FREEZEOUTS IN DELAWARE: AN EXPLORATION OF THE APPROPRIATE STANDARD OF REVIEW

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In the last decade, there has been a general increase in the number of transactions taking corporations private, and consequently an increase in the amount of litigation over the fair treatment of minority shareholders in such deals. Courts, particularly those in Delaware, are in the process of developing a framework for analyzing fairness in these cases, but have repeatedly confronted the issue of the appropriate standard of review. As different forms of going private transactions have developed, the case law has adapted to review the two primary forms—the negotiated merger freezeout and the tender offer freezeout—differently based on each transaction's specific structure.

Most recently, the Delaware Court of Chancery has advocated a new rule in which both types of freezeouts would be subject to the same unified standard of review, despite their different technical forms. This Note argues that the proposed unified standard may not be the best solution to the perceived discrepancy in the treatment of negotiated merger freezeouts versus tender offer freezeouts. The two forms of freezeouts involve different relationships between parties and require different levels of oversight from courts in order to ensure fair treatment. The current dual standard may not be perfect, but the CNX Gas *solution, in its current form, should not be adopted either.*

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I. INTRODUCTION

Since the passage of the Sarbanes-Oxley Act in 2002[1], there has been a general increase in the number of transactions taking corporations private.[2] This can be explained in part by the new requirements imposed on public companies by the Sarbanes-Oxley Act, which make regulatory compliance much more costly to corporations, particularly those with small or mid-level market capitalization.[3] In addition, stock market collapses in 2000 and 2007 reduced the availability of public funds, minimizing the incentive to maintain public status.[4]

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[1] Pub. L. No. 107-204, 116 Stat. 745 (2002).

[2] Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 6 (2005). According to data compiled by Subramanian, there were 128 announced transactions in the four years between July 2001 and July 2005 (32 per year, on average), which is a significant increase compared to only 154 freezeouts during the ten years between 1987 and 1996 (15 per year, on average). *Id.*

[3] *See* Joshua M. Koenig, *A Brief Roadmap to Going Private*, 2004 COLUM. BUS. L. REV. 505, 512–13 (2004) ("Thousands of companies with a market capitalization of less than $300 million now have fewer than two analysts following their stock."); Christopher J. Hewitt, *Going Private Transactions: Delaware Revisits Negotiated Mergers and Tender Offers Involving Controlling Stockholders*, JONES DAY (2006), http://www.jonesday.com/goingprivate/ ("Directors and managers of small and mid-cap public companies . . . have limited analyst coverage and research, which adversely affects both their stock prices and trading volumes.").

[4] Hewitt, *supra* note 3 ("[C]urrent market conditions are creating an environment where the number of companies entering the public market

Managers and directors of public corporations may also factor increased incidence of personal liability for corporate acts[5] and the desire to break from the market-driven focus on short-term results in their decisions to go private.[6] This combination of fewer benefits, increased costs, and increased risk has led many corporations to return to private status. This often involves a "freezeout" of minority shareholders.

As the frequency of "going-private transactions"[7] has risen, so too has the amount of litigation over the fair treatment of minority shareholders in such deals. Courts, particularly those in Delaware, are in the process of developing a framework for analyzing fairness in these cases, but have repeatedly confronted the issue of the appropriate standard of review for this particular type of transaction.[8]

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is approaching the number of participants leaving the public stage through going private transactions.").

[5] *Id. See also* Koenig, *supra* note 3, at 513–14 ("The cost of D&O insurance is expected to increase substantially in the wake of Sarbanes-Oxley, primarily due to the fact that executives are now personally liable for the accounting practices of their companies. Financially strong companies will likely face increases of 25% to 40% in premiums, while premiums for weaker companies could increase by as much as 400%.... However, the benefit of going private is clear, as the premiums for a company could fall by as much as 90% after the going private transaction is complete.").

[6] *See* Hewitt, *supra* note 3; Koenig, *supra* note 3, at 510; David A. Stockton, *Going Private: The Best Option?*, NAT'L L.J., June 23, 2003 (Many companies with promising ideas went public prematurely in the 1990s, and going private would allow them to turn around by "refocus[ing] on some basic aspects of their business model, which could be research and development, expanding into new markets or otherwise rationalizing or restructuring their operations.").

[7] The term "going-private" refers generally to a transaction in which "a controlling stockholder typically acquires the shares of the minority stockholders in a public company in exchange for cash, debt or stock, resulting in the delisting of the company." Michael J. McGuinness & Timo Rehbock, *Going-Private Transactions: A Practitioner's Guide*, 30 DEL. J. CORP. L. 437, 437 (2005).

[8] *See* Edward P. Welch & Joseph O. Larkin, *After CNX, An Evolving Standard for Controlling Stockholder Buyout Transactions*, 15 No. 6 M&A LAW. 6 (2011) (describing a number of recent cases in which Delaware

Establishing the correct standard is extremely important because "burdens and standards of review often are outcome determinative."[9] In addition, the standard of review may determine the stage at which a non-meritorious lawsuit can be dismissed, affecting the costs to both parties and their incentives in bringing or defending the case.

As a classic self-dealing transaction, freezeouts have long been subject to entire fairness review;[10] however, this standard has been modified and adapted over time as regulators and courts seek to maintain a balance between the interests of both the majority owner and the minority shareholders. The Securities and Exchange Commission ("SEC") has added the requirement that any controlling shareholder attempting to freeze out other shareholders must make extensive disclosures to the minority.[11] Furthermore, in the 1980s, the Delaware courts began to add procedural requirements and burden shifting in order to ensure fair treatment.[12] As different forms of going private transactions have developed, the case law has also adapted to review one form—the negotiated merger freezeout—slightly more strictly than the other form—the tender offer freezeout—based on each transaction's specific structure.[13]

Most recently, the Delaware Court of Chancery has advocated a new rule in which both types of freezeouts would be subject to the same unified standard of review, despite their different technical forms.[14] This Note argues that the

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courts have confronted the issue of the appropriate standard of review for negotiated merger and tender offer freezeouts).

[9] Lyman Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27, 67–68 (2003).

[10] *See, e.g.*, Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1952); Subramanian, *supra* note 2, at 9.

[11] Securities and Exchange Commission Rule 13e-3, 17 C.F.R. § 240.13e-3 (2005).

[12] Subramanian, *supra* note 2, at 11.

[13] Welch & Larkin, *supra* note 8, at 6 ("Until *CNX*, unilateral tender offers were reviewed under an evolving standard far less onerous than *Lynch's* inescapable entire fairness review.").

[14] *In re* CNX Gas Corp. S'holders Litig., 4 A.3d 397 (Del. Ch. 2010).

proposed unified standard may not be the best solution to the perceived discrepancy in the treatment of negotiated merger freezeouts versus tender offer freezeouts, and consequently that the Delaware Supreme Court should not affirm the change. Courts must balance the interests and rights of the controlling shareholder with the concern for exploitation of the minority, but it is not necessary to create a single unified standard for both types of transactions. Part II describes the structures and standards of review for negotiated merger and tender offer freezeouts, and provides an overview of the existing literature on the subject. Part III discusses the justifications for the dual standard and reasons for maintaining it. The two forms of freezeouts involve different relationships between the parties and consequently require different levels of oversight from courts in order to ensure fair treatment. Part IV argues that the unified standard should not be adopted. The unified standard, as articulated by the court in *CNX Gas*, overprotects the minority in a tender offer freezeout by imposing additional procedural safeguards before the controlling owner can escape entire fairness review, a level of review which simply should not be applied in the absence of self-interested corporate action because of the additional cost and time required. In addition, the unified standard reduces protection for the minority in negotiated merger freezeouts because a controlling owner who does engage in self-dealing can avoid entire fairness review even though the procedural safeguards do not definitively prevent abuse. The current dual standard may not be perfect, but the *CNX Gas* solution, in its current form, should not be adopted either.

II. BACKGROUND ON FREEZEOUTS

There are a number of methods for taking a corporation private, depending on which party ultimately gains ownership. A common type of going private transaction is the controlling shareholder freezeout, a transaction in which the majority shareholder eliminates the ownership stake of all minority shareholders.[15] Other variations of going private transactions include management buyouts ("MBOs") and leveraged buyouts ("LBOs"), both of which involve different sets of players and issues.[16] It is also possible for a third party to take a corporation private by acquiring all of the outstanding shares.[17] This Note will focus primarily on freezeouts by a controlling shareholder and the issues arising around the fair treatment and compensation of minority owners.

As discussed above, there are a variety of factors that influence the decision to take a corporation private. There may no longer be a compelling need or ability to effectively access the public capital markets, decreasing the value of having public status.[18] The corporation may improve profitability by cutting the regulatory, compliance, and insurance costs associated with being public.[19] Being publicly traded on the market incentivizes managers to seek short-term gains, but going private encourages long-term growth and value maximization, which is in the interest of the controlling shareholder.[20] Finally, going private and eliminating minority shareholders reduces agency costs by eliminating the divergence of interests between majority and

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[15] MARTIN LIPTON & ERICA H. STEINBERGER, TAKEOVERS AND FREEZEOUTS § 9.02[1] (2003). The "pure" controlling shareholder freezeout is similar in structure to a freezeout by a parent corporation, so both involve similar fairness considerations. *See id.* § 9.02[3]. Executing a freezeout falls within the powers of a controlling shareholder, as defined by the Delaware Supreme Court. Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 43 (Del. 1994) (defining the powers of a majority controlling owner as "the voting power to: (a) elect directors; (b) cause a break-up of the corporation; (c) merge it with another company; (d) cash-out the public stockholders; (e) amend the certificate of incorporation; (f) sell all or substantially all of the corporate assets; or (g) otherwise alter materially the nature of the corporation and the public stockholders' interests.").

[16] LIPTON & STEINBERGER, *supra* note 15, § 9.02[3].

[17] *Id.* § 9.02[2].

[18] Koenig, *supra* note 3, at 509.

[19] *Id.*

[20] *See id.* at 510; Stockton, *supra* note 6.

minority shareholders,[21] and it allows the controller to act unilaterally without concern for its fiduciary duties to the minority, which would no longer exist. Thus, once the benefits of being a public corporation fall below the costs of compliance and managing the agency problem, there may be an overall advantage to taking the company private again.

A. Negotiated Merger Freezeouts

There are two main structures in Delaware for a controlling shareholder to take a corporation private.[22] The first is the traditional statutory merger, often referred to as a negotiated merger or long-form merger.[23] In this type of transaction, the controlling shareholder proposes a merger of the target corporation into itself or one of its wholly owned subsidiaries. The target's board of directors, typically dominated by the controlling shareholder,[24] will then approve the merger, and target shareholders, also dominated by the controller,[25] will vote on whether to approve the merger as

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[21] Koenig, *supra* note 3, at 510–11.

[22] Other, less common freezeout methods include reverse stock splits and asset sales followed by dissolution. LIPTON & STEINBERGER, *supra* note 15, § 9.03.

[23] DEL. CODE ANN. tit. 8, § 251 (2012).

[24] Mary Siegel, *The Erosion of the Law of Controlling Shareholders*, 24 DEL. J. CORP. L. 27, 33 (1999) (noting that controlling "shareholders have significant, if not decisive, voting power; that power could skew decisions disproportionately in their favor because of their ability to elect and remove the board of directors").

[25] Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490, 502 (Del. Ch. 1990) ("The controlling stockholder relationship has the inherent potential to influence, however subtly, the vote of minority stockholders in a manner that is not likely to occur in a transaction with a noncontrolling party. Even where no coercion is intended, shareholders voting on a parent subsidiary merger might perceive that their disapproval could risk retaliation of some kind by the controlling stockholder. 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.").

well.[26] The controller's influence over both the board approval and shareholder voting process requires courts to apply the rigorous standard of entire fairness review to such a transaction.[27]

The development of the standard of review and allocation of burdens of proof for long-form merger freezeouts involves three main cases. The first, *Weinberger v. UOP, Inc.*,[28] involved a majority owner (Signal) acquiring the remaining 49.5% of the target corporation (UOP) through a cash-out merger. The Delaware Supreme Court ultimately found that, for a variety of reasons, the transaction was unfair to minority shareholders.[29] Entire fairness requires both fair dealing and fair price,[30] and in this case, the court found that the transaction was procedurally unfair.[31] Certain directors, serving on the boards of both Signal and UOP, had prepared a report that included a range of prices at which it would be a good investment for Signal to buy out the minority owners of UOP, but this report was not disclosed to the outside directors of UOP or to the minority shareholders.[32] The failure to disclose this material information, along with the rushed nature in which the deal was put together and the lack of real negotiation about the price led the court to conclude that the merger did not meet the test for fairness.[33] On remand, the Delaware Court of Chancery held that, although it could not award rescissory damages because the true value of the shares could not be determined with certainty, the court was empowered to grant an equitable remedy of one dollar per share.[34] In addition to establishing the elements of entire fairness review for a negotiated

[26] Koenig, *supra* note 3, at 533.

[27] *Id.* at 534.

[28] 457 A.2d 701 (Del. 1983).

[29] *Id.* at 712.

[30] *Id.* at 711.

[31] *Id.* at 712.

[32] *Id.*

[33] *Id.* at 711–12.

[34] Weinberger v. UOP, Inc., C.A. No. 5642, 10 DEL. J. CORP. L. 945, 960 (Del. Ch. Jan. 30, 1985).

merger freezeout, another consequence of the *Weinberger* decision was to increase the use of independent negotiating committees in subsequent transactions.[35] The court commented in a footnote that the use of such a committee could have changed the outcome by allowing the committee to negotiate with Signal at arm's length and supporting a presumption of fairness.[36]

In *Rosenblatt v. Getty Oil*, the court further developed the standard of allocating the burden of proof in a controlling shareholder freezeout.[37] In this case, the controlling shareholder (Getty Oil) froze out the minority shareholders of Skelly Oil through a negotiated merger. There was no independent committee of directors,[38] but the deal was approved by a vote of 58% of the minority shareholders.[39] The approval of a majority of the minority shareholders (an "MOM condition") receives deference from the court in evaluating fairness, but to a limited extent. Instead of dropping the standard to the business judgment rule[40] or

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[35] *See* Subramanian, *supra* note 2, at 12; McGuinness & Rehbock, *supra* note 7, at 445 (noting that "special committees have become a commonly used instrument in conflict-of-interest transactions").

[36] *Weinberger*, 457 A.2d at 709 n.7 ("Although perfection is not possible, or expected, the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's length. Since fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered nor pursued. Particularly in a parent-subsidiary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness.") (internal citations omitted).

[37] 493 A.2d 929 (Del. 1985).

[38] Subramanian, *supra* note 2, at 16 (noting that Skelly did not form a special committee, even though there were several independent directors on its board, because the deal was executed before the *Weinberger* decision had made clear the benefits of such a committee).

[39] *Id.* at 936.

[40] The business judgment rule is:

> a presumption that in making a business decision the directors of a corporation acted on an informed basis, in

waste,[41] as would be the case for a conflicted director or officer,[42] in a situation involving self-dealing by a controlling owner, deference is limited to shifting the burden of proof of entire fairness from the defendant to the plaintiff.[43]

The court created another avenue for burden shifting in *Kahn v. Lynch Communication Systems*.[44] Building on the footnote in *Weinberger* mentioned above, the court held that a properly empowered independent special committee would also shift the burden of proof to the plaintiffs;[45] however, the court must first scrutinize the true bargaining power of the committee.[46] In *Lynch*, even though the target had an independent special committee negotiating the price, the court held that the committee did not actually have the power to refuse the controlling shareholder's offer because the controlling shareholder threatened a hostile tender offer

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> good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (internal citations omitted).

[41] Waste is defined as "an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000).

[42] *See* DEL. CODE ANN. tit. 8, § 144 (2012); Gantler v. Stephens, 965 A.2d 695, 713 (Del. 2009) (stating the proposition that where shareholder ratification is not legally required, a fully informed shareholder vote changes the standard of review for a conflicted director transaction to business judgment).

[43] Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985); Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983).

[44] 638 A.2d 1110 (Del. 1994).

[45] *Id.* at 1117.

[46] *Id.* The court must determine that under the circumstances, the special committee was "truly independent, fully informed, and had the freedom to negotiate at arm's length" before the burden is shifted. *Id.* at 1120–21.

at a lower price if the target board did not accept.[47] An empowered special committee would have shifted the burden of proof to the plaintiff, perhaps changing the outcome. However, since the committee lacked independence to act freely, the court remanded the case for a determination of fairness with the burden placed on the defendant.[48]

In summary, the standard of review for a negotiated merger freezeout is always entire fairness. The burden of proof is on the conflicted party unless there is either approval by a majority of the minority shareholders or approval by an independent special committee of directors.[49] If either of these conditions is met, the burden of proof shifts to the plaintiffs.[50] Having both procedural protections, however, does not give the defendant any additional benefit; the transaction is still reviewed for entire fairness. Thus, once there is approval by a special committee, the controlling owner has very little reason to also include an MOM condition. In fact, one study found that only about one-third of negotiated merger freezeouts contained an MOM condition, while 94% used a special committee.[51] The current rule creates very little incentive to include both types of procedural protections, but it does allow the court to apply a relatively high level of scrutiny regardless of such safeguards in order to ensure fairness.

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[47] *Id.* at 1121. Even though the controlling shareholder, Alcatel, owned only 43.3% of the shares of the target, the court held that its interest was sufficient under the circumstances to invoke the duties of a majority shareholder. *Id.* at 1115.

[48] *Id.* at 1121–22. On remand, the Court of Chancery found that the transaction was entirely fair to the minority. Kahn v. Lynch Commc'n Sys., Inc., C..A. No. 8748, 1995 WL 301403 (Del. Ch. Apr. 17, 1995), *aff'd*, 669 A.2d 79 (Del. 1995).

[49] Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) ("The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.").

[50] *Lynch Commc'n Sys.*, 638 A.2d at 1117; Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985);.

[51] Subramanian, *supra* note 2, at 16–17 (using data from 2001–2005).

B. Tender Offer Freezeouts

The second common transactional structure, the two-step or tender offer freezeout, achieves the same final result, but uses a different process.[52] The controlling shareholder will first announce its intention to make a tender offer directly to the target shareholders.[53] The target will then form a special committee to assess the offer, negotiate on the price, and make a recommendation to shareholders about whether they should reject or accept it.[54] If the controller is able to obtain at least 90% of the shares through the tender offer, it can then unilaterally execute a short-form merger without any additional approval from the board or shareholders,[55] eliminating any remaining minority shares. The combination of a tender offer and short-form merger has recently become a popular option to accomplish a freezeout because courts have started reviewing both parts of the transaction under the business judgment standard, rather than entire fairness review,[56] although this may change in the future.[57]

The standards of review for each of the two pieces of the two-step freezeout—the tender offer and the short-form merger—developed separately, but once established they led to the increasing popularity of the combined method.[58] In the 1996 *Solomon v. Pathe Communications* case, the Delaware Supreme Court established that although a tender offer is not subject to entire fairness review, it cannot be coercive.[59] In the absence of coercion, the majority shareholder has no obligation to pay a fair price because

[52] McGuinness & Rehbock, *supra* note 7, at 453.

[53] *Id.* at 454.

[54] *Id.* at 454–55.

[55] DEL. CODE ANN. tit. 8, § 253 (2012).

[56] Koenig, *supra* note 3, at 535–36.

[57] *See* Welch & Larkin, *supra* note 8.

[58] McGuinness & Rehbock, *supra* note 7, at 456 (noting that since the emergence of the tender offer freezeout in 2001, 28% of going-private transactions have utilized this form).

[59] 672 A.2d 35 (Del. 1996).

minority shareholders are acting voluntarily in accepting the offer.[60] The *Solomon* case involved a tender offer made for only a portion of the minority shares and was not a full freezeout; nonetheless, it has been interpreted to apply to tender offer freezeouts.[61] It was not until 2001 that the Court of Chancery applied the rule to an actual tender offer freezeout.[62] In that case, *Siliconix*, the court held that because there were no disclosure violations and the stock-for-stock tender offer was not coercive, there was no obligation to pay a fair price or to demonstrate entire fairness.[63] The tender offer is treated differently from the negotiated merger freezeout because the minority shareholders are acting voluntarily and there is no "corporate action" by the board.[64]

In the same year, the Delaware Supreme Court established the standard of review for the second step—the short-form merger.[65] In *Glassman v. Unocal*, the parent corporation, owning 96% of the subsidiary, executed a short-form merger to freeze out the remaining 4% of publicly owned shares pursuant to Delaware statute.[66] Plaintiff minority shareholders brought suit alleging in part that the merger was not entirely fair. However, the court held that the entire fairness standard did not apply to short-form mergers because it would undermine the very purpose of the statute to require proof of fair dealing.[67] The legislature intended to create a simple and efficient way for a parent to accomplish a merger with a subsidiary, and the court sought to preserve this purpose by applying the business judgment

[60] *Id.* at 40.

[61] Subramanian, *supra* note 2, at 18–19.

[62] *In re* Siliconix Inc. S'holders Litig., C A. No. 18700, 2001 WL 716787 (Del. Ch. June 21, 2001).

[63] *Id.* at *6.

[64] *Id.* at *7.

[65] Glassman v. Unocal Exploration Corp., 777 A.2d 242 (Del. 2001).

[66] *Id.* at 243. *See also*, DEL. CODE ANN. tit. 8, § 253 (2012).

[67] *Glassman*, 777 A.2d at 247–48.

rule.[68] Absent fraud or illegality, plaintiffs' only remedy in a short-form merger is appraisal.[69]

The Delaware Court of Chancery clarified the non-coerciveness standard for tender offers in *Pure Resources*.[70] The case involved a stock-for-stock tender offer that plaintiffs claimed was for an inadequate price and contained misleading or inadequate disclosures.[71] The court refused to apply the entire fairness standard of *Lynch* and instead applied the coerciveness rule from *Solomon*.[72] The court, however, sought to harmonize the rules by proposing that if a tender offer is actually found to be coercive, it will no longer receive judicial deference and entire fairness review will apply.[73] In order to demonstrate that a tender offer is not coercive, (1) the offer must be subject to a non-waivable MOM tender condition; (2) the controller must guarantee a prompt short-form merger at the same price; (3) the controller can make no retributive threats; and (4) the independent directors on the target's board must have adequate time to consider the offer.[74] These protections minimize any "distorting influence of the tendering process on voluntary choice."[75] An additional safeguard for the minority is that the target board, despite not having any statutory role in a tender offer, still has the normal fiduciary duties to protect shareholders from any threat.[76] The court in *Pure Resources* found that the offer was not coercive, with the exception of a defective but easily curable MOM condition; the court granted the preliminary injunction

[68] *Id.*

[69] *Id.* at 248.

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

[71] *Id.* at 424.

[72] *Id.*

[73] *Id.*

[74] *Id.* at 445.

[75] *Id.*

[76] *Id.* at 441. *See also* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

because of this defect and concerns about improper and misleading disclosures.[77]

The *Solomon* and *Lynch* lines of cases establish two separate standards for a negotiated merger freezeout and a tender offer freezeout. The former is always reviewed under entire fairness, though the burden can be shifted to the plaintiff if there is either an MOM condition or an independent special committee of directors. The latter is reviewed under the business judgment rule unless it is shown to be coercive to the minority under the rules in *Pure Resources*.[78] Many have criticized the divergent standards as creating artificial distinctions between two transactional structures that ultimately accomplish the same result and should therefore be treated in the same way,[79] but the distinctions in form have, until recently, been sufficient to support disparate treatment by courts.

Recent cases indicate that the Delaware Court of Chancery may be moving towards a single standard as well.[80] In May of 2010, the court issued an opinion in *CNX Gas* in which it built on dicta from *Cox Communications* to propose a unified standard for both long-form and two-step freezeouts.[81] The proposed standard would apply entire fairness review (with the burden on the defendant) to all freezeouts.[82] Only with both an affirmative independent

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[77] *In re Pure Res.*, 808 A.2d at 452–53.

[78] *Id. See also In re* Aquila Inc., 805 A.2d 184 (Del. Ch. 2002).

[79] *See In re Pure Res.*, 808 A.2d at 435; Ely R. Levy, *Freeze-Out Transactions the Pure Way: Reconciling Judicial Asymmetry between Tender Offers and Negotiated Mergers*, 106 W. VA. L. REV. 305, 348 (2004); Brian M. Resnick, *Recent Delaware Decisions May Prove to Be "Entirely Unfair" to Minority Shareholders in Parent Merger with Partially Owned Subsidiary*, 2003 COLUM. BUS. L. REV. 253 (2003).

[80] Bradley R. Aronstam & David E. Ross, *Retracing Delaware's Corporate Roots Through Recent Decisions: Corporate Foundations Remain Stable While Judicial Standards of Review Continue to Evolve*, 12 DEL. L. REV. 1, 17 (2010).

[81] *In re* CNX Gas Corp. S'holders Litig., 4 A.3d 397, 400 (Del. Ch. 2010); *In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604 (Del. Ch. 2005).

[82] *In re CNX Gas*, 4 A.3d at 400.

special committee recommendation and MOM approval would the standard of review drop to the business judgment rule.[83] This new standard would lower the protections for minority shareholders in a negotiated merger freezeout by allowing the controlling owner to completely escape entire fairness review simply by including both conditions.[84] The standard would also increase the procedural requirements of the tender offer freezeout,[85] thereby perhaps protecting the minority, but also undermining the very purpose of the expedited transactional structure. The Delaware Supreme Court refused to hear an interlocutory appeal,[86] so it remains to be seen whether the proposed standard will truly become law.

C. Overview of Existing Literature

There are three main views within the current scholarship on freezeouts and the appropriate standard of review. The first is that the status quo of divergent standards is the best way to balance the interests of the minority and controlling owners under each transactional form.[87] The second view is that the two forms produce the same result and involve self-dealing, so they should therefore both be subject to entire fairness review.[88] The final view also supports a unified rule, but does not require entire fairness in all cases. This hybrid approach, like the one taken in *CNX Gas*, would subject both transactional forms to entire fairness review unless they meet certain procedural

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[83] *Id.*

[84] *In re Cox Commc'ns, Inc.*, 879 A.2d at 606.

[85] *Id.* at 607.

[86] *In re* CNX Gas Corp. S'holders Litig., No. 333, 2010 WL 2690402 (Del. July 8, 2010).

[87] Jon E. Abramczyk et al., *Going-Private "Dilemma"?—Not in Delaware*, 58 BUS. LAW. 1351 (2003); A.C. Pritchard, *Tender Offers by Controlling Shareholders: The Specter of Coercion and Fair Price*, 1 BERKELEY BUS. L.J. 83 (2004).

[88] *See* Levy, *supra* note 79; Resnick, *supra* note 79.

requirements, in which case the court will apply the business judgment standard.[89]

Advocates of the status quo make several arguments supporting their position. First, they argue that Delaware corporate law provides a role for the target board in a statutory merger,[90] but not in a tender offer, so there is technically no "corporate action" in the latter.[91] The counterargument is that target boards do play a role in hostile tender offers by taking defensive measures and making recommendations even in non-hostile tender offers. However, even if the board is involved in making a recommendation or deciding which defensive measures to enact, the actual decision of whether or not to tender is a voluntary choice of the minority shareholder.[92] As long as the current test for non-coerciveness is met, it can be assumed that the choice is a valid, independent decision that the shareholder is entitled to make and that does not require further judicial protection. This independence might be questioned if the shareholder fears retribution by the controlling owner, but the current rule already provides for elevating review to entire fairness in such a case.[93] Finally, in response to the assertion that tender offer freezeouts pay less to minority shareholders, indicating insufficient protection, some scholars argue that the possibility of a freezeout is already built into the price of a minority share ex ante.[94] If tender offer freezeouts pay less, the holders are not truly harmed because they were able to buy those shares at a lower value to begin with. These arguments are discussed in greater detail in the following section.

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[89] *See* Subramanian, *supra* note 2; William T. Allen, Jack B. Jacobs & Leo E. Strine, *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1309 (2001).

[90] DEL. CODE ANN. tit. 8, § 251 (2012).

[91] *In re* Siliconix Inc. S'holders Litig., C.A. No. 18700, 2001 WL 716787, at *7 (Del. Ch. June 21, 2001).

[92] *Id.*

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

[94] Pritchard, *supra* note 87, at 103.

Advocates of the consistent application of entire fairness review to both types of freezeouts prioritize form over structure and argue that if the end-result is the same, the courts should treat the transactions in the same way.[95] The controlling shareholder, by virtue of its position, is able to exert pressure and influence on the board and on minority shareholders, regardless of how the freezeout is executed. The "technical differences do not adequately account for the differences in policy emphasis," so courts should apply entire fairness review to both types, and not grant business judgment deference in non-coercive tender offers.[96] Critics argue that this view fails to take into account the high cost of entire fairness litigation and the necessary valuations.[97] Applying entire fairness to all freezeouts may also deter some value-creating transactions because the risk of costly litigation exceeds the benefit of the transaction to the controller.[98] Proponents assert that limiting the minority in a tender offer freezeout to the appraisal remedy allows them to receive only a "fair price," not the best price they could have received.[99] However, there is little evidence to suggest that minority shareholders are even entitled to receive anything more than the fair price, so perhaps appraisal alone is an adequate remedy even in the absence of fair dealing.[100]

The hybrid approach suggests that the standard of review itself should change when the procedural requirements are met. The court in *CNX Gas* proposed that both an affirmative recommendation from an independent special committee and MOM approval should change the standard

[95] Resnick, *supra* note 79, at 282.

[96] *See* Levy, *supra* note 79.

[97] Pritchard, *supra* note 87, at 111.

[98] Subramanian, *supra* note 2, at 23.

[99] Resnick, *supra* note 79, at 260–61.

[100] Solomon v. Pathe Commc'ns Corp., 672 A.2d 35, 39 (Del. 1996) ("In the case of totally voluntary tender offers, as here, courts do not impose any right of the shareholders to receive a particular price.").

from entire fairness to business judgment.[101] Former Chancellor Allen and Vice Chancellors Jacobs and Strine wrote an article proposing that either condition should be sufficient to change the standard to business judgment.[102] Guhan Subramanian has also proposed a framework for a similar hybrid approach.[103] He argues that the two current standards produce "a suboptimal distribution of companies between public and private status" because the tender offer freezeout doctrine goes too far in facilitating freezeouts while the negotiated merger doctrine does not go far enough.[104] Subramanian suggests a number of modifications to the entire fairness standard that focus on providing both disinterested board approval and disinterested shareholder approval.[105] When a freezeout transaction, regardless of form, provides sufficient procedural safeguards to emulate these fundamental prongs of an arm's length deal process, Subramanian maintains, the court should apply the business judgment rule.[106] Subramanian claims that his proposal would increase the efficiency of freezeouts by "reduc[ing] the controller's incentives to engage in opportunistic behavior" and "ability to use nonpublic information to the detriment of minority shareholders," "lower[ing] the procedural hurdles that currently deter some deals," and providing greater certainty by harmonizing the divergent standards.[107]

Other proposals for reform address areas outside of these judicial standards. One such proposal would create a "limited fairness hearing" for tender offer freezeouts, a compromise between the entire fairness and the business judgment standards.[108] Another idea is the creation of a new

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[101] *In re* CNX Gas Corp. S'holders Litig., 4 A.3d 397, 397 (Del. Ch. 2010).

[102] *See* Allen et al., *supra* note 89.

[103] Subramanian, *supra* note 2, at 7.

[104] *Id.*

[105] *Id.* at 55–62.

[106] *Id.* at 55.

[107] *Id.* at 64.

[108] Bradley R. Aronstam, R. Franklin Balotti & Timo Rehbock, *Delaware's Going-Private Dilemma: Fostering Protections for Minority*

appraisal statute that requires controlling shareholders to always pay a fair price to the minority in a short-form merger.[109] These proposals have not gained as much traction with the court as those reforms that focus on applying and interpreting the entire fairness standard.[110] The court is moving in the direction of a hybrid approach that encompasses both entire fairness and business judgment deference, but it is not yet certain exactly what the final form of review will entail.[111]

III. MAINTAINING THE DUAL STANDARD

This Note argues that a new unified standard, whether entire fairness or a hybrid approach, is altogether unnecessary and that the dual standard better balances controlling owner rights and minority shareholder protection. Accepting the assumption that the objective of the standard of review "is to replicate the elements of an arms-length negotiation—namely, disinterested board approval and disinterested shareholder approval—in the freezeout context,"[112] the manner in which the transaction is technically structured must still be taken into consideration. The minority should be protected only to the extent necessary to ensure that these conditions are met, which will differ based on the form of the transaction, even if the final outcome is the same. The differences in structure between negotiated merger freezeouts and tender offer freezeouts are sufficient to justify disparate treatment by courts; a unified standard forces consistency where it is not necessary.

The Delaware legislature itself treats the two types of freezeouts differently, which courts must also account for

Shareholders in the Wake of Siliconix *and Unocal Exploration*, 58 BUS. LAW. 519 (2003).

[109] *Id.*

[110] *See, e.g., In re* CNX Gas Corp. S'holders Litig., 4 A.3d 397 (Del. Ch. 2010); *In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604 (Del. Ch. 2005).

[111] *See* Welch & Larkin, *supra* note 8.

[112] Subramanian, *supra* note 2, at 8.

when determining the standard of review. Section 251 of the Delaware Code requires the target board to approve a negotiated merger freezeout.[113] In contrast, short-form mergers, under Section 253, do not require target board action, and the Delaware Code does not address any target board role in tender offers made directly to minority shareholders.[114] Given this legislative basis, courts should be hesitant to insert additional requirements into tender offer freezeouts. As stated in the *Glassman* decision:

> If a corporate fiduciary follows the truncated process authorized by Section 253, it will not be able to establish the fair dealing prong of entire fairness. If, instead, the corporate fiduciary sets up negotiating committees, hires independent financial and legal experts, etc., then it will have lost the very benefit provided by the statute—a simple, fast and inexpensive process for accomplishing a merger. We resolve this conflict by giving effect to the intent of the General Assembly. In order to serve its purpose, Section 253 must be construed to obviate the requirement to establish entire fairness.[115]

The Delaware Supreme Court recognized the deference owed to the legislative intent behind Section 253.[116] If subject to the same requirements as a negotiated merger freezeout, the short-form merger would no longer provide a quick and efficient method for a controlling owner with a substantial stake (over 90%)[117] to execute a merger. Given that the legislature has made no move towards changing this statute, courts should refrain from inserting additional

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[113] DEL. CODE ANN. tit. 8, § 251(b) (2012) ("The board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation and declaring its advisability.").

[114] *Id.*; *In re* Siliconix Inc. S'holders Litig., No. C.A. 18700, 2001 WL 716787, at *8 (Del. Ch. June 21, 2001).

[115] Glassman v. Unocal Exploration Corp., 777 A.2d 242, 247–48 (Del. 2001) (internal citation and footnotes omitted).

[116] *Id.*

[117] DEL. CODE ANN. tit. 8, § 253(a).

procedural requirements that would likely exceed their authority in that they would undermine legislative intent.

In addition to concerns of judicial activism, the mere fact that the two structures produce the same result does not necessitate the same standard of review. Delaware courts have prioritized form over substance in a number of areas.[118] Delaware has repeatedly rejected the de facto merger theory,[119] even while other states have found that if the outcome of a transaction is equivalent to a merger, the court should treat it as a merger regardless of technical structure.[120] Delaware courts have also given different legal treatment to the duties of a director facing a hostile takeover than they have to those facing a friendly takeover, even though the end result is the same.[121] It is therefore consistent with precedent to treat the two types of freezeout transactions differently based on their formal structure, despite the final outcome, particularly since the structures themselves have different consequences for minority rights.

A negotiated merger freezeout, by its nature, is an inherently conflicted transaction while a tender offer freezeout is not necessarily so.[122] A negotiated merger under Section 251 of the Delaware Code requires the conflicted target board to take action to approve the transaction.[123] The concern for self-dealing is significant here because the controlling shareholder typically dominates the target's board of directors as well as holding a majority of the

[118] *See generally* D. Gordon Smith, *Independent Legal Significance, Good Faith, and the Interpretation of Venture Capital Contracts*, 40 WILLAMETTE L. REV. 825 (2004) (discussing the doctrine of independent legal significance in Delaware, which prioritizes form over substance).

[119] Hariton v. Arco Elecs. Inc., 188 A.2d 123 (Del. 1963); Heilbrunn v. Sun Chem. Corp., 150 A.2d 755 (Del. 1959).

[120] *See* Rath v. Rath Packing Co., 136 N.W.2d 410 (Iowa 1965); Farris v. Glen Alden Corp., 143 A.2d 25 (Pa. 1958).

[121] Marco Ventoruzzo, *Freeze-Outs: Transcontinental Analysis and Reform Proposals*, 50 VA. J. INT'L L. 841, 875–76 (2010).

[122] Aronstam et al., *supra* note 108, at 525.

[123] DEL. CODE ANN. tit. 8, § 251 (2012).

outstanding shares.[124] The controlling owner stands on both sides of the transaction, as buyer and seller, and it is much more difficult to demonstrate that the decision of the board was the product of arm's length negotiation.[125] In such freezeouts, where the controlling shareholders would privately benefit at the expense of the minority, courts have applied entire fairness review to address the inherent probability of self-dealing.[126]

In contrast, when confronted with a tender offer, the shareholder always has a choice of whether or not to accept.[127] When the offer is made by a controlling shareholder, there is some concern that the minority will feel undue pressure to accept based on a fear of retribution or of being cashed out for even less value in a short-form merger.[128] However, the coerciveness standard articulated in *Pure Resources* already addresses these concerns: if the offer takes unfair advantage of the controller's position, the court will apply entire fairness review.[129] Furthermore, courts have held that the absence of any "corporate action" by the target's board makes entire fairness review inappropriate.[130] There is a "conceptual notion that tender offers essentially represent the sale of shareholders' separate property and such sales—even when aggregated into a single change in control transaction—require no 'corporate' action and do not

[124] Subramanian, *supra* note 2, at 9.

[125] Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994).

[126] Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. Pa. L. Rev. 1263, 1283–84 (2009).

[127] Lewis v. Fuqua Indus., No. 6534, 1982 WL 8783, at *480 (Del. Ch. Feb. 16, 1982); Abramczyk et al., *supra* note 87, at 1354.

[128] *In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 442 (Del. Ch. 2002); Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1039–40 (1982).

[129] *In re Pure Res.*, 808 A.2d at 424.

[130] *In re* Siliconix Inc. S'holders Litig., No. C.A. 18700, 2001 WL 716787, at *7 (Del. Ch. June 21, 2001)..

involve distinctively 'corporate' interests."[131] The board has no statutory role in a tender offer, which explains the disparity in treatment between the two forms of a freezeout.[132]

The status quo dual standard is not only justified by the structural differences in the two freezeout mechanisms, but has also proven adequate in protecting shareholders. Prior to the decision in *CNX Gas*, minority shareholders were not unprotected.[133] They did not receive lower payments than in negotiated merger freezeouts,[134] though there are conflicting studies.[135] Even if the minority does receive a lower premium on average in a tender offer freezeout, this might be the result of overcompensation in negotiated mergers, rather than under-compensation in tender offers, and there is still a premium over market price.[136] It is very difficult to identify exactly what the fair value of minority shares are, and typically there is a range of fair values, so comparing premiums paid is not a conclusive measure for an adequate standard of review.[137] It is unnecessary to overprotect minority shareholders at the expense of disallowing

[131] Abramczyk et al., *supra* note 87, at 1355 (citing TW Servs., Inc. v. SWT Acquisition Corp., C.A. Nos. 10427, 10298, 1989 WL 20290, at *9 (Del. Ch. Mar. 2, 1989)).

[132] *TW Servs., Inc.*, 1989 WL 20290, at *9.

[133] Ventoruzzo, *supra* note 121, at 873.

[134] *Id.*

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

[136] *In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 632 (Del. Ch. 2005) ("Even if premiums to market are lower in *Siliconix* transactions, the premiums paid are large in comparison to the routine, day-to-day trading prices, in which minority and liquidity discounts will be suffered. For that reason, at every settlement, the plaintiffs' lawyers say that they could not risk pushing farther, lest the controller decide not to press on and offer a deal, and the stockholders suffer the fate of continuing as owners of minority shares in a going concern. After all, events that generate liquidity for all minority stockholders at substantial premiums are usually welcomed by stockholders.").

[137] *See* Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CALIF. L. REV. 393, 411 (2003).

transactions that would make both parties better off. There must be a balance between the competing concerns of fairness and economic efficiency.

Shareholders are competent enough that, given the mandated disclosures and existing procedural protections, they can make an informed, voluntary decision about whether or not to tender their shares without involving the courts in a full-blown investigation of entire fairness.[138] The situation in *Siliconix* itself demonstrates that the minority is able to reject a tender offer.[139] The coerciveness standard already requires sufficient procedural protections to address concerns of overreaching or self-dealing by the majority.[140] There must be approval by a majority of the minority shareholders, assurance of a second step merger at an equivalent price, no threats of retribution, and adequate time for the target board to respond.[141] The controlling owner must also disclose all material facts relevant to the tender offer, including any information from the target that the controlling owner relied upon to determine the consideration for its offer.[142] The combination of these protections allows the minority to act independently from the

[138] *See* Allen et al., *supra* note 89, at 1308; Lewis H. Lazarus, *Standards of Review in Conflict Transactions: An Examination of Decisions Rendered on Motions to Dismiss*, 26 DEL. J. CORP. L. 911, 923 (2001) ("In this day and age in which investors also have access to an abundance of information about corporate transactions from sources other than boards of directors, it seems presumptuous and paternalistic to assume that the court knows better in a particular instance than a fully informed corporate electorate with real money riding on the corporation's performance.").

[139] *In re* Siliconix Inc. S'holders Litig., C.A. No. 18700, 2001 WL 716787, at *6 (Del. Ch. June 21, 2001); Aronstam et al., *supra* note 108, at 536 n.134.

[140] *In re Siliconix*, 2001 WL 716787, at *6 ("In short, as long as the tender offer is pursued properly, the free choice of the minority shareholders to reject the tender offer provides sufficient protection."). *See also* Solomon v. Pathe Commc'ns Corp., 672 A.2d 35, 39 (Del. 1996).

[141] *In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 424 (Del. Ch. 2002).

[142] *Id.* at 448.

controller and defend their own right to a fair price, without the court's interference. Furthermore, increased institutional investor activity and improved information flows have led to a greater willingness of minority stockholders to resist tender offers, so it is less necessary now to elevate the standard of review to entire fairness than it may have been in the past.[143]

The current jurisprudence for negotiated merger freezeouts also provides adequate protection to minority shareholders by applying entire fairness in all cases. Controlling shareholders are incentivized to provide at least some procedural protection—either an MOM condition or approval of an independent special committee—in order to shift the burden to the plaintiffs, but they can never escape the possibility of entire fairness review because the threat of self-dealing is so inherent in the deal structure.[144] Neither condition alone receives sufficient deference to shift the burden to business judgment review; the court always maintains the ability to use deeper scrutiny, even if in some cases the outcome of burden shifting might be very limited review. Negotiated merger freezeouts require target board approval, a distinctly "corporate action," so the directors on the target's board are required by their fiduciary duties to act in the best interests of all shareholders, including the minority.[145] They are therefore obligated to negotiate for fair treatment and price, and can be held accountable for any

[143] Abramczyk et al., *supra* note 87, at 1358 (paraphrasing *In re Pure Resources*).

[144] Aronstam et al., *supra* note 108, at 525 ("[T]he rationale for imposing the 'entire fairness' burden is that in a self dealing transaction, the minority shareholders' interests are not being adequately safeguarded, because the fiduciaries charged with protecting the minority have a conflicting self-interest. Our law, therefore, creates compensating procedural safeguards by subjecting those fiduciaries to the exacting requirement that they demonstrate to a carefully scrutinizing court 'their utmost good faith and the most scrupulous inherent fairness of the bargain.'").

[145] *Cf. In re Siliconix*, 2001 WL 716787, at *7 (explaining that tender offer freezeouts are distinguishable from negotiated merger freezeouts because they do not require any "corporate action").

failure to do so.[146] Admittedly, there is some room for improvement of the standard because the current rule provides no additional incentive for the controlling owner to go beyond what is required for burden shifting,[147] but it is not clear that the unified standard proposed in *CNX Gas* would solve this problem.

IV. REJECTING THE *CNX GAS* UNIFIED STANDARD

The proposed unified standard would modify the standard of review for both long-form and two-step mergers so that there is one rule applied consistently to all freezeouts.[148] In a negotiated merger freezeout it would become necessary to have both an MOM condition and an independent special committee of directors in order to receive the benefits of a more deferential standard of review. This deferential standard would be the business judgment rule, instead of just shifting the burden of entire fairness, as it would have been under *Lynch* and *Rosenblatt*.[149] There would be an additional requirement that the special committee have the same powers as the board would have in a third-party transaction, which includes use of the poison pill and any other defensive measure, subject to *Unocal* duties.[150] Tender offer freezeouts would also be subject to the requirement of heightened special committee powers, and would actually require affirmative approval from the committee. Previously, the controller was only required to give the committee adequate time to review the transaction and

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[146] *In re Pure Res.*, 808 A.2d at 445.

[147] Subramanian, *supra* note 2, at 16–17 (citing data indicating that the vast majority of negotiated merger freezeouts since *Siliconix* have included a special committee sufficient to shift the burden of proof, and consequently that very few have used an MOM condition).

[148] *In re* CNX Gas Corp. S'holders Litig., 4 A.3d 397, 400 (Del. Ch. 2010).

[149] Kahn v. Lynch Commc'n Sys., Inc, 638 A.2d 1110, 1117 (Del. 1994); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985).

[150] Unocal Corp. v. Mesa Petroleum Corp., 493 A.2d 946 (Del. 1985).

make a recommendation, whether or not it came out in favor of the deal.[151] Under the unified standard, any flaw in the required procedural protections, as determined at the court's discretion, allows the court to impose entire fairness review with the burden on the defendant, instead of simply giving plaintiffs an appraisal right.[152]

The unified standard would result in a number of inefficiencies in the market, both for controlling owners and minority shareholders. By imposing additional procedural requirements that can be quite costly to implement, and by creating additional potential issues for litigation, the unified standard increases the overall level of transaction costs in a freezeout.[153] This is particularly true for tender offer freezeouts, which were previously a relatively efficient route for consolidating ownership under the majority shareholder.[154] All freezeouts typically give rise to "legal and investment banker fees, printing, mailing, and other procedural expenses, and the loss of sunk accounting and systems costs," and these costs are significant even if the transaction is negotiated at arm's length.[155] When a

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[151] *In re Pure Res.*, 808 A.2d at 441.

[152] *In re CNX Gas*, 4 A.3d at 400.

[153] McGuinnes & Rehbock, *supra* note 7, at 450, 459 (The primary disadvantages of the negotiated merger freezeout structure, in which the use of an independent special committee shifts the burden of proof to the plaintiffs, are that:

> "1. It creates a risk that, notwithstanding good faith negotiation, the special committee rejects the proposed transaction or requires the controlling stockholder to pay a higher price than it might otherwise have been willing to offer.
> 2. The process of negotiating with the special committee is a costly one and can be time-consuming.
> 3. A transaction that is subject to the entire fairness standard of review may attract more stockholder litigation than a transaction subject to a lower standard of review.")

[154] *See* Pritchard, *supra* note 87, at 111.

[155] John C. Coates IV, *"Fair Value" As an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions*, 147 U. PA. L. REV. 1251,

transaction is conflicted, these fees (as a percentage of deal value) will further exceed those in an arm's length transaction because of the "litigation and reputation risks associated with transactions that by definition involve conflicts of interest."[156] For example, in an average $1 billion freezeout, legal and investment banking fees alone can exceed $20 million and mailing and printing costs associated with proxy or information statements and shareholder notices often exceed $100,000.[157] Even minority shareholders face costs from taxes and reinvestment expenses.[158]

Given the high costs associated with conflicted transactions, courts should, when possible, seek to reduce transaction costs in order to maximize market efficiency. However, at the same time, there must also be sufficient protection for minority rights, which the dual standards provide.[159] Freezeout transactions are typically executed when the controlling owner perceives it to be more efficient to run the corporation privately, eliminating the agency problem between the majority and minority shareholders and other costs associated with being a public company.[160] Freezeouts present an opportunity for controllers to expropriate wealth from the minority, though they are constrained by the enforcement of fiduciary duties and fairness litigation.[161] The purpose of corporate law, with respect to the standard of review, is to "effect a system of organization which will decrease agency costs overall, but to

1324 (1999) (arguing that Delaware courts should reject minority discounts in freezeout valuations); Stockton, *supra* note 6.

[156] *See* Coates, *supra* note 155.

[157] *Id.*

[158] *Id.*

[159] *See* Richard T. Hossfeld, *Short-Form Mergers After* Glassman v. Unocal Exploration Corp.: *Time to Reform Appraisal*, 53 DUKE L.J. 1337, 1365 (2004) (suggesting that Delaware appraisal law should be more in line with the concept of Pareto optimality).

[160] Koenig, *supra* note 3, at 510.

[161] Faith Stevelman, *Going Private at the Intersection of the Market and the Law*, 62 BUS. LAW. 775, 896 (2007). *See also* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 786 (2003).

do so without creating new agency costs—for example, by stimulating an inefficient amount of litigation."[162] The unified standard imposes increased transaction costs, beyond what is necessary to protect the minority's interest in their shares. As such, it would result in a number of inefficiencies.

The unified standard would weaken the controller's position in a tender offer freezeout, increase the cost of the transaction, and increase the risk of litigation. These effects might prevent certain transactions that would otherwise be efficient and in the best interest of both the majority and minority. The biggest change to the standard of review for tender offer freezeouts made by *CNX Gas* would be the imposition of an additional requirement that there be actual approval from an independent special committee in order to receive business judgment review, not just a recommendation of its opinion.[163] This would make tender offer freezeouts a much less efficient avenue because it would increase the cost of executing the transaction and, since it creates another contestable issue, the risk of subsequent litigation. Plaintiffs would have greater leverage over the controlling owner because any flaws in the special committee approval or MOM condition would force the court to apply the entire fairness standard, prolonging litigation and all of the associated costs.[164]

[162] *See* Stevelman, *supra* note 161.

[163] *In re* CNX Gas Corp. S'holders Litig., 4 A.3d 397, 414 (Del. Ch. 2010).

[164] Charles M. Nathan, *Practical Implications of* CNX Gas *on Controlling Shareholder Acquisitions*, THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (July 13, 2010, 9:03 AM), http://blogs.law.harvard.edu/corpgov/2010/07/13/practical-implications-of-cnx-gas-on-controlling-shareholder-acquisitions/ ("By agreeing to a non-waivable requirement that a majority of the disinterested shareholders approve the transaction, the controlling shareholder also risks that minority shareholders vote against the transaction in the hopes of obtaining a second bite at the control premium 'apple.' For this reason, the vote creates potential hold-up value for hedge funds and other short-term investors, including those that move into the stock post-

The new standard also includes several specific elements that would alter the bargaining powers of the interested parties and result in inefficiencies. First, the special committee of directors would have much greater leverage under *CNX Gas* because the court required that it be given all of the authority that the board would have when confronting a third-party tender offer in addition to giving affirmative approval of the tender offer.[165] The board's powers would therefore include the ability to deploy a rights plan or a poison pill, which presents a significant obstacle to any party attempting to take complete control.[166] If a special committee is created and that committee then takes such defensive measures or fails to approve the offer, it will become even harder for the controlling owner to prove entire fairness to a court than if no special committee was used at all.[167] Faced with this possibility, the controlling owner might choose to avoid the use of an independent special committee altogether, and instead subject itself to entire fairness review and the obligation to pay a fair price. The minority will have to expend resources to bring the claim and the controlling owner will have significant expenses in defending itself; these increased costs may prove sufficient to dissuade the controller from making the offer in the first place.[168] Assuming that the offer represents at least some premium over the market value of the minority shares, this destroys an opportunity for minority shareholders to profit

announcement, to use a 'vote no' threat or actual vote to create leverage for negotiation of a higher price.").

[165] *In re CNX Gas*, 4 A.3d at 415.

[166] *Id.*

[167] *See* HUNTON & WILLIAMS, MERGERS & ACQUISITIONS UPDATE: DELAWARE COURT REVISITS CONTROLLING STOCKHOLDER FREEZEOUT TRANSACTIONS 3 (2010), *available at* http://www.hunton.com/files/News/37c66f62-2396-429e-9dd9-3bbc7d52df38/Presentation/NewsAttachment/c249eb1a-7d57-43c9-8ff6-a004e361904b/delaware_court_revisits_controlling_stockholder_freeze_out_transactions.pdf.

[168] Subramanian, *supra* note 2, at 45 (noting that controlling shareholders may be deterred from merger-freezeouts due to high litigation costs, particularly if the controlling shareholder is required or agrees through settlement to pay plaintiffs' legal fees).

and distorts the efficient allocation of resources in the market for control. Second, in determining the effectiveness of the MOM condition, the *CNX Gas* opinion added consideration of whether minority shareholders also own shares in the parent corporation.[169] Given the diverse holdings of institutional investors and the rate of turnover,[170] it would be difficult to establish whether or not a shareholder of the target also has an indirect interest in the parent;[171] at the very least, it would require additional time and expense to find out.

Ultimately, the increased uncertainty produced by the new standard for the controlling shareholder would discourage some freezeout transactions if the potential costs of implementing the procedural safeguards and the risk of litigation outweigh the potential benefit of the transaction. This might be the case even if the majority had proposed to pay a significant premium over market value and both sides would have been made better off. Valuing shares is extremely complicated and fraught with disagreement,[172] so even if the majority owner thought it was offering a fair

[169] *In re CNX Gas*, 4 A.3d at 416.

[170] The average institutional investor turnover rate "ranges from a low of 16% for the indexed portion of the average public pension fund portfolio to a high of more than 95% for the aggressive growth portion of the average money manager portfolio." Dr. Carolyn Brancato & Michael Price, *The Institutional Investor's Goals for Corporate Law in the Twenty-First Century*, 25 DEL. J. CORP. L. 35, 45 (2000).

[171] David Fox, Thomas W. Christopher & Daniel E. Wolf, *Putting the Chill on Freeze-Out Transactions*, 14 No. 8 M&A LAW. 11 (2010) ("In holding that the determination of which stockholders of the subsidiary target are unaffiliated for purposes of applying the majority of the minority condition should take into consideration whether the subsidiary target's stockholders also own shares of the parent controller, the court interjects a new, and arguably unworkable, consideration into the analysis. For example, because institutional stockholders often hold shares in street name, invest in various derivative securities and hedge long positions through offsetting short positions and other securities, it will often be impossible to reliably determine which minority stockholders of the subsidiary target actually have offsetting exposure to the parent controller's equity securities.").

[172] *See generally* Hossfeld, *supra* note 159.

price, the minority might still dispute, and the court might agree, that the transaction was unfair. The controlling owner would therefore be more hesitant to make a tender offer because if there is litigation, it will be much more costly since there are more potential issues and the threat of intensive entire fairness review.[173] The proposed deal may even account for this risk by providing more thorough procedural protections, at least superficially, but also offering a lower price to shareholders. If the risk of losing fairness litigation is high enough, the controller may not make any offer at all, depriving the corporation of a potentially more efficient ownership structure and the minority owners from receiving a payout on their shares.

The unified standard would also permit some inefficient freezeout transactions to take place. The *CNX Gas* rule weakens protections for plaintiffs in a negotiated merger freezeout because although it requires both a special committee and an MOM condition, once applied, the business judgment standard would be highly deferential to defendants.[174] Entire fairness review, even with burden shifting, requires an intensive factual inquiry by the court into fair price and fair dealing, while the business judgment rule does not.[175] The inherent conflict of interest in a

[173] Fox et al., *supra* note 171, at 11 (The holding in *CNX Gas* "would dramatically change the dynamics of negotiations between a parent controller and the special committee of the subsidiary target's board regarding the price and terms of the tender offer. To the extent the parent controller and the special committee are not able to reach agreement on the price and terms and the parent nevertheless proceeds with the tender offer, the fact that it will be subject to the entire fairness standard means shareholder litigation regarding the fairness of the transaction will be a virtual certainty and will be more difficult and costly to settle. For these reasons, this ruling may effectively mean that there will be no easy (and from the parent controller's perspective, no inexpensive and non-litigious) means of completing a freeze-out transaction.").

[174] McGuinness & Rehbock, *supra* note 7, at 440–41.

[175] The business judgment rule presumes, absent a contrary showing by a challenger, that directors made a valid decision, but entire fairness review has consistently been referred to as "the most exacting standard of review utilized by Delaware courts." Aronstam et al., *supra* note 108, at

negotiated merger freezeout involving the controlling shareholder has repeatedly been recognized as a sufficient justification for entire fairness to apply in all cases.[176] Having both a special committee and an MOM condition does not fully resolve this conflict because the majority owner can take advantage of its position and its knowledge of the target company to freezeout minority shareholders at an unfair price.[177] Particularly if minority ownership is dispersed

523. The Delaware Supreme Court in *Weinberger* described the entire fairness inquiry as follows:

> The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness 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. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.

Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (internal citations omitted).

[176] *See, e.g.*, Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110 (Del. 1994); Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

[177] Thomas W. Bates, Michael L. Lemmon & James S. Linck, *Shareholder Wealth Effects and Bid Negotiation in Freeze-Out Deals: Are Minority Shareholders Left out in the Cold?*, 81 J. FIN. ECON. 681, 686 (2006) ("Controlling shareholders could also enjoy a negotiation advantage through their private information about the value of the consolidated claims. . . . Information asymmetry, combined with the potentially limited role of target directors as information agents for the minority, suggests that controlling shareholders can capture a portion of deal surplus that would otherwise accrue to the minority shareholders in a comparable full-information negotiation."). *See generally* Lucian Bebchuk & Marcel Kahan, *Adverse Selection and Gains to Controllers in Corporate Freezeouts*, *in* CONCENTRATED CORPORATE OWNERSHIP 247–59 (Randall K. Morck ed., 2000).

among many individuals, there may not be enough collective support or resources to bring suit,[178] so the controller will be able to gain complete ownership without being held fully accountable for the rights of the minority. Where value is not distributed fairly and in accordance with property rights, inefficiency is created in the market because the pricing of shares will be disconnected from their value in a freezeout.

Finally, the unified standard in *CNX Gas* should be rejected because it eliminates any efficiency benefit from the tender offer route, making negotiated mergers more desirable even though they are more costly and undermining the legislative intent behind Section 253.[179] Short-form mergers under Section 253 are meant to be done quickly and unilaterally, with little additional procedural protection beyond the appraisal right and general fiduciary duties.[180] A controlling owner with over 90% of the shares has a very significant investment in the corporation and has accordingly been afforded the right to proceed with a short-form merger by the legislature.[181] Requiring the procedural conditions in *CNX Gas* or an entire fairness inquiry would effectively remove this right.

The threat of entire fairness review increases administrative and litigation costs associated with going private; even a frivolous claim would be costly for the controlling owner. Entire fairness, because it is a factual

[178] *See* 1A GEORGE M. CONSTANTINIDES ET AL., HANDBOOK OF THE ECONOMICS OF FINANCE: CORPORATE FINANCE 17 (2003).

[179] Glassman v. Unocal Exploration Corp., 777 A.2d 242, 247–48 (Del. 2001).

[180] *Id.* ("If a corporate fiduciary follows the truncated process authorized by § 253, it will not be able to establish the fair dealing prong of entire fairness. If, instead, the corporate fiduciary sets up negotiating committees, hires independent financial and legal experts, etc., then it will have lost the very benefit provided by the statute—a simple, fast and inexpensive process for accomplishing a merger. We resolve this conflict by giving effect the intent of the General Assembly. In order to serve its purpose, § 253 must be construed to obviate the requirement to establish entire fairness.").

[181] *See* DEL. CODE ANN. tit. 8, § 253 (2012); ALAN S. GUTTERMAN, 29 BUSINESS TRANSACTIONS SOLUTIONS § 113:38 (2012).

issue, is less likely to be resolved on a motion to dismiss,[182] giving plaintiffs much more leverage to obtain a pre-trial settlement even if the probability of success is low.[183] Claims that require "enhanced judicial scrutiny," like those for self-dealing transactions, are usually not satisfied by a motion on the pleadings.[184] Claims that are decided under the business judgment rule, however, are more likely to be dismissed at an earlier stage.[185] Applying entire fairness review to tender offer freezeouts would allow plaintiffs to extract settlement value out of non-meritorious claims, as long as they can demonstrate enough evidence of a deficiency in one of the procedural requirements to get past a motion to dismiss. Controlling owners would have to factor this additional risk into their decision of whether or not to go through with the offer, perhaps deterring some otherwise value-creating deals from ever being proposed.

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[182] Lazarus, *supra* note 138, at 914.

[183] *See In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 605 (Del. Ch. 2005) (noting that because the standard of review under *Lynch* always requires entire fairness review, it "makes it impossible for a controlling stockholder ever to structure a transaction in a manner that will enable it to obtain dismissal of a complaint challenging the transaction, each *Lynch* case has settlement value, not necessarily because of its merits but because it cannot be dismissed. For that reason, plaintiffs and defendants both have an incentive to settle non-meritorious, premature suits attacking negotiable, going-private proposals.").

[184] *Id. See also In re* Santa Fe Pac. Corp. S'holder Litig., 669 A.2d 59, 72 (Del. 1995).

[185] *See In re* Freeport-McMoran Sulphur, Inc. S'holders Litig., C.A. No. 16729, 2001 WL 50203, at *2 (Del. Ch. Jan. 11, 2001) (The standard of review, whether entire fairness or business judgment, "is critical because it is outcome-determinative: if the standard is entire fairness, the motion must be denied because the complaint adequately states a claim that the Merger consideration was unfair. If, however, the applicable standard of review is business judgment, the complaint states no cognizable claim because (a) the plaintiffs have not adequately pled that the FSC defendants acted disloyally or in a grossly negligent manner, and (b) even if the Merger consideration paid to FSC shareholders was unfair, to overcome the business judgment rule presumption the plaintiff must allege that the price was so low as to constitute waste or fraud.").

Furthermore, it is unclear whether the previous burden-shifting rules would still apply if only one of the procedural requirements is satisfied, although *Cox Communications* provides some support for assuming that they would.[186] If so, it would be less risky for the controller to attempt a negotiated merger with a less empowered special committee and have the burden shifted than for it to attempt a tender offer freezeout in which it might fail to meet the procedural requirements and be subject to the burden of proving entire fairness. Essentially, the tender offer freezeout would become a much less attractive option for taking a corporation private, unnecessarily limiting the development of corporate transactional structures.[187] The efficiency benefits of a tender offer freezeout would be undermined by the increased risk of future litigation.

Another aspect of the issue is simply the desire for consistency. Although the *CNX Gas* standard would impose the same standard of review on the two types of freezeouts, it would create other types of inconsistencies in Delaware corporate law. The short-form merger would be treated differently depending on whether it was used alone or as part of a freezeout, as would tender offers.[188] In general, courts only apply entire fairness review where there is evidence of self-dealing, but under the unified standard it would be applied to tender offer freezeouts even where there is no such reason.[189] Furthermore, the many cases in which Delaware courts have recognized form over substance would

[186] *See Cox Commc'ns*, 879 A.2d at 644 (indicating that the *Lynch* burden shifting rules would still apply in cases where only one procedural requirement is included).

[187] Christopher A. Iacono, *Tender Offers and Short-Form Mergers by Controlling Shareholders under Delaware Law: The "800-Pound Gorilla" Continues Unimpeded*—In Re Pure Resources, Inc., Shareholders Litigation, 28 DEL. J. CORP. L. 645, 671 (2003).

[188] *See* Glassman v. Unocal Exploration Corp., 777 A.2d 242, 242 (Del. 2001); Solomon v. Pathe Commc'ns Corp., 672 A.2d 35 (Del. 1996).

[189] *In re* Siliconix Inc. S'holders Litig., C.A. No. 18700, 2001 WL 716787, at *8 n.26 (Del. Ch. June 19, 2001) (noting that the controlling shareholder in a tender offer freezeout only stands on "one side of the tender" so there is no "self-dealing").

be in conflict with the treatment of freezeouts.[190] In considering the *CNX Gas* standard, the Delaware Supreme Court should be mindful of the foundational concepts of corporate law that have been applied in the past, and whether or not freezeouts pose such a unique situation as to justify altering those rules.

V. CONCLUSION

The divergence in standards applied to negotiated merger freezeouts and tender offer freezeouts has its basis in foundational principles of corporate law concerning self-dealing, arm's length negotiation, and fairness to the minority. These goals are balanced with the competing need to give appropriate deference to the rights of a majority shareholder, by virtue of their investment and ownership interest, and to preserve an efficient market overall. The unified standard proposed in *CNX Gas* would alter the existing balance of these rights in order to change parties' incentives and hopefully result in a better system. However, as discussed in this Note, these changes are both unnecessary and potentially harmful. The status quo's dual standards respect the majority owner's right to take a corporation private while also providing adequate protection to the minority and ensuring fairness in price. The unified standard would distort the incentive scheme in a way that would both result in some unfair transactions being permitted and some fair transactions being heavily scrutinized. The increased transaction costs may prevent the controlling owner from even attempting the deal, which would leave both sides worse off. It is nearly impossible to implement a perfect standard, in which every transaction is fair to both sides, but the *CNX Gas* standard is no better than the dual standards; it forces consistency at the expense of efficiency.[191]

[190] *See* Hariton v. Arco Elecs., Inc., 188 A.2d 123 (Del. 1963) (rejecting the de facto merger theory); Heilbrunn v. Sun Chem. Corp., 150 A.2d 755 (Del. 1959).

[191] *See* Pritchard, *supra* note 87, at 111.

As a Court of Chancery decision, the *CNX Gas* holding is not yet settled law, and the Delaware Supreme Court should be hesitant to affirm the proposed set of rules. However, the court should act soon to clarify the standard because continued uncertainty itself produces more litigation and denies parties the ability to structure their transactions within a clear, final framework.[192] The court should facilitate efficient economic activity when it can, and an unambiguous standard for freezeouts would allow it to do so.

[192] Fox et al., *supra* note 171, at 11 ("With the uncertainty created by apparent dueling standards applied by different Chancery Court judges, the time is ripe for the Delaware Supreme Court to weigh in on this important issue so that dealmakers can structure freeze-out transactions with a greater degree of certainty as to the standard of judicial review that will be applied to the transaction and the path that deal-related litigation will likely take. Until the Delaware Supreme Court resolves this issue, there may be more, not less, litigation in freeze-out transactions, which could delay the closing of the transactions and result in higher settlement costs, potentially impacting the price paid for the minority shares in the deals.").