GOING PRIVATE TRANSACTIONS: DELAWARE'S RACE TO THE BOTTOM?

Jason M. Quintana*

---

* J.D. Candidate 2005, Columbia University School of Law; A.B. 2000, Princeton University. The author would like to thank Zohar Goshen, Visiting Professor of Law, Columbia University School of Law, for his invaluable comments and Yair Galil, Survey Editor, *Columbia Business Law Review*, for his respectful suggestions and guidance.

I. INTRODUCTION

Since the fall of companies such as Enron, Worldcom and Adelphia Communications corporate governance issues have gained national attention. As a result of these corporate crises and corresponding legislative responses such as the Sarbanes-Oxley Act ("Sarbanes-Oxley"), these issues have not only forced many public companies to reevaluate their governance policies, but also their status as a public concern altogether. As in the 1960's and 1970's, going private has once again become a viable option for many public companies. With this trend in mind, it is important for both practitioners and academics to analyze the legal issues surrounding going private transactions within a conceptual framework that both charts the current dynamics of the law and provides some answers as to where the law is headed.[1] For practitioners, the ability to frame and forecast going private developments is paramount to capably handling their clients' current and future needs. For the academician, a competent framework can operate as a prism to view and anticipate issues ranging from market inefficiencies to shifts in value so that they may be applied in a substantive way to the existing corporate legal regimes.

One such framework that has been utilized by both practitioners and academics can be seen in the market for corporate charters. The dynamics and characterizations of this market hinge on whether states are in a race to the bottom or a race to the top. Put another way, this market can be defined by determining whether states design rules that may be inefficient, but favor (and attract) those parties that are ultimately in charge of deciding where to incorporate, or whether those states promulgate optimal rules that buoy shareholder value as their core goal. While the race to the bottom/race to the top argument has been well-canvassed in existing legal, financial and economic literature, it has yet to be applied explicitly to going private transactions.

The purpose of this paper is to apply the debate and its theoretical framework to going private transactions and to argue that states are engaged in a race to the bottom within this context. Going private transactions offer a unique opportunity to analyze this debate specifically because there are multiple mechanisms to take a corporation private—including traditional negotiated mergers, tender offers, asset dispositions, and reverse stock splits.[2] Similarly, going private transactions raise the specter of self-dealing and shareholders may end up with a sub-optimal value because of the coercive nature of such transactions. As former SEC Commissioner A.A. Sommer aptly stated:

---

[1] For a discussion on the current legal and business environment, see Joshua M. Koenig, *A Brief Roadmap to Going Private*, 2004 COLUM. BUS. L. REV. 505.

[2] For the purposes of this analysis, I will consider only mergers, tender offers and asset dispositions. While reverse stock splits are important, they are infrequently used as a mechanism to take a company private.

> Faced with the prospect of a force-out merger, or a market reduced to glacial activity and the liquidity of the Mojave Desert. . .how real is the choice of the shareholder confronting the offer of management to acquire his shares, usually. . .with the corporation's resources that really belong to him and his fellow shareholders? In short, he usually decides he damn well better take the money and run.[3]

Part II of the article offers an overview of the different theories surrounding the state charter competition. It highlights the theoretical foundations for the race to the top and the race to the bottom arguments. It also explores the two major alternative positions on the debate, one of which argues that there really is no race at all, while the other theorizes that the federal government is the catalyst for the development of state law. Part III delineates the actors in the market for corporate charters. It analyzes the roles and interests of state legislators, the state bar, the judiciary, and most importantly, corporate management in deciding where to incorporate. It also seeks to explain why managers may favor a state with permissive going private laws. Part IV investigates the various hypotheses surrounding the debate by setting out what one would generally expect to find in rules that either restrict or favor managers. In order to generate these hypotheses, it is necessary to consider the various procedural, substantive, judicial oversight and remedial aspects of a particular state's legal regime. Part V of the article provides an empirical basis for the race to the bottom argument by explicitly examining various state rules and how they impact the manager's decision to reincorporate in order to go private. Particular emphasis is placed on Delaware law. The section traces the evolution and current status of Delaware's going private rules. This account will then be compared to other states' rules and how they approach going private transactions. It will demonstrate why

---

[3] A.A. Sommer, Jr., *"Going Private": A Lesson in Corporate Responsibility*, [1974-1975 Transfer Binder] Sec. Reg. & L. Rep. (BNA) No. 278, at D-3 (Nov. 20, 1974).

Delaware maintains its hegemony on corporate charters. Part VI then concludes by bringing these factors together.

II. AN OVERVIEW OF THE PREVAILING THEORIES OF COMPETITION

The debate on the merits of a market for incorporation arises out of traditional choice-of-law rules which dictate that a firm can incorporate wherever it chooses and that the corporation's affairs are governed by the law of its state of incorporation.[4] Under corporate legal principles, a company cannot reincorporate without a managerial proposal and shareholder approval. Thus, in making this choice, the manager plays one of the most important roles in the ultimate relocation of the firm. There are two competing hypotheses for why a manager would initiate such a proposal. First, managers may want to reincorporate to benefit themselves at the expense of shareholders. This entrenchment argument views the choice of the firm's legal domicile as a tactical step by management to dilute shareholder oversight and insulate itself from competition in the market for corporate control.[5] The second possible rationale relates to an efficiency gain from selecting a jurisdiction that minimizes organizational and operational costs.[6]

With these considerations in mind, two competing theories attempt to characterize the market for incorporation and the resulting state legal regimes that the competition produces: (i) that states are in a race to the bottom; or (ii) that they are in a race to the top. In addition, there are two theories which have recently developed in the literature which are capable of operating in the alternative to the two traditional race theories. One argues that there is no race at

---

[4] MELVIN A. EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 101 (8th ed. 2000).

[5] Randall A. Heron & Wilbur G. Lewellen, *An Empirical Analysis of the Reincorporation Decision*, 33 J. FIN. & QUANT. ANAL. 549, 549-50 (1998).

[6] *Id.* at 550.

all, while the other implicates the federal government as the true driver of a state's formation of corporate law.[7]

A. The Race to the Bottom

Under the race to the bottom theory, authorities have argued that states in the midst of a competition for corporate charters have designed their corporate law to favor managers instead of shareholders. As states are induced to join in the competition, the end result is an economically inefficient corporate law regime.[8] William L. Cary advanced this argument in his seminal article analyzing how Delaware is leading the race to the bottom. He stated: "Delaware is both the sponsor and the victim of a system contributing to the deterioration of corporation standards. This unhappy state of affairs, stemming in great part from the movement toward the least common denominator, Delaware, seems to be developing on both the legislative and judicial fronts."[9] This movement, Cary argued, has left shareholders in a vulnerable position subject to self-interested managers.

B. The Race to the Top

The race to the top theory, in contrast, suggests that state competition encourages a legal regime that is composed of value-enhancing rules.[10] First delineated by Ralph K. Winter Jr. as a response to Cary's article, this corporate federalism argument seeks to dispose of the race to the bottom theory on several levels.

First, if states such as Delaware permit corporate management to profit at the expense of shareholders and other states do not, then earnings of corporations chartered

---

[7] As will be observed in Section II.C., *infra*, the argument that the federal government is the driver of state corporate law formation can also act in conjunction with the race to the bottom theory.

[8] *See, e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

[9] *Id.*

[10] *See, e.g.*, Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

in Delaware will be less than those of comparable companies chartered in other states. Delaware corporations will therefore trade at a discount on the market. Second, corporations with lower earnings will be at a disadvantage in raising debt or equity in the capital markets. Third, the inability of a corporation to raise capital places the company at a disadvantage in competing in the product markets and thereby leads to a decline in share price. This price decline will lead to the specter of a successful takeover, which would replace incumbent management. In order to avoid this result, managers will therefore seek out legal regimes, which are more attractive to capital. Finally, states seeking corporate charters will respond by providing legal systems, which optimize the shareholder-corporation relationship.[11]

Under the race to the top argument, therefore, states such as Delaware are successful in the competition not because they provide legal regimes that adhere to the least common denominator, but instead because they induce "managers of a firm [to] take advantage of the competition among states to locate in a state which offers an efficient set of restrictions on the firm, given the firm's anticipated production-investment and financing decisions."[12] As a corollary, these efficient rules maximize shareholder value. It is this increase in value, according to proponents of the theory, that is the "genius" of the federal organization of corporate law.[13]

Even if it is assumed that, on balance, a race to top exists amongst states, the theory may nevertheless have significant structural problems within some settings.[14] Lucian Bebchuk

---

[11] *Id.* at 256.

[12] Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259, 282 (1980).

[13] *See generally* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993).

[14] *See* Lucian Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1441 (1992). *See also* Lucian Bebchuk & Allen Ferrell, *Federalism and*

has argued that failures in state competition may occur where management's interests are not aligned with shareholder interests and that management may seek a legal regime that serves their personal interests, even if the rules chosen are value-decreasing.[15] This happens when: (i) issues faced by the corporation are significantly redistributive (i.e., the impact on managers' or controlling shareholders' private interests is not insignificant to the relative impact on shareholder value); (ii) issues directly affect the strength of market discipline; and (iii) issues implicate not only interested parties such as managers or controlling shareholders, but also third parties.[16] These "issues" may arise in numerous situations ranging from insider trading to anti-takeover mechanisms. Going private transactions, under Bebchuk's theory, are also one of these exceptions.

C. Alternative Theories on the Market for Incorporation

The premise of this paper assumes that a state-state competition does indeed exist. The only question it seeks to unravel is whether there is a race to the top or to the bottom. However, some commentators have suggested different alternatives to the traditional debate. Marcel Kahan and Ehud Kamar have argued that currently no states are engaged in a competition for corporate charters other than Delaware.[17] They state that modern "state competition scholars have misconstrued the incentives of states to attract incorporations, misinterpreted their actions, misunderstood the economic and political barriers that states face, and arrived at mistaken conclusions about the market for

Corporate Law: The Race to Protect Managers from Takeovers, 99 COLUM. L. REV. 1168 (1999).

[15] Bebchuk, *supra* note 14, at 1441.

[16] *Id.* at 1435; *see also* Bebchuk & Ferrell, *supra* note 14, at 1172-73.

[17] Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 684 (2002).

incorporations."[18] Thus, they portray the incorporation market as one where states other than Delaware stand to gain very little by competing, and at most take "half-hearted steps" in attracting corporations.[19]

In the alternative, Mark Roe has advanced another theory, which argues that the federal government is the true driver of state corporate law development. This federal-state argument reconceptualizes the traditional debate by arguing that states respond to the threat of the "federal-veto" power. As Roe states, "[w]hether or not the states are racing, and whether they are racing to the top or to the bottom, we live in a federal system where Washington can, and often does, take over economic issues of national importance."[20] Thus, Roe argues that there has never been a true state-state race in the corporate arena, specifically because there has always been a federal component to the formation of state law.[21] As part of his evidence, he cites a "sharp federal incursion" in the area of going private transactions by the SEC in promulgating Rule 13e-3, "Going Private Transactions by Certain Issuers."[22]

However large the specter of federal incursion looms, the mere existence of the federal threat does not fully dispose of a race to the bottom. Roe acknowledges this fact when he states that, "[e]ven if empirical evidence showed incontrovertibly that Delaware was racing to the bottom, we

---

[18] *Id.* at 685. It is important to note that they do not argue that there was never a competition, nor that a competition will never arise in the future. *Id.*

[19] *Id.* For a similar argument, see Lucian Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553 (2002).

[20] Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 591 (2003).

[21] *Id.* at 592.

[22] *Id.* at 616-19. Roe also states that the *Singer* rule was developed by the Delaware Supreme Court "as an attempt to deter further federal usurpation of Delaware's corporate law power." *Id.* at 618 (citing RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 1256 n.40 (2d ed. 1995)). This assertion, and its limitations, are dealt with, *infra*, Section IV.B.ii. and Section IV.B.iii.b.

would not know whether the state reluctantly dropped down because of state-to-state competition or because it feared that congressional politics, errant judicial decisions, or an out-of-control SEC would have ousted Delaware had it risen to the top."[23] Thus, an examination of the drivers behind a race to the bottom, whether in its pure form or hybridized with the federal system, is no less important to developing a more complete picture of the formation of a state's legal regime.

III. THE ACTORS INVOLVED IN THE COMPETITION FOR CORPORATE CHARTERS

It is important to analyze the various actors involved in the competition for corporate charters. Commentators have generally recognized four distinct groups that are involved in the market for incorporation. Each of these groups ultimately has some control over the path that the legal regime has taken in a particular jurisdiction. On the supply side—those that are responsible for making the law—the relevant actors include the legislature, the corporate bar and the judiciary. On the demand side, managers of corporations are the major consumers of the particular state's legal regime. Each group has its own interests and constituencies that influence its decisions, and as such, these interests may be reflected in the rules which are promulgated.

A. The Supply-Side Actors

1. The Legislature

Most of the relevant commentary on the race to the bottom/race to the top argument has focused on state statutory developments.[24] The role of the legislator within this context therefore becomes important to the state's success in retaining and adding new corporate charters.

---

[23] Roe, *supra* note 20, at 592.

[24] *See generally* ROMANO, *supra* note 13 (discussing anti-takeovers); Bebchuk & Ferrell, *supra* note 14 (discussing anti-takeovers).

There are several compelling reasons why legislators may be interested in competing for corporate charters by drafting and passing statutes that favor companies and their management.

According to Cary, the primary reason for this behavior is that there is an enormous pecuniary interest in luring corporations to incorporate in a state. As an example, over the period 1960-1990, an average of 15.5% of Delaware's state tax revenue was derived from franchise tax revenues.[25] As Cary noted on Delaware, for "revenue reasons, 'creating a favorable climate' is declared to be the public policy of the state."[26] Furthermore, although the franchise tax as a percentage of total revenues decreases for larger states,[27] legislators may be driven by other reasons as well. Looking at interest group theory, legislators may seek to increase their political capital by adopting statutes that favor management.

However strong the legislator's incentive is to strengthen their influence, some observers have suggested that the state legislature is one of the least powerful and aggressive groups out of the four considered here. Particularly in Delaware, the legislature is not the juggernaut of corporate law innovation, but instead a passive body which provides a perfunctory check on any piece of proposed legislation that comes through its chambers.[28] Few legislators, either in the state Senate or the House, are denominated full time, and even fewer could even be considered to have enough substantive corporate law knowledge to render an informed decision about the Delaware General Corporation Law.[29] In fact, one committee member has noted that "if a corporate law bill has the support of the Delaware Bar Association and

---

[25] ROMANO, *supra* note 13, at 6-8.

[26] Cary, *supra* note 8, at 669.

[27] *See* ROMANO, *supra* note 13, at 10.

[28] Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 897-98 (1990).

[29] *Id.* at 898.

the Secretary of State's office, then it is passed without amendment or debate."[30]

2. The State Corporate Bar

The state bar holds a significant amount of power in the formation of state rules. Particularly in Delaware, the General Corporation Law Section of the Delaware Bar Association is the source of most of the statutory innovation, reforms, revisions, amendments and debates regarding corporate law.[31] Significantly, however, Delaware's Corporation Law Section is not the body from which any amendments are proposed regarding the state's franchise tax.[32] This fact may substantiate Cary's thesis regarding the importance given by state legislatures to the franchise taxes, but it does not dispose of the corporate bar's influence.

Such influence can be observed within an interest group theory of the market for corporate charters. Distilling this theory, Jonathan Macey and Jeffrey Miller, applying a supply-side model of rule formation to the market for corporate charters, have suggested that the importance of judges, legislators and managers is only part of the equation. Instead, they hypothesized that "the rules that Delaware supplies often can be viewed as attempts to maximize revenues to the bar, and more particularly to an elite cadre of Wilmington lawyers who practice corporate law in the state."[33] Thus, the corporate bar comes to play an important role in shaping the state's rules.

3. The Judiciary

The judiciary is the third major actor on the supply-side of state rule formation. Going private transactions offer a

[30] *Id.*

[31] *Id.* at 900.

[32] *Id.*

[33] Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 472 (1987); *see also* Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85 (1990).

unique perspective on this aspect of state rules because many states do not have statutes that specifically deal with these transactions. States such as Delaware deal with going private transactions in the same manner as any other statutory merger, but make use of case law involving going private transactions to augment and supplement its Code. Because of these factors, it is important to analyze how individual judges may be interested parties in the competition for corporate charters.

It may be argued that judges are not involved in the competition for state charters because they are isolated from the political pressures to which the legislative and executive branches are exposed. According to this argument, judges will be guided by their own sense of integrity, and as such the race to the bottom/race to the top only affects statutory developments and not case law.[34] As Bebchuk states, however, "[i]t is far from clear . . . that even state judges of great integrity . . . will ignore the state's interest in attracting incorporations."[35]

There are several reasons that judges may be interested parties. First, a judge considering a statute may believe that looking to legislative intent is part and parcel of the interpretive process. Thus, a judge may believe that the legislative intent of a particular statute is to increase and maintain corporate charters.[36] Put another way, the court may take it upon itself "to carry out the 'public policy' of the state and create a 'favorable climate' for management."[37] Second, judges may not be entirely insulated from the political process. Bebchuk observes: "It is only human for judges, at least sometimes and on the margin, to not want to disappoint those who are responsible for their employment. Furthermore, . . . judges might well be aware that if they rendered decisions that produced a prospect of corporate migration, their decisions would likely be wholly or partly

[34] Bebchuk, *supra* note 14, at 1453 n.74.

[35] *Id.*

[36] *Id.*

[37] Cary, *supra* note 8, at 670.

reversed by the legislature."[38] Similarly, judges may be cognizant of the strength of the state bar due to their significant participation in the election of judges to the bench. For these reasons, judges may play an active role in helping to maintain corporate charters in a particular state and may not be entirely insulated from state politics.

B. The Demand-Side Actors

With the supply-side actors now placed in proper perspective, it becomes important to examine the roles of the consumers of a legal regime. Namely, managers play the most important role on the demand-side. This section highlights two of the most important managerial decisions that occur within the corporate charter debate and their bearing on going private transactions. The first concept involves the nexus between the manager's decision to incorporate/reincorporate in a particular state and the state's incentives to attract charters, while the second comprises reasons that motivate a manager's decision to undertake a going private transaction in the first place.

1. The Reincorporation Decision

The basis for the argument that states have an incentive to favor managers stems from the premise that the primary goal in state competition is to attract and maintain corporate charters. In particular, there is more of an incentive for dominant states such as Delaware to maintain its current portfolio of charters rather than attract new ones. Bebchuk and Ferrell, speaking to Delaware, state that the "potential loss by Delaware of chartered companies through reincorporation, for any given period of time, is greater than

---

[38] Bebchuk, *supra* note 14, at 1453 n.74. One such example of this legislative reversal occurred in the aftermath of *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (increasing liability of directors for breach of duty of care). In response to this decision, the Delaware legislature promptly adopted Deleware General Corporation Law §102(b)(7). DEL. CODE ANN. tit. 8, § 102(b)(7) (1991) (enabling companies to limit the liability of their directors under certain circumstances).

the potential gain from initial incorporations. While the number of initial incorporations in any given year is likely to be fairly limited, the number of companies that Delaware could potentially lose through reincorporation . . . is significant."[39] Because of the manager's integral role in determining whether or not to reincorporate, it would stand to reason that a state that vies to maintain its corporate charters will cater to management interests.

Conversely, states that have few corporate charters also benefit from promanagement rules. Where management and shareholder interests diverge, a state that favors shareholders will place itself at a significant disadvantage in the market for reincorporations and incorporations in two ways. First, it jeopardizes the existing corporate charters and may force existing corporations to reincorporate elsewhere. Similarly, the state will also fail in attracting newly-formed corporations to incorporate within its jurisdiction.[40] Thus, nondominant states would profit by designing rules that also offer managers significant incentives to relocate their businesses.

The argument that states tailor their laws to fit managerial preferences does not, without more, lead to the conclusion that these rules are not value maximizing. Put another way, so long as a manager's interests are aligned with shareholders', states that design rules which favor managers will most likely lead to increased shareholder value.[41] There are a multitude of circumstances, however, that provide sufficient opportunity for managers to divest themselves from shareholder interests. Thus, managers may prefer states that allow them to accomplish this goal.

2. The Going Private Decision

One way in which managers may succeed in relieving themselves from their obligations to shareholders is by effecting a going private transaction: Such a transaction

---

[39] Bebchuk & Ferrell, *supra* note 14, at 1173.

[40] *Id.* at 1174.

[41] *Id.*

may serve as a signal that managers are willing to sacrifice shareholder value in order to salvage their leadership positions or obtain a larger share of surplus value. Furthermore, going private transactions serve as well-designed proxies for refuting traditional explanations in support of the race to the top/corporate federalism theory. The theory fails within the going private context when one considers: (i) the justification by race to the top proponents that market incentives sufficiently induce managers to maximize shareholder value;[42] and (ii) when one accounts for transaction costs, particularly information asymmetries.

(i) Market Considerations

Beginning with the concept of market incentives, one of the major criticisms of Cary's analysis is that he failed to examine the multiple markets in which corporations operate. Roberta Romano has stated that it is the existence of these markets that "constrain managers from choosing a legal regime detrimental to the shareholders' interest."[43] Specifically, she, Winter and other commentators have looked to the capital markets, the market for corporate control and the product markets as restraining managers.

State competition proponents, analyzing the role of the capital markets, argue that the market will penalize managers who seek value-decreasing rules by hindering the firm's ability to raise additional capital.[44] This argument, however, does not hold where companies have already had these incentives taken away by the market itself. Significant liquidity issues or a lack of access to the equity or debt capital markets may force managers to consider options that may leave shareholder value on the table.

One possible rebuttal to this rationale is that going private transactions actually optimize value by offering a premium to minority shareholders that they may never see so long as the company is a public concern. However, this

---

[42] *Id.* at 1174; *see, e.g.*, ROMANO, *supra* note 13, at 2.

[43] ROMANO, *supra* note 13, at 14 (citing Winter, *supra* note 10, at 251).

[44] Winter, *supra* note 10, at 275.

assertion is also incomplete. Purchasers, including interested managers, controlling shareholders and third parties, have an incentive to seek the lowest price possible once it is decided that the firm should go private. There arises, then, an incentive for managers and controlling shareholders to find the legal regime that affords the highest probability of attaining the lowest price. State rules that limit appraisal rights, offer lower standards of review, or shift burdens of proof will be favored by managers engaging in going private transactions.

Race to the top proponents also argue that the market for corporate control offers a significant incentive for managers to incorporate in a state that offers optimal rules. Under this theory, managers who choose a state with suboptimal rules will unnecessarily reduce share value and thus expose the company to takeover bids and proxy contests.[45] Implicit in the argument is the assumption that there will be a market for the shares following a reincorporation. A going private transaction is unique, however, because it deprives investors of such revaluation. Moreover, even if a going private transaction were postponed subsequent to reincorporating, any eventual decision to go private would favor managers in their search to purchase shares at the lowest price possible.

State competition proponents also state that product markets act as a constraint on a manager's decision to choose value-decreasing rules. If a manager acts inefficiently, the business will contract or fail.[46] However, Bebchuk has argued that, "[a]lthough product market competition does provide managers with some valuable incentives, it cannot discourage managers from seeking value-decreasing rules that are significantly redistributive in their favor."[47] In general, then, shareholder value-decreasing rules would not alter the cost and quality of the company's products but

[45] *Id.* at 266.

[46] Bebchuk, *supra* note 14, at 1466; *see also* Winter, *supra* note 10, at 264.

[47] Bebchuk, *supra* note 14, at 1466.

instead the manner in which the value produced by the company is divided between managers and shareholders.[48] Furthermore, going private transactions create the added possibility of a transfer in value from shareholders to managers precisely by increasing operational efficiency. This increase is achieved through reduced administrative or compliance costs which may result in a surplus that can be captured by private managers.

As a final consideration, the federal legal regime has undercut the effects of many of the market incentives that were once present. Legislation such as Sarbanes-Oxley, while attempting to fix one market inefficiency, may force managers to consider alternative means of increasing value. Managers may search for state rules that afford the best opportunity to decrease, or outright expunge, the risk found in federal rules. This transfer may come at the expense of shareholders—the very party whom the bulk of federal securities regulation was designed to protect—as an unintended by-product. Sandata Technologies chief executive Bert Brodsky, reflecting on going private, put it best: "I'm looking forward to running my own company the way I see fit. . . . I'll be liable only to myself."[49]

(ii) Transaction Costs

Another significant problem may arise in a going private transaction that is effected under the shadow of high transaction costs. The existence of asymmetrical information is one such situation where there may be a shift in value from shareholders to managers. The theoretical foundation for this argument is rooted in a shareholder's ability to properly price a security and estimate the defenses to a derogation in value that are carried with the security. In a perfectly efficient market (one without transaction costs), shareholders are able to correctly make this analysis

---

[48] *Id.*

[49] Tamara Loomis, *Sarbanes-Oxley Burdens Small Companies*, N.Y. LAW., Dec. 19, 2002, *available at* http://www.nylawyer.com/news/02/12/121902d.html.

and then choose an investment course that will optimize returns.[50] In reality, however, markets are not perfect, and the efficiency level of a capital market is a function of the economic and legal conditions in a given jurisdiction.[51]

This failure to accurately price the security "is due, in large part, to information costs."[52] Managers that are more familiar with the business or its prospects may be willing to take advantage of a legal regime that increases information costs so that they obtain a larger portion of the surplus value of a deal. Both pro- and anti-state competition commentators have argued that states like Delaware mitigate this problem by offering a legal regime that is certain, stable and predictable, thus allowing shareholders to accurately price their investment.[53] However, there is a significant body of work to the contrary. Delaware courts have consistently filled the state's jurisprudence with principles that are open-ended and unclear and that are often subject to the court's equitable powers and case-specific limitations.[54] One example is Delaware's adherence to an "entire fairness" standard for reviewing self-dealing transactions. The standard delineates a flexible approach in determining whether there was a fair price and fair dealing and affords less protection to minority shareholders in comparison to a rule that requires a majority of the minority to approve the deal.[55] Thus, an opportunistic manager operating under the fairness standard may be able to exploit her information advantage by incorporating under a legal regime that imposes high transaction costs on minority shareholders.

---

[50] Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CAL. L. REV. 393, 405 (2003).

[51] *Id.*

[52] *Id.*

[53] Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 273-79 (1985).

[54] Bebchuk & Ferrell, *supra* note 14, at 1191; *see also* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1913-23 (1998).

[55] Goshen, *supra* note 50, at 422.

IV. SETTING UP THE EMPIRICAL ANALYSIS: THE HYPOTHESES

A. Scale and Scope of the Analysis

With the role of the legislators, state bar associations, judges and managers delineated, it is now possible to set forth what types of going private rules one can expect to see under the race to the bottom and race to the top arguments as applied to Delaware. Regardless of the expected outcome, the scale of the analysis occurs in multiple dimensions. The first focuses on the internal development of Delaware going private rules, and demonstrates how Delaware law has evolved. This argument alone, however, does not necessarily prove that Delaware is leading the race to the bottom or to the top. The second dimension of the analysis compares Delaware rules to other states' development of similar jurisprudence.[56]

The scope of the investigation should cover four topical areas of rule formation. Namely, these variables govern the procedure, substance, judicial oversight and remedies within the corporate legal regime. Procedural requirements include rules that delineate the process by which a going private transaction may be achieved. They also encompass ways in which a party to a transaction can complete a transaction that is more likely to withstand scrutiny, such as shifting the burden of proof by independent committees or neutralized voting. Substantive requirements embody an inquiry into rules that address the substantive terms of a transaction, such as the concept of fair price. Judicial oversight speaks to the degree of permissiveness applied to the rules by judges. Thus, even if the proper standard of review in a case is entire fairness, states may differ in how liberally they apply the standard. Finally, the remedial consideration examines

[56] The inquiry is not a complete survey of all the relevant state rules. Instead it seeks to juxtapose Delaware rules with those states that differ significantly in their treatment of going private transactions.

when and how the rules as applied may warrant appraisal rights or an equitable remedy to plaintiffs.

B. Expected Rules under the Race to the Bottom and the Race to the Top

The ultimate determination of which side of the debate best characterizes the current and future status of Delaware law hinges on what types of rules one would expect to see under each argument. Beginning with the race to the bottom argument, one needs to go beyond the broad generalization that states engaged in this type of race will promulgate rules that favor managers. This broad generalization fails to show that rules that favor managers do not necessarily work to the detriment of shareholders. Thus, it is also true that the rules in a race to the bottom regime provide managers with the opportunity to: (i) shift value away from shareholders to themselves; or (ii) enlarge the corporate pie to such a point that it ultimately induces an increase in value for managers but not shareholders. In either case, states that provide permissive going private rules such as procedural safe harbors, substantive rules that provide for a range of "fair" prices, limited judicial oversight and rules that only allow for appraisal rights, favor managers by allowing them to sacrifice shareholder value in support of their individual goals.

Conversely, a race to the top framework predicts rules that optimize shareholder return. Under this argument, management's interests do not diverge from shareholders'. However, in order to assure that this agency problem does not arise, rules of procedure and substance may be more stringent, and the courts' oversight may be more exacting in order to protect shareholder interests should managers deviate from their duties. In addition, shareholder remedies under this regime may be broader than those under the race to the bottom formula. With these hypotheses set out, it is now possible to analyze Delaware law.

V. GOING PRIVATE LAW APPLIED: DELAWARE AS A LEADER TO THE BOTTOM

Because a going private transaction can be accomplished in numerous ways and may implicate different facets of the law, the analysis of the evolution of Delaware law and its comparison to other states will be arranged by the different mechanisms available to effect a going private transaction. Generally, there are four different ways to take a company private: negotiated mergers, tender offers, asset dispositions and reverse stock splits.[57] Despite the mechanical differences, each transaction type exhibits the common themes of manager opportunism and rule permissiveness that are exhibited in the race to the bottom argument.

Before analyzing these transactions, however, it is necessary to provide a brief background on the various standards of review that have been developed by the courts. The standards of review are important to the debate on the market for corporate charters for various reasons. First, they serve as an approximate benchmark, or signpost, by which judges are able to undertake their scrutiny of a particular transaction. Second, the various standards of review inevitably encompass the four variables of rule formation outlined above—process, substance, judicial oversight and remedy—in varying degrees. Thus, the values assigned to each variable within the application of the standards of review, and even the ultimate decision of which standard applies, become determinative of the level of permissiveness that characterizes the different approaches of a state's legal regime.

A. Synopsis of the Basic Standards of Review

Most authorities recognize three basic standards of review that courts apply when determining the validity of a transaction. The most permissive standard utilized is the business judgment rule, while the most restrictive is the

[57] As previously noted, for the purposes of this analysis this article will only be considering mergers, tender offers and asset dispositions.

entire fairness standard. Courts have also applied an intermediate, or heightened, level of scrutiny to certain aspects of transactions. Known as the director's *Unocal*[58] and *Revlon*[59] duties, this type of scrutiny looks, respectively, to the manner in which directors respond to the threat of a hostile takeover,[60] and when directors must relinquish their defenses in favor of obtaining the best price for a company.[61] While such scrutiny is important, this analysis focuses solely on the business judgment rule and the entire fairness standard because of their universal applicability to the transactions that are explored.

1. The Business Judgment Rule

In general, directors making ordinary, day-to-day business decisions are held to the business judgment rule.[62] In order to satisfy the standard, directors must uphold their duties of care and loyalty to the shareholders of the corporation.[63] In complying with their duty of care, directors must "inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with the requisite care in the discharge of their duties."[64] Similarly, the duty of loyalty is fulfilled if directors do not "appear on both sides of the transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the

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

[59] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985).

[60] *Unocal*, 493 A.2d at 954 (stating that directors have the authority to respond to a threat reasonably perceived).

[61] *Revlon*, 506 A.2d at 182 (noting that when duty of board changes from "defenders of the corporate bastion to auctioneers," directors have duty to get best price at sale of company).

[62] *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see also* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

[63] ARTHUR M. BORDEN & JOEL A. YUNIS, GOING PRIVATE, § 4.13[2] (2003).

[64] *Aronson*, 473 A.2d at 812.

corporation or all stockholders generally."[65] Under this standard, plaintiffs have the burden of proving gross negligence on the part of the directors.[66]

2. The Entire Fairness Standard

Where the threat of director and controlling shareholder self-interest is raised, or where directors fail to properly discharge their duties under the business judgment rule,[67] Delaware courts have traditionally applied the entire fairness standard.[68] This standard comprises two elements which the self-interested party must show: fair price and fair dealing. The court in *Weinberger v. UOP, Inc.*,[69] explaining the two concepts of fairness, stated that fair dealing "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. . . . [Fair price] relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock."[70] The *Weinberger* court further noted that the test is not a bifurcated one, but must be examined as a whole since the question is one of entire fairness.[71] Furthermore, director self-dealing is found to exist where directors have "stood on both sides of the transaction, dictated its terms, and derived a benefit to the exclusion of shareholders."[72] The entire

---

[65] *Id.*

[66] *Id.*

[67] Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156 (Del. 1995).

[68] As a corollary, Delaware courts have not utilized the entire fairness standard where the threat of self-dealing is not present. *See, e.g.*, Gilbert v. The El Paso Co., Nos. CIV.A.7075, 7079 & 7078, 1988 WL 124325 (Del. Ch. Nov. 21, 1988), *aff'd* 575 A.2d 1131 (Del. 1990).

[69] *Weinberger*, 457 A.2d 701.

[70] *Weinberger*, 457 A.2d at 711; *see also* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156 (Del. 1995).

[71] *Id.*

[72] *Gilbert*, 1988 WL 124325, at *8.

fairness standard as analyzed and refined under *Weinberger* is also the prevailing standard of review for most jurisdictions considering going private transactions.[73]

B. Going Private Mergers

The question of fairness is not completely unbending, particularly when one examines Delaware's permissiveness within the context of going private mergers. Significant inroads have been carved out of the standards of review from a procedural, substantive and remedial perspective, and as a result may adversely impact shareholder value. In order to determine the values attributed by the various state legal regimes to these variables and their implication of the various standards of review, two different facets of self-interested merger jurisprudence can be analyzed: (i) the appointment of independent directors as a means of shifting the burden of proof; and (ii) the requirement, or lack thereof, of a business purpose rule. This is followed by an analysis of the ultimate impact of the standards of review on shareholder value in mergers, with particular focus on the available shareholder remedies.

1. Appointment of Independent Directors

Under Delaware law, appointing independent directors to review a proposed transaction is a common practice. The

---

[73] *See, e.g.,* In re Valuation of Common Stock of McLoon Oil Co., 565 A.2d 997, 1003-04 (Me. 1989) (citing with approval *Weinberger*'s broad approach to share price valuation methods); Walter J. Schloss Assoc. v. The Chesapeake & Ohio Ry Co., 536 A.2d 147, 157 (Md. Ct. Spec. App. 1988) (allowing damages in addition to fair value through appraisal rights in certain circumstances); Coggins v. New Eng. Patriots Football Club Inc., 492 N.E.2d 1112 (Mass. 1986) (similar standard of review to *Weinberger* where director/controlling shareholder stood on both sides of the transaction); In re Seagroatt Floral Co. Inc., 576 N.Y.S.2d 831, 834 (N.Y. 1991) (allowing for a flexible share valuation analysis of a closely held corporation, and then upholding an illiquidity discount on the minority shares); Stepak v. Schey, 553 N.E.2d 1072, 1080 (Ohio 1990) (stating that appraisal rights may not be appropriate under certain circumstances involving over-reaching).

ultimate goal of appointing such a committee is to create a structurally fair transaction under which the business judgment rule would be applied, or at the very least to achieve a presumption of fairness even if a heightened standard of review is applied in lieu of the business judgment rule.[74] Despite the historical use of such committees, it is only recently that the courts have begun to explicitly circumscribe the exact legal consequences of a properly functioning committee of independent directors.

Beginning with the *Weinberger* decision, the court considered the validity of a parent-subsidiary merger in which two of the subsidiary's directors, who were also directors of the parent, did not share an internal study with the subsidiary's outside directors. The study suggested that a higher purchase price than what the parent, Signal, ultimately purchased the subsidiary, UOP, for was feasible. The court found that there was a breach of fiduciary duty on the part of the UOP directors, "because there were common Signal-UOP directors participating, at least to some extent, in the UOP board's decision-making processes without full disclosure of the conflicts they faced."[75]

While the court did not explicitly state what standard of review would be used if UOP had appointed a committee of independent negotiating directors, the court did note that if such a committee were appointed the result "could have been entirely different."[76] The court reasoned, "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

---

[74] *See* Andrew R. Brownstein, Mitchell S. Presser & David E. Shapiro, *The Use of Special Committees in Management LBOs and Other Conflict Transactions; An Update*, *in* FOURTH ANNUAL PRIVATE EQUITY FORUM: LEGAL & FINANCIAL STRATEGIES FOR DEALMAKING IN THE CURRENT MARKET, at 1339 (PLI Corp. Law and Practice Course, Handbook Series No. B0-01FF, 2002).

[75] *Weinberger,* 457 A.2d at 709.

[76] *Id.* at 715 n.7 (citing Harriman v. E.I. Du Pont de Nemours & Co., 411 F.Supp. 133 (D. Del. 1975)).

apparently was neither considered nor pursued."[77] At the very least, the appointment of such a committee would be strong evidence that the transaction meets the fairness standard.[78]

The confusion of what standard applies in parent-subsidiary mergers was laid to rest in *Kahn v. Lynch Communication Systems, Inc.*[79] The *Kahn* court noted that there were differing views on the subject: "One view is that such approval shifts to the plaintiffs the burden of proving that the transaction was unfair. . . . The other view is that such an approval renders the business judgment rule the applicable standard of judicial review."[80] The current rule, as stated in *Kahn*, is that the board of directors, through the appointment of an independent committee in a parent-subsidiary merger, does not escape the entire fairness standard but instead is able to shift the burden of proving entire fairness to the challenging shareholder-plaintiff.[81]

In conclusion, the evolution of Delaware law appears to offer some procedural protection to minority shareholders from the inherent coercion that is likely to exist in the merger context when a controlling shareholder engages in an acquisition. However, this is not the case with other aspects of Delaware's merger jurisprudence.

---

[77] *Id.* (citing Johnston v. Greene, 121 A.2d 919, 925 (Del. 1956)).

[78] *Id.* (citing Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 886 (Del. 1970) and Puma v. Marriott, 283 A.2d 693, 696 (Del. Ch. 1971)).

[79] 638 A.2d 1110 (Del. 1994).

[80] *Id.* at 1115-16.

[81] *Id.* The Kahn court was quick to point out, however, that the mere existence of an independent committee does not automatically shift the burden to the plaintiffs. Rather, the court reiterated a two-part test promulgated by the Court of Chancery in *Rabkin v. Olin Corp.*, No. CIV.A.7547, 1990 WL 47648 (Del. Ch. Apr. 17, 1990), *aff'd* 586 A.2d 1202 (Del. 1990). In *Olin*, the Court of Chancery stated: (i) the majority shareholder must not dictate the terms of the merger; and (ii) the special committee must have real bargaining power that it can exercise with the majority shareholder on an arms length basis. *Olin*, 1990 WL 47648, at *6. *See also* Kahn v. Tremont Corp., No. CIV.A.12339, 1996 WL 145452 (Del. Ch. Mar. 21, 1996).

2. The Requirement of a Business Purpose in Self-Interested Transactions

Another inroad on the entire fairness standard is evidenced by the Delaware court's move away from requiring a "business purpose" in conjunction with the entire fairness standard as a prerequisite to a valid merger. Principally, in *Singer v. Magnavox Co.*,[82] the Delaware Supreme Court stated that in order for a conflict of interest merger to be valid, it not only had to pass the entire fairness standard, but also that the proponents of the transaction had to cite some legitimate business purpose for the transaction.[83] Thus, in this second-step cash out by a controlling shareholder, the court ruled that "the use of corporate power solely to eliminate the minority is a violation of. . . [fiduciary] duty."[84]

In addition to circumscribing the entire fairness standard, *Weinberger* effectively abolished the business purpose rule utilized by *Singer* and its progeny. *Weinberger* noted that significant shareholder protections now existed that rendered the *Singer* rule impotent. The court stated:

> In view of the fairness test which has long been applicable to parent-subsidiary mergers. . ., the expanded appraisal remedy now available to shareholders, and the broad discretion of the Chancellor to fashion such relief as the facts of a given case dictate, we do not believe that any meaningful protection is afforded minority shareholders by the business purpose requirement . . . .[85]

[82] 380 A.2d 969 (Del. 1977).

[83] *Id.* at 980. For other Delaware cases requiring a business purpose, see, e.g., *Tanzer v. Int'l Gen. Indus. Inc.*, 379 A.2d 1121 (Del. Ch. 1977) [Tanzer I]; *Tanzer v. Int'l Gen. Indus. Inc*, 402 A.2d 382 (Del. Ch. 1979) [Tanzer II]; *Roland Int'l Corp. v. Najjar*, 407 A.2d 1032 (Del. 1979).

[84] *Singer,* 380 A.2d at 980.

[85] *Weinberger,* 457 A.2d at 715.

The court, therefore concluded that the "requirement shall no longer be of any force or effect."[86]

Despite Delaware's return to a pure entire fairness standard, other states have continued to require controlling shareholders to show a legitimate business purpose in effecting a merger. The Massachusetts Supreme Court, considering Delaware's abolition of the *Singer* rule, is exemplary of those jurisdictions that have elected to keep the standard. It stated: "Unlike the Delaware court . . . we believe that the 'business-purpose' test is an additional useful means under our statutes and case law for examining a transaction in which a controlling stockholder eliminates the minority interest in a corporation."[87]

New York has also maintained the business purpose doctrine, but courts have generally applied a loose standard to determine what actually constitutes a business purpose.[88] Moreover, it is questionable what type of business purpose is required in a true going private transaction in New York.[89] The general rule, as applied in a non-going private merger, was stated in *Alpert v. 28 Williams St. Corp.*[90] The *Alpert* court approved a freeze-out merger in which the interested party asserted the attraction of additional capital as their business purpose for the merger.[91] Dealing with the minority shareholders, the Court of Appeals wrote: "In the context of a

---

[86] *Id.*

[87] Coggins v. New England Patriots Football Club, Inc., 492 N.E.2d 1112, 1117 (Mass. 1986). For other jurisdictions requiring a business purpose, see Alabama: *Roussel v. Payne*, 352 So. 2d 1364 (Ala. Civ. App. 1977); California: *Jutkowitz v. Bourns*, 118 Cal. App. 3d 102 (Cal. Ct. App. 1981); Hawaii: *Perl v. IV Int'l Corp.*, 607 P.2d 1036 (Haw. 1980); Washington: *Van Buren v. Highway Ranch, Inc.*, 46 Wash. 2d 585 (Wash. 1955); West Virginia: *State ex. rel. Smith v. Evans*, 547 S.E.2d 278 (W. Va. 2001); Maryland: *Walter J. Schloss Assoc. v. Chesapeake & Ohio Ry. Co.*, 536 A.2d 147 (Md. Ct. Spec. App. 1988) (stating neither that a business purpose is required, nor that one is not, where, under the facts of the case, there was a business purpose for the freeze-out).

[88] BORDEN & YUNIS, *supra* note 63, § 4.16.

[89] *Id.* § 4.16[3].

[90] 473 N.E.2d 19 (N.Y. 1984).

[91] *Id.* at 29.

freeze-out merger, variant treatment of the minority shareholders—i.e., causing their removal—will be justified when related to the advancement of a general corporate interest. The benefit need not be great, but it must be for the corporation."[92]

In *Klurfeld v. Equity Enterprises, Inc.*,[93] the New York court had occasion to consider the business purpose doctrine within the context of a going private transaction. The decision was made prior to *Alpert*, and the standard is at least as narrow as the *Alpert* standard. The Appellate Division stated that there was no legitimate business purpose to the merger where the controlling shareholders, owning a profitable company, were not willing to give personal guarantees for the repayment of corporate loans. The court stated that while this "may be a legitimate personal concern, it is not a true corporate concern."[94] While it is unclear how *Klurfeld* stands in light of the *Alpert* business purpose standard,[95] commentators have generally viewed New York courts to have taken the middle road between jurisdictions such as Delaware that have outright abolished the *Singer* rule and those that keep the full doctrine intact.[96]

3. Analyzing the Standards of Review

(i) The Business Judgment Rule and the Duty of Care

Since William Cary's analysis in 1974, Delaware's posture toward controlling shareholders and directors has only changed slightly. Indeed, it has been a case of one step forward, two steps back, regarding its laissez-faire approach

---

[92] *Id.* at 28.

[93] 436 N.Y.S.2d 303 (N.Y. App. Div. 1981) (remanded on other grounds) (superceded by statute on other grounds).

[94] *Id.* at 310.

[95] BORDEN & YUNIS, *supra* note 63, § 4.16[3].

[96] *Id.*

to harnessing the interests of insiders. The Delaware courts, however, have made progress on the director's duty of care. Cary was highly critical of the decision in *Graham v. Allis-Chalmers Mfg. Co.*[97] as maintaining the "low standard that Delaware shares with most other jurisdictions as to the duty of care on the party of directors."[98] *Graham* denied plaintiffs' claim that the company's directors should have constructively known about various antitrust violations because they had a duty to put into effect a monitoring system that would have uncovered some of the company's employees' illegal conduct.[99] Instead the court stated that:

> [T]he directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. . . . [A]bsent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.[100]

Without explicitly overruling *Graham*, Delaware largely rectified the decision and imposed on managers some duty to monitor corporate activities. In *Caremark International Inc.*,[101] the court refused to impute a broad interpretation to the *Graham* decision, which effectively would have imposed no responsibility on corporate boards to assure that proper reporting systems are in place.[102] The court, interpreting *Graham*, instead took a narrow approach by imposing an affirmative duty to monitor on the board. The court stated, "[I]t is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a

---

[97] 188 A.2d 125 (Del. 1963).

[98] Cary, *supra* note 8, at 683.

[99] *Graham*, 188 A.2d at 130.

[100] *Id.*

[101] 698 A.2d 959 (Del. Ch. 1996).

[102] *Id.* at 969-70.

timely manner as a matter of ordinary operations, so that it may satisfy its responsibility."[103] Thus, Delaware has made some steps in the right direction toward protecting shareholders.

(ii) Entire Fairness and the Business Purpose Rule

The positive step taken in *Caremark* is not wholesale, however. The problem of inadequate shareholder protection can still be found in Delaware's abolition of the business purpose rule in conjunction with entire fairness review. Revocation of the *Singer* rule may be more detrimental than the *Weinberger* court realized. Specifically, derogation in shareholder value may occur without the *Singer* rule when one considers: (i) whether the benefits of the business purpose rule outweigh its costs to minority shareholders; and (ii) whether the fairness standard and the appraisal remedy under *Weinberger*, on their own, really resolve the problem of managerial value expropriation.

Beginning with the cost/benefit analysis of the business purpose rule, the *Weinberger* court may have been too presumptive of the rule's lack of benefit to minority shareholders. From a strictly theoretical perspective,[104] a jurisdiction's adherence to the business purpose rule has both costs and benefits. By requiring parties to provide a legitimate reason for their transaction, the rule would work to the benefit of minority shareholders where the interested party's ultimate purpose, whether implicitly or explicitly stated, is to expropriate shareholder value. On the other hand, the rule may foreclose certain efficient transactions

---

[103] *Id.* at 970.

[104] A survey of existing literature has yielded no explicit empirical analysis of the actual costs and benefits of the business purpose rule. For an examination of the costs and benefits of property-based versus liability-based rules in controlling self-dealing, see Goshen, *supra* note 50, at 427-29 (arguing that Delaware's use of the liability-based entire fairness standard provides the most efficient manner in protecting minority shareholders from self-dealing transactions).

where the interested party, for one reason or another, simply cannot, or chooses not to, provide a business purpose. This may be the case, for instance, where insiders possess valuable nonpublic information. Thus, the business purpose rule is likely to have some utility to minority shareholders where the costs of eliminating efficient transactions are lower than the benefits derived from preventing transactions which attempt to expropriate shareholder value.

The second problem with revocation of the business purpose rule deals with the effectiveness of the entire fairness standard, and the remedies available under that standard, in protecting minority shareholders from an expropriation in value. Primarily, a lone appraisal remedy may not fully value shareholder expectations within the context of going private transactions or freeze out mergers. This is due to the fact that under Delaware law, minority dissenters are only awarded the preinvestment market value of their shares.[105] This is compared to jurisdictions such as New York, which appraise the share value as the preinvestment market value plus any gains made from the going private transaction itself.[106] Thus, appraisal rights in Delaware do not account for the revocation of an ownership interest solely for the attainment of a freeze-out gain.[107]

Some commentators have argued, however, that the Delaware rule is more efficient than the New York approach. In an analysis of appraisal remedies in large-company buyout transactions, Benjamin Hermalin and Alan Schwartz have concluded that optimal investment by the majority is achieved, and the appraisal rule is most efficient, where the

---

[105] *See* DEL. CODE ANN. tit. 8, § 262(h) (1991) (stating that "the Court shall appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation. . . .").

[106] *Cf.* N.Y. BUS. CORP. LAW § 623(h)(4) (McKinney 2003) (entitling the Court to include the value derived from the transaction in its appraisal).

[107] Paul N. Cox, *Reflections on Ex Ante Compensation and Diversification of Risk as Fairness Justifications for Limiting Fiduciary Obligations of Corporate Officers, Directors, and Controlling Shareholders*, 60 TEMP. L. REV. 47, 89 (1987).

minority shareholders are given only the ex ante price of their investment.[108] The argument emphasizes the important role of the majority as investors and states that equitable justifications for the New York rule do not achieve the optimal contract. Pointing to this property theory of corporate contracts, they note that "[i]t is not unfair to exclude a person from gains over which she has no rightful claim."[109] However this analysis, as they suggest, only looks at large companies—many of whom have not undertaken true going private transactions in the current market.[110]

Even taking the Hermalin and Schwartz argument at face value, there may still be abnormal gains to which the minority is entitled. This second argument is predicated on the fact that in an efficient market, revisions in the information available to a particular shareholder may give rise to abnormal returns that the ex ante price did not contemplate.[111] Furthermore, where market inefficiencies do in fact exist, the problem of leaving shareholder value on the table is more acute. Investors are vulnerable not only to the shift in value that would have occurred under an efficient market, but also to the risk of a mispriced security. Put another way, under a regime that only allows appraisal rights, minority shareholders are not only denied abnormal returns but also lose from the market's mispricing of the security in the first place. The business purpose requirement at least attempts to solve the first problem by protecting shareholders *a priori* from any potential redistribution of value. The standard also raises scrutiny as to extra-market factors that may bear on the controlling party's decision to undertake the transaction.

---

[108] Benjamin Hermalin & Alan Schwartz, *Buyouts in Large Companies*, 25 J. LEGAL STUD. 351, 355 (1996).

[109] *Id.* at 362.

[110] *Id.* at 351.

[111] Cox, *supra* note 106, at 87. Cox defines 'abnormal return' as "an actual return in excess of expected return. . . . It is descriptively abnormal because it exceeds the ex ante expectations predicted by the asset pricing model. It is normatively 'abnormal' in the neoclassical sense because there is no entitlement to it." *Id.*

Finally, proponents of a rule that allows for the unequal distribution of gains have argued that minority shareholders can avoid the firm-specific risk and share in any potential gains by diversifying their investment portfolios.[112] Frank Easterbrook and Daniel Fischel, at the forefront of this argument, have stated that "ex post inequality . . . is not 'unfair' if, ex ante, all investors have an equal chance to win and can eliminate risk through diversification."[113] This argument, however, assumes perfect market efficiency and that at least one security in a given portfolio is negatively correlated with the security that is the subject of a corporate control transaction.[114] Thus, their argument is predicated on the assumption that in the market for corporate control, a shareholder, through diversification, is as likely to hold a share of the bidder as she is to hold a share of the target.[115]

Under the classical theory of financial economics, the Easterbrook and Fischel diversification argument is certainly tenable. However, the assertion does not work for true going private transactions. Recognizing the limits of diversification, they state: "There remain cases in which it is impossible for an investor to share in gains or diversify away the risk by holding stock in both firms. This would be true, for example, where one of the firms is privately held."[116] Thus, going private transactions which take a company out of the market altogether may leave shareholders without a viable investment alternative, and therefore unable to diversify.[117]

---

[112] Frank Easterbrook & Daniel Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 712 (1982); *see also* Cox, *supra* note 106, at 81 (commenting that under the assumptions of neoclassical theorists, namely that of efficient markets, the theory of diversification "appears nearly unassailable").

[113] Easterbrook & Fischel, *supra* note 111, at 713.

[114] *Id.* at 712.

[115] *Id.* at 712-13.

[116] *Id.* at 714.

[117] It is important to distinguish between a going private transaction in which the company exits the market completely, and one in which a public acquirer takes a company private. Minority shareholders in the

Easterbrook and Fischel attempt to solve this problem by stating that shareholders should therefore avoid "investing in firms that are controlled by an individual or a privately-held firm."[118] This solution may be sufficient when an investor is making her initial decision on whether or not to invest, but it does nothing to protect those shareholders who have already invested in a public company that is in the process of going private. Furthermore, "[e]ven if investors are not harmed in the senses contemplated by neoclassical theory, they are still harmed in the sense that the repeal of fiduciary obligations would eliminate the contribution of these obligations, if any, to the value of the expected outcome of firm operations."[119] The imposition of the business purpose standard therefore serves, at a minimum, as an additional shareholder protection against an unanticipated transfer in value.

Concluding, Delaware has taken significant steps forward with regard to its development of its business judgment and duty of care jurisprudence. The same cannot easily be said, however, for the courts' use of the entire fairness standard. Rather, the courts' inherent faith in the utility of entire fairness, acting alone, has significantly reduced the protections afforded to minority shareholders. This is evidenced by the revocation of the business purpose rule, without which interested parties may be able to construct transactions which expropriate significant shareholder value.

C. The Use of Tender Offers in Going Private Transactions

The second mechanism for going private is through the use of tender offers. The use of this transaction structure by management and controlling shareholders has traditionally come in two forms. The first is where a tender offer is used

latter transaction may be able to capture some upside potential by holding shares of the acquirer.

[118] Easterbrook & Fischel, *supra* note 111, at 714.

[119] Cox, *supra* note 106, at 81.

as the first step in a second-step takeout, while the second context involves a unilateral offer to the target's shareholders. In either case, however, recent Delaware tender offer jurisprudence is noticeably divergent from traditional merger rules in affording protection to minority shareholders.[120] This deviation is largely the result of low values assigned to the procedural/structural aspects of current Delaware tender offer jurisprudence, as well as to the judicial oversight and remedial variables, all of which have resulted in decreased shareholder value. The three cases that form the current backbone of Delaware tender offer law are *Siliconix, Inc., Shareholders Litigation*,[121] *Aquila, Inc., Shareholders Litigation*[122] and *Pure Resources, Inc., Shareholders Litigation*.[123]

1. *In re Siliconix, Inc., Shareholders Litigation*

Siliconix starkly demonstrates the court's different treatment of fiduciary obligations depending on whether the transaction is structured as a merger or a tender offer. The facts of the case surrounded an all-cash tender offer by a controlling shareholder for the remaining 19.6% of the shares of a subsidiary that it did not already own. In response to the offer, the target established an independent committee consisting of two board members in order to negotiate the transaction.The special committee rejected the original tender offer proposal, and in response, the controlling shareholder initiated a stock-for-stock tender offer without first seeking the consent of the independent committee. The independent committee elected to remain neutral and made no recommendation in its Schedule 14D-9

[120] Kimble C. Cannon, *Augmenting the Duties of Directors to Protect Minority Shareholders in the Context of Going-Private Transactions: The Case for Obligating Directors to Express a Valuation Opinion in Unilateral Tender Offers After Siliconix, Aquila and Pure Resources*, 2003 COLUM. BUS. L. REV. 191, 229.

[121] No. CIV.A.18700, 2001 WL 716787 (Del. Ch. June 19, 2001).

[122] 805 A.2d 184 (Del. Ch. 2002).

[123] 808 A.2d 421 (Del. Ch. 2002).

SEC filing.[124] Similarly, the committee did not request a fairness opinion from its financial adviser on whether or not the offer was fair to the minority shareholders because they "did not consider it customary or appropriate to obtain a fairness opinion in the context of the unilateral tender offer."[125]

The court rejected the plaintiff's claim that the board of directors, including the special committee, had breached its duties of care and loyalty and thus was under a duty to demonstrate that the transaction was entirely fair. The court stated that, "unless coercion or disclosure violations can be shown, no defendant has the duty to demonstrate the entire fairness of this proposed tender transaction."[126] The court also rejected the plaintiffs' claim that the board had to take a position on whether or not the tender offer was fair to the minority shareholders. Contrasting the board's position in a merger and a tender offer, the court stated that recommendation of the transaction is required in a merger "so that the shareholders may be better able to assess the acquiring party's offer and, thus, to assist in determining whether to pursue appraisal rights."[127]

As explained by the *Siliconix* court, the divergence in the treatment of noncoercive tender offers and mergers is premised on two concepts:

> The first is that accepting or rejecting a tender offer is a decision to be made by the individual shareholders, and at least as to the tender itself, he will, if he rejects the tender, still own the stock of the target company following the tender. The second concept is that the acquired company in the merger context enters into a merger agreement, but the target company in the tender context does not confront a comparable corporate decision because the

---

[124] *See* 17 C.F.R. § 240.14d-9 (2003). For a discussion of a going private-relevant SEC rules, see Koenig, *supra* note 1.

[125] *Siliconix*, 2001 WL 716787, at *5.

[126] *Id.* at *6 (citing *In re* Life Techs., Inc. S'holders Litig, C.A. No. 16513, 1998 WL 1812280 (Del. Ch. Nov. 24, 1998)).

[127] *Id.* at *8 (citing McMullin v. Beran, 765 A.2d 910, 922 (Del. 2000)).

> actual target of a tender is not the corporation (or its directors), but, instead, is its shareholders.[128]

The court did acknowledge, however, a significant flaw in its position. From the perspective of individual shareholders, in the event that a short-form second step merger was to be effectuated following a successful tender offer, the result would have little substantive difference from a single-step merger.[129]

2. *In re Aquila, Inc., Shareholders Litigation*

In *Aquila*, the Delaware Supreme Court had the occasion to consider a tender offer by a controlling shareholder for 20% of the shares that it did not already own. The target board, having no independent directors, did not express an opinion on the tender offer, but did provide the minority shareholders with an independent financial analysis of the offer. The board, however, did not ask for a fairness opinion. The plaintiffs sought to enjoin the tender offer until a court-appointed expert could conduct a financial analysis of the offer and make an appropriate recommendation or until the target board appointed at least two independent directors.

The court denied the injunction, and in the process affirmed the *Siliconix* position that in a noncoercive tender offer Delaware law does not impose a scrutiny of entire fairness on a controlling shareholder where minority shareholders have adequate information and time to make an informed decision.[130] Similarly, the court found that the board did not have a duty to appoint new independent directors to evaluate the fairness of the tender offer. The court stated that even if the board did appoint the directors, and "even if those two new directors were to conclude that the [acquirer] UtiliCorp offer is unfairly priced, they could do little more than communicate their conclusion to the

---

[128] *See id.* at *7.

[129] *See id.*

[130] *See In re* Aquila, Inc., S'holders Litig., 805 A.2d 184, 188 (Del. Ch. 2002).

stockholders in the Schedule 14D-9 and recommend that they not tender. Certainly, Utilicorp would have no duty to negotiate the price with them."[131]

The court, as in *Siliconix*, put considerable weight on the freedom of stockholders to tender their shares, thus deepening the line already drawn between tender offers and mergers. The court noted that while it has "no way of knowing if a majority of the shares held by [target] Aquila's minority stockholders will be tendered, the opportunity to decide whether or not to tender is certainly valuable."[132]

3. *In re Pure Resources, Inc., Shareholders Litigation*

Pure Resources represents the third case in the trilogy of cases to consider the proper standard of review for tender offers. Like in *Aquila,* the controlling shareholder was looking to consummate a second-step going private merger, with a tender offer at the front-end and a section 253 merger at the back. Unlike in *Aquila*, however, the court expressed significant indignation at the divergence in Delaware's emerging case law regarding its treatment of mergers and tender offers by controlling shareholders. The court stated: "These strands appear to treat economically similar transactions as categorically different simply because the method by which the controlling stockholder proceeds varies."[133] The court went on to note that:

> [A tender offer transaction] is arguably less protective than a merger . . . because the majority stockholder-offeror has access to inside information, and the offer requires disaggregated stockholders to decide whether to tender quickly, pressured by the risk of being squeezed out in a short-form merger at a different price later or being left as part of a much

---

[131] *Id.* at 195.

[132] *Id.*

[133] *In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 435 (Del. Ch. 2002).

> smaller public minority. This disparity creates a possible incoherence in our law.[134]

Despite this discussion, the court stopped well short of requiring that a noncoercive tender offer in conjunction with a merger be subject to the entire fairness standard. The court ruled instead that a tender offer is noncoercive so long as: "1) it is subject to a non-waivable majority of the minority tender condition; 2) the controlling stockholder promises to consummate a prompt § 253 merger at the same price if it obtains more than 90% of the shares; and 3) the controlling stockholder has made no retributive threats."[135]

This three-prong test has subsequently been adopted as the new paradigm for going private transactions involving tender offers and a back-end section 253 merger. In *Next Level Communications, Inc. v. Motorola, Inc.*,[136] the court followed *Siliconix*, *Aquila*, and *Pure Resources* by examining "both the structure of the transaction to insure that it is voluntary in nature and information disclosed to insure its adequacy and completeness. Where an offer is found to be both structurally noncoercive and fully disclosed, the court has left the decision whether to tender or not up to the stockholders."[137] The court then went on to recite the elements of the test, and stated that they "fully satisfy the model for structural non-coercion, applied in *Aquila* and explicated in *Pure Resources*."[138]

4. Analysis of the Tender Offer/Merger Divergence

Commentators have come down on both sides of the question of whether or not it is beneficial to resolve the merger/tender offer divergence. Ronald Gilson and Jeffrey Gordon have suggested that a resolution of the doctrinal

---

[134] *Id.*

[135] *Id.* at 445.

[136] C.A. Nos. 20144, 20114, 2003 WL 549083 (Del. Ch. February 25, 2003)

[137] *Id.* at *13.

[138] *Id.* at *14.

split between mergers and tender offers would ultimately be beneficial to minority shareholders.[139] They argue that the true inconsistency is seated in the availability of what, procedurally, amounts to a class appraisal remedy for shareholders dissenting in a freeze-out merger while leaving dissenting shareholders in a tender offer to perfect their appraisal rights informally by not tendering, and formally by meeting the statutory requirements in connection with the *Pure*-mandated short-form merger.[140] In order to resolve this inconsistency, while maintaining shareholder protection and at least some extraction of private benefits by insiders, they suggest that the Delaware Supreme Court take a hybrid approach to each doctrinal strand by further empowering an appointed special committee, while lowering the applicable standard to business judgment review. Further explaining, they state:

> [I]f the *Pure* litany is met and the special committee with the power to 'say no' approves, then the business judgment rule applies to the freeze out transaction and minority shareholders are limited to statutory appraisal. If the controlling shareholder chooses to go forward without the special committee's approval [as in *Siliconix*], then the transaction is subject to entire fairness review, and minority shareholders have a class based appraisal remedy.[141]

Thus, under this argument, resolution of the doctrinal inconsistency would ultimately result in better protection for the minority shareholders.

The view that closing the gap between the two doctrines is beneficial to shareholders is not held by all commentators. In response to Gilson and Gordon, A.C. Pritchard has argued

---

[139] *See* RONALD J. GILSON & JEFFREY N. GORDON, CONTROLLING CONTROLLING SHAREHOLDERS (Columbia Law Sch. Ctr. for Law and Econ. Studies, Working Paper No. 228, Stanford Law Sch. John M. Olin Program in Law and Econ., Working Paper No. 262, 2003), *available at* http://papers.ssrn.com/abstract=417181.

[140] *See id.* at 50.

[141] *Id.* at 57.

that doctrinal purity between the two regimes is not worth worrying about if shareholders are fully capable of extracting value.[142] This rationale is based on two major theoretical foundations: (1) that minority shareholders are not easily coerced into accepting a lowball tender offer;[143] and (2) that minority shareholders, at the time of their investment, have purchased shares that have already priced in the risk of unfair expropriation.[144] Taking a similar line of argument as Easterbrook and Fischel, he therefore argues that controlling shareholders should not have to pay a double control premium when investors, ex ante, can diversify their portfolios in order to participate in any upside gain.[145] As noted, however, this argument may fail in a true going private transaction where a shareholder may not be able to hold a share of the private acquirer.

I argue that the *Pure Resources* court, while making a step in the right direction, may not go far enough in protecting shareholder interests and obtaining optimum shareholder value. By not overruling *Siliconix*, the Delaware courts have effectively provided controlling interests with an easy path around the entire fairness standard, and have done so on a purely formalistic rationale. The *Siliconix* court, as noted above, recognized the problem with the merger/second-step merger distinction as it pertains to minority shareholders. The *Pure Resources* court was more skeptical, and further amplified the concern. Vice Chancellor Strine said that he remained "less than satisfied that there is a justifiable basis for the distinction,"[146] stating that any distinctions "reflect a difference in policy emphasis that is far greater than can be explained by the technical differences

[142] *See* A.C. PRITCHARD, TENDER OFFERS BY CONTROLLING SHAREHOLDERS: THE SPECTER OF COERCION AND FAIR PRICE, at 3 (Michigan Law & Econ. Research Paper No. 03-018, 2003), *available at* http://papers.ssrn.com/abstract=485022 (last visited Feb 1, 2004).

[143] *See id.* at 26.

[144] *See id.* at 29.

[145] *See id.* at 29-30.

[146] *In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 443 (Del. Ch. 2002).

between tender offers and negotiated mergers . . . ."[147] Commentators and practitioners have largely come to the same conclusion. They note that *Siliconix* only invites "corporate planners to maneuver around safeguards created in decisions like *Weinberger v. UOP, Inc.*,[148] *Rosenblatt v. Getty Oil Co.*,[149] and *Kahn v. Lynch Communications Systems, Inc.*"[150] Nor should the *Pure Resources* opinion be viewed as a panacea to minority shareholder interests.

The three-pronged paradigm set forth in *Pure Resources* only solves some of the problems with the divergent case law. First, the majority of minority requirement does little to ensure that minority shareholders extract the optimum value for their interests. Instead, shareholders will only get "the minimum price at which 50 percent of the minority shareholders will tender. . . . [Thus,] shareholders will likely accept a small premium over the market value of their shares if they do not have a negotiating committee."[151] The second provision—the promise to complete the merger if the tender offer is successful—does ensure that objectors to the tender offer receive the same compensation as if a one-step merger was effected. However, some value may be left on the table because a negotiated merger would have required the board to negotiate, perhaps using the threat of a poison pill, for the highest price possible.[152] Furthermore, there are divergent state and federal policies with respect to regulating the tender offer process. Delaware has largely empowered the board of directors to reject a tender offer.

---

[147] *Id.* For a detailed account of the *Pure Resources* court's concerns, see 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, 274.

[148] 457 A.2d 701 (Del. 1983).

[149] 493 A.2d 929 (Del. 1985).

[150] 638 A.2d 1110 (Del. 1994); Bradley R. Aronstam et al., *Delaware's Going-Private Dilemma: Fostering Protections for Minority Shareholders in the Wake of Siliconix and Unocal Exploration*, 58 BUS. LAW. 519, 520-21 (2003).

[151] Resnick, *supra* note 146, at 276.

[152] *Id.*

Finally, the third provision requiring that the acquirer not make any retributive threats is virtually useless. Overt threats are typically not needed so long as there is an omnipresent pressure to tender.

Recent tender offer developments therefore do little to protect minority interests. The Delaware courts persist in maintaining a formalistic division between tender offers and mergers, which ultimately results in the assignment of low values to each of the procedural and remedial variables examined. Moreover, while the *Pure Resources* court attempted to raise these values via its three-pronged test, the decision likely does not go far enough in protecting minority shareholders.

D. Asset Dispositions as a Means of Going Private

The final method to take a company private considered here is through a sale of substantially all of the company's assets. In a traditional asset disposition, the acquirer, through an acquisition vehicle, purchases all or substantially all of a target's assets through a planned liquidation that returns the proceeds to the target's shareholders. While not typically thought of as a going private transaction, a similar effect may be achieved if management purchases their company assets using outside funds.

Current Delaware asset disposition law suffers from the same general problems as its tender offer jurisprudence, the burden of which is borne by minority shareholders. Specifically, significant shareholder value may be sacrificed at the hands of savvy transaction engineers looking for an end-run around the procedural and substantive safeguards imposed by traditional merger laws. The ultimate result is the assignment of low values to the procedural and remedial variables in Delaware as compared to other states. In order to explore this idea, two different facets of Delaware asset disposition law need to be examined. In terms of the basic standard of review, Delaware law may offer some protection via the entire fairness standard utilized by the courts in examining self-interested asset dispositions. However, the rights and remedies available to shareholders may be limited due to the Delaware courts' failure to adopt the de facto merger doctrine.

1. Standard of Review for Asset Dispositions

The basis for determining the proper standard of review applicable to an asset disposition is no different from that of any other transaction in Delaware. Thus, in determining the validity of a disputed transaction, Delaware courts will traditionally defer to the business judgment of directors where the directors have acted in good faith and in the best interests of the shareholders.[153] However, this presumption vanishes when the specter of management self-dealing arises, and courts will then scrutinize the board's actions under the entire fairness standard in order to ensure fair dealing and fair price for minority shareholders.[154]

In *Ryan v. Tad's Enterprises, Inc.*, the Delaware Court of Chancery utilized the entire fairness standard in reviewing a majority stakeholder-negotiated asset sale to a third party.[155] The asset disposition was to be followed by a going private transaction. The *Ryan* plaintiffs asserted that the two controlling shareholders, who were also members of Tad's board, had a material conflict of interest in the asset sale and subsequent merger, and failed to show that the sale and merger were fair to the minority shareholders.[156] In particular, the plaintiffs claimed that the conflict of interest arose when the controlling shareholders negotiated for consulting and non-competition agreements with the buyer, which would necessarily come at the expense of minority shareholders.[157]

---

[153] Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994).

[154] Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983).

[155] 709 A.2d 682 (Del. Ch. 1996).

[156] *Id.* at 688.

[157] *Id.* The plaintiffs' rationale for this contention is that:

> [A] buyer of business (here, Riese) is willing to pay only a finite amount for the business, including the business's assets and the agreement of its principal selling

Finding for the plaintiffs, the Court of Chancery held that the defendants failed to carry their burden of proving that the asset sale was fair on two separate grounds. First, the court stated that the board of directors "fatally impaired" the fairness of the negotiation process for the asset sale when they failed to provide for independent representation or other structural protections for the minority shareholders.[158] The failure was particularly egregious since the legal counsel who negotiated the asset sale and its concomitant agreements not only held a significant share in Tad's, but also represented both the minority shareholders and two of Tad's three directors.[159] Similarly, the financial advisor, also retained by the majority-interested board, was not asked to opine on the fairness of the consulting and noncompetition agreements.

The defendants also failed to demonstrate entire fairness in the process by which shareholder approval was obtained for the asset sale. The court noted that two of the directors "dominated Tad's board and controlled 72.6% of the voting power of the corporation, their votes made both [the board and shareholder] approvals a foregone conclusion."[160] The court therefore found no evidence of fair dealing.

> stockholder-managers to consult, and not to compete with, the business being acquired. Plaintiffs' position is that the payments for consulting and noncompetition agreements, while different in form from payments for the assets, must nonetheless be viewed as but another component of the total purchase price. Therefore, if a self-interested fiduciary negotiates a significant noncompete/consulting payment for himself, that necessarily would diminish the amount of the value that would be paid to the corporation for its assets."

Id. at 689 n.9.

[158] *Id.* at 691.

[159] *Id.* at 692.

[160] *Id.*

2. Doctrinal Approaches to Asset Dispositions and their Implications

The benefits that inure to minority shareholders under the entire fairness standard of review may be lessened in some circumstances by the limited damages and voting rights that are available to shareholders under Delaware law. These limitations derive from the doctrinal approach that Delaware courts have taken in characterizing a sale of assets as a true sale, when the economic reality achieved may be the same as a merger.

In general, there are two prevailing views that courts have taken in determining what rights minority shareholders have in an asset disposition. One view is to classify the sale of assets as a de facto merger, which would then warrant the application of a state's traditional merger laws. Alternatively, courts may choose to characterize the sale of assets not as a merger, but only as a purchase by the acquirer and a sale of substantially all assets by the target. Each approach has important implications for minority shareholders.

(i) *Glen Alden* and the De Facto Merger Doctrine

Under the de facto merger approach, minority shareholders of both the target and acquirer are entitled to a vote and also receive appraisal rights. Many courts outside of Delaware take this approach, which honors the substance of the transaction over the form.[161] In *Farris v. Glen Alden Corp.*, the Pennsylvania Supreme Court considered a Glen Alden shareholder complaint seeking a temporary injunction for a stock-for-assets combination in which the smaller Glen Alden was the nominal purchaser and the larger List Industries was the nominal seller.[162] The complaint alleged,

---

[161] *See, e.g.*, Farris v. Glen Alden Corp., 143 A.2d 25 (Pa. 1958); Rath v. Rath Packing Co., 136 N.W.2d 410 (Iowa 1965) (characterizing a sale of assets as a merger based on legislative intent).

[162] 143 A.2d 25 (Pa. 1958).

among other things, that no notice was given to shareholders, that the true purpose of the Glen Alden annual shareholder meeting was to effect a merger or consolidation of the two companies, and that Glen Alden failed to give notice to its shareholders of their right to dissent to the plan of merger and claim fair value.[163] In response, the defendants moved for summary judgment because the transaction was a purchase of corporate assets to which shareholders had no rights of dissent or appraisal.[164]

Taking its cue from prior decisions interpreting the Pennsylvania merger statute, the court framed the issue as whether the combination so "fundamentally changed the corporate character of Glen Alden and the interest of the plaintiff as a shareholder therein, that to refuse him the rights and remedies of a dissenting shareholder would in reality force him to give up his stock in one corporation and against his will accept shares in another?"[165] The court, deciding the question in the affirmative, stated:

> [The merger provisions] provide only that the shareholders of a corporation which acquires the property or purchases the assets of another corporation, *without more*, are not entitled to the right to dissent from the transaction. So, as in the present case, when as part of a transaction between two corporations, one corporation dissolves, its liabilities are assumed by the survivor, its executives and directors take over the management and control of the survivor, and, as consideration for the transfer, its stockholders acquire a majority of the shares of stock of the survivor, then the transaction is no longer simply a purchase of assets or acquisition of property...but a merger governed by section 908, subd. A of the corporation law.[166]

---

[163] *Id.* at 27.

[164] *Id.*

[165] *Id.* at 29.

[166] *Id.* at 31.

Thus, the court looked to the ultimate effect of the transaction rather than its form in formulating its holding.

Furthermore, the court's emphasis of function over form was also exemplified by its recognition of the upside-down design of the transaction. One of the reasons for the smaller, Pennsylvania-based, Glen Alden to purchase the assets of the larger, Delaware-based, List was to avoid Pennsylvania's sale of assets statute which bestowed appraisal rights to the seller's shareholders. In contrast, Delaware's sale of assets statute did not grant appraisal rights to either the seller's shareholders or the purchaser's. To this end, the court stated that, even assuming that the transaction was a true sale of assets to which Pennsylvania's merger statute would not apply, "it would avail the defendants nothing; we will not blind our eyes to the realities of the transaction. Despite the designation of the parties and the form employed, Glen Alden does not in fact acquire List, rather, List acquires Glen Alden."[167]

(ii) *Hariton* and the Equal Dignity Approach

In contrast to *Glen Alden*, Delaware courts have rejected the de facto merger doctrine in favor of an approach that gives equal weight to Delaware's sale of assets and merger statutes. This interpretation has several implications for minority shareholders. First, under a Delaware General Corporation Law section 271 sale of assets, the purchaser's shareholders do not receive a vote to approve the transaction. Similarly, appraisal rights are not triggered as they would have been under Delaware's merger statutes. On the other side of the sale, the seller's shareholders do in fact receive a vote, but do not receive appraisal rights.[168]

The Delaware Supreme Court specifically considered whether a Delaware General Corporation Law section 271 sale of assets followed by a dissolution of the selling company, and a subsequent distribution of shares to the

---

[167] *Id.*

[168] *See* DEL. CODE ANN. tit. 8, § 271 (1991).

seller's stockholders should be considered a merger or a straight sale of assets in *Hariton v. Arco Electronics, Inc.*[169] The *Hariton* plaintiff-shareholder claimed that that the sale of assets achieved the same result as a merger, and therefore triggered appraisal rights.[170] While the court agreed with the plaintiff's contention, it nevertheless held that the reorganization "accomplished through section 271 and a mandatory plan of dissolution and distribution is legal." The court reasoned this was so, "because the sale-of-assets statute and the merger statute are independent of each other. They are, so to speak, of equal dignity, and the framers of a reorganization plan may resort to either type of corporate mechanics to achieve the desired end."[171] Thus, the court honored the different means employed by the transacting parties as a goal to achieving the same end as a merger.

Thus, the *Hariton* decision is important due to the fact that it may result in limited protection of minority shareholders through the assignment of low values to the remedy and procedure variables. Similar to Delaware's tender offer jurisprudence, the decision's formalistic interpretation of the sale of assets statute allows opportunistic transaction engineers to structure a deal that has the potential to reduce minority shareholder value by nullifying a shareholder's ability to exercise appraisal rights that would have been available to her under an economically

---

[169] 188 A.2d 123 (Del. 1963).

[170] *Id.* at 125. This same contention was made previous to *Hariton* in *Heilbrunn v. Sun Chem. Corp.*, 150 A.2d 755 (Del. 1959). The *Heilbrunn* plaintiff-stockholder's claim, however, was fundamentally different in one respect. In *Hariton*, the suit was brought by a shareholder of the transferor corporation, while in *Heilbrunn* the suit was brought by shareholders of the surviving corporation. The *Heilbrunn* court failed to reach the claim, however, stating that it did not "see how any injury has been inflicted upon the [survivor's] stockholders. Their corporation has simply acquired property and paid for it in shares of stock . . . The [survivor] stockholder is not forced to accept stock in another corporation. Nor has the reorganization changed the essential nature of the purchasing corporation . . . ." *Heilbrunn*, 150 A.2d at 758.

[171] *Hariton,* 188 A.2d at 125.

similar transaction. Furthermore, the decision is particularly restrictive in light of Delaware's sale of assets statute. Unlike some jurisdictions' sale of assets statutes,[172] which take an extra step in protecting a seller's minority shareholders by affording them both voting rights *and* appraisal rights, Delaware General Corporation Law section 271 only provides the seller's minority shareholders with voting rights. Thus, even if the equal dignity approach ultimately did afford the same value of protection as the de facto merger doctrine, a minority shareholder in Delaware may be left with less recourse than if the corporation was incorporated in a state which also gives appraisal rights.

VI. CONCLUSION

Given the current market environment, the prospect of self-interested managers utilizing going private transactions as a means of transferring shareholder value is quite acute. By incorporating or reincorporating in a state that has a relatively permissive legal regime, managers and other interested parties may ultimately be successful in achieving this goal.

In order to determine which state, on balance, affords managers the opportunity to achieve value shifts, one must evaluate the four variables that define the contours of a state's legal regime: procedure, substance, judicial oversight and remedy. Within the context of going private transactions, it is clear that Delaware is leading the race to the bottom by assigning low values to each of these variables. This deference to managers, with the concomitant shift in value that occurs, can be established by examining the variables in two ways: (i) by analyzing Delaware's internal development of its going private jurisprudence; and (ii) by comparing it to other states that have maintained certain checks on managers in the interest of protecting

---

[172] *See generally* MODEL BUS. CORP. ACT § 13.02(b)(4)(ii) (1979) (granting appraisal rights where there is a potential conflict of interest between shareholders and a person, or her affiliate, who is a director of the corporation).

minority shareholders. The gaps and dichotomies that arise through these analyses demonstrate that savvy transaction engineers can take advantage of Delaware's legal regime by designing going private methods that maximize a self-interested party's value at the expense of the minority.

Many commentators have urged for the increased federalization of the states' corporate legal regimes. This solution is not without its problems, however. It is certainly debatable whether or not the federal government, even in its capacity as a gatekeeper, can effectively legislate, and then police, the realignment of managerial interests with those of shareholders. This may have positive effects on the procedural aspects of a transaction, but substantive, judicial oversight and remedial problems may nevertheless remain.[173] Moreover, the overinclusive nature of federal legislation may ultimately create more problems than it solves. Put differently, a federal regime that targets the structural problems that give rise to a race to the bottom for going private transactions may adversely impact other portions of a legal regime that exhibit race to the top characteristics. This is exemplified by legislation such as Sarbanes-Oxley, which, through the imposition of high compliance costs, is effectively crowding out small public businesses. The trick thus becomes to align shareholder interests with those of controlling parties in such a way that eliminates the disparities that arise through the race to the bottom amongst states, and at the same time avoids the disparate impact that may occur under the federal regime.

[173] *See, e.g.*, J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 318 (2004) (stating, within the state legal regime, that "with proper procedures, the fairness of a transaction was not subject to judicial review. This approach allowed self-dealing by officers and directors almost without limits.").