (\$0.40), or \$5.40 per share. This method provides a determinate or unique solution to the sharing problem and avoids the dif-

⁵³ The duty to treat the subsidiary's public stockholders equally with the parent's stockholders would be altered if it could be shown that the subsidiary's public stockholders had consented to, or in some way expected exposure to the risk of unrestrained, unilaterally determined transactions between their enterprise and another enterprise which later acquires control of theirs. There is no evidence, however, that such risks enter into the pricing of a corporation's stock either when originally issued or when later traded (before it becomes a subsidiary). *But see* David J. Greene & Co. v. Schenley Indus., Inc., 281 A.2d 30, 35 (Del. Ch. 1971) (constructive notice to minority stockholder that he may be eliminated may be considered in valuation of stock). *See also* Folk, *Conflicts of Interest Under State Law*, PLI THIRD ANNUAL INST. ON SEC. REG. 179, 185-91 (1972); Note, *The Corporate Fiduciary Doctrine in the Context of Parent Subsidiary Relations*, 74 YALE L.J. 338 (1964).

ficulties inherent in the artificial assumption that dealing between *P* and *S* takes place at arm's length.⁵⁴

Apart from whether particular circumstances may justify or require departure from the formula,⁵⁵ the problems of practical implementation that can be foreseen seem not much greater than under present law. Where the stockholders of *S* receive stock of *P* in the merger, the proposed formula is satisfied by an exchange of shares based on the premerger value of each entity. A payout in the form of debt or cash, however, would make it necessary to place a value not merely on the shares of each entity before the merger, but on the combined entity after the merger in order to ascertain whether the *S* minority is adequately compensated.⁵⁶

⁵⁴ In analogous circumstances courts have not obligated the parent to share with its subsidiary the saving derived from filing consolidated federal income tax returns in which the subsidiary's loss offsets the parent's income. *See, e.g.,* Meyer-son v. El Paso Natural Gas Co., 246 A.2d 789 (Del. Ch. 1967); Greenbaum v. American Metal Climax, Inc., 27 App. Div. 2d 225, 320, 278 N.Y.S.2d 123, 129 (1967); Case v. New York Cent. R.R., 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965) (upholding contractual allocation of trivial part of tax benefit to subsidiary); *cf.* Western Pac. R.R. v. Western Pac. Ry., 197 F.2d 994, 1002-04 (9th Cir. 1951), *rehearing denied*, 206 F.2d 495, 498 (9th Cir.), *cert. denied*, 246 U.S. 910 (1953) (upholding subsidiary's enjoyment of the entire tax benefit. *But see* Alliegro v. Pan American Bank, 136 So. 2d 656, 658-62 (Fla. Dist. Ct. App. 1962), *aff'd mem.*, 149 So. 2d 45 (1963). As Professor Cary has pointed out, the decisions are egregiously at fault in awarding the entire benefit to the corporation with the otherwise taxable income and in failing to require sharing. *See generally* Cary, *Federalism and Corporate Law; Some Reflections on Delaware*, 83 YALE L.J. 663, 679-83 (1974). It is a mindless misconception to treat the subsidiary as contributing nothing to the tax saving and therefore as being entitled to no part of the benefit. The tax loss which the subsidiary gives up is no less an asset than tangible property. Although its value may be considerably more difficult to ascertain, that difficulty hardly justifies denying it *any* share in the gain. Indeed, to the extent that the courts' refusal to recognize a sharing requirement rests on judicial inability to determine how to divide the benefits, the formula offered in the text should eliminate that prop for erroneous decisions and offer a solution for division of the benefits. Since the tax saving, like the merger gain, cannot be realized by either corporation acting alone, fairness should require a proportionate sharing of the benefit, based on relative stock values, presumably determined at the close of the taxable year. *P* would still elect to file on a consolidated basis, no doubt, but the exercise of "business judgment" which that election reflects, instead of being entirely costless to *P*, would bear what seems to us to be an appropriate charge. The calculations are not without complexity, but again it does not follow that the subsidiary is therefore entitled to nothing. The problem, in short, is not to decide to whom the "opportunity" belongs, but how to share it.

⁵⁵ *Cf.* Levien v. Sinclair Oil Corp., 314 A.2d 216, 221-22 (Del. Ch. 1973).

⁵⁶ The distribution of forms of limited participation in the enterprise to outsiders or the public while the parent retains the residual equity interest increases the likelihood of disadvantageous and unpreventable inequality in the treatment of public security holders. Not only are tax burdens imposed upon public security holders, but payment in disparate forms makes it peculiarly difficult to test fairness or equivalence as between the risk-return combinations surrendered and received

Since the premise of common control precludes concealment of information by either party, earnings expectations or hidden resources of the subsidiary may not be as easily obscured as on the assumption of an arm's-length bargain. To the extent that fuller disclosure may be required, some of the problems of valuation heretofore encountered by courts in testing the fairness of mergers may actually be reduced in scope. In any event, expectations of the gains from the merger are appropriate subjects for disclosure.⁵⁷ No doubt there will always remain a substantial area

by the public, or as between the interest received by the public and that received by the parent, since the variables to be compared have been altered. And the likelihood of disadvantage to the outsiders is increased as those comparisons are made more difficult, because the insiders inevitably have a clearer vision of the earnings and risk expected in the future of the enterprise than do the outsiders, but can obscure it in the presentation — both to stockholders and in court.

Although historically the freeze-out has been primarily a problem for stockholders of close corporations, in recent years it has become a fashionable device in public mergers (the insiders forcing out the outsiders by merging the enterprise with a dummy) and in takeovers (the bidder offering senior securities to the common stockholders and then merging out the remaining stockholders with senior securities). When the freeze-out is an incident to an arm's-length merger with another business — either in one step or in a second step following a purchase of control — considerations of efficiency suggest that the problem of fairness to those frozen out may most appropriately be solved only by pressing for payment of fully adequate values, notwithstanding that the difficulties encountered in achieving such a solution have impelled requests for a more extreme remedy, such as a categorical prohibition against distributing different forms of participation to the public than are distributed to insiders; *compare* Kellogg v. Georgia-Pacific Paper Corp., 227 F. Supp. 719, 724–25 (W.D. Ark. 1964), *with* Alcott v. Hyman, 40 Del. Ch. 449, 184 A.2d 90 (Ch. 1962), *aff'd*, 42 Del. Ch. 233, 244–45, 208 A.2d 501, 508 (Sup. Ct. 1965), *and* Coyne v. Park & Tilford Distillers Corp., 38 Del. Ch. 514, 516–21, 154 A.2d 893, 896–97 (Sup. Ct. 1959). But when, as in the currently fashionable efforts to “go private,” the freeze-out is in substance only an internal reorganization, whether by merger with a controlled company or otherwise, there is less basis for urging considerations of efficiency (at least in public corporations) to require a selective rule which would permit transactions found on the facts to be fair, and every consideration of equity argues for a categorical prohibition against the freeze-out. *See In re San Joaquin Light & Power Corp.*, 52 Cal. App. 2d 814, 820–24, 127 P.2d 29, 34–36 (1942); *Outwater v. Public Service Corp.*, 103 N.J. Eq. 461, 143 A. 729 (1928), *aff'd*, 146 A. 916 (1929); *cf.* Eisenberg v. Central Zone Property Corp., 306 N.Y. 58, 115 N.E.2d 652 (1953). *But cf.* Willcox v. Stern, 18 N.Y.2d 195, 219 N.E.2d 401, 273 N.Y.S.2d 38 (1966). In either case, claims for relief are being made under rule 10b–5 with some success, *Levine v. Biddle Sawyer Corp.*, [Current] CCH FED. SEC. L. REP. ¶ 94,816 (S.D.N.Y., Oct. 17, 1974); *Bryan v. Brock & Blevins Co.*, 343 F. Supp. 1062 (N.D. Ga. 1972), *aff'd on other grounds*, 490 F.2d 563 (5th Cir. 1974), although the relevance of the “deception” said to be practiced on the minority is hard to detect. *Grimes v. Donaldson, Lufkin & Jenrette, Inc.*, [Current] CCH FED. SEC. L. REP. ¶ 94,722 (N.D. Fla., July 15, 1974); *Krafscin v. Lasalle Madison Hotel Co.*, [1972–1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,586 (N.D. Ill. 1972).

⁵⁷ *See note 48 supra.*

for dispute about estimates of the future or about appropriate capitalization rates, and the parent's experts will always have insiders' advantages over dissident stockholders' experts in proffering such evidence. But the expanding obligation to disclose will curtail those advantages by increasing the risk to the parent if it predicates the merger terms on assumptions about the future which rest upon past or present conditions that were not adequately set forth.⁵⁸

*C. Implications of the Sharing Concept
for "Corporate Opportunities"*

Especially in an era of conglomerate diversification, the question of how new business opportunities should be allocated between *P* and *S* while both are operated as separate entities has proved troublesome. In doctrinal terms the issue is usually presented as one of "corporate opportunity." Although the focus in the preceding discussion has been on merger transactions, to the extent that our revised notion of what is fair in mergers may help to solve problems of corporate opportunities arising between parent and subsidiary, we think that a digression on that subject is merited.

Typically, the corporate opportunity cases have involved officers or directors and the courts have applied an all-or-nothing rule; if the opportunity does not belong to the corporation, the officer or director may take it.⁵⁹ The doctrine, in short, has been a mechanism for disciplining officers and directors by entirely denying to them whatever is found to be a corporate opportunity, and allowing them to keep entirely for themselves that which is not such an opportunity. To the extent — and it is considerable — that the case law involves closely-held corporations and claimed usurpation by officers or directors, the problem differs from that created when a publicly-held parent corporation is charged with usurping a corporate opportunity of a publicly-held subsidiary.⁶⁰

⁵⁸ See *Beecher v. Able*, [Current] CCH FED. SEC. L. REP. ¶ 94,450 (S.D.N.Y., March 24, 1974).

⁵⁹ The parent-subsidiary cases have also generally allocated the opportunity exclusively to one entity and have tended to rely on factors such as the subsidiary's legal or financial inability to accept the opportunity or on the identity of the offeree. See, e.g., *Knauff v. Utah Constr. & Mining Co.*, 277 F. Supp. 564, 575 (D. Wyo. 1967), *aff'd*, 408 F.2d 958 (10th Cir.), *cert. denied*, 396 U.S. 831 (1969); *Blaustein v. Pan American Petroleum & Transp. Co.*, 293 N.Y. 281, 56 N.E.2d 705 (1944); *cf. Johnston v. Greene*, 35 Del. Ch. 479, 121 A.2d 919 (Sup. Ct. 1956); *Young v. Columbia Oil Co.*, 110 W. Va. 364, 158 S.E. 678 (1931).

⁶⁰ On the one hand, the duties of stockholding officers and directors to fellow stockholders may be more demanding in a close corporation than in a publicly-held enterprise, so that they may be more narrowly confined in acquiring business opportunities for themselves rather than for all the shareholders. See Note, *Cor-*

In the latter case, some sharing of the opportunity is generally possible; in the former case, sharing is almost never a feasible solution.⁶¹ Unlike the contest between a corporation, which presumably has attracted investors by its promise or history of limited business operations, and an officer or director with unlimited scope for his personal business opportunities, the parent-subsidiary situation involves competing claims by two enterprises, each of which has a history of relatively finite operations. To be sure, when the parent is a conglomerate firm, the limits of its legitimate operations are difficult to define, but the need to define them becomes less significant if the opportunity can be divided between the two enterprises and its benefits shared by the two groups of public investors. Once the issue ceases to be "all or none," the proper disposition of particular opportunities can be determined by the obligations of parent to subsidiary as joint participants in a common venture.

Assume a case in which *P* and *S* are engaged in easily differentiated lines of business at the time control is acquired by *P* — say oil refining for *P* and sporting-goods for *S*. Generally speaking, the existing corporate opportunity rule suggests — although with substantial qualifications — that growth or expansion in the sports field, whether through internal build-up or purchase of other firms, belongs exclusively to *S* and cannot be appropriated by *P*.⁶² As so applied the rule seems quite correct. The object of the law is, or should be, to preserve to *S*'s stockholders the expected returns on the risks which they assumed prior to the acquisition of control. Thus, the price-earnings ratio of *S*'s shares at the date control is acquired reflects the growth expectations which investors attach to the sporting-goods business. If *P*'s purchase of control permitted *P* to frustrate those expectations by allocating all future growth to itself, the result would be a decline in the price of *S* shares immediately after the control purchase or if not immediately, then at such later date as the permitted pattern of diversion became evident to the market. Pro-

porate Opportunity in the Close Corporation — A Different Result?, 56 GEO. L.J. 381, 387-91 (1967). On the other hand, officers and directors are not to be discouraged from entering business on their own, and presumably as individuals have a wider choice to accept new opportunities than do their corporations, whose opportunity sets may be viewed as more confined by the history of their prior operations.

⁶¹ Cf. Note, *Corporate Opportunity in the Close Corporation — A Different Result?*, 56 GEO. L.J. 381, 385-86 (1967); Note, *Corporate Opportunity*, 74 HARV. L. REV. 765, 770-71 (1961).

⁶² Under established doctrine, legal or financial limitations inhibiting corporate action cast doubts on the sweep of the prohibition against officers or directors. These doubts, however, should not be present in the case of a parent-subsidiary merger, in view of the feasibility of sharing the opportunity.

hibiting such conduct enforces *P*'s fiduciary duty to maintain *S*'s growth expectations for the benefit of its minority stockholders. Any lesser prohibition would allow an uncompensated taking of value which belongs to the *S* minority, and would therefore be unfair to them.

The question that remains, however, is whether the corporate opportunity doctrine, even as so viewed, goes far enough in meeting the legitimate claims of minority interests. For the purpose of illustration, three very simple hypotheticals can be added to the one given in the preceding paragraph: assume that (1) *P* and *S* are in different businesses and an opportunity arises to acquire a business different from either of those; or (2) *P* and *S* are in the same business, which can now be profitably expanded; or (3) *P* and *S* are in the same business and an opportunity arises to acquire a different business. Quite obviously, the issue is which of the two entities shall be entitled to take credit for the new or expanded business opportunity, *P* or *S*.

In dealing with problems of this sort, the courts have largely carried over into the parent-subsidary context the traditional approach taken to problems involving officers and directors.⁶³ Thus, a stockholder of *S* who objects to the allocation of new or expanded business opportunities to *P* must establish (at least) that the new business closely resembles or "fits" with an activity previously carried on exclusively by *S*. If he fails to make that showing, the result in general is to permit management, in an exercise of "sound business judgment," to allocate the entire investment to *P* alone.⁶⁴

But is this latter outcome fair to the *S* minority? Does equity require merely that the public investors be protected against the destruction of an expectant interest which is defined in terms of *S*'s preacquisition activities only, or should the corporate opportunity rule and its supporting concept of fiduciary obligation be cast in broader terms? We think that a broader fairness standard should apply. In each of the three hypotheticals neither *P* nor *S* has an exclusive claim to the fruits of management's skills; in the circumstances posited, the corporate opportunity is not exclusively within the line of business of either firm. Allowing management, under the guise of "sound business judgment," to allocate the opportunity solely to *P* suggests that management's primary fiduciary duty is to the *P* stockholders and that the *S* shareholders can claim only a secondary obligation.

We think that this notion of two standards is incorrect. *P*'s action in acquiring control of *S* ought not to impair the claim of

⁶³ See note 59 *supra* & note 67 *infra*.

⁶⁴ See Folk, *supra* note 53, at 179, 185-91.

S's stockholders to a fully managed enterprise, or result in the subordination of *S*'s interest to that of *P*, despite management's evident difficulty of meeting a dual responsibility. Management could have acquired 100 percent of *S*'s assets at the outset instead of contenting itself with mere control. If it chooses to permit a minority interest to survive, however, the problem of divided loyalty that inevitably results should not be resolved by simply treating one constituency as inferior to the other. Our view is that, as in the case of mergers, the fruits of management's skill in identifying attractive investment projects should be shared with *S*'s public stockholders proportionately.⁶⁵ Hence, when a new acquisition is made which does not fall exclusively within the line of business of either *P* or *S*, or an expansion is undertaken in an area in which *P* and *S* are both engaged, the new investment should be allocated to *S*'s public stockholders in the same ratio that the value of *S*'s public shares bears to the total value of the shares of both firms.

The result may be illustrated simply by adapting the earlier example. Thus, assume that at the time a new acquisition is identified, the aggregate value of *P*'s shares is \$120 million while that of *S*'s public shares is \$5 million. Suppose the new acquisition is expected to add \$10 million to the overall value of existing assets. Under present law the \$10 million increment is allocated entirely to *P*'s stockholders, with no benefit whatever to the public stockholders of *S*. By contrast, under the approach taken here, management would be required to allocate to *S* itself a "partnership" interest in the new investment sufficient to afford the public stockholders a $5/125$ ths participation. *S*'s public shares would then be expected to rise to a value of \$5.4 million in total, while *P*'s stock — reflecting both *P*'s direct interest in the new acquisition and its indirect interest via its 50-plus percent ownership of *S* — would rise to a value of \$129.6 million. *S* would, of course, make an appropriate contribution to the cost of the acquisition, by paying cash or issuing additional securities to *P*.

Acceptance of this sharing formula does not mean that line-of-business considerations can be dispensed with. On the contrary, the goal of any fairness doctrine must be that the expectations of *P* and *S* stockholders not be frustrated solely by reason of acquisition of control. When the new opportunity is clearly within the

⁶⁵ To be sure, in the case of new external investment opportunities, in contrast to mergers, the claim of the subsidiary's public stockholders rests more on management's obligation to share investment opportunities with two constituencies than on the subsidiary's contribution to the joint opportunity. But neither the claim nor the obligation is any less compelling. See *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

pre-affiliation line of business of one firm and not the other, exclusive allocation is appropriate. We mean only to add a second objective to be invoked when line-of-business considerations are not dispositive, namely, that the exercise of management skill be based on a principle of equal obligation to both sets of investors. We concede that the two goals cannot be reconciled perfectly; if, for example, *P*'s management is more innovative or diversification-minded than the old management of *S*, a proportionate sharing rule might dilute the expectations of *P*'s stockholders. If such dilution occurs, however, it is a consequence of *P*'s willingness to settle for mere control rather than full ownership of *S*, and should be viewed as an additional cost for the controlling interest. Putting the same point differently, we do not accept the argument that any new business acquisition must belong to *P* merely because *P*'s "business" is diversification, that is, management. To accept that position would be to resurrect the primary-secondary concept of fiduciary duty, which we regard as essentially unfair.⁶⁶

We should add that the addition of a sharing requirement will not make it either easier or harder to decide the troublesome factual issues that often present themselves in corporate opportunity cases, and which are perhaps inherent in any effort at industrial classification. The question of whether a new undertaking is basically similar to a preexisting activity carried on by one but not the other of the two entities, or is instead an appropriate candidate for sharing, will have to be dealt with by the courts on the basis of subjective impression, just as is done at present.⁶⁷ Our approach would have an impact on the disposi-

⁶⁶ If instead of looking only to lines of business, we also assume that *S* and *P* are in businesses with significantly different degrees of risk, the sharing formula we propose need not be altered. Unlike the problem of an investment adviser, who must take individual risk preferences into account in allocating scarce investment opportunities among his individual clients, corporate management, which is investing in real assets on behalf of an operating enterprise, need make no restrictive assumptions about acceptable risk class except as respects the financial community as a whole. If a project is identified which the investment community will view as having a positive present value, it should be taken on, whether its risk is higher or lower than the company's existing projects (which may well differ in degree of risk among themselves). It is not generally corporate management's duty to reflect the risk-return preferences of particular investors in publicly-held firms if the individual investors are appropriately informed about asset changes in the corporate portfolio. They can adjust to their own risk preferences by selling some shares, buying others, or increasing or reducing leverage. In short, as between *P* and *S* the determination of *whose* is the opportunity should be unaffected by the fact that it is in a different risk class from that of either *P* or *S* — so long as the opportunity has positive expectations.

⁶⁷ Courts frequently refer to the enterprise's line of business in assessing whether the opportunity "belonged" to it. "Line of business" is, of course, an imprecise concept. While it appears to exclude totally unrelated activities (of the

tion of unclassified investments, but not on the factfinding process itself.

III. TWO-STEP ACQUISITIONS

Integrated mergers — mergers which follow immediately or very shortly after the purchase of a controlling stock interest in the target company — have become a common event during the past dozen years, largely as a consequence of the growth of conglomerates and the increased use of tender offers as an acquisition technique. In many instances the public tender (or exchange) offer is itself preceded by an unsuccessful attempt to reach agreement with the target company's management on a voluntary merger. When that attempt breaks down, the acquiring company often resorts to direct solicitation of the stockholders — over the heads of management — with the object of obtaining a large enough percentage of the target company's shares to assure approval of any merger plan that it may subsequently propose. Incumbent management can usually be expected actively to oppose the tender offer in these circumstances. While the cost per share of acquiring control is therefore likely to be considerably

sort frequently assembled in a conglomerate), it includes complementary activities or any operating activity which is "so closely associated with the existing and prospective activities of the corporation that the defendants should fairly have acquired that business for or made it available to the corporation." *Rosenblum v. Judson Eng'r Corp.*, 99 N.H. 267, 273, 109 A.2d 558, 563 (1954). See also *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 277-80, 5 A.2d 503, 513-14 (Sup. Ct. 1939); *Production Mach. Co. v. Howe*, 327 Mass. 372, 99 N.E.2d 32 (1951). The line-of-business cases also rely on additional factors. Such essentially fortuitous variables as whether the opportunity was "offered" to the corporation or to the usurping officer or director, whether the corporation was "able" to finance the opportunity when it was offered, or whether its charter or bylaws permitted acceptance of the opportunity have entered into the decisions. At best, the analysis in the opinions suggests that the line-of-business requirement is a necessary but not a sufficient condition for an activity to constitute an "opportunity." See *Burg v. Horn*, 380 F.2d 897 (2d Cir. 1967); Walker, *Legal Handles Used to Open or Close the Corporate Opportunity Door*, 56 Nw. U. L. Rev. 608 (1961); Note, *Corporate Opportunity*, 74 HARV. L. REV. 765 (1961). Some of the opinions suggest, however, that an activity not thought to be within the corporation's line of business nevertheless can constitute a corporate opportunity usurped by the officers or directors, see *Equity Corp. v. Milton*, 43 Del. Ch. 160, 165, 221 A.2d 494, 497 (Sup. Ct. 1966); *Johnston v. Greene*, 35 Del. Ch. 479, 487, 121 A.2d 919, 924 (Sup. Ct. 1956); *Durfee v. Durfee Canning Co.*, 323 Mass. 187, 199, 80 N.E.2d 522, 529 (1948), and it has often been held that an activity plainly within the corporation's line of business was not such an opportunity, presumably because it was not "essential" to preservation of the business. See *Burg v. Horn*, *supra*, at 200; *American Inv. Co. v. Lichtenstein*, 134 F. Supp. 857 (E.D. Mo. 1955); *Colorado & Utah Coal Co. v. Harris*, 97 Colo. 309, 49 P.2d 429 (1935); *Lincoln Stores, Inc. v. Grant*, 309 Mass. 417, 34 N.E.2d 704 (1941). See also Note, *supra*, at 772-74.

higher than the cost per share of purchasing assets with management's consent, the entire cost of the acquisition will obviously depend on what further consideration must be paid in the second-step merger. Less commonly, but still not infrequently, control may be acquired from a single stockholder or group of related stockholders in a privately negotiated transaction. In both instances, the combined cost of the control purchase and the subsequent merger represents the true acquisition price of the two-step takeover. These two acquisition patterns may not exhaust the field,⁶⁸ but they are probably the principal instances in which merger serves as the tag-end, or subordinate step, in what is essentially a unitary procedure aimed at taking full ownership of the target company's assets.

When full ownership is acquired in *one* step the stockholders of the acquired concern are entitled to approve the sale or merger in advance by majority vote, and to share pro rata in the total proceeds. The question we consider in this part is whether the same rights (or a reasonable substitute) should be afforded even though *two* transactions are involved in the acquisition. In that posture the focus of the problem shifts from fairness in self-dealing to fairness in dividing an aggregate purchase price between the two groups of stockholders in the sold corporation — those who sold “control” and the others — on the premise that the price paid for control is the benchmark of fairness.

A. Negotiated Transactions

Taking up the transactions mentioned above in reverse order, suppose that *P* acquires a controlling interest in *S* from a single individual or related group off the market. Very often the sellers in such circumstances will demand a premium for the transfer of control. If *P* further plans to merge with *S* immediately after the acquisition of control, what standard of fair treatment should be observed in respect to the public stockholders of *S*?

By way of illustration, assume *P* is willing to pay \$1 million for all the assets of *S*. *S* has 200,001 common shares outstanding, of which 100,001 are owned by a single individual and 100,000 by the public. Though valued at approximately \$5 per share by *P*, the *S* stock is currently selling in the market at \$3. The question is whether it would be fair, and permissible, for *P* to pay (say) \$600,000 to the controlling stockholder for his 50-plus percent interest, and then complete the acquisition by merging *S* for an additional consideration to the public stockholders of only

⁶⁸ Another acquisition method would be market purchases of stock over a period of months or even years. Cf. *Ervin v. Oregon Ry. & Navigation Co.*, 27 F. 625 (C.C.D.N.Y. 1886), *appeal dismissed*, 136 U.S. 645 (1890).

\$400,000. From a fairness standpoint the issue that would arise is not whether too little had been paid for the assets of *S*—\$1 million, after all, was the maximum that *P* stood willing to commit. Rather, it is whether the 60–40 division of proceeds between the controlling and the public stockholders is permissible. That division is solely the product of a bargain between *P* and the seller of control; in effect, the *S* minority would be bound by an agreement that was made without its consent or even participation.

In such transactions, the sale of control and the subsequent merger are, in substance, integrated steps in a unitary purchase of assets. *P*'s aim is to pay not more than \$1 million for not less than all of *S*'s property. Negotiations with the controlling stockholder are presumably directed at establishing an overall purchase price for the enterprise, and not merely a price for the controlling interest. If the transaction were cast in a more conventional form, *P* would simply pay \$1 million to *S* in exchange for *S*'s assets, and *S* would distribute the proceeds of sale to its stockholders as their interests appeared, and would then dissolve. The consent of the controlling stockholder would be required for the sale itself and for the liquidation, but the right of all the stockholders to share pro rata in the liquidating dividend would have been predetermined by the corporate charter and could not be altered at the will of the owner of control. By contrast, the two-step variation permits the controlling stockholder, with *P*'s collaboration, to effect what amounts to a subordination of the minority interest by accepting for himself a disproportionate share of the liquidation proceeds.⁶⁹ Moreover, while it is not certain that a buyer of control which contemplates merger would offer a merger price that is less than the price paid for the control shares, the temptation to complete the merger at less than a fair price is comparable to the temptation to misappropriate corporate opportunities which was found in *Pertman v. Feldmann*.⁷⁰

⁶⁹ See *Seagrave v. Mount*, 212 F.2d 389 (6th Cir. 1954). The cases have required sharing of the premium obtained on the sale of control when it is shown that the buyer wished to acquire 100 percent of the enterprise and that the seller of control knowingly assisted him in this endeavor. See, e.g., *American Trust Co. v. California W. States Life Ins. Co.*, 15 Cal. 2d 42, 62–64, 98 P.2d 497, 507–08 (1940); *Brown v. Halbert*, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (1969); *Commonwealth Title Ins. & Trust Co. v. Seltzer*, 227 Pa. 410, 76 A. 77 (1910); *Dunnett v. Arn*, 71 F.2d 912 (10th Cir. 1934). But cf. *Roby v. Dunnett*, 88 F.2d 68 (10th Cir.) (proof of deception necessary), cert. denied, 301 U.S. 706 (1937). While the cases seem to turn on the fact of the controlling shareholder's knowing assistance, the rights of the public stockholders are no less sacrificed when the buyer can achieve his goal by conversion in a forced merger rather than by deception with the seller's aid.

⁷⁰ 219 F.2d 173, 176–77 (2d Cir. 1955). See also *Dasho v. Susquehanna Corp.*,

How should minority rights be protected in these circumstances? One possible approach is to give the public stockholders a formal right of approval by requiring, prior to the purchase of control, (1) advance disclosure to them of the intended later merger and the price to be paid in that merger,⁷¹ and (2) a vote by them as a separate class to accept or reject the contemplated merger. Thus, the seller of control would be required to bargain with the public stockholders for division of the control premium in order to obtain their consent to the later merger. But apart from the considerable practical difficulties which would have to be overcome in devising such a procedure, the fact that the seller of control commands the proxy apparatus by which the public stockholders' consent is sought makes illusory any bargain between public stockholders and the controlling stockholder over division of the control premium. The controlling stockholder would simply offer the public shareholders as small a share of the premium as he thinks necessary to purchase their willingness to go along; experience with the use of the proxy apparatus suggests that stockholders will accept a pittance which bears no relationship to any freely bargained division of the premium.

If a requirement of advance consent by public stockholders to the sale of control is not feasible as a procedure for forcing the parties to bargain over the division of the premium, any effort to enforce judicially a fair division — other than by a pro rata

461 F.2d 11 (7th Cir.), *cert. denied*, 408 U.S. 925 (1972); *cf.* *Cole v. Schenley Indus., Inc.*, [1973 Decisions] CCH FED. SEC. L. REP. ¶ 94,003 (S.D.N.Y. 1973). When sale of the controlling interest is not immediately followed by merger, the likelihood that the remaining stockholders will be benefited by the change in control is the principal justification for allowing the seller of control to keep the premium, and for exposing the remaining stockholders to the risk that the buyer will seek to recoup the premium by exploiting them. But that justification is lacking when the buyer plans to buy simultaneously the remaining stock. In that case the premium for control is paid for the power to dictate subsequent merger terms. *See Boggess v. Hogan*, 328 F. Supp. 1048 (N.D. Ill. 1971). Thus, the justification for allowing the seller to retain the premium (*i.e.*, that he was thus encouraged to turn control over to a more efficient manager for the benefit of the other stockholders) is substantially diluted since the buyer's efficiency will not benefit the former public stockholders, and the buyer's principal effort is to exploit them in setting the merger price. *Cf. Brown v. Halbert*, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (Ct. App. 1969).

⁷¹ *But cf. Abelow v. Symonds*, 40 Del. Ch. 462, 184 A.2d 173 (Ch. 1962), *aff'd sub nom. Abelow v. Midstates Oil Corp.*, 41 Del. Ch. 145, 189 A.2d 675 (Sup. Ct. 1963). In *Northway, Inc. v. TSC Indus., Inc.*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,646 (N.D. Ill. 1972), the court rejected the argument that the seller of control should extract from the buyer a promise to pay in any subsequent merger the same price to the remaining stockholders as was paid to the seller.

sharing — is equally problematic. A fictional bargain is no more feasible as a device to allocate the premium than it was to determine a fair price in a parent-subsidary merger. Indeed, there is substantial basis to urge that when a purchase of control is privately negotiated by a buyer who expects thereafter to acquire 100 percent of the enterprise, *any* increment above market being paid by the buyer should be divided among all stockholders on a pro rata basis. There has been much debate over whether the seller of control may *generally* receive and retain a premium for the sale of control.⁷² But a different and simpler question is presented when the buyer contemplates full ownership of the enterprise from the outset. As we have stated, the situation is then indistinguishable from a sale of assets followed by a distribution of the proceeds in liquidation. Whatever may be the value of control and the limits of the controlling stockholders' obligation to the minority on a continuing basis,⁷³ there is no doubt that in liquidation the assets of the firm must be distributed pro rata to all stockholders;⁷⁴ the corporate charter provides that each outstanding share is entitled to a pro rata portion of the company's income stream, whether paid out in the form of current dividends or as liquidating distributions. Circumvention of that provision should not be permitted by executing the transaction in two steps. While a controlling stockholder is entitled to elect a majority of the board of directors and thereby to dominate the company's business policies, nothing in his status as controller empowers him to allocate returns on a disproportionate basis.

Accordingly, a transaction which is effectively a sale of assets followed by a distribution of the proceeds in liquidation calls

⁷² See Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965); Javaras, *Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews*, 32 U. CHI. L. REV. 420 (1965); Berle, "Control" in *Corporate Law*, 58 COLUM. L. REV. 1212, 1220-24 (1958); Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986 (1957); Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956); Katz, *The Sale of Corporate Control*, 38 CHI. B. REC. 376 (1957); Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725 (1956).

⁷³ See Note, *The Corporate Fiduciary Doctrine in the Context of Parent Subsidiary Relations*, 74 YALE L.J. 338 (1964).

⁷⁴ See *Mansfield Hardwood Lumber Co. v. Johnson*, 263 F.2d 748 (5th Cir. 1959); *Lebold v. Inland Steel Co.*, 125 F.2d 369 (7th Cir. 1941), *cert. denied*, 316 U.S. 675 (1942), *on appeal from award of damages*, 136 F.2d 876 (7th Cir.), *cert. denied*, 320 U.S. 787 (1943); *Lebold v. Inland Steamship Co.*, 82 F.2d 351 (7th Cir. 1936). *But cf.* *Krafcsin v. Lasalle Madison Hotel Co.*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,586 (N.D. Ill. 1972); *Abelow v. Symonds*, 40 Del. Ch. 462, 184 A.2d 173 (Ch. 1962), *aff'd sub nom.* *Abelow v. Midstates Oil Corp.*, 41 Del. Ch. 145, 189 A.2d 675 (Sup. Ct. 1963).

for a flat prohibition against any attempt to differentiate among the common shares solely on the basis of the larger number of such shares held by a particular stockholder. Such a prohibition requires simply that a buyer which purchases the controlling interest in contemplation of merging out the minority pay the same price per share on *both* occasions, just as if the two-step⁷⁵ transaction had been cast in the form of a unitary sale of assets.⁷⁶ This, however, need not prohibit *P* from paying a premium solely to the owner of control, provided that the public shares thereafter remain outstanding; or, if no merger is contemplated, even from paying one price for the control shares and then, after adequate disclosure of the prior purchase price,⁷⁷ inviting tenders of the minority shares at a lower price, an invitation which the public stockholders would be free to accept or reject in their individual discretion. Arguably a buyer which pays \$6 per share for the controlling interest — but with no assurance that the average cost per share can be reduced by acquiring the remaining shares for less than \$6 — must consider that the investment value of the shares it has purchased is not less than the \$6 it has paid for them. Presumably, the market will reach the same conclusion once the buyer announces its new management plans. Assuming that expectation is well founded, the minority stockholders of *S* would then enjoy an equivalent rise in the market value of their shares and, in effect, be as well off as the seller of control.

As indicated, there is disagreement among scholars over whether that expectation is, indeed, well founded, and in any event, over whether the owner of control should *ever* be allowed to dispose of his shares for a premium without the same opportunity being offered to minority stockholders.⁷⁸ Some authorities urge a general requirement of equal sharing or equal opportunity on the ground, among others, that control is a corporate asset which properly belongs to no particular stockholder. If that view is ultimately accepted, the broader requirement of equal opportunity which it embodies would easily absorb the limited prescription urged here. However, whether or not that view is accepted, the rule of equal sharing has valid application in the

⁷⁵ The difficulties of proving the state of mind of the buyer at the time of its acquisition of control raise the question whether to presume an intent to merge if the second step is reasonably proximate in time to the acquisition of control. See p. 338 & notes 79, 87 *infra*.

⁷⁶ Of course, an increment in the value of *S* between acquisition of control and consummation of the merger may require *P* to pay a higher price to the public shareholders in the merger. See note 79 *infra*.

⁷⁷ Cf. *Roby v. Dunnett*, 88 F.2d 68 (10th Cir.), *cert. denied*, 301 U.S. 706 (1937); *Dunnett v. Arn*, 71 F.2d 912 (10th Cir. 1934).

⁷⁸ See note 72 *supra*.

limited circumstance with which we are concerned — where acquisition of control and merger are steps in a single integrated transaction.

B. Public Tenders

Where *P* acquires control of *S* through a public tender offer which is preliminary to a complete absorption of *S* by merger, the function of a fairness standard should primarily be one of preventing deception. To illustrate, suppose that *P* offers to buy no more than 51 percent of *S*'s shares for cash in a public tender offer at \$40 per share, but says nothing about its subsequent plans for *S*. If *P* then promptly merges out the balance of *S*'s stock at \$30, it is perhaps obvious that the cost to *P* of acquiring all the assets of *S* is about \$35 per share. While this may be a perfectly fair price for *S*'s assets, the method of acquisition may not provide equal compensation to the two groups of *S* stockholders, depending upon the response to the tender offer. If all outstanding shares are tendered, and the tenders are taken up pro rata, each stockholder will receive the same average price of \$35 for his shares. If less than all are tendered, plainly some stockholders will receive a higher average price per share than others.

We think it evident that the outcome in the latter case — where different prices are paid per stockholder and not merely per share — is objectionable as a matter of equitable treatment. Once again, since merger is a step that *P* can virtually force once it has obtained control, and since by hypothesis *P* planned to take that step from the beginning, it seems clear that the tender-cum-merger must be viewed as a unitary sale of assets. It follows that the nontendering stockholders of *S* should be entitled to no less than the tendering stockholders in any distribution of the sale proceeds. We do not assert that *P* is bound to pay the same price per share to every *S* stockholder under all circumstances. But in the circumstances given, where *P*'s object is to acquire full ownership of *S* in two related steps, with the second being concealed from public view at the time the first is taken, it seems to us unfair for nontendering stockholders to sustain a penalty.

The objection, however, is really a broader one, and can be extended even to the case where all, or virtually all, the shares of *S* are tendered in response to the initial offer. To be sure, the pro rata acceptance of shares at \$40 and the subsequent merger at \$30 would leave each *S* stockholder with an average payment of \$35 per share, so that inequality among the stockholders is absent. But even so, the legal and economic position of the *S* stockholders is plainly weaker than it would be in an ordinary one-step sale of assets. In the latter situation, the stockholders would of course

be made aware, at the time the sale was submitted for their approval, that \$35 per share was the price offered by *P*. A majority vote in favor of the sale could then be accepted as based on adequate knowledge. But in the circumstance where the merger step is concealed at the time the tender offer is made, the *S* stockholders obviously cannot know that they will finally be obliged to sell all their shares at an average price of \$35. Hence, the action of the stockholders in accepting a tender offer of \$40 can hardly be regarded as the practical equivalent of approving by majority vote a "real" offer of \$35 when the stockholders are unaware at the time they tender their shares that the balance of their holdings will afterwards be merged out at \$30.

It would seem to follow that if the approval rights of the *S* stockholders in a unitary sale of assets are to be carried over and made available in the two-step variation, *P* should be obliged to disclose its plans for merger — including its intention to pay only \$30 for the remaining shares — at the time the initial tender offer is announced. Paradoxically, however, although disclosure should be the appropriate way of coping with the dangers of concealment, the dynamics of the present situation are such that advance disclosure of *P*'s merger plans would be likely to reduce, rather than enhance, the ability of the *S* stockholders to make a free choice about the proposed sale of assets, *unless* joined to a rule of equal payment per share. Given the inability of *S*'s dispersed stockholders to communicate with one another during the tender, the act of offering a higher price on tender than would be paid on merger would have a "whipsaw" effect on *S*'s stockholders. Individual stockholders would find it difficult or impossible to refuse a tender price of \$40 when they are also made aware that if the tender succeeds, the remaining shares will be merged out at \$30. In effect, an announced disparity between the tender and the merger figure would deprive *S*'s stockholders of their ability to make an unforced, independent judgment on whether an average of \$35 per share is an acceptable overall price for the assets of the firm. Hence, although the presence of a concealed disparity must be regarded as unfair, the presence of an announced differential is plainly coercive.

The remedy is fairly obvious. What is needed to provide full protection for *S*'s stockholders is a double-barrelled safeguard consisting of (1) advance disclosure of intent to merge and (2) a rule which obligates *P* to pay the *same* price per share on merger as it offered on tender. All stockholders — whether or not they tender — would then receive the same price per share and none would be coerced into tendering by the prospect of a lower price on merger. In the example above, therefore, under our rule the

tender price would have to be reduced and the merger price raised to \$35, if that represents the maximum price per share that *P* is willing to pay for all the assets of *S*, with the intent to merge being revealed at the time the tender offer is made.⁷⁹ *P*'s acquisition effort might very well fail under these conditions; if so, however, it would be because of *P*'s unwillingness to pay a price that is acceptable to a majority of the *S* stockholders.

We should add, again, that if *P* does not plan a second-step merger, it is of course free to set the tender offer at any price it wishes. As suggested in connection with private sales of control,⁸⁰ a willingness on *P*'s part to pay \$40 per share on the initial tender, with no expectation that the average cost per share can be reduced by paying less on merger, should be taken to reflect *P*'s estimate that a share of *S* has an intrinsic value of at least \$40. And that estimate, if sound, will also be reflected in the value of *S*'s remaining shares once *P*'s new business plans are made known to investors generally.

Existing case law does not require uniform payments in the two-step transaction, although occasional opinions note favorably that the consideration paid on merger was not less than that paid on the tender or purchase of control, where the two steps were

⁷⁹ Once disclosure is made of *P*'s intent to merge, *P* should not be left free to fail to consummate the merger. Only a showing of radically changed circumstances should suffice to excuse a failure to consummate. Events such as stock market fluctuation or changes in *P*'s financial condition ought not to be accepted as a sufficient "change in circumstance" for this purpose. In the absence of excuse, if no merger ensues, *P* should be liable to the public stockholders for not less than the tender price. As a consequence, disclosure of an intent to merge at \$35 following the tender would tend to peg *S*'s shares at just under that price throughout the acquisition period; presumably arbitragers would act to acquire virtually all of the company's stock in the expectation that all shares will presently be taken up by *P* at the \$35 bid price. Both *P* and the public stockholders are virtually as free of market risks as they would be if *P* had entered into an agreement to purchase *S*'s assets. If the tender is on a share-for-share basis, then of course the value of *S* stock will move in a fixed relationship to the value of *P* stock until the acquisition is completed. The market price will presumably be subject to some discount for uncertainty as to the consummation of the merger. To avoid any temptation to take advantage of the discount, both *P* and its insiders should be precluded from purchasing minority stock during the interim at less than the tender price.

By contrast, failure to disclose the intended second-step merger will, and should, result in a nonsymmetrical consequence from *P*'s standpoint. If the market for *S*'s untendered shares rises following the tender, *P* should be obliged to pay the higher market price on merger or else forego that step; if the market for *S* shares drops, *P* should later be obliged to pay the higher tender price or else forego the merger. All this follows from the theory of the proposal — which is that *P* should be restrained from offering more for *S*'s shares on tender than the investment value it assigns to those shares, where *P*'s intention is to recoup the excess by later merger.

⁸⁰ See p. 335 *supra*.

closely spaced and hence presumably integrated.⁸¹ Even with respect to disclosure requirements, while the language of the Williams Act⁸² and the import of the Securities Act⁸³ require disclosure of the terms of any contemplated second-step merger, both statutes allow large scope for uncertainty as to whether such a second step is actually contemplated. However, while the thrust of earlier opinions under the Williams Act was to shy away from a reading of the statute to require the parties to “overstate the definiteness of plans” to merge,⁸⁴ more recently judicial admonitions have been directed against understatement.⁸⁵ To the extent that management of a bidding company is truly uncertain about a later merger — and especially about its terms — in the event of a successful takeover bid,⁸⁶ it is impossible to force a meaningful statement of merger terms at the time of the takeover proposal. But it is also impracticable to police effectively on a case-by-case basis the acquirers’ intentions with respect to merger at the time of the takeover proposal. The only feasible solution, therefore, is to measure fairness — that is, require payment — to the remaining stockholders in the later merger by an amount

⁸¹ See *Levin v. Great W. Sugar Co.*, 406 F.2d 1112, 1117-19 (3d Cir. 1968), *cert. denied*, 396 U.S. 848 (1969); *Alcott v. Hyman*, 40 Del. Ch. 449, 456-57, 184 A.2d 90, 94-95 (Ch. 1962), *aff’d*, 42 Del. Ch. 233, 208 A.2d 501 (Sup. Ct. 1965); *Homer v. Crown Cork & Seal Co.*, 155 Md. 66, 81, 141 A. 425, 432 (1928); *Brundage v. New Jersey Zinc Co.*, 48 N.J. 450, 482, 226 A.2d 585, 602 (1967). *But see* *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967); *Northway v. TSC Indus.*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,646 (N.D. Ill. 1972); *Abelow v. Symonds*, 40 Del. Ch. 462, 184 A.2d 173 (Ch. 1962), *aff’d sub nom.* *Abelow v. Midstates Oil Corp.*, 41 Del. Ch. 145, 189 A.2d 675 (Sup. Ct. 1963).

⁸² 15 U.S.C. §§ 78m(d)(1)(C), 78n(d) (1970); see *Electronic Speciality Co. v. International Controls Corp.*, 409 F.2d 937 (2d Cir. 1969).

⁸³ 15 U.S.C. § 77(a) to 77aa (1970). See also 17 C.F.R. § 230.434(b) (1973); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971).

⁸⁴ *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937, 948 (2d Cir. 1969). See *Susquehanna Corp. v. Pan American Sulphur Co.*, 423 F.2d 1075, 1085 (5th Cir. 1970). *But cf. In re Susquehanna Corp., Securities Exchange Act Release No. 8933* (July 17, 1970), [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,842, at 83,988.

⁸⁵ *Compare* *Susquehanna Corp. v. Pan American Sulfur Co.*, 423 F.2d 1075, 1085-86 (5th Cir. 1970), *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937, 948-49 (2d Cir. 1969), and *Metro-Goldwyn-Mayer, Inc. v. Transamerica Corp.*, 303 F. Supp. 1344, 1353 (S.D.N.Y. 1969), with *Sonesta Int’l Hotels Corp. v. Wellington Associates*, 483 F.2d 247, 253 (2d Cir. 1973), and *General Host Corp. v. Triumph American Inc.*, 359 F. Supp. 749, 755-56 (S.D.N.Y. 1973). See generally *Krasik, Tender Offers: The Target Company’s Duty of Disclosure*, 25 BUS. LAW. 455 (1969); Note, *The Courts and the Williams Act: Try a Little Tenderness*, 48 N.Y.U. L. REV. 991 (1973).

⁸⁶ See *Feder v. Harrington*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,689, at 93,049 (S.D.N.Y. 1972).

which is equal to the tender price if the merger occurs in any period of time reasonably proximate to the takeover, unless a showing is made that the merger was actually occasioned by specific events that were not initially foreseen.⁸⁷

In the event that the tender offer and merger are truly independent transactions, the fairness of the price paid on merger would be determined in accordance with the fiduciary principle described in Part II.⁸⁸ But where the tender offer and merger are integrated steps, the obligation of management is to avoid deception. This goal is best implemented by a requirement of disclosure coupled with a prohibition against differential payments per share.

C. *The Problem of Side Payments*

It may be of some interest to note that if stated in terms of "fairness," the requirement of equal treatment suggested above promotes at last a "true" arm's-length standard of fiduciary conduct: in effect, the price that is regarded as fair on the merger of the subsidiary into its parent is necessarily the same price that was offered by an "outsider" (*P*) immediately prior to the merger. This is not to deny, however, that even the apparently arm's-length price arrived at either in a privately negotiated sale of control or on a tender solicitation may be tainted. In a negotiated sale of control, part of the purchase price of the stock may be concealed in employment contracts or other side payments to the seller, so that the purchase price is not the equivalent of an arm's-length bargain price. In the case of a tender offer, if the solicitation is made in anticipation of an acquiescent or even a neutral reaction by the incumbent management of the target company, experience indicates that often the price will be lower than if the takeover were actively opposed by the incumbents.⁸⁹ If

⁸⁷ To avoid the bog of subjective intent which characterizes tax problems involving such mergers, see, e.g., Note, *The Relevancy of Subjective Intent in Two-Step Asset Acquisitions*, 42 GEO. WASH. L. REV. 589 (1974), and in which the ingenuity of corporate lawyers can mire the acquiring corporation's disclosure, cf. *Grimes v. Donaldson, Lufkin & Jenrette, Inc.*, [Current] CCH FED. SEC. L. REP. ¶ 94,722 (N.D. Fla., July 15, 1974); Metz, *GL's Cerro-Assets Plan*, N.Y. Times, Sept. 18, 1974, at 56, cols. 3-4, some rule of thumb is required for determining when the transactions are integrated. One rule, but neither the only nor necessarily the best one, would raise a presumption that the tender offer was undertaken with an intent to merge if a merger in fact follows within a stated period of years after a successful tender. Such a rule could be adopted by the SEC if consistent with the results of its pending investigation of takeovers. Cf. Securities Exchange Act Release No. 5526, [1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,956 (Sept. 9, 1974).

⁸⁸ See pp. 318-25 *supra*.

⁸⁹ By contrast, if the tender offer is made over the opposition of the target

management's reaction is shaped by considerations of self-interest — job security and personal income — then quite obviously the tender price must be regarded as the product of a corrupt arrangement, and in that respect is unfair.

When there is reason to suspect that side payments either have induced a target's management to temper opposition to a merger or have constituted part of the premium paid to a seller of control, it is entirely appropriate to make available a challenge to the fairness of a merger price notwithstanding its equivalence to the price paid in a successful tender offer or a negotiated purchase of control. The problem occasioned by such side payments involves two kinds of inquiries. In the first place, there is the question whether deception was practiced either on those stockholders who tendered in response to the public solicitation or on those who later acquiesced in the merger, if they were not informed of the side payments and their possible impact on the

company's management, the tender price is not tainted by side payments. And since it is made against the possibility — often realized — of competitive bidding, *see* G. McCARTHY, *ACQUISITIONS AND MERGERS* 13 (1963), it is likely to offer stockholders a price which would not be exceeded by other bidders. Hence, the nontendering stockholders find themselves in the position of a minority in an enterprise whose assets have been sold for the highest price — a price which there is no reason to suspect is corrupted either by managerial acquiescence in exchange for side payments or by chilled bidding.

Even an overhead tender price is likely (in the absence of strong opposition) to produce less for a seller than would theoretically be produced by a hypothetical bargain between management of a seller single-mindedly devoted to getting the maximum price and management of a buyer equally devoted to paying the minimum price. Since the tender price is unilaterally set at what the buyer believes is just enough to capture the public stockholders' acquiescence, it will not reflect the same sharing of the full gains of the merger, which a single negotiator for the seller is more likely to perceive and demand than would the dispersed stockholders of the seller. The seller's public stockholders are thus exposed to the risk of receiving less from a tender solicitor than they would receive in a bargain negotiated by diligent management, because each investor's individual interest is so fractured as to preclude either the efficient acquisition of investment information or the exercise of the concentrated bargaining power which would be available in a merger negotiation conducted on their behalf. There is no evidence that either the original issue price or the later market prices of a corporation's stock generally reflect that ultimate risk of dispersed ownership. But that risk matures, and produces a tender price which reflects it, when a scattered and unorganized constituency of stockholders is faced with an offer from a single buyer who has the facilities and talent to perceive advantages unascertainable by the dispersed offerees. If the rights of minority stockholders in a merger should reflect that risk, the measure of fair treatment should be the theoretical operation of the market for takeovers by tender solicitation — *i.e.*, the overhead tender-offer price. By that test, the public stockholders are entitled to something less than the share of the gains of the merger which they would receive if they acted in a coherent and organized fashion through an efficient and diligent management.

tender price or on the price paid for control.⁹⁰ In the second place, it involves all the complex questions encountered in attempting to define and apply a fairness standard to mergers between previously unrelated companies. As in the case of such mergers, the first stage of a two-step merger may involve a transaction negotiated with, and agreed to by, the management or controlling element of the target company. In exchange for their acquiescence, the target's management is in a position to exact a fee or commission.⁹¹ The acquiring company will be willing to make such a side payment because it will represent only a fraction of the reduction in purchase price which would have been sought by a nonacquiescent management. There is ample evidence to suggest that the cost to the acquiring company of carrying out an acquisition by merger will be substantially less than that associated with other takeover devices such as tender bids.⁹²

⁹⁰ See, e.g., *Bogges v. Hogan*, 328 F. Supp. 1048 (N.D. Ill. 1971); cf. *Vine v. Beneficial Fin. Co.*, 374 F.2d 627, 635 (2d Cir.), cert. denied, 389 U.S. 970 (1967) (stockholder need not show reliance).

⁹¹ Such commissions commonly take the form of extended employment contracts, bonuses, stock options, or other varieties of management compensation, some portion or occasionally all of which actually represents the purchase price of management's consent to the acquisition. See note 92 *infra*.

⁹² Commentators who are not noted for their hostility towards management have indicated that a lively sense of favors bestowed, or to be bestowed, upon the seller's management affects its willingness to negotiate a lower price in mergers. See, e.g., Fleischer & Mundheim, *Corporate Acquisition by Tender Offer*, 115 U. PA. L. REV. 317, 318 (1967); *Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 222, 228-30 (1967) [hereinafter cited as 1967 *Hearings*]; Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 118 (1965). See also Eisenberg, *supra* note 1, at 27. And those seeking to acquire an enterprise regularly consider how much it will be necessary to do for the benefit solely of the target's management in order to obtain its cooperation in the acquisition. See Fleischer & Mundheim, *supra*, at 318; 1967 *Hearings, supra*, at 228. See also *Seagrave Corp. v. Mount*, 212 F.2d 389 (6th Cir. 1954); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971); *Bogges v. Hogan*, 328 F. Supp. 1048 (N.D. Ill. 1971); *Condec Corp. v. Lunkenheimer*, 43 Del. Ch. 353, 230 A.2d 760 (Ch. 1967). Most important, there is evidence suggesting that overhead tenders cost more (from the acquiring company's standpoint) than unopposed tenders, see 1967 *Hearings, supra*, and presumably, therefore more than negotiated mergers. There is also reason to believe that the managements of acquiring corporations will often overpay for the acquired corporations because their personal interest so requires, rather than because the interests of the stockholders of the acquiring corporation so require. See, e.g., *Norte & Co. v. Huffines*, 416 F.2d 1189 (2d Cir. 1969), cert. denied, 397 U.S. 989 (1970); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), cert. denied, 389 U.S. 977 (1967); *Muschel v. Western Union Corp.*, 310 A.2d 904 (Del. Ch. 1973); *Lewis v. Scotten Dillon Co.*, 306 A.2d 755 (Del. Ch. 1973); *Lewis v. Hat Corp. of America*, 38 Del. Ch. 313, 150 A.2d 750 (Ch. 1959). See generally W. BAUMOL, *BUSINESS BEHAVIOR, VALUE AND GROWTH* (1959); R. GORDON, *BUSINESS LEADERSHIP IN THE LARGE CORPORATION* (1961); R. MARRIS, *THE ECONOMIC*

The objection to this outcome from the standpoint of fiduciary theory is clear. Legally, the proceeds of merger and takeover belong exclusively to the shareholders of the companies involved and may not, to any extent, be drained off into the pockets of directors as such. Management has no legal right whatever to receive commissions on a transfer of company assets to a new set of managers, or to be rewarded by outsiders for the exercise of its discretionary authority in submitting the merger plan to its stockholders. Not only would any such side payments have to be refunded if initially accepted, but the propriety of the entire agreement would be open to inquiry.⁹³

All this is hardly disputable. But except for an occasional instance in which a side payment has been impossible to conceal, the prohibition against special rewards to incumbent managers has also proved well-nigh unenforceable.⁹⁴ It is extremely difficult to prove that management's judgment has been tainted by self-interest, or that expectations of personal gain have led to price concessions at the stockholders' expense. Employment arrangements apparently entered into by parties dealing with each other at arm's length are hard to challenge on their own terms, especially when the parties themselves are prepared to testify in support of the honest character of their undertakings. In effect, quantitative proof of wrongdoing on the part of individual managers and of its impact upon the merger price — which is what is needed if fiduciary rules are to be enforced directly in these circumstances — is virtually unattainable.

The solution, if there is one, to this abuse requires a search for procedures to enable effective judicial or administrative review of the process of bargaining so that effect may be given to the role of side payments.⁹⁵ It will also inevitably entail a re-

THEORY OF "MANAGERIAL" CAPITALISM 46-109, 225-65 (1964); McGuire, Chiu, & Elbing, *Executive Incomes, Sales and Profits*, 52 AM. ECON. REV. 753 (1962); Marris, *Profitability and Growth in the Individual Firm*, BUSINESS RATIOS (Spring 1967).

⁹³ See *Fidanque v. American Maracaibo Co.*, 33 Del. Ch. 262, 92 A.2d 311 (Ch. 1952); cf. *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955).

⁹⁴ See, e.g., *Jackson Co. v. Gardiner Inv. Co.*, 200 F. 113 (1st Cir. 1912); *Muschel v. Western Union Corp.*, 310 A.2d 904 (Del. Ch. 1973); *Marks v. Wolfson*, 41 Del. Ch. 115, 188 A.2d 680 (Ch. 1963); *Alcott v. Hyman*, 40 Del. Ch. 449, 184 A.2d 90 (Ch. 1962), *aff'd*, 42 Del. Ch. 233, 208 A.2d 501 (Sup. Ct. 1965); *Lewis v. Hat Corp. of America*, 38 Del. Ch. 313, 150 A.2d 750 (Ch. 1959); *Cotterell v. Pawcatuck*, 35 Del. Ch. 309, 116 A.2d 787 (Ch. 1955), *aff'd*, 128 A.2d 226 (Sup. Ct. 1956), *appeal dismissed and cert. denied*, 355 U.S. 12 (1957); *Fidanque v. American Maracaibo Co.*, 33 Del. Ch. 262, 92 A.2d 311 (Ch. 1952); *Mitchell v. Highland-Western Glass Co.*, 19 Del. Ch. 326, 167 A. 831 (Ch. 1933); *Allaun v. Consolidated Oil Co.*, 16 Del. Ch. 318, 147 A. 257 (Ch. 1929); *Allied Chem. & Dye Corp. v. Steel & Tube Co. of America*, 14 Del. Ch. 1, 120 A. 486 (Ch. 1923).

⁹⁵ In mergers between previously unrelated enterprises, the courts tend to view

examination of the operating assumptions of the fiduciary standard which measures fairness by reference to imputed arm's-length exchanges of the securities of merging companies for which there may be no readily ascertainable market prices. The indeterminacies to which these assumptions lead⁹⁶ imply a further search for a solution.⁹⁷ That search, however, is beyond the scope of the present discussion.

the management of the acquired company as uncorruptedly seeking the best possible bargain for the enterprise, and therefore apply the business judgment test in weighing challenges to the fairness of the transaction. Under the test, little short of actual fraud, in the sense of intentional deceit of the seller's management, will support a finding of unfairness. See, e.g., *Gimbel v. Signal Cos., Inc.*, 316 A.2d 599, 609-10 (Del. Ch.), *aff'd*, 316 A.2d 619 (Sup. Ct. 1974); *Marks v. Wolfson*, 41 Del. Ch. 115, 188 A.2d 680 (Ch. 1963); *Cole v. National Cash Credit Ass'n*, 18 Del. Ch. 47, 156 A. 183 (Ch. 1931); *Allaun v. Consolidated Oil Co.*, 16 Del. Ch. 318, 147 A. 257 (Ch. 1929). To recognize the pervasiveness of side payments to, or personal incentives of, managements in effecting mergers is not to assert that in all mergers management's judgment—*i.e.*, the merger price—has in fact been tainted by self-interest. There is ample evidence to suggest that acquiring companies, particularly conglomerates, often wish to retain the acquired company's management for its continued usefulness, and will pay extra to induce that management to remain. See Herrmann, *Corporate Acquisition Criteria: A Study*, 8 MERGERS & ACQUISITION 4 (Summer 1973). Similarly, whatever the merits of the debate over management's preference for growth or profitability, the management of an acquiring company is not inevitably motivated to increase the size of the company at the expense of increased profitability. Hence a prophylactic presumption of corrupting side payments would be untenable because it would prevent or discourage desirable mergers, where clearly the acquiring corporation wishes to retain the acquired company's management because of its effectiveness in the future and not because of its assistance in the acquisition process. To reject a prophylactic approach, however, does not require courts to blind themselves to the pervasive temptation for a seller's management to accept less than the maximum amount obtainable for its stockholders because it understands that its own compensation and rewards are inextricably involved in the process.

Whatever may be the solution to the problem of deference to the business judgment of management in determining fairness when negotiated mergers between previously unrelated companies are challenged, arguably a somewhat different problem is presented by a challenge to a merger proposed immediately after a public tender offer. That offer, with its attendant publicity and disclosures, may suggest a "fairer" price than obtains when a privately negotiated merger occurs, and therefore, a less pressing need for a critical view of the likelihood (or the effect) of side payments' being made to the target company's management. On that less critical view, a complainant challenging a merger after a public tender offer must bear the conventional burden of demonstrating either that the disclosure was inadequate or that side payments have in fact been made to the target's management *and* have influenced it to support or to refrain from opposing the merger. In the absence of such proof, the propriety of the transaction may appropriately be measured against the tender price.

⁹⁶ See p. 316-17 & note 49 *supra*.

⁹⁷ In the alternative, various proposals have been made which would reduce management's domination and control over the merger process. It has been suggested, for example, that a higher stockholder majority be required than the

IV. CONCLUSION

Our principal effort in this Article has been to work out rules of equitable division in mergers between parent corporations and partly-owned subsidiaries. We have tried to construct a plausible sharing formula which satisfies the legitimate claims on both sides of the transaction, and in the process have concluded that the familiar concept of arm's-length dealing needs either to be discarded or reinterpreted. The implications of this finding extend to transactions between parent and subsidiary entirely apart from mergers — particularly in respect to the allocation of opportunities for growth and diversification.

We have also considered what rules should apply where the merger of a controlled subsidiary serves as the second step in a unitary process aimed at purchasing all of the subsidiary's assets. We have argued that existing rules should be reformed, or at least clarified, so as to assure that the rights of the subsidiary's stockholders — to avoid being deceived about the buyer's overall purpose, and to share equally in the proceeds of sale — are adequately protected.

We have urged that fairness requires recognition and sharing of gains from mergers and that, at least in parent-subsidiary mergers, the most appropriate basis for a sharing formula by which to measure fairness is an equal return on the contribution made to the merger by each set of stockholders. Concededly, our proposals do not solve the intractable valuation problems which have bedeviled challenges to merger proceedings in the past, and

simple (or even the two-thirds) majority found in most state statutes; that the direct submission to stockholders of competitive merger bids be permitted; that a longer period be required for consideration of, and organization of a response to merger proposals; or that stockholders be permitted to have some voice in initiating or modifying the merger proposal. *See* Eisenberg, *supra* note 1.

However, the likelihood of such institutional changes being made by state legislatures is not great. Far from enhancing the stockholder's role, state statutes are increasingly giving him less participation in the approval process. *See, e.g.*, ABA-ALI MODEL BUS. CORP. ACT § 80 (1969); DEL. CODE ANN., tit. 8, §§ 251(k), 253 (Supp. 1968); N.J. STAT. ANN. § 14A:11-1 (Supp. 1974). Thus, the proportion of the vote required for approval has been reduced from two-thirds to a simple majority in many jurisdictions. If the requirement of ratification thus offers a shield of only limited protective value, it may also be a cumbersome disservice to stockholders. To the extent that courts regard it as a meaningful protection, and therefore restrain their intervention in assessing the fairness of the merger, it is a false basis for denying judicial protection. *See* SEC PROTECTIVE COMMITTEE STUDY, *supra* note 2, at 554.

which create the uncertainties that erode enforcement of any proposed standard. But making more explicit the considerations which determine fairness should help to narrow the range of the difficulties faced by challengers and the imponderables confronting courts in valuation proceedings in which management controls the bulk of the evidence addressed to the future of the enterprise. Moreover, explicit standards of fairness imply expanded disclosure obligations which, in turn, should further reduce the leeway which management now enjoys, and from which courts now suffer, in determining the fairness of mergers.⁹⁸ To be sure, only in two-step mergers, where fairness turns essentially on a price established in an actual arm's-length transaction — the purchase of control — are the uncertainties of a valuation proceeding substantially eliminated. But even where a fair price must be imputed, as in mergers between long-term affiliates, the explicit statement of a sharing formula will furnish a benchmark for the unavoidable process of approximation, instead of leaving that process at large as does the present law.

⁹⁸ If the standard of fairness is based on an explicit sharing formula, the information which is material to the merger is more readily identifiable than if a vague and indefinite fairness standard is the constraint on the transaction. Not only is the mandate to disclose thus made more easily enforceable because the information to be disclosed must reveal how the proposed merger relates to a proportionate division, but the damages payable for failure to disclose can also be determined. The disclosure requirement thus becomes a part of the process of enforcing the requirement of fairness instead of simply a predicate for a nuisance settlement on terms that have no rational connection with any perceived goal of fairness. See note 15 *supra*.