

## BACK TO BASICS: HARMONIZING DELAWARE'S LAW GOVERNING GOING PRIVATE TRANSACTIONS<sup>©</sup>

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### I. INTRODUCTION

Under Delaware law, there are two primary means by which a controlling stockholder can eliminate the non-controlling stockholders from the corporate enterprise.<sup>1</sup> The first is a long-form merger (a “going-private merger”) accomplished under section 251 of the Delaware General Corporation Law (“DGCL”).<sup>2</sup> The second is a two-step process. In the first step, the controlling stockholder makes a tender offer for enough shares to bring its holdings up to at least 90% of the company’s stock (a “going-private tender offer”).<sup>3</sup> In the second step, the controlling stockholder effectuates a short-form merger under section 253 of the DGCL to eliminate the remaining stockholders.<sup>4</sup>

Each path leads to the same result – the elimination of the non-controlling stockholders – but the Delaware Courts judge them under different legal standards. The going-private merger is reviewed by the exacting requirements of the “entire fairness” standard in which the controlling stockholder bears the burden of proving that the transaction was accomplished through “fair dealing” and at a “fair price.”<sup>5</sup> The two-step process, on the other hand, allows the controlling stockholder to

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1. The elimination of the unaffiliated stockholders is a way the controlling stockholder can “extract [private] benefit[.]” from the company. See Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 787 (2003).

2. DEL. CODE ANN. tit. 8, § 251 (2006).

3. DEL. CODE ANN. tit. 8, § 253(a) (2006).

4. *Id.*

5. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 703, 711 (Del. 1983).

avoid the burden of proving either fair price or fair dealing because the going-private tender offer is not required to be made at a fair price,<sup>6</sup> and the short-form merger (which is accomplished unilaterally by the controlling stockholder) does not require “fair dealing.”<sup>7</sup>

Commentators<sup>8</sup> and Delaware’s Court of Chancery<sup>9</sup> have called on the Delaware Supreme Court to eliminate the disparate treatment given to these functionally identical transactions. Some commentators argue that because both types of transactions involve the elimination of non-controlling stockholders in a transaction initiated by the controlling stockholder, they should be judged under the entire fairness standard of review.<sup>10</sup> Other commentators criticize this argument because it would increase the litigation costs attendant to going-private transactions.<sup>11</sup> Even a frivolous claim brought under the entire fairness standard cannot be disposed of without a trial, and the trial of such claims is invariably complex and expensive. This article also rejects this approach because it does not give full effect to Delaware law governing controlling stockholders in other types of transactions or to Delaware’s public policy requiring judges to defer to decisions made in good faith by independent

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6. *Solomon v. Pathe Commc’ns Corp.*, 672 A.2d 35, 39-40 (Del. 1996) (holding that a majority stockholder has no duty to offer a fair price in a tender offer for the minority shares); *In re Siliconix Inc. S’holders Litig.*, No. CIV. A. 18700, 2001 WL 716787, at \*6, \*15 (Del. Ch. June 19, 2001) (finding that the same principle applies where the tender offer is the first step in a two-step squeeze-out); *In re Pure Res, Inc. S’holders Litig.*, 808 A.2d 421, 445 (Del. Ch. 2002) (defining terms a tender offer must include to avoid being coercive).

7. *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242, 247-48 (Del. 2001). Moreover, the adequacy of the merger price is subject to challenge only in a statutory appraisal action “only if stockholders’ complaints are limited to ‘judgmental factors of valuation.’” *Id.* at 247; DEL. CODE ANN. tit. 8, § 262.

8. See generally Guhan Subramanian, *Fixing Freezeouts*, 115 Yale L.J. 2, 2 (2005); Bradley R. Aronstam, R. Franklin Balotti & Timo Rehbock, *Revisiting Delaware’s Going-Private Dilemma – Post Pure Resources*, 59 BUS. LAW. 1459, 1459-60 (2004); Gilson & Gordon, *supra* note 1, at 833; Brian M. Resnick, Note, *Recent Delaware Decisions May Prove To Be “Entirely Unfair” to Minority Shareholders in Parent Merger with Partially Owned Subsidiary*, 2003 COLUM. BUS. L. REV. 253, 279-82 (2003). Other commentators defend the current state of Delaware law. Jon E. Abramczyk et al, *Going-Private “Dilemma”?—Not in Delaware*, 58 BUS. LAW. 1351, 1353 (2003); A. C. Pritchard, *Tender Offers by Controlling Shareholders: The Specter of Coercion and Fair Price*, 1 BERKELEY BUS. L.J. 83, 84-85 (2004).

9. See *In re Cox Commc’ns S’holders Litig.*, 879 A.2d 604, 642-49 (Del. Ch. 2005); *In re Pure Res.*, 808 A.2d at 435.

10. Ely R. Levy, *Freeze-out Transactions the Pure Way: Reconciling Judicial Asymmetry Between Tender Offers and Negotiated Mergers*, 106 W. VA. L. REV. 305, 347-48 (2004); Kimble Charles Cannon, *Augmenting the Duties of Directors to Protect Minority Shareholders in the Context of Going-Private Transactions: The Case for Obligating Directors to Express a Valuation Opinion in Unilateral Tender Offers After Siliconix, Aquila and Pure Resources*, 2003 COLUM. BUS. L. REV. 191, 240-43 (2003); Resnick, *supra* note 8, at 279.

11. Subramanian, *supra* note 8, at 23.

corporate decision-makers.

Other commentators,<sup>12</sup> joined by one of the sitting Vice Chancellors,<sup>13</sup> have urged a change in the law governing both types of transactions. Under this “hybrid approach,”<sup>14</sup> a going-private transaction, whether a merger or a tender offer, approved by independent decision-makers would be subject to the business judgment rule, but in the absence of such independent approval the transaction would be subject to the entire fairness standard of review.<sup>15</sup> The hybrid approach uses these different judicial standards of review to create incentives for transactional planners to structure going-private transactions so that price is determined through arm’s-length negotiation.<sup>16</sup> To accomplish this, the hybrid approach would have the Delaware Court of Chancery create new rules governing going-private transactions.<sup>17</sup> But, this answer neglects to take into account the fact that the Court of Chancery is a court of equity, not a legislative body. Its job is to apply the common law of equity as it relates to the fiduciary duties of corporate controllers, not to make rules.

This Article agrees with the objectives of the hybrid approach, but argues that a more doctrinally consistent way to achieve that result would be to shift the analytical focus from the duties of the controlling stockholder to the duties of the corporation’s board. The Article will show that the Delaware Supreme Court’s focus on the duties of controlling stockholders in going-private transactions and its resistance to applying traditional modes of analysis to decisions by independent, disinterested directors has led to the current “incoherence”<sup>18</sup> of Delaware’s going-private jurisprudence. Moreover, under the approach urged by the Court of Chancery in the *Pure Resources* decision<sup>19</sup> that same focus threatens to lead to a confusing, transactionally specific

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12. Gilson & Gordon, *supra* note 1, at 838-39; and Subramanian, *supra* note 8, at 55-62.

13. In *Pure Resources*, Vice Chancellor Strine created new rules governing going-private tender offers. *In re Pure Res.*, 808 A.2d at 444-45 (Del. Ch. 2002). In dictum of his *Cox Communications* opinion, Vice Chancellor Strine called for a modification of *Kahn v. Lynch Communication System, Inc.*, 638 A.2d 1110 (Del. 1994). *In re Cox Commc’ns*, 879 A.2d at 606-07 (Del. Ch. 2005). The Vice Chancellor’s approach is largely consistent with that proposed by Subramanian in *Fixing Freezeouts*, *supra* note 8, and the Vice Chancellor cites a working draft of Subramanian’s paper in *In re Cox Communications*, 879 A.2d 604 *passim*.

14. This phrase is used in Gilson & Gordon, *supra* note 1, at 838, and Subramanian, *supra* note 8, at 29.

15. Gilson & Gordon, *supra* note 1, at 839.

16. *See id.* at 839-40.

17. *See id.* at 842-43.

18. *In re Pure Res.*, 808 A.2d at 435.

19. *Id.* at 445.

patchwork of duties for controlling stockholders.

This Article, supported by a number of decisions decided by the Court of Chancery during the summer of 2006, shows that by shifting the analytical focus to the board and by applying traditional principles for the review of business judgments, the standards by which these two types of going-private transactions are judged can be brought into harmony with one another and with the rest of Delaware law. The aim of encouraging arm's-length negotiation in going private transactions would be served because, under traditional principles, only a transaction negotiated at arm's-length and approved by independent corporate decision-makers is entitled to protection under the business judgment rule.

#### A. *Going-Private Mergers*

Under existing Delaware law, when a controlling stockholder causes its company to engage in a going-private merger, the courts apply the entire fairness standard *ab initio*,<sup>20</sup> because the controlling stockholder is deemed to control “both sides of the transaction.”<sup>21</sup> This simple phrase ignores an important fact. The controlling stockholder has direct control over the “buy” side, but it does not have *direct* control over the “sell” side. In a merger, the “seller” is the corporation, and the corporation is controlled by its board of directors.<sup>22</sup> In particular, a corporation cannot enter into a going-private merger unless its board votes to approve the transaction.<sup>23</sup> Thus, for a controlling stockholder to be in control of the “sell” side of the transaction, it must be able to control the board of directors.<sup>24</sup> It follows that the Delaware courts’ application of the entire fairness standard *ab initio* amounts to a presumption that the independence of the board is corrupted by the presence of a controlling stockholder. The courts follow this practice even when a majority of the company’s directors would be deemed independent under traditional modes of analysis.<sup>25</sup> In this respect the law governing going-private mergers stands at odds with the business

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20. Orman v. Cullman (*Cullman I*), 794 A.2d 5, 20 n.36 (Del. Ch. 2002) (“Usually the entire fairness standard only applies at the outset (‘ab initio’) in certain special circumstances, viz, a squeeze out merger between two companies under the control of a controlling shareholder.”).

21. Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 110 (Del. 1952).

22. DEL. CODE ANN. tit. 8, § 141(a) (2006).

23. DEL. CODE ANN. tit. 8, § 251(b) (2006).

24. Stated differently, the controlling stockholder must have corrupted the independence of the directors so that they base their decisions on the best interests of the controlling stockholder rather than those of the company.

25. *In re Cysive Inc. S’holders Litig.*, 836 A.2d 531, 547-48 (Del. Ch. 2003).

judgment rule and with Delaware's "safe harbor" statute for interested transactions.<sup>26</sup>

In *Kahn v. Lynch Communications Systems, Inc.*<sup>27</sup> the court held that the entire fairness standard of review would apply even where the company neutralizes the controlling stockholder's presumed control over the board by appointing a committee of independent, disinterested directors to determine whether the proposed going-private merger would be fair to the non-controlling stockholders.<sup>28</sup> The *Lynch* court refused to defer to the business judgment of the independent committee because it was concerned that even apparently independent directors might be subtly influenced by the expressed (or supposed) desires of a powerful controlling stockholder.<sup>29</sup> *Lynch's* only deference to the committee's decision to approve such a transaction was to shift the burden of proof so that the plaintiff would be required to prove that the squeeze-out merger was not entirely fair.<sup>30</sup> By retaining the entire fairness standard, the *Lynch* decision permitted judges to look past procedural protections and make their own substantive review of the fairness of the squeeze-out merger.

This Article argues that by appointing a special committee of independent directors, a majority stockholder removes itself from the other side of the transaction. Accordingly, the jurisprudential foundation for the imposition of a duty of entire fairness is eliminated. The majority stockholder is not, as a matter of fact, on both sides of the transaction. When the majority stockholder is no longer able to influence the board's decision (made through the special committee) the courts should follow the traditional practice of reviewing the board's decision under the business judgment rule. Pursuant to the procedural aspects of the business judgment rule, the burden would be on the plaintiff to prove particularized facts giving reason to question the committee's independence, power, diligence, or good faith. If the plaintiff fails to plead such facts, the claim would be subject to a motion to dismiss. On the other hand, if the plaintiff pleads facts that give reason to believe that the committee was lacking in independence or power, it would follow

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26. See DEL. CODE ANN. tit. 8, § 144(a) (2006); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled by* *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) (defining business judgment rule as the "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company"); see also *infra* note 81 (defining safe harbor).

27. 638 A.2d 1110 (Del. 1994).

28. *Id.* at 1117.

29. *Id.* at 1116-17.

30. *Id.* at 1117.

that the controlling stockholder had failed to remove itself from its presumed place on the other side of the transaction, and under traditional principles, the controlling stockholder (and the directors whose independence it presumably compromised) would be required to satisfy the entire fairness standard of review.<sup>31</sup>

### B. Going-Private Tender Offers

Under current Delaware law, going-private tender offers are not reviewed under the entire fairness standard because the controlling stockholder is not deemed to stand on both sides of the tender offer.<sup>32</sup> In this context, as with going-private merger, the controlling stockholder is on the “buy” side. But, unlike the going-private merger, the controlling stockholder is not able to control the “sell” side. The sellers are the individual non-controlling stockholders, not the corporation. For this reason, the courts conclude that the entire fairness standard does not apply, and thus, the controlling stockholder does not have a duty to offer a fair price.<sup>33</sup>

Despite the fact that the controlling stockholder is not viewed as straddling both sides of the tender offer and thus would not be in fiduciary position with regard to the tender offer, the Court of Chancery in *Pure Resources Stockholder Litigation* created a new fiduciary duty that requires a controlling stockholder to include certain judicially mandated terms in its tender offer for non-controlling shares to prevent the offer from being deemed coercive.<sup>34</sup>

This article argues that the *Pure Resources* decision exceeds the traditional bounds of equity jurisprudence, imposing a duty where the factual foundation for such a duty does not exist. The more doctrinally consistent approach to this problem would be to focus on the fiduciary duties of the board of directors. Although the corporation is not a formal party to a tender offer and plays no statutory role in the transaction, the common law defining the board’s fiduciary duties imposes on the board a “fundamental duty and obligation” to protect the company’s stockholders from tender offers that threaten their interests.<sup>35</sup> The board

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31. If the plaintiff pleads facts that give reason to doubt that the members of the committee satisfied their duties of care, the committee would bear the burden of proving the entire fairness of the transaction.

32. See *In re Aquila, Inc.*, 805 A.2d 184, 190 (Del. Ch. 2002).

33. *In re Siliconix Inc. S’holder Litig.*, No. Civ. A. 18700, 2001 WL 716787, \*5-\*6 (Del. Ch. 2001).

34. *In re Pure Res., Inc. S’holders Litig.*, 808 A.2d 421, 445 (Del. Ch. 2002).

35. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 953-54 (Del. 1985).

meets this duty to function as the agent for the disaggregated stockholders by taking such action in response to the tender offer as may be required to protect them from a bad deal and attempt to negotiate a better one.<sup>36</sup> This Article argues that these duties, first articulated in the context of hostile third-party offers, apply with equal force in the context of a going-private tender offer by a controlling stockholder.

When the focus is shifted to the board, the crucial question becomes this: Was the board in a position to exercise its independent judgment as to the fairness of the going-private tender offer and to negotiate on behalf of, and protect the interests of, the non-controlling stockholders?

This Article argues that the power to prevent a board from saying “no” to a going-private tender offer is just as effective as the power to cause a board to say “yes” to a going-private merger. Thus, when a controlling stockholder takes no steps to neutralize its presumed control over the board, the courts should presume that the controlling stockholder was able to influence, however subtly, the only agent charged with responsibility for protecting the non-controlling stockholders. For this reason, the controlling stockholder should be deemed to have placed itself “on the other side of the transaction” and the entire fairness standard should apply. As a self-interested fiduciary, the controlling stockholder would have a duty to make the tender offer entirely fair to the unaffiliated stockholders.

But, if the corporation creates a special committee of independent directors and empowers that committee to respond to the tender offer in a way that serves the best interests of the non-controlling stockholders, the controlling stockholder should be deemed to have removed itself from the other side of the transaction. Once again, the jurisprudential foundation for the imposition of a duty of entire fairness would be eliminated because the majority stockholder would not, as a matter of fact, be able to neutralize the ability of the board to defend the unaffiliated stockholders. As with other tender offer situations, if the committee accepts the proposed tender offer, its decision would be subject to review under the procedural and substantive aspects of the business judgment rule. But, if the committee were to take defensive action to block the tender offer, its decision would be subject to review under the *Unocal* standard of review.<sup>37</sup>

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36. *In re Pure Res., Inc.*, 808 A.2d at 445.

37. *In Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946,

The court determined that the board was entitled to the benefits of the business judgment rule as general matter but that, because the board faced the inherent conflict of being eliminated if the transaction succeeded, it would be required to show reasonable grounds

*C. Harmonizing the Standards of Review for Going-Private Transactions*

By focusing on the board rather than on the controlling stockholder, the standard of review for these two types of squeeze-out transactions can be harmonized with one another and with other areas of Delaware common law governing fiduciary duties. Where a controlling stockholder chooses not to create an independent committee to neutralize its presumed power over the board, the presumption that the controlling stockholder is on both sides of the transaction should remain in effect and the entire fairness standard should be applied. This approach would apply equally in the context of a going-private merger and a going-private tender offer. On the other hand, where the board creates a special committee of independent directors to neutralize the controlling stockholder's presumed power over the board, the committee should be entitled to the favorable presumptions of the business judgment rule. This approach would serve the policy favoring the making of business judgments in boardrooms rather than courtrooms.

This Article proceeds in three parts. In Part I, it describes the current approach to reviewing going-private mergers, criticizes that approach, and proposes changes to make the review of going-private mergers consistent with other areas of Delaware law. Part II describes the current approach to going-private tender offers, criticizes that approach, and proposes changes that will bring this area into harmony with going-private mergers. Part III, the conclusion, explains how this harmonized approach to functionally identical transactions will improve the welfare of unaffiliated stockholders.

## II. GOING PRIVATE MERGERS AND ENTIRE FAIRNESS

Delaware law has long held that a fiduciary who engages in self-dealing must prove that the transaction is entirely fair to the entity to which it owes its fiduciary duty.<sup>38</sup> The entire fairness standard of review subjects a challenged transaction to the most demanding form of review used by the Delaware courts.<sup>39</sup> The Delaware Supreme Court expresses it this way: "The requirement of fairness is unflinching in its demand

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for its determination that a risk of harm existed with respect to the company and that its response to this risk was proportional.

Cannon, *supra* note 10, at 228.

38. Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); Gottlieb v. Heyden Chem. Corp., 91 A.2d 57, 58 (Del. 1952).

39. Gilson and Gordon, *supra* note 1, at 791 (2003).

that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.”<sup>40</sup>

Generally, a stockholder who exercises control over a corporation is subject to this duty of entire fairness<sup>41</sup> when it exercises its power to cause the corporation to enter into a transaction from which the controlling stockholder stands to profit at the expense of the non-controlling stockholders.<sup>42</sup> A “going-private merger”<sup>43</sup> is a type of self-dealing transaction because the controlling stockholder “stand[s] on both sides of the transaction.”<sup>44</sup>

#### A. *Both Sides of the Merger*

The statement that a controlling stockholder “stands on both sides” of a going-private merger glosses over important details of corporate governance. Clearly, the controlling stockholder stands on the “buy” side of the merger because it proposed the merger, and at the end of the process it acquires the exclusive ownership of the corporation. But, the controlling stockholder does not have clear control of the “sell” side.

The corporation, not the controlling stockholder, stands on the “sell” side. Here is where the simplicity of the idea that a controlling stockholder straddles both sides of the transaction becomes misleading. Under Delaware law, a corporation must follow a two step process to effectuate a merger.<sup>45</sup> First, the merger must be approved by the

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40. *Weinberger*, 457 A.2d at 710.

41. The Delaware Courts, typically, do not define a controlling stockholder’s fiduciary duty with the same precision as they define the fiduciary duties of directors. A controlling stockholder is not said to have a duty of loyalty, or care, or good faith. *Tanzer v. Int’l General Indus., Inc.*, 379 A.2d 1121, 1124 (Del. 1977), *overruled on other grounds by Weinberger*, 457 A.2d 701. Rather, in the self-dealing context, the courts merely invoke the existence of the duty and require the controlling stockholder to prove that the transaction is entirely fair. *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594-95 (Del. Ch. 1986). For this reason, this article will refer to the fiduciary duty of controlling stockholders as the duty of entire fairness.

42. *Jedwab*, 509 A.2d at 594-95.

43. This article uses the phrase, “going-private merger,” to refer to long-form merger under title 8, section 151 of the Delaware Code, DEL. CODE ANN. tit. 8, § 151 (2006), between a corporation and a corporate stockholder with a large block of the corporation’s stock in which the corporate stockholder acquires exclusive ownership of the corporation. In a going-private merger the shares of the corporation held by persons not affiliated with the large stockholder (the “unaffiliated stockholders”) are canceled, and in exchange, the unaffiliated stockholders receive cash, stock, or debt. *See, e.g., Weinberger*, 457 A.2d 701. Because their shares have been cancelled, they are no longer stockholders – they have been “squeezed-out,” and the corporation is now privately held by the large stockholder. *See id.*

44. *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 109-10 (Del. 1952).

45. DEL. CODE ANN. tit. 8, § 251 (2006).

corporation's board of directors,<sup>46</sup> and second, it must be approved by an absolute majority of the corporation's stockholders.<sup>47</sup> A majority stockholder clearly has the voting power to assure stockholder approval. But, stockholder approval, standing alone, is not enough to commit the corporation to the merger.<sup>48</sup> The board must take the first step. It must negotiate the merger, approve the merger agreement, and submit it to the stockholders for their vote.<sup>49</sup> To control the corporation's side of the transaction, the stockholder must be able to influence at least a majority of the directors as the board proceeds through the first step of the merger process.<sup>50</sup>

### 1. Controlling vs. Powerful Stockholder

The ability to exercise practical control over a majority of the board is what makes a stockholder a "controlling stockholder."<sup>51</sup> But, under Delaware law, the analysis of the question whether a stockholder is a "controlling stockholder" begins not with its ability to influence a majority of the directors; rather, it begins with the size of its stockholdings. Size matters. A stockholder that owns more than 50% of a company's shares is automatically and conclusively presumed to be a "controlling stockholder."<sup>52</sup> Thus, a majority stockholder is presumed to be on both sides of the transaction. On the other hand, a stockholder that owns a large but less than majority block of the corporation's shares is

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46. *Id.* § 251(b).

47. *Id.* § 251(c).

48. See Deborah A. DeMott, *The Mechanisms of Control*, 13 CONN. J. INT'L L. 233, 236 (1999) ("Holding a majority of voting power does not in itself place a shareholder in a position of active control. If the shareholder assumes no additional role within the corporation, the shareholder is not a direct participant in operational decisions or in the formulation of strategic policy."). Moreover, the exercise of the majority stockholder's voting power is not the source of its fiduciary duty of entire fairness because a majority stockholder is free to vote its shares in its self-interest free of any fiduciary duty to the minority stockholders. See *Thorpe v. CERBCO, Inc.*, 676 A.2d 436, 442-43 n.9 (Del. 1996); see also *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 845 (Del. 1987); *Orman v. Cullman (Cullman II)*, No. Civ.A. 18039, 2004 WL 2348395, at \*5 (Del. Ch. 2004); *Peter Schoenfeld Asset Mgmt., LLC v. Shaw*, No. Civ.A. 20087-NC, 2003 WL 21649926, at \*1 (Del. Ch. July 10, 2003), *aff'd mem.*, 840 A.2d 642 (Del. 2003); *Omnicare v. NCS Healthcare, Inc.*, 818 A.2d 914, 938 (Del. 2003).

49. DEL. CODE ANN. tit. 8, § 251(b), (c).

50. As a matter of statutory law, the business and affairs of a Delaware corporation are controlled by its board of directors; not its stockholders. DEL. CODE ANN. tit. 8, § 141 (2006); *Cullman I*, 794 A.2d 5, 19 (Del. Ch. 2002) (quoting *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984) *overruled by* *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000)).

51. *In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531, 553 (Del. Ch. 2003).

52. See *In re W. Nat'l Corp. S'holders Litig.*, No. 15927, 2000 WL 710192 at \*1 (Del. Ch. May 22, 2000).

not presumed to be a controlling stockholder.<sup>53</sup> In that situation, the burden is on the plaintiff to prove that the large stockholder is, *in fact*, a controlling stockholder and thus subject to a fiduciary duty of entire fairness.<sup>54</sup>

The use of the term “controlling stockholder” to define a category that includes majority stockholders and large stockholders who exercise control over the corporation is imprecise. A majority stockholder is always powerful, but it may not use that power to exercise control over the members of the corporation’s board. And even a large stockholder that customarily exercises control over a corporation may relinquish that control for purposes of the specific transaction that is the subject of judicial review.<sup>55</sup> Thus, the broad use of the phrase “controlling stockholder” assumes the existence of control when, in fact, control may not exist.

In the interest of clarity, this Article will use the term “powerful stockholder” to refer collectively to majority stockholders and to stockholders whose holdings are large enough to give them clout.<sup>56</sup> The term “controlling stockholder” will be used to refer to a powerful stockholder that actually uses that power to exercise control over the board with respect to the challenged transaction.<sup>57</sup> Thus, by this definition, a majority stockholder that does not control the board of directors or a large stockholder that has relinquished its customary control with respect to the challenged transaction would not be a “controlling stockholder.”

## 2. Going-Private Mergers

The early going-private merger cases all involved majority stockholders who clearly dominated and controlled the boards of their subsidiary corporations. For example, in *Sterling v. Mayflower Hotel Corp.*,<sup>58</sup> the first Delaware case to deal with a going private merger, a majority of the members of the board that approved the merger were

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53. *Weinstein Enters., Inc. v. Orloff*, 870 A.2d 499, 507 (Del. 2005).

54. *In re W. Nat'l*, 2000 WL 710192 at \*6. By exercising control over the corporation with respect to a self-interested transaction, the large stockholder takes on a fiduciary duty to the other stockholders to make sure the transaction is entirely fair. *Weinstein Enterprises*, 870 A.2d at 507.

55. *See In re Sea-Land Corp. S'holders Litig.*, Civ. A. No 8453, 1988 WL 49126, at \*3 (Del. Ch. 1988).

56. Where a corporation has a “powerful stockholder” this Article will use the term “unaffiliated stockholders” to refer to the stockholders not affiliated with the powerful stockholder.

57. Where a corporation has a “controlling stockholder” this Article will use the term “non-controlling stockholders” to refer to the other stockholders.

58. 93 A.2d 107 (Del. 1952).

employed as officers or served as directors of the majority stockholder.<sup>59</sup> For this reason, the court concluded that the majority stockholder and the directors who were under its control “occupy, in relation to the minority, a fiduciary position in dealing with [the corporation’s] property. Since they *stand on both sides of the transaction*, they bear the burden of establishing its entire fairness, and it must pass the test of careful scrutiny by the courts.”<sup>60</sup>

In modern times, what had been a finding of fact, the domination of directors by the majority stockholder, has evolved into a conclusion of law. This evolution began with *Singer v. Magnavox Co.*,<sup>61</sup> where the Delaware Supreme Court said: “It is a settled *rule of law* in Delaware . . .” that a “majority stockholder . . . owe[s] to the minority stockholders . . . a fiduciary obligation in dealing with the latter’s property.”<sup>62</sup> The court continued: It is “established *law* in this State that the dominant corporation, as a majority stockholder standing on both sides of a merger transaction, has ‘the burden of establishing its entire fairness’ to the minority stockholders sufficiently to ‘pass the test of careful scrutiny by the courts.’”<sup>63</sup>

Thus, the application of the entire fairness standard to review a going-private merger no longer required a finding that the majority stockholder had exercised control over the subsidiary corporation.<sup>64</sup> Rather the exercise of control was assumed and the entire fairness standard was imposed as a matter of law.<sup>65</sup>

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59. In *Sterling*, a majority of the board was made up of individuals who also served as officers or directors of the majority stockholder. *Id.* at 109.

60. *Id.* (emphasis added).

61. 380 A.2d 969 (Del. 1977), *overruled by* *Weinberger v. UOP, Inc.* 457 A.2d 701 (Del. 1983). The *Singer* case held that a majority stockholder had a fiduciary duty to the minority stockholders that would prevent the majority stockholder from effectuating a going-private merger unless it could prove that the merger was being accomplished for a valid business purpose. *Id.* at 979-80. A going-private merger could not be accomplished for the sole purpose of eliminating the minority stockholders. *Id.* Notably, in *Singer*, the fiduciary duty was linked to the majority stockholder’s motive in executing the merger. See *id.*

62. *Id.* at 976. (emphasis added) (citing *Sterling*, 93 A.2d at 109-10).

63. *Id.* (emphasis added) (quoting *Sterling*, 93 A.2d at 110).

64. For example, in *Tanzer v. International General Industries, Inc.*, the court did not even consider the composition of the subsidiary’s board. 379 A.2d 1121, 1123-24 (Del. 1977), *overruled on other grounds by* *Weinberger*, 457 A.2d 701. Rather, the opinion simply assumes (without so stating) that the parent corporation controlled the board. See *id.* The decision focuses not on the parent corporation’s “director control” over the subsidiary “which is a consequence of its power” but on the parent’s right to vote its shares in accordance with its self-interest. *Id.* at 1123. The court declines the defendant’s invitation to consider the business judgment rule saying that the business judgment rule “is not the measure of [parent corporation’s] responsibility to minority shareholders in its subsidiary.” *Id.* at 1124.

65. See *Emerald Partners v. Berlin*, 787 A.2d 85, 96 (Del. 2001) (*Emerald Partners III*).

In *Weinberger v. UOP, Inc.*<sup>66</sup> the Delaware Supreme Court overruled *Singer*'s business purpose test.<sup>67</sup> *Weinberger* seemed to signal a return to the practice of examining the relationship between the corporation's board of directors and its majority stockholder. It cited the *Mayflower Hotel* case, among others, for the proposition that the entire fairness standard would apply where the same individuals served as *directors* of the parent corporation and the subsidiary corporation.<sup>68</sup> The court reasoned that these directors' divided loyalties created a question of breach of fiduciary duty.<sup>69</sup> In the *Weinberger* case, two of these directors used information that belonged to the subsidiary corporation to help the parent corporation price the going-private merger and failed to disclose this fact to their fellow board members.<sup>70</sup> For these reasons, the court held that they and the majority stockholder would have to prove that the merger had been entirely fair to the minority stockholders.<sup>71</sup>

*Weinberger* also refined the analysis of the "entire fairness" standard, explaining that the standard required (1) that the stockholders receive a "fair price" for their shares and (2) that the transaction be the product of "fair dealing."<sup>72</sup> "Fair price" would be determined by the standards applicable to a statutory appraisal action.<sup>73</sup> "Fair dealing" would include, among other things,<sup>74</sup> the use of a process that replicates negotiations in an arm's-length transaction<sup>75</sup> and the disclosure of

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66. 457 A.2d 701.

67. *Id.* at 715.

68. *Id.* at 710-11.

69. *Id.*

70. *Id.* at 708-09.

71. *Id.* at 710.

72. *Id.* at 711.

73. *Id.* at 712-13. The court also liberalized the standards by which Delaware courts could determine the value of a corporation, holding that value could be proved "by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court." *Id.* at 713. "Only the speculative elements of value that may arise from the 'accomplishment or expectation' of the merger are excluded." *Id.*

74. Fair dealing also includes issues related to the timing of the transaction and the way the transaction is presented to the subsidiary corporation. *Id.* at 711.

75. *Id.* at 709, n. 7. The court said:

Although perfection is not possible, or expected, the result here could have been entirely different if [the subsidiary corporation] had appointed an independent negotiating committee of its outside directors to deal with [the parent corporation] at arm's length. Since fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered nor pursued. Particularly in a parent-sub subsidiary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness.

*Id.* at 709-10, n.7 (citations omitted). See Gilson and Gordon, *supra* note 1, at 798 (2003).

material information to the unaffiliated stockholders.<sup>76</sup>

The replication of arm's-length negotiations requires that the parent corporation be separated from control over the decision-making process of the subsidiary's board by creating a special committee of independent directors with the power to reject the parent's merger proposal.<sup>77</sup> Under common law fiduciary duty analysis, a decision by independent directors to approve a transaction with a self-interested director (even one who controls a large block of the corporation's stock) would be entitled to the favorable presumptions of the business judgment rule.<sup>78</sup>

Another transactional device used to reduce a large stockholder's power is to require that the merger be approved by a majority of the disinterested stockholders.<sup>79</sup> Thus, stockholder approval amounts to ratification of the transaction by the disinterested stockholders. Traditionally, stockholder ratification "has the effect of protecting the transaction from judicial review except on the basis of waste."<sup>80</sup>

These two devices (the special committee of independent directors and ratification by a majority of independent stockholders)<sup>81</sup> function at different theoretical levels and provide independent mechanisms to avoid the entire fairness standard of review.<sup>82</sup> The use of independent directors has the effect of placing the board's decision-making function into impartial hands. Thus, it can restore the favorable presumptions of the business judgment rule. The use of ratification by a majority of the disinterested stockholders does not implicate the business judgment rule

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76. *Weinberger*, 457 A.2d at 711-12. This obligation derives from the parent's superior access to information. *Id.* at 711.

77. *Gilson & Gordon*, *supra* note 1, at 798, 804.

78. *Puma v. Marriott, Inc.*, 283 A.2d 693, 695-96 (Del. Ch. 1971). This practice is consistent with Delaware's preference for having corporate decisions made by neutral decision-makers empowered through corporate procedures. *See In re Cox Commc'ns, Inc. S'holders Litig.*, 879 A.2d 604, 606-07 (Del. Ch. 2005).

79. *In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531, 547-48 (Del. Ch. 2003).

80. *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997). *See also* *Gottlieb v. Heyden Chem. Corp.*, 91 A.2d 57, 58 (Del. 1952); *Keenan v. Eshleman*, 2 A.2d 904, 909 (Del. 1938).

81. These two transactional devices are also consistent with the Delaware statute which provides a safe-harbor for transactions involving self-interested directors. DEL. CODE ANN. tit. 8, § 144 (2006). *See generally* EDWARD P. WELCH, ANDREW J. TUREZYN & ROBERT S. SAUNDERS, *FOLK ON THE DELAWARE GENERAL CORPORATION LAW*, § 251.6.4, .6.4.4, .6.4.6 (5th ed., Aspen 2006). Under the safe-harbor provision, a transaction between a corporation and one of its officers or directors is not deemed to be per se voidable if it was approved by a majority of the disinterested directors, DEL. CODE ANN. tit. 8, § 144(a)(1) (2006), or a majority of the disinterested stockholders, tit. 8, § 144(a)(2). *Cooke v. Oolie*, No. Civ. A. 11134, 1997 WL 367034, at \*9 (Del. Ch. 1997). In other words, section 144 upholds the validity of a transaction where it is approved by neutral directors or ratified by neutral stockholders.

82. *In re Trans World Airlines, Inc. S'holders Litig.*, Civ. A. No. 9844, 1988 WL 111271, at \*7 (Del. Ch. 1988), *abrogated by* *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110 (Del. 1994).

because the business judgment rule does not apply to stockholder decisions. Stockholder ratification functions like ratification by a principal of an agent's unauthorized actions. It is a means by which the stockholders, to whom the duty of loyalty is owed, are able to accept the board's decision and thus place it beyond judicial review.

### B. *The Lynch Doctrine*

*Weinberger's* emphasis on the importance of determining price through arm's-length negotiation was thought by some to suggest that by neutralizing the majority stockholder's control over the "sell" side of the merger, the majority stockholder would no longer be on both sides of the transaction; thus, the majority stockholder would not have to prove the entire fairness of the merger.<sup>83</sup> In other words, the court might be willing to accept the fairness of the merger price if it was the result of arm's-length negotiation.<sup>84</sup> This idea fits well with the business judgment rule which prohibits courts from second guessing decisions made in good faith by independent and disinterested directors<sup>85</sup> and with Delaware's preference for having corporate decisions made by neutral decision-makers empowered through corporate procedures rather than by judges.<sup>86</sup>

Two cases in the Court of Chancery accepted the use of these neutralizing devices as means of avoiding the automatic imposition of the entire fairness standard of review.<sup>87</sup> On the other hand, two other cases decided by different judges in the same court held that the use of either of these devices would not remove the transaction from the exacting requirements of the entire fairness standard; rather, it would merely shift to the plaintiff the burden of proving that the transaction was not entirely fair.<sup>88</sup>

This split was resolved by *Kahn v. Lynch Communication Systems, Inc.*,<sup>89</sup> in which the Delaware Supreme Court rejected the proposition

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83. Gilson & Gordon, *supra* note 1, at 798.

84. *See id.*

85. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

86. *In re Cox Commc'ns, Inc. S'holders Litig.*, 879 A.2d 604, 606-07 (Del. Ch. 2005).

87. *In re Trans World Airlines*, 1988 WL 111271, at \*7; *Cinerama, Inc. v. Technicolor, Inc.*, Civ. A. No. 8358, 1991 WL 111134, at \*9-11 (Del. Ch. 1991), *aff'd in part and rev'd in part on other grounds*, *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993).

88. *Citron v. E. I. Du Pont de Nemours & Co.*, 584 A.2d 490, 500-02 (Del. Ch. 1990); *Rabkin v. Olin Corp.*, C.A. No. 7547, 1990 WL 47648, at \*6 (Del. Ch. 1990), *aff'd on other grounds*, 586 A.2d 1202 (Del. 1990).

89. 638 A.2d 1110.

that the use of either of the neutralizing devices would defeat a breach of fiduciary duty claim and leave stockholders with only the statutory remedy of appraisal.<sup>90</sup> Establishing what has come to be known as the “*Lynch Doctrine*,”<sup>91</sup> the Court held that a going-private merger between a “controlling stockholder”<sup>92</sup> and the controlled corporation would be judged under Delaware’s “entire fairness” standard of review even if the merger had been negotiated by an independent special committee or approved by a majority of the independent stockholders.<sup>93</sup>

Under the *Lynch Doctrine*, a going private transaction must necessarily be judged under the entire fairness standard of review.<sup>94</sup> Thus use of either the special committee or requiring approval by disinterested stockholders merely has the effect of shifting the burden to the plaintiff to show that the transaction was not entirely fair to the unaffiliated stockholders.<sup>95</sup> The Court explained: “Entire fairness remains the proper focus of judicial analysis in examining an interested merger, irrespective of whether the burden of proof remains upon or is shifted away from the controlling or dominating shareholder, because the unchanging nature of the underlying ‘interested’ transaction requires careful scrutiny.”<sup>96</sup>

In other words, the court retained the entire fairness standard because it provided the jurisprudential tool that would allow the court to examine the substantive merits of the transaction to make sure it was entirely fair. The business judgment rule and its requirement of judicial deference to a decision by impartial directors would not permit such an

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90. See *id.* at 1116-17. See Gilson & Gordon, *supra* note 1, at 800.

91. The term “*Lynch doctrine*” was coined by Vice Chancellor Strine in *In re Cysive, Inc. S’holders Litig.*, 836 A.2d 531, 547 (Del.Ch. 2003). The doctrine takes its name from the name of the defendant corporation in *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110, rather than the name of the plaintiff because there are so many Delaware cases filed by plaintiffs with the name Kahn.

92. The term “controlling stockholder” is used here to refer to a stockholder who owns a large block of stock in the subject corporation and uses the clout conferred by its stockholdings to exercise practical control over the corporation. See *Lynch*, 638 A.2d at 1113-14; *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987); *Gilbert v. El Paso Co.*, 490 A.2d 1050, 1055 (Del. Ch. 1984). A stockholder who owns a majority of a company’s shares is deemed as a matter of law to be a “controlling stockholder.” *Weinstein Enters., Inc. v. Orloff*, 870 A.2d 499, 507 (Del. 2005). See *Paramount Commc’ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42 (Del. 1994); *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 70 (Del. 1989). Where a stockholder holds less than a majority of the subject corporation’s shares, the presumption is that the stockholder does not exercise control and the burden is on the plaintiff to show that the stockholder does, in fact, exercise practical control over the corporation. *Id.*; *Gilbert*, 490 A.2d at 1055.

93. *Lynch*, 638 A.2d at 1115-17.

94. *Emerald Partners III*, 787 A.2d 85, 92-93 (Del. 2001).

95. *Id.*

96. *Lynch*, 638 A.2d at 1116.

inquiry.

The court retained the ability to examine the merits of the transaction because it did not fully trust the directors' independence, objectivity, or their will to negotiate as aggressively as they would in a true arm's-length transaction.<sup>97</sup> The Court explained: "in a merger between the corporation and its controlling stockholder – even one negotiated by disinterested, independent directors – no court could be certain whether the transaction terms fully approximate what truly independent parties would have achieved in an arm's length negotiation."<sup>98</sup>

The Court also feared that the presence of a controlling stockholder would intimidate the disinterested stockholders. Thus, it refused to give effect to stockholder ratification in the context of a going-private merger because it thought the stockholders might vote to approve the merger solely out of fear that the controlling stockholder might visit retribution on them if they did not do so.<sup>99</sup>

Thus, in the context of a going-private merger, the court was so concerned about the latent power of a controlling or majority stockholder, even when that power had been formally neutralized by the use of a special committee of independent directors and even when the transaction had been ratified by independent stockholders, that the court retained the entire fairness standard to allow the court to make sure the merger was the product of fair dealing and that the unaffiliated stockholders were paid a fair price for their shares. In other words, the court wanted the last word as to whether the corporation should enter into the going-private merger.

### C. *Problems with Lynch*

The *Lynch* Doctrine's automatic application of the entire fairness standard of review was intended to allow the court an opportunity to

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97. *Id.* at 1117.

98. *Id.* at 1116. The facts in *Lynch* did not provide a fully empowered independent committee. The transaction was between the corporation and a stockholder that owned 43.3% of its stock. *Id.* at 1114. The court found, as a matter of fact, that the stockholder exercised actual control over the corporation. *Id.* at 1115. It also found that the special committee was lacking in power and had been bullied by the stockholder. *Id.* at 1114-15. Thus, the stockholder had stood "on both sides of the transaction." *Id.* at 1117. *Lynch* suggests that to accomplish the shift, the committee must actually have the power to say no. Gilson & Gordon, *supra* note 1, at 802.

99. *Lynch*, 638 A.2d at 1116-17. Quoting *Citron v. E. I. Du Pont de Nemours & Co.*, 584 A.2d 490, 502, the court said: "Even where no coercion is intended, shareholders voting on a parent subsidiary merger might perceive that their disapproval could risk retaliation of some kind by the controlling stockholder." *Lynch*, 638 A.2d at 1116.

review the substance of the transaction to make sure that the transaction was the product of “fair dealing” and that the unaffiliated stockholder received a “fair price” for their shares.<sup>100</sup> But, in practice it has generated unintended results that make it inefficient and ineffective.<sup>101</sup>

### 1. Lynch Makes Trial Unavoidable

The *Lynch* Doctrine’s imposition of the entire fairness doctrine *ab initio*<sup>102</sup> renders the usual motions by which a trial court can dispose of non-meritorious litigation ineffective.<sup>103</sup> If a *Lynch* claim is brought as a derivative action, a Rule 26 motion to dismiss for failure to comply with the demand requirement is of no avail.<sup>104</sup> The *Aronson* decision holds that demand is excused if the plaintiff can plead facts showing that the challenged transaction is not the product of a valid business judgment.<sup>105</sup> Under the *Lynch* Doctrine, the business judgment rule does not apply to going-private mergers.<sup>106</sup> Accordingly, the stockholder challenge to a going-private merger automatically satisfies the “demand excused” prong of the demand requirement.<sup>107</sup>

A Rule 12(b)(6) motion to dismiss is also ineffective.<sup>108</sup> The entire fairness standard requires the court to determine whether the merger was the product of fair dealing and paid a fair price.<sup>109</sup> The fairness of the price is determined by the fair value of the corporation as measured by modern financial techniques.<sup>110</sup> The concept of fair value is so vague and so fact-intensive that a plaintiff can always plead in good faith that the merger price is not entirely fair.<sup>111</sup> Even after complete discovery,

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100. *Lynch*, 638 A.2d at 1115-17; *Emerald Partners III*, 787 A.2d at 97; *Cullman I*, 794 A.2d 5, 20 (Del. Ch. 2002).

101. See *In re Cox Commc’ns, Inc. S’holders Litig.*, 879 A.2d 604, 605-07, 617-23 (Del. Ch. 2005); *In re Cysive Inc. S’holders Litig.*, 836 A.2d 531, 547-51 (Del. Ch. 2000); *In re Pure Res., Inc., S’holders Litig.*, 808 A.2d 421, 435, 444 (Del. Ch. 2002).

102. *Emerald Partners III*, 787 A.2d at 92-93.

103. See *In re Cox Commc’ns*, 879 A.2d at 619-20.

104. *Orman v. Cullman*

105. *Aronson v. Lewis*, 473 A.2d 805, 816-17 (Del. 1984), *overruled by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

106. *In re Cox Commc’ns*, 879 A.2d at 616-17.

107. See *Aronson*, 473 A.2d at 815.

108. *Krasner v. Moffett*, 826 A.2d 277, 279 (Del. 2003) (holding that the validity of a special committee could not be decided at the pleading stage).

109. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

110. *Id.* at 713.

111. *In re Cox Commc’ns*, 879 A.2d at 635. The determination of fair price requires the court to determine the range of value for the corporation’s shares. WELCH, TUREZYN, & SAUNDERS, *supra* note 81, § 251.6.3. This is always subject to dispute between exporters as to the appropriate financial theory to apply, the appropriate variables to use in making financial projections and

the factual complexity of this analysis makes this issue unlikely to be subject to resolution by a Rule 56 motion for summary judgment.<sup>112</sup>

## 2. Lynch Increases the Complexity of the Trial

*Lynch* not only makes it all but impossible to avoid trial; it makes trial more complex.

### a. Litigation over Standard of Review

The *Lynch* Doctrine only applies to a stockholder who owns less than a majority of the corporation's shares if that stockholder is a "controlling stockholder."<sup>113</sup> In a case asserting a *Lynch* claim, the stockholder defendant will seek to avoid the entire fairness standard of review by arguing that it did not, in fact, exercise control over the corporation. This becomes a question of fact that must be resolved at the outset to determine what legal standard the court will use to judge the case.<sup>114</sup> A lot is at stake. If the plaintiff fails to persuade the court that the stockholder defendant is in control, the case will be decided under the highly deferential business judgment rule.<sup>115</sup> But, if the plaintiff succeeds in proving control, the burden shifts to the defendants to prove entire fairness.<sup>116</sup>

The issue of control is fact intensive and not likely to be resolved by pre-trial motion.<sup>117</sup> Thus, it becomes part of the trial. Because it determines what standard of review will govern the plaintiff's claim, the plaintiff should prove this issue first. But the facts that will determine the issue of control often relate to "fair dealing" issues as to which the defendant may have a burden of proof.

### b. Litigation over Burden Shifting

The defendant stockholder, after having been found to have been a controlling stockholder, may then seek to shift the burden back to the

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present value estimates, and even the facts on which these estimates are to be based. Valuation is not an exact science.

112. *In re Cysive S'holders Litig.*, 836 A.2d 531, 548 n.19 (Del. Ch. 2003); *In re Cox Commc'ns*, 879 A.2d at 648.

113. *In re Cysive S'holders Litig.*, 836 A.2d at 550.

114. *Id.* at 551.

115. *In re W. Nat'l Corp. S'holders Litig.*, No. 15927, 2000 WL 710192 at \*1-2 (Del. Ch. May 22, 2000).

116. *Kahn v. Lynch Commc'ns Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994).

117. *In re Cysive*, 836 A.2d at 550-51.

plaintiff by proving that the transaction was negotiated and approved by a special committee of independent directors or that it was ratified by a majority of the independent stockholders.<sup>118</sup>

Where a special committee has been appointed, the defendant has the burden of proving the independence, diligence and power of the committee.<sup>119</sup> Each of these points is fact-intensive and each is unlikely to be resolved before the trial by a motion *in limine*.<sup>120</sup> Thus the defendants must proceed with proof at trial on each of these points. Alternatively, where the transaction has been approved by a majority of the disinterested stockholders, the defendants must prove that the disclosures sent to the stockholders to solicit their votes were complete and not misleading.<sup>121</sup> This, too, is the sort of thing that can involve disputed facts. As a result, the question whether the stockholder ratification was fully informed and thus earned a shift in the burden of proof on the entire fairness must usually be resolved at trial.<sup>122</sup>

This presents another point of confusion. The use of an effective special committee is “strong evidence” of fair dealing.<sup>123</sup> So, too, is the completeness of the disclosures made to the unaffiliated stockholders in the documents soliciting their approval of the transaction.<sup>124</sup> Thus, to shift the burden of proof on the entire fairness issue, the defendants must prove most of the facts that will satisfy the fair dealing component of the entire fairness standard.<sup>125</sup> In other words, to shift the burden of proof as to the “entire fairness” of the merger, the defendants must prove most of the facts that establish the “fair dealing” component of “entire fairness.” That is not a meaningful shift.

Although it would be a slight overstatement, the effect of the *Lynch* Doctrine’s shift in the burden of proof on the entire fairness issue could be summarized this way: if the defendants can prove the “fair dealing” component of fair dealing, the burden shifts to the plaintiff to prove that the merger consideration does not satisfy the “fair price” component.

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118. *In re Cysive*, 836 A.2d at 547.

119. *Id.* at 550.

120. *Id.* at 551.

121. *In re Cox Commc’ns, Inc. S’holders Litig.*, 879 A.2d 604, 618-19 (Del. Ch. 2005).

122. *In re Cysive*, 836 A.2d at 549.

123. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709 n.7 (Del. 1983).

124. *See id.* at 709.

125. Fair dealing can also raise issues relating to the way the merger is initiated and whether it is timed to the advantage of the controlling stockholder and the concomitant disadvantage of the unaffiliated stockholders. WELCH, TUREZYN, & SAUNDERS, *supra* note 81, § 251.6.4.1.

### c. The Insignificance of Burden Shifting

The benefit conferred by shifting the burden of proof with regard to the “entire fairness” issue is slight. As the Court of Chancery recently explained, the question of who has the burden of proof is only important when the facts are in precise equipoise.<sup>126</sup> In that circumstance, under the preponderance of the evidence standard of proof, the party with the burden is said to have failed to prove its case. But it is seldom, if ever, the case that the facts in these complicated going private cases are in equipoise.<sup>127</sup> If follows that burden of proof is of little consequence. For this reason, and because the determination of the burden of proof issue requires a finding of fact regarding facts that also bear on the ultimate question of entire fairness, it is the practice for both parties to proceed at trial as if they had the burden of proof.<sup>128</sup>

### D. Lynch Creates a “Class Appraisal Action”

Traditionally, the statutory remedy of appraisal has been considered the exclusive remedy available to a plaintiff who challenges only the price at which a merger is effectuated.<sup>129</sup> But, the *Lynch* Doctrine’s automatic application of the entire fairness standard of review allows a plaintiff to bring a breach of fiduciary duty action, even when the merger has been approved by a special committee of independent directors, claiming that the merger price is not entirely fair.<sup>130</sup> As discussed above, approval of the merger by independent directors satisfies the fair dealing component of the entire fairness standard and shifts the burden to the plaintiff to prove that the price is not entirely fair.

This reveals another problem with the *Lynch* Doctrine. It creates what amounts to a class appraisal action as the remedy for going private mergers, making them the only merger for which statutory appraisal is not the exclusive remedy. The difference between a class action and an

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126. See *In re Pure Res, Inc. S’holders Litig.*, 808 A.2d 421, 436 (Del. Ch. 2002).

127. See *id.*

128. *In re Cysive S’holders Litig.*, 836 A.2d 531, 549 (Del. Ch. 2003).

129. *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001); *Weinberger*, 457 A.2d at 703.

130. WELCH, TUREZYN, & SAUNDERS, *supra* note 8181, § 251.6.2, .6.2.1. This common law remedy is in addition to the statutory remedy of appraisal. DEL. CODE ANN. tit. 8, § 262 (2006). Before the challenged transaction is effectuated, a *Lynch* Doctrine claim can be brought as a derivative action seeking injunctive relief. See, e.g., *In re Cox Commc’ns, Inc. S’holders Litig.*, 879 A.2d 604, 605-06 (Del. Ch. 2005). After the transaction is completed it becomes an individual action brought by a stockholder on behalf of him or her self, or more likely, a class of similarly situated stockholders. See, e.g., *Weinberger*, 457 A.2d at 702-03.

appraisal action is more than merely procedural.

An appraisal action is technical, expensive, and risky. To bring an appraisal claim a stockholder must comply with the technicalities of the appraisal statute.<sup>131</sup> Only a stockholder who has complied with the statute is entitled to participate in the appraisal action.<sup>132</sup> Thus an appraisal action cannot be brought as a class action on behalf of all stockholders; rather, it is brought only for the benefit of those who have complied with the statutory requirements for perfecting their appraisal rights.<sup>133</sup> Once a stockholder demands appraisal, he or she is no longer entitled to receive the merger consideration. The stockholder receives no compensation for his or her canceled shares until the appraisal litigation is concluded.<sup>134</sup> At that point, the stockholder is entitled to receive the amount determined by the court to be the fair value of his or her shares, which may be less than the merger price.<sup>135</sup>

A “class appraisal action” brought under the *Lynch* Doctrine is a much more attractive remedy for stockholders. The stockholder does not have to comply with the technicalities of the appraisal statute, does not have to wait until the conclusion of the litigation to be paid for his or her shares, and does not risk receiving less than the merger price.<sup>136</sup> Moreover, the costs of litigation can be distributed among all shareholders.<sup>137</sup>

In summary, the *Lynch* Doctrine allows a plaintiff to challenge a going-private merger, even one negotiated by a special committee, solely on the basis of price and have the valuation issues resolved under the same principles that would apply in an appraisal action without complying with the statute’s technicalities and without taking on appraisal’s down-side risk.<sup>138</sup>

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131. Under the appraisal statute a stockholder must perfect its right to appraisal by not voting for the merger, making a timely appraisal demand on the corporation, and filing the action in the court of chancery within 120 days. DEL. CODE ANN. tit. 8, § 262(a), (d)(1), (e).

132. Gilson & Gordon, *supra* note 1, at 798. Typically, this is a small number. *Id.* at 798-99.

133. See Raynor v. LTV Aerospace Corp., 317 A.2d 43, 45 (Del. Ch. 1974); *In re Shell Oil Co.*, slip op at 2 (Del. Ch. 1986); *In re Shell Oil Co.*, slip op at 2 (Del. Ch. 1988).

134. See Henke v. Trilithic, Inc., No. Civ. A. 13155, 2005 WL 3578094, at \*2 n.13 (Del. Ch. Dec. 20, 2005).

135. *Id.*

136. See Gilson and Gordon, *supra* note 1, at 798-99. The Delaware appraisal statute does not authorize a class action procedure. *Id.* at 799.

137. *Id.*

138. *Id.*

### *E. Lynch Encourages "Tag-Along" Settlements*

Because the *Lynch* claim cannot be resolved short of trial, defendants find it cost-effective to settle even frivolous claims.<sup>139</sup> This has led to a new style of litigation in which stockholder plaintiffs file their claims solely for the purpose of having a bargaining position from which to seek a settlement.

The practice works this way: The plaintiff files a "generic" breach of fiduciary duty complaint within minutes<sup>140</sup> after a majority stockholder (or a large and thus a potentially controlling stockholder) proposes a merger between itself and the corporation.<sup>141</sup> These complaints are filed even when the controlling stockholder states that the merger price is negotiable and asks the corporation to appoint a special committee to conduct that negotiation.<sup>142</sup> At this stage of the transaction the corporation has not agreed to anything and thus there can have been no breach of fiduciary duty by the corporation's directors. Nonetheless, the plaintiffs are able to state a claim by alleging the controlling stockholder has breached its fiduciary duty of entire fairness by offering an inadequate merger price.<sup>143</sup> Thus, the complaint can be filed even though, as yet, there is no transaction to challenge.

In response to the controlling stockholder's offer, the corporation's board appoints a special committee of independent directors to negotiate a better deal for the unaffiliated stockholders.<sup>144</sup> Because the controlling stockholder, like any other person proposing a transaction, is unlikely to begin the process by offering its best price, these negotiations typically result in an improvement in the merger price.<sup>145</sup> Concurrently with these negotiations the controlling stockholder opens parallel negotiations with the stockholder plaintiffs.<sup>146</sup> When the special committee and the controlling stockholder reach tacit agreement on price, the controlling stockholder proposes settlement with the stockholder plaintiffs at the

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139. *In re Cox Commc'ns, Inc. S'holders Litig.*, 879 A.2d 604, 605-06 (Del. Ch. 2005).

140. Going-private mergers, like other financial transactions, are usually announced early in the morning so that they will appear in that day's financial newspapers. The office of the Registrar in Chancery (the clerk for the Delaware Court of Chancery) opens at 8:30 a.m. Typically, on the day a transaction is announced, the Registrar will have received several "generic" complaints challenging the transaction before 9:00 a.m. Plaintiffs' lawyers rush to be the first filed in the hope of gaining advantage vis-à-vis one another in the battle to control the litigation.

141. *See In re Cox Commc'ns*, 879 A.2d at 607-08.

142. *Id.*

143. *Id.* at 608.

144. *Id.* at 605-06.

145. *Id.* at 621.

146. *Id.* at 620-21.

same price.<sup>147</sup> The special committee then agrees to the merger at the increased price provided the controlling stockholder can produce a global settlement with the stockholder plaintiffs, and the stockholder plaintiffs agree to the global settlement provided the special committee agrees that their participation in the negotiations contributed to the increase in the merger price.<sup>148</sup>

The Court of Chancery has referred to this as “an odd form of tantra”<sup>149</sup> that produces the “simultaneous bliss” of the plaintiffs’ lawyers (who have earned the right to claim attorney’s fees), the directors on the special committee (who by virtue of court approval of the settlement avoid any possibility of personal liability) and the controlling stockholder (who has succeeded in taking the corporation private without having to litigate a *Lynch* claim in court).<sup>150</sup>

The vast majority of *Lynch* Doctrine claims are settled this way.<sup>151</sup> Ironically, a legal rule that was intended to give courts the opportunity to review going-private mergers to make sure they are entirely fair to stockholders has, in practice, relegated the court to the role of reviewing settlement agreements.<sup>152</sup>

#### *F. The Lynch Doctrine Deviates from Traditional Corporation Law*

The source of these problems are the *Lynch* doctrine’s focus on the fiduciary duties of the controlling stockholder, its automatic application of the entire fairness standard to going-private mergers, and its burden-shifting provisions. In each respect *Lynch* departs from traditional doctrine. A return to traditional principles will solve these problems by making the law governing fiduciary duties in going-private mergers consistent with the law governing fiduciary duties in other self-interested transactions, and by establishing a framework that will allow the two types of going private transactions to be governed by the same standards.

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147. *Id.* at 621.

148. *Id.*

149. *Id.* at 621. The word “tantra” derives from the Sanskrit and refers to certain meditative and sexual practices and rituals.

150. *Id.* These cases, which are part of the unintended consequence of the *Lynch* Doctrine have been justly criticized. *Id.* at 622-23.

151. *Id.* at 631-32. The rare exception is *In re Cysive*. See *In re Cysive, Inc. S’holders Litig.*, 836 A.2d 531 (Del. Ch. 2003).

152. When reviewing a settlement, a court is merely required to determine whether the plaintiff’s complaint stated a colorable claim and whether the settlement consideration is adequate when measured against the strength of the claim. Thus, the court does not give close scrutiny to the fairness of the merger as contemplated by *Lynch*.

## 1. Directors' Breach of Duty

*Lynch's* automatic imposition of the entire fairness standard is based on the assumption that the corporation is controlled by its majority stockholder.<sup>153</sup> But, as a matter of statutory law, no stockholder, not even a majority stockholder, has direct control in the management of a corporation.<sup>154</sup> The power to manage a corporation is vested exclusively in the board of directors.<sup>155</sup> The implications of this point are profound.

A majority stockholder can only exercise control over a corporation with respect to a particular transaction when a majority of the members of its board of directors subordinate themselves to the domination, control, or influence of the majority stockholder. In other words, the majority of the board must be willing to make a decision based on the best interests of the majority stockholder rather than the best interests of the corporation. Put differently, the majority of the board is doing the bidding of the majority stockholder, in violation of its fiduciary duty of loyalty to the corporation. Thus, for a "controlling stockholder" to exist, it must have the ability to corrupt a majority of the board of directors, and concomitantly, a majority of the board must be willing to abandon its duty of loyalty. Conversely, where a board satisfies its fiduciary duty to make decisions in the best interests of the company, regardless of the wishes of the powerful stockholder, the board is in control.<sup>156</sup> The powerful stockholder is not a "controlling stockholder."

## 2. The Business Judgment Rule

But what of the directors who are assumed to be controlled (or at least intimidated) by the majority stockholder? Traditionally, the directors' decision to approve a merger is reviewed under the business judgment rule.<sup>157</sup> The business judgment rule functions as a procedural

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153. The Court recently put it this way: "In the context of imposing fiduciary responsibilities, it is well established in the corporate jurisprudence of Delaware that control exists when a stockholder owns, directly or indirectly, more than half of a corporation's voting power." *Weinstein Enterprises, Inc., v. Orloff*, 870 A.2d 499, 507 (Del. 2005).

154. DEL. CODE ANN. tit.8, § 141(a) (2006). See DeMott, *supra* note 48, at 236. Stockholders do not have the power or right to manage the business and affairs of the corporation. *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984), *overruled by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *Cullman I*, 794 A.2d 5, 19 (Del. Ch. 2002).

155. DEL. CODE ANN. tit.8, § 141(a).

156. For an example of an independent board defying the wishes of a controlling stockholder see *Hollinger International, Inc. v. Black*, 844 A.2d 1022 (Del. Ch. 2004).

157. *E.g.*, *Krasner v. Moffett*, 826 A.2d 277, 287-88 (Del. 2003); *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985); *Muschell v. Western Union Corp.*, 310 A.2d 904, 907-08 (Del. Ch. 1973) (stockholders of acquiring company challenge a stock swap merger negotiated at arm's-length);

and a substantive rule.<sup>158</sup>

The procedural aspects of the business judgment rule begin with the presumption that “in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”<sup>159</sup> In other words, the business judgment rule presumes the directors have met their fiduciary duties of loyalty, care, and good faith in approving the challenged transaction.<sup>160</sup> The business judgment rule requires the stockholder-plaintiff to rebut this presumption<sup>161</sup> by pleading (and at trial proving) facts that create reason to question the directors’ performance of these fiduciary duties.<sup>162</sup> With respect to issues pertinent to going-private mergers, a plaintiff may meet this burden by placing directors’ performance of their duty of loyalty in question.<sup>163</sup> Typically this is accomplished with facts that suggest the directors lack disinterestedness or independence with respect to the challenged transaction.<sup>164</sup>

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*Cole v. Nat’l Cash Credit Ass’n.*, 156 A. 183, 188 (Del. Ch. 1931) (rejecting preferred stockholder’s challenge to an arm’s-length merger because the presumption of fairness that supports the discretionary judgment of directors means that the court must defer to the action of the board even though it may be ill-advised or apparently unprofitable.); *Cinerama, Inc. v. Technicolor, Inc.* 663 A.2d 1156, 1162 (Del. 1995).

158. *Cinerama*, 663 A.2d at 1162; *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 746-47 (Del. Ch. 2005).

159. *Emerald Partners III*, 787 A.2d 85, 90 (Del. 2001) (quoting *Aronson*, 473 A.2d at 812).

160. See *Cullman I*, 794 A.2d at 19-20 (Del. Ch. 2002) (citing cases supporting this presumption).

161. *Cinerama*, 663 A.2d at 1162.

162. *Id.* at 1163-64 (citing *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993), *modified*, 636 A.2d 956 (1994)). Challenges to a board’s decision making function are often brought as stockholder derivative actions. In the demand refused context, the burden imposed by the business judgment rule overlaps with Rule 23.1 and *Aronson* which require a plaintiff to plead with particularity facts that tend to establish a reason to doubt that the challenged transaction will be subject to the protection of the business judgment rule. *Aronson v. Lewis*, 473 A.2d 805, 808, 814 (Del. 1984), *overruled by Brehm v. Eisner*, 716 A.2d 244 (Del. 2000).

163. *Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 984 (Del. Ch. 2000). A plaintiff can dispel the presumption by showing that directors failed to fulfill their duty of care or did not make the decision in good faith. *Id.*

164. *Cullman I*, 794 A.2d 5, 22 (Del. Ch. 2002).

To rebut successfully business judgment presumptions in this manner, thereby leading to the application of the entire fairness standard, a plaintiff must normally plead facts demonstrating ‘that a *majority* of the director defendants have a financial interest in the transaction or were dominated or controlled by a materially interested director.’

*Id.* (quoting *Crescent/Mach I Partners*, 846 A.2d at 979) (emphasis added by *Cullman I* court). To show domination and control, the director should be independent. “Independence means that a director’s decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.” *Cullman I*, 794 A.2d at 24 (quoting *Aronson*, 473 A.2d at 816).

For example, in *Wisconsin Investment Board v. Bartlett*,<sup>165</sup> the court said:

In the context of a merger, a breach of fiduciary duty analysis begins with the rebuttable presumption that a board of directors acted with care, loyalty, and in 'good faith.' Unless this presumption is sufficiently rebutted, raising a reasonable doubt about self-interest or independence, the Court must defer to the discretion of the board and acknowledge that their decisions are entitled to the protection of the business judgment rule.<sup>166</sup>

Under the *Lynch* Doctrine the presumptions are precisely the opposite of those under the business judgment rule. The *Lynch* doctrine rests on the presumption that a majority of the board is to some extent corrupted by the intimidating power of the majority stockholder.<sup>167</sup> But under the business judgment rule, the mere existence of majority stockholder is not sufficient to place the loyalty of the board in issue.<sup>168</sup> For example, in the context of the demand requirement in stockholder derivative litigation, the fact that a person holds 94% of the voting power in a corporation is not sufficient to challenge the ability of the board to make an impartial decision regarding that person.<sup>169</sup> And when the board makes a decision in other contexts, the existence of a controlling stockholder, standing alone, is not sufficient to call into question the independence of the board.<sup>170</sup> By way of contrast, under the

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165. No. Civ. A. 17727, 2000 WL 238026 (Del. Ch. Feb. 24, 2000).

166. *Id.* at \*4. *See also* *Porges v. Vadsco Sales Corp.*, 32 A.2d 148, 151-52. (Del. Ch. 1943) (stating a board is entitled to a presumption that it acted in good faith when approving the terms of the challenged merger). Even in an arm's-length merger the standard by which the target company's board decision to approve the merger will be judged will vary depending on the nature of the consideration to be received by the target company stockholders in exchange for the canceled target company shares. *See Omnicare v. NCS Healthcare, Inc.*, 818 A.2d 914, 928-29 (Del. 2003). If they receive cash or other consideration that does not involve on-going participation in the company's future, they will be judged under the *Revlon* articulation of the business judgment rule. *Id.* If it is a stock-swap, then the decision will be judged under the business judgment rule. *Id.* at 29.

167. *See Kahn v. Lynch Comm'n Sys., Inc.*, 638 A.2d 1110, 1116 (Del. 1994).

168. *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1054 (Del. 2004).

169. *Id.* *See also Aronson*, 473 A.2d at 815 (stating that for purposes of the demand requirement in stockholder derivative litigation, the defendant's ownership of a majority of the company's stock is not enough to create a doubt as to the independence of the board).

170. *See Williams v. Geier*, 671 A.2d 1368, 1378 n.22 (Del. 1996). "The mere fact that the Family Group owned a dominant stock interest does not rebut the presumption of the business judgment rule or call the directors' independence into question." *Id.* *See also Puma v. Marriott, Inc.*, 283 A.2d 693, 695 (Del. Ch. 1971). Members of the Marriott group owned some 46% of Marriott Corp's stock, but that is not enough to place them in control of the company. *Id.* They have made no attempt to "impugn the integrity," independence or "good faith" of the five outside

*Lynch* Doctrine, the entire fairness standard of review applies “[e]ven if the controlling stockholder has elected a board comprised of a majority of independent directors, which has negotiated and approved the merger terms. . . .”<sup>171</sup>

The conflict between the business judgment rule and the *Lynch* Doctrine creates an anomaly. Consider a going-private merger in which a majority of the members of the corporation’s board are independent outsiders who form a special committee to negotiate with the majority stockholder. After diligent and hard bargaining, they negotiate and agree to a merger they believe will serve the best interests of the unaffiliated stockholders. If the merger is challenged, the members of the committee and the majority stockholder will be named as defendants. But the members of the committee will be entitled to the substantive protections of the business judgment rule, and a claim against them will be dismissed. The claim against the majority stockholder, on the other hand, will be judged under the entire fairness standard.<sup>172</sup> That claim will proceed to trial, and at trial, the majority stockholder faces potential liability for breach of its fiduciary duty to pay an entirely fair price.<sup>173</sup> This result makes no sense. The directors, whose approval of the merger allowed the transaction to be effectuated, would be protected from liability by the business judgment rule; but the stockholder who merely proposed the deal and had no control over the corporation’s decision to accept would face liability.

### 3. Controlling Stockholder’s Duty

The *Lynch* Doctrine’s review of going-private mergers under the “entire fairness” standard where the transaction has been negotiated and approved by a special committee of independent directors is inconsistent with the reasons why the law imposes a duty of entire fairness on controlling stockholders.<sup>174</sup> That duty is imposed when the stockholder is able to exercise actual control over the corporation’s board of

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directors. *Id.* Moreover, the Marriott group did not dictate the “terms of the transactions.” *Id.* On the contrary, the majority of the Marriott Directors initiated the deal. *Id.* Therefore, the board’s approval will be reviewed under the business judgment rule, because the Marriott group did not stand “on both sides of the transaction.” *Id.*

171. *In re Cysive, Inc. S’holders Litig.*, 836 A.2d 531, 547 (Del. Ch. 2003).

172. *Id.*

173. The only effect the approval by an impartial special committee or a board of independent directors would have on the claim against the majority stockholder would be to impose on the plaintiff the burden of proving that the merger was unfair in some respect. *See In re Cysive*, 836 A.2d at 548.

174. *See In re Cox Comm’ns, Inc. S’holders Litig.*, 879 A.2d 604, 616-17 (Del. Ch. 2005).

directors.<sup>175</sup>

The emphasis on the reality of control is significant. It is the actual exercise of control over the board that causes the law to impose a fiduciary duty on stockholder.<sup>176</sup> In *Jedwab v. MGM Grand Hotels, Inc.*,<sup>177</sup> the Court explained it this way: entire or intrinsic fairness standard applies “when fiduciaries [by which the Court was referring to controlling stockholders] elect to *utilize their power over the corporation* to effectuate a transaction in which they have an interest that diverges from that of the corporation or the minority shareholders.”<sup>178</sup> This fiduciary duty prevents the controlling stockholder “from exercising corporate power (either formally as directors or officers or informally through control over officers and directors) so as to advantage themselves while disadvantaging the corporation.”<sup>179</sup>

In the absence of the ability to exercise control over the board, a powerful stockholder is not, as a matter of fact, a controlling stockholder. Without control, there is no doctrinal foundation to impose a fiduciary duty to make the transaction entirely fair. The powerful stockholder controls only one side of the transaction. It cannot, unilaterally, make the transaction entirely fair.<sup>180</sup> There can be no deal unless the corporation agrees, and the powerful stockholder has no control over that decision.

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175. See *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994).

176. The importance of the control over the board as the jurisprudential foundation for the imposition of a fiduciary duty on a majority stockholder is illustrated by the way the courts treat a stockholder who owns less than a majority of the company's shares. In the absence of majority ownership, a fiduciary duty of entire fairness is not imposed on a stockholder unless the plaintiff is able to demonstrate that the stockholder used the clout conferred by its stockholdings to actually exercise control over the corporation. *Lynch*, 638 A.2d at 1113-14; *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987); *In re W. Nat'l Corp. S'holders Litig.*, No. Civ. A. 15927, 2000 WL 710192 at \*6 (Del. Ch. May 22, 2000). The mere potential to have the ability to exercise control is not enough; the actual exercise of control is required to impose a fiduciary duty of entire fairness. *In re Sea-Land Corp. S'holders Litig.*, No. Civ. A. 8453, 1987 Del. Ch. LEXIS 439 at \*12-13 (Del. Ch. May 22, 1987).

177. 509 A.2d 584 (Del. Ch. 1986).

178. *Id.* at 594 (emphasis added). See DeMott, *supra* note 48, at 236.

179. *Thorpe v. CERBCO, Inc.*, Civ. A. No. 11713, 1995 WL 478954 at \*8 (Del. Ch. Aug. 9, 1995).

180. This fits well with the proposition that “entire fairness” includes “fair dealing,” and a process that replicates arm's-length negotiation is powerful evidence of “fair dealing.” *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709 n.7 (Del. 1983). If the powerful stockholder were required to unilaterally make the deal entirely fair, it would have to begin by offering a fully fair price. In such a circumstance there would be nothing left to negotiate. Surely, the objective or replicating arm's-length negotiations contemplates that the powerful stockholder will begin the process with less than its best offer.

*G. Proposed Solutions to the Lynch Doctrine*

Commentators<sup>181</sup> and one judge on the Court of Chancery<sup>182</sup> have proposed solving the *Lynch* Doctrine problems by abandoning the automatic application of the entire fairness standard when the merger is approved by both a special committee and a majority of the disinterested stockholders.<sup>183</sup> Under these proposals, the court would defer to the decision of a special committee of independent directors and give effect to ratification by independent stockholders.<sup>184</sup>

A complaint challenging a going-private merger would be subject to dismissal unless the plaintiff can plead particularized facts that (1) call into question the validity of board approval by either (a) creating doubt as to the special committee's independence, effectiveness, or performance of its fiduciary duties or (b) demonstrating that the committee was deceived or defrauded by the controlling stockholder, or (2) call into question the validity of stockholder ratification by either (a) faulty disclosures or (b) actual or structural coercion.<sup>185</sup> If the plaintiff succeeds in pleading facts that satisfy any one of these elements, the transaction would be judged under the entire fairness standard.<sup>186</sup>

This proposal has merit. It creates an incentive for transactional planners to fully remove the powerful stockholder from decision-making on the corporation's side of the transaction.<sup>187</sup> In this respect it accomplishes the goal of the *Lynch* Doctrine – to recreate as nearly as

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181. Subramanian, *supra* note 8, at 70; Gilson & Gordon, *supra* note 1, at 786.

182. *In re Cox Commc'ns, Inc. S'holders Litig.*, 879 A.2d 604, 606, 643 (Del. Ch. 2005). The proposal is laid out in what may be the longest dictum in Delaware jurisprudence.

183. *Id.* The Vice-Chancellor points out that in *Lynch* the Delaware Supreme Court held that the use of either (1) a special committee of independent directors, standing alone, and (2) ratification by a majority of the disinterested stockholders would shift the burden of proving unfairness to the plaintiff. *Id.* at 643-44. But, the Supreme Court has not yet ruled on the effect of using both devices concurrently. Thus, the Supreme Court would not have to overrule *Lynch* to hold that a going-private merger can be reviewed under the procedural and substantive aspects of the business judgment rule where the controlling stockholder conditions the merger on the use of both devices (requiring that board approval of the merger be based on the recommendation of a special committee of independent, disinterested directors and that stockholder approval come from disinterested stockholders).

184. *In re Cox Commc'ns*, 879 A.2d at 644.

185. *Id.*

186. *See id.* The opinion suggests that “if a controller proposed a merger, subject from inception to negotiation and approval of the merger by an independent special committee *and* a Minority Approval Condition, the business judgment rule should presumptively apply.” *Id.* Yet the opinion infers that, if the plaintiffs can plead “particularized facts that the special committee was not independent or was not effective because of its own breach of fiduciary duty or wrongdoing by the controller” then the entire fairness standard still applies. *Id.*

187. *Id.* at 606-07.

possible the dynamics of an arm's-length negotiation.<sup>188</sup>

The *Lynch* Doctrine was intended to encourage transactional planners to structure going-private mergers in a way that would assure that the merger price reflected arm's-length negotiation.<sup>189</sup> In an arm's-length merger, the board, functioning as an agent for the stockholders, seeks to negotiate the best deal it can achieve.<sup>190</sup> When it reaches a satisfactory agreement, the deal is submitted to the stockholders for their approval.<sup>191</sup> This provides the stockholders the opportunity to accept or reject the deal negotiated by their agent.<sup>192</sup> The acquiror's knowledge that the deal must be good enough to earn stockholder approval gives the target corporation's board a tool to negotiate a higher price.

To fully replicate this arm's-length process, the corporation would have to put the negotiation of the merger terms in the hands of independent directors and the stockholder approval in the hands of the independent stockholders. In this way, the independent directors could use the argument that the merger price would have to be attractive enough to earn the approval of the independent stockholders as a negotiating tool.<sup>193</sup>

The real flaw in the *Lynch* Doctrine is its preference for allowing the decision as to the fairness of the merger to be made by judges.<sup>194</sup> The court refused to rely on the business judgment of independent directors who approve, because it feared they would be intimidated by the controlling stockholder.<sup>195</sup> However, experience has shown that the use of a special committee has generated transactions that are more favorable to stockholders than transactions where the committee is not used.<sup>196</sup> The *Lynch* court also refused to give ratification effect to

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188. See Subramanian, *supra* note 8, at 8 (stating an arm's length negotiation consists of disinterested board approval and disinterested shareholder approval). "Translating the arms-length standard to the freezeout arena requires, first, meaningful approval by . . . [a special committee] of independent directors; and second, approval by a majority of the minority shareholders." *Id.*

189. See *In re Cox Commc'ns*, 879 A.2d at 617.

190. *Id.* at 618.

191. See *id.*

192. See *id.* at 618-19.

193. In practice, the *Lynch* Doctrine has not provided an incentive to condition going-private mergers on approval of the disinterested stockholders. See *id.* at 642-43. The Doctrine rewards the use of a special committee by shifting to the plaintiff the burden of proving unfairness. See *id.* at 616-17. But, *Lynch* provides no additional reward for taking the added step of conditioning the merger on approval by independent stockholder approval. See *id.* at 642-43.

194. See *Kahn v. Lynch*, 638 A.2d 1110, 1116 (Del. 1994).

195. See *In re Cox Commc'ns*, 879 A.2d at 617.

196. See Subramanian, *supra* note 8, at 25 (explaining that based on empirical evidence, special committees do generate transactions that are more favorable to stockholders than transactions where they are not present). For example, Subramanian notes that minority

approval of the transaction by disinterested stockholders because it feared that they would be intimidated by the controlling stockholder.<sup>197</sup> These proposals deal with this concern by discouraging the powerful stockholder from threatening retribution or attempting to inappropriately influence the stockholders. If the powerful stockholder were to engage in that type of behavior, it would lose the benefit of the business judgment rule.

Under these proposals, the plaintiff has the burden of pleading particularized facts that call into question whether the committee was truly independent and diligent and whether it performed its tasks in good faith. This is precisely in accord with the business judgment rule. Additionally, the question of whether the committee was vested with the power to allow it to truly negotiate at arm's length also bears on whether the committee has been allowed to function as a truly independent negotiator.<sup>198</sup>

These proposals are also consistent with the fundamental idea that a stockholder assumes a fiduciary duty to the corporation when the stockholder exercises control over the corporation's board. In the absence of facts suggesting that a stockholder, even a majority stockholder, is in a position to control or influence the board, there is no basis to impose on the stockholder a fiduciary duty of entire fairness. By creating a special committee of independent directors, the majority stockholder relinquishes the ability to exercise control over the board's decision. It is no longer "on both sides of the transaction" and thus should not have a duty of entire fairness.

However, the Vice Chancellor's proposal has one aspect that diverges from traditional ideas regarding the fiduciary duties of controlling stockholders. The Vice Chancellor would require a majority stockholder to state in its initial merger proposal that the merger be approved by the vote of a majority of the disinterested stockholders.<sup>199</sup> If such a provision is not included, the Vice Chancellor's proposal would require that a majority stockholder shoulder a fiduciary duty of entire fairness.<sup>200</sup>

This requirement conflicts with the traditional view that a majority

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shareholders receive less in tender offer freezeouts, where a committee is not required, than in merger freezeouts, where one is. *Id.* at 25. Subramanian continued, "This finding is further supported by practitioner impressions that the binary choice of a tender decision is not a substitute for vigorous bargaining by a [special committee]." *Id.*

197. Gilson & Gordon, *supra* note 1, at 800-01.

198. See *Lynch*, 638 A.2d at 1117.

199. *In re Cox Commc'ns*, 879 A.2d at 643-44.

200. *Id.* at 644.

stockholder's voting power is not limited by a fiduciary duty to the minority stockholders.<sup>201</sup> The court's insistence on approval by a majority of the minority necessarily has the effect of neutralizing the majority stockholder's voting power. In this respect, the proposal would limit a majority stockholder free to exercise its voting power in its self-interest. And by imposing the entire fairness standard of review if the majority stockholder does use its voting power, the court enters unprecedented territory. No Delaware case has held that a majority stockholder's exercise of its voting power, standing alone, can be judged under the exacting requirements of the entire fairness standard of review.<sup>202</sup> Indeed, the cases hold precisely the opposite.<sup>203</sup>

The better way to achieve the desirable result of giving the unaffiliated stockholders a veto over the going-private merger would be to focus on duties of the special committee. In the exercise of its independent duty to seek the best transaction for the public stockholders,<sup>204</sup> such a committee would have an obligation to seek to give the public stockholders (the ones whose shares will be canceled) a separate voice on the decision to approve the transaction. Thus the committee should at least demand that the merger be subject to approval by the independent stockholders. If the majority stockholder rejects this demand, that would be a fact that would call into question the majority stockholder's willingness to fully empower the of the committee, because the committee would not be able to use the argument that the price would have to be high enough to earn the approval of the stockholders as one of its negotiating tools.

Balance needs to be maintained. If the special committee is given too strong a hand, it may block a merger that would be good for stockholders.<sup>205</sup> The controlling stockholder can proceed in the face of a special committee's refusal with a going-private tender offer.<sup>206</sup>

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201. *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 845 (Del. 1987).

202. In *Hollinger International*, the court found that the exercise of voting power to further a scheme that was, itself, a breach of duty failed the entire fairness duty.

203. *E.g.*, *Thorpe v. CERBCO, Inc.*, Civ. A. No. 11713, 1995 WL 478954 at \*1 (Del. Ch. Aug. 9, 1995).

204. Cases have held that a majority stockholder does not have a Revlon duty to *offer* the best available price for the minority shares in a going-private merger. But, no case has held that a special committee charged with negotiating on behalf of the minority stockholders did not have an obligation to obtain the best available transaction. Indeed, the emphasis on trying to recreate the dynamics of an arm's-length negotiation demands that the committee be held to such an obligation.

205. *See In re Cox Comme'ns*, 879 A.2d at 644 n.86 (citing Subramanian, *supra* note 8, at 57-58).

206. *Id.* From the controlling stockholder's point of view, the more difficult problem is presented when the disinterested stockholders are few in number, and in a coordinated effort, the

### III. THE TWO-STEP GOING-PRIVATE PROCEDURE

The alternative means of eliminating the unaffiliated stockholders from the corporate enterprise is a two-step process.<sup>207</sup> At the first step, the controlling stockholder makes a tender offer for the shares held by the unaffiliated stockholders to bring its holdings up to at least 90%.<sup>208</sup> The second step is a short-form merger by which the shares held by the remaining stockholders are cancelled.<sup>209</sup> At the end of the two step process the controlling stockholder has acquired 100% of the corporation's equity.<sup>210</sup>

This Article deals with the judge-made common law of fiduciary duty as it relates to going-private transactions. Because the second step of this two-step process, the short-form merger, is governed entirely by statute, it will be discussed only briefly. Greater attention will be directed to the first step, the going-private tender offer.

#### A. *The Short-Form Merger*

Under Section 253 of the DGCL, a corporation (the "parent corporation") that holds at least 90% of the outstanding shares of another corporation (the "subsidiary corporation") may cause the subsidiary to be merged into parent by merely executing and filing with the Delaware secretary of state a certificate of merger.<sup>211</sup> This is called a "short-form" merger.<sup>212</sup> It can be accomplished unilaterally by the board of directors of the parent corporation.<sup>213</sup> It does not require approval by the subsidiary corporation's board or its stockholders.<sup>214</sup> Indeed, a parent

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majority withhold their votes in an effort to capture a premium for themselves. By resisting the controlling stockholder's going-private tender offer their numbers may be large enough to prevent the controlling stockholder from reaching the 90% minimum for the second-step, short-form merger.

207. See, e.g., *In re Pure Res., Inc. S'holders Litig.*, 808 A.2d 421, 435, 437 (Del. Ch. 2002); *In re Aquila, Inc. S'holders Litig.*, 805 A.2d 184 (Del. Ch. 2002); *In re Siliconix, Inc. S'holders Litig.*, No. Civ. A. 18700, 2001 WL 716787 (Del. Ch. June 21, 1990).

208. DEL. CODE ANN. tit. 8 § 253 (2006). The controlling stockholder would seek to increase its holdings to at least 90% because that is the minimum amount required to be able to effectuate a short-form merger under title 8, section 253, which is the second step of the two-step going-private procedure. *Id.*

209. *Id.*

210. *Id.*

211. *Id.* See also *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242, 244 (Del. 2000).

212. *In re Cox Commc'ns, Inc. S'holders Litig.*, 879 A.2d 604, 623 (Del. Ch. 2005) (indicating that a short-form merger permits the controller "to merge out the remaining stockholders if the controller's ownership had increased to 90% through the tender offer").

213. *Glassman*, 777 A.2d at 247.

214. DEL. CODE ANN. tit. 8 § 253; *Glassman*, 777 A.2d at 247.

corporation need not even notify the subsidiary or its minority stockholder until ten days *after* the merger.<sup>215</sup> Because the subsidiary's board has no role to play in the transaction, its members have no opportunity, much less a fiduciary duty, to protect the minority stockholders.<sup>216</sup>

A short-form merger is plainly a self-dealing transaction,<sup>217</sup> but Delaware law does not permit minority stockholders to challenge a short-form merger on the basis of breach of its fiduciary duty of entire fairness.<sup>218</sup>

The nature of a short-form merger is not consistent with the components of a duty of entire fairness.<sup>219</sup> The duty of entire fairness requires two things: "fair dealing" and the payment of a "fair price."<sup>220</sup> The short-form merger statute does not contemplate any "dealing" between parent and subsidiary.<sup>221</sup> Rather, the merger is accomplished unilaterally by the parent corporation.<sup>222</sup> For this reason, the Supreme Court concluded as a matter of statutory construction that it could not, as a matter of judge-made fiduciary duty law, impose a "fair dealing" requirement.<sup>223</sup> The only other component of the "entire fairness" standard that could be challenged would be "fair price." But, statutory appraisal is the "exclusive remedy" where the only basis for challenging a merger is the adequacy of the merger consideration.<sup>224</sup> Thus, the Delaware Supreme Court held that a short-form merger cannot be challenged for breach of the parent corporation's duty of entire fairness and that the exclusive remedy for a minority stockholder who objects to a short-form merger is statutory appraisal.<sup>225</sup>

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215. § 253; *Glassman*, 777 A.2d at 247.

216. *See generally* Subramanian, *supra* note 8 (explaining that "Delaware corporate law provides an important role for a target board in a statutory merger but no role for the board in a tender offer.")

217. *Glassman*, 777 A.2d at 247. Indeed, in a short-form merger the parent is not merely on "both sides of the transaction;" it is on the only side of the transaction. *Id.* A short-form merger is not something a parent does *with* a subsidiary corporation; it is something it does *to* the subsidiary corporation and its stockholders. *See id.*

218. *See id.* at 248.

219. *Id.* at 247-48.

220. *Id.* at 247.

221. *Id.*

222. *Id.* at 247-48.

223. *Id.* at 248.

224. *Id.*

225. *Id.*

### B. *The Going-Private Tender Offer*

Because a short-form merger is not governed by the entire fairness standard, transactional planners view it as an attractive means of finishing the process of taking a corporation private. But to do a short-form merger, the parent corporation must hold at least 90% of the subsidiary's stock.<sup>226</sup> The tender offer is the means by which a parent corporation may acquire enough shares to satisfy the 90% requirement.<sup>227</sup>

A tender offer is “[a]n offer to purchase shares made by a bidder directly to the stockholders of a target company . . . communicated to the shareholders by means of newspaper advertisements and (in most cases) by a general mailing to the entire list of shareholders.”<sup>228</sup> The significant point here is that the offer is made directly from the bidder to the stockholders.<sup>229</sup> It does not pass through, or require, approval by the corporation's board.<sup>230</sup> The decision to accept or reject the bidder's offer is made by the stockholders.<sup>231</sup> The corporation's board had no formal role to play.<sup>232</sup> Indeed, “[t]ender offers are not [even] addressed by the Delaware General Corporation Law. . . .”<sup>233</sup>

#### 1. Entire Fairness Is Not Required

Delaware courts have refused to impose a duty of entire fairness on a controlling stockholder that makes a tender offer for the unaffiliated shares.<sup>234</sup> The rationale is simply this: the controlling stockholder is not deemed to stand on both sides of the transaction.<sup>235</sup> The decision to accept the terms of the tender offer will be made by the corporation's stockholders, not by its board of directors.<sup>236</sup> The corporation is not a

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226. DEL. CODE ANN. tit. 8 § 253 (2006).

227. *In re Pure Res., Inc. S'holders Litig.*, 808 A.2d 421, 437 (Del. Ch. 2002).

228. STEPHEN M. BAINBRIDGE, *MERGERS AND ACQUISITIONS* 17 (Foundation Press 2003).

229. *See In re Pure Res.*, 808 A.2d at 437. Tender offers are regulated by provisions in the Federal securities laws. *See* Securities Exchange Act of 1934 §§ 13, 14, 15 U.S.C.A. §§ 78m(d), (e), 78n(d), (e) (West, Westlaw through 2007 legislation). *See generally* BAINBRIDGE, *Supra* note 227, at 277-310.

230. *In re Pure Res.*, 808 A.2d at 437.

231. *Id.*

232. *Id.* at 437-38.

233. *Id.* at 437.

234. *See, e.g., In re Siliconix, Inc. S'holders Litig.*, No. Civ. A. 18700, 2001 WL 716787, at \*6 (Del. Ch. June 21, 2001); *In re Aquila, Inc. S'holders Litig.*, 805 A.2d 184 (Del. Ch. 2002).

235. *See In re Siliconix*, 2001 WL 716787, at \*7-8.

236. *Id.* at \*7.

party to the transaction.<sup>237</sup> It issues the stock that is the subject of the transaction, but the parties to the transaction are the controlling stockholder (who makes the offer to buy) and the stockholders (who will decide based on their personal circumstances whether to sell).<sup>238</sup> Thus, the controlling stockholder's presumed ability to influence the board is not relevant.<sup>239</sup>

In the absence of a duty to be "entirely fair," the controlling stockholder is free to offer to purchase the shares at any price it chooses.<sup>240</sup> "[C]ourts do not impose any right of the shareholders to receive a particular price."<sup>241</sup> The controlling stockholder does not have to duty to offer a "fair" price.<sup>242</sup>

## 2. Controlling Stockholder's Disclosure Duty

A controlling stockholder has access to confidential corporate information.<sup>243</sup> This information gives it an advantage over the public stockholders.<sup>244</sup> Thus, Delaware requires the controlling stockholder who makes a tender offer for the public shares of its corporation to disclose all material information.<sup>245</sup>

## 3. Controlling Stockholder's Duty to Avoid Coercion

Delaware courts have long recognized that tender offers can be coercive.<sup>246</sup> The classic example is the "two-tier, front-end loaded" tender offer addressed by the Court in the famous *Unocal* case.<sup>247</sup> In that case, the bidder made a cash tender offer for enough shares to bring its holdings to 51%, and promised that when the tender offer closed, it would cause the company to enter into a merger in which the remaining shares would be canceled in exchange for junk bonds with a value that

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237. *Id.*

238. *Id.* at \*6-7.

239. *See Solomon v. Pathe Commc'ns Corp.*, 672 A.2d 35, 39 (Del. 1996); *see also* Subramanian, *supra* note 8, at 18 ("The [Solomon] court reasoned that a tender offer was a deal between the controlling shareholder and minority shareholders, which involved no conflict of interest.").

240. *See In re Pure Res., Inc. S'holders Litig.*, 808 A.2d 421, 438 (Del. 2002).

241. *Solomon*, 672 A.2d at 39.

242. *In re Pure Res.*, 808 A.2d at 438.

243. *Id.* at 442-43.

244. *Id.*

245. *In re Siliconix, Inc. S'holders Litig.*, No. Civ. A. 18700, 2001 WL 716787, at \*9 (Del. Ch. June 21, 2001).

246. *See, e.g., Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

247. *Id.*

was probably less than the tender offer price.<sup>248</sup> The structure of the transaction forced stockholders to respond favorably to the cash tender offer to avoid being stuck with dubious junk bonds in the merger.<sup>249</sup>

In a going-private tender offer, a controlling stockholder has a duty to structure the offer so that it is not coercive.<sup>250</sup> Structural coercion embraces the traditional idea of a wrongful threat that has the effect of intimidating stockholders into responding to the tender offer.<sup>251</sup> An example would be a tender offer structured to punish stockholders who chose to hold their stock rather than tender.<sup>252</sup> But, courts do not consider that kind of “inherent coercion” that troubled *Lynch* and its progeny in the context of a going-private merger to be coercive in the context of a going-private tender offer.<sup>253</sup>

#### 4. Common Law Duty of the Board of Directors

Although a corporation’s board has no statutory role to play when a tender offer is made to its shareholders, the board does have a common law duty.<sup>254</sup> In the context of a tender offer launched as part of a hostile takeover bid, the Delaware Supreme Court held that the board of a Delaware corporation has a “fundamental duty and obligation to protect the corporate enterprise, *which includes stockholders*, from harm reasonably perceived, irrespective of its source.”<sup>255</sup> It is this duty and power that provides the authority that allows boards of Delaware corporations to adopt poison pills and other defensive measures to fend off hostile tender offers.<sup>256</sup>

This duty to protect stockholders from potentially harmful tender offers derives from Delaware’s view that directors are “well-positioned to understand the value of the target company, to compensate for the disaggregated nature of stockholders by acting as a negotiating and auctioning proxy for them, and as a bulwark against structural coercion.”<sup>257</sup> Because stockholders are often disaggregated, they are not able to coordinate a common defense or negotiate a better deal for

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248. *Id.* at 949-51.

249. *Id.* at 956.

250. *See In re Siliconix*, 2001 WL 716787, at \*6.

251. *In re Pure Res., Inc. S’holders Litig.*, 808 A.2d 421, 438 (Del. 2002).

252. *Id.*

253. *Id.* at 438-39.

254. *Unocal*, 493 A.2d at 954.

255. *Id.* (emphasis added).

256. *See In re Pure Res.*, 808 A.2d at 440.

257. *Id.* at 441.

themselves; therefore, the corporation's board performs this function.<sup>258</sup>

The Delaware law regarding the duties of directors faced with a tender offer for their corporation's shares can be summarized this way: under the fiduciary duty principles established in *Unocal*, directors have a duty and a right to employ defensive measures to protect their corporation's stockholders from a poorly priced tender offer made by an unsolicited bidder,<sup>259</sup> but no case has held that directors have a duty to protect their corporation's stockholders from a poorly priced tender offer made by the controlling stockholder.<sup>260</sup> In the latter context, stockholders are left to fend for themselves.

Despite this obvious incongruity, the Delaware Court of Chancery has refused to impose a *Unocal* duty to protect stockholders or directors of a corporation faced with a tender offer by a controlling stockholder.<sup>261</sup> Indeed, the court held that even when the board of a controlled corporation appoints a special committee of the independent directors to respond to the controlling stockholder's tender offer, the committee does not have a duty to seek the power to employ defensive measures against the tender offer.<sup>262</sup> Deferring to what it referred to as the "sociology of controlled subsidiaries,"<sup>263</sup> the court refused to require the directors to protect stockholders from tender offers by controlling stockholders because it would be "awkward" to require directors to take aggressive action against the stockholder who had nominated and elected them.<sup>264</sup>

### C. The "Pure Resources" Solution

Instead of relying on the corporation's board of directors to perform the duties required of them under the Supreme Court's *Unocal* decision, in the *Pure Resources Stockholder Litigation* case, the court fashioned a new and highly specific fiduciary duty that controlling stockholders

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258. *See id.*

259. *Unocal*, 493 A.2d at 955. Bidders who launch unsolicited offers usually acquire about 5% of the corporation's stock before they announce the tender offer. Thus, they, like a controlling stockholder, are stockholders seeking to buy the shares held by other stockholders. The only difference is that the unsolicited bidder does not hold enough shares to influence the board.

260. *See In re Pure Res.*, 808 A.2d at 444. The court noted that there are many "edifying examples of subsidiary directors courageously taking no position on the merits of offers by a controlling stockholder." *Id.* at 443. The difference between the two circumstances, of course, is that the unsolicited bidder threatens the directors' retention of their positions on the board while the controlling stockholder is the one who nominated and elected the directors to serve on the board.

261. *See id.* at 421.

262. *Id.* at 446. This holding assumes that the tender offer is not "coercive."

263. *Id.*

264. *Id.*

must satisfy in a going-private tender offer.<sup>265</sup> This fiduciary duty requires a controlling stockholder to include three fairly meaningful terms in the offer:<sup>266</sup> (1) the offer must be subject to a non-waivable condition that a majority of the unaffiliated<sup>267</sup> shares tender,<sup>268</sup> (2) the controlling stockholder must promise that if it reaches the 90% threshold, it will consummate a prompt short-form merger for the same consideration as that offered in the tender offer,<sup>269</sup> and (3) the controlling stockholder must not make retributive threats.<sup>270</sup>

In addition, the Court of Chancery held that a “majority stockholder owes a duty to permit the independent directors of the target board both free rein and adequate time to react to the tender offer.”<sup>271</sup> For its part, the board of the controlled company must delegate to the independent directors the duty of fashioning the corporation’s response to the tender offer.<sup>272</sup> The independent directors should hire their own advisors, provide the unaffiliated stockholders with a recommendation as to the advisability of the offer, and provide the unaffiliated stockholders

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265. See *id.* at 445. These rules apparently apply only in the context of a going-private tender offer.

266. *Id.* at 445. The court does this by building on the controlling stockholder’s duty to structure the tender offer so that it is “non-coercive.” *Id.* The court holds that an offer that does not include these terms will be “coercive” as a matter of law. *Id.*

267. The court uses the term “majority of the minority,” but the requirement is imposed on a “controlling stockholder,” and a stockholder who holds less than a majority of the shares may nonetheless exercise practical control over the corporation. Thus, just as “minority” is the corollary to “majority,” so “unaffiliated stockholders” would be the corollary to “controlling stockholder.”

268. The duty to include these terms is imposed when the tender offer is launched for the purpose of bringing the controlling stockholder up to 90% as the first step of a two-step going-private transaction. In this context, the obligation to acquire a majority of the unaffiliated shares would be of consequence only to a controlling stockholder who owns between 80% and 89.999% of the controlled corporation’s stock. A controlling stockholder that owns less than 80% will always need to acquire a majority of the unaffiliated shares to bring its holdings up to 90%, and a controlling stockholder that owns 90% already has sufficient holdings to allow it to effectuate the short-form merger. Thus, only when a controlling stockholder owns between 80% and 89.999% of the controlled company’s stock is it possible to acquire less than a majority of the unaffiliated shares and still reach the 90% threshold for a short-form merger.

269. This term has little, if any, impact on these transactions because a tender offer made as the first step of a two-step going-private transaction will almost always provide that the acquisition is for enough shares to bring the controlling stockholder’s holdings up to 90% as a condition of the tender offer. In other words, in the usual case, the tender offer will not close unless the controlling stockholder receives enough shares to bring it up to 90%. Subramanian, *supra* note 8, at 18.

270. This term is of no consequence because the law already prohibits a controlling stockholder from threatening to use its clout to punish the unaffiliated stockholders who do not bend to its will. See *In re Cysive, Inc. S’holders Litig.*, 836 A.2d 531, 548 (Del. Ch. 2003). Moreover, the Delaware courts have long held that coercive tender offers are subject to injunctive relief. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

271. *In re Pure Res.*, 808 A.2d at 445.

272. See *id.*

adequate information to allow them to make an informed judgment.<sup>273</sup> Where these requirements have been satisfied, the court holds that the tender offer will not be judged under the entire fairness standard.<sup>274</sup> But, if they are not satisfied, the entire fairness standard will apply.<sup>275</sup> The court does not, however, offer a doctrinal justification for the application of the entire fairness standard to a tender offer.<sup>276</sup>

The court's solution essentially trusts stockholders, acting with the benefit of a recommendation from a special committee, to protect themselves from an inadequate tender offer.<sup>277</sup> The proposition that a recommendation from a board of directors is sufficient to protect disaggregated stockholders from a poorly priced tender offer is squarely contrary to the proposition on which the *Unocal* decision rests.<sup>278</sup> *Unocal* operated from the premise that a tender offer forces disaggregated stockholders to deal with a prisoner's dilemma.<sup>279</sup> Without the ability to speak and act as one, they are forced to accept what is offered.<sup>280</sup> By recognizing the board's right and duty to take defensive measures and to negotiate the terms under which such defenses would be removed, the Supreme Court empowered the board to act as an agent for the disaggregated stockholders to achieve a better deal.<sup>281</sup>

#### *D. A Better Way to Analyze Going-Private Tender Offers*

The present way of analyzing going-private tender offers begins with the proposition that a controlling stockholder is not on both sides of the transaction and thus does not bear a fiduciary duty of entire fairness.<sup>282</sup> The controlling stockholder is said not to straddle both sides

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273. *Id.* Of course the controlling stockholder also has a fiduciary duty to make fair disclosure to the stockholders and not mislead the stockholders or the independent directors. *Id.* at 445 n.47.

274. *Id.* at 445-46.

275. *See id.*

276. *See id.*

277. *See id.* at 444-46.

278. The court candidly acknowledges this inconsistency: "If our law trusts stockholders to protect themselves in the case of a controlling stockholder tender offer . . . this will obviously be remembered by advocates in cases involving defenses against similarly non-coercive third-party tender offers." *Id.* at 446 n.50.

279. *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 (Del. 1985); *In Re Pure Res.*, 808 A.2d at 442 ("[S]ome view tender offers as creating a prisoner's dilemma—distorting choice and creating incentives for stockholders to tender into offers that they believe are inadequate in order to avoid a worse fate.").

280. *See Unocal*, 493 A.2d at 956.

281. *Id.* at 957.

282. *See In re Pure Res.*, 808 A.2d at 441.

of the transaction because the tender offer is viewed as involving only the purchase (by the controlling stockholder) and sale (by the unaffiliated stockholders) of the company's stock.<sup>283</sup> This Article suggests that, in fact, the controlling stockholder is on both sides of a going-private tender offer because its power over the corporation's board of directors neutralizes the agent that is charged by Delaware common law with the task of defending the unaffiliated stockholders.

### 1. The Board's Duty to Defend

Under *Unocal* the board owes stockholders a duty to assess whether a tender offer for their shares poses a threat.<sup>284</sup> An offer may pose a threat where it is structured in a coercive way ("structural coercion") or where it is under-priced ("substantive coercion").<sup>285</sup> Where the board perceives such a threat, it has a duty and a right to protect the shareholders by taking appropriate defensive measures against the offer.<sup>286</sup> The ability to block a threatening tender offer gives the board the power to negotiate the removal of the block in exchange for restructuring the offer to remove the threat. The board's duty to protect unaffiliated stockholders, especially disaggregated stockholders from a poorly priced tender, applies with equal force no matter whether the offeror is a third-party or a stockholder.<sup>287</sup>

### 2. The Controlling Stockholder Is On Both Sides

To the extent a controlling stockholder is able to influence the board in its role as protector of the unaffiliated stockholders, the controlling stockholder has taken a position on the other side of the transaction. The controlling stockholder does not have the ability to accept the tender offer. But, by influencing the board it has the ability to prevent the board (in its capacity as the protector of the unaffiliated stockholders) from saying no to the tender offer. The ability to cause a board not to say "no" to a tender offer does just as much to place the controlling stockholder "on both sides of the transaction" as its ability to cause the board to say "yes" to a merger.

By disarming the stockholders' defenders, a controlling stockholder

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283. *In re Siliconix, Inc. S'holders Litig.*, No. Civ. A. 18700, 2001 WL 716787, at \* 7 (Del. Ch. June 21, 2001).

284. *Unocal*, 493 A.2d at 954.

285. *See In re Pure Res.*, 808 A.2d at 441.

286. *Unocal*, 493 A.2d at 955.

287. *Id.*

straddles both sides of the transaction and thus takes on a duty to assure that the structure and price of the tender offer are entirely fair to the unaffiliated stockholders. Seen in this light, and following traditional principles governing the fiduciary duties of controlling stockholders, a going-private tender offer should be subject to entire fairness review unless the controlling stockholder takes affirmative steps to neutralize its influence over the corporation's board of directors. The obvious way to do this would be to cause the corporation's board to appoint a special committee of independent directors to review the tender offer and to empower the committee to take such actions (including defensive actions) as it deems appropriate to serve the best interests of the unaffiliated stockholders.

### 3. Special Committee of Independent Directors

Where the corporation appoints a special committee of independent directors to respond to the tender offer and empowers these directors to take such defensive measures as they deem appropriate to protect the unaffiliated stockholders, it can be said that the controlling stockholder has been removed from the other side of the deal. The role of guardian for the unaffiliated stockholders has been returned to independent and powerful protectors. In this circumstance, the controlling stockholder is like any other offeror, except it presumably has an informational advantage because of its access to inside information. This informational advantage requires the controlling stockholder to make full disclosure to the corporation's board and its stockholders. Where these criteria are satisfied, there would be no grounds to support the imposition of a fiduciary duty of entire fairness on the controlling stockholder. And the decision of the independent committee would be entitled to the favorable presumptions of the business judgment rule, viewed with heightened scrutiny under the *Unocal* standard.

Viewed this way, the duty of protecting the unaffiliated stockholders would rest with the empowered independent directors. They would have duty to protect unaffiliated stockholders from poorly priced offers.

## IV. CONCLUSION

The revisions recommended by this Article in the way going-private mergers and going-private tender offers are analyzed would harmonize the standards by which these functionally identical transactions are reviewed by courts.

In both instances, the analysis would begin with the board of directors and would be conducted under the procedural and substantive aspects of the business judgment rule. In both cases, the corporation's board should delegate the job of negotiation and decision-making to a special committee of independent directors.<sup>288</sup> Failure to do so would support the inference that the powerful stockholder had retained its presumed control over the company's side of the transaction. In this event, the powerful stockholder would be deemed to be a controlling stockholder who was on both sides of the transaction. Accordingly, the transaction (going-private merger or going-private tender offer) would be reviewed under the entire fairness standard with the proponents of the transaction bearing the burden of proof.

Alternatively, where the negotiation and decision-making function is delegated to a special committee of independent directors, the committee's actions and decisions would be reviewed under the business judgment rule. Consistent with the procedural aspects of the business judgment rule, a complaint challenging the committee's actions or decisions would be subject to a motion to dismiss unless the plaintiff could meet its burden of pleading with particularity (1) facts that showed that the committee had not been given the power and resources to enable it to negotiate effectively on behalf of the unaffiliated stockholders (including, in the context of a going-private tender offer, the power to defend them when necessary), or (2) facts that called into question the independence, diligence, or good faith of the members of the committee. If the plaintiff is able to shoulder this burden as to the first point, the court would conclude that the powerful stockholder remained a "controlling stockholder." If the plaintiff proves facts that bear on the second point, then the plaintiff would have rebutted the favorable presumptions of the business judgment rule. In either event, the proponents of the transaction (going-private merger or tender offer) would have the burden of proving that it was entirely fair.

In the case of the going-private merger, the committee would decide whether the merger was in the best interests of the unaffiliated stockholders. Its fiduciary duties to the unaffiliated stockholders would require it to negotiate to give them a voice by requiring that the merger be approved by an absolute majority of their number.

In the case of the going-private tender offer, the committee would

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288. Consistent with other areas of the law, the mere fact that a majority of the corporation's stock is held by a single stockholder or an identifiable group would not, standing alone, be sufficient to impugn the directors' independence.

be charged with responsibility of determining whether the offer was structurally or substantively coercive. In either event the committee would have a *Unocal* duty to take appropriate measures to protect the stockholders.<sup>289</sup> The nature of these defensive measures would be a matter to be decided by the committee based on the nature of the threat and the needs of the unaffiliated stockholders.<sup>290</sup> For example, where the unaffiliated stockholders are sophisticated and able to coordinate their response, the committee might be able to meet this obligation by merely recommending that they reject the offer. Where the unaffiliated stockholders are numerous and disaggregated, the committee might need to implement stronger defensive measures (such as a poison pill) to block the offer. The decision as to what defense is appropriate should be left to the business judgment of the committee. A challenge to the committee's decision would be subject to the *Unocal* standard of review.<sup>291</sup>

Thus, the judicial standard by which the two types of transactions would be reviewed becomes identical. In both instances the business decision would be made by independent directors, not judges.

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289. See *Unocal*, 493 A.2d at 954-56.

290. *Id.* at 955.

291. Because of the presence of a controlling stockholder, these cases differ from takeover bids by third-parties where the corporation's managers can seek offers from others in the market for corporate control. Accordingly, *Unocal* would require members of the committee to explain why they blocked the offer.