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Fixing Freezeouts

ABSTRACT. Freezeout transactions, in which a controlling shareholder buys out the minority shareholders, have occurred more frequently since the stock market downturn of 2000 and the Sarbanes-Oxley Act of 2002. While freezeouts were historically executed as statutory mergers, recent Delaware case law facilitates a new mechanism – freezeout via tender offer – by eliminating entire fairness review for these transactions. This Article identifies two social welfare costs of the current doctrinal regime. First, the tender-offer-freezeout mechanism facilitates some inefficient (value-destroying) transactions by allowing the controller to exploit asymmetric information against the minority. Second, the merger-freezeout mechanism deters some efficient (value-increasing) transactions because of the special committee's veto power against the deal. These negative wealth effects are unlikely to be resolved through private contracting between the controller and the minority in the corporate charter. Rather than advocating patchwork reforms to correct these problems, this Article proposes a return to first principles of corporate law in the freezeout context. The result of this re-grounding would be a convergence in judicial standards of review for freezeouts and the elimination of the efficiency loss that is inherent in the existing doctrine.

AUTHOR. Joseph Flom Professor of Law & Business, Harvard Law School. A companion paper, *Post*-Siliconix *Freeze-Outs: Theory & Evidence* (Harvard Law Sch. John M. Olin Discussion Paper Series, Working Paper No. 472, 2005), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/Subramanian_472_revised.pdf, presents empirical evidence on freezeouts. I thank Bernard Black, John Coates, Jill Fisch, Ron Gilson, Victor Goldberg, Jeff Gordon, Zohar Goshen, Gregory Grogan, Joe Grundfest, Hon. Jack Jacobs, Jennifer Peresie, Hon. Leo Strine, Dan Titelbaum, and seminar participants at Boston University, the University of Chicago, Columbia University, the University of Delaware, Harvard University, and the University of Texas at Austin for comments on earlier drafts. I also benefited from insights developed at a panel discussion on freezeouts held at the Harvard Law School in April 2004, in which I participated with Frank Balotti, Bob Clark, Jim Morphy, Gil Sparks, and Hon. Leo Strine. The summer research fund at Harvard Law School, the Harvard Negotiation Research Project, and the John M. Olin Center for Law, Economics, and Business at Harvard Law School provided financial support.

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INTRODUCTION

On August 2, 2004, Barbara Cox Anthony and Anne Cox Chambers, who together owned a 62% equity interest and a 73% voting interest in Cox Communications, announced that they would offer $32 cash per share in a "freezeout"[1] of the Cox minority shareholders.[2] The offer represented a 16% premium over the preannouncement trading price for Cox, or $7.9 billion in total value.[3] Cox formed a special committee (SC) of three independent directors to review the offer and negotiate with the Cox sisters' representatives.[4] Minority shareholders sued alleging that the offer price was unfair.[5] Over the following four months, the SC bargained hard: counter-offering at $38 per share, walking away from the table at several points, and finally agreeing to a deal at $34.75 per share, representing a 26% premium over the pre-offer price.[6] The deal closed on December 8, 2004.[7]

One month later, on January 10, 2005, News Corporation, controlled by publishing magnate Rupert Murdoch, announced a freezeout exchange offer for the 18% of Fox Entertainment Group that it did not already own.[8] The proposed ratio of 1.9 News shares for each Fox share represented a 7.4% premium over the preannouncement trading price for Fox, or $6.0 billion in total value.[9] As in the Cox freezeout, Fox formed an SC of independent

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1. A freezeout is a transaction in which a controlling shareholder buys out the minority shareholders in a publicly traded corporation, for cash or the controller's stock. Freezeouts are also known, with some occasional loss of precision, as "going private mergers," "squeeze-outs," "parent-subsidiary mergers," "minority buyouts," "take outs," or "cash-out mergers."
2. Press Release, Cox Enters., Inc., Cox Enterprises, Inc. Proposes To Acquire Public Minority Stake in Cox Communications, Inc. (Aug. 2, 2004), *reprinted in* Cox Commc'ns Inc., Tender Offer Statement (Schedule TO-C), at Exhibit 99.1 (Aug. 2, 2004).
3. *See id.*
4. *See* Cox Commc'ns, Inc., Solicitation/Recommendation Statement (Schedule 14D-9), at 11-12 (Nov. 3, 2004).
5. *See In re* Cox Commc'ns, Inc. S'holders Litig., C.A. No. 613-N, 2005 WL 2001310, at *4 (Del. Ch. June 6, 2005).
6. *See* Cox Commc'ns, Solicitation/Recommendation Statement, *supra* note 4, at 5-9.
7. *See* Cox Commc'ns, Inc., Current Report (Form 8-K) (Dec. 8, 2004).
8. *See* Press Release, News Corp., News Corporation Announces Exchange Offer for Publicly Held Fox Common Stock (Jan. 10, 2005), *reprinted in* News Corp., Current Report (Form 8-K), at Exhibit 99.1 (Jan. 10, 2005).
9. *See id.*

directors to review the offer,[10] and plaintiffs' counsel filed suit alleging that the offer price was unfair to the minority. However, in contrast to the Cox freezeout, News stated that it might go forward with the transaction even if the Fox SC did not approve the offer.[11] On January 24, the Fox SC issued a statement taking no position on the News offer, explaining that it needed more time.[12] On March 4, News raised its offer to 2.04 News shares per Fox share, or a 17.6% premium over the preannouncement trading price for Fox.[13] On March 7, the SC approved the revised offer,[14] and the deal closed on March 22, 2005.[15]

As the Cox Communications and Fox Entertainment Group examples illustrate, freezeouts are back. Due at least in part to the stock market decline of 2000 and the additional costs imposed on public companies under the Sarbanes-Oxley Act of 2002,[16] freezeout activity in the United States has increased to more than twice its historical levels: 128 announced transactions in the four years between July 2001 and July 2005 (32 per year, on average),[17] compared to 154 freezeouts during the ten years between 1987 and 1996 (15 per year, on average).[18] At the same time that freezeout activity has been

10. *See* Fox Entm't Group, Solicitation/Recommendation Statement (Schedule 14D-9), at 9 (Jan. 24, 2005).

11. *See* Letter from K. Rupert Murdoch, Chairman and CEO, News Corp., to the Fox Entm't Group Bd. of Dirs. (Jan. 10, 2005), *reprinted in* Fox Entm't Group, Inc., Solicitation/Recommendation Statement, *supra* note 10, at 8 (stating that "Delaware law does not require that News Corporation negotiate with the Fox board or reach any agreement with the Fox board concerning the offer").

12. *See* Fox Entm't Group, Solicitation/Recommendation Statement, *supra* note 10, at 9-10.

13. *See* News Corp., Tender Offer Statement (Schedule TO), at 5 (Mar. 4, 2005).

14. *See* Fox Entm't Group, Amendment to Solicitation/Recommendation Statement (Schedule 14D-9/A), at 7 (Mar. 7, 2005).

15. *See* Fox Entm't Group, Solicitation/Recommendation Statement (Schedule 14D-9), at 4 (Mar. 22, 2005).

16. *See* Deborah Solomon & Cassell Bryan-Low, *Companies Complain About Cost of Corporate Governance Rules*, WALL ST. J., Feb. 10, 2004, at A1 (noting Sarbanes-Oxley compliance costs of between $1 and $2 million for larger U.S. public companies). The most recent estimates suggest even larger costs. *See, e.g.*, *Sarbanes-Oxley Compliance Cost Estimates Soar 62% Since January 2004*, PR NEWSWIRE, Aug. 11, 2004, http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/08-11-2004/0002229830&EDATE= (estimating average compliance costs of $3.1 million for larger U.S. public companies).

17. *See* Guhan Subramanian, Freezeouts Database (last updated Aug. 12, 2005) (on file with author) (compiling data from SEC filings and press releases on deal structure, negotiation process, and outcomes for all freezeouts of U.S. companies since June 2001).

18. *See* John C. Coates IV, *"Fair Value" as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions*, 147 U. PA. L. REV. 1251, 1334 (1999). This comparison may slightly understate the increase in freezeout activity, because the prior study defines freezeouts as acquisitions by shareholders with 30% or more of the shares, *see id.* at 1333 n.248, compared

increasing, the Delaware courts have established different standards of judicial review for the two ways of freezing out minority shareholders. The traditional route, known as a statutory merger freezeout, mandates an SC with veto power over the deal, followed by stringent "entire fairness" review by the courts. The Cox sisters (or, more accurately, their legal advisors) chose this transactional form for the Cox Communications freezeout. The new route, known as a tender offer freezeout, does not give the SC veto power and, at least as of mid-2001, is subject only to deferential business judgment review by the courts. News Corporation chose this transactional form for the Fox Entertainment freezeout.

These procedural differences have substantive implications. Examining the outcomes of all freezeouts in the current doctrinal regime, I find that minority shareholders received less in tender offer freezeouts than in merger freezeouts, as measured by premiums over preannouncement stock prices.[19] This finding is illustrated dramatically by the Cox and Fox examples above: If the Fox minority shareholders had received the same 26.0% premium that the Cox minority shareholders received (rather than their actual 17.6%), they would have achieved an additional $504 million in total consideration from News Corporation.

Commentators have debated the wisdom of doctrinal contours that create procedural and substantive differences based on choice of transactional form, and several have advocated convergence toward a single judicial approach to freezeouts.[20] The need for change has nevertheless remained unclear because of the possibility for adjustments in ex ante pricing of a minority stake. This Article makes the case for change by identifying two social welfare costs of the current regime. First, the tender-offer-freezeout mechanism facilitates some inefficient (value-destroying) transactions by allowing the controller to exploit asymmetric information against the minority. Second, the merger-freezeout mechanism deters some efficient (value-increasing) transactions because of the SC's power to veto the deal. Tender-offer-freezeout doctrine goes too far, and merger-freezeout doctrine does not go far enough, in facilitating freezeouts. Put another way, some companies that should not "go private" do, while others that should do not. As a result, there is a suboptimal distribution of companies between public and private status.

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to the 35% cutoff used in Guhan Subramanian, *Post*-Siliconix *Freeze-Outs: Theory & Evidence* (Harvard Law Sch. John M. Olin Discussion Paper Series, Working Paper No. 472, 2005), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/Subramanian_472_revised.pdf.

19. *See* Subramanian, *supra* note 18, at 48-49 tbl.3. These findings hold for the full sample as well as the subsample of Delaware targets. *See id.*

20. *See infra* Section I.D.

After identifying this efficiency loss, this Article proposes specific doctrinal adjustments that would fix freezeouts. Rather than propose a patchwork solution, this Article advocates a return to first principles of corporate law in the freezeout context. The objective is to replicate the elements of an arms-length negotiation—namely, disinterested board approval and disinterested shareholder approval—in the freezeout context. Translating the arms-length standard to the freezeout arena requires, first, meaningful approval by an SC of independent directors; and second, approval by a majority of the minority shareholders. When both of these procedural protections are provided, this Article proposes that courts should apply deferential business judgment review to assess the transaction. If either or both of these protections are absent, this Article proposes that courts should step in to scrutinize the transaction under the entire fairness standard. The result of this re-grounding would be convergence in standards of judicial review for freezeouts and elimination of the efficiency loss inherent in the existing doctrine.

The remainder of this Article proceeds as follows. Part I provides a brief history of freezeout doctrine, beginning with the Delaware Supreme Court's landmark decision *Weinberger v. UOP* in 1983, and tracing the evolution of this doctrine through *Kahn v. Lynch Communication Systems*, *Solomon v. Pathe Communications*, and the combination of *In re Siliconix Inc. Shareholders Litigation*, *Glassman v. Unocal Exploration Corp.*, and *In re Pure Resources, Inc. Shareholders Litigation* in 2001-2002. Part I also summarizes the literature to date examining this latest doctrinal contour and demonstrates that the case for change has remained unclear. Part II identifies an efficiency loss that arises in the current doctrinal regime. With the case for change thus clarified, Part III puts forward my proposal for reform.

I. BACKGROUND

A. Historical Origins of Freezeouts

Until the 1920s, minority shareholders had a property interest in the corporation that allowed them to hold out against a controlling shareholder's efforts to freeze them out.[21] While Florida enacted the first cash-out merger statute in the mid-1920s,[22] freezeouts only became commonplace when Delaware in the 1950s, and the Model Business Corporation Act in the 1960s,

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21. *See* Elliott J. Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624, 627-29 (1981) (citing case law).

22. *See id*. at 632.

adopted similar cash-out statutes.[23] These laws provided the statutory merger mechanism for freezing out minority shareholders, which remains the most common procedure today.[24] In a merger freezeout, the controlling shareholder establishes a wholly owned corporation; the target board (typically dominated by the controller) approves the merger; and the shareholders of the target (again, dominated by the controller) approve the transaction.[25] Under the terms of the merger, the minority shareholders receive either cash or the controller's stock in exchange for their shares in the target.[26] The transaction is executed as a statutory merger under section 251 of the Delaware General Corporation Law or analogous provisions in other states.

Delaware courts quickly established that freezeouts would be subject to judicial review for entire fairness to the minority shareholders.[27] The application of entire fairness review to freezeouts was unremarkable, as it is consistent with the Delaware courts' general approach to self-dealing transactions.[28] The situation became more interesting in the late 1960s and early 1970s, however, when the level of freezeout activity increased at the same time that the stock market experienced substantial declines.[29] Concerns emerged that controlling shareholders were taking advantage of fire-sale prices to eliminate powerless minority shareholders.[30] In a much-publicized speech given at the University of Notre Dame in November 1974, SEC Commissioner A.A. Sommer said:

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23. *See id*. at 648.

24. *See* Subramanian, *supra* note 18, at 18 (finding that more than two-thirds of freezeouts between June 2001 and April 2005 were executed through the statutory merger route).

25. *See* MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 1109-10 (8th ed. 2000) (describing the mechanics of statutory merger freezeouts and noting other techniques that, until twenty-five years ago, had "met with only indifferent success at the hands of the courts").

26. *Cf. id.* (noting that minority shareholders can also receive debt or redeemable preferred stock in the freezeout). I found that all freezeouts between June 2001 and April 2005 have offered either cash or common stock to the minority. *See* Subramanian, *supra* note 17.

27. *See, e.g.*, Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1952); Gottlieb v. Heyden Chem. Corp., 91 A.2d 57 (Del. 1952).

28. *See* DENNIS J. BLOCK ET AL., 1 THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 282-88 (5th ed. 1998) (discussing conflict transactions).

29. *See* WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 465 (2003).

30. *See, e.g.*, Lynch v. Vickers Energy Corp., 351 A.2d 570, 573 (Del. Ch. 1976) (describing a freezeout transaction by the controller in September 1974, "when the market price of TransOcean stock was abnormally depressed due to general unhealthy economic conditions"), *rev'd on other grounds*, 383 A.2d 278 (Del. 1977).

> Daily we read of companies which are offering to buy out all, or substantially all, of their shareholders, thus enhancing the control of the controlling shareholders and freeing the corporation of the "burdens" of being publicly-held. In other instances clever and indeed most imaginative devices are used to afford the small shareholders little, if any, choice in the matter. What is happening is, in my estimation, serious, unfair, and sometimes disgraceful, a perversion of the whole process of public financing, and a course that inevitably is going to make the individual shareholder even more hostile to American corporate mores and the securities markets than he already is.[31]

The SEC responded to the perceived problem with the promulgation of Rule 13e-3 in 1979.[32] Under this Rule, a controlling shareholder must make extensive disclosures to the minority in conjunction with a freezeout transaction—including the purpose of the transaction (and why alternative methods for achieving the same purpose were rejected),[33] a summary of the investment banker's fairness opinion,[34] and financial information such as current and historical market prices[35]—in order to facilitate an informed decision by minority shareholders.

While the SEC focused on disclosure, the Delaware courts, in a more gradual movement, established procedural protections for minority shareholders. I will now examine the evolution of this case law, which took place during the 1980s and 1990s.

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31. A.A. Sommer, Jr., Comm'r, SEC, Law Advisory Council Lecture, Notre Dame Law School (Nov. 1974), *in* [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,010, at 84,695 (Nov. 20, 1974); *see also* Arthur M. Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987, 987 (1974) ("A recent spate of attempts by public companies to rejoin the private sector has become, in less than one year, perhaps the most discussed topic in corporate law. News media, cases and the SEC have all become suddenly conscious of this unexpected offspring of an uncertain economy.").

32. *See* SEC Rule 13e-3, 17 C.F.R. § 240.13e-3 (2005).

33. *See* SEC Schedule 13e-3, Item 7, 17 C.F.R. § 240.13e-100 (2005) (referencing Item 1013 of Regulation M-A, 17 C.F.R. § 229.1013 (2005)).

34. *See id.* at Item 9 (referencing Item 1015 of Regulation M-A, 17 C.F.R. § 229.1015 (2005)).

35. *See id.* at Item 8 (referencing Item 1014 of Regulation M-A, 17 C.F.R. § 229.1014 (2005)).

B. *Development of Procedural Protections*

1. Weinberger v. UOP

The seminal case on freezeouts in the modern era is *Weinberger v. UOP*,[36] handed down by the Delaware Supreme Court in 1983. *Weinberger* involved a freezeout of UOP's minority shareholders by its 50.5% shareholder, Signal Companies. Minority shareholders brought suit alleging that the price paid, $21 per share in cash, was not fair to them. The Delaware Chancery Court held for the defendant directors, who were affiliated with both UOP and Signal.[37] The Delaware Supreme Court reversed, finding that the deal process did not meet the entire fairness standard, and remanded the case to the chancery court for an inquiry into the fair value of the minority shares.[38]

While *Weinberger* did several notable things,[39] for present purposes its most important contribution was the identification of the procedural protections that minority shareholders should receive in freezeout mergers. The Court began by noting that entire fairness review required both "fair dealing" and "fair price," and clarified what each of these entailed:

> [Fair dealing] embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. [Fair price] relates to the economic and financial considerations of the proposed merger, including all relevant factors . . . . However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.[40]

In assessing the transaction at hand, the court found several aspects problematic under this standard. First, the court criticized the fact that a valuation report prepared by two officers of Signal, who were also directors of UOP, was shared only with the Signal board and not with UOP.[41] This report

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36. 457 A.2d 701 (Del. 1983).

37. Weinberger v. UOP, Inc., 426 A.2d 1333 (Del. Ch. 1981), *rev'd*, 457 A.2d 701 (Del. 1983).

38. *See Weinberger*, 457 A.2d at 715.

39. For example, in *Weinberger*, the Delaware Supreme Court replaced the antiquated "Delaware block" method for valuing shares with "any techniques or methods which are generally considered acceptable in the financial community." *Id.* at 712-13.

40. *Id.* at 711 (citations omitted).

41. *Id.* at 708-09.

was "of obvious significance to both Signal and UOP"[42] because it indicated that any price up to $24 per share (14% higher than the $21 per share that was actually paid) would have been a good investment for Signal. Second, the court noted the casualness of the fairness opinion rendered by Lehman Brothers to the UOP board.[43] Among other deficiencies, the Lehman partner seemed to have reviewed the opinion only on the flight to the UOP board meeting, and, even at this late stage, the actual price being assessed by Lehman had been left blank.[44] Finally, the Court criticized James Crawford, President and CEO of UOP, for failing to negotiate in response to Signal's first offer of $21.[45]

But in the midst of its litany of criticisms of Signal's freezeout process, the *Weinberger* court paused to provide crucial guidance for transactional lawyers. In a much-noticed footnote, the court stated:

> Although perfection is not possible, or expected, the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's length. Since fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered nor pursued. Particularly in a parent-subsidiary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness.[46]

Transactional lawyers took the hint: An SC of independent directors quickly became standard practice in freezeout mergers.[47]

Two opposing concerns developed in response to the *Weinberger* SC mechanism. The first, voiced primarily by judges and academics, is that an SC

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42. *Id.* at 708.

43. *Id.* at 707.

44. *Id.*

45. *Id.* at 711 ("Crawford, Signal's man at UOP, never really talked price with Signal, except to accede to its management's statements on the subject, and to convey to Signal the UOP outside directors' view that as between the $20-$21 range under consideration, it would have to be $21. The latter is not a surprising outcome, but hardly arm's length negotiations.").

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

47. *See* Donald J. Wolfe, Jr., & Janine M. Salomone, Pure Resources, Printcafe *and the Pugnacious Special Committee*, M&A LAW., May 2003, at 10, 10 ("Since [*Weinberger*], the use of special negotiating committees has become commonplace . . . .").

can never be truly independent from the controlling shareholder because the controller is an "800-pound gorilla"[48] who inevitably will dominate the independent directors.[49] Among those who hold this view, some (generally academics) conclude that SCs should not warrant significant deference from the courts as suggested by *Weinberger*,[50] while others (generally judges) conclude that, even if soft ties exist between the controller and the SC, at least some judicial deference to an SC process is warranted because courts are not well-positioned to assess questions of value.[51]

The second concern, diametrically opposite from the first and voiced primarily by practitioners, is that SCs are too independent from the controller. As described by Charles Nathan, global co-chair of the mergers and acquisitions group at Latham & Watkins: "There are a number of times the committee turns down perfectly fine deals, or drags things out for months, because they can't get their act together. And it's a very, very frustrating experience."[52] Under this view, the *Weinberger* SC roadmap actually works to the detriment of minority shareholders by allowing independent directors with imperfect incentives to veto Pareto-improving transactions.

2. Kahn v. Lynch Communication Systems

In the years following *Weinberger*, these opposing views on the wisdom and efficacy of SCs, invoking fundamental questions of human nature and organizational behavior, manifested themselves in the Delaware courts as a narrow, but crucial, legal question: What level of deference should courts afford to a freezeout merger that was approved by an SC of independent directors? Footnote 7 of *Weinberger* was vague on this critical question. In the

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48. *See* Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 DEL. J. CORP. L. 499, 509 (2002) ("[T]his strain of thought was premised on the notion that when an 800-pound gorilla wants the rest of the bananas, little chimpanzees, like independent directors and minority stockholders, cannot be expected to stand in the way, even if the gorilla putatively gives them veto power.").

49. *See, e.g.*, Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) ("Entire fairness remains applicable even when an independent committee is utilized because the underlying factors which raise the specter of impropriety can never be completely eradicated and still require careful judicial scrutiny."); William T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1308 (2001) (noting that outside directors "are not hermetically sealed off from the inside directors").

50. *See, e.g.*, Melvin Aron Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 1002-03 (1988).

51. *See, e.g.*, ALLEN & KRAAKMAN, *supra* note 29, at 312; Allen et al., *supra* note 49, at 1306-07.

52. Telephone Interview with Charles Nathan, Global Co-Chair of Mergers and Acquisitions, Latham & Watkins LLP (Feb. 20, 2004).

absence of guidance, judges on the Delaware Chancery Court divided in their approaches in the late 1980s and early 1990s. In *In re Trans World Airlines, Inc. Shareholders Litigation*, for example, Chancellor Bill Allen held that SC approval changed the standard of review for a freezeout merger from entire fairness to highly deferential business judgment review.[53] In contrast, in *Citron v. E.I. Du Pont de Nemours & Co.*[54] and *Rabkin v. Olin Corp.*,[55] Vice Chancellors Jack Jacobs and Bill Chandler, respectively, held that SC approval only shifted the burden on entire fairness review from the defendant to the plaintiff.

These competing approaches were reconciled by the Delaware Supreme Court eleven years after *Weinberger* in *Kahn v. Lynch Communication Systems*.[56] *Lynch* involved a freezeout of the minority shareholders in Lynch Communications by Lynch's controlling shareholder, Alcatel. Following the *Weinberger* roadmap, the Lynch board established an SC of independent directors to negotiate with Alcatel.[57] Unlike the UOP representatives in *Weinberger*, the Lynch SC was not spineless: Alcatel proposed $14 per share in cash; the Lynch SC counter-offered $17; Alcatel responded with offers of $15, $15.25, and then a "final offer" of $15.50, all rejected by the Lynch SC.[58] To break the stalemate, Alcatel informed the SC that it was "'ready to proceed with an unfriendly tender [directly to the minority shareholders] at a lower price' if the $15.50 per share price was not recommended."[59] In the face of this threat, the Lynch SC caved and unanimously recommended approval of the $15.50 offer.[60]

Minority shareholders in *Lynch* brought suit seeking entire fairness review. The chancery court entered judgment for the defendants Alcatel and Lynch Communications,[61] and the plaintiffs appealed. The Delaware Supreme Court reversed on the grounds that the Lynch SC did not have the "power to say no" when faced with Alcatel's tender offer threat.[62] The court remanded the case to

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53. Civ. A. No. 9844, 1988 WL 111271, at *7 (Del. Ch. Oct. 21, 1988), *abrogated by* Kahn v. Lynch Commc'n Sys., 638 A.2d 1110 (Del. 1994).

54. 584 A.2d 490, 504-10 (Del. Ch. 1990).

55. C.A. No. 7547, 1990 WL 47648, at *6 (Del. Ch. Apr. 17, 1990), *aff'd*, 586 A.2d 1202 (Del. 1990).

56. 638 A.2d 1110 (Del. 1994).

57. *Id.* at 1113.

58. *Id.*

59. *Id.*

60. *Id.*

61. Kahn v. Lynch Commc'n Sys., Civ. A. No. 8748, 1993 WL 290193 (Del. Ch. July 9, 1993), *rev'd*, 638 A.2d 1110 (Del. 1994).

62. *Lynch*, 638 A.2d at 1119-20.

the Delaware Chancery Court with the burden on the defendants to demonstrate the entire fairness of the transaction.[63]

One of the interesting features in *Lynch* is that Alcatel did not threaten to execute a statutory merger unilaterally—which it had the legal ability to do because it controlled Lynch's board—but only threatened to go directly to the minority shareholders through a tender offer. Because Alcatel held only 43% of the Lynch shares, it would have needed 83% support from the minority shareholders (47% out of the remaining 57%) to achieve the 90% control that would then have allowed a short-form back-end merger.[64] Therefore, Alcatel's "threat" was nothing more than an invocation of Alcatel's otherwise legal walk-away alternative, in which Alcatel would have had to achieve overwhelming support from the minority in order to be successful. The *Lynch* court ignored this point, making clear the extent to which a controller must behave nicely in its negotiations with the SC.

And what exactly does the controller get from behaving nicely? Here too the *Lynch* court provided an unsatisfying answer from the controller's perspective. *Lynch* resolved the two strands of Delaware Chancery Court cases noted above by holding that even a pristine SC process only shifts the burden of proof to the plaintiff on entire fairness review.[65] Thus, *Lynch* implicitly endorses the view that independent directors cannot be truly independent from the controlling shareholder, and that courts still need to scrutinize freezeout transactions for entire fairness because of the inability to replicate an arms-length process between the controlling shareholder and the SC.

3. Rosenblatt v. Getty Oil

One could argue that while an SC may be captured by the controller, the minority shareholders cannot be, and therefore greater judicial deference should be afforded to approval by a majority of the minority shareholders (a

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63. On remand, the Delaware Chancery Court found that the defendants had met their burden to show entire fairness. Kahn v. Lynch Commc'n Sys., Civ. A. No. 8748, 1995 WL 301403, at *3 (Del. Ch. Apr. 17, 1995). The Delaware Supreme Court affirmed. Kahn v. Lynch Commc'n Sys., 669 A.2d 79 (Del. 1995). This result demonstrated that entire fairness review would not be outcome determinative. Thus, on remand, the chancery court left the bar high by not relinquishing entire fairness review, but the Supreme Court subsequently made clear that this bar was not insurmountable. *See* Jesse A. Finkelstein, *Special Committees, Entire Fairness, and* Kahn v. Lynch Communications, INSIGHTS, Mar. 1996, at 2, 5.

64. *See infra* text accompanying note 76. Because Alcatel held less than 50% of the shares, the court needed to determine whether it was a controlling shareholder, and concluded that it was. *Lynch*, 638 A.2d at 1114-15.

65. *See id.* at 1120-21.

"MOM condition").[66] Whatever appeal this argument may have as a matter of logic, the Delaware courts have rejected it, choosing instead to afford only minimal deference to MOM conditions. The seminal case on this point is *Rosenblatt v. Getty Oil Co.*,[67] handed down by the Delaware Supreme Court just two years after *Weinberger*. *Rosenblatt* involved the 1976 freezeout of the minority shareholders in Skelly Oil Company, which was 80% owned (directly and through a subsidiary) by Getty Oil.[68] In this deal, extensive negotiations took place between Harold Berg, Getty's Chief Operating Officer, and James Hara, President of Skelly. Because the deal was a pre-*Weinberger* transaction, before the benefits of the SC route were made clear, Skelly did not form an SC, even though Skelly had several independent directors on its board. Berg and Hara agreed to an exchange ratio of 0.5875 Getty shares for each Skelly share.[69] The Skelly board approved the deal and submitted it to a shareholder vote. Although the deal did not expressly contain a MOM condition, 89% of the voting Skelly minority shares, representing 58% of all minority shares, approved the transaction.[70]

The deal closed, and minority shareholders brought a fairness claim in the Delaware Chancery Court. The chancery court found the deal to be fair to the minority shareholders, and the plaintiffs appealed. In affirming the chancery court, the Delaware Supreme Court held that approval by the minority shareholders shifted the burden on entire fairness to the plaintiff but did not shift the standard of review to business judgment.[71] This case, like *Lynch* nine years later, illustrates the Delaware Supreme Court's unwillingness to relinquish entire fairness review regardless of the procedural protections that the controller provides.

Today, one puzzling (if unintended) consequence of the *Rosenblatt* and *Lynch* combination is that either SC approval or a MOM condition shifts the burden on entire fairness review, but the combination of the two procedural protections provides no further benefit to the controlling shareholder in terms of standards of judicial review. Empirically, the vast majority of controllers in my sample of post-*Siliconix* merger freezeouts (eighty out of eighty-five, or 94%) went through an SC process.[72] With the burden thus shifted through a well-functioning SC, controllers have no further incentive to provide a MOM

66. *See, e.g.*, Allen et al., *supra* note 49, at 1307-08 (proposing such an approach).

67. 493 A.2d 929 (Del. 1985).

68. *Id.* at 931.

69. *Id.* at 936.

70. *Id.*

71. *Id.* at 937.

72. *See* Subramanian, *supra* note 18, at 44 fig.1.

condition. Consistent with this prediction, I find that only one-third (eighteen out of fifty-five) of the merger freezeouts in my sample included a MOM condition.[73]

To summarize, while *Weinberger* provides the procedural roadmap for freezeout transactions, *Lynch* limits the benefits of this route by requiring a "Caesar's wife" SC process, and *Lynch* and *Rosenblatt* together hold that even an SC/MOM combination does not eliminate entire fairness review. From a transactional lawyer's perspective, merger-freezeout doctrine after *Lynch* and *Rosenblatt* represents the worst of all possible worlds: a fully empowered SC and a feisty negotiation with the controller, to be followed nevertheless with entire fairness review by the court, even if minority shareholders have approved the deal.[74] Of course, the potential beneficiaries of this approach are the minority shareholders, who should gain from both the procedural protections that *Weinberger* encourages and the judicial scrutiny that *Lynch* and *Rosenblatt* mandate.

In effect, the *Weinberger*-to-*Rosenblatt*-to-*Lynch* trajectory represents the Delaware courts' gradual approach to the problem of inadequate minority shareholder protections that presented itself in the 1970s. This gradual trajectory would be disrupted by the *Siliconix* and *Glassman* combination in 2001. I now turn to this latest doctrinal contour.

C. *Disruptive Technology: The Tender Offer Freezeout*

A statutory merger is not the only way to execute a freezeout; it can also be executed through a reverse stock split or an asset acquisition, though these methods are rare in practice.[75] Another method that began to appear in the 1990s was a freezeout via tender offer. In this route, the controlling shareholder would begin, or announce its intention to begin, a tender offer directly to the minority shareholders. The target would form an SC of independent directors to assess the transaction, negotiate with the controller, and issue a Schedule 14D-9 recommendation to the minority (e.g., approve, reject, neutral, or unable to take a position). If the controller gained sufficient

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73. *See id.*

74. *Cf.* Donald J. Wolfe, Jr., *The Odd Couple: Majority of Minority Approval and the Tender Offer*, M&A LAW., Nov./Dec. 2002, at 6, 8 ("Delaware law now seems to require that the committee be fully empowered to represent the interests of the minority actively in connection with the structuring and pricing of the deal . . . . Any less than this is highly likely to result in a judicial refusal to afford the committee process any of the hoped-for cleansing effect on the otherwise interested transaction.").

75. *See* Subramanian, *supra* note 18, at 15-16 (noting that 2 out of 121 post-*Siliconix* freezeouts were executed as reverse stock splits rather than as statutory mergers or tender offers).

shares in its tender offer to get to 90% voting control of the target, it would then execute a short-form merger, which does not require a shareholder vote, in order to eliminate the remaining (nontendering) minority shareholders.[76] Because 90% is the critical threshold in a tender offer freezeout, the controller would typically condition its offer on getting to 90% control (a "90% condition").

1. Solomon v. Pathe Communications

Historically, practitioners assumed that tender offer freezeouts would also be subject to entire fairness review, because they achieved the same end result as merger freezeouts, namely, the elimination of the minority shareholders.[77] As a result there was no obvious benefit to be gained from a tender offer freezeout, and the merger form continued to dominate in practice. This calculus began to change in the mid-1990s with the Delaware Supreme Court's decision in *Solomon v. Pathe Communications Corp*.[78] The *Solomon* court affirmed a chancery court holding that a tender offer by a controlling shareholder to the minority was not subject to entire fairness review.[79] The court reasoned that a tender offer was a deal between the controlling shareholder and minority shareholders, which involved no conflict of interest.[80]

Because the tender offer was for less than all the minority shares, *Solomon* was not a freezeout situation, and could easily have been limited to its facts.[81] Practitioners nevertheless read the tea leaves of *Solomon* to suggest that a

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76. *See* DEL. CODE ANN. tit. 8, § 253 (2001 & Supp. 2004); *see also* MODEL BUS. CORP. ACT § 11.04 (1983).

77. *See* Bradley R. Aronstam et al., *Delaware's Going-Private Dilemma: Fostering Protections for Minority Shareholders in the Wake of* Siliconix *and* Unocal Exploration, 58 BUS. LAW. 519, 520 (2003). While *Lynch v. Vickers Energy Corp.*, 351 A.2d 570 (Del. Ch. 1976), *rev'd on other grounds*, 383 A.2d 278 (Del. 1977), declined to apply entire fairness review to a tender offer freezeout, it was not clear that this decision survived *Weinberger*, nine years later.

78. 672 A.2d 35 (Del. 1996).

79. *See id.* at 39.

80. *See id.* at 39-40 ("In the case of totally voluntary tender offers, as here, courts do not impose any right of the shareholders to receive a particular price. . . . [I]n the absence of coercion or disclosure violations, the adequacy of the price in a voluntary tender offer cannot be an issue.") (citations omitted).

81. *See* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 818 n.122 (2003) (noting a potential narrow reading of *Solomon*).

tender offer freezeout might not be subject to entire fairness review.[82] But even if this interpretation were correct, it was not clear that a controlling shareholder could avoid entire fairness review in the back-end short-form merger that would be necessary to complete the freezeout.[83] As a result of this doctrinal uncertainty, practitioners continued to stay away from tender offer freezeouts in favor of the traditional merger route.

2. *In re* Siliconix Inc. Shareholders Litigation

The test case on the front-end tender offer came five years after *Solomon*, in *In re Siliconix Inc. Shareholders Litigation*.[84] *Siliconix* involved Vishay Intertechnology's freezeout of the minority shareholders in Siliconix. Vishay, which owned 80.4% of Siliconix, announced a tender offer for the minority shares at $28.82 cash per share.[85] With Vishay's encouragement, Siliconix appointed an SC of two independent directors to negotiate with Vishay.[86] The SC hired legal and financial advisors and concluded that the offer price was inadequate.[87] After three months of negotiations, Vishay switched from a cash tender offer to a stock exchange offer at a ratio of 1.5 Vishay shares for every Siliconix share.[88] Minority shareholders brought suit alleging that the exchange ratio being offered was unfair. Citing *Solomon*, among other cases, the Delaware Chancery Court declined to apply entire fairness review to the tender offer freezeout: "Because . . . there were no disclosure violations and the tender is not coercive, Vishay was not obligated to offer a fair price in its tender."[89]

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82. An unpublished opinion two years after *Solomon* and three years before *Siliconix* foreshadowed that these tea leaves were correct. *See In re* Life Tech., Inc. S'holders Litig., No. C.A. 16513, 1998 WL 1812280 (Del. Ch. Nov. 24, 1998).

83. *See In re* Pure Res., Inc. S'holders Litig., 808 A.2d 421, 437 (Del. Ch. 2002) (explaining the uncertainty that existed in the mid-1990s regarding whether entire fairness would apply).

84. No. Civ. A. 18700, 2001 WL 716787 (Del. Ch. June 19, 2001).

85. *Id.* at *1-2.

86. *Id.* at *2.

87. *Id.* at *3.

88. *Id.* at *3-4.

89. *Id.* at *6. As defenders of the decision point out, Vishay did not receive sufficient tenders to meet its MOM condition, thus calling into question whether its offer might have been "coercive" to the minority. *See, e.g.*, A.C. Pritchard, *Tender Offers by Controlling Shareholders: The Specter of Coercion and Fair Price*, 1 BERKELEY BUS. L.J. 83, 101 (2004); Strine, *supra* note 48, at 512-13. In March 2005, Vishay announced a new exchange offer for the 20% of Siliconix that it did not hold. *See* Press Release, Siliconix, Inc., Siliconix Announces Engagement of Lehman Brothers Inc. and Heller Ehrman LLP To Assist Siliconix Special

3. Glassman v. Unocal Exploration

Just one month after *Siliconix*, the Delaware Supreme Court provided an answer on the remaining piece, the back-end short-form merger. In *Glassman v. Unocal Exploration Corp.*,[90] handed down in July 2001, the parent company Unocal Corporation (Unocal) owned 96% of its subsidiary Unocal Exploration Corporation (UXC).[91] Unocal decided to freeze out the minority shareholders, and UXC appointed an SC of three directors to negotiate the terms of the deal.[92] The parties negotiated an exchange ratio of 0.54 Unocal shares for each UXC share, and, because Unocal held more than 90% of UXC, the freezeout was executed as a short-form merger under section 253 of the Delaware corporate code.[93]

Minority shareholders brought suit alleging that the transaction was unfair. The Delaware Chancery Court declined to apply entire fairness review and dismissed the claim.[94] The Delaware Supreme Court affirmed, holding that "absent fraud or illegality, appraisal is the exclusive remedy available to a minority shareholder who objects to a short-form merger."[95] The court reasoned that section 253 was intended to provide a streamlined process for accomplishing a merger, which is squarely at odds with the procedural apparatus that the fair process prong of entire fairness requires: "If . . . the corporate fiduciary sets up negotiating committees, hires independent financial and legal experts, etc., then it will have lost the very benefit provided by the statute—a simple, fast and inexpensive process for accomplishing a merger."[96]

Thus, with *Glassman*, the other shoe had dropped, and practitioners now had a blueprint for avoiding entire fairness review in a freezeout transaction. Under *Siliconix*, a tender offer to the minority would be exempt from entire

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Committee in Evaluating Vishay Tender Offer (Mar. 24, 2005), *reprinted in* Siliconix, Inc., Current Report (Form 8-K), at Exhibit 99 (Mar. 24, 2005). This time, the offer was successful, more than four years after Vishay began its effort to take its 80% subsidiary private. *See* Press Release, Vishay Int'l, Vishay Announces Successful Completion of Siliconix Tender Offer (May 12, 2005), *reprinted in* Vishay Intertechnology, Inc., Current Report (Form 8-K), at Exhibit 99 (May 13, 2005). The deal closed on May 17, 2005.

90. 777 A.2d 242 (Del. 2001).

91. *Id.* at 243.

92. *Id.*

93. *Id.* at 243-44.

94. *In re* Unocal Exploration Corp. S'holders Litig., 793 A.2d 329 (Del. Ch. 2000), *aff'd sub nom.* Glassman v. Unocal Exploration Corp. (*In re* Unocal Exploration Corp. S'holders Litig.), 777 A.2d 242 (Del. 2001).

95. *Glassman*, 777 A.2d at 248.

96. *Id.* at 247-48.

fairness review, and if the controller got to 90% voting control, the back-end short-form merger would also be exempt under *Glassman*. Practitioners,[97] academics,[98] and judges[99] quickly noted the disparity in judicial treatment between tender offer freezeouts and merger freezeouts. At the same time that *Lynch* refused to abandon entire fairness review, even with a well-functioning SC process, *Siliconix/Glassman* readily deferred to the unilateral action of the controlling shareholder. The result was dramatically different standards of review for two functionally identical transactional forms.

4. *In re* Pure Resources

In re Pure Resources Shareholder Litigation,[100] the most recent doctrinal development on freezeouts, begins to address this disparity. *Pure Resources* involved Unocal Exploration (again) tendering for the 35% of Pure Resources that it did not own. Minority shareholders (again) brought suit alleging unfairness. After an extensive discussion of the "two strands of authority that answer these questions differently,"[101] Vice Chancellor Leo Strine, following *Solomon*, declined to apply entire fairness review to Unocal's freezeout tender offer.[102] However, in a clear effort to close some of the gap between the two doctrinal strands, Vice Chancellor Strine noted that the *Solomon* exemption from entire fairness review only applied to tender offers that were noncoercive to the minority.[103] The court seized on this qualification to establish three procedural conditions that must be met in order for a tender offer to be noncoercive: (1) the offer must be subject to a nonwaivable MOM condition;

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97. *See, e.g.*, Aronstam et al., *supra* note 77; Jesse A. Finkelstein, *Recent Delaware Court Decisions Show Path To Avoid Entire Fairness Review in Subsidiary Buy-Out Transactions*, 33 Sec. Reg. & L. Rep. (BNA) 1151 (2001); Charles Nathan & David Schwartzbaum, Latham & Watkins LLP, Client Presentation: Going Private Via Unilateral Tender Offer (2002) (on file with author).

98. *See, e.g.*, Gilson & Gordon, *supra* note 81, at 817-27; Pritchard, *supra* note 89, at 83.

99. *See, e.g.*, *In re* Pure Res., Inc. S'holders Litig., 808 A.2d 421, 443 (Del. Ch. 2002) ("I admit being troubled by the imbalance in Delaware law exposed by the *Solomon*/Lynch lines of cases."); *In re* Siliconix Inc. S'holders Litig., No. Civ. A. 18700, 2001 WL 716787, at *7 (Del. Ch. June 19, 2001) ("It may seem strange that the scrutiny given to tender offer transactions is less than the scrutiny that may be given to, for example, a merger transaction . . . .").

100. 808 A.2d 421.

101. *Id.* at 435.

102. *Id.* at 443-44.

103. *See* Solomon v. Pathe Commc'ns Corp., 672 A.2d 35, 40 (Del. 1996) ("[I]n the absence of coercion or disclosure violations, the adequacy of the price in a voluntary tender offer cannot be an issue.").

(2) the controller must guarantee to consummate a prompt short-form merger at the same price if it obtains 90% or more of the shares; and (3) the controller must make no "retributive threats" in its negotiations with the SC.[104] The *Pure Resources* court confirmed, however, that if these conditions were met then a tender offer freezeout would not be subject to entire fairness review.

5. *Synthesis*

To summarize, Delaware law currently offers a controlling shareholder two transactional forms for a freezeout: the statutory merger route and the tender offer route. These two forms appear similar at the outset. In each case the process begins when the controller informs the target board of its intention to freeze out the minority, and the target board responds by establishing an SC of independent directors. But at this point the similarity disappears. While the SC in a merger freezeout has veto power over the transaction and in theory can negotiate indefinitely, the SC in a tender offer freezeout cannot veto the transaction and has only ten days to issue its 14D-9 recommendation to the minority. The difference continues in the standard of judicial review imposed: entire fairness review for merger freezeouts compared to business judgment review for tender offer freezeouts. Perhaps not surprisingly in view of this procedural divergence, the substantive outcomes differ significantly as well: Controlling shareholders pay less to the minority, on average, in tender offer freezeouts than in merger freezeouts.[105] I now review the academic and practitioner commentary that has developed in response to this state of play.

D. *Prior Literature*

Commentators have divided on the *Weinberger*-to-*Pure Resources* line of cases. These responses can be divided into three categories: those who advocate convergence in standards of judicial review by subjecting tender offer freezeouts to entire fairness review; those who defend the status quo; and

104. *See In re Pure Res.*, 808 A.2d at 445. In a companion paper I report that these conditions were present in most tender offer freezeouts even before *Pure Resources*. *See* Subramanian, *supra* note 18, at 48 tbl.2; *see also* Christopher A. Iacono, Comment, *Tender Offers and Short-Form Mergers by Controlling Shareholders Under Delaware Law: The "800-Pound Gorilla" Continues Unimpeded—In re* Pure Resources, Inc., Shareholders Litigation, 28 DEL. J. CORP. L. 645, 668-69 (2003) ("The court's requirement that tender offers contain these three prerequisites will have little practical effect. This is because most recent tender offer/short-form merger transactions have already been structured to include these requirements." (footnote omitted)).

105. *See* Subramanian, *supra* note 18, at 48 tbl.3.

those who propose hybrid approaches. This Section summarizes and assesses each of these positions in turn.

1. *Advocating Entire Fairness Review for Tender Offer Freezeouts*

At one end of the spectrum, some commentators argue for doctrinal convergence through entire fairness review for tender offer freezeouts on the grounds of doctrinal coherence.[106] Although this simple solution has some superficial appeal, there are two problems with it. First, it does not take into account the costs of judicial intervention. Because courts are not well positioned to engage in the difficult task of valuation, entire fairness review should be deployed sparingly. In fact, part of the explanation for the dramatic doctrinal gap between *Lynch* (a Delaware Supreme Court decision) and *Siliconix* (a Delaware chancery court decision) may be the fact that chancery judges "personally face the daunting task of valuation" and, therefore, may be "institutionally inclined to avoid it wherever they can do so responsibly."[107] This aspect of judicial realism suggests that the simple solution of applying entire fairness review may not adequately account for institutional realities and may introduce judicial costs that outweigh the benefits of doctrinal convergence.

Second, and more importantly, entire fairness review for all freezeouts does not necessarily follow from the general argument in favor of doctrinal convergence. The argument for convergence "up" focuses on providing adequate procedural protections to minority shareholders, but an important counterargument is that entire fairness review for all freezeouts may deter some value-creating transactions. In an important article published just before *Siliconix*, two sitting Vice-Chancellors and a former Chancellor proposed convergence "down" to business judgment review for all freezeouts that received SC approval, in effect proposing a reconsideration of the rule in

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106. *See, e.g.*, Ely R. Levy, *Freeze-out Transactions the* Pure *Way: Reconciling Judicial Asymmetry Between Tender Offers and Negotiated Mergers*, 106 W. VA. L. REV. 305 (2004); 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 (2003); *see also* 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 (2003) (proposing entire fairness review for tender offers in addition to possible amendments to the Delaware corporate code or federal intervention).

107. ALLEN & KRAAKMAN, *supra* note 29, at 312.

Lynch.[108] The question of convergence "up" or convergence "down" cannot be resolved on a theoretical level. But at the very least it is clear that arguments for convergence only invite the larger question of convergence to what. Commentators who support entire fairness review for all freezeouts do not adequately address this issue.

2. *Defending the Status Quo*

A second group of commentators defend the doctrinal contour that *Siliconix* and *Glassman* establish.[109] These commentators put forward three arguments in support of this view. The first is formalistic: 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. Therefore, judicial scrutiny of a tender offer is not warranted because there is no corporate action. This argument was central to the court's reasoning in *Siliconix*: "[T]ender offers essentially represent the sale of shareholders' separate property and such sales—even when aggregated into a single change in control transaction—require no 'corporate' action and do not involve distinctively 'corporate' interests."[110]

The problem with this argument, as noted by academics[111] and even other chancery court judges,[112] is that it ignores one of the most important strands of Delaware corporate law of the past twenty years, which is precisely about articulating the board's role in a tender offer: the degree to which a target board may adopt defensive measures against a hostile tender offer.[113] Thus, this argument creates a tension, if not outright contradiction, between the board's

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108. *See* Allen et al., *supra* note 49, at 1306-09.

109. *See, e.g.*, Jon E. Abramczyk et al., *Going-Private "Dilemma"?—Not in Delaware*, 58 BUS. LAW. 1351 (2003); Pritchard, *supra* note 89.

110. *In re* Siliconix Inc. S'holders Litig., No. Civ. A. 18700, 2001 WL 716787, at *7 (Del. Ch. June 19, 2001).

111. *See* Gilson & Gordon, *supra* note 81, at 820-21.

112. *See In re* Pure Res., Inc. S'holders Litig., 808 A.2d 421, 441 (Del. Ch. 2002) ("Because tender offers are not treated exceptionally in the third-party context, it is important to ask why the tender offer method should be consequential in formulating the equitable standards of fiduciary conduct by which courts review acquisition proposals made by controlling stockholders.").

113. The list is well known to students of Delaware corporate law; the most important in this line of cases are *Unitrin v. American General Corp.*, 651 A.2d 1361 (Del. 1995); *Paramount Communications v. Time*, 571 A.2d 1140 (Del. 1990); *Blasius Industries v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988); and *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). *See generally* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 940-44 (2002) (summarizing the evolution of this doctrine).

role in freezeout tender offers (none) and the board's role in hostile tender offers (substantial). If the distinguishing feature is the nature of the bidder (controlling shareholder versus hostile bidder), then it would seem that minority shareholders should receive more protection in the freezeout case, rather than less, because in a freezeout there is no market check on the bidder's actions.[114]

A second argument made by proponents of the status quo is that minority shareholders have adequate protection from coercive or inadequate tender offers from their tender decision itself.[115] Again, this theory was offered as part of the rationale in *Siliconix*: "[A]s long as the tender offer is pursued properly, the free choice of the minority shareholders to reject the tender offer provides sufficient protection."[116] The problem with this argument is that it is inconsistent with my empirical evidence, which shows that minority shareholders receive less in tender offer freezeouts than in merger freezeouts. This finding is further supported by practitioner impressions that the binary choice of a tender decision is not a substitute for vigorous bargaining by an SC. As described by Jim Morphy, head of the mergers and acquisitions practice at Sullivan & Cromwell in New York City:

> In a tender offer the controlling stockholder, in effect, says to the other stockholders, "Here is my offer: the stock was trading at $6.25, I'm willing to pay you $8.00. That's your choice—you can have $8.00 or you can have $6.25." Because it is difficult for stockholders, as a group, to bargain collectively, the tendency if you are a stockholder is to take the $8.00. Someone might have a mathematical analysis of how this all works but that is essentially what takes place in the absence of an effective bargaining agent like a special committee. In the merger scenario, given the difference in statutory and legal standards, the special committee is not as easily by-passed by the controlling stockholder. Therefore its choice is not between $6.25 and $8.00.

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114. *See In re Pure Res.*, 808 A.2d at 441-42.

115. *See, e.g.*, Abramczyk et al., *supra* note 109; Pritchard, *supra* note 89, at 101-03; *cf.* Thomas M. McElroy, II, Note, *In re* Pure Resources*: Providing Certainty to Attorneys Structuring Going-Private Transactions, or Not?*, 39 WAKE FOREST L. REV. 539, 555 (2004) (arguing that procedural protections introduced by *Pure Resources* make the merger-freezeout and tender-offer-freezeout processes "more similar").

116. *In re* Siliconix Inc. S'holders Litig., No. Civ. A. 18700, 2001 WL 716787, at *6 (Del. Ch. June 19, 2001).

> Armed with information and sufficient authority, it can go out and negotiate for something better.[117]

In short, both empirical evidence and practitioner impressions reject the view that minority shareholders have adequate protections in freezeout tender offers, at least as measured against the benchmark of the freezeout merger process.

The final argument put forward in defense of the status quo is less easily dismissed. In a standard, yet important, law-and-economics move, Adam Pritchard points out that the arrival of tender offer freezeouts will, at most, create a one-time wealth transfer from minority shareholders to the controller.[118] Going forward, minority shareholders will simply pay less for a minority stake knowing that they may get frozen out at a lower price sometime in the future. Therefore, from an ex ante perspective, *Siliconix* does not influence the distribution of gains between minority shareholders and the controller; by extension, *Siliconix* will have no effect on allocational efficiency.

This is a simple but powerful argument, one that commentators in favor of doctrinal convergence have not addressed. Nevertheless, there are some problems with it. Pritchard overstates the simplicity of the ex ante calculation by assuming that all, or virtually all, practitioners have shifted to the tender offer mechanism for freezing out minority shareholders in the aftermath of *Siliconix* and *Glassman*. Indeed, this assumption has found strong support among academics,[119] practitioner-oriented journals,[120] and even practitioners

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117. Jim Morphy, Partner, Sullivan & Cromwell, Remarks at Harvard Law School Panel Discussion on Freezeouts (Apr. 9, 2004).

118. *See* Pritchard, *supra* note 89, at 103; *see also* ROBERT CHARLES CLARK, CORPORATE LAW § 12.2, at 506 (1986) ("[O]nce the power of a controlling group to freeze out other shareholders becomes clearly established by case law or statute and the governing rules become widely known, shareholders can't raise the defeated-expectations argument anymore.").

119. *See, e.g.*, Gilson & Gordon, *supra* note 81, at 805 ("[W]hen rules governing one or another alternative get out of line, transaction planners are quick to adjust their strategies to compensate, such that the Delaware Chancery Court sees the implications of its previous decisions quickly and is promptly given the opportunity to adjust the rules and restore balance.").

120. *See* David Marcus, *Cleaning Up Your Corporate Structure*, CORP. CONTROL ALERT, July 2003, at 20 ("The current thinking on minority buyouts, many lawyers say, boils down to two words: tender offer."); *see also In re* Pure Res., Inc. S'holders Litig., 808 A.2d 421, 443 (Del. Ch. 2002) ("The absence of convincing reasons for this disparity in treatment inspires the plaintiffs to urge me to apply the entire fairness standard of review to Unocal's offer. Otherwise, they say, the important protections set forth in the *Lynch* line of cases will be rendered useless, as *all controlling stockholders* will simply choose to proceed to make subsidiary acquisitions by way of a tender offer and later short-form merger." (emphasis added)).

themselves.[121] If this assumption were correct, then the ex ante price adjustment would be an estimate of the lower price that minority shareholders would expect to receive in a tender offer freezeout relative to a merger freezeout, discounted for time value and likelihood of freezeout. In reality, however, the fact that two-thirds of freezeouts are still executed through the merger route[122] introduces another probability that must be factored into the analysis, namely, the likelihood that the controlling shareholder will proceed via tender offer rather than merger. This probability may be particularly difficult to estimate if it is a moving target—for example, due to gradual shifts in legal guidance on transactional forms.

But the argument that an ex ante pricing adjustment is complicated does not refute Pritchard's basic claim that it is possible. As long as there is no reason to believe that the marketplace will misestimate any of the relevant pieces of the calculation in a systematically biased way, the pricing mechanism should, on average, compensate minority shareholders fairly, which is all that is needed to address equity concerns and preserve allocational efficiency in the marketplace. Moreover, the increased risk that arises from the controller's choice of transactional form (or, more precisely, the increased volatility of returns for minority shareholders due to the possibility of a merger freezeout) should not depress the value of a minority stake because this is a firm-specific (unsystematic) risk that does not get priced in the capital-asset pricing model.[123]

A different, but also potentially problematic assumption inherent in Pritchard's ex ante pricing story is that *Siliconix* constitutes "public" information that will be reflected in market pricing under the semi-strong

121. *See* Marcus, *supra* note 120, at 20 (quoting Victor Lewkow, Partner, Cleary, Gottlieb, Steen & Hamilton, stating that "I am not sure I can think of a going-private deal since Pure Resources [in August 2002] that has been done the old-fashioned way of negotiating a one-step merger agreement with a special committee of the target"); Telephone Interview with Charles Nathan, *supra* note 52 ("All things being equal, which they never are, I would go the *Siliconix* route nine times out of ten. And I think that's where most of the sophisticated M&A guys I talk to are.").

122. *See* Subramanian, *supra* note 18, at 44 fig.1.

123. Addressing the related question of minority discounts, John Coates argues that "rules of corporate law should at least be consistent" and that "a consistent, reliable discount rule would permit better corporate and investment planning." Coates, *supra* note 18, at 1295. This point is correct with respect to the issue of minority discounts, which creates uncertainty from the controller's perspective as to whether the court will apply a discount in valuing the minority shares. In contrast, *Siliconix/Glassman* only creates uncertainty from the perspective of the minority shareholders, because the controller has complete control over which transactional form it uses. If these minority investors hold a diversified portfolio, the risk created by *Siliconix/Glassman* is fully diversifiable and, therefore, should not influence their investment decision.

version of the efficient capital markets hypothesis (ECMH). Although this assumption is usually uninteresting for most applications of the ECMH, the translation of legal doctrine to investment implications may be nontrivial in some situations.[124] In fact, the available evidence suggests that *Siliconix* may not constitute publicly available information. For example, the finding that two-thirds of transactions still proceed through the traditional merger route is consistent with the view that even corporate law practitioners (who stand to benefit far more than potential investors from understanding *Siliconix*) are not fully aware of the benefits of the *Siliconix* mechanism and its implications for the price that the controller will pay. Recent corporate law textbooks do not include references to *Siliconix*, much less its implications for the choice of transactional form.[125] Taken together, this evidence suggests that minority shareholders may not be aware of *Siliconix* or its implications for price, which is an obvious prerequisite for the claim that minority investors will adjust price to account for the new tender-offer-freezeout mechanism.

But this argument, too, does not refute Pritchard's basic contention, because the mispricing (if any) is based solely on a learning effect rather than a potentially more robust behavioral phenomenon. To the extent that *Siliconix* should influence the pricing of a minority stake, potential minority shareholders who fail to incorporate this information into their investment decisions will systematically underperform compared to those who do. Over time, *Siliconix* will be fully priced as investors either learn or are driven from the marketplace.

Thus Pritchard's provocative question remains: Why should we worry about *Siliconix*? Certain shareholders experienced a one-time negative wealth effect from a shift in legal rules, but this happens all the time in corporate law.[126] Ex ante pricing of a minority stake will adjust, either immediately or

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124. *See* Coates, *supra* note 18, at 1307 ("What is not so clear . . . is whether the case law [on minority discounts] or the analysis itself should be viewed as 'public information' . . . .").

125. *See, e.g.*, ROBERT W. HAMILTON & JONATHAN R. MACEY, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES (8th ed. 2003) (not referencing *Siliconix* or *Pure Resources*); WILLIAM A. KLEIN ET AL., BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, AND CORPORATIONS (5th ed. 2003) (same); CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS (4th ed. 2003) (same); *cf.* D. GORDON SMITH & CYNTHIA A. WILLIAMS, BUSINESS ORGANIZATIONS: CASES, PROBLEMS, AND CASE STUDIES 642 (2004) (not referencing *Siliconix* but excerpting *Pure Resources*). *But see* ALLEN & KRAAKMAN, *supra* note 29, at 483 (noting implications of *Siliconix* for transactional form and excerpting *Pure Resources*).

126. *See, e.g.*, Paramount Commc'ns v. QVC Network 637 A.2d 34 (Del. 1994) (holding that sale of control triggers *Revlon* duties, which in this case forced Viacom to pay $107 per Paramount share, rather than the original $70, thereby transferring wealth from Viacom over time, thereby resolving equity concerns for prospective minority shareholders and preserving efficiency in the marketplace.

Within the terms of the current debate, Pritchard's response to proponents of doctrinal convergence hits home. In Part II, however, I identify an efficiency loss inherent in existing doctrine that provides an answer to Pritchard's important question.

3. *Proposing Doctrinal Convergence Through Hybrid Approaches*

Two sets of commentators have taken middle-ground approaches. Ronald Gilson and Jeff Gordon proposed business judgment review if the controller has complied with the procedural protections identified in *Pure Resources* and the SC has veto power over the transaction (i.e., a reconsideration of *Lynch*), but would impose entire fairness review if the controller goes directly to shareholders through a tender offer without gaining SC approval (i.e., a reconsideration of *Siliconix*).[127] Prominent Delaware practitioner Frank Balotti, with two colleagues, also proposed a hybrid approach, urging a "limited fairness hearing" for freezeout tender offers, or an amendment to the Delaware appraisal statute requiring the controller to pay all minority shareholders the appraised valued of their shares.[128]

These approaches are well considered in that they seek to balance the competing concerns of protecting minority shareholders and facilitating value-creating transactions. As I describe in Part III, my own proposal for reform comes closest to these middle-ground approaches, but for different reasons. However, these proposals do not explain why the effects of *Siliconix* and *Glassman* will not simply be priced ex ante. As described in the previous Subsection, defenders of the status quo point out that there are no apparent barriers to a private solution in the freezeout arena. Specifically, potential investors will simply pay less, going forward, for a minority position in a controlled company, on the expectation that they will receive less if they are forced to exit.[129] Without addressing this basic point, proponents of doctrinal

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shareholders, notably controlling shareholder Sumner Redstone, to Paramount shareholders).

127. *See* Gilson & Gordon, *supra* note 81, at 838-40.

128. *See* Aronstam et al., *supra* note 77, at 552-57; Bradley R. Aronstam et al., *Revisiting Delaware's Going-Private Dilemma Post-*Pure Resources, 59 BUS. LAW. 1459 (2004).

129. For a general description of this point, see, for example, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 146 (1991), which notes that "the majority, not the minority, bears the cost *ex ante* of the potential exploitation of the minority *ex post*."

reform cannot motivate the case for change. In the next Part, I attempt to do so.

II. THE PROBLEM WITH EXISTING DOCTRINE

In Part I, I reviewed the divergent doctrinal strands on freezeouts and summarized the already substantial body of literature that has developed in response. I concluded that while the doctrinal differences are indeed dramatic, and have had an impact on deal outcomes, the case for change has remained unclear. In this Part, I identify the real problem with existing doctrine. Tender-offer-freezeout doctrine facilitates some inefficient (value-destroying) transactions by allowing the controller to exploit asymmetric information against the minority. Merger-freezeout doctrine makes the opposite mistake—deterring some efficient (value-creating) transactions—because the SC has excessive power to block the deal. Taken together, this analysis identifies an efficiency loss that motivates my proposal for reform, which I describe in Part III.

A. Opportunistic Behavior in Tender Offer Freezeouts

1. The Determination of Price in Tender Offer Freezeouts

In a merger freezeout, the SC bargaining process and the prospect or actuality of entire fairness review determine the price paid to the minority shareholders. The determination of price in a tender offer freezeout differs in two important respects. First, the SC does not have meaningful bargaining power in freezeout negotiations: It cannot veto the transaction, and its only formal authority is to issue a 14D-9 recommendation within ten days of the offer. This absence of bargaining power manifests itself in deal outcomes: Controllers pay less in tender offers than in mergers.[130]

A second difference is that minority shareholders' exclusive remedy in a tender offer freezeout is appraisal, not an entire fairness proceeding, which is less potent for two reasons. First, unlike plaintiff shareholders in a class action claim for entire fairness, plaintiffs in an appraisal proceeding must bear their own costs, including legal fees and the costs of expert witnesses.[131] Second, unlike plaintiffs in an entire fairness action, minority shareholders in appraisal

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130. *See* Subramanian, *supra* note 18, at 49 tbl.3.

131. *See* Cede & Co. v. Technicolor, Inc., 684 A.2d 289, 301 (Del. 1996); Andra v. Blount, 772 A.2d 183, 184 (Del. Ch. 2000).

proceedings must choose between accepting the consideration offered and demanding a judicially determined appraisal of their shares.[132] Because of these factors it is well accepted among academic commentators and practitioners that appraisal is a weak remedy compared to entire fairness review.[133]

Without a meaningful SC bargaining process or the background threat of entire fairness review, the sole remaining constraint on the price that the controller pays in a tender offer freezeout is the prevailing market price. Practitioner interviews and anecdotal evidence confirm this conclusion. For example, according to Charles Nathan of Latham & Watkins: "What you're doing in *Siliconix* is negotiating with the market, you're not negotiating with the special committee, in the sense that as long as your price will clear enough of the market to get to ninety percent, you win."[134] In fact, in *Siliconix* itself, the chancery court found that the controlling shareholder had determined its offer price simply "by applying a 10% premium to the then market price of Siliconix stock."[135]

2. *Categories of Opportunistic Behavior*

The ability to freeze out the minority at some increment over the market price in a tender offer freezeout, as opposed to "fair value" in a merger freezeout, introduces the possibility of opportunistic behavior by the controller. I now describe the two basic ways in which opportunistic behavior can manifest itself.

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132. *See* DEL. CODE ANN. tit. 8, § 262(h) (2001).

133. *See, e.g.*, CLARK, *supra* note 118, § 12.2, at 508 ("[A]ppraisal is often a cumbersome remedy."); John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 359, 412 (1996) ("Standing alone, the appraisal remedy cannot begin to assure the receipt of proportionate value."); Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 48-49 (1995); *see also* Aronstam et al., *supra* note 77, at 556 (proposing statutory amendments that would shore up the appraisal remedy).

134. *See* Telephone Interview with Charles Nathan, *supra* note 52; *see also* Morphy, *supra* note 117 ("In a tender offer the controlling stockholder, in effect, says to the other stockholders, 'Here is my offer: the stock was trading at $6.25, I'm willing to pay you $8.00. That's your choice—you can have $8.00 or you can have $6.25.'").

135. *In re* Siliconix Inc. S'holders Litig., No. Civ. A. 18700, 2001 WL 716787, at *2 (Del. Ch. June 19, 2001).

a. *Freezeout Timing*

First, the controller determines the timing of a freezeout. This means that a controller can freeze out the minority when it perceives that the market price of the target stock is lower than its intrinsic value.[136] Although insider trading restrictions prevent the most egregious forms of this kind of opportunism, the controller may be able to take advantage of smaller pieces of nonpublic information, which individually do not meet the test for materiality, but collectively give the controller greater insight than the public minority shareholders about the intrinsic value of the company.[137]

This kind of opportunism is not possible in a merger freezeout because the court will engage in, and the SC will bargain in the shadow of, a de novo examination of fair value. This background legal entitlement works to detach the offer price from the market price, because in entire fairness proceedings courts give little evidentiary weight to prevailing market prices.[138] Because the controller will have little or no informational advantage over the SC, it is unable to exploit differences between market price and intrinsic value in merger-freezeout negotiations.

b. *Influencing the Target's Value*

A second way in which a controller might engage in an opportunistic tender offer freezeout is by influencing the value of the target, thereby altering the target's market price and, in turn, the baseline for the tender-offer-freezeout price.[139] John Coates summarizes the three categories of this kind of

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136. *See* CLARK, *supra* note 118, §12.2, at 507 ("[A]t what time is [the controller] likely to stage a freezeout? The answer is clear: when he knows that the company is really worth more than its current market price.").

137. *See id.* at 507-08.

138. *See, e.g.*, *In re* Emerging Commc'ns, Inc. S'holders Litig., No. Civ. A. 16415, 2004 WL 1305745 (Del. Ch. June 4, 2004) (involving a $7.00 pre-deal market price, a $10.25 deal price, and a $38.05 judicially assessed fair value); Harris v. Rapid-Am. Corp., Civ. A. No. 6462, 1992 WL 69614 (Del. Ch. Apr. 6, 1992) (involving a $21.88 pre-deal market price, a $28 merger price, and a $73.29 judicially assessed fair value); *In re* Shell Oil Co., Civ. A. No. 8080, 1990 WL 201390 (Del. Ch. Dec. 11, 1990), *aff'd*, 607 A.2d 1213 (Del. 1992) (involving a $44 market price and a $71.20 judicially assessed fair value). *See generally* Daniel R. Fischel, *Market Evidence in Corporate Law*, 69 U. CHI. L. REV. 941, 941 (2002) ("Market prices are frequently given little or no weight in resolving valuation disputes in corporate law.").

139. It might be possible to influence the market price without influencing the value of the underlying assets through selective disclosure. *See* Victor Brudney, *Efficient Markets and Fair Values in Parent Subsidiary Mergers*, 4 J. CORP. L. 63, 71 (1978) (noting the controller's potential for expropriation that arises from "systematic impediments to the flow of behavior: underinvestment in positive net present value (NPV) projects; investment in negative NPV projects; and shirking managerial responsibilities.[140] Each of these three categories can be further divided into reversible value reductions and nonreversible value reductions.

Value reductions that are fully reversible are difficult to come by in the real world, but are theoretically possible. Consider the case of a one-time positive NPV project, for which the only question is whether to implement the project before or after the freezeout. If the project is not completely transparent to the marketplace, a controller might rationally delay this investment until after the freezeout, in order to reap the full benefit rather than sharing the benefit with the minority. This value diversion would be difficult to detect, and, even if detected, would likely be protected by the business judgment rule, particularly if there were some plausible basis for the delay (e.g., reduced risk due to the delay).

As demonstrated by the example in the previous Subsection,[141] this opportunistic behavior would not be possible in a merger freezeout because the opportunity presented by the positive NPV project would likely be known to the SC and to the court. It is the information asymmetry between the controller and the minority shareholders, as compared to the relative symmetry between the controller and the SC, that facilitates the controller's opportunistic behavior in a tender offer freezeout.

In contrast to the one-time positive NPV project, most value reductions are at least partially nonreversible. Take the example of managerial shirking, which reduces firm value in ways that cannot be fully recovered after the freezeout if certain corporate opportunities are time-limited. When the value reduction cannot be reversed fully, the controller's incentives are less clear, because the reduction will hurt the controller in proportion to its pre-deal stake in the target. But even with respect to these types of value reductions, it is easy to identify situations in which it is still in the controller's interest to deliberately reduce firm value pre-freezeout, provided the value reduction is at least

information to the market"). To take the simplest example, the controller might cause the target to deliberately delay the release of positive information about the company in order to buy the minority shares at an artificially depressed price in a tender offer freezeout. Outside of quarterly disclosures mandated by SEC rules and a duty to correct statements previously made, there is generally no affirmative duty to disclose even material developments to the marketplace. *See* THOMAS J. DOUGHERTY, THE DIRECTORS' HANDBOOK 28 (2004). However, the ability to buy minority shares without disclosing material facts about the target company is severely limited by insider trading restrictions, the controller's general fiduciary duty to the target corporation, and the controller's "duty of candor" that arises from membership on the target board.

140. *See* Coates, *supra* note 18, at 1316.

141. *See supra* Subsection II.A.2.a.

partially reversible after the freezeout.[142] In any particular case the controller would compare its share of the nonreversible value reduction (which is proportional to the controller's pre-freezeout stake) against the benefit that arises from a lower tender offer price.

3. Efficiency Implications

Following the ex ante pricing argument described in Part I,[143] one could argue that the controller's opportunistic behavior will also be priced in the minority's initial stake. That is, minority investors will understand not only the lower price that they will receive in a freezeout under the tender offer mechanism, but also the controller's enhanced ability to exploit asymmetric information to its benefit. Over time, both of these effects will be fully priced ex ante, eliminating any unfairness to the minority and maintaining allocational efficiency.

Despite the superficial appeal of this argument, the possibility for opportunistic behavior does, in fact, yield three types of efficiency losses: through nonreversible value reductions, the facilitation of some value-reducing freezeouts, and reduced access to minority capital. I now discuss each of these effects in turn.

a. Nonreversible Value Reductions

The first, most obvious, social welfare loss arises from nonreversible value reductions. As described above, the controller may have incentives to engage in nonreversible value reductions in order to pay a lower price in the tender offer freezeout, because the loss from the nonreversible value reduction may be offset by the gain to the controller in the form of a lower tender offer price. These nonreversible value reductions, by definition, constitute an efficiency loss because they reduce the intrinsic value of the target company.

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142. For example, consider a 50% controller contemplating a $10 value-reducing maneuver, of which $8 can be regained after the freezeout. The controller would bear $5 out of the $10 in value reduction but then would gain $8 back after the freezeout, for a net gain of $3. *See also* Coates, *supra* note 18, at 1316 n.208 (providing a similar quantitative example). To generalize, the controller will engage in value-reducing behavior whenever the fraction of value regained after the freezeout is greater than the controller's pre-deal stake in the company.

143. *See supra* Subsection I.D.2.

b. *Facilitating Some Inefficient Freezeouts*

A second social welfare loss arises from the possibility of buying the minority shares at less than their intrinsic value. In many cases, the gap between intrinsic value and market value might be bridged by the premium over market that the controller must pay in order to succeed in a tender offer freezeout. The empirical evidence in my companion paper indicates that, on average, premiums in post-*Siliconix* tender offer freezeouts are approximately 25% higher than the preannouncement market price of the target stock.[144] While this kind of gap between intrinsic value and market value would be rare (though not implausible) in well-functioning capital markets, the controller's ability to influence the market price makes a gap of this magnitude more likely in the controlled company context.

To the extent the controller is able to buy the minority shares for less than their intrinsic value, the controller would be able to make a profit on a value-destroying (negative synergy) freezeout. To see this point, consider a company that has a higher intrinsic value as a public company than as a private company—for example, from the ability to attract managers with publicly traded stock options, the benefit of having an acquisition currency, or the advantage of analyst coverage. The controller might nevertheless decide to take the company private through a tender offer freezeout if it has the opportunity to buy the minority shares for less than their intrinsic value. The gains from the tender offer would subsidize the negative consequences of going private, even though overall social welfare is higher if the company remains publicly traded. In these cases the tender-offer-freezeout mechanism might facilitate some value-destroying (inefficient) transactions.

c. *Reduced Access to Minority Capital*

The third, more subtle, social welfare loss that arises from tender offer freezeouts arises from the "lemons effect" in corporate freezeouts, first identified and described in detail by Lucian Bebchuk and Marcel Kahan.[145] If, as described above, the controller will freeze out the minority when the market price is lower than the intrinsic value, then minority shareholders should (rationally) receive an important signal when the controller does *not* freeze them out—namely, that the market price fully values or perhaps overvalues the

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144. *See* Subramanian, *supra* note 18, at 46 tbl.2A.

145. *See* Lucian Arye Bebchuk & Marcel Kahan, *Adverse Selection and Gains to Controllers in Corporate Freezeouts*, *in* CONCENTRATED CORPORATE OWNERSHIP 247 (Randall K. Morck ed., 2000).

company. Through backward induction, the minority shareholders should rationally bid down the value of the stock. In the extreme form of the Bebchuk and Kahan model, the market price of the minority shares is bid down to zero because of the negative signal that the lack of a freezeout conveys.[146]

Zohar Goshen and Zvi Wiener develop a more general model of the Bebchuk and Kahan lemons effect to demonstrate that the greater the influence of market prices in determining the freezeout price, the more depressed the market price of the minority stock will be.[147] At one extreme, if market prices have no influence in the determination of the freezeout price, the minority stock is only slightly discounted relative to a pro rata share of going concern value. At the other extreme, and consistent with the Bebchuk and Kahan model, if market prices are the only determinant of the freezeout price, the minority shares will be worthless. Goshen and Wiener conclude that "ironically, the less reliance courts put on market prices, the more accurate are market prices as a reflection of fair value."[148]

These theoretical models have important implications for the current doctrinal regime. Because the merger-freezeout process detaches the freezeout price from the market price, through the combination of the SC bargaining process and the shadow of entire fairness review, merger freezeouts do not trigger the lemons effect. But because prevailing market prices are the primary determinant of price in a tender offer freezeout, the lemons effect will work to depress the value of the minority shares to the extent that the tender offer mechanism is used.

Of course, several real-world factors might limit the manifestation of the lemons problem. For example, while the theoretical models assume that the controlling shareholder can unilaterally freeze out the minority, in the real world minority shareholders may say no through their tender decision. If a sufficient percentage of minority shareholders refuse to tender, the controller will be unable to get to the 90% threshold that allows a short-form merger. Minority shareholders might refuse to tender even if the offer is at a substantial premium if they infer good news from the controller's tender offer itself. Similarly, if the controller only makes a tender offer when the inherent value of the firm is higher than the market value, then minority shareholders, knowing

146. Paul G. Mahoney, *Comment*, *in* CONCENTRATED CORPORATE OWNERSHIP, *supra* note 145, at 259, 260 (discussing Bebchuk and Kahan's chapter in the same volume).

147. *See* Zohar Goshen & Zvi Wiener, The Value of the Freezeout Option (Sept. 2003) (unpublished manuscript, on file with author).

148. *Id.* at 8.

this fact ex ante, should refuse to tender in order to share in the upside that the controller signals by making a tender offer.[149]

Other constraints are also possible. A controlling shareholder might not freeze out the minority even if the inherent value is greater than the market value if the controller has capital constraints. (Indeed, capital constraints may have caused the controller to issue the minority stake in the first place.) The absence of a freezeout by a capital-constrained controller should convey no signal to the minority, thereby preventing the adverse inference which would trigger the lemons effect. Another possibility is that lawyers will not recommend tender offer freezeouts to their clients, either due to doctrinal uncertainty[150] or unfamiliarity with the benefits of the tender-offer-freezeout mechanism.[151]

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149. One term for this effect might be "reactive revaluation," as it is the converse of the well-known phenomenon of "reactive devaluation." *Cf.* John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307, 357 (2000) (identifying the possibility of "reactive revaluation" in a bidding contest between competing bidders). While rational revaluation is theoretically plausible, the theory's prediction—that minority shareholders should never tender—does not square with empirical reality. In my database of all post-*Siliconix* freezeouts, I find that thirty out of thirty-six freezeout tender offers (83%) were successful. Subramanian, *supra* note 18, at 44 fig.1. One possible explanation for this finding is behavioral: Minority shareholders might not "look forward and reason back" in a sufficiently sophisticated way to rationally revalue in response to a freezeout tender offer. *See* MAX H. BAZERMAN & MARGARET A. NEALE, NEGOTIATING RATIONALLY 109-13 (1992). This explanation, if correct, would be consistent with a large and growing literature from behavioral economics indicating that even sophisticated investors do not always follow the predictions of the rational actor model. *See generally* Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135 (2002). There is a potential rational explanation as well. If the gains from the freezeout are contingent upon the success of the freezeout, then minority shareholders should not rationally revalue their shares in response to the freezeout tender offer. The most obvious example would be Sarbanes-Oxley compliance costs, which many controlling shareholders cite as an important motivation for their freezeouts. *See supra* note 16. Clearly, these savings would not be realized if the freezeout were not successful; therefore minority shareholders should not rationally revalue in response to the freezeout offer. The controller can also construct a contingent gain of this kind, as a way of inducing minority shareholders to tender, by threatening to not implement the value-increasing initiative unless the freezeout is successful. While this kind of threat would no doubt be implicit, and the credibility of the threat may be lacking given the controller's already-large stake in the company, the threat is at least plausible because the controller has the ability to make investment and operational decisions for the target.

150. *See* David Marcus, *An End Run in Delaware*, CORP. CONTROL ALERT, Dec. 2001, at 8, 9 (quoting Charles Nathan, Partner, Latham & Watkins, stating that "[t]he risk is being the poster child for the reversal of *Siliconix*").

151. *See* Telephone Interview with Richard Hall, Partner, Cravath, Swaine & Moore (Mar. 4, 2004) ("In the current environment, I would say to a controlling stockholder, 'it is very hard to see any reason to go the special committee route rather than the *Pure Resources* [tender

These checks are likely to prevent the extreme manifestation of the lemons effect, in which minority shares are worthless. But to the extent that the lemons effect depresses the price of minority shares, pre-IPO owners would have to sell a greater fraction of the company in order to raise the same dollar value of public capital. The increase in dilution may deter some entrepreneurs from selling a public stake, even when it would be socially desirable for the entrepreneur to do so.[152] The clearest example would be a situation in which, absent a lemons effect, the controller would only have to sell a minority stake, and therefore would retain control; but with a lemons effect the controller would have to sell more than 50% to the public in order to raise the same amount of capital. In this scenario the entrepreneur might be deterred from going to the public capital markets at all and instead might prefer a strategy that could be financed through internally generated capital.

One could argue that the entrepreneur in this situation has another alternative—a dual-class IPO—which would allow the pre-IPO owners to retain control while raising public capital. However, dual-class structures generate considerable skepticism in the marketplace,[153] which in itself depresses the trading price for the nonvoting or low-voting class of stock.[154] In order to avoid this treatment, pre-IPO owners may wish to maintain the connection between cash-flow ownership and voting rights through a single class of stock. But the possibility of a tender offer freezeout will depress the price that they will receive in this offering. The result will be a distortion, at the margin, of the entrepreneur's decision on whether to sell a public stake.

offer] route.' But I believe there may be lawyers who, when they observe some reluctance on the part of their controlling stockholder clients in acting unilaterally [through a tender offer], do not firmly enough impress upon them the benefits of the *Pure Resources* structure over the special committee structure."); Interview with Charles Nathan, *supra* note 52 ("[T]here may be lack of awareness on the part of many lawyers of the availability and value of the *Siliconix* structure.").

152. This point differs only in magnitude from a potential efficiency loss that arises from ex ante pricing of *Siliconix* itself. Unlike minority shareholders in some developing countries, who have very few protections against self-dealing by the controller, U.S. minority shareholders have certain baseline protections (e.g., appraisal) that make it unlikely that *Siliconix* will have a significant direct effect on the controllers' ability to raise capital. The argument here is that an indirect lemons effect, rather than a direct pricing effect, is more likely to affect the controller's ability to raise minority capital.

153. *See, e.g.*, Holman W. Jenkins Jr., *Google Baloney*, WALL ST. J., May 5, 2004, at A15.

154. *See* Paul A. Gompers et al., Incentives vs. Control: An Analysis of U.S. Dual Class Companies (Dec. 2004) (unpublished manuscript, on file with author).

B. *Deterring Efficient Freezeouts Through the Merger Mechanism*

In the previous Section, I demonstrated how existing doctrine encourages some inefficient tender offer freezeouts. I now discuss ways in which existing doctrine also discourages some efficient merger freezeouts. Specifically, I demonstrate that the procedural protections for minority shareholders identified in Part I—the negotiation between the controlling shareholder and the SC and the possibility (or actuality) of entire fairness review—can deter some value-increasing merger-freezeout transactions.

1. *The Problem of Special Committee Resistance*

a. *With Special Committee Veto Power*

As described in Part I, the post-*Lynch* world of freezeout merger negotiations seems to require SC veto power over the transaction.[155] To the extent that there is ambiguity about this point (discussed in the next Subsection[156]), many controllers explicitly bestow veto power on the SC in a merger freezeout.[157] My empirical evidence indicates that SCs have made frequent use of this veto power. In my database of all post-*Siliconix* freezeouts, I find that the controller withdrew in eighteen out of the eighty freezeout merger negotiations with an SC that were announced between June 2001 and April 2005, a 23% failure rate, even though the controller's first offer invariably represented a premium over the prevailing market price.[158]

An obvious concern in this area is that SCs might reject some freezeout offers out of self-interest rather than the interest of minority shareholders. The

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155. *See In re* First Boston, Inc. S'holders Litig., Civ. A. No. 10338, 1990 WL 78836, at *7 (Del. Ch. June 7, 1990) (noting the importance of an SC retaining "the critical power: the power to say no"); Coffee, *supra* note 133, at 389 ("[*Lynch*] creates an apparent standoff: the monopolistic buyer confronts the monopsonistic seller, and the outcome of these negotiations becomes uncertain even in theory."); *see also In re* W. Nat. Corp. S'holders Litig., No. 15927, 2000 WL 710192, at *24 (Del. Ch. May 22, 2000) ("The Special Committee indicated that it would *not* recommend a deal at $29.00 per share and counter-offered $31.00 per share. Devlin [the controller] rejected $31.00 per share and walked away.").

156. *See infra* Subsection II.B.1.b.

157. *See, e.g.*, Press Release, Cox Commc'ns, Response from Cox Communications, Inc., Regarding Cox Enterprises, Inc.'s Proposal to Acquire Public Minority Shares (Aug. 2, 2004), *reprinted in* Cox Commc'ns, Current Report (Form 8-K), at Exhibit 99.1 (Aug. 2, 2004) (noting the appointment of an SC to review the proposal).

158. *See* Subramanian, *supra* note 18, at 44 fig.1.

independent directors who are appointed to the SC typically leave the target board when the target becomes a wholly owned subsidiary of the controlling shareholder. Therefore, precisely the same agency issues that have pervaded the debate about target-board resistance in hostile takeovers apply to SC resistance against a controlling shareholder. Yet the Delaware courts have approached these two questions in dramatically different ways. In the hostile takeover context, defensive tactics taken by target boards are subject to enhanced intermediate scrutiny as articulated in *Unocal Corp. v. Mesa Petroleum*,[159] because of the "omnipresent specter" that directors are acting in their self-interest rather than in the interest of the corporation.[160] But in the merger-freezeout context, the Delaware courts have not only permitted unfettered SC veto power, they seem to have required it. This dramatically different approach in the merger-freezeout arena may deter some efficient freezeouts.

Agency problems may play out in a more subtle way as well, due to the litigious nature of the merger-freezeout process. According to a senior corporate lawyer with significant experience advising SCs in freezeouts:

> Imagine yourself in that role [of an SC member]. You are, to be sure, paid a special fee for this combat duty—but peanuts in the greater scheme of things . . . say $50K. You receive that fee irrespective of whether you do or don't endorse the controller's proposal. There's a near certainty that you'll be sued if you endorse that proposal. And, your asserted independence notwithstanding, some subset of the world suspects, or at least the plaintiffs' bar will assert, that the game is rigged. The easiest and safest course is plainly to duck or run. No wonder you insist on the controller's offering $X more per share before you present your chin in the middle of the ring.[161]

As suggested by this anecdotal evidence, unchecked veto power, combined with potentially misaligned incentives between the SC members and the minority shareholders, creates at least the potential for some efficient freezeouts to be blocked.[162]

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159. 493 A.2d 946 (Del. 1985).

160. *Id.* at 954.

161. *See* Confidential E-mail from Senior Corporate Lawyer to Guhan Subramanian (June 30, 2004, 09:28:07 EST) (on file with author).

162. One way of empirically testing this possibility would be to examine the aftermath of failed freezeout negotiations. If final offers in failed freezeouts are unduly low, then targets that are able to successfully resist (through a loyal SC) should experience positive abnormal returns. If, instead, final offers in failed freezeouts are fully priced, then targets that *b. Without Special Committee Veto Power*

As practitioners become more comfortable with the tender-offer-freezeout mechanism, merger freezeouts may increasingly be negotiated in the shadow of a tender-offer-freezeout threat. In a curious twist of Delaware corporate law, the controller would be subject to entire fairness review, with no burden shift, if the controller threatens a tender offer, and the SC agrees to a merger deal on the basis of the threat.[163] But if the controller simply breaks off negotiations, a subsequent (even immediate) tender offer to the minority would seem to avoid entire fairness review.[164] In view of these twists, a well-advised controller will engage in a kabuki dance of making a final offer, and perhaps hinting at its walk-away alternative, but not threatening the SC in a manner that would eliminate the SC's ability to say no under *Lynch*.

Interestingly, no freezeout of a Delaware target since *Siliconix* has exhibited the pattern of merger freezeout negotiations, impasse, and a tender offer to the minority, possibly due to a broad reading of *Lynch* that requires SC veto power. But a recent freezeout involving a Minnesota target, where *Lynch* is not binding authority, illustrates how this shadow might play out going forward. In December 2003, Kontron AG (Kontron) offered to buy the remaining 35% of Kontron Mobile (Mobile) that it did not already own for $0.45 cash per share.[165] Kontron proposed to structure the deal as a two-step tender offer, subject to approval by an SC of independent directors and a MOM condition.[166] The Mobile SC hired legal and financial advisors and began negotiating with Kontron.

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successfully resist should experience zero or negative abnormal returns. Unfortunately, the empirical evidence does not resolve this issue: examining all sixteen failed merger freezeouts that were announced between July 2001 and April 2004, I find an even split between deals in which the minority shareholders did better and deals in which minority shareholders did worse over the subsequent twelve months, relative to the controller's final offer. *See* Subramanian, *supra* note 17.

163. *See* Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1118 (Del. 1994).

164. *See In re* Siliconix Inc. S'holders Litig., No. Civ. A. 18700, 2001 WL 716787 (Del. Ch. June 19, 2001).

165. *See* Kontron Mobile Computing, Inc., Current Report (Form 8-K), at 1 (Dec. 3, 2003).

166. *See* Kontron Mobile Computing Inc., Tender Offer Statement (Schedule TO), at 14 (June 15, 2004). Because the deal was conditioned on SC approval, it required board action that would have triggered entire fairness review. *See* Transcript of Settlement Hearing at 5-7, Hartley v. Peapod, Inc., No. Civ. A. 19025-NC, 2002 WL 31957458 (Del. Ch. Feb. 27, 2002) (Lamb, V.C.) (stating that a two-step tender offer pursuant to a merger agreement is "completely different than *Siliconix*" and "is definitely an entire fairness case under settled [Delaware] Supreme Court law.").

In March 2004, Kontron expressed "disappointment" about the lack of progress in these negotiations, and, in an effort to push things forward, took the unusual step of offering to either match or sell to any bona fide third-party bidder that the Mobile SC might come up with.[167] The SC responded that it would take "a significant amount of time" to undertake the market check that Kontron had suggested.[168] Kontron responded that it would make a tender offer directly to the minority shareholders at $0.55 per share, with a 90% closing condition.[169] The Mobile SC issued a 14D-9, remaining neutral on the offer.[170] Kontron successfully acquired 91% of the voting shares in its tender offer, thereby satisfying the 90% condition,[171] and completed its short-form back-end merger in August 2004.[172]

As the Kontron fact pattern begins to appear more often, the efficiency loss that arises from tender-offer-freezeout doctrine will spill over into the merger-freezeout arena. The reason is that the controller's walk-away alternative is no longer to do nothing, but rather, if carefully orchestrated, to make a tender offer to the minority. The SC may therefore agree to a price, even if it does not believe that this price represents fair value (perhaps due to nonpublic information), if it believes that the controller would be successful in a tender offer to the minority at that price.

In a regime in which the tender offer option is well understood, therefore, prices in merger freezeouts will be driven down to the predicted prices in tender offer freezeouts.[173] Plaintiffs' counsel will be even less effective than the SC in extracting more than the tender offer price because the tender offer alternative avoids entire fairness review entirely. Therefore, there is no settlement value that translates into a higher price in the merger-freezeout negotiations. This conclusion introduces the efficiency loss that is inherent in tender offer doctrine, including the controller's incentive to engage in opportunistic behavior against the minority.

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167. *See* Transcript of Settlement Hearing, *supra* note 166, at 5-7.

168. *See id.*

169. *See* Kontron Mobile Computing Inc., Solicitation/Recommendation Statement (Schedule 14D-9), at 1 (July 21, 2004).

170. *See id.*

171. *See* Kontron Mobile Computing Inc., Tender Offer Statement (Schedule TO), at 3 (Aug. 9, 2004).

172. *See* Kontron Mobile Computing Inc., Certification and Notice of Termination of Registration (Form 15) (Aug. 23, 2004).

173. The empirical evidence available to date neither supports nor rejects this theoretical prediction. *See* Subramanian, *supra* note 18, at 29.

2. *The Problem of Deterred Deals*

While the problem of blocked deals involves efficient freezeouts that are initiated by the controller but are not consummated, the problem of deterred deals involves efficient freezeouts that are never initiated. I discuss two deterrent effects: the fact that SCs in the current regime are likely to extract some part of the synergies in freezeout mergers that occur; and the possibility that entire fairness litigation acts as a "tax" on the controller's freezeout decision.

a. *Through Allocation of Deal Synergies*

I begin with the assumption that the likelihood that a controller will initiate a freezeout increases monotonically with the controller's expected profits from the deal.[174] It follows that the controller should receive the full value of the synergies from the deal, in order to maximize the likelihood that controllers will initiate value-creating freezeouts.[175] The question then becomes whether and to what extent the merger-freezeout process provides the controller with the full value of the synergies from the deal.

The overall picture on this question is that courts have been notoriously unpredictable in their approach to synergy value in entire fairness proceedings. As a starting point, courts in entire fairness proceedings generally look to the appraisal remedy, and here section 262(h) of the Delaware corporate code mandates that "fair value" in appraisal shall be determined "exclusive of any

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174. I thank Victor Goldberg for helpful conversations in developing this assumption. In contrast, Gilson and Gordon assume that the controller will initiate a freezeout as long as its profits from the deal are positive. *See* Gilson & Gordon, *supra* note 81, at 804 n.73.

175. Easterbrook and Fischel, and Hermalin and Schwartz, reach the same conclusion, but for reasons that are problematic in a similar way. Easterbrook and Fischel examine corporate control transactions generally and conclude that "all shareholders can benefit from rules that allow the party responsible for a gain to allocate to himself as much as he can." Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 700 (1982). This is only true if the controller needs to expend effort in order to identify and realize the gain, as is the case, for example, with corporate opportunities. In freezeouts, however, the gains often arise with no effort required from the controller—elimination of Sarbanes-Oxley compliance costs is a paradigmatic example of the kind of benefit that, in fact, requires "negative effort" from the controller in order to be realized. Similarly, Hermalin and Schwartz develop a theoretical model demonstrating that the controller will expend suboptimal effort to generate gains unless the controller does not have to share these gains with the minority. *See* Benjamin Hermalin & Alan Schwartz, *Buyouts in Large Companies*, 25 J. LEGAL STUD. 351, 358 (1996). Again, this model assumes that effort is required in order to achieve the benefits from the deal, a plausible assumption in general, but often not valid in the context of freezeouts.

element of value arising from the accomplishment . . . of the merger."[176] Although this language on its face would seem to exclude synergy value, Delaware courts have muddied the water considerably. *Weinberger* began the confusion with its holding that section 262(h) only excludes "speculative elements of value that may arise from the 'accomplishment or expectation' of the merger."[177] While subsequent chancery court opinions have read *Weinberger* narrowly in order to exclude synergy value from the minority's entitlement,[178] on the one occasion that the Delaware Supreme Court revisited *Weinberger*'s reading of section 262(h) it confirmed its earlier holding.[179]

In addition, there is a more subtle way in which courts might arrive at a share of the synergies. In contrast to valuation in an appraisal proceeding, courts are not bound by the statutory language of section 262(h) in an entire fairness proceeding. In particular, a court may determine that fairness requires rescissory damages, defined as what minority shareholders would receive if the freezeout transaction were rescinded.[180] If the synergies from the deal do not depend on taking the company from public to private status, then a rescissory damages approach would provide minority shareholders with a share of the synergies from the deal.

Using either *Weinberger's* interpretation of section 262(h) or the flexibility inherent in an equitable remedy, then, courts have the authority to award a share of the synergies in an entire fairness proceeding. As a result, SCs bargaining in the shadow of entire fairness will be able to extract a share of the synergies as well. Reducing the controller's expected profits from the freezeout in this way deters some value-increasing freezeouts, under the assumption that the likelihood of freezeout increases monotonically with the controller's profits from the deal.

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176. DEL. CODE ANN. tit. 8, § 262(h) (2001).

177. Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983).

178. *See, e.g.*, Union Illinois 1995 Inv. Ltd. P'ship v. Union Fin. Group Ltd., 847 A.2d 340, 343 (Del. Ch. 2004) ("The appraisal award excludes synergies in accordance with the mandate of Delaware jurisprudence that the subject company in an appraisal proceeding be valued as a going concern."); *In re* Vision Hardware Group, 669 A.2d 671, 677 (Del. Ch. 1995) ("The objective of this appraisal proceeding is to provide the dissenting shareholders the value of their shares at the time of the merger from which they dissented." (citing DEL. CODE ANN. tit. 8, § 262(h) (2001))).

179. *See* Cede & Co. v. Technicolor, Inc., 684 A.2d 289 (Del. 1996) (reversing a chancery court ruling that synergy value should be excluded in determining fair value in an appraisal proceeding). I thank Jill Fisch for helpful conversations on this point.

180. *See* ALLEN & KRAAKMAN, *supra* note 29, at 454.

b. Through Litigation Costs

A second factor that might deter some deals is the high likelihood of litigation costs that arises from merger-freezeout doctrine. The availability of a class action claim for entire fairness, combined with a presumption that the first to file should be named lead or co-lead counsel, creates a "race to the courthouse" in which plaintiffs' counsel will typically file multiple lawsuits in the few days (and even hours) after the freezeout merger is announced.[181] This litigation activity imposes costs on the controlling shareholder because the controller will typically agree, in effect, to pay plaintiffs' legal fees as part of its settlement.[182] These litigation costs do not create an ex post social welfare loss, because they merely represent a wealth transfer from the controller to plaintiffs' counsel. Rather, a social welfare loss might arise because a controller may be deterred ex ante from initiating an efficient transaction by the expected "tax" imposed by plaintiffs' counsel.

The empirical evidence indicates that this tax represents a trivial fraction of the overall value of transactions: One study of shareholder class actions in Delaware finds a fee range of 0.005% to 1.36% of the deal value, with an average fee of 0.19%.[183] By way of comparison, the tax imposed by investment bankers, lawyers, and accountants in arms-length acquisitions is typically in the range of 1.0% to 2.0% of deal value.[184] Therefore, while expected litigation costs might deter merger freezeouts in theory, the magnitude of the litigation costs as a percentage of deal value suggests that such deterrence, if any, should be small in practice.

In the recent and important decision *In re Cox Communications, Inc. Shareholders Litigation*,[185] Vice Chancellor Strine of the Delaware Chancery Court reduced the fee for plaintiffs' counsel in the Cox Communications freezeout from the requested $4.95 million (amounting to 0.06% of deal value) to $1.275 million (0.015% of deal value). The case involved the merger freezeout of the Cox Communications minority shareholders described in the

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181. *See* Elliott J. Weiss & Lawrence J. White, *File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions*, 57 VAND. L. REV. 1797, 1827-28, 1833-34, 1846 (2004).

182. *See id.* at 1818.

183. *See id.* at 1831.

184. *See* Coates & Subramanian, *supra* note 149, at 382 n.209 (reporting that "total financial advisor fees," which include banker fees but not accountant or lawyer fees, averaged 1.4% of deal value in 1999, but noting that data on fees is "spotty").

185. C.A. No. 613-N, 2005 WL 2001310 (Del. Ch. June 6, 2005). The reader should note that I was retained by plaintiffs' counsel to provide empirical evidence on freezeouts generally and to apply this evidence to the Cox freezeout.

Introduction to this Article. While the court endorsed the empirical claim that prices in merger freezeouts are higher than prices in tender offer freezeouts,[186] the court held that the vast majority of the difference was attributable to the SC's bargaining power and not to the efforts of plaintiffs' counsel armed with a litigation threat over fairness.[187] The court also expressed its displeasure at the "premature, hastily-drafted, makeweight complaints attacking a fully negotiable proposal by the Cox family."[188]

Of course, it is too soon to tell what the consequences of the court's decision in *Cox Communications* will be. Simplistic, first-order predictions are obvious: To the extent that other chancery court judges follow this precedent, fee awards and fee requests will be lower, which will lead to an even smaller deterrence effect in the merger freezeout arena than currently exists. In addition, plaintiffs' counsel will be more likely to wait until the SC has agreed to a price before deciding whether to bring a class action fairness claim, both to make their contribution transparent and to avoid the accusation of "premature" litigation.

Potential second-order effects are more troubling. If plaintiffs' counsel do in fact hold back to let the SC "work its magic," as urged by the *Cox* court, controlling shareholders will be less likely to pay full value to the SC due to the uncertainty in its next round of negotiations with plaintiffs' counsel. The prospect of two sequential negotiations, in which the first negotiation sets a price floor for the second, is likely to be more onerous to the controller than a single simultaneous negotiation with the SC and plaintiffs' counsel. The result would be increased (not decreased) deterrence of merger freezeouts and, in the case of undeterred deals, a greater likelihood of impasse with the SC because of the controller's lower willingness to pay full value.

Another problematic effect arises from the fact that plaintiffs' counsel have choices about where to bring shareholder class action complaints. If Delaware courts are perceived as being stingy about fees in freezeout litigation, plaintiffs' counsel will bring their claims in other states that can exercise jurisdiction over the deal, such as the state that is home to the target's headquarters or principal place of business.[189] These other states will have less well-developed judicial approaches to freezeouts than Delaware, which would introduce further

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186. *Id.* at *20-22 (citing Subramanian, *supra* note 18).

187. *Id.* at *32 (holding that the increase "was almost entirely due to the Special Committee's diligent efforts and not to any litigation threat posed by the plaintiffs").

188. *Id.* at *1.

189. *See* David Marcus, Lynch *Mob*, THE DEAL, June 20, 2005, at 19 ("By reducing the plaintiffs' lawyers' fees so drastically [in *Cox*], Strine may have ensured a reduced load of such cases for the Court of Chancery, as plaintiffs' lawyers will look elsewhere for generous judges.").

uncertainty from the controller's perspective, which, in turn, would deter value-increasing freezeouts.

Of course, the Delaware courts need not entertain these second-order policy arguments in determining the appropriate level of fees in *Cox* or other freezeout transactions. But to the extent that the courts' objective in formulating freezeout doctrine is to facilitate value-increasing transactions, it is important to recognize that the reduction of fees may work in the opposite direction. Under the present regime, the empirical evidence indicates that litigation costs are unlikely to have a significant deterrent effect on merger-freezeout activity. In an alternative regime in which fairness actions involving Delaware freezeout targets are regularly brought in California or New York, for example, the deterrent effect may be larger.

Rather than mount a frontal attack on fees, the better approach would be to recalibrate standards of judicial review, as proposed in Part III of this Article. Indeed, in dicta, the *Cox Communications* court endorsed elements of the proposal put forward here and by Gilson and Gordon in their recommended approach to freezeouts.[190]

C. *The Absence of a Private Solution*

I now turn to the question of whether and to what extent the efficiency losses identified in this Part are avoidable through private contracting between the controller and the minority. The structure of corporate law in the United States has evolved from a regime of largely mandatory rules to a regime of largely default rules that may be modified through the corporate charter.[191] In many areas of corporate law, then, the controller and the minority have the ability to contract around the default provisions if these provisions are inefficient, unclear, or both.

Surprisingly, the efficiency losses identified in this Part seem to be an exception to this general approach. On merger-freezeout doctrine, the efficiency loss arises primarily from the SC's power to block the deal, which is mandated by the *Weinberger*-to-*Lynch* line of cases and cannot be avoided through private contracting. On tender-offer-freezeout doctrine, a potential solution would be to amend the corporate charter: for example, the charter could mandate the payment of fair value in any freezeout transaction, as determined in a judicial proceeding or by an arbitrator, thereby disconnecting

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190. *See In re Cox Commc'ns*, 2005 WL 2001310, at *34-38.

191. *See* ALLEN & KRAAKMAN, *supra* note 29, at 86-88.

the freezeout price from the market price.[192] This charter term would not apply to the tender offer itself, because a tender offer does not require corporate action and therefore is not subject to any restrictions that the charter might impose. But in order to complete a tender offer freezeout a controller must use the short-form merger statute. The short-form merger constitutes corporate action, which therefore would be subject to a corporate charter provision mandating a particular valuation process or formula.

The problem with this analysis is that the minority's exclusive remedy in a short-form merger is appraisal, not entire fairness.[193] As discussed in Subsection II.A.1 above, this remedy imposes significant procedural and substantive hurdles on minority shareholders that make it an ineffective backstop against opportunistic tender offers. As a result, this private solution would be unlikely to solve the efficiency loss identified in this Part.

Another potential private solution would be through a so-called standstill agreement, in which the controller would be unable to increase its stake without the target board's approval.[194] In effect, a controller would relinquish its right to execute a tender offer freezeout through the standstill. The problem with this approach, however, is that it goes too far. By forcing the controller to go through the merger route, the SC would gain veto power over the deal which would reintroduce the problem of blocked deals described in Subsection II.B.1.a above.

III. A PROPOSAL FOR REFORM

Part II identifies an efficiency loss inherent in existing freezeout doctrine. The most important source of the efficiency loss arises from tender-offer-freezeout doctrine, as it has developed through *Siliconix* and *Glassman*. A secondary, but still important, efficiency loss arises from merger-freezeout doctrine as it has developed through *Weinberger* and *Lynch*. Because these social welfare losses are unlikely to be resolved through private contracting, they are likely to persist until the judiciary intervenes. In this Part, I propose such an intervention.

In contrast to prior commentators, who have generally taken a patchwork approach to freezeout doctrine, I propose a doctrinal recalibration that is grounded in first principles of corporate law. This grounding would reduce

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192. *See* Coates, *supra* note 18, at 1288-89 (identifying this possibility).

193. *See* Glassman v. Unocal Exploration Corp. (*In re* Unocal Exploration Corp. S'holders Litig.), 777 A.2d 242 (Del. 2001).

194. *Cf.* Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621, 659-62 (2003) (noting the role of standstill agreements in arms-length acquisitions).

perceptions of arbitrariness, increase doctrinal coherence, and limit possibilities for future (and currently unforeseen) transactional arbitrage that might again create an efficiency loss.

A. *First Principles of Corporate Law*

1. *The Arms-Length Approach to Fundamental Transactions*

In arms-length transactions, the general approach for consummating a merger or acquisition requires two stages of approval: first, approval by the target board; and second, approval by the target shareholders.[195] Tender offers might be considered an exception to this general approach because a bidder, at least in theory, can bypass the board and make a tender offer directly to target shareholders. However, in practice, the poison pill makes board approval a prerequisite even for tender offers.[196] And on the second step of shareholder approval, the Delaware corporate code requires approval from a majority of the shares outstanding in a merger[197] and approval from a majority of shares outstanding (in the form of shares tendered) in a tender offer. Therefore, in the modern (post-pill) world, we have parity between tender offers and mergers in both stages of the approval process.[198]

For a deal that has received both board approval and shareholder approval, the standard of judicial review for the transaction turns on whether there is a "sale of control." Deals in which shareholders lose their governance rights—for example, an acquisition for cash—clearly constitute a sale of control and therefore trigger enhanced scrutiny under *Revlon*.[199] When *Revlon* duties apply, the target board of directors has the burden of showing that it maximized immediate value for its shareholders.[200] Other deals—for example, part-cash, part-stock deals—may or may not trigger *Revlon* duties.[201] The Delaware courts

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195. DEL. CODE ANN. tit. 8, § 251 (2001).

196. *See* Bebchuk, Coates & Subramanian, *supra* note 113, at 907-08.

197. *See* DEL. CODE ANN. tit. 8, § 251(c) (2001).

198. *See* Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037, 1043-44 (2002) (noting that the pill provides the board a role in responding to unsolicited tender offers).

199. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986).

200. *See* Guhan Subramanian, *The Drivers of Market Efficiency in* Revlon *Transactions*, 28 J. CORP. L. 691, 699 & n.52 (2003).

201. *See, e.g.*, *In re* Santa Fe Pac. Corp. S'holder Litig., 669 A.2d 59, 70-71 (Del. 1995) (holding that a transaction in which 33% of shares are acquired for cash does not trigger *Revlon*); *In re* Lukens Inc. S'holders Litig., 757 A.2d 720, 732 n.25 (Del. Ch. 1999) (holding that a merger in which the consideration was 62% cash likely triggers *Revlon*); *see also* Equity-Linked have held that freezeouts do not trigger *Revlon* duties, for the simple reason that minority shareholders in a controlled company do not have control to begin with.[202]

If a deal receives both board approval and shareholder approval and is not subject to *Revlon* duties, the business judgment rule will protect the transaction from judicial review. The recent case of *Klein v. Roslyn Bancorp*[203] illustrates the degree to which courts will defer to the board and approving shareholders in this scenario. *Roslyn* involved the arms-length merger between Roslyn Bancorp and New York Community Bancorp in June 2003. The boards of Rosyln and New York Community had both approved the stock-for-stock merger, in which each share of Roslyn would be exchanged for 0.75 newly issued shares of New York Community.[204] Roslyn shareholders subsequently approved the deal, even though it represented only a 3.2% premium when it was announced and a negative premium by the time the deal closed.[205] Plaintiffs were former Roslyn shareholders, who claimed that the Roslyn directors had breached their fiduciary duty in approving the merger with New York Community at too low of a price. A New York state court, applying Delaware law, dismissed the complaint for failure to state a claim "in light of the long standing principles of the Business Judgment Rule."[206] Despite the unusually low price, the court refused to second-guess a deal that had been approved by a disinterested target board and a majority of its shareholders.

The conceptual underpinnings for this two-stage approach can be found in the different roles that board approval and shareholder approval play. A target board (or, in practice, one or a few of its members) can negotiate with the acquirer. If the parties negotiate effectively, they will explore various options, assess tradeoffs across issues, and make offers and counteroffers, thus identifying a fair range for the deal.[207] In this multiround, repeated interaction, the target and acquirer allocate the surplus. Target shareholders then make a single "binary choice" on a take-it-or-leave-it offer presented to them by their board. While this choice serves as a useful check on a disloyal or complacent board, it is not of the same quality as a negotiation with the acquirer. In

Investors, L.P. v. Adams, 705 A.2d 1040, 1055 (Del. Ch. 1997) ("How this 'change in control' trigger works in instances of mixed cash and stock or other paper awaits future cases.").

202. *See* Mendel v. Carroll, 651 A.2d 297, 306-07 (Del. Ch. 1994); Freedman v. Rest. Assocs. Indus., Inc., No. Civ. A. 9212651, 1987 WL 14323 (Del. Ch. Oct. 16, 1987).

203. No. 016055, slip op. (N.Y. Sup. Ct. Apr. 6, 2004) (on file with author).

204. *See id.*, slip op. at 2.

205. *See id.*, slip op. at 2-3.

206. *Id.*, slip op. at 8.

207. *See* BAZERMAN & NEALE, *supra* note 149, at 67-76.

particular, the threat of a withheld tender by minority shareholders might be effective against grossly inadequate offers but may not be effective in providing more than the low end of the bargaining range—much less a "fair" price.[208]

Although the basic approval process in the arms-length arena requires two stages, there is a way around the first step of board approval. For the past thirty years, the Delaware courts have assiduously protected the right of target shareholders to elect directors,[209] who must then be able to act with a free hand in the management and oversight of the company.[210] The ability to run a proxy contest to replace the target board gives an acquirer a way to go around an incumbent board's determination of inadequacy. By extension it means that the target board does not have an unfettered right to resist a takeover; rather, in the arms-length arena, this veto right is constrained by the ability of target shareholders to elect a new board.

Admittedly, this end-run around the target board may not always be viable. A proxy contest can cost millions of dollars, which is not reimbursed unless the insurgent is successful.[211] In addition, when the target board is staggered, a potential acquirer needs to run not one but two proxy contests, spaced as long as thirteen months apart, in order to replace a majority of the target-board directors. Bebchuk, Coates, and I have presented empirical evidence indicating that this is an extremely difficult route.[212] But this finding does not change the basic point that no board, including a board that is staggered, has an absolute veto right against a controller. Rather, if the acquirer can gain sufficient support from target shareholders and is sufficiently patient, it can override a target-board veto to proceed to the second step (shareholder approval) in an arms-length deal.[213]

Thus, the picture we have from the arms-length arena can be characterized as follows: substantial, but not unfettered, discretion for a target board to

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208. *Cf.* Wolfe, *supra* note 74, at 8 (describing the procedural hurdles of the SC and MOM condition as "the difference that distinguishes a Swiss Army knife from a meat ax"). I thank Vice Chancellor Leo Strine for helpful conversations on this point.

209. *See, e.g.*, Schnell v. Chris-Craft Indus., 285 A.2d 437 (Del. 1971); Blasius Indus. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988).

210. *See* Quickturn Design Sys. v. Shapiro, 721 A.2d 1281 (Del. 1998) (invalidating slow hand pill); Carmody v. Toll Bros., 723 A.2d 1180 (Del. Ch. 1998) (denying motion to dismiss claim that dead hand pill is invalid).

211. *See* Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291 (N.Y. 1955).

212. *See* Bebchuk, Coates & Subramanian, *supra* note 113, at 927-29.

213. *See, e.g.*, Jim Carlton & Robin Sidel, *Willamette Agrees To Be Bought by Weyerhaeuser*, WALL ST. J., Jan. 22, 2002, at A3 (noting that Weyerhaeuser was successful after a fourteen-month hostile bid effort against Willamette, which had a poison pill and an effective staggered board).

negotiate with an acquirer, followed by a shareholder vote as a final check on the deal. Of course, neither of these procedural protections is directly available in the freezeout arena, because the acquirer controls both the target board and the target shareholder vote. But the Delaware courts have urged procedural protections in the freezeout context that invoke features of the arms-length process. *Weinberger*'s insistence on an SC of independent directors,[214] *Lynch*'s focus on the SC's "power to say no,"[215] and *Pure Resources*'s promotion of a MOM condition[216] can all be seen as manifestations of this approach.

2. *Application to Freezeout Doctrine*

While Delaware courts have drawn comparisons between procedural protections in freezeouts and the two steps of the arms-length approach, they have never made the features of the arms-length approach the basis for assessing the procedural protections in freezeouts.[217] As a result, current freezeout doctrine falls short of the arms-length standard for both tender offer freezeouts and merger freezeouts. Specifically, tender-offer-freezeout doctrine is deficient with respect to the first step of the arms-length standard (board approval), while merger-freezeout doctrine is deficient with respect to the second step of the arms-length standard (shareholder approval). I describe these two points in more detail in the remainder of this Subsection.

a. *Tender Offer Freezeouts*

The deficiency in tender-offer-freezeout doctrine is easy to understand: As demonstrated by empirical evidence as well as practitioner commentary, SCs lack adequate bargaining power against a controlling shareholder. This fact minimizes the first-stage negotiation that is so critical in the arms-length arena for ensuring an adequate price. In fact, some practitioner commentary suggests that too much back-and-forth with the SC in a tender offer freezeout may cause a future Delaware court to find "board action" that would eliminate the safe harbor provided by *Siliconix* and trigger entire fairness review.[218] The

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

215. *See* Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1119 (Del. 1994).

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

217. Recent opinions nevertheless indicate that the Delaware courts may be receptive to the arms-length analogy. *See, e.g.*, *In re* Cysive, Inc. S'holders Litig., 836 A.2d 531, 549 n.23 (Del. Ch. 2003); *In re Pure Res.*, 808 A.2d at 444 n.43.

218. *See* Nathan & Schwartzbaum, *supra* note 97, at 11. The irony of this point is worth noting: While merger-freezeout doctrine relies heavily (perhaps excessively) on the SC as a result is that SCs in tender offer freezeouts typically play a minimal role, consisting of making 14D-9 recommendations to minority shareholders on offers that have been predetermined, or at least largely determined, by the controller.

b. *Merger Freezeouts*

In contrast to tender-offer-freezeout doctrine, merger-freezeout doctrine falls short on the second step of the arms-length process, approval from disinterested shareholders. Only one-third of post-*Siliconix* merger freezeouts included a MOM condition.[219] In the remaining two-thirds of merger freezeouts, minority shareholders received no opportunity to express a view on the transaction because the controller can (and does) simply vote its stake in favor of the deal. The reason stems from *Rosenblatt*: Because a controller receives no incremental benefit in terms of judicial scrutiny from including a MOM condition after the SC has approved the deal (either or both of these protections merely shift the burden on entire fairness review), most controllers do not provide a MOM condition to the minority.[220] Contrast this outcome to the arms-length process, which always requires shareholder approval in the form of a merger vote or tendered shares.

MOM conditions serve two critical purposes in freezeouts. First, they provide a final check through a binary choice on a board recommendation, as described in the arms-length context above. Second, and unique to the freezeout context, a MOM condition implicitly subjects the controller's offer to a "market check."[221] For example, take a 60% controlling shareholder who negotiates a freezeout merger with an SC of independent directors, at $10 cash per share. Without a MOM condition, the deal is finalized at this point: The target board will recommend the deal to its shareholders, and the controller will vote its 60% stake in favor of the deal. In contrast, with a MOM condition, there is the possibility of a "deal jumper" who can offer more. Consider a third-party *T* who is willing to pay $12 cash for all shares. After the announcement of the merger, and before the shareholder vote required by the MOM condition, *T* can announce a tender offer for the minority shares at $12 per share. Minority shareholders now face a choice between voting in favor of a merger in which they will receive $10 per share, or tendering to *T* at $12. The outcome is

bargaining agent for the minority shareholders, tender-offer-freezeout doctrine has evolved in a manner that actually discourages the SC from acting as a bargaining agent.

219. *See* Subramanian, *supra* note 18, at 44 fig.1.

220. *See supra* Subsection I.B.3.

221. *See* CLARK, *supra* note 118, § 12.3, at 518.

not difficult to predict. If the controller nevertheless persists, *T* can block the deal by voting its newly acquired majority-of-the-minority stake against it. The controller will then be forced to either buy out *T*, presumably at more than $12 per share, or sell its stake to *T* as well.

In short, a MOM condition can facilitate an implicit market check in a merger freezeout, and, in fact, is the only way to subject a merger freezeout to a market check. This is because a controlling shareholder cannot be compelled to sell its shares to a higher-value bidder (or anyone else),[222] and the Delaware courts have held that a merger freezeout does not trigger *Revlon* duties, which would require the SC to facilitate and possibly even seek out competing bids.[223] Instead, the vast majority of controlling shareholders indicate in their initial approach to the target that they are not interested in selling to a competing bidder.[224] As a result, the SC typically cannot develop options away from the table, which are often considered to be an important source of bargaining power in negotiations generally.[225]

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

223. *See supra* note 202.

224. *See, e.g.*, ARV Assisted Living, Inc., Current Report (Form 8-K), at 4 (Sept. 24, 2002) (noting that controlling shareholder Prometheus "stated that it is not interested in selling its shares in ARV"); Letter from William J. Hannigan, Chairman and CEO, Sabre Holdings Corp., to F. William Conner, Chairman of the Special Comm., Travelocity.com, Inc. (Feb. 20, 2002), *reprinted in* Travelocity.com, Inc., Solicitation/Recommendation Statement (Schedule 14D-9), at 23 (Mar. 5, 2002) ("[R]egardless of the outcome of our tender offer, we have no intention of selling any of our equity interests in Travelocity.com . . . , nor are we willing to explore the possibility of another party making an investment in Travelocity.com . . . ."); Press Release, Minuteman Int'l, Inc. (Apr. 5, 2004), *reprinted in* Minuteman Int'l, Inc., Tender Offer Statement (Schedule TO), at Exhibit 99.1 (Apr. 5, 2004) ("Hako-Werke International [the controller] stated in its letter that it is not willing to consider any alternative transaction in which it would sell any of the common stock of Minuteman beneficially owned by it to a third party, or that would diminish in any way its ownership interest in Minuteman."); *see also* Expedia, Inc., Current Report (Form 8-K), at 28 (Oct. 11, 2002) (noting that "because IAC controls approximately 94.9% of the total voting power of Expedia shares, and does not intend to sell its Expedia shares, the possibility of a third party offer to acquire Expedia at a premium is minimal and cannot occur without the consent of IAC"). *But see* Press Release, Westerbeke Corp., Westerbeke Announces Agreement for $3.00 Per Share Cash Merger (May 5, 2003), *reprinted in* Westerbeke Corp., Current Report (Form 8-K), at Exhibit 99.1 (May 5, 2003) ("Pursuant to the terms of the merger agreement, Westerbeke is free to seek and consider acquisition proposals for the sale or merger of Westerbeke through June 12, 2003. . . . In the event that the merger agreement is terminated to accept a third party proposal or under certain other circumstances, Westerbeke has agreed to pay expenses of up to $75,000 to Mr. Westerbeke.").

225. *See* ROGER FISHER ET AL., GETTING TO YES 97-106 (2d ed. 1991) (noting that developing options away from the table is generally an important source of bargaining power in negotiations).

3. *Synthesis*

The comparison between the arms-length process and the freezeout process illuminates the ways in which freezeout doctrine should be reformed. The target of my proposal is the judiciary, because the Delaware legislature is unlikely to act in this arena anytime soon. The principal lever is the application of entire fairness review rather than business judgment review. Fairness review is a judicial (not statutory) construct, and therefore can be shaped with a relatively free hand by the Delaware courts. The central claim in the remainder of this Article is that courts should assess the extent to which the freezeout negotiation process emulates both prongs of the arms-length deal process—namely, disinterested board approval and disinterested shareholder approval. When a freezeout process provides both of these procedural safeguards, a court should apply business judgment review, regardless of the transactional form that is used. Conversely, when the process does not include these procedural safeguards, a court should apply entire fairness review.

The objective, then, is to construct a more tailored application of standards of judicial review that is sensitive to specific procedural choices that the controller and the SC make. If properly constructed, the system of standards of review would create incentives for controllers to provide adequate procedural protections to the minority, regardless of the transactional form used. These procedural protections would eliminate the efficiency loss identified in Part II. In the remainder of this Article, I describe the details that follow from this overall approach.

B. *Reforming Tender-Offer-Freezeout Doctrine*

1. *Increasing Special Committee Bargaining Power*

On tender-offer-freezeout doctrine, the objective is to increase SC bargaining power so as to emulate the board approval step in an arms-length transaction. Providing SCs with meaningful bargaining power would reinsert a well-informed committee on the other side of the negotiation process in tender offer freezeouts. This would reduce the information asymmetry between the parties at the table, which, in turn, would reduce the controller's ability to engage in the socially inefficient opportunistic behavior described in the previous Part.

There are two ways in which SC bargaining power might be increased: by constructing standards of judicial review that encourage SC approval, or by mandating the SC's use of a poison pill against the controller. In this Part, I examine these two approaches and conclude that adjusting standards of judicial review is preferable to the private solution of a pill.

a. Through Standards of Judicial Review

Increasing SC bargaining power through standards of judicial review would require a reconsideration, in part, of *Siliconix*. The critical departure from existing doctrine is that a tender offer freezeout that does not receive affirmative SC approval should be subject to entire fairness review rather than simply business judgment review.[226] As a result, and in contrast to the current regime, the SC in a tender offer freezeout would have something to give (or withhold)—namely, judicial deference to the offer price. The new bargaining process, conducted in the shadow of a judicial determination of entire fairness, would detach the price paid to the minority from the prevailing market price, by allowing other, nonpublic, factors to enter into the negotiation. This would reduce incentives for the controller to respond to, or create, discrepancies between intrinsic value and market price.

Although the proposed approach might seem to increase litigation costs because of the new potential for entire fairness review in tender offer freezeouts, the actual cost increase may be zero in a dynamic framework because controllers could avoid entire fairness review by reaching an agreement with the SC. This point highlights another benefit of the proposed approach over other, more simplistic, approaches. Under current doctrine, no party engages in a fair price determination in a tender offer freezeout. In simplistic proposals for reform, courts should engage in a determination of entire fairness, with all of the attendant difficulties of judicial valuation proceedings. In contrast, the approach outlined here allows the SC and the controller to make a fairness determination together. While both of these parties will of course be biased, the biases are in opposite directions and should cancel out, at least in part, through the give and take of a meaningful negotiation. Therefore, not only would this approach avoid the administrative costs of a fairness

226. The requirement of affirmative approval means that "no recommendation" would trigger entire fairness review. Gilson and Gordon make the same proposal in the tender-offer-freezeout context. *See* Gilson & Gordon, *supra* note 81, at 839-40. They reach their conclusion, however, through a different efficiency objective—namely, balancing the benefits of better monitoring that a controller provides in the context of the manager-shareholder relationship against the costs of private benefit extraction that arise in the controller-minority relationship. *See id.* at 785-86. The problem with this approach is that there is no "fundamental truth" in the pre-*Siliconix/Glassman* array of rules that would suggest that a deviation from this configuration must represent a social welfare loss. Nevertheless, the fact that commentators using different analytical lenses can arrive at the same policy conclusion suggests the robustness of the proposed reforms.

determination by the court, it would also lead to a more accurate fairness determination than a court could provide.

b. Through Ability To Deploy a Pill

Instead of adjusting standards of judicial review, courts could enhance SC bargaining power by requiring SCs to adopt poison pills against controlling shareholders in tender-offer-freezeout negotiations.[227] The Delaware Chancery Court has recently confirmed that SCs may adopt a pill against a controller;[228] some commentators go further to suggest that the SC should seek, and the target board should be required to give, the ability to block the bid at least temporarily through a pill.[229] This expansion was considered and rejected in *Pure Resources* itself, though Vice Chancellor Strine noted in his opinion the "analytical and normative appeal" of such an approach.[230] As of May 2005, an SC has adopted a pill against a controller only once, in ICN Pharmaceutical's June 2003 freezeout tender offer for the remaining 19.9% interest in Ribapharm. This move yielded a 12% increase over ICN's initial offer, consistent with the goal of increasing SC bargaining power in tender offer freezeouts.

The problem with this alternative is that a pill might either go too far, or not far enough, in providing SC bargaining power. First, too far: A pill might give an SC absolute veto power that might then deter some efficient freezeouts, for the reasons described in the analysis of merger-freezeout doctrine.[231] On its face, a pill would seem to give this veto power because a pill is generally regarded as a "show stopper" against potential acquirers, including, if structured correctly, a controlling shareholder.[232] If the controller has veto

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227. A "poison pill," more formally known as a shareholder rights' plan, is a warrant that gives all shareholders the right to buy shares at a substantially discounted price in the event that any individual or entity acquires more than a certain percentage of the target's stock, typically between 10% and 20%. The pill's bite comes from the fact that the entity that triggers the pill loses its right to buy shares; therefore, triggering the pill severely dilutes the bidder's stake, as all other shareholders exercise their deep-in-the-money options.

228. *See* Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1088-89 (Del. Ch. 2004), *aff'd*, 872 A.2d 559 (Del. 2005); Transcript of Oral Argument and Ruling of the Court at 72-81, Creo Inc. v. Printcafe Software, Inc., Civ. A. No. 20184 (Del. Ch. Feb. 21, 2003) (Chandler, C.) (on file with author).

229. *See* Gilson & Gordon, *supra* note 81, at 830-31, 839 (advocating the time-limited *Interco* pill).

230. *See In re* Pure Res., Inc. S'holders Litig., 808 A.2d 421, 446 (Del. Ch. 2002).

231. *See supra* Subsection II.B.1.a.

232. Recent commentators have argued that the pill is not in fact a "show-stopper" against an arms-length acquirer. *See* William J. Carney & Leonard A. Silverstein, *The Illusory Protections* power over the transaction (through its ability to rescind its offer) and the SC has veto power (through a pill), the predicted outcome will be determined by their relative bargaining power rather than in the shadow of entire fairness review. An SC may use its bargaining power to attempt to extract all of the synergies (or more), which would then deter potentially efficient freezeouts.

Alternatively, the pill might not go far enough. Because the controller typically controls the target's board, it might rescind the pill over the objection of an obstinate SC and then proceed unilaterally with its tender offer to the minority. There has not been sufficient experience with pills in the context of controlled companies to know whether a controller could or would do this.[233] But the unclear legal rules that would govern this sort of maneuvering suggest that a pill deployed by an SC might be mere window dressing, to be pulled by the controller at the moment the SC puts up a fight.

To summarize, there is no conceptual reason to believe that the ability to deploy a pill would achieve the socially optimal outcome. Even the direction of the error is ambiguous, given the absence of case law on the use of pills in the freezeout context. This is not to say that a pill might not be useful for an SC to demand—and a target board to give—in some contexts. But the analysis in this Section suggests that the better approach in bolstering SC bargaining power in freezeout tender offers is through adjustments to standards of judicial review. The ability to deploy a pill should continue to be a matter of negotiation between the SC and the target board, and not a matter of fiduciary duty imposed by the courts.[234]

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of the Poison Pill, 79 NOTRE DAME L. REV. 179, 188-89 (2003). This argument only holds for low pill-trigger thresholds, where the total dilution of the potential acquirer is relatively small. In the freezeout context, the trigger threshold would have to be extremely high, for the simple reason that the potential acquirer already holds a controlling stake. In this context, the total dilution would be quite large; by extension, the pill is far more likely to be a showstopper in this context.

233. The closest example is the recent attempt to sell control of Hollinger, in which the infamous Lord Conrad Black did not control the board himself but had the ability to replace the board through his control of the voting shares. Black threatened to use this power if the Hollinger board adopted a poison pill. *See* Transcript of Record at 43, *Hollinger Int'l*, 844 A.2d 1022 (C.A. No. 183-N).

234. Gilson and Gordon suggest that an SC should have the right to adopt a "time-limited" *Interco* pill, defined as a pill that "allows management time to secure an alternative transaction and persuade shareholders that the price bid is too low, but does not allow management ultimately to block the offer." Gilson & Gordon, *supra* note 81, at 830-31 & n.181 (citing Ronald J. Gilson, *Lipton & Rowe's Apologia for Delaware: A Short Reply*, 27 DEL. J. CORP. LAW 37, 47 (2002)). The problem with this approach is that the SC's ability to seek out an alternative transaction is severely limited by the controller's right to not sell. *See supra* text accompanying notes 223-225. In fact, most controlling shareholders explicitly disavow the possibility of a sale to a third party. *See supra* note 224 and accompanying text. And

2. *Promoting Majority-of-the-Minority Conditions*

SC approval should be a necessary but not sufficient condition for business judgment review of tender offer freezeouts. Following *Pure Resources*, an offer should be deemed noncoercive only if it includes a MOM condition as well.[235] When the freezeout includes meaningful SC approval and a MOM condition, it resembles an arms-length deal and therefore should receive minimal scrutiny from the courts. Any deviation from this blueprint—SC approval without a MOM condition, or a MOM condition without SC approval—does not look like an arms-length process and, therefore, should trigger entire fairness review. This insistence on a two-stage approval process emphasizes the point that SC approval and a MOM condition are not substitutes for each other; rather, as explained above, the SC's function is to bargain vigorously with the controller, while a MOM condition can provide only a final check through the binary choice of minority shareholder approval.[236]

While *Pure Resources* indicates that a tender offer freezeout will be subject to entire fairness review, not business judgment review, unless it includes a nonwaivable MOM condition, the decision does not make clear who would have the burden in the scenario in which the SC rejects the deal but the controller nevertheless gets MOM approval. If the burden remained with the defendant in this scenario, then a controller would have no incentive to provide a MOM condition if the SC withheld its approval. In order to create such an incentive, I propose extending the rule articulated in the merger-freezeout context[237] to tender offers: A MOM condition, even without SC approval, will shift the burden to the plaintiff. This means that a controller who goes around the SC would have an incentive to nevertheless include a MOM condition in order to achieve burden-shifting on entire fairness.

3. *The Influence of Sarbanes-Oxley and Stock Exchange Listing Requirements*

One concern with these proposed reforms is that they might trigger fairness review where current doctrine does not, in instances when a controller has complied with the full set of procedural protections that are available to it. This would happen when a target board has no independent directors, and,

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among those that do not explicitly make this point to the SC in its initial offer, most would likely reject a third-party offer if one were to materialize.

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

236. *See supra* note 208 and accompanying text.

237. *See* Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985).

therefore, cannot form an SC to negotiate with the controller. In my sample of post-*Siliconix* freezeouts, I find four such transactions out of thirty-five tender offer freezeouts.[238] Under existing doctrine, these transactions were subject only to business judgment review by the court.[239] In contrast, under the reforms proposed in this Part, these transactions would have been subject to entire fairness review due to the absence of SC approval.

Fortunately, this problem will not exist under the Sarbanes-Oxley Act and the new stock exchange listing requirements. While companies with a controlling shareholder are exempt from the requirement that a majority of the directors be independent,[240] all publicly traded companies, including controlled companies, must have a completely independent audit committee.[241] Therefore, under current corporate governance rules, all target companies will have the ability to form an SC, which means that corporate law should draw a negative inference in situations where an SC is not formed. This inference is built into the reforms proposed above, in that a controller cannot get business judgment review for the transaction if an SC is not formed. The converse of this point is equally important: The proposed reforms give a controller substantial incentives to form an SC, because this is the only way to avoid entire fairness review by the courts.

C. *Reforming Merger-Freezeout Doctrine*

1. *Promoting Majority-of-the-Minority Conditions*

My principal proposal for merger-freezeout doctrine seeks to promote MOM conditions in addition to an SC process in order to emulate both prongs of arms-length negotiations, namely, disinterested board approval and disinterested shareholder approval. Under current doctrine, either an SC process or a MOM condition shifts the burden on entire fairness review from defendant to plaintiff. My proposed addition is that the combination of an SC process and a MOM condition should shift the standard of judicial review from

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238. *See* Subramanian, *supra* note 18, at 45 fig.2. All four of these deals were subject to a MOM condition.

239. *See In re* Aquila, Inc. S'holders Litig., 805 A.2d 184 (Del. Ch. 2002).

240. *See, e.g.*, N.Y. STOCK EXCH., LISTED COMPANY MANUAL § 303A.00 (2004), *available at* http://www.nyse.com/lcm.

241. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301(3)(A), 116 Stat. 745, 776 (codified as amended at 15 U.S.C. § 78j-*l* (2002)).

entire fairness to business judgment review.[242] A merger-freezeout process that looks like an arms-length process—meaningful bargaining by the SC followed by an informed vote of the minority shareholders—is not inherently suspect and, therefore, should receive deference from the courts.

This refinement would have two effects. First, and most obviously, it would increase the number of MOM conditions by creating doctrinal incentives for the controller to provide a MOM condition to the minority. As noted above, a MOM condition would provide an implicit market check on the controller's offer to the minority. Second, and equally important, it would minimize the application of fairness review, which would reduce administrative costs.

This proposed refinement would not require a reconsideration of the burden-shifting approach outlined in *Lynch*. An SC process *or* a MOM condition would continue to shift the burden on entire fairness. The additional layer proposed here is that the combination of an SC process *and* a MOM condition would give the controller business judgment review by the court.

2. *Bolstering the Tender Offer Threat*

A second, more subtle, refinement to existing doctrine involves the court's specific holding in *Lynch*, that threatening the SC with a tender offer to the minority eliminates the SC's "ability to say no."[243] Following the approach described in Subsection III.A.1, the SC's veto power in a freezeout merger negotiation should emulate a target board's veto power in an arms-length merger, which is subject to a "proxy contest out." This means that a controller should be able to resort to its otherwise legitimate walk-away alternative of a tender offer directly to minority shareholders. By extension, a controller should be able to threaten this route as a negotiating tactic at the table with the SC—a reversal of the court's holding in *Lynch*.

Even under this proposed approach, certain threats may continue to be impermissible. Consider, for example, a threat to proceed unilaterally with the transaction—i.e., ignoring the SC, voting the deal through at the board level

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242. Other commentators have also proposed expansions of business judgment review in the freezeout arena, which amount to a carving back of the *Weinberger*-to-*Lynch* line of cases. *See, e.g.*, Allen et al., *supra* note 49, at 1306-09 (proposing business judgment review if the freezeout receives either SC approval or minority approval); Donald J. Wolfe, Jr., *The Special Negotiating Committee and the Business Judgment Rule: A Modest Proposal*, M&A LAW., Apr. 2002, at 1 (proposing business judgment review if the freezeout receives SC approval); Steven M. Haas, Note, *Toward a Controlling Shareholder Safe Harbor*, 90 VA. L. REV. 2245, 2272-75 (2004) (same).

243. *See supra* Subsection I.B.2.

over the independent directors' objections, and then voting the deal through at the shareholder level without a MOM condition.[244] This kind of threat should continue to be impermissible under *Lynch* (meaning that the controller should have the burden to demonstrate fairness) because it strips the SC of its veto power, leaving no further check on the controller's actions.

The guiding principle for treating unilateral threats differently continues to be the arms-length standard. In the arms-length context, a threat to go around the target board still requires the approval of a majority of target shareholders in the proxy contest—that is, there is no way for the buyer to unilaterally acquire the target. Likewise, a threat to go around the SC in the freezeout context must still be subjected to shareholder approval through the tender offer route.

This refinement would complement the change on MOM conditions proposed in the previous Subsection. If merger freezeouts will be increasingly subjected to MOM conditions, because of the benefit of business judgment review, then courts should be less determined to provide SCs with absolute veto power. Taken together, the proposed approach to merger freezeouts increases the procedural protection provided by MOM conditions and reduces (slightly) the procedural protection provided by SC approval. The combination more closely emulates the procedural protections that are inherent in the arms-length merger process.

Bolstering the tender offer threat in merger freezeouts would not drive prices in freezeout merger negotiations down toward market prices, as described in Subsection II.B.1.b. The reason is that the threatened tender offer would be subject to entire fairness review, due to the absence of SC approval. Entire fairness review detaches the price paid from market prices, which, in turn, reduces the incentives for inefficient opportunistic behavior by the controller. Therefore, the threat of a tender offer provides a controller a second opinion against an intransigent SC but would not allow the controller to pay a lower price.

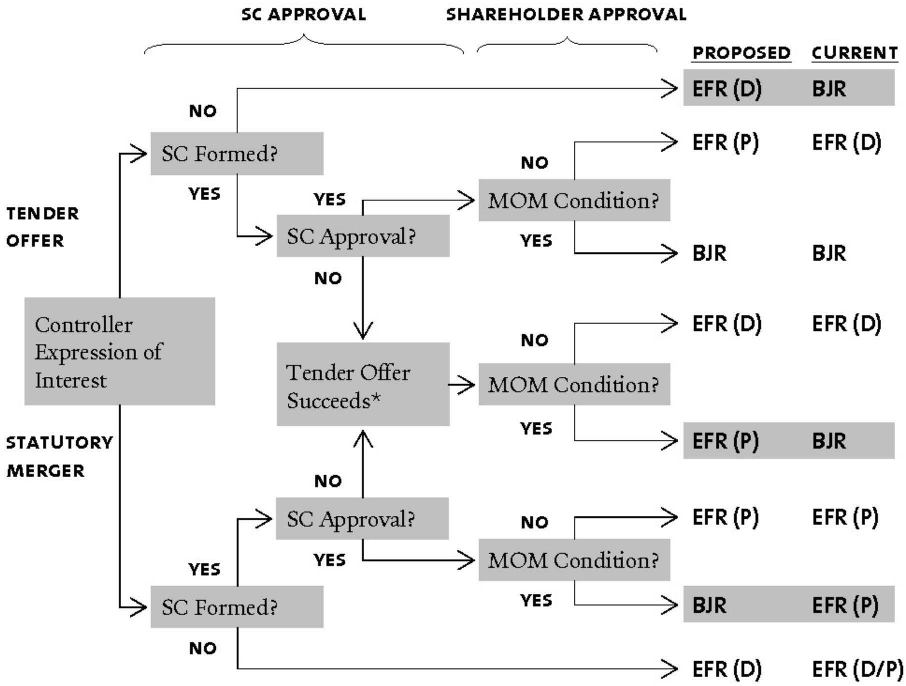
D. Synthesis

Figure 1 summarizes the standards of judicial review that would apply according to the transaction structure and procedural protections that are included in the deal. The most important departures from existing doctrine in the application of entire fairness review (EFR) and business judgment review

244. For an example of this kind of threat, see *American General Corp. v. Texas Air Corp.*, Nos. Civ. A. 8390 et al., 1987 WL 6337 (Del. Ch. Feb. 5, 1987), which involved the freezeout of Continental Airlines's minority shareholders by Frank Lorenzo's Texas Air.

(BJR) are shaded on the right side of the chart. For fairness review, the party that has the burden of proof is indicated in parentheses.

Figure 1.
PROPOSED STANDARDS OF JUDICIAL REVIEW FOR FREEZEOUTS



* Without a successful tender offer at this stage there is no transaction to be examined by the courts.

While the details are somewhat complicated, the proposal can be summarized with two simple points. First, a point on SC bargaining power: While SCs should have meaningful bargaining power against the controller, this bargaining power should be subject to the controller's right to proceed directly to minority shareholders through a tender offer freezeout (overruling aspects of *Lynch*). The controller should bear a cost, in terms of standards of review, from going around the SC, but this cost should not be prohibitive.

Second, a point on standards of judicial review: SC approval and a MOM condition should lead to business judgment review rather than entire fairness (again, overruling aspects of *Lynch*); SC approval or a MOM condition should shift the burden on entire fairness to the plaintiffs (following aspects of *Lynch* and *Rosenblatt*); and neither SC approval nor a MOM condition should trigger entire fairness review by the courts, with the burden on the defendants (overruling aspects of *Siliconix*).

One way to think about these proposed reforms is that courts should step in to fill gaps, as needed, in the procedural protections that are provided to the minority shareholders. So, for example, if a freezeout receives SC approval but not minority shareholder approval, the court should review the transaction for fairness, with the burden on the plaintiff, to fill the shoes of the minority shareholders. Likewise if the SC does not approve the transaction but minority shareholders do, the court should step in to fill the SC's shoes, again with the burden on the plaintiff shareholders to show unfairness. If both the SC and minority shareholders approve, there are no gaps to fill and so the court should defer to the outcome of the process.[245]

These proposed reforms would increase efficiency in the freezeout context in three important ways. First, by giving the SC meaningful bargaining power in tender offer freezeouts, the proposed reforms would reduce the controller's incentives to engage in opportunistic behavior and reduce (if not eliminate) the controller's ability to use nonpublic information to the detriment of the minority shareholders. Second, by softening the SC's unfettered veto power and by promoting MOM conditions in merger freezeouts, the proposed reforms would lower the procedural hurdles that currently deter some deals in this category. Putting these points together, a final benefit of the proposed reforms is convergence in the procedural protections provided to minority shareholders across transactional forms. This harmonization should eliminate the difference in freezeout outcomes and facilitate both transactional planning and the accurate valuation of a minority stake.

E. Applications

Thus far I have described my proposed reforms on a theoretical level. To see how these reforms might play out in real-world deals, I return to the two freezeout cases described in the Introduction: the Cox sisters' freezeout of the

245. An important caveat is that business judgment review should not be invoked if the plaintiff can (1) challenge the independence of the SC under the standard set forth in *Aronson v. Lewis*, 473 A.2d 805, 815-16 (Del. 1984), and more recently developed in *In re Oracle Corp. Derivative Litigation*, 824 A.2d 917 (Del. Ch. 2003); (2) undermine the validity of a MOM vote by showing inadequate disclosure or coercion; or (3) plead with particularity that the SC process was corrupted despite the facial independence of the SC. *Cf. In re* Cysive, Inc. S'holders Litig., 836 A.2d 531, 549 n.23 (Strine, V.C.) (2003) (suggesting that courts should not apply the business judgment rule when the merger was the product of fiduciary misconduct).

minority shareholders of Cox Communications in late 2004; and News Corporation's freezeout of the minority shareholders of Fox Entertainment Group in early 2005. Both targets were incorporated in Delaware. Both targets employed an SC of independent directors (three directors at Cox, two at Fox) that eventually approved the deal, and both deals included a MOM condition as a nonwaivable deal term. And, in the end, both deals were successful. But a critical difference lies in their choice of transactional form: Cox was a merger freezeout, while Fox was a tender offer freezeout. This difference allows an illustration of the full spectrum of reforms proposed in this Article.

1. Cox Communications (August 2004)

Cox Enterprises Inc. (CEI), 98% owned by the Cox sisters, announced its intention to freeze out the minority shareholders of Cox Communications Inc. (CCI) on August 2, 2004. In its press release CEI made clear that it was pursuing a merger freezeout, and that the CCI SC would have the ability to veto the deal.[246] CEI offered $32 cash per share for the minority shares, a 16% premium over the preannouncement trading price for CCI, or $7.9 billion in total value. CCI formed an SC of the three directors on its board who were independent from CEI: Janet Clarke (chair), President of Clarke Littlefield LLC; Andrew Young, former mayor of Atlanta and former U.S. ambassador to the United Nations; and Rodney Schrock, CEO of Panasas, Inc.[247] On August 17, the SC retained Goldman Sachs as its financial advisor and Fried, Frank, Harris, Shriver & Jacobson as its legal advisor. On September 28, more than seven weeks after CEI's initial offer, the SC responded that $32 per share was inadequate and that "the Special Committee desired that CEI significantly increase its proposal."[248] CEI increased its offer to $33.50 as its "highest and final offer."[249] A stalemate then followed that loomed dangerously close to an impasse. Janet Clarke described her negotiations on October 15 with James Kennedy, the CEO of CEI, as follows:

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246. *See* Press Release, Cox Enters., *supra* note 2 ("CEI expects the Board of Directors of CCI to form a special committee of independent directors to consider the proposal with the assistance of outside financial and legal advisors and to negotiate the proposal with CEI. Directors of CCI affiliated with CEI will not participate in the evaluation of the proposal, *which requires the approval of the special committee*." (emphasis added)).

247. *See* Cox Commc'ns, Inc., Solicitation/Recommendation Statement (Schedule 14-D9), at Exhibit 99.1 (Aug. 10, 2004).

248. *See* Affidavit of Janet Clarke at 2-3, *In re* Cox Commc'ns, Inc. S'holders Litig., C.A. No. 613-N, 2005 WL 2001310 (Del. Ch. Mar. 10, 2005) (on file with author).

249. *Id.*

> We stated that we had previously indicated that a $35 per Share price would not be acceptable. Mr. Kennedy stated that $34.50 was CEI's highest price and that CEI would withdraw its proposal if this price were not acceptable to us . . . . [Later that day] I told Mr. Kennedy that the Special Committee would not support a price lower than $35 per Share. Mr. Kennedy again stated that he was not willing to increase CEI's offer above $34.50 per Share and was prepared to immediately withdraw CEI's proposal.[250]

Note the way in which the shadow of merger-freezeout doctrine influenced this negotiation.[251] CEI's "final and best" offer of $34.50 represented a 25% premium over the preannouncement price of CCI's minority shares, or $1.7 billion in aggregate additional value for the minority shareholders; yet at no point in the negotiation did CEI (through its CEO Kennedy) threaten to take its offer directly to the minority shareholders through a tender offer, likely due to the insistence in *Lynch* of "playing nicely" with the SC.[252] In addition, the background legal rules forced CEI to negotiate with both the SC and Abbey Gardy, chair of the plaintiffs' committee, because the SC could not, through its approval, extinguish the plaintiffs' entire fairness claim.

On the SC's side, Clarke and her colleagues made full use of their veto power, extending the negotiation for more than four months, and, in the end-game, threatening to walk away from $1.7 billion in an effort to extract an extra $123 million (50 cents per share) for the minority. In this case the brinksmanship tactic worked, at least in part: CEI increased its offer by an additional 25 cents per share, or $61 million, in order to reach an agreement with the SC and with plaintiffs' counsel. But the standard agency cost concerns that pervade so much of corporate law are at least lurking in the background here. Clarke, Young, and Schrock each earned $75,000 per year as board members of CCI,[253] and, as is normally the case, did not join the CEI board after the freezeout.[254] While this level of director compensation is well within the acceptable limits for companies like Cox and is unlikely to have had a significant influence on the SC's decision-making, it is clear that the financial

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250. *Id.* at 3-4.

251. *Cf.* Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950 (1979) (demonstrating how the "shadow of the law" provides endowments that influence outcomes).

252. *See supra* Subsection I.B.2.

253. *See* Cox Commc'ns, Inc., Proxy Statement (Schedule 14A), at 12 (Apr. 5, 2004).

254. *See* Cox Commc'ns, Inc., Amendment No. 11 (Schedule 13D/A), at Schedule I (Dec. 22, 2004) (listing members of Cox Enterprises board after the freezeout).

incentives and other perquisites for the SC members created a structural incentive against the deal, at least at the margin.

Consider the influence that the reforms proposed in this Article might have had in the Cox situation. First, CEI would have had greater bargaining power in the negotiation because it could have threatened to take its deal directly to the minority shareholders—that is, CEI's walk-away alternative would have been a tender offer freezeout rather than no deal. This subtle shift would increase the likelihood that value-creating freezeouts would be realized because the SC would be less likely to adopt brinksmanship tactics if it no longer had unchecked veto power over the deal. Reasoning back, a controller would be more likely to initiate a value-creating freezeout due to the reduced likelihood that an intransigent SC would hold up the deal.

In situations where the controller actually made good on its threat to go to minority shareholders over the objection of the SC, the minority would be adequately protected through fairness review by the courts. The converse of this point is also critical: The controller could extinguish the class action fairness claim by gaining the SC's approval and subjecting the deal to a MOM condition. As a result, the litigation costs that arise under current doctrine would be reduced or eliminated.

What difference would these reforms have made in the Cox situation? While any answer is of course speculative, one plausible scenario is that CEI would have made $34.50 its true "final and best" offer, coupled with a tender offer threat; in view of this credible threat the SC would have accepted the $34.50 offer, conditional on MOM shareholder approval; and, after the MOM vote, the transaction would have been subjected only to business judgment review. Relative to the actual outcome, this hypothesized outcome would have represented a transfer of $63 million (or 25 cents per share) from the minority to the controller, and a transfer of $1.3 million (the size of the court-approved attorneys' fee) from plaintiffs' counsel to the controller. More important than these wealth transfers, efficiency improvements would have arisen from the increased likelihood that controllers would initiate value-creating freezeouts and the increased likelihood that such deals, once initiated, would be successful.

2. *Fox Entertainment Group (January 2005)*

News Corporation's freezeout of the Fox Entertainment minority shareholders illustrates the other set of reforms proposed in this Article. On January 10, 2005, News announced its initial offer of 1.9 News shares for each Fox share, which represented a 7.4% premium over the preannouncement trading price for Fox. While News CFO David DeVoe declared that the offer represented "full and fair value for the Fox shareholders,"[255] investors immediately denounced the premium as "a little thin"[256] and "a little bit skinny."[257] Consistent with the theory developed in this Article,[258] some investors also claimed that News was acting opportunistically, freezing out the Fox minority shareholders while Fox was in a "rough patch."[259]

From the outset, and in stark contrast to the Cox freezeout process, News made clear its intention to go forward with its offer regardless of whether Fox formed an SC, and, if an SC were formed, regardless of what the SC recommended.[260] Despite this saber-rattling, just hours after the offer was announced Fox formed an SC consisting of the two directors on its board who were independent of News: Christos Cotsakos, former CEO of E*Trade, and Peter Powers, a strategy consultant who headed his own firm. Within one week the SC retained the Blackstone Group and Morgan Stanley as its financial advisors, and Simpson, Thacher & Bartlett as its legal advisor. On January 21, faced with the deadline for its initial 14D-9 filing, the SC stated that it was not yet able to take a position on the offer. On February 25, the SC counteroffered with a 2.25 exchange ratio for the Fox shares. On March 1, News indicated that it "might be willing to increase its exchange ratio to 2.00 plus possibly a very small additional increment if this would result in a favorable recommendation by the Special Committee."[261] The next day the parties agreed on an exchange ratio of 2.04 News shares for each Fox share. The agreement was announced

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255. *See* News Corp., January Investor Conference Call (Jan. 10, 2005) (statement of David DeVoe, Chief Fin. Officer, News Corp.), *reprinted in* News Corp., Filing of Certain Prospectuses and Communications in Connection with Business Corporation Transactions (Form 425), at 9 (Jan. 10, 2005).

256. *See id.* at 13 (statement of David Meller, Sanders, Morris & Harris) ("The 7.4% premium you announced this morning seems a little thin—no offense.").

257. *See id.* at 16 (statement of Scott Suprelli, Copper R. Capital) ("I would echo the earlier comment that the premium seems a little bit skinny, based on a number of factors. . . . [Based on comparable companies] you're looking at a price that's closer to $41 than the current price offered.").

258. *See supra* Subsection II.A.2.a.

259. *See* News Corp., January Investor Conference Call, *supra* note 255, at 9 (Mike Gallant, CIBC: "I was just wondering if you [could] comment [on] buying it now. [I]t's been pretty well documented that the broadcast network is going through a rough patch; SPOT-TV is in pretty tough shape. They're coming off a huge couple years on the filmed entertainment side. So I'm just curious, again, just following-up on Rich Greenfield's question of why now and not six to nine months when things settle out a little better on that front?" Dave Devoe: "I don't think I really have a lot more to add to it.").

260. *See* Letter from K. Rupert Murdoch to the Fox Entm't Group Bd. of Dirs., *supra* note 11.

261. Fox Entm't Group, Solicitation/Recommendation Statement (Schedule 14D-9/A), at 11 (Mar. 7, 2005).

on March 3, and the deal closed on March 22, less than eleven weeks after the initial offer from News.

Note the difficult bargaining situation that confronted the Fox SC. It could not hold up the deal; indeed, the tender offer was underway at the same time that the SC was attempting to extract a higher price from News. Plaintiffs' counsel, though present in this deal, had limited bargaining power as well because the *Siliconix* precedent eliminated entire fairness review for the transaction. Putting these points together, the Fox freezeout seems consistent with the theory developed in this Article that the binding constraint on News's final offer price was simply what the requisite fraction of the minority would accept—a "binary choice" that would not necessarily reflect "fair value" in the freezeout. Perhaps illustrating this point, the final premium paid to the Fox minority shareholders was 8.4% lower than the premium paid in Cox. Put differently, if the Fox minority had received the same premium as the Cox minority, they would have achieved an additional $504 million in total consideration from News.[262]

More important than this wealth transfer, however, are the efficiency implications. Under the reforms proposed in this Article, the SC would have had greater bargaining power because News would only be able to avoid entire fairness review by gaining the SC's approval. As a result, News would want to gain SC approval in order to minimize or eliminate settlement value for plaintiffs' counsel. The implication is that at least one party with access to nonpublic information about the value of Fox would have had meaningful bargaining power against the controller: most likely the Fox SC, but alternatively plaintiffs' counsel (through discovery) or the Delaware courts (through a judicial determination on entire fairness). As a result, the incentives for News to engage in opportunistic behavior (as was alleged), or to initiate socially inefficient freezeouts, would be reduced, if not eliminated.

CONCLUSION

At its core, corporate law seeks to manage three basic relationships: between shareholders and managers; between shareholders and other constituencies; and

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262. If this analysis is correct, an obvious question is why CEI chose a merger-freezeout structure. Indeed, one practitioner-oriented journal reported that some transactional lawyers were "scratching their heads" over this question. *See* David Marcus, *From Theory to Practice*, CORP. CONTROL ALERT, Dec. 2004, at 10.

between controlling shareholders and minority shareholders.[263] While most corporate law commentary during the 1980s and 1990s focused on the first two of these three fundamental relationships, considerable attention has shifted recently to the third. This shift has occurred in response to the Delaware courts' decisions in *Siliconix* and *Glassman* in the summer of 2001, as well as the increased economic significance of freezeouts in the aftermath of Sarbanes-Oxley.

Despite the intensity of the debate on freezeout doctrine over the past four years, the case for change has never been made clear. By identifying an efficiency loss from existing doctrine, this Article makes the case for change. The current tender-offer-freezeout mechanism facilitates some inefficient (value-destroying) transactions by allowing the controller to exploit asymmetric information against the minority. In addition, the merger-freezeout mechanism deters some efficient (value-increasing) transactions because of the SC's veto power and the prospect of entire fairness review. Put simply, tender-offer-freezeout doctrine goes too far, and merger-freezeout doctrine does not go far enough, in facilitating freezeouts. Unlike deficiencies in most other areas of corporate law doctrine, this efficiency loss cannot be solved through private contracting between the controller and the minority. Thus, one contribution of this Article is that it identifies why we should try to fix freezeouts.

This Article then takes up the challenge. Rather than proposing a patchwork solution, I propose a return to first principles of corporate law. At the highest level, I propose that minority shareholders should receive, to the extent possible, the same procedural protections that are built into the arms-length merger process. In the freezeout context, this principle means approval by an SC of disinterested directors, to be followed by approval from a majority of the minority shareholders. If these procedural protections are met, courts should defer to the outcome and apply only business judgment review. If these procedural protections are not met, courts should step in to apply stringent entire fairness review. These reforms, which do not require legislative intervention, would reduce, if not eliminate, the efficiency loss that is inherent in existing doctrine. The result would be a more efficient ordering of U.S. companies between public and private status.

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263. *See* Henry Hansmann & Reinier Kraakman, *The Basic Governance Structure*, *in* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 33 (2004).