

NOTE**TOWARD A CONTROLLING SHAREHOLDER SAFE HARBOR***Steven M. Haas**

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INTRODUCTION

MINORITY shareholders of a public corporation generally take their equity position with two basic entitlements: the right to vote and the protections afforded by fiduciary principles.¹ The right to vote authorizes a shareholder to participate in select corporate decisions.² The fiduciary protections available are the duties of care, loyalty, good faith, and disclosure.³ The presence of a controlling shareholder, however, presents unique challenges to corporate law by undermining, if not eliminating, the minority's voting power. Minority shareholders are left to rely on fiduciary principles,⁴ limited statutory rights,⁵ or "vot[ing] with their feet."⁶ In addition, courts have compensated minority shareholders for the loss of their voting power by utilizing a heightened standard of review for controlling shareholder transactions.⁷

¹ Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 91 (1991).

² Shareholder voting typically exists in board elections, corporate charter amendments, and other fundamental corporation actions. See Del. Code Ann. tit. 8, § 242 (2001 & Supp. 2002) (amendments to certificate of incorporation); id. § 251 (mergers or consolidations); id. § 271 (sale of assets); see also William T. Allen, *Ambiguity in Corporation Law*, 22 Del. J. Corp. L. 894, 897 (1997).

³ See Hillary A. Sale, *Delaware's Good Faith*, 89 Cornell L. Rev. 456, 487 (2004) ("Disclosure is sometimes referred to as a separate duty, though it is not listed as part of the Delaware triad of care, loyalty, and good faith."); see also *Malone v. Brincat*, 722 A.2d 5, 11 (Del. 1998) ("The duty of directors to observe proper disclosure requirements derives from the combination of the fiduciary duties of care, loyalty and good faith.").

⁴ See *McMullin v. Beran*, 765 A.2d 910, 918–19 (Del. 2000).

⁵ See, e.g., Del. Code Ann. tit. 8, § 203 (2001 & Supp. 2002) (three year limitation on interested stockholder transactions).

⁶ J.A. Livingston, *The American Stockholder* 60–61 (1958).

⁷ As explained by Professor Eisenberg, "[a] *standard of conduct* states how an actor should conduct a given activity or play a given role. A *standard of review* states the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief." Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 Fordham L. Rev. 437, 437 (1993).

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This Note will survey the Delaware law governing transactions between public corporations and their controlling shareholders. It explains that neither the Delaware Code nor the Revised Model Business Corporation Act (“Model Act”) have enacted statutes addressing controlling shareholder transactions. In the absence of a legislative mandate, Delaware courts review controlling shareholder transactions for entire fairness⁸—the most demanding standard of review in corporate law.⁹ Yet both Delaware and the Model Act have statutes providing for interested director safe harbors that apply the business judgment standard of review to independently approved transactions between directors and their corporations.¹⁰ This Note will question the efficiency of this disparate treatment of interested directors and controlling shareholders, as well as the lack of statutory guidance, and will suggest that the same constraints on interested directors—namely, disinterested approval and market forces—are at least as effective in supervising controlling shareholders.

The law surrounding interested director transactions can be analogized to controlling shareholders because the two actors share many characteristics and present some of the same concerns. For instance, courts closely review the actions of directors and controlling shareholders when there is a high probability of self-interested behavior and cheating. Yet equity ownership of these parties can align their interests with the minority shareholders so long as everyone seeks aggregate shareholder wealth. In both types of self-interested transactions, the concern is enforcing the fiduciary duty of loyalty. Because this is done with interested director safe harbors, the same cleansing process of informed disinterested approval should be extended to controlling shareholder transactions as well.

The rationale for subjecting controlling shareholder transactions to an entire fairness review reflects a distrust of the statutory mechanisms of independent director and minority shareholder ap-

⁸ See *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997).

⁹ See *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1279 (Del. 1989).

¹⁰ Del. Code Ann. tit. 8, § 144 (2001 & Supp. 2002); Model Bus. Corp. Act §§ 8.60–.63 (2002).

proval.¹¹ Under Vice Chancellor Strine's so-called "800-pound gorilla" theory, critics of independent approval believe that directors and minority investors will vote in favor of the transaction to avoid later retribution from the controlling shareholders.¹² Critics also allege that shareholders are too detached from the corporation to offer a meaningful approval mechanism.¹³ To be sure, there are valid reasons for a protectionist view of minority shareholders, especially when collective shareholder interests diverge in the so-called "final period."¹⁴ This Note will attempt to demonstrate, however, that these arguments fail to justify the overinclusive rule currently applied in the Delaware chancery that subjects virtually all controlling shareholder transactions to entire fairness.¹⁵ It will argue that there is dubious utility in a judicial regime that questions the independent judgment of those charged with managing the corporation and that a review of the *integrity* of the approval process—not the substance of the decision—usually provides a sounder and more economically efficient judicial approach.¹⁶

Consistent with that view, this Note will propose applying a safe harbor doctrine when reviewing controlling shareholder transactions. Specifically, it will contend that the Model Act's bright-line rule upholding interested director transactions that are ratified by disinterested directors or minority shareholders can be applied with equal success to controlling shareholders.¹⁷ So long as the interests of controlling and minority shareholders are aligned, independent approval and market checks together provide sufficient constraints to obvi-

¹¹ For a discussion of director independence, see generally James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 Duke L.J. 959 (1982).

¹² Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 Del. J. Corp. L. 499, 509 (2002).

¹³ Eisenberg, *supra* note 7, at 456.

¹⁴ This Note defines the final period as minority freeze-out transactions by the controlling shareholder, but it also can extend to any situation in which the end result is the elimination of minority shareholders.

¹⁵ See *T. Rowe Price Recovery Fund, L.P. v. Rubin*, 770 A.2d 536, 551–53 (Del. Ch. 2000); *Kahn v. Tremont Corp.*, CA No. 12339, 1996 Del. Ch. LEXIS 40, *19–24 (Del. Ch. Mar. 21, 1996).

¹⁶ In addition to acting independently, the approving directors always are subject to the triad of fiduciary duties: loyalty, good faith, and due care. See *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939).

¹⁷ See Model Bus. Corp. Act §§ 8.60–.63 (2002).

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ate the need for the current entire fairness review.¹⁸ The modest safe harbor proposal advanced in this Note may be accomplished either by legislatures¹⁹ in the form of statutes analogous to Section 144 and Subchapter F, or by courts. The result is to create a predictable framework for business planning and a standard of review with “an emphasis on functionality” for the judiciary.²⁰

Although it is possible that independent approval of final-period freeze-out transactions could be reviewed under the business judgment rule, that debate falls outside the scope of this Note. Instead, this Note will advocate a compromise that conforms to Delaware precedent by providing heightened scrutiny to transactions where minority interests are to be eliminated. This can be done by a controlling shareholder safe harbor that bifurcates transactions into (1) final-period and (2) nonfinal-period categories.²¹ Business judgment is appropriate for independently approved, going-concern transactions²² in the nonfinal period where the interests of shareholders are aligned in the market. In the final period, when interests diverge and market rewards and punishments fail to constrain the risk of cheating by the controlling shareholder, an entire fairness standard of review provides a greater level of protection to minority shareholders.

This Note primarily builds upon two Delaware cases: *Puma v. Marriott*²³ and *Kahn v. Lynch Communication Systems, Inc.*²⁴ *Puma*

¹⁸ See, e.g., Henry Hansmann, Ownership of the Firm, 4 J.L. Econ. & Org. 267, 283 (1988) (“Another great strength of investor-owned firms is the fact that the owners generally share a single, well-defined objective: to maximize the net present value of the firm’s earnings per dollar invested.”).

¹⁹ “Although some may argue that all . . . conflicted transactions should be subject to judicial review, it is hard to think of an argument in favor of not specifying in the statute what rules apply . . .” Michael P. Dooley & Michael D. Goldman, Some Comparisons Between the Model Business Corporation Act and the Delaware General Corporation Law, 56 Bus. Law. 737, 745 (2001).

²⁰ William T. Allen, Jack B. Jacobs, & Leo F. Strine, Jr., Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law, 56 Bus. Law. 1287, 1297 (2001).

²¹ See supra note 14.

²² This Note defines “going-concern transactions” as any transaction that contemplates the same continuing corporate entity and does not directly or indirectly involve an acquisition or exchange of the minority shareholder’s stock. This is a transaction that takes place outside the final period.

²³ 283 A.2d 693 (Del. Ch. 1971).

²⁴ 638 A.2d 1110 (Del. 1994).

dealt with an independently approved, going-concern transaction that the court reviewed under the business judgment rule,²⁵ an arguably efficient result because the controlling shareholders' interests were aligned with the minority and both the disinterested directors and the minority itself approved the transaction. Over twenty years later and after numerous intervening cases that divided on the proper standard of review, in *Lynch Communication* the Delaware Supreme Court held that entire fairness is the appropriate standard of review in all controlling shareholder transactions.²⁶ This Note suggests that *Lynch Communication* was an implicit reaction to the dangers posed by a final-period transaction—perhaps the right decision, but for a more limited reason. A controlling shareholder safe harbor would offer a new doctrine in corporate law, but it would be firmly grounded in the principles of these two cases.

Part I of this Note will discuss relevant cases in Delaware's controlling shareholder law. It will begin by setting out the doctrine for independent approval found in *Weinberger v. UOP, Inc.*²⁷ It then will discuss Delaware cases that applied either business judgment or entire fairness to independently approved transactions and show how this doctrinal divide was ultimately resolved in *Lynch Communication*. Part II will set forth the procedural framework for a controlling shareholder safe harbor that may be adopted by legislatures or courts. It will discuss the value of a defined set of safe harbor rules and explain its superiority to a per se entire fairness standard of review. Specifically, it shall demonstrate the ability of both market forces and independent approval to check the conduct of controlling shareholders. It will then explain why these constraints might tend to fail in the final period, hence the dichotomy drawn between the two types of transactions.

I. DELAWARE CASE LAW OF CONTROLLING SHAREHOLDER TRANSACTIONS

This Part describes the evolution of Delaware case law governing controlling shareholder transactions. Currently, Delaware

²⁵ See *Puma*, 283 A.2d at 695.

²⁶ See *Lynch Communication*, 638 A.2d at 1117.

²⁷ 457 A.2d 701 (Del. 1983).

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courts apply entire fairness as the appropriate standard of review for nearly all of these transactions.²⁸ This was the rule established in *Lynch Communication*²⁹ yet earlier cases including *Sinclair Oil Corp. v. Levien*³⁰ and *Puma v. Marriott*³¹ applied the business judgment rule. Unlike the business judgment cases, however, *Lynch Communication* involved a final-period freeze-out transaction. Thus, *Puma*'s precedential value is unclear and it is uncertain to what degree *Lynch Communication* also controls the standard of judicial review for going-concern transactions.

Section A of this Part briefly recounts the case of *Weinberger*. It begins with *Weinberger* to provide a background of that case's tentative, incomplete framework for independently approved controlling shareholder transactions. Section B discusses the doctrinal split in the Delaware chancery resulting from *Weinberger*'s ambiguous guidance as to whether business judgment or entire fairness is the resulting standard of review for independently approved transactions. Section B.1 reviews Delaware pre- and post-*Weinberger* cases that applied business judgment. It begins with *Sinclair Oil* and then discusses *Puma*, a decision cited in *Weinberger*.³² Section B.2 contrasts the business judgment line of cases with post-*Weinberger* decisions that applied entire fairness. Section C discusses *Lynch Communication*, in which the Delaware Supreme Court apparently resolved the doctrinal split between business judgment and entire fairness review, and established entire fairness as the proper standard of review in controlling shareholder transactions.³³

A. *Weinberger v. UOP, Inc.: The Framework for Predictability?*

In the 1983 *Weinberger* decision, the Delaware Supreme Court took a significant step in establishing the modern standard of re-

²⁸ See, e.g., *Kahn v. Tremont Corp.*, 694 A.2d 422, 423–24 (Del. 1997) (applying entire fairness to review a parent's sale of stock from one partially-owned subsidiary to another); *T. Rowe Price Recovery Fund, L.P. v. Rubin*, 770 A.2d 536, 538, 551–53 (Del. Ch. 2000) (applying entire fairness to review management and shared services agreements because they involved a majority shareholder).

²⁹ 638 A.2d 1110 (Del. 1994).

³⁰ 280 A.2d 717 (Del. 1971).

³¹ 283 A.2d 693 (Del. Ch. 1971).

³² *Weinberger*, 457 A.2d at 709 n.7.

³³ 638 A.2d at 1115.

view for controlling shareholder transactions. It did so by suggesting the use of an independent decisionmaking body,³⁴ the same mechanism endorsed in the Delaware and Model Act interested director safe harbor provisions.³⁵ The *Weinberger* court stopped short, however, of articulating a complete framework by failing to address the practical consequences of independent approval. Under the Delaware and Model Act interested director safe harbors, independent approval triggers business judgment instead of entire fairness, leaving one to expect the same treatment for controlling shareholders.

Weinberger presented the Delaware Supreme Court with a cash-out merger of a subsidiary corporation, UOP, Inc. by its parent-majority stockholder, Signal Corporation—a final-period transaction.³⁶ Despite approval by a committee of independent directors and also by a majority of the minority shareholders, the court invalidated the merger. Due to the involvement in the negotiating process of two Signal officers who also served as UOP directors,³⁷ the court held that the transaction was neither “fair” nor conducted at “arm’s length.”³⁸

Although the outcome of *Weinberger* was unremarkable in addressing the fiduciary responsibilities of directors serving on both sides of a transaction, it held real significance for future controlling shareholder transactions. In dicta, the court offered a procedural framework for parent-subsidiary transactions, the quintessential controlling shareholder-minority shareholder relationship.³⁹ Recognizing the inherent impracticalities of a hypothetical, perfect-world transaction, the court suggested that a fully independent negotiating structure, presumably the same as those in the interested

³⁴ *Weinberger*, 457 A.2d at 709 n.7 (stating that “the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors”).

³⁵ See Del. Code Ann. tit. 8, § 144 (2001 & Supp. 2002); Model Bus. Corp. Act §§ 8.60–.63 (2002).

³⁶ *Weinberger*, 457 A.2d at 701. Signal Corporation owned 50.5% of UOP’s outstanding common stock and appointed seven of its thirteen directors, including UOP’s chief executive officer. *Id.* at 704–05.

³⁷ The two directors, Charles Arledge and Andrew Chittea, failed to share key information with UOP, most notably the price that they determined Signal should pay to acquire the minority stake. See *id.* at 709–10.

³⁸ See *id.* at 712.

³⁹ See *id.* at 710.

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director safe harbors, would insulate a transaction from a minority shareholder's challenge:

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.*⁴⁰

It then added that, especially in the parent-subsidary relationship where some degree of conflict is inevitable, proof of arm's-length bargaining "is strong evidence that the transaction meets the test of fairness."⁴¹

On the facts presented in *Weinberger*, independent approval failed due to the interested directors' inadequate disclosure, constituting a breach of loyalty and fair dealing. To be sure, the opinion at times seemed to conflate the fiduciary obligations of controlling shareholders and corporate directors⁴² and left unnoticed the fact that different corporate actors are bound by different sets of fiduciary obligations.⁴³ Because the facts fell short of *informed* approval, however, the court was silent on the procedural consequences of legitimate, independent ratification. Thus, while the standard of conduct was "fairness," it remained uncertain whether independent approval would require a plaintiff to survive the business judgment or entire fairness standard of review.

⁴⁰ Id. at 709 n.7 (citing *Harriman v. E.I. Du Pont de Nemours & Co.*, 411 F. Supp. 133 (D. Del. 1975)) (emphasis added).

⁴¹ Id.

⁴² Conflated judicial discussion of fiduciary duties of different actors is a recurring problem in the parent-subsidary context. See, e.g., *Singer v. Magnavox Co.*, 380 A.2d 969, 976-77 (Del. 1977) (addressing simultaneously the duties of officers, directors, and controlling shareholders); see also *Zahn v. Transamerica Corp.*, 162 F.2d 36, 42-43 (3d Cir. 1947) (same).

⁴³ See Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 Duke L.J. 879, 879 (1988) ("Although one can identify common core principles of fiduciary obligation, these principles apply with greater or lesser force in *different contexts involving different types of parties and relationships.*" (emphasis added)).

It was completely reasonable, however, for subsequent courts to conclude that business judgment was applicable.⁴⁴ First, one may draw an analogy to the interested director safe harbors that apply business judgment or entire fairness, depending on whether there was proper approval. Second, and more convincingly, the cases cited in the *Weinberger* opinion—*Getty Oil Co. v. Skelly Oil Co.*⁴⁵ and *Puma*—both applied the business judgment rule,⁴⁶ implicitly suggesting that business judgment would have been the resulting standard of review, but for the actions of the Signal directors. Admittedly, *Getty Oil* and *Puma* are distinguishable from *Weinberger* on their facts, but both cases still provided ample precedent for subsequent courts to conclude that *Weinberger*'s framework for independent approval triggered business judgment review.⁴⁷

B. Standards of Review in Controlling Shareholder Transactions

Because *Weinberger* stopped short of articulating a complete framework for controlling shareholder transactions, subsequent courts were left to guess as to the legal consequences of independent approval. One school of thought, explained in Section B.1, was premised on pre-*Weinberger* opinions holding that business judgment applied once disinterested directors or shareholders ratified the transaction. This position finds support in *Sinclair Oil* and *Puma*, among other opinions.⁴⁸ The second school of thought, discussed in Section B.2, held that entire fairness still applied to an independently approved controlling shareholder transaction, even though it would have been reviewed under business judgment if it were a Section 144 or Subchapter F interested director transaction. While both interpretations were reasonable, this Section will attempt to demonstrate that the business judgment approach embod-

⁴⁴ See *infra* Section I.B.1.

⁴⁵ 267 A.2d 883 (Del. 1970).

⁴⁶ See *id.* at 886; *Puma*, 283 A.2d at 695.

⁴⁷ Independent approval was a technique in use long before *Weinberger*. See, e.g., Strine, *supra* note 12, at 502 (citing *Gottlieb v. Heyden Chem. Corp.*, 91 A.2d 57, 58–59 (Del. 1952)).

⁴⁸ In addition to *Sinclair Oil* and *Puma*, other pre-*Weinberger* business judgment cases include *Michelson v. Duncan*, 407 A.2d 211 (Del. 1979); *Getty Oil Co.*, 267 A.2d at 887; *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789, 793–94 (Del. 1967); *Beard v. Elster*, 160 A.2d 731, 738 (Del. 1960); *Gottlieb*, 91 A.2d at 58; and *Kaufman v. Shoenberg*, 91 A.2d 786, 790 (Del. Ch. 1952).

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ied in *Puma* is a reasonable and efficient standard of review in going-concern transactions, and that it can be implemented successfully through a safe harbor.

1. The Business Judgment Rule & Controlling Shareholder Transactions

a. Sinclair Oil Corp. v. Levien

Among the most important cases in Delaware controlling shareholder jurisprudence is *Sinclair Oil Corp. v. Levien*. *Sinclair Oil* was significant “because the court refused to require all parent-subsidary transactions” to be reviewed under the entire fairness rule.⁴⁹ In addressing allegations that the parent, Sinclair Oil, improperly ordered dividend payments and breached a contract with its subsidiary corporation,⁵⁰ the Delaware Supreme Court held that a fairness review is proper only when there is “self-dealing” under an advantage-disadvantage test.⁵¹ So long as the minority shareholders did not suffer a “detriment” to the benefit of the controlling shareholder, business judgment—not entire fairness—was the appropriate standard of review.⁵² Because the subsidiary’s minority shareholders received pro rata dividends along with Sinclair Oil, they were not disadvantaged by the controlling shareholder’s actions.⁵³

This advantage-disadvantage test provided a bright-line rule for judges and corporate planners alike, but it did not leave the minor-

⁴⁹ Mary Siegel, *The Erosion of the Law of Controlling Shareholders*, 24 Del. J. Corp. L. 27, 50 (1999). “Entire fairness” and “intrinsic fairness” are terms used interchangeably by Delaware courts. See *Tanzer v. Int’l Gen. Indus., Inc.*, 402 A.2d 382, 386 (Del. Ch. 1979). Their concept of fairness is codified in the Delaware § 144(a)(3) interested director safe harbor. See *Unitrin v. Am. Gen. Corp.*, 651 A.2d 1361, 1371 n.7 (Del. 1995).

⁵⁰ Sinclair Oil owned 97% of the outstanding stock of its subsidiary, Sinven. *Sinclair Oil*, 280 A.2d at 719. In addition to the excessive dividend payment allegations, Sinclair also was accused of breaching a contract with the subsidiary. See *id.* at 719.

⁵¹ *Id.* at 720. The development of the advantage-disadvantage doctrine is credited to *Case v. New York Central Railroad Co.*, 204 N.E.2d 643 (N.Y. 1965). See Note, *The Fiduciary Duty of Parent to Subsidiary Corporation*, 57 Va. L. Rev. 1223, 1240 (1971) [hereinafter Note, *Fiduciary Duty*].

⁵² *Id.* at 720, 722. An earlier decision also held that business judgment was appropriate when the controlling shareholder did not dominate the terms of the transaction. See *Getty Oil*, 267 A.2d at 887.

⁵³ See *Sinclair Oil*, 280 A.2d. at 721–22.

ity shareholders defenseless. First, entire fairness applies if the controlling shareholder received a benefit to the “exclusion of and detriment[] to its minority stockholders.”⁵⁴ It follows that had the minority shareholders been disadvantaged, it is nearly inconceivable that the court could still find the transaction “fair.”⁵⁵ In fact, the *Sinclair Oil* court reviewed the contract count against the parent under entire fairness and found it in breach of the agreement.⁵⁶ Second, the court was sure to leave other avenues for plaintiffs to check the controlling shareholder’s conduct. Minority shareholders could argue that the dividend distributions were made under “improper motives and amounted to waste,” or they could allege that the controlling shareholder usurped a corporate opportunity.⁵⁷ Finally, the court noted that even when the business judgment rule applied,⁵⁸ the judiciary could not overlook fraud or “gross and palpable overreaching.”⁵⁹

Sinclair Oil presents a threshold test⁶⁰ and its holding limits court involvement and raises the costs of challenging parent-subsidary transactions.⁶¹ It also demonstrates an interesting effort to distinguish controlling shareholder transactions from interested director conflicted transactions, even though both doctrines used a business judgment/entire fairness dichotomy. The “*Sinclair* [court] did not explain why, despite the presence of interlocking directors in this parent-subsidary relationship, it neither utilized nor referenced section 144.”⁶² Rather, the courts have separately crafted interested director and parent-subsidary laws as distinct categories without

⁵⁴ Id. at 721.

⁵⁵ See Note, Fiduciary Duty, supra note 51, at 1240.

⁵⁶ See 280 A.2d at 722–23. The contract was one of self-dealing because only the parent shared in its benefits and the breach of the contract disadvantaged the minority. See id. at 723.

⁵⁷ See id. at 722.

⁵⁸ At least one commentator has argued that the advantage-disadvantage test is based on more objective factors than typical business judgment review. See Note, Fiduciary Duty, supra note 51, at 1236 (“[T]he new test resembles the intrinsic fairness test, except that the new test provides an equation—disadvantage to subsidiary + advantage to parent = lack of fairness—by which the evidence may be evaluated.”).

⁵⁹ *Sinclair Oil*, 280 A.2d at 722.

⁶⁰ See Siegel, supra note 49, at 29.

⁶¹ Michael P. Dooley, *Fundamentals of Corporation Law* 610 (1995).

⁶² Siegel, supra note 49, at 51.

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referencing one to the other.⁶³ Under both categories, however, business judgment still could be triggered. The practical result after *Sinclair Oil* was that if the controlling shareholder was a director, then he had to go through the approval process of Delaware Section 144, but if he was not a director, then he had to show that there was no self-dealing at the minority's expense.⁶⁴

After *Weinberger*, the strength of *Sinclair Oil*'s holding remains unknown. In fact, the *Weinberger* court all but ignored *Sinclair Oil*, referencing it only for the "indisputable proposition that interlocking directors in such transactions owe fiduciary duties to both corporations."⁶⁵ And in post-*Weinberger* cases *Sinclair Oil* has essentially disappeared,⁶⁶ it seems to live in dividend⁶⁷ and tax cases⁶⁸ rather than serve as an overarching principle of controlling shareholder law. Yet, as the next Section discusses in the context of *Puma*, the business judgment rule as used in *Sinclair Oil* can be employed in a controlling shareholder safe harbor to review going-concern transactions without exposing minority shareholders to substantial risks of cheating.

b. *Puma v. Marriott*

Puma v. Marriott, decided just months after *Sinclair Oil*, involved a nonfinal-period transaction between Marriott Corporation and its controlling shareholders.⁶⁹ The controlling shareholders, four of whom served on Marriott's board of directors, were members of the corporation's founding family and collectively owned nearly forty-four percent of Marriott's outstanding shares. The independently negotiated transaction provided for the corpo-

⁶³ Dooley, *supra* note 61, at 610.

⁶⁴ See Ronald J. Gilson & Jeffrey N. Gordon, Controlling Controlling Shareholders, 152 U. Pa. L. Rev. 785, 789–90 (2003).

⁶⁵ Siegel, *supra* note 49, at 55.

⁶⁶ See *id.* at 31; see also *id.* at 57–70 (describing the fragmenting of *Sinclair Oil* in several post-*Weinberger* cases).

⁶⁷ See, e.g., *Gabelli & Co., Profit Sharing Plan v. Liggett Group Inc.*, 479 A.2d 276, 281 (Del. 1984) (discussing *Sinclair* in holding that there was no self-dealing or detriment in a controlling shareholder's decision to compel dividend payments).

⁶⁸ See generally Bruce A. McGovern, Fiduciary Duties, Consolidated Returns, and Fairness, 81 Neb. L. Rev. 170 (2002) (discussing parent-subsidiary relations and their interaction with corporate taxation).

⁶⁹ 283 A.2d 693, 693 (Del. Ch. 1971).

ration to purchase from the controlling shareholders several real property holding companies in exchange for additional shares of Marriott stock, though it was an inconsequential amount relative to their preexisting equity stake in the corporation.⁷⁰ Following approval by independent directors, the board also presented the transaction to the Marriott shareholders, including the plaintiff, who overwhelmingly voted in favor of it. Subsequently, the plaintiff-minority shareholder had a change of heart and challenged the transaction as self-dealing inherently unfair to the corporation.⁷¹

Because none of the controlling shareholder/interested directors voted to approve the transaction, the court focused on (1) the fiduciary duties owed by controlling shareholders who abstained from voting and (2) whether the approval process was truly independent. To prove independence, it was not enough that the controlling shareholders did not appoint the directors. Rather, the court examined whether the Marriott family's influence dominated or controlled the directors in any way. Concluding that it did not, the court held that "the test here applicable is that of business judgment, there being no showing of fraud."⁷² Indeed, the court gave full deference to the board decision and passed on judging the effect of the majority of the minority shareholder approval.⁷³

Puma establishes the rule that business judgment applies to a controlling shareholder's going-concern transaction with its corporation if that transaction has been approved by independent direc-

⁷⁰ See *id.* at 693–94.

⁷¹ See *id.* at 694–95.

⁷² *Id.*

⁷³ The defendants raised the majority of the minority vote as a defense. Such approval is fully consistent with the Delaware and Model Act safe harbor provisions allowing directors or shareholders to approve interested director transactions. See Del. Code Ann. tit. 8, § 144(a)(2) (2001); Model Bus. Corp. Act § 8.63 (2002). *Puma* upheld the transaction on the basis of the independent directors' approval alone. 283 A.2d at 696 ("[I]t is unnecessary to consider defendants' contention that ratification of the transaction by Marriott's stockholders effectively barred this action."). Thus, the case stands for the proposition that the *directors' decision alone*, when made independently, triggers the business judgment rule and shifts the burden to the challenging shareholder. There seems no reason to doubt that the outcome would have differed if decided on the grounds of shareholder approval. Cf. *Williams v. Geier*, 671 A.2d 1368, 1379 (Del. 1996) (noting the importance of shareholder approval, regardless of directors' self-interest in the transaction).

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tors.⁷⁴ Independent ratification, the same as contemplated in the interested director safe harbor statutes,⁷⁵ precludes the court “from substituting its uninformed opinion for that of the experienced, independent board members.”⁷⁶ After reiterating that transactions—even interested transactions—are business decisions to be made by firm managers, the court added that the Marriott Corporation, not the controlling shareholder, initiated the deal in the firm’s self-interest.⁷⁷

In notable contrast to *Weinberger* and subsequent controlling shareholder decisions, *Puma* was not a final-period transaction. This may explain the decision in *Puma*, but it also demonstrates why entire fairness would have been inappropriate. The time and expense involved in a chancellor’s review for fair price and fair dealing of the sale of property to the corporation would be disproportionate to the value of the transaction. In addition, it would second-guess not only the board’s decision, but the approving shareholder’s decision as well. Under a business judgment approach, the chancellor should review only the approval procedure and the contents of the disclosures.

c. Post-Weinberger Business Judgment Cases

After *Weinberger*, *Puma*’s doctrine stood on equal footing with *Sinclair Oil*: Its precedential value was uncertain. Yet there were implicit and explicit reasons to believe *Puma* survived. In 1987, the Delaware Supreme Court in *Marciano v. Nakash* addressed a dispute between the two co-owners and equal shareholders of a corporation regarding loans that one of the parties made to the corpo-

⁷⁴ See Michael P. Dooley, Two Models of Corporate Governance, 47 Bus. Law. 461, 492 n.109 (1992). This is not to say that *Puma* was definitive law. See, e.g., David J. Greene & Co. v. Dunhill Int’l, Inc., 249 A.2d 427, 432 (Del. Ch. 1968) (rejecting defendant’s argument that “approval by a majority of so-called ‘disinterested’ stockholders creates a presumption of fairness, thus shifting to plaintiffs the burden of showing unfairness”).

⁷⁵ See Del. Code Ann. tit. 8, § 144(a)(1) (2001); Model Bus. Corp. Act § 8.62 (2002).

⁷⁶ *Puma*, 283 A.2d at 696.

⁷⁷ See *id.* at 694. Prior to the transaction, Marriott Corporation leased the properties from the controlling shareholders. *Id.* The independent directors approved the purchase of the properties in consideration for Marriott shares in an effort to eliminate existing potential conflicts in the lessor-lessee relationship and to obtain membership in the New York Stock Exchange. *Id.* at 694, 696.

ration.⁷⁸ Though there was no independent approval of the loans,⁷⁹ both the chancery court and the Delaware Supreme Court upheld the transaction under *Weinberger's* entire fairness standard.⁸⁰ In dicta, the supreme court commented that "approval by fully-informed disinterested directors under section 144(a)(1), or disinterested stockholders under section 144(a)(2), permits invocation of the business judgment rule and limits judicial review."⁸¹ While the court premised its discussion explicitly on the statutory safe harbor for directors, it still follows that if the business judgment rule would have applied to Marciano and Nakash as directors, the same goes for the pair as shareholders, too. There would be little sense in discussing the application of the business judgment rule if the court still was required to apply entire fairness because the directors also were large shareholders (unless the pair did not qualify as "controlling shareholders"⁸²). But a reading of the case suggests that, had Nakash, despite being a fifty-percent shareholder and a director, obtained independent approval from Marciano or other independent directors, the business judgment rule of Section 144 would control the court's review. This result would be supported by the fact that Nakash's large equity holding should act as a market constraint outside of the final period.

In 1988, Chancellor Allen followed the business judgment doctrine of *Puma in In re Trans World Airlines, Inc. Shareholders Liti-*

⁷⁸ 535 A.2d 400, 401 (Del. 1987).

⁷⁹ See *id.* at 405 n.3. Naturally, there was a deadlock between the two 50% shareholders making § 144 inapplicable.

⁸⁰ See *id.* at 407 ("[B]ecause of the interested nature of this transaction, *Weinberger's* concept of fairness is implicated." (citing *Gottlieb v. Heyden Chem. Corp.*, 90 A.2d 660, 663 (Del. 1952)); *Marciano v. Nakash*, No. CIV.A.7910, 1987 WL 11284, at *2-*4 (Del. Ch. May 25, 1987).

⁸¹ *Marciano*, 535 A.2d at 405 n.3.

⁸² This seems the best explanation of *Marciano* as a noncontrolling shareholder case, for arguably the two shareholders did not meet the definition of "controlling shareholder" due to their inability to fully dominate and control the corporation in a manner that would adversely affect a powerless minority interest. Cf. *In re Western Nat'l Corp. Shareholders Litig.*, No. CIV.A.15927, 2000 WL 710192, at *6 (Del. Ch. May 22, 2000) ("In the absence of majority stock ownership, a plaintiff must demonstrate that the minority shareholder held a dominant position and actually controlled the corporation's conduct [to trigger controlling shareholder duties.]). Yet each had significant control through an effective veto power to deadlock the corporation, which is exactly what precipitated the case.

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gation, which, this time, involved a final-period transaction.⁸³ Focusing on a seventy-seven percent controlling shareholder who initiated a minority freeze-out, he wrote in unequivocal terms:

Both the device of the special negotiating committee of disinterested directors and the device of a merger provision requiring approval by a majority of disinterested shareholders, when properly employed, *have the judicial effect of making the substantive law aspect of the business judgment rule applicable* and, procedurally, of shifting back to plaintiffs the burden of demonstrating that such a transaction infringes upon rights of minority shareholders.⁸⁴

Like *Puma*, this approach conforms to the judicial theory of deferential review in evaluating the conduct of corporate decision-makers. It allows the directors to manage the firm and, moreover, it protects their managerial decisions from judicial “second-guessing.”⁸⁵

Although *Trans World Airlines* granted a preliminary injunction to bar the proposed merger, it did so on the grounds that the special negotiating committee, not the controlling shareholder, failed to provide an independent, arm’s-length bargaining structure—that is, the committee was not truly independent.⁸⁶ Thus, at least in dicta, Chancellor Allen endorsed the business judgment rule as applied to a controlling shareholder transaction. The case protected (by finding in favor of) minority shareholders while still engaging in substantive judicial review of the transaction. Moreover, unlike *Puma*, the case involved a final-period cash-out merger. Yet the decision added to the confusion between business judgment and entire fairness and, as the *Lynch Communication* court later noted,

⁸³ No. CIV.A.9844, 1988 WL 111271 (Del. Ch. Oct. 21, 1988).

⁸⁴ *Id.* at *7 (emphasis added).

⁸⁵ Charles Hansen et al., *The Role of Disinterested Directors in “Conflict” Transactions: The ALI Corporate Governance Project and Existing Law*, 45 *Bus. Law.* 2083, 2087 (1990).

⁸⁶ See *In re Trans World Airlines*, *supra* note 83, at *7. Relying on *Weinberger’s* procedural guidelines, the opinion concluded that “the special committee did not supply an acceptable surrogate for the energetic, informed and aggressive negotiation that one would reasonably expect from an arm’s-length adversary.” *Id.* (citing *Weinberger*, 457 A.2d at 709 n.7; *Freedman v. Rest. Assocs. Indus.*, No. 9212, 1987 Del. Ch. LEXIS 498, at *8–*14 (Del. Ch. Oct. 16, 1987)).

Chancellor Allen never cited to the entire fairness cases emerging from other courts around the same time.⁸⁷

2. Entire Fairness & Controlling Shareholder Transactions

While the *Puma* line of cases stood for the proposition that an independently approved transaction between the corporation and a controlling shareholder was entitled to the business judgment rule, a contrary line of cases emerged holding that entire fairness was the appropriate test, regardless of independent approval. Yet no court until *Lynch Communication* ever explicitly stated that entire fairness was the only standard of review for controlling shareholder transactions. The fragmented state of the case law was colorfully described by Vice Chancellor Strine. After explaining the business judgment rule approach of some courts, Vice Chancellor Strine outlined the competing entire fairness approach:

Under this view, a squeeze-out merger posed special dangers of overreaching by the majority. In essence, this strain of thought was premised on the notion that when an 800-pound gorilla wants the rest of the bananas, little chimpanzees, like independent directors and minority stockholders, cannot be expected to stand in the way, even if the gorilla putatively gives them veto power.⁸⁸

Thus, in an effort to constrain the 800-pound gorilla, this second strand of post-*Weinberger* cases, including the supreme court decisions of *Rosenblatt v. Getty Oil Co.*⁸⁹ and *Rabkin v. Philip A. Hunt Chemical Corp.*,⁹⁰ and the chancery court decision in *Citron v. E.I. Du Pont de Nemours & Co.*,⁹¹ applied entire fairness.

The problem with *Rosenblatt* and *Rabkin*, however, was that the supreme court never fully articulated the entire fairness standard as the rule governing controlling shareholder transactions, hence the confusion and resulting doctrinal divergence in the Delaware

⁸⁷ See *Lynch Communication*, 638 A.2d at 1116 n.4.

⁸⁸ Strine, *supra* note 12, at 508–09 (citations omitted). Chancellors Allen and Strine, and now-Justice Jacobs, writing together, similarly have noted the bifurcation of tests following *Weinberger*. Allen et al., *supra* note 20, at 1306.

⁸⁹ 493 A.2d 929, 937 (Del. 1985).

⁹⁰ 498 A.2d 1099, 1104–05 (Del. 1985).

⁹¹ 584 A.2d 490, 500 (Del. Ch. 1990).

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chancery. For example, in *Rosenblatt*, the supreme court upheld a stock-for-stock merger that was approved by an independent negotiating committee in compliance with *Weinberger*. Although the court reiterated and applied the two-prong entire fairness review to the independently approved merger, it cited *Sinclair Oil* and *Puma* when it noted that proper arm's-length bargaining "may give rise to the proposition that the directors' actions are more appropriately measured by business judgment standards."⁹² Perhaps this discussion of the bargaining structure was aimed at merely applauding model negotiations.⁹³ And while the analytic framework of *Rosenblatt* could have instructed future courts to go through an entire fairness review, the opinion never made clear that this was the only option available.⁹⁴ The most certain aspect of the case was that the court reiterated the *Weinberger* procedural framework, but again it failed to unequivocally hold that entire fairness was the only standard of review for controlling shareholder transactions.⁹⁵

Next, in *Rabkin v. Philip A. Hunt Chemical Co.*, a decision announced just months after *Rosenblatt*, the court invalidated a (final-period) cash-out merger.⁹⁶ The *Rabkin* court held that in alleging the controlling shareholder breached its fiduciary duty by strategically allowing a stock purchase agreement to expire so as to avoid a contractual floor imposed on any follow-up offers for the minority shares, the complaint still stated a cause of action despite supposed independent approval of the merger.⁹⁷ Demonstrating the divergence of interests in the final period, the controlling shareholder sought to pay as little as possible in acquiring the corporation's outstanding shares. Like *Rosenblatt*, however, *Rabkin* failed

⁹² *Rosenblatt*, 493 A.2d at 937–38.

⁹³ "Because of the majority shareholder's [extensive] efforts to be fair, the Delaware Supreme Court may well have chosen this specific case to be the first one to apply the *Weinberger* principles . . . [and] find a scenario that met with its approval . . ." Rand D. Richey, *Balancing the Rights of Majority and Minority Shareholders in Take-Out Mergers: Trends in Delaware Law*, 25 *New Eng. L. Rev.* 699, 719 (1990).

⁹⁴ In *Lynch Communication*, the Delaware Supreme Court rejected the notion that it had been vague, and suggested that *Rosenblatt* resolved the business judgment-entire fairness debate. 638 A.2d at 1116 (citing *Rosenblatt*, 493 A.2d at 937).

⁹⁵ See *Rosenblatt*, 493 A.2d at 937–38.

⁹⁶ *Rabkin*, 498 A.2d at 1107–08. For a discussion of *Rosenblatt* and *Rabkin* and their application of the *Weinberger* principles, see generally Richey, *supra* note 92, at 716–24.

⁹⁷ See *Rabkin*, 498 A.2d at 1101–03, 1105–07.

to rectify *Weinberger's* shortcomings. Instead, the court focused on false public statements made by the controlling shareholder.⁹⁸ Thus, the decision can be more properly relied upon for the proposition of a controlling shareholder's duty of truthful (but not necessarily complete) disclosure.⁹⁹

The lingering uncertainty of entire fairness was most directly addressed in the chancery by then-Vice Chancellor (now Justice) Jacobs in *Citron v. E.I. Du Pont de Nemours & Co.*¹⁰⁰ There, the chancery court addressed a share-for-share merger between a parent and subsidiary corporation.¹⁰¹ Despite approval by an independent negotiating committee *and* a majority of the minority shareholders, Vice Chancellor Jacobs speculated that he was bound to apply the entire fairness standard because the case presented a controlling shareholder transaction. Explaining the convoluted jurisprudence, he wrote:

The precise circumstances that will trigger the "entire fairness" standard of review have not been consistently articulated in the Delaware cases. *Sinclair Oil Corp. v. Levien* . . . holds that the plaintiff must demonstrate that the parent corporation stood on both sides of the transaction *and* have dictated its terms. . . . [But *Weinberger* indicates] that to invoke the exacting review standard, all that is required is that the parent corporation have stood on both sides of the transaction.¹⁰²

Looking to its interpretation of the most recent precedent (namely, *Weinberger*), combined with the risk of controlling shareholder retaliation (the "800-pound gorilla" theory), the court opted for en-

⁹⁸ See *id.* at 1101-02.

⁹⁹ On remand after six years of litigation, the chancery court found both fair price and fair dealing. See *Rabkin v. Olin Corp.*, Consol. C.A. No. 7547, 1990 Del. Ch. LEXIS 50, at *11-*36 (Del. Ch. Apr. 17, 1990).

¹⁰⁰ 584 A.2d 490 (Del. Ch. 1990).

¹⁰¹ *Id.* at 492. The parent corporation owned 69.54% of the subsidiary's stock and appointed at least three of the eight members of the board of directors. See *id.* at 492-93.

¹⁰² *Id.* at 500 n.13 (citations omitted); see also *id.* at 501 n.15 (pointing out that the *Trans World Airlines* court ignored *Rosenblatt*, thus casting doubt on the continued viability of the business judgment standard of review).

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tire fairness.¹⁰³ In rendering judgment, however, Vice Chancellor Jacobs was careful to clarify his methodology: He reviewed the transaction under the entire fairness standard; he reviewed the independent directors' conduct in the negotiations under the business judgment rule; he found that the majority of the minority shareholder vote transferred the burden of entire fairness back to the plaintiff; and he determined the transaction to be entirely fair to the minority shareholders.¹⁰⁴

In summary, between 1983 and 1994, the state of controlling shareholder jurisprudence was uncertain. The earliest cases, *Sinclair Oil* and *Puma*, offered business judgment as the appropriate standard of review. And because the *Weinberger* court cited *Puma* in its discussion of independent approval, subsequent decisions, including Chancellor Allen's dicta in *Trans World Airlines*, suggested business judgment was the proper standard of review once a transaction was properly approved by directors or minority shareholders. At the same time, however, another line of cases suggested that controlling shareholder transactions should be reviewed for entire fairness, regardless of independent approval. Although it was this second line that ultimately was endorsed by the Delaware Supreme Court, this Note argues that the business judgment doctrine of *Puma* should be adapted into a safe harbor, at least for non-takeout transactions.

3. *Entire Fairness as the Proper Standard of Review: Kahn v. Lynch Communication Systems, Inc.*

The Delaware Supreme Court, in *Lynch Communication*,¹⁰⁵ finally confronted the issue of whether business judgment or entire fairness is the appropriate standard of review when a controlling shareholder takeout transaction is approved by a disinterested party—and “it resolved the issue in favor of the 800-pound gorilla theory.”¹⁰⁶

¹⁰³ See id. at 500; see also id. at 500 n.13 (“Being the most recent pronouncements of the Supreme Court in the parent-subsiary context, *Weinberger* [and] *Rosenblatt* . . . are authoritative.”).

¹⁰⁴ See id. at 499–502, 512.

¹⁰⁵ 638 A.2d 1110 (Del. 1994).

¹⁰⁶ Strine, *supra* note 12, at 509.

In *Lynch Communication*, Alcatel Corporation owned 43.3% of Lynch Communication's common shares, enjoyed certain supermajority voting privileges, and appointed five of the firm's eleven board members.¹⁰⁷ The litigation was set in motion when Lynch proposed merging with a third-party, a plan promptly rejected by Alcatel through its dominant veto power.¹⁰⁸ Alcatel instead countered with a proposal that Lynch merge into one of Alcatel's other subsidiaries. Lynch formed a special committee of independent directors, which rejected the proposal. Alcatel responded with a series of other offers, but all hovered around the same price. In all, the Lynch special committee rejected four Alcatel proposals—one share exchange and three cash offers.¹⁰⁹

The decisive moment arrived when Alcatel played its trump card: third-party proposal veto power combined with a bear hug. In other words, Alcatel warned the Lynch special committee that it would launch a hostile tender offer if the committee rejected its final offer. Because the special committee knew that Alcatel would veto any third-party option, it conceded and approved the deal. The remaining independent directors on Lynch's board then ratified the terms of the acquisition.¹¹⁰

On appeal, Justice Holland, writing for the supreme court, held that Alcatel dominated the entire board of directors, and therefore the negotiations failed to constitute arm's-length bargaining.¹¹¹ Relying on the trial court record, the opinion continued by noting that "the non-Alcatel [independent] directors deferred to Alcatel because of its position as a significant stockholder and not because they decided in the exercise of their own business judgment that Alcatel's position was correct."¹¹² Thus, the court could have held that, because the independent directors were dominated and not really "independent," there was a flawed bargaining process to which entire fairness applied. But the opinion went further and

¹⁰⁷ 638 A.2d at 1112.

¹⁰⁸ This never was alleged as a breach of fiduciary duty itself, even though the Lynch board wanted to pursue the third-party proposal. The Delaware Court of Chancery has held that a controlling shareholder does not have an affirmative duty to vote in favor of a proposal. See *Mendel v. Carroll*, 651 A.2d 297, 306 (Del. Ch. 1994).

¹⁰⁹ See *Lynch Communication*, 638 A.2d at 1112–13.

¹¹⁰ See *id.* at 1113, 1119.

¹¹¹ See *id.* at 1121–22.

¹¹² *Id.* at 1115 (alteration in original).

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eliminated any possibility for future courts to invoke the business judgment rule in reviewing controlling shareholder transactions.

The Delaware Supreme Court unmistakably held that “the exclusive standard of judicial review in examining the propriety of an interested *cash-out merger* transaction by a controlling or dominating shareholder is entire fairness.”¹¹³ This was despite the instruction in *Weinberger* eleven years earlier that independent approval was a proper means for proving fairness and the accompanying citation to *Puma*.¹¹⁴ After recognizing the “differing views” on the appropriate standard of review for independently approved controlling shareholder transactions, the court rejected *Trans World Airlines* and endorsed the holding of *Citron*.¹¹⁵ It did not mention *Puma*, however, thus leaving its fate undecided.

The *Lynch Communication* holding thus applies even though a corporation sanitizes the transaction through an independent approval process.¹¹⁶ And the court rejected independent approval as a per se indication of fairness, contrary to the business judgment cases following *Puma*.¹¹⁷ As two commentators have explained, *Lynch Communication* stands for the proposition that “[t]he mere creation and existence of a special negotiating committee . . . is *insufficient* to justify shifting the burden of proof. Rather, courts must scrutinize the special committee’s ‘real bargaining power before shifting the burden of proof on the issue of entire fairness.’”¹¹⁸ But regardless of the bargaining process, entire fairness applies.

Lynch Communication has been understood as representative of a strong protectionist theory of minority shareholders’ interests in public corporations.¹¹⁹

¹¹³ *Id.* at 1117 (emphasis added).

¹¹⁴ *Weinberger*, 457 A.2d at 709 n.7 (citing *Puma*, 283 A.2d at 696).

¹¹⁵ See *Lynch Communication*, 638 A.2d at 1115–17; see also *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490, 502 (Del. Ch. 1990) (adopting *Rosenblatt*’s entire fairness standard).

¹¹⁶ See *Lynch Communication*, 638 A.2d at 1116–17.

¹¹⁷ See *id.* at 1115.

¹¹⁸ A. Gilchrist Sparks, III & S. Mark Hurd, *Special Committees of Directors—When Does the Business Judgment Rule Apply and to What Extent are Committee Proceedings Confidential?*, 2 *Del. L. Rev.* 215, 216 (1999) (emphasis added).

¹¹⁹ Supporters of *Lynch Communication* have labeled it a “reformist” opinion. See Park McGinty, *The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 *Emory L.J.* 163, 175–76 n.9 (1997). But it also has been said that the case did not go far enough. See, e.g., *id.*

In colloquial terms, the [*Lynch Communication*] 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 putatively independent directors who might well have been hand-picked by the gorilla (and who at the very least owed their seats on the board to his support).¹²⁰

Thus, approval even by a majority of the minority shareholders was unable to circumvent an entire fairness test.

The departure from *Puma* and the business judgment rule is obvious, but the scope of *Lynch Communication* or, more precisely, the precedential value of *Puma* is unclear. Perhaps the cases can be distinguished so as to live side by side. For example, *Puma* can be differentiated because it involved an independent majority of the entire board, rather than the small special committee utilized in *Lynch Communication*. This argument finds analogous support in the law governing shareholder demands in derivative litigation.¹²¹ Yet that distinction between *Puma* and *Lynch Communication* is only partially convincing. For one, the Delaware Section 144 safe harbor does not require a majority vote of the entire board to approve an interested director transaction, and the board can form a quorum without the presence of every disinterested director.¹²² For another, the more widely adopted Model Act demand requirements mandate only that a majority (as few as two¹²³) of all disinterested directors be present to constitute a quorum necessary to vote on the transaction.¹²⁴ In short, the difference between an inde-

¹²⁰ *In re Pure Res. S'holders Litig.*, 808 A.2d 421, 436 (Del. Ch. 2002).

¹²¹ Delaware accords conclusive authority to a decision by a disinterested majority of the board that rejects a shareholder's request to commence derivative litigation, but the same decision made by a special committee receives greater scrutiny. See *Zapata Corp. v. Maldonado*, 430 A.2d 779, 786 (Del. 1981). "[U]nder the procedures established in *Zapata*, a court has the discretion to apply its own 'business judgment' to the special litigation committee's decision, and thus, may 'second guess' a decision made by disinterested and independent directors." Grover C. Brown et al., *Director and Advisor Disinterestedness and Independence Under Delaware Law*, 23 Del. J. Corp. L. 1157, 1190 (1998).

¹²² See Del. Code Ann. tit. 8, § 144 (2001).

¹²³ See Model Bus. Corp. Act § 8.62(c) (2002).

¹²⁴ See id. § 7.44(b).

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pendent board and an independent committee is too slight to justify the more demanding standard of review.¹²⁵

Instead, it may be that the contexts of the respective transactions in *Puma* and *Lynch Communication* explain (and rationalize) their disparate treatment. *Puma* presented a going-concern transaction that required the board of directors to reach an ordinary decision of business judgment. *Lynch Communication*, by contrast, was a takeover transaction in the final period—a situation with a much greater chance for oppression by a controlling shareholder as the minority shareholders were forced out of the corporation. These dangers may have justified the court's use of entire fairness in an effort to protect the minority interests, but because the dangers are limited to certain transactions, they fail to justify an overinclusive application of entire fairness.

To date, the questions surrounding *Puma*'s precedential value have gone unanswered. It seems under *Lynch Communication* that entire fairness is the gaining, omnipresent standard for controlling shareholder transactions.¹²⁶ As one Delaware practitioner lamented on the post-*Lynch Communication* landscape:

There is [another] scenario which hasn't directly been addressed, and that is the fact pattern in *Puma v. Marriott*, a case which is dear to many of our hearts, but which many of us fear is becoming like a dinosaur. We are not sure if it still stalks the earth or not.¹²⁷

Thus, the lurking question is, if the Delaware Supreme Court once again confronts facts analogous to those in *Puma*, will the *Lynch Communication* decision dictate entire fairness? Assuming that entire fairness is the optimal standard of review for the final-period

¹²⁵ In *In re Western National Corp. Shareholders Litigation*, the chancellor applied business judgment to review a decision approved by three independent directors. No. 15927, 2000 WL 710192, at *27 (Del. Ch. May 22, 2000). In reaching this decision, he noted that the fact that *Puma* involved a decision approved by *five* independent directors was not enough to distinguish the two cases and warrant a higher standard of review of the Western National special committee. *Id.*

¹²⁶ See, e.g., *T. Rowe Price Recovery Fund, L.P. v. Rubin*, 770 A.2d 536, 539, 552 (Del. Ch. 2000) (reviewing management and shared services agreements under entire fairness because they involved a majority shareholder).

¹²⁷ Judicial Standards of Review of Corporate Fiduciary Action: May 23, 2001, 26 Del. J. Corp. L. 993, 1050 (2001) (comments of A. Gilchrist Sparks, III, Esq.).

transaction in *Lynch Communication*, the converse cannot be true: Imposing entire fairness on the nonfinal-period transaction in *Puma* seems incredulous. It would inefficiently expend significant resources to review an independently approved going-concern business transaction where all shareholder interests are aligned that, absent a controlling shareholder, would be a routine matter of business judgment.¹²⁸

Yet recent Delaware decisions indicate that entire fairness now applies to going-concern transactions as well as freeze-out mergers. In *Kahn v. Tremont Corporation*, Chancellor Allen addressed the issue and, in light of *Lynch Communication*, found that “no plausible rationale [exists]” to distinguish freeze-outs and “other corporate transactions” in determining whether entire fairness applies.¹²⁹ On appeal, furthermore, the supreme court, without analysis or explanation, similarly used entire fairness to scrutinize the controlling shareholder’s actions.¹³⁰ This left a subsequent chancery court in *T. Rowe Price Recovery Fund, L.P. v. Rubin* to infer from the supreme court an “implicit endorsement of Chancellor Allen’s explicitly stated” position that entire fairness applies to all controlling shareholder transactions.¹³¹ It felt bound to apply entire fairness, not just to mergers, but to “business transactions” as well, regardless of independent approval or the alignment of parties’ interests. The promise of efficiency gains in *Puma*’s business judgment approach to nonfinal-period transactions thus appears subsumed by entire fairness review. It is to the resurrection of *Puma* and the creation of a controlling shareholder safe harbor that this Note now turns.

¹²⁸ William J. Carney, *The ALI’s Corporate Governance Project: The Death of Property Rights?*, 61 *Geo. Wash. L. Rev.* 898, 917 (1993) (arguing that “the costs of dispute resolution in the courts are so high that they make enforcement of fiduciary duties a negative-sum game”).

¹²⁹ See CA No. 12339, 1996 Del. Ch. LEXIS 40, *24 (Del. Ch. Mar. 27, 1996).

¹³⁰ *Kahn v. Tremont Corp.*, 694 A.2d 422, 424, 428, 432–33 (Del. 1997).

¹³¹ 770 A.2d 536, 552 (Del. Ch. 2000). See also the chancery decision in *Cooke v. Oolie*, CA No. 11134, 2000 WL 710199, *13 (Del. Ch. 2000), which is said to be in “direct conflict” with *Puma*. See Eric G. Orlinsky, *Corporate Opportunity Doctrine and Interested Director Transactions: A Framework for Analysis in an Attempt to Restore Predictability*, 24 *Del. J. Corp. L.* 451, 485 (1999).

II. DEFINING A CONTROLLING SHAREHOLDER SAFE HARBOR

The preceding Part explained the development of Delaware case law governing controlling shareholder transactions. It showed that, after years of uncertainty and a split among the chancery courts, the Delaware Supreme Court in *Lynch Communication* opted for heightened scrutiny via entire fairness, choosing not to follow the interested director safe harbors. This Note suggests that it is a mistake to apply this beyond takeout transactions, as done in *T. Rowe Price Recovery Fund, L.P. v. Rubin*.¹³² Instead, this Note contends that *Puma's* and *Sinclair Oil's* business judgment standard is appropriate for *Puma*-like transactions (that is, nonfinal-period activity), and that entire fairness in *Lynch* can be justified—if at all—only as a response to the final-period problem.

This Part advocates for courts and legislatures to develop a safe harbor that distinguishes between transactions that warrant entire fairness and those that deserve business judgment review. It argues that the entire fairness standard is an overly broad rule that ignores the incentives for controlling shareholders not only to act “fairly,” but also to act in a manner that maximizes aggregate shareholder wealth. It further contends that a controlling shareholder safe harbor based on the interested director provisions found in Subchapter F of the Model Act would lead to a more economically efficient, and therefore desirable, result.

Section A describes the framework, scope, and boundaries of a controlling shareholder safe harbor. Section B explains the efficiencies produced by a safe harbor's defined set of rules. Section C sets out the case for the safe harbor by explaining the use of disinterested director and minority shareholder approval methods and refuting much of the criticism aimed against them. Section D then discusses the final period and the use of market checks in judicial standards of review. Lastly, Section E explains why market checks might fail in the final period of play and how entire fairness compensates for that possible failure.

¹³² See 770 A.2d at 552.

A. Framework For a Controlling Shareholder Safe Harbor

This safe harbor proposal is limited to publicly held corporations¹³³ and is dependent on disinterested approval as set forth in Subchapter F of the Model Act.¹³⁴ Disinterested approval of a non-final-period transaction qualifies as: informed approval by a quorum of no less than two independent directors not appointed by the controlling shareholder; or informed approval by all shareholders

¹³³ From the outset, an important caveat to this discussion is that it is limited to publicly held corporations with an efficient market providing a valuation appraisal and share liquidity to firm owners, even though closely held corporations provide fertile grounds for inter-shareholder lawsuits. This is especially so in the venture capital industry where the shareholders, consisting of financiers and founders, often have adverse interests. See, e.g., Janet Whitman, Will "Wash-out" Investments Spawn a Flurry of Lawsuits?, *Wall St. J.*, Feb. 26, 2003 (noting the increasing possibility of lawsuits after the technology fallout); see also *Kalashian v. Advent VI L.P.*, No. CV-739278, 1996 WL 33399950 (Cal. App. Dep't Super. Ct. Oct. 4, 1996) (discussing the case of Alantec brought by the founders against the financiers who allegedly improperly diluted the minority position).

Closely held corporations simply have too many variables to fall within the scope of this Note. For example, minority shareholders (namely founders) in the closely held business may not be able to eliminate unsystematic risk, unlike small investors in publicly traded companies. See Carney, *supra* note 128, at 918. There is also a greater problem of asymmetric information in the closely held context. See *id.* While public company shareholders have access to federal and state mandated disclosure, shareholder meetings, and proxy ballot information, the same cannot be said for small, passive business investors.

One should remember, however, that minority shareholders in a closely held company are not without recourse. Private bargaining is a common means to determine contractual rights, see *id.* at 901, and monitoring costs may be lower for minority shareholders who are actively involved in the business. Also, many states have developed laws unique to closely held businesses to provide greater protection to shareholders, such as dissolution. See 1 F.H. O'Neal & R. Thompson, *O'Neal's Oppression of Minority Shareholders: Protecting Minority Rights in Squeeze-Outs and Other Intracorporate Conflicts* (2d ed. 1997) (discussing protection of minority shareholders); see also 15 Pa. Cons. Stat. Ann. § 1767(a)(2) (West 1995) (authorizing a court-appointed custodian in cases where directors or "those in control" have acted "illegally, oppressively, or fraudulently" towards minority shareholders).

It remains plausible that a safe harbor could apply to controlling shareholder transactions in privately held corporations. It would still rely on independent approval. If a minority shareholder is able to demonstrate a procedural flaw, such as an interested decisionmaker, entire fairness would apply. Similarly, it may be that a majority of the minority approval is most desirable in this situation because it gives a greater voice to small equity holders. Cf. Thomas Lee Hazen, *Silencing the Shareholders' Voice*, 80 N.C. L. Rev. 1897, 1922-23 (2002) (discussing the importance of the minority voice in the closely held context).

¹³⁴ See Model Bus. Corp. Act §§ 8.60-.63 (2002).

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entitled to vote on the transaction, other than the controlling shareholder.¹³⁵

A controlling shareholder safe harbor should recognize the limited nature of fiduciary duties applicable to controlling shareholders and restrict accordingly the number of transactions subject to review. A transaction should be considered for entire fairness only when there is (1) a defined “controlling shareholder” (2) transacting business with the corporation (3) while acting in the capacity of *shareholder* (4) outside the final period. The first requirement limits the number of shareholders that need to comply with the safe harbor by recognizing that most shareholders do not owe fiduciary duties to their fellow investors. Thus, only those with authoritative control need to qualify the transaction with independent approval.¹³⁶ Under the *Aronson v. Lewis* test, fiduciary duties attach only to a controlling shareholder who dominates the corporation and its board of directors through actual control of the corporation’s conduct.¹³⁷

The second requirement—that the shareholder conduct business with the corporation—limits the number of transactions that require approval. This recognizes the property rights vested in stock ownership—specifically that shareholders generally may exercise total control over their shares without fiduciary restrictions.¹³⁸ Historically, the law rarely endeavored to deal with shareholder transactions occurring outside of the corporation,¹³⁹ and a control bloc never has required a large investor in Delaware to act “altruisti-

¹³⁵ *Id.* §§ 8.62–.63.

¹³⁶ See *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 1113 (Del. 1994) (citing *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987)).

¹³⁷ See *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984) (defining domination as “a direction of corporate conduct in such a way as to comport with the wishes or interests of [those] doing the controlling”) (quoting *Kaplan v. Centex Corp.*, 284 A.2d 119, 123 (Del. Ch. 1971)); see also Adolf A. Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property* 239 (Legal Classics Library spec. ed. 1993) (1932) (noting that legal rules are applied to shareholders only when such shareholders enjoy unusual influence).

¹³⁸ Cf. *In re Frederick’s of Hollywood, Inc. S’holders Litig.*, No. 15944, 1998 WL 398244, at *5 (Del. Ch. July 9, 1998) (recognizing a majority shareholder’s right to vote against a proposed transaction).

¹³⁹ See Berle & Means, *supra* note 137, at 243.

cally” towards the minority shareholders.¹⁴⁰ The voting of corporate stock outside of direct conflict transactions falls outside the scope of fiduciary duties,¹⁴¹ as do decisions regarding the free transferability of equity interests.¹⁴² Because self-interest is a tenet of stock ownership,¹⁴³ these actions are more properly dealt with by existing laws, fiduciary duties, and statutes protecting minority shareholders, rather than an entire fairness review.¹⁴⁴

The third requirement is that the controlling shareholder act in his or her capacity as a shareholder—an owner of the firm. This preserves rights otherwise available to the shareholder. For example, in *Odyssey Partners, L.P. v. Fleming Co.*, a minority shareholder challenged the majority shareholder’s purchase of substantially all the firm’s assets through a foreclosure proceeding.¹⁴⁵ Because the majority shareholder also was a legal creditor of the corporation, Vice Chancellor Lamb applied the business judgment rule rather than entire fairness.¹⁴⁶

In an attempt to conform to current Delaware law under *Lynch Communication*, the fourth and final component of a controlling shareholder safe harbor departs from current interested director

¹⁴⁰ *Odyssey Partners, L.P. v. Fleming Cos.*, 735 A.2d 386, 411 (Del. Ch. 1999) (quoting *Thorpe v. CERBCO, Inc.*, CIV.A.11713, 1993 WL 443406, at *7 (Del. Ch. Oct. 29, 1993)).

¹⁴¹ See Berle & Means, *supra* note 137, at 241.

¹⁴² See *Mendel v. Carroll*, 651 A.2d 297, 306 (Del. Ch. 1994).

¹⁴³ See *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 845 (Del. 1987); *Jedwab v. MGM Grand Hotels*, 509 A.2d 584, 598 (Del. Ch. 1986).

¹⁴⁴ See, e.g., Del. Code Ann. tit. 8, § 203 (2003) (providing rules for interested stockholder business transactions); *Thorpe v. CERBCO*, 676 A.2d 436, 437 (Del. 1996) (finding a controlling shareholder in breach of his fiduciary duties in an asset sale); *Mills Acquisition Co. v. MacMillan*, 559 A.2d 1261, 1283 (Del. 1989) (“[F]iduciaries, corporate or otherwise, may not use superior information or knowledge to mislead others in the performance of their own fiduciary obligations.”); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 723 (Del. 1971) (finding a parent corporation breached a contract with its subsidiary); *Hollinger Int’l v. Black*, 844 A.2d 1022, 1028–29 (Del. Ch. 2004) (finding a controlling shareholder-director breached his fiduciary duties through self-dealing).

¹⁴⁵ See 735 A.2d 386, 388–89, 406 (Del. Ch. 1999).

¹⁴⁶ See *id.* at 414–15 (“A controlling shareholder is not required to give up legal rights that it clearly possesses; this is certainly so when those legal rights arise in a nonstockholder capacity.” (quoting *Solomon v. Pathe Communications Corp.*, No. CIV.A.12563, 1995 WL 250374, at *5 (Del. Ch. Feb. 15, 1995) (mem.))). The “foreclosure sale [initiated by the controlling shareholder] was not a negotiated transaction” invoking *Weinberger*, but rather a statutory process in the debtor-creditor relationship. *Id.* at 414.

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safe harbors. Controlling shareholder transactions can be separated into two categories: final-period and nonfinal-period transactions. In nonfinal-period transactions, the going-concern market value of the shares aligns the interests of all shareholders. Thus, business judgment is appropriate because controlling and minority shareholders' mutual interest in maximizing shareholder wealth, combined with an independent-approval procedure, provides sufficient safeguards for nonfinal-period transactions. In the final period, conversely, the market may no longer check the controlling shareholder, interests diverge, and concerns about independent approval become more serious. This justifies enhanced scrutiny via the entire fairness standard under the safe harbor. This Note argues that such categorization is supported by existing Delaware precedent, even though this position has never been adopted by the Delaware courts. Specifically, the holdings of *Lynch Communication* and *Puma* implicitly recognized when the market for corporate stock works as an instrumentality to align shareholder interests, minimizing the need for judicial intervention. This Note combines those views and attempts to codify them for transactional certainty.

B. The Efficiencies of a Controlling Shareholder Safe Harbor

The interrelated problems with the *Lynch Communication* entire fairness test are that it applies a heightened standard of review in all controlling shareholder transactions, leading to significant litigation expenditures, where the courts have never defined with any certainty the scope of a controlling shareholder's fiduciary duties. A safe harbor reduces the instances of an intrusive entire fairness review, thereby reducing the costs to litigants by avoiding prolonged litigation. It also provides a "functional role" for the judiciary by way of a bright-line rule of proper statutory compliance.¹⁴⁷ Moreover, it avoids the uncertainty surrounding shareholder fiduciary duties and instead articulates a set of rules for structuring transactions, creating predictability for shareholders and corporate planners alike.

Entire fairness arguably is an unpredictable standard because of its in-depth inquiry into the transaction. Ambiguous legal rules are

¹⁴⁷ See Allen et al., *supra* note 20, at 1298.

inefficient and, consequently, quite costly.¹⁴⁸ An optimal set of laws provides “well defined property rights . . . [which in turn] provide the most efficient legal system because they facilitate exchange.”¹⁴⁹ This is because all parties understand their rights and recourse before entering into agreements. While the outcome of an entire fairness review may be left to speculation, a safe harbor guarantees business judgment review if the parties adhere to the statutory and case law requirements for disinterested ratification.

Relying on shareholder fiduciary duties in this area of law is unsatisfactory because these duties are simply too indeterminate. Yet, because control through equity ownership involves commonly owned property (the firm),¹⁵⁰ it is well-settled that controlling shareholders do owe *some* fiduciary duties to the corporation and its minority owners—particularly, the duty of loyalty.¹⁵¹ Moreover, the Delaware Supreme Court stated in *Singer v. Magnavox Co.* that directors, officers, and controlling shareholders all owe the duties of honesty, loyalty, and good faith.¹⁵² This does not set out the case, however, for enforcement of these fiduciary responsibilities without additional guidance. First, case law is nearly silent on defining these duties in the shareholder context, and early judicial attempts to define the fiduciary duties of controlling shareholders frequently invoked broad language of “ritualistic verbal standard[s]”¹⁵³ and “moralistic rhetoric”¹⁵⁴ rather than clear, workable standards of conduct and review.¹⁵⁵ Second, imposing these duties

¹⁴⁸ See Carney, *supra* note 128, at 908–09.

¹⁴⁹ *Id.* at 902.

¹⁵⁰ See, e.g., *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 109–10 (Del. 1952).

¹⁵¹ See, e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 719 (Del. 1971). Historically, courts were reluctant to constrain the power of majority shareholders through fiduciary obligations. See Carney, *supra* note 128, at 938.

¹⁵² 380 A.2d 969, 977 (Del. 1977).

¹⁵³ Allen et al., *supra* note 20, at 1298.

¹⁵⁴ J.A.C. Hetherington, *Defining the Scope of Controlling Shareholders' Fiduciary Responsibilities*, 22 *Wake Forest L. Rev.* 9, 11 (1987).

¹⁵⁵ Opinions from outside of Delaware have offered more flourishing rhetoric. Among the most famous is then-Judge Cardozo's opinion in *Meinham v. Salmon*:

Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the “disintegrating erosion” of particular exceptions. Only thus has the level of conduct

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upon controlling shareholders does not logically follow from their application to other firm agents. After all, shareholders are property owners, not employed agents of the firm. Also, “[l]oyalty may seem inconsistent with the common-sense belief, firmly grounded in economics, that people act from self-interest in business.”¹⁵⁶ In other words, if loyalty requires an agent to subordinate his or her own interests to those of the group, this is at odds with an investor’s self-interested profit motive. The safe harbor responds to these concerns by providing a clear procedural framework to bypass an entire fairness hearing while maintaining the integrity of the decision through a cleansing process, and it works even if the courts never expound the exact scope of shareholder fiduciary duties.

This is consistent with an “expectations” theory of fiduciary duties, in that the “*only* basis for imposing obligations on one party or the other is their express or implied intention.”¹⁵⁷ Where the fiduciary obligations are equivocal, it is doubtful that the controlling shareholder would have bargained for them; an entire fairness review, however, invites litigation of these very open-ended issues. It eradicates “pre-transaction certainty” that accompanies the business judgment doctrine,¹⁵⁸ which in turn discourages conflicted transactions “no matter how beneficial they may be.”¹⁵⁹ The courts could define these duties with greater precision or, in the alternative, they could look to a cleansing mechanism to satisfy them (whatever they might be). The safe harbor, therefore, is a procedural solution to the complexity of defining fiduciary duties of controlling shareholders without taking on the daunting task of actually defining those duties.

A safe harbor produces efficiencies in litigation as well. First are the savings realized by the corporation and all other parties to the litigation. Commentators have said that litigating these claims of-

for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

164 N.E. 545, 546 (N.Y. 1928) (citation omitted).

¹⁵⁶ Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. Rev. 1045, 1074 (1991).

¹⁵⁷ Hetherington, *supra* note 154, at 19. For a discussion of an “expectations”-based approach to defining fiduciary duties, see generally *id.*

¹⁵⁸ Hansen et al., *supra* note 85, at 2089.

¹⁵⁹ *Id.* at 2088.

ten is a “negative-sum game” for corporate actors, who expend sizeable amounts of time and money, and forego other opportunities.¹⁶⁰ Corporate litigation that survives an initial motion to dismiss can then exist in the court system for a prolonged length of time¹⁶¹—and any benefits to the plaintiffs or the corporation often are outweighed by the costs of the process.¹⁶² A plaintiff-shareholder, furthermore, currently is almost certain to survive a defendant’s motion to dismiss if the plaintiff can invoke the entire fairness standard.¹⁶³ Thus, strategic pleading methodologies emerge—there is an opportunistic incentive to challenge controlling shareholder transactions. This is particularly problematic where parties initiate strike suits because corporate defendants are likely to settle once the plaintiff overcomes the initial motions for dismissal.¹⁶⁴

¹⁶⁰ See, e.g., Carney, *supra* note 128, at 904, 916–17. In the context of takeover transactions, several studies demonstrate that firm value often declines after unsuccessful takeover attempts. See Richard S. Ruback, Do Target Shareholders Lose in Unsuccessful Control Contests?, *in* Corporate Takeovers: Causes and Consequences 137, 150 (Alan J. Auerbach ed., 1988) (citing studies); see also Frank H. Easterbrook & Gregg A. Jarrell, Do Targets Gain from Defeating Tender Offers?, 59 N.Y.U. L. Rev. 277, 291–92 (1984) (same).

¹⁶¹ For example, six years passed from the first chancery court decision to the second and last supreme court decision in *Lynch Communication*. See Kahn v. Lynch Communication Sys., 669 A.2d 79 (Del. 1995); Kahn v. Lynch Communication Sys., No. 8748, 1989 Del. Ch. LEXIS 102, at *1 (Del. Ch. Aug. 24, 1989). Other examples are more worrisome. See, e.g., Cede & Co. v. Technicolor, No. CIV.A.7129, 2003 WL 23700218, at *1 (Del. Ch. July 9, 2004) (awarding plaintiffs \$4.4 million after twenty years of litigation). It may be that the lawyers are the only ones who gain benefits from many of these legal battles. See Cinerama v. Technicolor: The Anticlimax (Mar. 11, 2004), at http://www.professorbainbridge.com/corporation_law/index.html (last accessed Mar. 24, 2004) (discussing the recent decision that ended the drawn-out controversy and speculating as to the only rewards—those enjoyed by the attorneys) (on file with the Virginia Law Review Association).

¹⁶² See Carney, *supra* note 128, at 917.

¹⁶³ See generally Lewis H. Lazarus, Standards of Review in Conflict Transactions: An Examination of Decisions Rendered on Motions to Dismiss, 26 Del. J. Corp. L. 911, 913–26 (2001) (discussing strategy in surviving motions to dismiss when a complaint invokes the entire fairness standard instead of the business judgment rule).

¹⁶⁴ Lucian Arye Bebchuk, Suing Solely to Extract a Settlement Offer, 17 J. Legal Stud. 437 (1988) (discussing strike suits); James D. Cox, Making Securities Fraud Class Actions Virtuous, 39 Ariz. L. Rev. 497, 498 (1997) (noting the “devastating” consequences of class action awards).

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In contrast, a safe harbor that triggers the business judgment rule (imperfectly) filters claims,¹⁶⁵ thereby curtailing the costs imposed on courts and litigants in the process of adjudication.¹⁶⁶ Plaintiffs are still left to challenge the integrity of the approval process—true disinterested parties, accurate disclosures, and the business judgment rule itself¹⁶⁷—in order to pursue meritorious claims beyond the early pleadings.¹⁶⁸ This still allows plaintiffs to invoke the entire fairness standard, but under much more limited circumstances. It may follow, then, that given the choice between litigation, on the one hand, and a lower standard of review but under a bright-line procedural rule, on the other hand, the rational (that is, profit-oriented) investor will prefer defined rules over litigation.¹⁶⁹

The second line of benefits realized in litigation are the reduced costs imposed on the judiciary. A “practical and logical framework,” as found in the safe harbor, provides a pragmatic test to reduce needless efforts in litigation.¹⁷⁰ The entire fairness standard requires the expenditure of significant judicial resources, but it is doubtful whether such expenditures add utility to an otherwise valid, independently approved transaction.¹⁷¹ Seen this way, the safe harbor is consistent with the theoretical foundation of the business judgment rule: A safe harbor reduces judicial second-

¹⁶⁵ See *infra* note 267.

¹⁶⁶ See Jill E. Fisch, *Teaching Corporate Governance Through Shareholder Litigation*, 34 Ga. L. Rev. 745, 753 (2000) (noting that “because the business judgment rule imposes a threshold pleading burden on a plaintiff-shareholder, it allows courts to dismiss much litigation at an early stage”).

¹⁶⁷ While often outcome determinative and clearly the lowest standard of review, the business judgment rule is not an instant pass for the directors. See, e.g., Lyman Johnson, *The Modest Business Judgment Rule*, 55 Bus. Law. 625, 628 (2000).

¹⁶⁸ This is not necessarily a high threshold, so long as the plaintiff is able to invoke specific facts in the pleading to challenge the approval process. A motion to dismiss will be granted only after the court reviews the pleadings “in a light most favorable to the plaintiff” and “determine[s] . . . with reasonable certainty that under any set of facts that could be proven . . . the plaintiffs would not be entitled to relief.” *McMullin v. Beran*, 765 A.2d 910, 916 (Del. 2000). Providing even greater protection to Delaware plaintiffs, appellate courts have *de novo* reviews of dismissals for failure to state a claim. See *id.* (citing *In re Santa Fe Pac. Corp. S’holder Litig.*, 669 A.2d 59, 70 (Del. 1995)).

¹⁶⁹ See Carney, *supra* note 128, at 916; Easterbrook & Fischel, *supra* note 1, at 119.

¹⁷⁰ Allen et al., *supra* note 20, at 1297 (noting that the ideal standard of review should “avoid needless complexity that creates opportunities for inefficient processing of cases that have little likelihood of ultimate success”).

¹⁷¹ *Id.* at 1306.

guessing of corporate decisionmaking.¹⁷² The role of the judiciary is to police the process, not the substantive decision.¹⁷³ An entire fairness standard with its avowed two-prong focus on fair price and fair dealing necessarily goes beyond procedure in its review.¹⁷⁴ It delves into the substance of the transaction and invites litigious inquiries. Under this Note's proposal, such litigation is avoided through disinterested corporate agents or principals that trigger business judgment review, so long as the efficacy of these two bodies holds fast.

Proponents of entire fairness review in every controlling shareholder transaction are generally skeptical of these transactions due to the controlling shareholder's possible exercise of dominating power. But this postulation is debatable, and, as far as justifying an absolute rule of entire fairness, largely unconvincing. The safe harbor incorporates the normative proposition that controlling shareholder transactions should not be second-guessed as a routine matter. Empirical evidence, furthermore, while not conclusive, hints that the presence of a controlling shareholder does not adversely affect firm value, suggesting that the market does not view controlling shareholders as inherently detrimental to firm profitability.¹⁷⁵ Of course, the possibility of controlling shareholder misconduct

¹⁷² See *id.* at 1297.

¹⁷³ The impracticality of this second-guessing is exacerbated when considering the actual structure of many controlling shareholder transactions, which run a wide spectrum from the most daily, mundane contracts, see Eisenberg, *supra* note 7, at 456, to complex corporate transactions requiring sophisticated (and expensive) expertise, see Orlinsky, *supra* note 131, at 484–85.

¹⁷⁴ In explaining the fair price component of entire fairness, the *Weinberger* court stated that it “relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.” *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983). Continuing, the court explained that “the test for fairness is not a bifurcated one . . . [and] [a]ll aspects of the issue must be examined as a whole since the question is one of entire fairness.” *Id.*

¹⁷⁵ See generally Clifford G. Holderness & Dennis P. Sheehan, Constraints on Large-Block Shareholders, in *Concentrated Corporate Ownership* 139 (Randall K. Morck ed., 2000). Professors Holderness and Sheehan conclude, however, that this is due to the legal rules currently in place, so it could be argued that reducing the standard of review from entire fairness to business judgment could have detrimental effects on firm value. See *id.* at 166. Judge Easterbrook and Professor Fischel posit that share value will be lower in an efficient market because of the risk that the controlling shareholder may initiate a cash-out merger at an inadequate price. See Easterbrook & Fischel, *supra* note 1, at 146.

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imposes additional risk and added private agency costs. That risk, however, is unsystematic and, consequently, capable of elimination through diversification.¹⁷⁶ Moreover, all shareholders generally benefit from the controlling shareholder's nonfinal-period monitoring activities.¹⁷⁷ For example, in addition to probing for managerial misconduct, "the controlling shareholder can more easily detect managerial risk aversion" and help ensure that the firm's managers pursue strategies for shareholder wealth maximization.¹⁷⁸ In addition, these transactions are efficient because they can compensate controlling shareholders for the risk and costs associated with their equity stake and monitoring activities.¹⁷⁹ Finally, approval by independent decisionmakers minimizes the risk of controlling shareholder misconduct in the nonfinal period.¹⁸⁰

There also is support for conducting these transactions outside of heightened scrutiny because entire fairness inhibits (by discouraging or raising the costs of pursuing) efficient transactions between controlling shareholders and their corporations.¹⁸¹ These transactions may offer the most efficient allocation of the firm's resources. An absolute rule of entire fairness review is reminiscent of the old and abandoned common law voidability of interested director transactions.¹⁸² The rigidity of that rule had the effect of a per se prohibition on an entire class of transactions because it ignored the underlying principles of contractual private ordering.¹⁸³ This unquestionably was an overbroad rule that was far too skeptical of conflicted transactions.¹⁸⁴ Entire fairness presents a quite similar

¹⁷⁶ See generally Burton G. Malkiel, *A Random Walk Down Wall Street* (7th ed. 1999) (discussing expected return as it relates to systematic and unsystematic risk).

¹⁷⁷ See Gilson & Gordon, *supra* note 64, at 785–86.

¹⁷⁸ Nina A. Mendelson, *A Control-Based Approach to Shareholder Liability for Corporate Torts*, 102 *Colum. L. Rev.* 1203, 1250 (2002).

¹⁷⁹ See Gilson & Gordon, *supra* note 64, at 785.

¹⁸⁰ See, e.g., *Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022, 1077–82 (Del. Ch. 2004).

¹⁸¹ See Hansen et al., *supra* note 85, at 2088.

¹⁸² See Orlinsky, *supra* note 131, at 455.

¹⁸³ See Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 *Stan. L. Rev.* 271, 280 (1986); see also Dennis J. Block et al., *The Duty of Loyalty and the Evolution of the Scope of Judicial Review*, 59 *Brooklyn L. Rev.* 65, 76 (1993).

¹⁸⁴ The comment to the Model Act explains its approval process in contrast to prior interested director law:

[I]t is important to keep firmly in mind that it is a contingent risk we are dealing with, that an interest conflict is not in itself a crime or a tort or necessarily inju-

problem: The benefits of an otherwise efficient transaction with a controlling shareholder may be outweighed by the costs of litigating an entire fairness hearing.¹⁸⁵ Instead, a judicial laissez-faire approach is “economically sound” when proper safeguards are in place.¹⁸⁶ Here, the safeguard of self-interest—that is, the aggregate shareholder interests outside the final period—allocates assets to their most valuable use.¹⁸⁷ All parties should pursue wealth-maximizing transactions. Recall in *Puma* that the Marriott corporation was best served by owning the real property holding companies that it purchased from the controlling shareholders. This should have benefited all shareholders of the firm. And even if one argues that the Marriott controlling shareholders extracted disproportionate benefits (the purchase price of the property plus the increased value of their shares), the rational investor should prefer unequal distributions of gains as long as that investor still profits from the transaction.¹⁸⁸

C. The Efficacy of Independent Approval

A central premise underlying a successful controlling shareholder safe harbor is a belief in the efficacy of independent decisionmakers to screen transactions and protect the corporation. Heightened scrutiny through entire fairness necessarily reflects skepticism in the abilities of both disinterested directors and minority shareholders.¹⁸⁹ In order to justify entire fairness, the *Lynch Communication* court must have believed that independent approval falters in dealing with controlling shareholders. Indeed, this

rious to others. Contrary to much popular usage, having a “conflict of interest” is not something one is “guilty of”; it is simply a state of affairs. Indeed, in many situations, the corporation and the shareholders may secure major benefits from a transaction despite the presence of a director’s conflicting interest.

Model Bus. Corp. Act § 8.60–.63 (2002) (Intro. Cmt. to Subch. F).

¹⁸⁵ Cf. Easterbrook & Fischel, *supra* note 1, at 7 (questioning whether the costs of diverging interests “can be cut by mechanisms that are not themselves more costly”).

¹⁸⁶ *Id.* at 110.

¹⁸⁷ *Id.* at 113.

¹⁸⁸ See *id.* at 119–21.

¹⁸⁹ See *In re Pure Res. S’holders Litig.*, 808 A.2d 421, 436 n.17 (Del. Ch. 2002) (noting the Delaware Supreme Court’s “less trusting view of independent directors” embodied in *Lynch Communication*).

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debate is the crux of diverging theories in corporate governance,¹⁹⁰ and it has been said that there is “little prospect of reconciling the disputants, given their radically different philosophical starting points.”¹⁹¹ Despite these criticisms, it is indisputable that the modern modes of corporate governance depend on disinterested directors, and a safe harbor encourages full disclosure to independent decisionmakers. This Section draws on these ideas to explain why independent approval principles can be properly applied to controlling shareholder transactions.

Section C.1 will demonstrate that a court is readily capable of reviewing the independent status of directors in the early stages of litigation,¹⁹² and this Note argues that directors found to be “independent” are capable of making good faith business decisions. It further notes that the abilities of independent directors are relied upon in many areas of corporate law,¹⁹³ and there is no convincing justification for setting apart controlling shareholder transactions for disparate treatment. Section C.2 will explain that informed, shareholder approval should be given effect in approving a controlling shareholder transaction. In addition to providing an additional cleansing channel, majority of the minority shareholder approval encourages shareholder activism and empowers large, non-controlling shareholders to direct the corporation. This Section also stresses that shareholders do not share the same questionable

¹⁹⁰ See generally Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 *Stan. L. Rev.* 923 (1984) (discussing the competing theories of corporate governance).

¹⁹¹ Carney, *supra* note 128, at 899. The ALI’s minority-friendly approach challenging the independence of directors has been harshly criticized and generally represents the opposite side of the spectrum in this debate. For a summary of the competing views, see Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 *Geo. Wash. L. Rev.* 1034, 1035 (1993).

¹⁹² See Lazarus, *supra* note 163, at 916–19.

¹⁹³ See generally *Developments in the Law—Corporations and Society, And Now, the Independent Director! Have Congress, the NYSE, and NASDAQ Finally Figured Out How to Make the Independent Director Actually Work?*, 117 *Harv. L. Rev.* 2181 (2004). For specific examples, see Ellen Byron, *Managers: Keep Out*, *Wall St. J.*, June 21, 2004 at R4 (discussing the growing powers and responsibilities of independent directors); Press Release, Securities & Exchange Commission, *SEC Adopts Changes to Short Sale Rules, Disclosures Regarding Advisory Contract Approval and Investment Company Governance Provisions*, (June 23, 2004), at <http://www.sec.gov/news/press/2004-87.htm> (modified June 23, 2004) (announcing rules for independent directors of mutual funds) (on file with the Virginia Law Review Association).

relationships with controlling shareholders that often challenge the independence of directors.

1. Approval by Disinterested Directors

A controlling shareholder safe harbor doctrine presupposes the ability of directors to be disinterested.¹⁹⁴ Many commentators criticize directors, however, for possessing conflicting interests in their interactions with controlling shareholders due to business motivations, social relationships,¹⁹⁵ and directors' personal desires to retain their board seats (with the accompanying "prestige and perquisites"¹⁹⁶). Nevertheless, the criticism targeted at the business judgment rule and director independence is largely unconvincing—at least in the context of controlling shareholder transactions.

First, there is no reason why the common law *Aronson* test¹⁹⁷ is insufficient in determining whether directors are in fact "independent." This Note acknowledges that "independent directors"

¹⁹⁴ See generally Sanjai Bhagat & Bernard Black, The Uncertain Relationship Between Board Composition and Firm Performance, 54 Bus. Law. 921 (1999); Arnoud W.A. Boot & Jonathan R. Macey, Monitoring Corporate Performance: The Role of Objectivity, Proximity, and Adaptability in Corporate Governance, 89 Cornell L. Rev. 356 (2004); Victor Brudney, The Independent Director—Heavenly City or Potemkin Village?, 95 Harv. L. Rev. 597 (1982); Donald C. Langevoort, The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability, 89 Geo. L.J. 797 (2001).

¹⁹⁵ As observed by Delaware chancellors:

It is commonplace for outside directors to have social, and in some cases business, relationships (e.g., a partner in the company's outside law firm or investment bank serving as a director). That reality may explain the Delaware supreme court's reluctance to give the special committee device full credit as a cleansing mechanism.

Allen et al., *supra* note 20, at 1308.

¹⁹⁶ *Unitrin v. Am. Gen. Corp.*, 651 A.2d 1361, 1380 (Del. 1995); see also Melvin A. Eisenberg, The Structure of the Corporation: A Legal Analysis 30–34 (1976) (discussing the inabilities of directors). But see Michael P. Dooley & E. Norman Veasey, The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared, 44 Bus. Law. 503, 534–35 (1989) (criticizing that position and supporting the ability of directors to act independently).

¹⁹⁷ See *Aronson v. Lewis*, 473 A.2d 805, 815–17 (Del. 1984). The *Aronson* court added that "in the demand context [for a derivative suit] even proof of majority ownership of a company does not strip the directors of the presumptions of independence, and that their acts have been taken in good faith and in the best interests of the corporation." *Id.* at 815.

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may be independent only in name,¹⁹⁸ so a safe harbor does not supplant an inquiry that ensures the independence of directors. To the contrary, a safe harbor relies on that preliminary finding to trigger the business judgment standard of review.¹⁹⁹ This preliminary finding serves, furthermore, a functional role for the judiciary, as it can be done at the early stages of litigation to determine whether to proceed with an entire fairness hearing.²⁰⁰ *Aronson* is workable because it retains flexibility insofar as it “takes a view of human nature that says that directors without conflicting financial ties can resist a majority stockholder.”²⁰¹ In addition, Delaware courts have recognized that directors are not “interested” merely because a transaction involves the controlling shareholder who appointed them.²⁰² Rather, *Aronson* ascertains whether a director is “beholden” to the controlling shareholder, a determination readily made at the chancery court level.²⁰³

Second, the skepticism of independent directors ignores important market constraints, such as a director’s reputational and future income considerations. Independent directors have “considerable investments in reputation but [they] have invested most of their human capital elsewhere.”²⁰⁴ Their actions are subject to public review by way of annual shareholder meetings, routine shareholder disclosures, media outlets, analyst inquiries, and federally-mandated securities disclosures.²⁰⁵ “Because they gain little from approving an insider’s transaction, even a modest penalty in other markets makes them effective monitors.”²⁰⁶ These boundaries may

¹⁹⁸ See, e.g., Bainbridge, *supra* note 191, at 1059 (1993) (noting that independent directors may still have relationships that affect their ability to be disinterested).

¹⁹⁹ See William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 *Bus. Law.* 2055, 2060 (1990) (discussing the Delaware chancery courts’ function in reviewing the integrity of independent approval processes).

²⁰⁰ See Lazarus, *supra* note 163, at 916–19.

²⁰¹ Strine, *supra* note 12, at 506.

²⁰² See *Andreae v. Andreae*, No. CIV.A.11905, 1992 WL 43924, at *5 (Del. Ch. Mar. 5, 1992); *Stein v. Orloff*, No. 7276, 1985 WL 11561, at *3 (Del. Ch. May 30, 1985).

²⁰³ *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984).

²⁰⁴ Dooley & Veasey, *supra* note 196, at 535.

²⁰⁵ Sean J. Griffith, *Deal Protection Provisions in the Last Period of Play*, 71 *Fordham L. Rev.* 1899, 1937 (2003). Criminal and debtor-creditor laws also exist to prevent fraudulent transactions. See *id.*

²⁰⁶ Easterbrook & Fischel, *supra* note 1, at 104.

not be infallible, but this alone is insufficient to justify a per se rule of entire fairness.²⁰⁷

Third, and on a more foundational level, modern corporate law is built upon the loyalty and good faith of disinterested directors because that is the most efficient method to manage a firm with dispersed ownership.²⁰⁸ Operational authority within a firm is allocated by its owners to the board, and then to management, in order to maximize shareholder wealth.²⁰⁹ To review skeptically the conclusions of an independent board of directors is akin to removing the leg of a chair: It undermines the central premise of a wider range of corporate laws. If one believes that *Aronson*-approved independent directors cannot free themselves from the tainting influence of a controlling shareholder, then *Aronson*-approved directors should also falter in dealing with their fellow directors under Delaware Section 144 and Subchapter F of the Model Act.²¹⁰ Yet despite those potential conflicts, courts recognize disinterested ap-

²⁰⁷ Cf. Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 *Yale L.J.* 541, 548 (2003) (suggesting that mandatory rules for business contracts are inefficient).

²⁰⁸ As Chancellor Allen writes:

[O]ur statutory corporation law has long assumed that disinterested directors can exercise a business judgment unaffected by the fact that the CEO of the firm may be self-interested. Indeed, one of the principal threads in the development of corporation law over the past 20 years has been the emphasis on bringing more outside directors onto boards, and the creation of more board committees comprised of outside directors.

See Allen, *supra* note 199, at 2057 (citations omitted).

²⁰⁹ See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 *Nw. U. L. Rev.* 547, 552 (2003). Professor Bainbridge summarizes the idea:

In order for an organization to survive, its governance system must allocate authority to make adaptive decisions and define the norms that should guide the chosen decisionmakers. For U.S. corporations, the latter is provided by the shareholder wealth maximization norm. The former is effected through a branching hierarchy headed by a board of directors with the power to effect adaptive change through fiat.

Id. (footnotes omitted); see also Dooley, *supra* note 61, at 466–67.

²¹⁰ In evaluating a fellow director's proposed transaction with the corporation, the remaining directors are placed in the embarrassing and invidious position of having to pass upon, scrutinize and check the transactions and accounts of one of their own body, with whom they are associated on terms of equality in the general management of all the affairs of the corporation.

Melvin Aron Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 *J. Corp. L.* 997, 997 (1988) (internal quotations omitted).

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proval as a valid means of pursuing conflicted transactions that can be beneficial to the corporation.²¹¹ Moreover, even though the interested director safe harbors are not flawless, no one has seriously suggested that corporate law return to the early days of voidability for interested director transactions. Indeed, the Delaware Supreme Court has rejected the structural bias argument as it relates to interested director transactions, finding that courts and independent approval are adequate safeguards against misconduct.²¹² And even though one can distinguish interested director and controlling shareholder situations (for instance, controlling shareholders can remove a director), the slippery slope argument remains. As two commentators have asked, “[D]oes this not suggest a wholesale abandonment of the business judgment rule in favor of judicial review of every board approval . . . that turns out badly?”²¹³

The ability of independent directors to withstand the retributive fear of a controlling shareholder was recently demonstrated in the chancery court decision in *Hollinger International v. Black*.²¹⁴ There, an active minority shareholder requested independent directors to investigate the actions of the corporation’s dominating shareholder, Lord Conrad Black.²¹⁵ The dispute intensified, but rather than retreat, the independent directors “were not cowed by” the controlling shareholder’s actions.²¹⁶ In fact, the independent directors went to the quite unusual measure of adopting a shareholder-rights plan to constrain Black’s misconduct.²¹⁷ While *Hollinger International* no doubt was an atypical situation insofar as the case involved a defiant, high-profile shareholder, at the very least, it illustrates the power of independent directors to protect minority interests.

²¹¹ See Hansen et al., *supra* note 85, at 2088–89.

²¹² See *Aronson v. Lewis*, 473 A.2d 805, 815 n.8 (Del. 1984), *cited in* Dooley & Veasey, *supra* note 196, at 534.

²¹³ Dooley & Veasey, *supra* note 196, at 535.

²¹⁴ 844 A.2d 1022 (Del. Ch. 2004).

²¹⁵ See *id.* at 1034.

²¹⁶ *Id.* at 1055–56.

²¹⁷ *Id.* at 1056.

2. Majority of the Minority Shareholder Approval

Minority shareholders are the other ratifying body by which a going-concern controlling shareholder transaction can be approved under a statutory or common law safe harbor. The so-called “majority of the minority” vote should entitle the transaction to business judgment deference. Yet, like the disinterested director provision, opponents have criticized majority of the minority shareholder approval as an ineffective mode of corporate governance. This Section demonstrates, however, that shareholder approval may be the most desirable method of approving a transaction because shareholders do not have a conflicting relationship with the controlling shareholder and because it places decision-making power in the hands of the firm’s owners.

The first line of criticism against minority shareholders is that they fail to give proper time and study to proxy statements and, therefore, make unintelligent decisions.²¹⁸ Minority investors, the argument continues, maintain a passive role in the corporation, pay little attention to the daily operations of the corporation,²¹⁹ have little incentive to engage in corporate activities,²²⁰ and are prone to vote in favor of management’s recommendations.²²¹ There also exists a general problem of collective action and shareholder apathy.²²² Thus, at a minimum, nonfinal-period transactions allegedly arouse minimal interest in shareholders.

²¹⁸ Professor Melvin Eisenberg, for instance, has explained that “a very forceful argument can be made” that because shareholders are unlikely to study or understand the proxy statement describing the transaction, “at least in the case of a publicly held corporation . . . shareholder approval of self-interested transactions should not be given any weight at all.” See Eisenberg, *supra* note 7, at 456. Eisenberg also states that, if anything, shareholder approval “should only serve to shift the standard of review from a full-fairness standard to an intermediate standard.” *Id.*

²¹⁹ See J. Robert Brown, Jr., *Speaking with Complete Candor: Shareholder Ratification and the Elimination of the Duty of Loyalty*, 54 *Hastings L.J.* 641, 642 (2003).

²²⁰ Lynne L. Dallas, *The Control and Conflict of Interest Voting Systems*, 71 *N.C. L. Rev.* 1, 37 (1992).

²²¹ See Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 *U. Cin. L. Rev.* 347, 353–56 (1991) (discussing reasons why shareholders tend to delegate decisionmaking authority to management by voting in favor of management’s proposals).

²²² See Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 *J.L. & Econ.* 395, 402–03 (1983).

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These arguments, which noticeably are at odds with the shareholder-approval provisions already endorsed in the interested director safe harbors,²²³ fail to account for several key points. First, shareholders possess statutory and contractual voting rights to participate in fundamental corporate actions and amendments to corporate charters,²²⁴ surely nontrivial decisions requiring speculation into the best future course for the corporation and its residual claimants. Second, disclosure laws protect shareholders and ensure adequate information for an informed vote.²²⁵ Third, it is impossible for shareholders to ratify a fraudulent transaction; courts have the power to set aside such transactions regardless of approval.²²⁶ Finally, if the law allows the unstudied shareholder to vote on fundamental corporate actions, such as a recapitalization plan,²²⁷ then why would the law single out controlling shareholder transactions for different treatment? Few reasons emerge to explain different standards, especially if the concern is ensuring a “smart” shareholder decision (if that is the proper role of the judiciary in the first place).

The unlearned investor argument relies on a “helpless investor” theory in which shareholders are unable to comprehend the issues presented on the ballot. Yet the federal securities laws clearly reject this notion; they take the position that our mandatory disclosure system enables investors to make informed investment decisions.²²⁸ Admittedly, even armed with this information, few investors both study and understand the information being disclosed.²²⁹ The law, however, still recognizes their right to vote (or, for that matter, to sell or purchase shares based on information

²²³ See Del. Code Ann. tit. 8, § 144(a)(2) (2001); Model Bus. Corp. Act § 8.63 (2002). These provisions clearly contemplate the ability of shareholders to make a valid decision regarding a conflicted transaction.

²²⁴ See *supra* note 2 (citing Del. Code Ann. tit. 8, § 242 (2001 & Supp. 2002); *id.* § 251; *id.* § 271).

²²⁵ See, e.g., *Shell Petroleum v. Smith*, 606 A.2d 112, 115–16 (Del. 1992) (holding that a controlling shareholder breached its duty of disclosure).

²²⁶ Easterbrook & Fischel, *supra* note 1, at 81 (citing *Kerbs v. Cal. E. Airways*, 90 A.2d 652 (Del. 1952)).

²²⁷ See *Williams v. Geier*, 671 A.2d 1368 (Del. 1996).

²²⁸ See Edmund W. Kitch, *Proposals for Reform of Securities Regulation: An Overview*, 41 Va. J. Int'l L. 629, 649 (2001).

²²⁹ See *id.* (“The problem is that if the investors lack the sense to protect themselves, they probably also lack the sense to make any use of the disclosures.”).

found in mandatory disclosures). The two situations are quite similar: The law arms investors with accurate information, but courts refrain from any hand-holding of the investor in making the proper choice.²³⁰ And even though collective action and shareholder apathy are frequent problems in corporate governance, especially where the minority shares are widely dispersed, shareholder voting may still “be superior to managerial fiat.”²³¹ It incorporates a sense of accountability among those behind the transaction.²³² The requirements of disclosure and, more importantly, the resulting penalties for nonconformance, are themselves worthwhile constraints on misbehavior. The fact that independent approval is necessary will likely shape the transaction that is to be approved.²³³ These safeguards are further bolstered by the presence of outspoken shareholders who have the potential to generate negative publicity, regardless of the number of shares they own.

Contrary to the criticism, a controlling shareholder safe harbor providing for minority ratification tends to promote even greater independence in the decisionmaking process. Simply put, minority shareholders do not maintain the same suspect relationships with controlling shareholders as do directors.

Majority of the minority shareholder approval . . . stands on a different footing, because by definition minority stockholders are not conflicted . . . [and so where] the vote is uncoerced and is fully informed, there is no reason why the shareholder vote should not be given that effect, particularly given the [Delaware] supreme court’s rightful emphasis on the importance of the shareholder franchise and its exercise.²³⁴

²³⁰ As noted by Vice Chancellor Strine, “[i]f stockholders are presumed competent to buy stock in the first place, why are they not presumed competent to decide when to sell in a tender offer after an adequate time for deliberation has been afforded them?” *Chesapeake Corp. v. Shore*, 771 A.2d 293, 328 (Del. Ch. 2000).

²³¹ *Dallas*, supra note 220, at 37 (“[A]pathy can quickly change to activism when conditions warrant it . . .”).

²³² Cf. *id.* at 38 (noting the effects of shareholder voting on management behavior, even when the shareholder vote is perceived as a “rubber stamp”).

²³³ See *id.* Parties are unlikely to offer suspect transactions for a vote if they do not anticipate approval. See *id.*

²³⁴ *Allen et al.*, supra note 20, at 1308; see also *Eisenberg*, supra note 13, at 456 (noting the possibility that shareholders’ lack of relationships with directors can make them “factually objective”); *Eisenberg*, supra note 210, at 1006 (“Disinterested share-

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It follows that shareholder approval is the more trustworthy approval mechanism in some circumstances because it is free from the possible taint of personal relationships. Shareholders also make their decision based on reliable information, as a result of federal securities laws, stock exchange rules,²³⁵ and the controlling shareholder's duty to not make false or misleading disclosures.²³⁶

The second line of criticism against majority of the minority shareholder approval is the "800-pound gorilla" theory. Minority shareholders supposedly fear retribution if they vote against a controlling shareholder.²³⁷ The entire fairness standard in *Lynch Communication* assumed that controlling shareholder-initiated cash-out mergers are inherently coercive.²³⁸ This proposition, however, is unproven and fails to justify a heightened standard of review for every controlling shareholder transaction. In fact, it runs counter to an important exception that the Delaware courts have

holders, unlike disinterested directors, are not in a collegial relationship with the interested directors, and would have no reason to be concerned about exposing a director or senior executive to suit.").

²³⁵ The NYSE requires all directors to be independent; the NASDAQ requires a majority to be independent; and the American Stock Exchange just recommends the use of independent directors. See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees 24 (1999); Stephen M. Bainbridge, A Critique of the NYSE's Director Independence Listing Standards, 30 Sec. Reg. L.J. 371 (2002).

²³⁶ See *Shell Petroleum v. Smith*, 606 A.2d 112, 114 (Del. 1992) (stating that a majority shareholder must be held accountable for any errors contained in disclosures made to minority shareholders); *Kahn v. Household Acquisition Corp.*, 591 A.2d 166, 171 (Del. 1991) (recognizing a majority shareholder's duty to disclose information to minority shareholders on a proposed merger). An uninformed vote by the majority of the minority shareholders is meaningless and will be set aside. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 712 (Del. 1983).

²³⁷ See *Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110, 116–17 (Del. 1994); *In re Pure Res. S'holders Litig.*, 808 A.2d 421, 436 (Del. Ch. 2002); *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490, 502 (Del. Ch. 1990). The retaliation might take shape in several ways.

"For example, the controlling stockholder might decide to stop dividend payments or to effect a subsequent cash out merger at a less favorable price, for which the remedy would be time consuming and costly litigation. At the very least, the potential for that perception, and its possible impact upon a shareholder vote, could never be fully eliminated."

Lynch Communication, 638 A.2d at 1116 (quoting *Citron*, 584 A.2d at 502).

²³⁸ Strine, *supra* note 12, at 510.

already carved out to *Lynch Communication*.²³⁹ *Solomon v. Pathe Communications*²⁴⁰ and *In re Siliconix Shareholders Litigation*²⁴¹ held that entire fairness is inapplicable to a controlling shareholder's tender offer for the remaining minority shares of the firm. These cases significantly undercut any notion that controlling shareholders exert a level of coercion requiring heightened scrutiny. Instead, Delaware courts in these cases treated controlling shareholders as third-party bidders, not as conflicted parties.²⁴²

In explaining *Solomon* and *Siliconix* and why the retaliation theory is inapplicable to tender offers, the Delaware courts have concluded that tender offers do not possess the same level of coercion as negotiated mergers.²⁴³ This line-drawing is questionable.²⁴⁴ It is difficult to explain why a controlling shareholder's coercive capabilities vary among the context of different methods of acquisition.²⁴⁵ The *Solomon/Siliconix* doctrine, furthermore, allows the controlling shareholder to bypass *Lynch Communication*'s entire fairness rule altogether.²⁴⁶ The controlling shareholder can make a direct tender offer, thus providing the controlling shareholder a disincentive to negotiate with a special committee or minority shareholders. A controlling shareholder safe harbor, conversely, would encourage negotiations, perhaps increasing the transaction's value to minority shareholders.

The retaliation theory is also deficient on the grounds that it is too overstated to warrant any impact in framing judicial review of

²³⁹ Short-form mergers also avoid an entire fairness review. See *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242, 248 (Del. 2001). This is unsurprising, for a contrary result requiring an entire fairness hearing would run counter to the very purpose of short-form merger statutes. See Del. Code Ann. tit. 8, § 253 (2001).

²⁴⁰ 672 A.2d 35, 39–40 (Del. 1996); see also *In re Aquila S'holders Litig.*, 805 A.2d 184, 190 (Del. Ch. 2002).

²⁴¹ No. 18700, 2001 Del. Ch. LEXIS 83, at *22–*24 (Del. Ch. June 19, 2001).

²⁴² See *In re Pure Res. S'holders Litig.*, 808 A.2d 421, 444 (Del. Ch. 2002). The response by the directors to the tender offer presumably should be subject to both their fiduciary duties and the *Unocal* test. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

²⁴³ See *In re Pure Res. S'holders Litig.*, 808 A.2d at 444.

²⁴⁴ See *id.* at 435.

²⁴⁵ For a discussion of the differences in coercion between tender offers and negotiated transactions, see generally Jon E. Abramczyk et al., *Going-Private "Dilemma"?—Not in Delaware*, 58 Bus. Law. 1351, 1359–63 (2003).

²⁴⁶ See Strine, *supra* note 12, at 511 (noting the tension between *Lynch Communication* and *Siliconix*).

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corporate decisions, and it ignores important market constraints and legal rules already in place. Chancellors Allen and Strine and now-Justice Jacobs have written that their collective “experience has shown that that concern is too insubstantial to justify a review standard that requires judges to second-guess a business transaction that rational investors have approved.”²⁴⁷ There are few documented cases of retributive controlling shareholder behavior, yet “Delaware case law is replete with cases where majority stockholders have been held legally accountable for abusing the minority.”²⁴⁸ To date, no empirical evidence exists showing that the “threat of liability would not, in most cases, check [retributive] majority stockholder misconduct.”²⁴⁹ Moreover, anecdotal evidence indicates minority shareholders have stood their ground in rejecting a controlling shareholder’s tender offer,²⁵⁰ implying, at least in that case, that the controlling shareholder’s coercive power was rather weak. Thus, the retribution argument seems to be more theoretical than real, and hence unworthy of any doctrinal implications.²⁵¹

Lastly, there is normative support for shareholder approval. That is, the ultimate decision lies in the hands of the residual claimants of the corporation,²⁵² and majority of the minority approval tends to undercut the plutocratic governance of many large corporations.²⁵³ There certainly are collective-action hurdles, among

²⁴⁷ Allen et al., *supra* note 20, at 1308.

²⁴⁸ *Id.*

²⁴⁹ *Id.* at 1308–09.

²⁵⁰ See *In re Siliconix S’holders Litig.*, No. 18700, 2001 Del. Ch. LEXIS 83, at *22–*24 (Del. Ch. June 19, 2001); Strine, *supra* note 12, at 511 (discussing the result in *Siliconix*).

²⁵¹ The cynic also would note the inconsistency between the retaliation theory and the unstudied investor. If the average investor is passive and uninformed, then it would stand to reason that the same investor might not be aware of the controlling shareholder’s implied retaliatory threats.

²⁵² In proportion to their growing financial interest in the firm, rational shareholders are increasingly more likely to cast an informed vote in corporate matters. See Easterbrook & Fischel, *supra* note 1, at 66–67. It must be admitted, however, that the concept of shareholder ownership is somewhat misleading—and perhaps unrealistic. See Bainbridge, *supra* note 209, at 550–51 (explaining the power directors have over the use of corporate assets); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. Cal. L. Rev. 1189, 1192 (2002) (explaining that shareholder ownership is an “empirically incorrect” concept from “both a legal and an economic perspective”).

²⁵³ See Livingston, *supra* note 6, at 69.

others, to overcome, but an active minority should have an authoritative voice. Allen, Jacobs, and Strine, in critiquing *Lynch Communication*, suggest that minority shareholder approval, if not merely board approval, should trigger business judgment review: "Because the [*Lynch Communication*] standard of review presently gives no greater effect to conditioning a transaction on an informed majority of the minority vote than it does to approval by . . . independent directors, there is little incentive . . . to use the stockholder vote mechanism as a protective device."²⁵⁴ A safe harbor provision permitting majority of the minority approval would remedy this anomaly by encouraging truthful disclosure and a minority shareholder vote.²⁵⁵ A controlling shareholder thus would have an incentive to seek approval in order to trigger business judgment.²⁵⁶ As it stands now, however, the controlling shareholder faces an entire fairness review regardless of the approval process, which fails to provide a similar incentive.

D. Relying on Market Restraints to Check Controlling Shareholders Outside the Final Period

A controlling shareholder safe harbor doctrine that triggers a business judgment standard of review depends upon two checks on the controlling shareholder's power: (1) independent approval and (2) the alignment of shareholder interests via the market. When either check fails, the *Lynch Communication* entire fairness standard works to protect minority shareholders. This can be understood as a response to end-game divergence of interests. To conform with Delaware law, therefore, a controlling shareholder safe harbor

²⁵⁴ See Allen et al., *supra* note 20, at 1309.

²⁵⁵ See, e.g., Model Bus. Corp. Act § 8.60(4) (2002). Under the Model Act, "required disclosure" to disinterested directors or shareholders is defined as:

[D]isclosure by the director who has a conflicting interest of (i) the existence and nature of his conflicting interest, and (ii) all facts known to him respecting the subject matter of the transaction that an ordinarily prudent person would reasonably believe to be material to a judgment about whether or not to proceed with the transaction.

Id.

²⁵⁶ Professor Eisenberg recognizes this principle as it applies to directors. He writes, "if such [independent] approval provides some insulation against liability, interested directors and officers will have a strong incentive to bring proposed self-interested transactions before disinterested directors at an early stage." Eisenberg, *supra* note 7, at 453-54.

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doctrine can tailor its cleansing procedures by imposing entire fairness to takeout transactions and business judgment to going-concern transactions. This commingling of doctrines works because of the combination of various market constraints that monitor controlling shareholders' behavior in nonfinal-period activities.

The proposition here is that equity ownership leads to the alignment of interests between controlling and minority shareholders. Controlling shareholder self-interest usually is synonymous with aggregate shareholder interests. Empirical research, furthermore, supports the notion that when there is stock liquidity, directors and employees with substantial equity positions act increasingly in the aggregate interest of all shareholders.²⁵⁷ Monitoring costs fall as management's proportionate equity ownership increases due to the reduction in the agents' incentives to pursue unprofitable or needlessly risky business strategies. As put by Professors Jensen and Meckling:

[Compare] the behavior of a manager when he owns 100 percent of the residual claims on a firm to his behavior when he sells off a portion of those claims to outsiders. If a wholly owned firm is managed by the owner, he will make operating decisions which maximize his utility. . . .

If the owner-manager sells equity claims on the corporation which are identical to his (i.e., share proportionately in the profits of the firm and have limited liability)[,] agency costs will be generated by the divergence between his interest and those of the outside shareholders, since he will then bear only a fraction of the costs of any non-pecuniary benefits he takes out in maximizing his own utility.²⁵⁸

This is a familiar concept to corporate legal theory and has long been utilized in corporate governance to supervise firm agents.

²⁵⁷ See R. Franklin Balotti et al., *Equity Ownership and the Duty of Care: Convergence, Revolution, or Evolution?*, 55 *Bus. Law.* 661, 672–77 (2000).

²⁵⁸ Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. Fin. Econ.* 305, 312 (1976). See generally Berle & Means, *supra* note 137, at 119–25 (discussing the divergence of ownership and control).

The crux of a successful controlling shareholder safe harbor, however, is the connection between directors and controlling shareholders: The same incentives and constraints already recognized and approved in monitoring director behavior are even more effective in governing the firm's largest equity holders.²⁵⁹ Directors, though, often maintain only a small stake in the corporation, which in turn limits their incentive to maximize shareholder wealth.²⁶⁰ In contrast, a controlling shareholder possesses an approximate-majority position in the firm—a substantial incentive-aligning device. If the law places trust in a director with, for example, a five percent stake in the firm, then there is little reason to question the motives of a large bloc investor, provided that such investor contemplates a future with the minority shareholders.

In addition to these equity-based notions of market constraints, contract theory supports nonfinal-period cooperative behavior between large and small shareholders. When parties contemplate an ongoing relationship, their behavior is constrained by the recognition that cheating in present transactions will be penalized in subsequent transactions.²⁶¹ The safe harbor, therefore, relies on the mutual interests of shareholders and the resulting cooperation between the parties to maximize the potential of their current investment. "Because both parties have a stake in the future, the prospect of future interactions dramatically changes their . . . strategies."²⁶² Continuous relationships in long-term associations require opposing parties to modify their behavior accordingly, "so the threat of a cooperative pattern unraveling is implausible."²⁶³

²⁵⁹ See Balotti et al., *supra* note 257, at 665–71.

²⁶⁰ Jensen & Meckling, *supra* note 258, at 6 ("Indeed, it is likely that the most important conflict arises from the fact that as the manager's ownership claim falls, his incentive to devote significant effort to create activities such as searching out new profitable ventures falls."); see Berle & Means, *supra* note 137, at 122.

²⁶¹ Ronald J. Gilson & Bernard S. Black, *The Law and Finance of Corporate Acquisitions* 720 (2d ed. 1995).

²⁶² Robert E. Scott, *Conflicts and Cooperation in Long-Term Contracts*, 75 *Cal. L. Rev.* 2005, 2024 (1987); see also Troy A. Paredes, *The Firm and the Nature of Control: Toward a Theory of Takeover Law*, 29 *J. Corp. L.* 103, 115 (2003) (noting that shareholders "invest for the life of the firm and their claims are located at the end of the queue" (quoting Oliver Williamson, *Corporate Governance*, 93 *Yale. L.J.* 1197, 1210 (1984))).

²⁶³ Scott, *supra* note 262, at 2033.

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Any direct misconduct that impairs firm value has a corresponding effect on the controlling shareholder's value.²⁶⁴ But even indirect misbehavior is subject to market punishments, including reputational constraints.²⁶⁵ For example, both internal and external parties negatively interpret heavy-handed tactics outside the final period. Accordingly, minority shareholders may exit the firm and potential stock purchasers will be less willing to acquire shares, which then will be reflected in a reduced share price in an efficient market. Further, it likely will impair the ability of the going-concern corporation to raise capital:

The greater the probability that the shares will be acquired by the majority, the less the minority will pay. So the majority, not the minority, bears the cost *ex ante* of the potential exploitation of the minority *ex post*. Dominant investors want to constrain their later conduct in order to realize the best price at the outset.²⁶⁶

Lastly, a controlling shareholder's negative reputation could foster resistance in future targets of the shareholder. Just like market rewards and punishments for directors, controlling shareholders face a "multistrand web of imperfect constraints" that work collectively to prevent inequitable conduct.²⁶⁷

Notably, Delaware law already reflects the importance of aligned interests through equity ownership. Numerous Delaware cases have relied upon the equity ownership of directors in determining whether those directors fulfilled their duty of care.²⁶⁸ Yet

²⁶⁴ See John C. Coates IV, "Fair Value" as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions, 147 U. Pa. L. Rev. 1251, 1278 n.87 (1999).

²⁶⁵ For a discussion of reputational constraints on directors, see *supra* notes 204–207 and accompanying text.

²⁶⁶ Easterbrook & Fischel, *supra* note 1, at 146.

²⁶⁷ See Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 522 (1990). It is important to recognize that market checks and mandatory legal rules both are imperfect. The goal, then, is to find out which of the two is less imperfect. Melvin Aron Eisenberg, Bad Arguments in Corporate Law, 78 Geo. L.J. 1551, 1552 (1990); see also Harold Demsetz, Information and Efficiency: Another Viewpoint, 12 J.L. & Econ. 1, 1–2 (1969) (describing the imperfect nature of markets and legal rules).

²⁶⁸ Balotti et al., *supra* note 257, at 666. For a discussion of cases on point, see *id.* at 666–71 (citing cases); see also *id.* at 685–86 ("Existing Delaware Court of Chancery precedent suggests that each director's equity position should be evaluated as a por-

there is also precedent connecting equity ownership to a director's duty of loyalty. In *Unitrin v. American General Corp.*, the Delaware Supreme Court stated unequivocally that the directors' stock ownership superceded any allegations that the directors acted in self-interest.²⁶⁹ The *Unitrin* court concluded that stockholders, even director-stockholders, "are presumed to act in their own best economic interests when they vote in a proxy contest."²⁷⁰ Likewise, in *Giammargo v. Snapple Beverage Corp.*, Chancellor Allen denied a motion for an expedited preliminary injunction proceeding over plaintiff's loyalty and good faith challenges to three directors/controllers/shareholders.²⁷¹ Despite allegations of side-payments made to the director-controlling shareholders, Chancellor Allen noted the logical inconsistencies in comparing the relatively small, alleged side payments made to the defendants with the defendants' significant sixty-eight percent equity stake in the company.²⁷² The *Giammargo* opinion reiterated the consequences of the common ownership (that is, their aligned interests), adding that the outcome might be different "were this a company without a dominant shareholders group or in which the minority was to receive less consideration for its stock than the controlling shareholders were to receive."²⁷³

To be sure, there are several objections to the use of market forces in constraining controlling shareholders in nonfinal-period transactions. For example, one commentator notes that "because the majority's losses are only proportional, the market is not a

tion of that director's wealth to determine whether the stake will have a material effect on the director's decision making."). The authors take the position, however, that equity compensation should not be used in assessing a director's compliance with the duty of loyalty. See *id.* at 689-91.

²⁶⁹ 651 A.2d 1361, 1380-81 (Del. 1995). In fact, in *Rosenblatt v. Getty Oil Co.*, No. CIV.A.5278, 1983 WL 8936, at *26 (Del. Ch. Sept. 19, 1983), *aff'd* 493 A.2d 929 (Del. 1985), the court commented on the equity position held by one of the independent directors who approved the transaction between the corporation and its controlling shareholder. "Implicit in the *Rosenblatt* court's discussion . . . was that Mr. Stuart's stock ownership gave him an incentive not only to maximize the value of his shares, but also to reach a careful and considered decision." Balotti et al., *supra* note 257, at 670.

²⁷⁰ *Unitrin*, 651 A.2d at 1381.

²⁷¹ No. 13845, 1994 Del. Ch. LEXIS 199 (Del. Ch. Nov. 15, 1994).

²⁷² *Id.* at *7-*8.

²⁷³ *Id.* at *8.

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complete constraint.”²⁷⁴ It might also be claimed that the controlling shareholder’s interests no longer are aligned when the gain extracted for the transaction exceeds the losses inflicted on share value. These points are not persuasive, however, because this safe harbor proposal responds to them in several ways. First, *Sinclair Oil* offers the bright-line principle rejecting the business judgment rule whenever a controlling shareholder receives an advantage to the detriment of the minority shareholders.²⁷⁵ The appearance of disproportionate benefits, detrimental conduct, or other improprieties also questions the integrity of the approval process. Moreover, even if business judgment is triggered, it is not a free pass for controlling shareholders. As Professor Eisenberg notes, even under the Model Act’s business judgment standard, “it is widely understood that, statute or no statute, approval of a self-interested transaction by disinterested directors will not prevent a court from applying to self-interested transactions a ‘smell’ test that is more rigorous than the business judgment rule.”²⁷⁶ The law holds controlling shareholders and independent directors to a duty of good faith in dealing with the corporation,²⁷⁷ a duty likely breached on facts demonstrating a controlling shareholder’s misappropriations.

Another contention against the use of market forces outside of the final period challenges the market’s ability to detect cheating. In particular, a controlling shareholder who intends to acquire the minority interest may engage in a pattern of misconduct that decreases firm value so as to minimize the fair price eventually paid for the freeze-out. In response, however, a safe harbor requires disinterested approval to trigger business judgment review. Approval of misconduct would raise questions as to the integrity of the process’s independence. More importantly, the final period is defined by a divergence of interests, rather than a specific transaction. Thus, a chancellor could determine that this conduct was part of a larger design precipitating a freeze-out, thereby triggering an entire fairness standard to police the final period.

²⁷⁴ See Dooley, *supra* note 61, at 602.

²⁷⁵ See *supra* Section I.B.1.a.

²⁷⁶ Eisenberg, *supra* note 7, at 455.

²⁷⁷ See *id.*

E. The Failure of Market Constraints in the Final Period

This Section explains why market checks may fail when there is a divergence of interests among corporate shareholders. *Lynch Communication* responded to concerns of oppressive controlling shareholder conduct by imposing entire fairness in the final period. The more radical view that could be argued here is that business judgment is sufficient—even in the final period—as long as there is independent approval by either the board or by a majority of the minority shareholders. Instead, this Note attempts a more balanced approach (or a compromise between competing doctrines) that conforms to current Delaware law. It also recognizes the risks inherent in takeover transactions. First, in the final period, the concern is for the “one-shot appropriations, of the ‘take the money and run’ sort, in which subsequent penalties through markets are inadequate.”²⁷⁸ Second, the *Lynch Communication* court “believed that the controlling shareholder retained the capacity to influence the minority that cannot be procedurally dissipated.”²⁷⁹ If so, using the final period context to distinguish transactions for different treatment makes sense from both standpoints.

Final-period problems go to the center of the minority shareholders’ ownership rights in the corporation. These cases involve what Bayless Manning, former dean of Stanford Law School, calls “ownership claim issues.”²⁸⁰ Ownership claims have an intimate relationship with the corporate shareholder: They “hit him directly in his role as an ‘owner,’ not ‘owner of the corporation’ as legal doctrine would have it, but owner of his own reified piece of property, *his* share of stock.”²⁸¹ Thus, final-period situations may seem to be attractive forums for judicial intervention because they directly implicate the most significant “‘ownership claim’ issue of all,”²⁸²

²⁷⁸ Easterbrook & Fischel, *supra* note 1, at 103.

²⁷⁹ Gilson & Gordon, *supra* note 64, at 800–01.

²⁸⁰ See Bayless Manning, Reflections and Practical Tips on Life in the Boardroom After *Van Gorkum*, 41 Bus. Law. 1, 5 (1985). Dean Manning distinguishes “ownership claims” from “enterprise claims,” the latter reflecting more of an operational decision in managing the business. He predicts that the level of judicial review will vary depending on whether the complaint presents an ownership or enterprise claim. *Id.* at 5–6.

²⁸¹ *Id.*

²⁸² *Id.* at 6.

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which is the decision to sell one's share—and at what price—to the controlling shareholder.

The final-period transaction is characterized by a fall-out of the previously existing constraints that police a controlling shareholder's conduct in going-concern business transactions.

If the parties know in advance the termination point of their relationship, they confront a well-known “end-game” problem that threatens cooperation in the iterated prisoner's dilemma. Because cooperation will no longer be beneficial at the last adjustment opportunity, a party will be motivated to evade and capture its largest payoff. . . . Following this logic, the cooperative solution to the entire [relationship] unravels.²⁸³

No party maintains persuasive incentives to pursue collective welfare maximization—rather, each has opposing incentives to pursue self-interest.

Also, many previously effective contractual solutions break down in takeout transactions. Generally, the fiduciary duty of loyalty “involves a last-period problem frequently thought to be less amenable to solution through contract specification or governance rules.”²⁸⁴ For example, even though the last period divergence of interests affects managers and controlling shareholders alike, the equity-based compensation solution for management simply cannot be extended to the controlling shareholder freeze-out scenario. Whereas management can receive stock to motivate them in the final period to maximize target corporation shareholder wealth,²⁸⁵ controlling shareholders, conversely, are motivated to act as any other bidder in a takeout merger: “Where the business is being sold to a third party, the majority has an incentive to negotiate the best possible price; where the majority itself is the purchaser, its incentive is the opposite.”²⁸⁶ Cooperative behavior ceases, the controlling shareholder's adherence to the duty of loyalty becomes

²⁸³ Scott, *supra* note 262, at 2033 (citation omitted).

²⁸⁴ Carney, *supra* note 128, at 914.

²⁸⁵ Jensen & Meckling, *supra* note 258, at 312. This is the case at least to the degree to which the marginal utility produced from each dollar's expenditure of corporate resources equals the marginal utility of an additional amount of general purchasing in the same amount as the manager's ownership proportion.

²⁸⁶ Hetherington, *supra* note 154, at 32.

dubious at best,²⁸⁷ and auction-like third-party bidding likely is impossible due to the controlling shareholder's veto power.²⁸⁸ Thus, the market's ability to check begins to erode: "[W]hen last-period problems crop up only the cumbersome (expensive, imprecise) methods of litigation are available."²⁸⁹

There are a number of additional dissimilarities between going-concern transactions, such as that found in *Puma*, and freeze-out transactions like that in *Lynch Communication*, that justify different standards of review. First, the final period presents an omnipresent risk of "cheating" because the majority is immune to the effects of the firm's declining market value—that is, there are no longer any market rewards or punishments.²⁹⁰ Second, minority and controlling shareholders cannot interact on a level playing field due to the controlling shareholders' informational advantages and ability to dominate the firm's decisionmaking procedures.²⁹¹ Opportunistic behavior, consequently, is more likely to occur. Third, defensively speaking, minority holdout tactics are futile and collective action remains a constant problem. Fourth, perhaps it is the freeze-out (rather than the nonfinal-period transaction) that is more susceptible to controlling shareholder coercion and retaliation (the 800-pound gorilla theory).²⁹² Finally, although the minority might hope to vote with their feet, a suboptimal final-period offer from the controlling shareholder destroys the security's liquidity.

For the reasons stated above, entire fairness is warranted, for "[i]n a structural approach to corporate law, it is precisely when

²⁸⁷ See Paula J. Dalley, To Whom it May Concern: Fiduciary Duties and Business Associations, 26 Del. J. Corp. L. 515, 518 (2001).

²⁸⁸ See Dooley, *supra* note 61, at 649–50. The controlling shareholder's veto power was a central issue in *Lynch Communication* because it effectively locked up the transaction. See *Lynch Communication*, 638 A.2d at 1112–13. It follows, however, that the rational controlling shareholder would accept an offer that was superior to the controlling shareholder's anticipated gains produced in acquiring the subsidiary.

²⁸⁹ Easterbrook & Fischel, *supra* note 1, at 169; see also Carney, *supra* note 128, at 921 ("Markets, not law, are the primary constraint . . . unless agents believe themselves in a last period in which normal market constraints are no longer relevant.").

²⁹⁰ Griffith, *supra* note 205, at 1937.

²⁹¹ Dooley, *supra* note 61, at 648.

²⁹² Namely, the stakes for all parties are much greater than in nonfinal-period (ordinary business) transactions. The minority are faced with a freeze-out to eliminate their participation in a public corporation; controlling shareholders likely have high expectations contingent on a successful takeout, and they also will have expended significant resources in planning and executing the final period transaction.

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market constraints on . . . misbehavior fail that legal constraints play a central role.”²⁹³ In *Lynch Communication*, the court responded to the final-period divergence of interests.²⁹⁴ There, the 800-pound gorilla appeared in the form of a cash-out merger to eliminate the minority interests, but only after the controlling shareholder vetoed third-party bids and did not substantially increase its own bid. Alcatel’s self-interest ran counter to the minority’s equity interests. Thus, the *Lynch Communication* court applied entire fairness, and this perhaps was most appropriate because it involved a final-period takeout transaction—not because it was merely a controlling shareholder transaction. Had the transaction in *Lynch Communication* been a nonfinal-period transaction, the business judgment approach of *Puma* should have been applied because independent approval and market constraints would have reduced the need for intensive judicial scrutiny. This is the thrust of the arguments presented above. It is only final-period transactions that present unique problems requiring an exception to the business judgment safe harbor.

CONCLUSION

This Note has proposed a codification of two different Delaware doctrines in controlling shareholder jurisprudence. Historically, shareholders rarely owed fiduciary duties to other shareholders. Over time, however, Delaware courts developed an advantage-disadvantage test before moving from a business judgment to the current entire fairness standard of review for controlling shareholder transactions. Yet, unlike interested director transactions, the Delaware legislature and the Model Act never provided statutory guidance for controlling shareholders—a problem that this Note has attempted to address.

This Note has set forth the theory and framework for a controlling shareholder safe harbor that operates similar to Delaware Section 144 and Subchapter F of the Model Act, and that may be adopted by both legislatures and courts. It differs from interested director safe harbors, however, by first dividing controlling shareholder transactions into two categories: going-concern and final-

²⁹³ Gilson & Black, *supra* note 261, at 721.

²⁹⁴ 638 A.2d at 1112–13.

period transactions, each singled out for different treatment. Going-concern transactions that are independently approved by disinterested directors or a majority of the minority shareholders should be reviewed under the business judgment standard. There, independent approval along with the alignment of shareholder interests in the market provides sufficient protection for minority interests. Final-period transactions, however, are less susceptible to independent approval solutions. Moreover, market checks may fail because controlling and minority shareholder interests diverge. Entire fairness, therefore, is appropriate in reviewing takeout transactions. Establishing these concepts in a safe harbor, furthermore, provides predictability and certainty to directors, corporations, and the judiciary.

This Note has built upon two Delaware doctrines set forth in the cases of *Puma v. Marriott* and *Kahn v. Lynch Communication*. Under *Puma*, the business judgment rule applies to independently approved transactions. This provides an efficient result for the judiciary and transactional certainty for the corporation. *Lynch Communication* responded to the final-period problem, however, and used entire fairness to police end-game transactions. Thus, this safe harbor proposal offers a new solution but is firmly grounded in Delaware case law and concepts imported from the interested director safe harbors found in the Delaware Code and Subchapter F of the Model Act.