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FIXING FREEZEOUTS

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Freeze-out 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 freeze-outs were historically executed as statutory mergers, recent Delaware case law facilitates a new mechanism – freeze-out 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 freeze-out tender offer mechanism facilitates some inefficient (value-destroying) transactions by allowing the controller to exploit asymmetric information against the minority. Second, the freeze-out merger mechanism may deter some efficient (value-increasing) transactions because of the special committee's ability to block the deal. These negative wealth effects are unlikely to be resolved through private contracting between the controller and the minority. Rather than advocating patchwork reforms to correct these problems, this Article proposes a return to first principles of corporate law in the freeze-out context. The result of this re-grounding would be convergence in judicial standards of review for freeze-outs, and elimination of the efficiency loss that is inherent in existing doctrine.

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Guhan Subramanian

Fixing Freezeouts

I. Introduction

A freeze-out[1] is a transaction in which a controlling shareholder buys out the minority shareholders for cash or the controller's stock. Freeze-outs have been on the rise over the past few years,[2] due at least in part to the general decline of the stock market since 2000 as well as the increased costs associated with being a public company under the Sarbanes-Oxley Act of 2002.[3] The basic legal question surrounding freeze-outs can be stated simply: Using what process, and on what terms, should minority shareholders exit? Judicial deference to an arms-length negotiation is usually not possible because of the self-dealing nature of the transaction (self-dealing because the controller is the buyer and typically controls the seller's board). Instead, the Delaware courts have generally subjected freeze-outs to stringent "entire fairness" review, in which the court assesses the fairness of both the process used and the price paid to the minority.

An important exception to this general approach appeared in the summer of 2001. In *In re Siliconix Shareholders Litigation*,[4] the Delaware Chancery Court held that a freeze-out executed as a tender offer is not subject to entire fairness review, and in *Glassman v. Unocal Exploration*,[5] the Delaware Supreme Court held that a short-form back-end merger is also exempt. Taken together, *Siliconix* and *Glassman* create a difference between tender offer freeze-outs, which are not subject to entire fairness review, and merger freeze-outs, which are. In a companion paper I construct a new database of all post-*Siliconix* freeze-outs

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[1] Also known, with some occasional loss of precision, as a "going private merger," a "squeeze-out," a "parent-subsidiary merger," a "minority buyout," a "take out," or a "cash-out merger."
[2] *See* Guhan Subramanian, *Post*-Siliconix *Freeze-outs: Theory & Evidence* (Harvard Law School Olin Series Discussion Paper # 472, August 2004), at 1 (reporting 30 freeze-outs per year during the period 2000-04, more than twice the rate reported by John Coates for the period 1985-96).
[3] *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 $1-2 million annually 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. 13, 2004) (estimating average compliance costs of $3.1 million annually for larger U.S. public companies).
[4] 2001 WL 716787 (Del. Ch. 2001).
[5] 777 A.2d 242 (Del. 2001).

and find that minority shareholders receive less in tender offer freeze-outs than in merger freeze-outs.[6]

Commentators have debated whether the tender offer mechanism is unfair to minority shareholders, and, by extension, whether judicial standards of review should be reconciled between tender offer and merger freeze-outs. The case for change has nevertheless remained unclear because of the possibility for adjustments in *ex ante* pricing of a minority stake. This Article identifies two social welfare costs of the current doctrinal regime. First, the freeze-out tender offer mechanism facilitates some inefficient (value-destroying) transactions by allowing the controller to exploit asymmetric information against the minority. Second, the freeze-out merger mechanism may deter some efficient (value-increasing) transactions because of the special committee's ability to block the deal. Put simply, freeze-out tender offer doctrine goes too far, and freeze-out merger doctrine does not go far enough, in facilitating freeze-outs. These effects are unlikely to be resolved through private contracting between the controller and the minority.

Rather than a patchwork solution to overcome these problems, this Article proposes a return to first principles of Delaware corporate law in the freeze-out context. At the highest level, the proposed reforms would attempt to replicate the elements of an arms-length negotiation in the arena of fundamental transactions – namely, disinterested board approval and disinterested shareholder approval – in the freeze-out context. This Article provides specific reforms that would achieve this goal. The result of this re-grounding would be convergence in judicial standards of review for freeze-outs, and elimination of the efficiency loss that is inherent in existing doctrine.

The remainder of this Article proceeds as follows. Part II provides a brief history of freeze-outs, beginning with the Delaware Supreme Court's landmark decision *Weinberger v. UOP* in 1983, and tracing the evolution of the doctrine through *Kahn v. Lynch*, *Solomon v. Pathe Communications*, and *Siliconix* and *Glassman* in 2001. Part II also summarizes the literature to date that has examined the *Siliconix*/*Glassman* doctrinal contour and demonstrates why the case for change has remained unclear. Part III identifies an efficiency loss that arises in the current doctrinal regime. With the case for change thus motivated, Part IV puts forward my proposal for reform. Part V concludes.

[6] *See* Subramanian, *supra* note 2, at 23-32.

II. Background

A. Historical origins of freeze-outs

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.[7] Florida enacted the first cash-out merger statute in the mid-1920s,[8] but freeze-outs only became commonplace when Delaware in the 1950s, and the Model Business Corporate Act in the 1960s, adopted similar cash-out statutes.[9] These statutes provided the statutory merger mechanism for freezing out minority shareholders, which is still the most common mechanism today.[10] In a merger freeze-out, 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.[11] 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.[12] The transaction is executed as a statutory merger under Section 251 of the Delaware corporate code or analogous provisions in other states.

Delaware courts quickly established that freeze-outs would be subject to judicial review for "entire fairness" to the minority shareholders.[13] The application of entire fairness review to freeze-outs was unremarkable, as it is consistent with the Delaware courts' general approach to self-dealing transactions.[14] The situation began to get more interesting in the late 1960s and early 1970s, when the level of freeze-out activity increased at the same time that the stock market experienced substantial declines.[15] Concerns emerged that

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[7] *See* Elliott J. Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 NYU L. REV. 624, 627-29 (1981) (providing case law).

[8] *See id.* at 632.

[9] *See id.* at 648.

[10] *See* Subramanian, *supra* note 2, at 16-18 (finding that more than two-thirds of freeze-outs between June 2001 and December 2003 were executed through the statutory merger route).

[11] *See* MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS COMBINATIONS (8th ed. 2000) 1109-1110 (describing mechanics of statutory merger freeze-out and noting other techniques that have "met with only indifferent success at the hands of the courts").

[12] *Cf. id.* (noting that minority shareholders can also receive debt or redeemable preferred stock in the freeze-out). In my companion paper I find that all freeze-outs since June 2001 have offered either cash or common stock to the minority. *See* Subramanian, *supra* note 2, at 51 (Table 1).

[13] *See, e.g.*, Gottlieb v. Heyden Chemical Corp., 91 A.2d 57 (Del. 1952), Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1952).

[14] *See* DENNIS J. BLOCK, NANCY E. BARTON & STEPHEN RADIN, 1 THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 282-88 (5th ed. 1998 & Supp. 2002).

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

controlling shareholders were taking advantage of fire-sale prices to eliminate powerless minority shareholders. According to one commentator in 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.[16]

The SEC responded to the perceived problem with the promulgation of Rule 13e-3 in 1979.[17] Under this Rule, a controlling shareholder must make extensive disclosures to the minority in conjunction with a freeze-out transaction, including the purpose of the transaction (and why alternative methods for achieving the same purpose were rejected),[18] a summary of the investment banker's fairness opinion,[19] and financial information such as current and historical market prices,[20] in order to facilitate an informed decision by minority shareholders.

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

B. Development of procedural protections

1. *Weinberger v. UOP*

The seminal case on freeze-outs in the modern era of corporate law is *Weinberger v. UOP*,[21] handed down by the Delaware Supreme Court in 1983. *Weinberger* involved a freeze-out of UOP's minority shareholders by its 50.5% shareholder Signal Companies. The 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.[22] The Delaware Supreme Court reversed, finding that the deal process did not meet the fairness standard, and remanded the case to the Chancery Court for an inquiry into the fair value of the minority shares.[23]

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[16] Arthur M. Borden, *Going Private – Old Tort, New Tort, or No Tort?*, 49 NYU L. REV. 987 (1974).
[17] *See* Rule 13e-3.
[18] *See* Schedule 13e-3, Item 7 (requiring information specified in Reg.M-A Item 1013).
[19] *See id.* Item 9 (requiring information specified in Reg. M-A Item 1015).
[20] *See id.* Item 8 (requiring information specified in Reg. M-A Item 1014).
[21] 457 A.2d 701 (Del. 1983).
[22] Weinberger v. UOP, Inc., 426 A.2d 1333 (Del. Ch. 1981).
[23] *See* Weinberger, 457 A.2d at 715.

Weinberger did several notable things. First, it replaced the antiquated Delaware Block Method for valuing shares with "any techniques or methods which are generally considered acceptable in the financial community."[24] Thus *Weinberger* brought Delaware valuation methods into line with modern finance theory. Second, in determining the elements of the minority's entitlement, the *Weinberger* court read the exclusion of synergies under Section 262 of the Delaware corporate code[25] to mean that only "speculative" elements of future value should be excluded: "[E]lements of future value . . . which are known or susceptible to proof as of the date of the merger and not the product of speculation, may be considered [in determining fair value]."[26] Third, *Weinberger* eliminated the "business purpose" test that had been established in prior Delaware cases.[27] Fourth, in a short-lived effort,[28] the *Weinberger* court attempted, prospectively, to make appraisal the exclusive remedy for minority shareholders in freeze-out transactions.[29]

Finally, and most importantly for the purposes of this Article, *Weinberger* clarified the procedural protections that minority shareholders should receive in freeze-out mergers. On this aspect 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.[30]

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

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[24] *Id.* at 713.
[25] *See* DEL. GEN. CORP. L. §262(h) (determination of fair value shall exclude "any element of value arising from the accomplishment or expectation of the merger").
[26] Weinberger, 457 A.2d at 713.
[27] *See id.* at 715 (overruling business purpose test articulated in Singer v. Magnavox, 380 A.2d 969 (Del. 1977), Tanzer v. Intl. General Industries Inc., 379 A.2d 1121 (Del. 1977), and Roland Intl. Corp. v. Najjar, 407 A.2d 1032 (Del. 1979)).
[28] *See* Rabkin v. Philip A. Hunt Chemical Corp., 498 A.2d 1099, 1108 (Del. 1985) (holding, just two years after *Weinberger*, that appraisal is not an exclusive remedy if minority shareholders allege breach of fiduciary duty).
[29] *See* Weinberger, 457 A.2d at 714-15.
[30] *Id.* at 711. (citations omitted)

UOP, was shared only with the Signal board and not with UOP.[31] This report was "of obvious significance to both Signal and UOP"[32] because it indicated that any price up to $24 per share would have been a good investment for Signal, 14% higher than the $21 per share that was actually paid. Second, the Court noted the casualness of the fairness opinion rendered by Lehman Brothers to the UOP board.[33] Among other deficiencies, the Lehman partner seems 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.[34] Finally, the Court criticized James Crawford, President and CEO of UOP, for failing to negotiate in response to Signal's first offer of $21.[35]

But in the midst of its litany of criticisms of Signal's freeze-out 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.[36]

Transactional lawyers took the hint. A special committee (SC) of independent directors quickly became standard practice in freeze-out mergers, to the point where the only freeze-outs that do not employ this mechanism today are transactions in which the target board does not have directors who are independent from the controlling shareholder.[37]

Two opposing concerns developed in response to the *Weinberger* SC mechanism. The first, voiced primarily by judges and academics, is that a SC can never be truly independent from the controlling shareholder because the controller

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[31] *Id.* at 708.
[32] *Id.*
[33] *Id.* at 707.
[34] *See id.*
[35] *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.").
[36] *Id.* at 709 n.7. (citations omitted)
[37] *See* Subramanian, *supra* note 2, at 19.

is an "800-pound gorilla"[38] who inevitably will dominate the independent directors.[39] Among those who hold this view, some (generally academics) conclude that SC's should not warrant significant deference from the courts as suggested by *Weinberger,*[40] 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.[41]

The second concern, diametrically opposite from the first concern and voiced primarily by practitioners, is that SC's are too independent from the controller. As described by one senior New York City corporate lawyer: "There are a number of times the committee turns down perfectly fine deals, or drag things out for months, because they can't get their act together. And it's a very very frustrating experience."[42] Under this view, then, 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 Communications*

These opposing views on the wisdom and efficacy of SC's, invoking fundamental questions of human nature and organizational behavior, manifested themselves in the Delaware courts in the years following *Weinberger* as a narrow, but crucial, legal question: What deference should courts afford to a freeze-out merger that was approved by an SC of independent directors? Footnote 7 of *Weinberger* was vague on this critical question. In the absence of guidance, judges on the Delaware Chancery Court divided in their approach in the late 1980s and early 1990s. In *In re Trans World Airlines, Inc. Shareholders Litigation*,[43] for example, Chancellor Bill Allen held that SC approval changed the standard of review for a freeze-out merger from entire fairness to highly

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[38] *See* In re Pure Resources Inc., Shareholder Litigation, 808 A.2d 421, 436 ("In colloquial terms, the Supreme Court saw the controlling stockholder as the 800-pound gorilla whose urgent hunger for the rest of the bananas is likely to frighten less powerful primates like putatitvely independent directors.").

[39] *See, e.g.*, William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *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."); Kahn v. Tremont, 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.").

[40] *See, e.g.*, Melvin Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997 (1988). *See generally* Victor Brudney, *The Independent Director – Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982).

[41] *See, e.g.*, Allen, Jacobs & Strine, *supra* note 39, at 1306-07.

[42] Interview with Senior Partner, New York City Law Firm (Feb.2004).

[43] 1988 WL 111271 (Del. Ch. Oct. 21, 1988).

deferential business judgment review. In contrast, in *Citron v. E.I. Du Pont de Nemours & Co.*[44] and *Rabkin v. Olin Corp.*,[45] Vice Chancellors Jack Jacobs and Bill Chandler, respectively, held that SC approval only shifted the burden on entire fairness from the defendant to the plaintiff.

These competing approaches were resolved by the Delaware Supreme Court eleven years after *Weinberger*, in *Kahn v. Lynch Communications*.[46] *Lynch* involved a freeze-out of the minority shareholders in Lynch Communications by Lynch's controlling shareholder Alcatel. Following the *Weinberger* roadmap, the Lynch board established a SC of independent directors to negotiate with Alcatel.[47] Unlike the UOP representatives in *Weinberger*, the Lynch SC was not spineless: Alcatel proposed $14 per share in cash; the Lynch SC made a counter-offer of $17; Alcatel responded with $15, $15.25, and then a "final offer" of $15.50, all rejected by the Lynch SC.[48] 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."[49] In the face of this threat, the Lynch SC caved and unanimously recommended the $15.50 offer.[50]

Minority shareholders brought suit seeking entire fairness review. The Chancery Court entered judgment for the defendants Alcatel and Lynch Communications,[51] 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.[52] The Court remanded the case to the Delaware Chancery Court with the burden on the defendant corporations to demonstrate the entire fairness of the transaction.[53]

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

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[44] 584 A.2d 490 (Del. Ch. 1990).
[45] 1990 WL 47648 (April 17, 1990).
[46] 638 A.2d 1110 (Del. 1994).
[47] *See id.* at 1113.
[48] *See id.*
[49] *See id.*
[50] *See id.*
[51] Kahn v. Lynch Communications, 1993 WL 290193 (Del. Ch.), 19 DEL. J. CORP. L. 784 (unpublished opinion).
[52] Kahn v. Lynch, 638 A.2d at 1119.
[53] On remand, the Delaware Chancery Court found that the defendants had met their burden to show entire fairness, *see* Kahn v. Lynch Communications, 1995 WL 301403, and the Delaware Supreme Court affirmed, *see* Kahn v. Lynch Communications, 669 A.2d 79 (Del. 1995). This result demonstrated that entire fairness review would not be outcome determinative. Thus *Lynch I* left the bar high by not relinquishing entire fairness review, but *Lynch II* made clear that this bar was not insurmountable. *See* Jesse A. Finkelstein, *Special Committees, Entire Fairness, and* Kahn v. Lynch Communications, 3 INSIGHTS 2 (Mar. 1996).

of its control of Lynch's board, but only to go to 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 have been successful in its tender offer.[54] 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 these points, 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 provides an unsatisfying answer from the controller's perspective. *Lynch* resolves 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.[55] Thus *Lynch* implicitly endorses the view that independent directors cannot truly be independent from the controlling shareholder, and that courts still need to scrutinize transactions for entire fairness because of the inability to replicate an arms-length process between the controlling shareholder and the SC.

3. <u>*Rosenblatt v. Getty Oil*</u>

It might be argued that, while a 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 "MOM condition").[56] 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 as well. The seminal case on this point is *Rosenblatt v. Getty Oil Company*,[57] handed down by the Delaware Supreme Court just two years after *Weinberger*. *Rosenblatt* involved the 1976 freeze-out of the minority shareholders in Skelly Oil Company, which was 80%-owned (directly and through a subsidiary) by Getty Oil.[58] 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.[59] The

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[54] Because Alcatel held less than 50%, the Court needed to determine whether it was a controlling shareholder, and concluded that it was. *See* Kahn v. Lynch, 638 A.2d at 1114-16.
[55] *See id.* at 1120-21.
[56] *See, e.g.*, Allen, Jacobs & Strine, *supra* note 39, at 1307-08. (proposing such an approach).
[57] 493 A.2d 929 (Del. 1985).
[58] *Id.* at 931.
[59] *Id.* at 936.

Skelly board approved the deal and submitted it to a shareholder vote. Although the deal was not expressly conditioned on a majority-of-the-minority vote, 89% of the Skelly minority shares were voted, of which 58% were voted in favor of the deal.[60]

The deal closed and the inevitable entire fairness class action suit was brought in the Delaware Chancery Court. The Chancery Court found the deal to be entirely 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, but did not shift the standard of review to business judgment.[61] 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 might provide.

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 judicial standards of review. Empirically, the vast majority of controllers in my sample of post-*Siliconix* merger freeze-outs (60 out of 64, or 94%) went through an SC process.[62] With the burden thus shifted by a well-functioning SC, controllers have no further incentive to provide a MOM condition. Consistent with this prediction, I find that only one-third of the merger freeze-outs in my sample included a MOM condition.[63]

To summarize, while *Weinberger* provides the procedural roadmap for freeze-out transactions, *Lynch* limits the benefits of this route by requiring a "Caesar's wife" SC process, and *Lynch* and *Rosenblatt* together reveal that even a SC/MOM combination does not eliminate entire fairness review. From a transactional lawyer's perspective, merger freeze-out 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.[64]

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[60] *Id.*
[61] *Id.* at 937.
[62] *See* Subramanian, *supra* note 2, at 17 (Figure 2).
[63] *See id.*
[64] *See* Donald J. Wolfe, Jr., *The Odd Couple: Majority of Minority Approval and the Tender Offer*, M&A LAWYER (Nov./Dec. 2002) at 6 ("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.").

Of course, the potential beneficiaries of this approach are the minority shareholders, who should gain from 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 freeze-out

A statutory merger is not the only way to execute a freeze-out. A freeze-out can also be executed through a reverse stock split or an asset acquisition, though these methods are rare in practice.[65] Another method that began to appear in the 1990s was a freeze-out 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 then form a special committee of independent directors to assess the transaction, negotiate with the controller, and issue a Schedule 14D-9 recommendation to the minority (approve, reject, neutral, or unable to take a position). If the controller gained sufficient 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 (non-tendering) minority shareholders.[66] Because 90% is the critical threshold in a tender offer freeze-out, 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 freeze-outs would also be subject to entire fairness review, because they achieved the same end-result as merger freeze-outs, namely, the elimination of the minority shareholders.[67] As a result there was no obvious benefit to be gained from a tender offer freeze-out, and the merger form dominated in practice. This calculus began to change in the mid-1990s with the Delaware Supreme Court's decision in *Solomon v. Pathe Communications Corp*.[68] In *Solomon*, the Delaware Supreme Court affirmed a Chancery Court holding that a tender offer by a controlling shareholder to the

[65] *See* Subramanian, *supra* note 2, at 16 (noting 2 out of 96 post-*Siliconix* freeze-outs that were executed as reverse stock splits rather than as statutory mergers or tender offers).
[66] *See* DEL. GEN. CORP. L. § 253; RMBCA §11.05.
[67] *See* Bradley R. Aronstam, R. Franklin Balotti & Timo Rehbock, *Delaware's Going-Private Dilemma: Fostering Protections for Minority Shareholders in the Wake of* Siliconix *and* Unocal Exploration, 58 BUS. LAW. 519, 521 (2003).
[68] 672 A.2d 35 (Del. 1996).

minority was not subject to entire fairness review.[69] The Court reasoned that a tender offer was a deal between the controlling shareholder and minority shareholders, which involved no conflict of interest.[70] Importantly, *Solomon* was not a freeze-out situation, and could have easily been limited to its facts.[71] Nevertheless, practitioners read the tea leaves of *Solomon* to suggest that a tender offer freeze-out might not be subject to entire fairness review.

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 freeze-out.[72] As a result of this doctrinal uncertainty, practitioners continued to stay away from tender offer freeze-outs in favor of the traditional merger route.[73]

2. *In re Siliconix Shareholders Litigation*

The test case on the front-end tender offer came five years after *Solomon*, in *In re Siliconix Shareholders Litigation*.[74] *Siliconix* involved Vishay's freeze-out 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.[75] With Vishay's encouragement, Siliconix appointed a special committee of two independent directors to negotiate with Vishay.[76] The SC hired legal and financial advisors and concluded that the offer price was inadequate.[77] After three months of negotiations, Vishay switched from a cash tender offer to a stock exchange offer at 1.5 Vishay shares for every Siliconix share.[78] 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 freeze-out: "Because . . . there were no disclosure violations and the tender is not coercive, Vishay was not obligated to offer a fair price in its tender."[79]

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[69] *See id.* at 39.
[70] *See* Solomon v. Pathe Communications Corp., 672 A.2d 35, 39 ("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.").
[71] *See* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PENN. L. REV. 785, 818 n.122 (2003) (noting potential narrow reading of *Solomon*).
[72] *See* Pure Resources, 808 A.2d at 437.
[73] *See* Subramanian, *supra* note 2, at 17 (noting only 14 tender offers out of 242 total freeze-outs in the period between *Solomon* and *Siliconix*).
[74] 2001 WL 716787 (Del. Ch. 2001).
[75] *See id.* at *2.
[76] *See id.*
[77] *See id.* at *3.
[78] *See id.* at *4.
[79] *Id.* at *6.

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*,[80] handed down in August 2001, the parent corporation Unocal Exploration ("Unocal") owned 96% of its subsidiary Unocal Exploration Corporation ("UXC").[81] Unocal decided to freeze-out the minority shareholders, and UXC appointed a special committee of three directors to negotiate the terms of the deal.[82] 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 freeze-out was executed as a short-form merger under Section 253 of the Delaware corporate code.[83]

Minority shareholders brought suit alleging that the transaction was unfair. The Delaware Chancery Court declined to apply entire fairness review and dismissed the claim.[84] 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."[85] The Court reasoned that Section 253 was intended to provide a streamlined process for accomplishing a merger, which would be thwarted if the transaction were then subject to entire fairness review. In particular, the target company would have difficulty establishing the fair process prong of entire fairness: "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."[86]

Thus with *Glassman* the other shoe had dropped, and practitioners now had a blueprint for avoiding entire fairness review in a freeze-out transaction. Under *Siliconix* a tender offer to the minority would be exempt from entire fairness review, and if the controller got to 90% voting control the back-end short-form merger would also be exempt under *Glassman*. Practitioners,[87] academics,[88]

[80] 777 A.2d 242 (2001).
[81] *See id.* at 243.
[82] *See id.*
[83] *See id.* at 243-44.
[84] Glassman v. Unocal Exploration, C.A. No. 12453 (Del. Ch. 2001).
[85] Glassman v. Unocal Exploration, 777 A.2d at 248 (Del. 2001).
[86] *Id.* at 247.
[87] *See, e.g.,* Aronstam, Balotti & Rehbock, *supra* note 67; CHARLES NATHAN & DAVID SCHWARTZBAUM, GOING PRIVATE VIA UNILATERAL TENDER OFFER (2001) (Latham & Watkins client presentation, on file with author).
[88] *See, e.g.,* Gilson & Gordon, *supra* note 71, at 817-827; A.C. Pritchard, *Tender Offers by Controlling Shareholders: The Specter of Coercion and Fair Price,* 1 BERKELEY BUS. L. J. 83 (2004).

and judges[89] quickly noted the disparity in judicial treatment between tender offer freeze-outs and merger freeze-outs. 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 transactional forms that achieved the same result in practice.

4. *In re Pure Resources*

In re Pure Resources Shareholder Litigation,[90] the most recent doctrinal development on freeze-outs, 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,"[91] Vice Chancellor Leo Strine, following *Solomon*, declined to apply entire fairness review to Unocal's freeze-out tender offer.[92] 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 non-coercive to the minority.[93] The court seized on this qualification to establish three procedural conditions that must be met in order for a tender offer to be non-coercive: (1) the offer must be subject to a non-waivable majority-of-the-minority tender condition; (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 special committee.[94] The *Pure Resources* court confirmed, however, that if these conditions were met then a freeze-out tender offer would not be subject to entire fairness review.

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[89] *See, e.g.*, In re Siliconix Shareholders Litigation, 2001 WL 716787 at *6 ("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."); In re Pure Resources, 808 A.2d 421, 442 ("I admit being troubled by the imbalance in Delaware law exposed by the *Solomon*/*Lynch* lines of cases.").

[90] 808 A.2d 421 (Del. Ch. 2002).

[91] *Id.* at 435.

[92] *Id.* at 443-444.

[93] *See* Solomon, 672 A.2d 39 ("[I]n the absence of coercion or disclosure violations, the adequacy of the price in a voluntary tender offer cannot be an issue.").

[94] *See* Pure Resources, 808 A.2d at 445. In a companion paper I report that these conditions were present in most tender offer freeze-outs even before *Pure Resources*. *See* Subramanian, *supra* note 2, at 51 (Table 1). *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., Shareholder Litigation*, 28 DEL. J. CORP. L. 645, 668 (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.").

D. Practitioners' response

Practitioners, particularly those at the major New York City corporate law firms, responded to *Siliconix*, *Glassman*, and *Pure Resources*. The percent of freeze-outs that were executed as tender offers increased from 6% during the period between *Solomon* and *Siliconix*, to 28% in the period after *Siliconix*,[95] and virtually all of the tender offer freeze-outs in this new era include the procedural protections enumerated in *Pure Resources*.[96] In a companion paper, I examine all post-*Siliconix* freeze-outs (n=99) and find that controlling shareholders pay less to the minority, on average, in tender offer freeze-outs relative to merger freeze-outs.[97]

The explanation for this finding begins with the different standards of judicial review. Specifically, the possibility of entire fairness review for merger freeze-outs gives the SC bargaining power and plaintiffs' counsel settlement value, which collectively force the controller to pay full value for the minority shares. In contrast, the SC in a tender offer freeze-out has a limited formal role (only to issue a 14D-9 recommendation), and cannot veto the transaction. In fact, the controller often initiates its tender offer before the SC is even formed. Interviews and informal conversations with senior New York City practitioners confirm the point that SC's have greater bargaining power in a merger freeze-out than a tender offer freeze-out. For example, Charles Nathan, Global Co-Chair of the M&A department at Latham & Watkins in New York City states: "If you were to ask me, from a practical point of view, is there a difference in the leverage, the answer is vast. If this is a traditional [merger] transaction, the special committee has a lot more leverage."[98]

Of course, this analysis raises a puzzle: why would a controlling shareholder ever proceed via statutory merger in the current doctrinal regime? Or, put differently, why haven't more than 28% of controlling shareholders taken advantage of the "get-out-of-jail-free-card"[99] and "fire sale"[100] that the

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[95] *See* Subramanian, *supra* note 2, at 17.
[96] *See id.* at 51 (Table 1).
[97] *See id*. at 23-32. I use premiums over the pre-deal market price and increases over first offers to measure deal outcomes. In addition, the completion rate is higher for tender offer freeze-outs than merger freeze-outs. *See id.*
[98] *See* Interview with Charles Nathan, Global Co-Chair of Mergers & Acquisitions, Latham & Watkins (Feb. 20, 2004) [hereinafter "Nathan Interview"]. *See also* Interview with Richard Hall, Partner, Cravath, Swaine & Moore (Mar. 4, 2004) [hereinafter "Hall Interview"] ("The special committee [in a tender offer freeze-out] has no ultimate authority. It makes an important recommendation, but it has no ultimate authority.").
[99] *See* Gilson & Gordon, *supra* note 71 at 827.
[100] *See* Pritchard, *supra* note 88, at 83. *See also* Robin Sidel, *Takeover Targets Force Up Offers in "Minority Squeeze-Out" Deals*, WALL ST. J. (May 10, 2002) at C3 ("A couple of major court

Siliconix/*Glassman* combination provides? In my companion paper I provide answers to this puzzle that focus on the shareholder vote requirement in different transactional forms, as well as the pattern of diffusion of the tender offer freeze-out mechanism among corporate law firms.[101] But for purposes of the present analysis, only three points are critical. First, current Delaware law provides different standards of judicial review for merger freeze-outs and tender offer freeze-outs, even though both transactional forms allow the controlling shareholder to eliminate the minority.[102] Second, and as a result, the SC has substantially less bargaining power against the controlling shareholder in a tender offer freeze-out than the same SC in a merger freeze-out. And finally, this difference in bargaining power manifests itself in deal outcomes. I now review the academic and practitioner commentary that has developed in response to this state of play.

E. Prior literature

Commentators have divided on the *Weinberger* to *Siliconix* line of cases. These responses can be divided into three categories: those who advocate convergence in judicial standards of review by subjecting tender offer freeze-outs to entire fairness review; those who defend the status quo; and those who propose hybrid approaches. This Part summarizes and assesses each of these positions in turn.

<u>1. Advocating entire fairness review for tender offer freeze-outs</u>

At one end of the spectrum, some commentators argue for doctrinal convergence through entire fairness review for tender offer freeze-outs, on grounds of substance-over-form and doctrinal coherence.[103] Although this simple solution does have some superficial appeal, there are three problems with it. First, the substance-over-form argument is in tension with Delaware's

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decisions handed down last year . . . essentially permit those big holders to buy the minority investors out on the cheap.").

[101] *See* Subramanian, *supra* note 2, at 9-13.

[102] *Cf.* In re Cysive Inc. Shareholders Litigation, 836 A.2d 531, 547 (Del. Ch. 2003) ("This case brings to the fore an aspect of our corporation law that is passing strange [referring to freeze-out doctrine].").

[103] *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).

formalistic approach to corporate law, in which choice of transactional form is respected. For example, Delaware affords "equal dignity" to the corporate code provisions authorizing statutory mergers and sale of assets, thereby tolerating different procedural protections in these two types of transactions even though they can yield the same end result.[104] Therefore, if this argument were sufficient on its own, it would require a reformulation of other areas of Delaware law beyond freeze-outs.

A second problem is that the simple solution of expanding entire fairness review does not take into account the costs of judicial intervention. Because valuation is inherently difficult, and courts are not well-positioned to engage in this task, 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 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."[105] This aspect of judicial realism suggests that the simple solution of applying entire fairness may not adequately account for institutional realities, and may introduce judicial costs that outweigh the benefits of doctrinal convergence.

Finally, and most importantly, entire fairness review for all freeze-outs 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 counter-argument is that entire fairness review for all freeze-outs 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 if the freeze-out receives SC approval, in effect proposing a reconsideration of the rule in *Kahn v. Lynch*.[106] The question of convergence "up" or convergence "down" cannot be resolved at the level of theory. But at the very least it is clear that arguments for convergence only beg the larger question of convergence to what. Commentators who support entire fairness review for all freeze-outs do not address this issue.

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[104] *See, e.g.*, Hariton v. Arco Electronics, Inc., 182 A.2d 22 (Del. Ch. 1962), aff'd, 188 A.2d 123 (Del. 1963).
[105] ALLEN & KRAAKMAN, *supra* note 15, at 312.
[106] *See* Allen, Jacobs & Strine, *supra* note 39, at 1306.

2. Defending the status quo

A second group of commentators defend the current doctrinal contour that *Siliconix* and *Glassman* provide.[107] There are three basic arguments that these commentators put forward in support of this view. The first is doctrinal: 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 is not warranted because there is no corporate action. This argument was central to the court's reasoning in *Siliconix* itself: "[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."[108]

The problem with this argument, as noted by academics[109] and even other Chancery Court judges,[110] is that it ignores one of the most important strands of Delaware corporate law for the past twenty years, which is precisely about establishing the boundaries of the board's role in a tender offer – or more specifically, the degree to which a target board may adopt defensive measures against a hostile tender offer.[111] Thus this argument creates a tension, if not outright contradiction, between the board's role in freeze-out 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 freeze-out case, where there is no market check on the bidder's actions.[112]

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.[113] Again, this theory was offered as part of the

[107] *See, e.g.*, Jon E. Abramczyk, Jason A. Cincilla & James D. Honaker, *Going-Private "Dilemma"? Not in Delaware*, 58 BUS. LAW. 1351 (2003); Pritchard, *supra* note 88.

[108] In re Siliconix Shareholders Litigation, 2001 WL 716787 at *7.

[109] *See* Gilson & Gordon, *supra* note 71, at 820-21.

[110] *See* Pure Resources, 808 A.2d at 441 ("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.").

[111] The list is well known to students of Delaware corporate law; the most important in this line of cases are Unocal v. Mesa Petroleum, 493 A.2d 946 (Del. 1985); Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989); Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988); Unitrin v. American General Corp., 651 A.2d 1361 (Del. 1995). *See also* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence & Policy*, 54 STAN. L. REV. 887, 940-43 (summarizing the evolution of this doctrine).

[112] *See* Pure Resources, 808 A.2d at 441-42.

[113] *See e.g.*, Abramczyk, Cincilla & Honaker, *supra* note 107; Pritchard, *supra* note 88. *Cf.* Thomas M. McElroy II, Note, *In re Pure Resources: Providing Certainty to Attorneys Structuring*

rationale in *Siliconix*: "[A]s long as the tender offer is properly pursued, the free choice of the minority shareholders to reject the tender offer provides sufficient protection."[114] The problem with this argument is that it is inconsistent with my empirical evidence, which shows that minority shareholders receive less in tender offer freeze-outs than in merger freeze-outs. This finding is consistent with practitioner impressions that the binary choice of a tender decision is not a substitute for vigorous bargaining by a special committee. As described by Jim Morphy, head of the M&A 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. Armed with information and sufficient authority, it can go out and negotiate for something better.[115]

In short, the empirical evidence and practitioner impressions reject the view that minority shareholders have adequate protections in freeze-out tender offers, at least as measured against the benchmark of the freeze-out 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 *Siliconix* will, at most, create a one-time wealth transfer from minority shareholders to the controller.[116] Going forward, minority shareholders will simply pay less for a minority stake knowing that they will 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

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Going-Private Transactions, Or Not?, 39 WAKE FOREST L. REV. 539, 555 (2004) (arguing that procedural protections introduced by *Pure Resources* make the merger freeze-out and tender offer freeze-out processes "more similar").

114 Siliconix, 2001 WL 716787 at *6.

115 Comments at panel discussion on freeze-outs, held at the Harvard Law School on April 9, 2004.

116 *See* Pritchard, *supra* note 88, at 103. *See also* ROBERT CHARLES CLARK, CORPORATE LAW 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.").

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. 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 found strong support among academics,[117] judges,[118] practitioner-oriented journals,[119] and even practitioners themselves.[120] 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 freeze-out relative to a merger freeze-out, discounted for time value and likelihood of freeze-out. In reality, however, the fact that two-thirds of freeze-outs are still executed through the merger route[121] 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 choice of transactional form.

But the argument that an *ex ante* pricing adjustment is complicated does not refute Pritchard's basic claim that an *ex ante* pricing adjustment is possible. As long as there is no reason to believe that the marketplace will mis-estimate 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

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[117] *See* Gilson & Gordon, *supra* note 71, 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.").

[118] *See* Pure Resources, 808 A.2d at 443 ("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 shareholders* will simply choose to proceed to make subsidiary acquisitions by way of a tender offer and later short-form merger.") (emphasis added).

[119] *See* David Marcus, *Cleaning Up Your Corporate Structure*, CORPORATE CONTROL ALERT, at 20 (July 2003) ("The current thinking on minority buyouts, many lawyers say, boils down to two words: tender offer.").

[120] *See* Interview with Charles Nathan, Latham & Watkins, *supra* note 98 ("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."); Comments of Victor Leukow, Partner, Cleary, Gottlieb *cited in* Marcus, *supra* note 119 ("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.").

[121] *See* Subramanian, *supra* note 2, at 17 (Figure 2).

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 tender offer freeze-out or a merger freeze-out) should not depress the value of a minority stake because this risk is firm-specific (unsystematic) risk that does not get priced in the capital asset pricing model.[122]

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."[123] 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, the uncertainty created by *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.

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 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 non-trivial 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 profit 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.[125] Recent corporate law textbooks do not include references to *Siliconix*, much less its implications for choice of transactional form.[126] Taken together, this

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[122] *See generally* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 167-168 (6th ed. 2000).

[123] *See* John C. Coates IV, *"Fair Value" as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions*, 147 U. PENN. L. REV. 1251, 1295 (1999).

[124] *See id.* 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* Subramanian, *supra* note 2.

[126] *See, e.g.*, WILLIAM A. KLEIN, J. MARK RAMSEYER & STEPHEN M. BAINBRIDGE, BUSINESS ASSOCIATIONS (5th ed. 2003) (not referencing *Siliconix*); ROBERT W. HAMILTON & JONATHAN R. MACEY, CASES AND MATERIALS ON CORPORATIONS (8th ed. 2003) (same); CHARLES R.T.

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 freeze-out mechanism.

But this argument, too, does not refute Pritchard's basic contention, because the mis-pricing (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 decision will systematically under-perform 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.[127] *Ex ante* pricing of a minority stake will adjust, either immediately or 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 the next Part, however, I identify an efficiency loss inherent in existing doctrine that provides an answer to Pritchard's question.

3. Proposing doctrinal convergence through hybrid approaches

Two sets of commentators take middle-ground approaches. Ronald Gilson and Jeff Gordon propose 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*).[128] Prominent Delaware practitioner Frank Balotti, with two colleagues, also proposes a hybrid approach, urging a "limited fairness hearing" for freeze-out

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O'KELLY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS (4th ed. 2003) (same). *Cf.* D. GORDON SMITH & CYNTHIA A. WILLIAMS, BUSINESS ORGANIZATIONS 642 (2004) (not referencing *Siliconix* but excerpting *Pure Resources*). *But see* ALLEN & KRAAKMAN, *supra* note 15, at 483 (2003) (noting implications of *Siliconix* for freeze-out deal structure).

[127] *See, e.g.*, Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994) (sale of control triggers *Revlon* duties, which in this case forced Viacom to pay $107 rather than the original $70 per Paramount share, which in turn cost Viacom controlling shareholder Sumner Redstone an additional $1.0 billion).

[128] *See* Gilson & Gordon, *supra* note 71, at 838-840.

tender offers, or an amendment to the Delaware appraisal statute to require the controller to pay all minority shareholders the appraised valued of their shares.[129]

These approaches are well-considered, in that they seek to balance the competing concerns of protecting minority shareholders and facilitating value-creating transactions. As will be seen in Part IV, my own proposal for reform comes closest to these middle-ground approaches, if for different reasons. However, a basic flaw with both proposals is that they do not answer the question of why the effects of *Siliconix* and *Glassman* will not simply be priced *ex ante*. As described in the previous Section, defenders of the status quo point out that there are no apparent barriers to a private solution in the freeze-out 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 when they are forced to exit.[130] Without addressing this basic point, proponents of doctrinal reform cannot motivate the case for change. In the next Part, I attempt to do so.

III. The Problem with Existing Doctrine

In Part II I reviewed the divergent doctrinal strands on freeze-outs 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 both choice of transactional form and deal outcomes, the case for change nevertheless remains unclear. In this Part I identify the real problem with existing doctrine. Freeze-out tender offer doctrine facilitates some inefficient (value-destroying) transactions by allowing the controller to exploit asymmetric information against the minority. Freeze-out merger 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 the case for change, which I take up in detail in Part IV.

A. Opportunistic behavior in tender offer freeze-outs

1. The determination of price in tender offer freeze-outs

In a merger freeze-out, the SC bargaining process and the prospect or actuality of entire fairness review determine the price paid to the minority

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[129] *See* Aronstam, Balotti & Rehbock, *supra* note 67, at 552-57; Bradley R. Aronstam, R. Franklin Balotti & Timo Rehbock, *Revisiting Delaware's Going Private Dilemma Post-*Pure, BUS. LAW. (forthcoming 2004).

[130] For a general description of this point, *see, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991) at 146 ("[T]he majority, not the minority, bears the cost *ex ante* of the potential exploitation of the minority *ex post*.").

shareholders. The determination of price in a tender offer freeze-out is different from this characterization in two important respects. First, the empirical evidence presented in my companion paper suggests that SC's do not have meaningful bargaining power against controlling shareholders in tender offer freeze-outs. Almost half of all controllers in freeze-out tender offer negotiations do not increase their price beyond their initial offers.[131] And among those that do move from their first offers, the increases are smaller, on average, than the increases in merger freeze-out negotiations.[132] This empirical evidence suggests that controllers are able to take advantage of the SC's weak bargaining position to pay less in tender offer freeze-outs.

A second difference is that shareholders' exclusive remedy in a tender offer freeze-out is appraisal, not an entire fairness proceeding, which is a far less potent remedy for several reasons. First, as a threshold issue, appraisal is not available to minority shareholders in the approximately 20% of tender-offer freeze-outs that involve stock consideration,[133] due to the so-called "market out" exception.[134] Second, 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.[135] And finally, unlike plaintiffs in an entire fairness action, minority shareholders in appraisal must choose between accepting the consideration offered and demanding a judicially-determined appraisal of their shares.[136] Because of these factors is it well-accepted among academic commentators and practitioners that appraisal is a notoriously weak remedy compared to entire fairness review.[137] This conclusion is confirmed by the fact that minority shareholders rarely exercise their appraisal rights.[138]

Without a meaningful SC bargaining process or the background threat of entire fairness review, the sole remaining constraint on the price that the

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[131] *See* Subramanian, *supra* note 2, at 25.
[132] *See id.*
[133] *See* Subramanian, *supra* note 2, at 51 (Table 1).
[134] *See* DEL. GEN. CORP. L. §262(b)(2).
[135] *See* Andra v. Blount, 772 A.2d 183, 184 (Del. Ch. 2000); Cede & Co. v. Technicolor, Inc. 684 A.2d 289, 301 (Del. 1996).
[136] *See* DEL. GEN. CORP. L. §262(d)(1).
[137] *See, e.g.*, 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."); CLARK, *supra* note 116, at 508 ("[A]ppraisal is often a cumbersome remedy."); Randall Thomas, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L. J. 1, 48-49 (1995). *See also* Aronstam, Balotti & Rehbock, *supra* note 67, at 556 (proposing statutory amendments that would beef up the appraisal remedy).
[138] *See, e.g., Big MONY Holders Push AXA Bid into Court*, Wall St. J. (Nov. 5, 2003) ("Shareholders rarely exercise such rights because the action can be costly and time-consuming.").

controller pays in a freeze-out tender offer 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 90%, you win."[139] Jim Morphy, head of the M&A group at Sullivan & Cromwell, similarly states: "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."[140] 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 market price of the Siliconix stock."[141]

2. Categories of opportunistic behavior

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

a. Freeze-out timing

First, the controller controls the timing of a freeze-out. 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.[142] 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 non-public information, that each individually do not meet the test for materiality, but that collectively give the controller greater insight than the public minority shareholders about the intrinsic value of the company.[143]

Note that this kind of opportunism is not possible in a merger freeze-out 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 is detached from market prices, because courts in entire fairness proceedings give little

[139] *See* Nathan Interview, *supra* note 98.
[140] Comments at panel discussion on freeze-outs held at the Harvard Law School on April 9, 2004.
[141] In re Siliconix Shareholders Litigation at *2.
[142] *See* CLARK, *supra* note 116, 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.").
[143] *See id.* at 507-08 ("[I]nsiders occasionally have insight into their companies' futures that is better than the market's because of continual exposure to numerous bits and pieces of information and opinion that come their way…").

evidentiary weight to prevailing market prices.[144] Because the controller will have little or no informational advantage over the SC, it will be unable to exploit differences between market price and intrinsic value.

b. Influencing the target's value

A second way in which a controller might engage in an opportunistic tender offer freeze-out is by influencing the value of the target, which would then be reflected in the target's market price that sets the baseline for the freeze-out tender offer price.[145] John Coates summarizes the three categories of this kind of behavior: underinvestment in positive NPV projects; investment in negative NPV projects; and shirking managerial responsibilities.[146] Each of these three categories can be further divided into reversible value reductions and non-reversible value reductions.

Value reductions that are fully reversible are difficult to come by in the real world, but are at least 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 freeze-out. If the project is not completely transparent to the marketplace, a controller might rationally delay this investment until after the freeze-out, 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 from delay).

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[144] *See, e.g.*, Harris v. Rapid-American Corp., C.A. No. 6462, 1992 WL 69614 (Del. Ch. Apr. 6, 1992) ($21.88 pre-deal market price, $28 merger price, and $73.29 judicially-assessed fair value); In re Shell Oil Co., 1990 WL 201390 (Del. Ch. Dec. 11, 1990) ($44 market price, $71.20 judicially-assessed fair value); In re Emerging Communications Inc. Shareholders Litigation, C.A. No. 16415 (Del. Ch. May 3, 2004) ($7.00 pre-deal market price, $10.38 deal price, $38.05 judicially-assessed fair value). *See generally* Daniel R. Fischel, *Market Evidence In Corporate Law*, 69 U. CHI. L. REV. 941 (2002) ("Market prices are frequently given little or no weight in resolving valuation disputes in corporate law.").

[145] 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 controller's potential for expropriation that arises from "systematic impediments to the flow of 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 freeze-out. 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" as a board member.

[146] *See* Coates, *supra* note 123, at 1316.

As with the example in the previous Section, this opportunistic behavior would not be possible in a merger freeze-out because the opportunity presented by the positive NPV project would likely be known to the SC and to the court in its determination of fair value. 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 opportunistic behavior by the controller.

In contrast to the example presented thus far, most value reductions are at least partially non-reversible. Take the example of managerial shirking, which reduces firm value in ways that cannot be fully recovered after the freeze-out if certain corporate opportunities are time-limited. The controller's incentives with respect to partially non-reversible value reductions are less clear than the controller's incentives with respect to fully-reversible value reductions, because non-recoverable reductions in firm value will hurt the controller in proportion to the controller's 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-freeze-out, if the value reduction is at least partially reversible after the freeze-out.[147] In any particular case the controller would balance the controller's share of the non-reversible value reduction (which is proportional to the controller's pre-freeze-out stake) against the benefit that arises from a lower tender offer price.

<u>3. Efficiency implications</u>

Under the *ex ante* pricing argument described in Part II, it might be argued 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 at freeze-out 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 as described in the previous Section does, in fact, yield three types of efficiency losses, through non-reversible value reductions, the facilitation of some value-reducing freeze-outs, and reduced access to minority capital. I now discuss each of these effects in turn.

<u>a. Non-reversible value reductions</u>

The first, most obvious, social welfare loss arises from non-reversible value reductions. As described above, the controller may have incentives to

[147] *See* Coates, *supra* note 123, at 1316 n.208 (providing a quantitative example of this possibility).

engage in non-reversible value reductions in order to pay a lower price in the tender offer freeze-out. The intuition behind this finding is that the loss from the non-reversible value reduction may be offset by the gain to the controller in the form of a lower tender offer price. These non-reversible value-reductions, by definition, constitute an efficiency loss because they reduce the intrinsic value of the target company.

b. Facilitating some inefficient freeze-outs

A second social welfare loss arises from the possibility of buying the minority shares at less than their intrinsic value. Note that 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 freeze-out. The empirical evidence presented in my companion paper indicates that, on average, premiums in post-*Siliconix* tender offer freeze-outs 25-35% over the pre-announcement market price of the target stock.[148] 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, then, the controller would be able to make a profit on a value-destroying (negative synergy) freeze-out. 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, or the benefit of having an acquisition currency, or the benefit of analyst coverage. The controller might nevertheless decide to take the company private through a tender offer freeze-out, 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 this way the tender offer freeze-out 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 freeze-outs arises from the so-called "lemons effect" in corporate freeze-outs, first identified and described in detail by Lucian Bebchuk and Marcel Kahan.[149] If, as described above, the controller will freeze-out the minority when the market price

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[148] *See* Subramanian, *supra* note 2, at 53 (Table 2D).
[149] *See* Lucian Arye Bebchuk & Marcel Kahan, *Adverse Selection and Gains to Controllers in Corporate Freezeouts*, in RANDALL K. MORCK, ED., CONCENTRATED CORPORATE OWNERSHIP (2000).

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 over-values the company. Through backward induction, the minority shareholders should rationally bid down the value of the stock. In the extreme form of the Bebchuk & Kahan model, the market price of the minority shares is bid down to zero because of the negative signal that the lack of a freeze-out conveys.[150]

Zohar Goshen and Zvi Wiener develop a more general model of the Bebchuk & Kahan lemons effect to demonstrate that the greater the influence of market prices in determining the freeze-out price, the more depressed the market price of the minority stock will be.[151] At one extreme, if market prices have no influence in the determination of the freeze-out 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 & Kahan model, if market prices are the only determinant for the freeze-out price, the minority shares will be worthless. Goshen & Wiener conclude that "ironically, the less reliance courts put on market prices, the more accurate are market prices as a reflection of fair value."[152]

These models have important implications for the current doctrinal regime. Because the merger freeze-out process detaches the freeze-out price from the market price, through the combination of the SC bargaining process and the shadow of entire fairness review, the lemons effect is not triggered in the merger freeze-out arena. But because the primary determinant of price in a tender offer freeze-out is the prevailing market price, 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 have a choice to say no, through their tender decision. If sufficient 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 the minority infers good news from the controller's tender offer itself. More specifically, 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 this fact *ex ante*,

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[150] Paul Mahoney, *Comment on Bebchuk & Kahan*, in RANDALL K. MORCK, ED., CONCENTRATED CORPORATE OWNERSHIP (2000) at 260.

[151] *See* Zohar Goshen & Zvi Wiener, *The Value of the Freezeout Option* (working paper Sept. 2003) (on file with author).

[152] *See id.*, manuscript at 8.

should refuse to tender in order to share in the upside that the controller signals by making a tender offer.[153]

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 freeze-out 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 freeze-outs to their clients, either due to doctrinal uncertainty[154] or due to unfamiliarity with the benefits of the tender offer mechanism.[155]

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[153] 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 & Evidence*, 53 STAN. L. REV. 307, 357 (2000) (identifying possibility of "rational revaluation" in 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* freeze-outs, I find that 25 out of 27 freeze-out tender offers (93%) were successful, higher than the success rate for freeze-out mergers (76%) or arms-length M&A deals (87%). *See* Subramanian, *supra* note 2, at 17 (Figure 2); Coates & Subramanian, *supra* at 347. 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 freeze-out tender offer. *See, e.g.*, MAX H. BAZERMAN & MARGARET A. NEALE, NEGOTIATING RATIONALLY 109-113 (1992). This explanation, if correct, would be consistent with a large and growing literature from behavioral economics indicating that investors, 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 freeze-out are not inevitable, but rather contingent upon the success of the freeze-out, then minority shareholders should not rationally revalue their shares in response to the freeze-out tender offer. The most obvious example would be Sarbanes-Oxley compliance costs, which many controlling shareholders cite as an important motivation for their freeze-outs. Clearly, these savings would not be realized if the freeze-out were not successful; therefore minority shareholders should not rationally revalue in response to the freeze-out 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 freeze-out is successful. While this kind of threat would no doubt be implicit, and the credibility of the threat may be difficult given the controller's already-large stake in the company, the threat is at least plausible since the controller has the ability to make investment and operational decisions for the target.

[154] *See* Charles Nathan, Latham & Watkins, *quoted in* David Marcus, *An End Run in Delaware*, CORPORATE CONTROL ALERT (Dec. 2001) at 9 ("The risk is being the poster child for the reversal of *Siliconix*.").

[155] *See* Hall Interview, *supra* note 98 ("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 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

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.[156] 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, instead preferring a strategy that could be financed through internally-generated capital.

It might be argued 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,[157] which in itself depresses the trading price for the non-voting or low-voting class of stock.[158] 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 freeze-out will depress the price that they will receive in this offering. The result will be a distortion, at the margin, in the entrepreneur's decision on whether to sell a public stake.

B. Deterring efficient freeze-outs through the merger mechanism

As described in Part II, the two procedural hurdles in merger freeze-outs are, first, the negotiation between the controlling shareholder and the special committee of the target, and second, the possibility (or actuality) of entire fairness

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tender offer], do not firmly enough impress upon them the benefits of the *Pure Resources* structure over the special committee structure."); Nathan Interview, *supra* note 98 ("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. . . . But there may be lack of awareness on the part of many lawyers of the availability and value of the *Siliconix* structure.").

[156] 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 *Siliconx* would 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.

[157] *See, e.g.*, Holman W. Jenkins Jr., *Google Baloney*, WALL ST. J. (May 5, 2004) at A15.

[158] *See* Paul Gompers, Andrew Metrick & Joy Ishii, *Incentives vs. Control: An Analysis of U.S. Dual Class Companies* (working paper July 2004).

review. In this Part, I demonstrate how each of these procedural protections can reduce overall social welfare.

1. The problem of SC resistance

a. With SC veto power

As described in Part II, the post-*Kahn* world of freeze-out merger negotiations seems to require SC veto power over the transaction.[159] To the extent that there is ambiguity about this point (discussed in the next Section below), many controllers explicitly bestow veto power on the SC in a merger freeze-out.[160] My empirical evidence indicates that SC's have made frequent use of this veto power. In my database of all post-*Siliconix* freeze-outs, I find that the controller withdrew in 16 out of the 68 freeze-out freeze-out merger negotiations with an SC that were announced between June 2001 and April 2004, a 24% impasse rate, despite the fact that even the controller's first offer will invariably represent a premium over the prevailing market price.[161]

An obvious concern in this area is that SC's might be rejecting some freeze-out offers due to self-interest rather than the interest of minority shareholders. The independent directors who are appointed to the SC typically leave the target board when the target becomes a wholly-owned subsidiary of the (formerly) controlling shareholder. Therefore, precisely the same agency issues that have pervaded the debate about target board resistance in hostile takeovers are applicable 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 v. Mesa Petroleum*,[162] because of the "omnipresent specter" that directors are acting in their self-interest rather than in the interest of the corporation.[163] But in the freeze-out merger context, the Delaware courts have not only permitted unfettered SC veto power, they seem to have required it. This dramatically different approach in the freeze-out merger arena may deter some efficient freeze-outs.

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[159] *See* Coffee, *supra* note 137, 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, e.g.*, In re Western National Corp. Shareholders' Litigation, 2000 WL 710192, at *24 ("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.") (emphasis in original) (Del. Ch. 2000).

[160] *See, e.g.*, Cox Communications Press Release (August 2, 2004) (indicating that the freeze-out proposal "requires the approval of the special committee").

[161] *See* Subramanian, *supra* note 2.

[162] 493 A.2d 946 (Del. 1985).

[163] *See id.* at 954.

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

> 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 $50,000. 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.

While suggestive, these structural features of the freeze-out merger negotiation are not dispositive on the question of whether efficient transactions might be blocked. For example, it may be the case that the high impasse rate in merger freeze-outs simply reflects the fact that SC's reject unduly low offers made by controlling shareholders. Empirical evidence can provide some evidence on this possibility. If failed freeze-outs are due to low offers from controllers, then targets that were able to successfully resist (through a loyal SC) should have higher share prices in the aftermath of the failed negotiations. To test this theory, I examine all 16 failed freeze-out merger negotiations in my database of post-*Siliconix* freeze-outs, and compare the final offer made by the controlling shareholder against the market price of the target company as of June 30, 2004. Table 1 reports the results of this analysis.[164]

[164] One failed freeze-out in the sample (BCT International) is omitted from this analysis because neither the target nor the controlling shareholder reported an offer price publicly.

Table 1: Aftermath of Failed Merger Freeze-out Negotiations

Target	Date Announced	Final Offer Price	Value if Reinvested in S&P 500	Current Market Price[165]
Concepts Direct	Dec. 2002	$0.68	$0.85	$0.12
Cuisine Solutions Inc.	May 2002	$0.81	$0.83	$1.84
Emerging Vision Inc.	June 2003	$0.07	$0.08	$0.16
Engage Inc.	May 2002	$0.24	$0.25	$0.00
Marlton Technologies	Nov. 2002	$0.25	$0.30	$0.61
National Steel Corp.	Jan. 2002	$2.18[166]	$2.14	$0.00
Riverside Group Inc.	Feb. 2003	$0.04	$0.05	$0.02
Televideo Inc.	Oct. 2002	$0.07	$0.09	$0.13
Troy Group	March 2003	$2.76	$3.59	$3.50
Tumbleweed Inc.	June 2002	$1.75	$1.94	$1.25
UniMark Group	Nov. 2002	$0.65	$0.77	$0.14
U.S. Medical Group	Oct. 2001	$0.30	$0.31	$0.12
WFS Financial	July 2002	$22.45	$27.16	$50.02
WJ Communications Inc.	Sept. 2002	$1.10	$1.49	$3.12
Zones Inc.	May 2003	$1.00	$1.14	$2.75

The first two columns of Table 1 indicate the target company in the failed merger freeze-out negotiation, and the date that the controller initially proposed a freeze-out. The third column indicates the final price that the controller offered to the SC before withdrawing. The fourth column calculates the value per share that the minority shareholders would have achieved by June 2004 if (counter-factually) the SC had accepted the controller's final offer, and the minority had invested the proceeds from the transaction in the S&P 500 index. The fifth and final column indicates the target's market price as of June 2004.

The analysis in Table 1 reveals a mixed bag. In seven deals (shaded), the minority shareholders would have done better, usually significantly better, had the SC accepted the controller's final offer: Concepts Direct, Engage, National Steel, Riverside, Tumbleweed, UniMark, and U.S. Medical. In fact, two of these companies filed for bankruptcy in the aftermath of the failed freeze-out (Engage and National Steel), two more were forced to de-list due to thinly traded stock (Concepts Direct and U.S. Medical), and one is currently in the midst of a heated proxy contest for board control against a dissatisfied large-block (but non-controlling) shareholder (Emerging Vision).

[165] As of June 30, 2004.
[166] This figure is estimated from the controller's offer of a 50% premium over the 120-day average trading price of the minority stock.

Conversely, in seven other deals the minority shareholders have done better by holding their shares than they would have done had they sold to the controller at its final offer price: Cuisine Solutions, Emerging Vision, Marlton Technologies, Televideo, WFS Financial, WJ Communications, and Zones. In one of these deals (WFS Financial), the controller returned to the negotiating table two years after the failed freeze-out, and successfully completed its deal at more than double its previous final offer price.[167]

The shareholder wealth effects in the last failed freeze-out in the sample (Troy Group) depend on what re-investment assumptions are made. On one hand, without any re-investment assumption, minority shareholders have been better off by holding their shares ($3.50 market price versus $2.76 final offer price). On the other hand, if minority shareholders had taken the $2.76 final offer and re-invested it in the S&P 500 index, they would have achieved $3.59 today, slightly more than the current market price.

Overall, the evidence does not support the hypothesis that the freeze-outs that were vetoed were uniformly low-ball bids by controllers. The evidence also does not support the hypothesis that SC's consistently rejected bids that would have been beneficial to minority shareholders, with the benefit of hindsight.[168] In the absence of definitive empirical evidence on the question of blocked bids, we are left with the theoretical points noted above – that at the level of theory, unchecked veto power, combined with potentially mis-aligned incentives between the SC members and the minority shareholders, creates at least the potential for some efficient freeze-outs to be blocked.

b. Without SC veto power

As practitioners become more experienced with the tender offer freeze-out mechanism, it may become increasingly the case that merger freeze-outs are negotiated in the "shadow" of a tender offer freeze-out 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

[167] *See* WFS Financial 8-K (filed July 17, 2002) (announcing offer to freeze-out minority for $22.45 in Westcorp stock); WFS Financial Press Release (Sept. 26, 2002) (indicating that Westcorp had withdrawn its offer "because the two special committees were unable to reach an agreement on a mutually acceptable exchange ratio for the proposed transaction"); WFS Financial 8-K (filed May 24, 2004) (announcing freeze-out merger at $47.29 in Westcorp stock);

[168] This evidence contrasts with findings on third-party tender offers, which show that, on average, target shareholders would have received higher returns from selling to the hostile bidder than they received by remaining independent. *See* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence & Policy*, 54 STAN. L. REV. 887 (2002); Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Commentators*, 55 STAN. L. REV. 885 (2002).

agrees to a merger deal on the basis of the threat.[169] But if the controller simply breaks off negotiations, a subsequent (even immediate) tender offer to the minority would seem to avoid entire fairness review.[170] 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*.

This analysis suggests that merger freeze-outs will increasingly be negotiated in the shadow of the tender offer freeze-out threat. Interestingly, no freeze-out of a Delaware target since *Siliconix* has exhibited the pattern of merger freeze-out 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 freeze-out 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.[171] Kontron proposed to structure the deal as a two-step tender offer, subject to approval by a special committee of independent directors and a majority-of-the-minority condition.[172] The Mobile SC hired legal and financial advisors and began negotiating with Kontron.

In March 2004, Kontron expressed "disappointment" on 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 in to any bona fide third-party bid that the Mobile SC might come up with.[173] The SC responded that it would take "a significant amount of time" to undertake the market check that Kontron had suggested.[174] Kontron responded that it would make a tender offer to the minority shareholders at $0.55 per share, with a 90% closing condition.[175] The Mobile SC issued a 14D-9 remaining neutral on the offer.[176] Kontron made its tender offer and successfully acquired 91% of the voting shares, thereby satisfying the 90% condition.[177] Kontron completed its short-form back-end merger in August 2004.[178]

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[169] *See* Kahn v. Lynch Communications, 638 A.2d 1110 (Del. 1994).
[170] *See* In re Siliconix Shareholders Litigation, 2001 WL 716787 (Del. Ch. 2001); Glassman v. Unocal Exploration, 777 A.2d 242 (Del. 2001).
[171] *See* Kontron Mobile Computing, Inc. Form 8-K (filed Dec. 3, 2003).
[172] *See* Kontron Mobile Computing, Inc. Form SC-TO-T (filed June 15, 2004). Because the deal was conditioned on SC approval, it required board action that would have triggered entire fairness review. *See* Hartley v. Peapod, C.A. No. 19025 at 40 n.26 (Del. Ch. Feb. 27, 2002).
[173] *See* Kontron Mobile Computing, Inc., Form SC-TO-T (filed June 15, 2004).
[174] *See id.*
[175] *See* Kontron Mobile Schedule 14D-9/A (filed July 21, 2004).
[176] *See id.*
[177] *See* Kontron Mobile Scheduled 14D-9/A (filed August 9, 2004).
[178] *See* Kontron Mobile Form 15 (filed August 23, 2004).

As the Kontron fact pattern begins to appear more often, the efficiency loss that arises from tender offer freeze-out doctrine will spill over into the merger freeze-out 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 non-public information), if it believes that the controller would be successful in a tender offer to the minority at that price.

In a regime where the tender offer option is well-understood, therefore, prices in merger freeze-outs will be driven down to the predicted prices in tender offer freeze-outs.[179] 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 freeze-out 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.

2. The problem of deterred deals

While the problem of blocked deals involves efficient freeze-outs that are initiated by the controller but are not consummated, the problem of deterred deals involves efficient freeze-outs that are never initiated. This problem exists because SC's in the current regime are likely to extract some part of the synergies in freeze-outs mergers that occur; and because controllers may be deterred by the riskiness of entire fairness review.

a. Through allocation of deal synergies

I begin with the assumption that the likelihood that a controller will initiate a freeze-out is monotonically increasing in the controller's expected profits from the deal.[180] The conclusion that follows from this assumption is that the controller should receive the full value of the synergies from the deal, in order

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[179] In my companion paper I test this theoretical prediction by including a time trend variable in my outcome regressions. *See* Subramanian, *supra* note 2, at 33. The theory developed in this Part predicts that the coefficient for this time trend variable should be negative and statistically significant in predicting merger freeze-out prices, because merger freeze-outs will be increasingly negotiated in the shadow of a tender offer freeze-out. However, I find that this variable is not stable in magnitude or sign, and is not statistically significant. *See id.* Therefore, the empirical evidence available to date does not either support or reject the theoretical prediction developed in this Section.

[180] I thank Victor Goldberg for helpful conversations in developing this assumption. In contrast, Gilson & Gordon assume that the controller will initiate a freeze-out as long as its profits from the deal are positive. *See* Gilson & Gordon, *supra* note 71, at 804 n.73.

to maximize the likelihood that value-creating freeze-outs will be initiated.[181] The question then becomes whether and to what extent the freeze-out merger 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 element of value arising from the accomplishment of the merger."[182] Although this language on its face would seem to exclude synergy value, Delaware courts have muddied the water considerably. *Weinberger* begins 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."[183] While subsequent Chancery Court opinions have read *Weinberger* narrowly in order to exclude synergy value from the minority's entitlement,[184] on the one occasion in which the Delaware Supreme Court has re-visited *Weinberger*'s reading of Section 262(h) it has confirmed its earlier holding.[185]

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[181] Easterbrook & Fischel and Hermalin & Schwartz reach the same conclusion, but for reasons that are problematic in a similar way. Easterbrook & Fischel examine corporate control transactions generally to 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 freeze-outs, however, the gains often arise with no effort required from the controller – elimination of Sarbanes-Oxley compliance costs is a paradigmatic example of this kind of benefit that, in fact, requires "negative effort" from the controller in order to be realized. Similarly, Hermalin & Schwartz develop a theoretical model demonstrating that the controller will expend sub-optimal 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. LEG. 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 freeze-outs.

[182] DEL GEN. CORP. L. §262(h).

[183] Weinberger, 457 A.2d 701, 713 (Del. 1983).

[184] *See*, *e.g.*, Cinerama v. Technicolor, Inc., 1991 WL 111134 (Del. Ch. 1991) (rejecting Weinberger reading of §262(h) because "that reading is too difficult to square with the plain words of the statute"); In re Vision Hardware Group., Inc., 669 A.2d 671 (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. GEN. CORP. L. §262(h)); Union Illinois v. Union Financial Group Ltd., 847 A.2d 340, 343 (Del. Ch. 2004) ("The appraisal award excludes synergies in accordance with the mandate of the Delaware jurisprudence that the subject company in an appraisal proceeding be valued as a going concern.").

[185] *See* Cede v. Technicolor, 684 A.2d 289 (Del. 1996) (reversing Chancery Court ruling that synergy value should be excluded in determining fair value in appraisal proceeding). I thank Jill Fisch for helpful conversations on this point.

There is a more subtle way as well 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, i.e., what minority shareholders would receive if the freeze-out transaction were rescinded.[186] 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.[187]

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. SC's 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 freeze-out in this way deters some value-increasing freeze-outs, under the assumption that the likelihood of freeze-out is monotonically increasing in the controller's profits from the deal.

<u>b. Through controller risk aversion</u>

Another reason that some value-creating deals might be deterred by the merger freeze-out mechanism is the risk introduced by entire fairness review. Unlike an appraisal action, in which the plaintiff class is limited to minority shareholders who formally dissent from the deal, the plaintiff class in entire fairness may include all minority shareholders, including those who voted in favor of the deal.[188] Valuation is an inherently uncertain process, and the trial court is typically presented with widely divergent views from the experts on both sides of the litigation.[189] Judges are called upon to make judgments on narrow, technical questions that are often at the cutting edge of finance theory.[190] The result is that the controller in an entire fairness claim is exposed to the risk that it will have to

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[186] *See* ALLEN & KRAAKMAN, *supra* note 15, at 454.

[187] *See, e.g.*, Cede v. Technicolor (awarding minority shareholders share of synergies in freeze-out).

[188] *See* In re JCC Holding Co., Inc., 2003 WL 222466591 (Del. Ch. 2003) (minority shareholders who voted for freeze-out merger and accepted merger consideration are not barred by the doctrine of acquiescence from challenging the fairness of the deal).

[189] *See, e.g.*, Gilbert v. MPM Enterprises, 1997 WL 633298 (Del. Ch. 1997) (opposing experts valuing equity value at $87 million and $357 million); In re Emerging Communications Shareholder Litigation (Del. Ch. May 3, 2004), transcript at 51 (opposing experts valuing equity value at $10.38 and $41.16 per share).

[190] *See, e.g.*, In re Emerging Communications Inc. Shareholders Litigation, C.A. No. 16415 (May 3, 2004), at 71-76 (determining whether a "small stock premium," a "super-small stock premium," and a "hurricane premium" should be included in calculating the appropriate discount rate).

make a substantial payout to all minority shareholders.[191] While the controller can in theory negotiate away this risk, by settling with the plaintiff shareholders' attorneys, the plaintiffs' attorneys can extract more than the expected value of an entire fairness proceeding in this negotiation if the controller is risk averse. For this reason a controlling shareholders considering an efficient freeze-out merger might nevertheless be deterred by the risk inherent in entire fairness review.

To summarize: merger freeze-out doctrine may deter some value-creating freeze-outs for three reasons. First, SC's may block some socially beneficial transactions because of their considerable bargaining power, combined with incentives that may not be perfectly (or even well) aligned with the incentives of the minority shareholders that they represent. Second, merger freeze-out doctrine may deter some value-creating freeze-outs because of the possibility that entire fairness review will award some share of the synergies from the transaction to the minority, thereby reducing the controller's *ex ante* incentives to initiate welfare-increasing transactions. And finally, merger freeze-out doctrine may deter some value-creating freeze-outs because of the riskiness of entire fairness review.

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, which are subject to modification through the corporate charter.[192] In many areas of corporate law, then, the controller and the minority have the ability to contract around the default provisions to the extent that these provisions are inefficient, unclear, or both.

Surprisingly, the efficiency losses identified in this Part seem to be an exception to this general approach. Consider first the easier case of merger freeze-out doctrine. The sources of efficiency loss are the potential allocation of some of the synergy gains to the minority, and the uncertainty inherent in entire fairness review. Neither of these features are avoidable. The appraisal statute, which courts generally look to in determining the minority's entitlement under entire fairness, is one of the Code's few mandatory provisions;[193] therefore the case law interpreting this statute (including, importantly, *Weinberger*) is also not avoidable through the corporate charter. Even if the appraisal statute were

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[191] *See, e.g., id.* (finding controlling shareholder Jeffrey Prosser liable to the minority for an additional $200 million, including penalties and interest, in a freeze-out merger that initially cost $54.8 million).
[192] *See* ALLEN & KRAAKMAN, *supra* note 15, at 86.
[193] *See* DEL. GEN. CORP. L. §262(a) (omitting default provision language that is used through other parts of the Delaware corporate code).

avoidable, a court might give the minority a share of the synergies as an equitable remedy. Similarly, entire fairness review in itself is a common law construct, deployed by the courts at its discretion. Therefore the risk inherent in its application cannot be avoided by contracting parties.

Contracting around the inefficiencies introduced by tender offer doctrine is similarly problematic. One potential solution would be through a corporate charter amendment: for example, the charter could mandate the payment of "fair value" in any freeze-out transaction, as determined in a judicial proceeding or by an arbitrator, thereby disconnecting the freeze-out price from the market price.[194] This charter term would not apply to a tender offer, 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 freeze-out a controller would need to be able to use the short-form merger statute. In this short-form merger, because of the need for corporate action, a corporate charter provision might in theory provide a useful backstop to prevent a tender offer at below intrinsic value.

The problem with this potential approach is that the minority's exclusive remedy in a short-form merger is appraisal, not entire fairness.[195] As discussed in Part III.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.[196] In effect, a controller would be relinquishing its right to execute a tender offer freeze-out through the standstill agreement. The problem with this approach is that it goes too far. By forcing the controller to go through the merger route, the SC gains veto power against the deal. This result re-introduces the problem of blocked deals as described in Part III.B.1.a above.

D. Motivating the case for change

The Delaware courts' decisions in *Siliconix* and *Glassman* have generated a flurry of academic and practitioner commentary over the past three years. Most commentators have urged some form of convergence between tender offer freeze-outs and merger freeze-outs on the basis of fairness to the minority. Pritchard effectively responds to these commentators by pointing out that any such unfairness will be resolved through *ex ante* pricing of a minority position.

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[194] *See* Coates, *supra* note 123, at 1288-89 (identifying this possibility).
[195] *See* Glassman v. Unocal Exploration, 777 A.2d 242 (Del. 2001).
[196] *Cf.* Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L. J. 621, 659-621 (noting the role of standstill agreements in arms-length acquisitions).

Distinct from this exchange, Gilson & Gordon motivate their proposal for reform in the freeze-out context by urging judges and policymakers to collectively consider the three different ways in which a controller can extract private benefits from the company: by freezing out the minority, by selling control, and by taking a disproportionate amount of the corporation's ongoing earnings.[197] This argument implicitly assumes that the three methods of extracting private benefits are substitutes for each other, which may not always be the case. For example, a family group that controls a public company is likely to have developed company-specific managerial expertise – for this group a freeze-out of the minority is far more likely than a sale of control and the two methods of rent extraction are not substitutes for each other.

More fundamentally, the Gilson & Gordon argument still does not identify an efficiency loss that would arise if one particular method of rent extraction got out of line. Their general efficiency goal is to balance 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.[198] But there is no "fundamental truth" in the pre-*Siliconix*/*Glassman* array of rules which would suggest that a deviation from this configuration necessarily represents a socially welfare loss.

This Article identifies an efficiency loss that is inherent in existing doctrine. The most important source of the efficiency loss arises from freeze-out tender offer doctrine, as it has developed through *Siliconix* and *Glassman*. A secondary, but still important, efficiency loss arises from merger freeze-out 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 judicial intervention. I now propose such an intervention.

IV. A Proposal for Reform

Prior commentators have generally taken a patchwork approach to freeze-out doctrine, which, in the aftermath of *Siliconix*, has meant proposing ways in which judicial scrutiny should be bolstered in tender offer freeze-outs. In this Part I propose a recalibration that is grounded in first principles of corporate law. This grounding in fundamental principles reduces perceptions of arbitrariness, increases doctrinal coherence, and reduces possibilities for future (and currently unforeseen) transactional arbitrage that might again create an efficiency loss.

The primary objective for my proposal is to resolve the efficiency loss that is identified in the previous Part. A secondary goal, distinct but still closely tied to efficiency, is to reduce administrative costs. In the context of freeze-outs, this

[197] *See* Gilson & Gordon, *supra* note 71, at 786.
[198] *See* Gilson & Gordon, *supra* note 71, at 785-86.

means eliminating the application of entire fairness review in situations where minority shareholders have other procedural protections. We are therefore not indifferent between two regimes that both achieve the efficient level of freeze-out activity, if one requires greater judicial intervention than the other. For this reason the simplistic solution of imposing entire fairness review on all freeze-outs is not the optimal one.

Part IV.A identifies first principles of corporate law as they have developed in the context of arms-length acquisitions, and describes how existing freeze-out doctrine falls short of these principles. Part IV.B proposes reforms with respect to tender offer freeze-out doctrine. Part IV.C proposes reforms with respect to merger freeze-out doctrine. Part IV.D summarizes these proposals.

A. First principles of corporate law

1. The arms-length approach to fundamental transactions

In the arms-length arena, 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.[199] Tender offers might be thought to be an exception to this general approach because a bidder, at least in theory, can by-pass 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.[200] And on the second step of shareholder approval, the Delaware corporate code requires approval from a majority of the shares outstanding in a merger,[201] and approval from close to a majority of shares outstanding, in the former of shares tendered, in a tender offer.[202] Therefore, in the modern (post-pill) world, we have parity between tender offers and mergers on both stages of the approval process.

If a deal receives both board approval and shareholder approval, the business judgment rule will protect the transaction from judicial review. The recent case of *Stewart v. Roslyn Bancorp*[203] illustrates the degree to which courts will defer if both approval steps are met. *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-

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[199] *See* DEL. GEN. CORP. L. § 251; RMBCA 11.04.
[200] *See* Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037 (2002) (stating that the pill was developed to achieve parity between tender offers and mergers).
[201] *See* DEL. GEN. CORP. L. 251(c).
[202] The shareholder approval requirement in a tender offer is not precisely 50% because the acquirer typically gains a toehold position of slightly more than 5% before beginning its tender offer. For example, an acquirer with an 8% toehold would need 43% out of the remaining 92%, or 47% of the remaining shares, in order to achieve voting control of the target.
[203] N.Y. Sup.Ct. (April 5, 2004).

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 trade-offs across issues, and make offers and counter-offers, thus identifying the deal space.[207] In this multi-round, 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 the board. While this choice serves as a useful check on a disloyal or incompetent board, it is not (and cannot be) a negotiation with the acquirer. In particular, the threat of a withheld tender 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 an important outlet on 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

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[204] *See id.* at 2.
[205] *See id.* at 2-3.
[206] *Id.* at 8.
[207] *See* BAZERMAN & NEALE, *supra* note 153, at 67-76.
[208] I thank Vice Chancellor Leo Strine for helpful conversations on this point.
[209] *See, e.g.*, Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971); Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988).
[210] *See* Carmody v. Toll Bros., Inc., 723 A.2d 1180 (Del. Ch. 1998) (invalidating dead hand pill); Mentor Graphics Corp. v. Quickturn Design Systems, Inc., 721 A.2d 1281 (Del. 1998) (invalidating slow hand pill).

arms-length arena, this veto right is constrained by the ability of target shareholders to elect a new board.

Admittedly, the viability of this end-run around the target board can be debated. A proxy contest can cost millions of dollars, and this cost 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 present empirical evidence indicating that 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 this: substantial, but not unfettered, discretion for a target board to negotiate with an acquirer, followed by a shareholder vote as a final check on the deal. Of course, neither of these procedural protections is available in the freeze-out arena, because the acquirer controls the target board and the target shareholder vote. But the Delaware courts have urged procedural protections in the freeze-out context that invoke features of the arms-length process. *Weinberger*'s insistence on a special committee of independent directors,[214] *Lynch*'s focus on the SC's "ability to say no,"[215] and *Pure Resources*' promotion of a majority-of-the-minority condition,[216] can all be seen as manifestations of this approach.

2. Application to freeze-out doctrine

While Delaware courts have made comparisons between procedural protections in freeze-outs and the two steps of the arms-length approach, these courts have never made the features of the arms-length approach the basis on which the procedural protections in freeze-outs are assessed. As a result, current freeze-out doctrine falls short of the arms-length standard for both tender offer freeze-outs and merger freeze-outs. Specifically, tender offer freeze-out doctrine is deficient with respect to the first step of the arms-length standard (i.e., board approval), while merger freeze-out doctrine is deficient with respect to the second

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[211] *See* Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291 (N.Y. 1955).
[212] *See* Bebchuk, Coates & Subramanian, *supra* note 111, at 927-29.
[213] *See, e.g.*, Jim Carlton & Robin Sidel, *Willamette Agrees to be Bought by Weyerhaeuser,* WALL ST. J. (Jan. 22, 2002) (Weyerhaeuser successful after 14-month hostile bid effort against Willamette, which had a poison pill and an effective staggered board).
[214] *See* Weinberger v. UOP, Inc., 457 A.2d 701, 709 n.9.
[215] *See* Kahn v. Lynch Communications, 638 A.2d 1110, 1119.
[216] *See* In re Pure Resources Shareholders Litigation, 808 A.2d 421, 445.

step of the arms-length standard (i.e., shareholder approval). I describe these two points in more detail in the remainder of this Section.

a. Tender offer freeze-outs

The deficiency in freeze-out tender offer doctrine is easy to understand: as indicated by the empirical evidence as well as the practitioner commentary, SC's do not have bargaining power against a controlling shareholder. This fact eliminates the first-stage negotiation that is so critical in the arms-length arena for ensuring an adequate price. My evidence indicates that almost half of controllers in freeze-out tender offer negotiations do not increase their price beyond their initial offer – hardly what one would expect in an arms-length negotiation.[217] Among the approximately half of controllers that do move from their first offers, the increases are smaller, on average, than the increases in merger freeze-outs. In fact, some practitioner commentary suggests that too much back-and-forth with the special committee in a tender offer freeze-out 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 result is that SC's in tender offer freeze-outs typically play a minimal role, making a 14D-9 recommendation to minority shareholders on an offer that has been pre-determined, or at least largely determined, by the controller. This deficiency influences outcomes: without a meaningful arms-length bargaining process, minority shareholders receive significantly lower prices in freeze-out tender offers as compared to freeze-out mergers.[219]

b. Merger freeze-outs

In contrast to tender offer freeze-out doctrine, merger freeze-out doctrine falls short on the second step of the arms-length process, approval from disinterested shareholders. Only one-third of post-*Siliconix* merger freeze-outs include a MOM condition.[220] In the remaining two-thirds of merger freeze-outs, minority shareholders receive 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*: becomes a controller receives no incremental benefit in terms of judicial scrutiny from including a MOM condition once the SC has approved the deal (either or both merely shift the burden on entire fairness), most controllers do not provide a MOM condition to the minority.[221] Contrast

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[217] *See* Subramanian, *supra* note 2, at 25 (Figure 3).
[218] *See* NATHAN & SCHWARTZBAUM, *supra* note 87.
[219] *See* Subramanian, *supra* note 2, at 23-32.
[220] *See id.* at 19.
[221] *See supra* Part II.B.3.

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 freeze-outs. First, there is the final check through a "binary choice" on a board recommendation, as described in the arms-length context above. Second, and unique to the freeze-out context, a MOM condition implicitly subjects the controller's offer to a "market check."[222] For example, consider a 60% controlling shareholder who negotiates a freeze-out 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 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 freeze-out. In fact, it turns out that a MOM condition is the only way in which a merger freeze-out can be subjected to a market check. The reason is that a controlling shareholder cannot be compelled to sell its shares to a higher-value bidder (or anyone else), and the Delaware courts have held that a merger freeze-out does not trigger so-called *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] The result is that the SC

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[222] *See* CLARK, *supra* note 116, at 517-518.

[223] *See* Mendel v. Carroll, 651 A.2d 297 (Del. Ch. 1994); Freedman v. Restaurant Assocs. Indus., Inc. (Del. Ch. 1987), *reprinted in* 13 DEL. J. CORP. L. 651 (1988). *See generally* Guhan Subramanian, *The Drivers of Market Efficiency in* Revlon *Transactions*, 28 J. CORP. L. 691 (2003).

[224] *See, e.g.*, ARV Assisted Living 8-K (Sept. 24, 2002) (indicating 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 William Conner, Chairman of the Special Committee, Travelocity.com (Feb. 19, 2002) (on file with author) ("[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…"); Minuteman International Press Release (April 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

typically cannot develop options away from the table, which are often considered to be an important source of bargaining power in negotiations generally.[225]

To summarize, then, the only way to provide a market check on a controlling shareholder's offer is through a MOM condition, but existing Delaware doctrine makes such conditions rare in practice.

3. Synthesis

The comparison between the arms-length process and the freeze-out process illuminates the ways in which freeze-out 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.[226] Here, the principle lever is the application of entire fairness review versus business judgment review. It is important to note that 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 freeze-out negotiation process emulates both prongs of the arms-length deal process, namely, disinterested board approval and disinterested shareholder approval. The more the process provides both of these procedural safeguards, the more likely a court should be to apply business judgment review, regardless of the transactional form that is used. Conversely, the more the process does not include these procedural safeguards, the more likely a court should be to apply entire fairness review.

The objective, then, is to construct a more tailored application of judicial standards of review that is sensitive to specific procedural choices that the controller and the SC make. Specifically, when a deal process includes meaningful (but not unchecked) SC bargaining power against the controller and minority shareholder approval, courts should apply business judgment review; when either or both of these process prongs are weak or non-existent, courts should apply entire fairness review. If properly constructed, the system of

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to a third party, or that would diminish in any way its ownership interest in Minuteman."). *See also* Expedia Inc. Form 425 (June 4, 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* Westerbeke Corp. Press Release (May 5, 2003) ("Pursuant to the terms of the merger agreement, Westerbeke is free to seek and consider other 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, WILLIAM URY & BRUCE PATTON, GETTING TO YES (2nd ed. 1991) at 97-106.

[226] The last time the Delaware legislature acted in a significant way was in 1987, when it enacted a freeze-out statute. *See* DEL. GEN. CORP. L. § 203. Despite its short-hand name, this statute is generally not applicable to most "real" freeze-outs. *See* Subramanian, *supra* note 2, at 36 n.47.

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 resolve the efficiency loss as identified in Part III. In the remainder of this Article I describe the details that follow from this overall approach.

B. Reforming freeze-out tender offer doctrine

1. Increasing SC bargaining power

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

There are two ways in which SC bargaining power might be increased: by constructing judicial standards of 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 judicial standards of review is preferable to the private solution of a pill.

a. Through judicial standards of review

Increasing SC bargaining power through judicial standards of review would require a reconsideration, in part, of *Siliconix*. The critical departure from existing doctrine is that a tender offer freeze-out which does not receive affirmative SC approval should be subject to entire fairness review rather than simply business judgment.[227] In this way, and in contrast to the current regime, the SC in a tender offer freeze-out 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, non-public, factors to enter into the negotiation. The result would be reduced incentives for the controller to respond to, or create, discrepancies between intrinsic value and market price.

Although the proposed approach might seem to increase administrative costs because of the new potential for entire fairness review in tender offer freeze-outs, the actual cost may be zero in a dynamic framework, because controllers

[227] The requirement of affirmative approval means that "no recommendation" would trigger entire fairness review. Of 27 post-*Siliconix* tender offers in my sample, only two SC's made no recommendation. *See* Subramanian, *supra* note 2, at 51 (Table 1).

would be able to 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 freeze-out. 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 do we avoid the administrative costs of a fairness determination by the court, we also get a fairness determination that should be more accurate than what a court could actually provide.

b. Through ability to deploy a pill

Instead of adjusting judicial standards of review, courts could require SC's to adopt poison pills against controlling shareholders in freeze-out tender offer negotiations. The Delaware Chancery Court has recently confirmed that SC's 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] To date, an SC has adopted a pill against a controller only once, in ICN Pharmaceutical's June 2003 freeze-out 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 freeze-outs.

The problem 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 freeze-outs, for the reasons described in the analysis of merger freeze-out 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 power over the transaction

[228] *See* Creo, Inc. v. Printcafe Software, Inc (Del. Ch. Feb. 21, 2003) (unpublished opinion); Hollinger Intl., Inc. v. Black, (Del. Ch. Feb. 26., 2004).
[229] *See* Gilson & Gordon, *supra* note 71, at 830-31, 839 (advocating time-limited, *Interco* pill).
[230] *See* Pure Resources, 808 A.2d 421, 446.
[231] *See supra* Part III.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 of the*

(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 through the shadow of entire fairness review. A SC may use its bargaining power to attempt to extract all of the synergies (or more), which would then deter potentially efficient freeze-outs.

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. We have insufficient 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 suggests 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 will 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 freeze-out context. This is not to say that a pill might not be useful for a 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 freeze-out tender offers is through adjustments to judicial standards of 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 a fiduciary duty imposed by the courts.

Gilson & Gordon take a half-way position on the pill question in freeze-outs. They 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 bid is too low, but does not allow management ultimately to block the offer."[234] 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.[235] In fact, most controlling

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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 freeze-out context, the trigger threshold would have to be extremely high, for the simple fact 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 show-stopper in this context.

[233] The closest we have is the recent attempt to sell control of Hollinger, in which the infamous Lord 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* Hollinger Intl. Inc. v. Black, transcript at 43.

[234] *See* Gilson & Gordon, *supra* note 71, at 830 n.181.

[235] *See supra* TAN 223-225.

shareholders explicitly disavow the possibility of a sale to a third-party.[236] And 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.

On the other aspects of an *Interco* pill, the SC already has an obligation under SEC Rule 14D-9 to issue a recommendation to minority shareholders. This recommendation will invariably include a detailed account of the reasons why the SC believes the offer should be accepted or rejected. A controller would be wise to give the SC as much time as it needed in order to make its 14D-9 recommendation, in order to ensure that the offer is deemed to be non-coercive under *Pure Resources*. And if the SC nevertheless feels rushed, it can make an initial 14D-9 filing stating that it needs more time, and then amend its filing at a later date. Presumably, if the recommendation would have any influence in the first place, minority shareholders would wait for the SC's recommendation before making a tender decision.[237]

Thus an *Interco* pill does not seem to provide any benefits beyond what current SEC rules already mandate. What remains is the potential downside of entrenchment behind an *Interco* pill: for example, an SC might take the view that it has not fully completed the task of persuading shareholders until shareholders have adopted the view that the offer is inadequate. While this kind of reasoning may seem paternalistic, such paternalism has already been used to uphold pills in the arms-length arena.[238]

In short, with benefits that are not apparent and costs that are potentially large, I conclude that the better approach continues to be through adjustments to judicial standards of review rather than through the use of a pill.

2. Promoting majority-of-the-minority conditions

SC approval is a necessary but not sufficient condition for business judgment review. Following *Pure Resources*, an offer should be deemed non-coercive only if it includes a majority-of-the-minority condition as well.[239] This point continues the connection to first principles as discussed above: when the

[236] *See supra* note 224 and accompanying text. This empirical finding is consistent with the earlier point that controllers do not view sale of control and a freeze-out as substitutes. *See supra* TAN 197-198.

[237] Of course, if standards of review were adjusted as described above, the controller would have a strong incentive to wait for SC approval in order to avoid entire fairness review.

[238] *See, e.g.*, Moore Corp. v. Wallace Computer Services, Inc., 907 F. Supp. 1545, 1557 n.14 (D. Del. 1995) (endorsing "substantive coercion, " defined by Ronald Gilson and Reinier Kraakman as "the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic value"); Unitrin Inc. v. American General Corp., 651 A.2d 1361, 1385 (Del. 1995) (same). *See generally* Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 267 (1989) (coining the term "substantive coercion").

[239] *See* Pure Resources, 808 A.2d at 445.

freeze-out 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 reflects 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 only provide a final check through the binary choice of minority shareholder approval.

While *Pure Resources* indicates that a freeze-out tender offer will be subject to entire fairness review, not business judgment, unless it includes a non-waivable MOM condition, the decision does not make clear who would have the burden in the scenario where 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 freeze-out context[240] to also apply to tender offers: a MOM condition, even in isolation, will shift the burden on entire fairness 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.

A MOM condition has the desirable feature of becoming more potent as the controller's stake increases. When the controller holds less than an 80% pre-deal stake, a MOM condition has no substantive bite, because the critical hurdle is getting to 90% in order to be able to execute a short-form merger. For example, a 60% controller needs 30% out of the remaining 40% (75% of the minority) in order to go forward with the transaction, which is greater than the simple majority required by a MOM condition. For these controllers a MOM condition is costless and should be provided automatically if it will lead to a benefit in terms of standards of review. At 80% and higher, a MOM condition becomes the binding constraint. For example, an 85% controller would only need 33% of the minority in order to get to 90%, but with a MOM condition would need 50% of the minority, or 7.5% of the shares outstanding, in order to go forward with the freeze-out.

The critical point from this analysis is that the size of a blocking coalition becomes smaller as the controller's stake increases. Take the extreme case of a controller just short of 90%: with a MOM condition in place, a mere 5% minority shareholder (or shareholder group) can block the deal. As an empirical matter

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[240] *See* Rosenblatt v. Getty Oil, 493 A.2d 929 (Del. 1985).

there will always be some fraction of minority shareholders who will never tender, often for logistical rather than substantive reasons, e.g., because they are simply unaware of the tender offer. This means that a MOM condition forces larger controllers to appeal to a larger fraction of the minority. So, for example, if the 90% controller can only tolerate 5% non-tendering, and 2% will not tender regardless of the offer price, then the controller must offer a price that appeals to 5% out of the actively-traded 8% (=65% of the minority) in order to satisfy the MOM condition.

In my companion paper I demonstrate that larger controllers are more likely to "turn the screws" on minority shareholders in tender offer freeze-outs than smaller controllers.[241] A MOM condition increases the hurdles for larger controllers, precisely where the empirical evidence suggests that this protection is needed. To reiterate, a MOM condition is not a substitute for a vigorous SC bargaining process, which I propose should be promoted through judicial standards of review. Rather, a MOM condition provides a second-stage check on the deal, a check that (it turns out) has the desirable of becoming more stringent as the controller's pre-deal stake increases.

3. The influence of stock exchange listing requirements

One concern with these proposed reforms is that they might trigger entire 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 therefore cannot form a SC to negotiate with the controller. In my sample of post-*Siliconix* freeze-outs, I find two such transactions out of 27 tender offer freeze-outs (7%).[242] Under existing doctrine, these transactions were subject only to business judgment review by the court.[243] In contrast, under the reforms proposed in this Part, these transactions would have been subject to entire fairness due to the absence of SC approval.

Fortunately, this problem will not exist under 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,[244] all publicly-traded companies, including controlled companies, must have a completely independent audit committee.[245] Therefore, under current corporate governance rules, all target companies will have the ability to form an SC, which means that the corporate law should draw a negative inference in situations where

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[241] *See* Subramanian, *supra* note 2, at 33-34.
[242] *See id.* at 17 (Figure 2). Both of these deals were subject to a MOM condition.
[243] *See* In re Aquila, Inc. Shareholders Litigation, 805 A.2d 184 (Del. Ch. 2002).
[244] *See, e.g.,* Section 303A, NEW YORK STOCK EXCHANGE COMPANY MANUAL.
[245] *See* SARBANES-OXLEY ACT OF 2002 §301.

an SC is not formed. This inference is built in to 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 freeze-out merger doctrine

1. Promoting majority-of-the-minority conditions

My principal proposal for freeze-out merger doctrine seeks to promote MOM conditions in addition to an SC process. Again, the goal is to emulate both prongs of an arms-length process, namely, disinterested board approval and disinterested shareholder approval. Under current doctrine, either a SC process or a MOM condition shifts the burden on entire fairness. My proposed addition is that the combination of a SC process and a MOM condition should shift the standard of judicial review from entire fairness to business judgment review.[246] The intuition is that a freeze-out merger 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 should therefore receive deference from the courts.

This refinement would have two effects. First, and most obviously, it would increase the number of MOM conditions from their current low levels, 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 reduce the application of entire 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.

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[246] This approach was also suggested by Vice Chancellor Strine in *Pure Resources*. *See* Pure Resources, 808 A.2d at 444 n.43. As an alternative approach, Allen, Jacobs & Strine propose business judgment review if the freeze-out receives either SC approval or minority shareholder approval. *See* Allen, Jacobs & Strine, *supra* note 39, at 1306. For reasons that should be clear from the analysis in the text, the incentives created by this alternative approach would fail to emulate the arms-length standard that is advocated here.

2. Bolstering the tender offer threat

A second, more subtle, refinement to existing doctrine involves the Court's specific holding in *Kahn v. Lynch*, that threatening the SC with a tender offer to the minority eliminates the SC's "ability to say no." Following the approach described in Part IV.A.1, the SC's veto power in a freeze-out 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 over the independent directors' objections, and then voting the deal through at the shareholder level without a MOM condition.[247] 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, with 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 freeze-out 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 Section. If merger freeze-outs will be increasingly subjected to MOM conditions, because of the benefit of business judgment review, then courts should be less determined to provide SC's with absolute veto power. Taken together, the proposed approach to merger freeze-outs bolsters 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 freeze-outs would not drive prices in freeze-out merger negotiations down toward market prices, as described in Part III.B.1.b. The reason is that the threatened tender offer would be subject

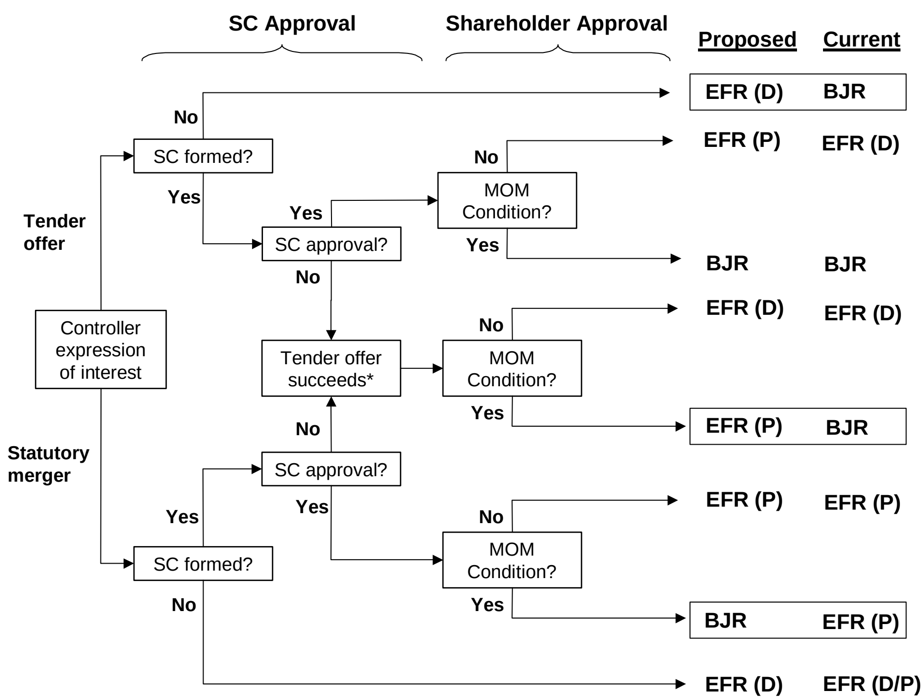
[247] For an example of this kind of threat, *see, e.g.*, American General Corp. v. Texas Air Corp., 1987 WL 6337 (Del. Ch. 1986), 13 DEL. J. CORP. L. 173 (unpublished opinion) (involving the freeze-out of Continental Airlines' minority shareholders by Frank Lorezno's Texas Air).

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 obstinate SC, but would not allow the controller to pay a lower price.

D. Synthesis

Figure 1 summarizes the judicial standards of review that would apply according to the transaction structure and procedural protections that are included in the deal. For entire fairness review, the party that has the burden of proof is indicated in parentheses. The most important departures from existing doctrine are boxed on the right side of the chart.

Figure 1: Proposed Judicial Standards of Review for Freeze-outs



* 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 SC's 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 freeze-out tender offer (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 judicial standards of review: SC approval and a MOM condition should lead to business judgment review rather than entire fairness (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*).

This second point resembles Gilson & Gordon's policy recommendation, which advocates business judgment review if the freeze-out receives board approval and minority shareholder approval, and entire fairness review if not.[248] However, as noted in Part II.E.3, Gilson & Gordon do not identify the efficiency loss that would motivate this kind of policy proposal. Also, as discussed in Part IV.B.1.b, Gilson & Gordon advocate the use of an *Interco* pill while I do not. Finally, Gilson & Gordon do not address the middle-ground case of either SC approval or a MOM condition. One way of thinking about this middle ground is that courts should step in only to fill in gaps, as needed, in procedural protections that are provided to the minority shareholders. So, for example, if a freeze-out 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 board does not approve the transaction but minority shareholders do, the courts should step in to fill the special committee's shoes. If both the SC and minority shareholders approve, there are no gaps to fill and so the courts should defer to the outcome of this process.

These proposed reforms would yield three important benefits. First, they would improve efficiency in the freeze-out arena by reducing the controller's incentives for opportunistic behavior in freeze-out tender offers and softening the SC's unfettered veto power in freeze-out mergers. Second, by achieving greater parity in SC bargaining power across transactional forms, the proposed reforms would achieve convergence in outcomes for minority shareholders, which would increase the coherence of corporate law and facilitate transaction planning and the valuation of a minority stake. And third, by deferring to the outcomes of a robust SC bargaining process that is followed by minority shareholder approval, the proposed reforms would reduce the application of entire fairness review, which would improve judicial administrability.

[248] *See* Gilson & Gordon, *supra* note 71, at 839-840.

V. Conclusion

I conclude with the same question that I posed in the Introduction: Using what process, and on what terms, should minority shareholder exit a publicly-traded company? Despite the intensity of the debate on this question in the three years since *Siliconix* and *Glassman* were decided, the case for change has not been clear. This Article identifies an efficiency loss from existing freeze-out doctrine that motivates the case for change. 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 freeze-outs.

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 in to the arms-length merger process. In the freeze-out context, this principle means approval by a special committee 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.

While the specific proposal is somewhat detailed, it is important to also keep in mind the bigger picture. At its core, corporate law seeks to manage three basic relationships: between shareholders and managers; between shareholders and other constituencies; and between controlling shareholders and minority shareholders.[249] *Siliconix* and *Glassman* have disrupted the third of these three basic relationships, from an already unstable baseline. In the United States, controlled companies are generally perceived to be a temporary middle ground, quick to become either widely-held or return to private control within a few years. In contrast, controlled companies tend to be a more stable structure in other countries, notably in Europe. *Siliconix* and *Glassman*, therefore, have further destabilized an already unstable form of corporate ownership in the U.S. This Article proposes certain reforms to existing doctrine, reforms that can be achieved without legislative intervention. These reforms would reduce if not eliminate the efficiency loss that is inherent in existing doctrine, thereby providing greater stability to the controlled company structure in the U.S.

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