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*

Kimble Charles Cannon*

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* The author is a 1994 graduate of Columbia Law School and has previously published articles on corporate and securities law in publications including the Securities Regulation Law Journal and the Columbia Business Law Review.

I. INTRODUCTION

Much has been written, both by commentators[1] and the courts,[2] about the need to protect shareholders in the context of third-party offers to acquire a company. Third-party offers in general, and hostile acquisitions in particular, have led to the development of many of the central concepts that define appropriate directorial behavior, including the classic duties of loyalty and due care that directors owe to the company

[1] *See generally*, Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037 (2002) (discussing the history of the academic and professional commentary regarding corporate measures responsive to hostile takeovers, including a detailed record of the debate over the use of poison pill and other defensive measures). *See also* Kimble C. Cannon & Patrick J. Tangney, *Protection of Minority Shareholder Rights Under Delaware Law: Reinforcing Shareholders as Residual Claimants and Maximizing Long-Term Share Value by Restricting Directorial Discretion*, 1995 COL. BUS. L. REV. 725 (urging that directors have an obligation to maximize long term as well as immediate shareholder value in the context of multiple-bid hostile acquisitions). *See also* Frederick H. Alexander et al., *Advanced Doing Deals – A Delaware Checklist*, *in* ADVANCED DOING DEALS 2002: WHAT YOU NEED TO KNOW NOW (PLI Corp. Law and Practice Course, Handbook Series PLI Order No. B0-01AV, 2002) (surveying cases concerning duties of directors to maximize share value).

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

generally and shareholders specifically.[3] The requirement that directors ensure shareholders receive maximum value for their shares when the company is for sale, as articulated in the Delaware Supreme Court's *Revlon, Inc. v. MacAndrew & Forbes Holdings, Inc.*,[4] decision, likewise arises most prominently in the third-party acquisition context. However, today it is not an entrenched board's opposition to a third-party transaction that raises the greatest concern with respect to protecting shareholder interests, but rather board inaction in the face of an unfairly priced related-party acquisition,[5] particularly where the acquisition is structured as a unilateral tender offer.[6]

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[3] The duty of due care generally requires that directors act in good faith and maintain active and attentive involvement in governing the company. While a violation of the duty of due care can result from either a failure to consider all relevant information or a failure to take sufficient time to evaluate a given transaction, it has been commented that boards "that have failed to exercise due care are frequently boards that have been rushed." Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 67 (Del. 1985). The duty of loyalty has been summarized as providing that a corporate fiduciary cannot take a business opportunity for himself if it is a business opportunity which the corporation is financially able to undertake or is, from its nature, either in the line of the corporation's business and is of practical advantage to it, or one in which the corporation has an interest or a reasonable expectancy. *See* Guth v. Loft, 5 A.2d 503, 511 (Del. 1939). In properly discharging their fiduciary responsibilities, directors must exercise each of their duties of care, good faith and loyalty whenever they communicate with shareholders about the corporation's affairs. *See* McMullin v. Beran, 765 A.2d 910, 925 (Del. 2000). A breach of any one of these duties rebuts the business judgment presumption and permits a challenge to the board's action under the entire fairness standard. *See* Emerald Partners v. Berlin, 726 A.2d 1215, 1221 (Del. 1999) (citing Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162-64 (Del. 1995) and *In re* Tri-Star Pictures, Inc., Litig., 634 A.2d 319, 333 (Del. 1993)).

[4] 506 A.2d 173 (Del. 1986).

[5] Transactions in which corporate insiders seek to acquire a publicly held company and delist or cease the over-the-counter trading of its shares, generally termed going-private transactions, are often referred to as leveraged buyouts when financed through the issuance of debt and as management buyouts when initiated by an acquisition group that includes corporate officers. When the terms of an offer require that the public

While related-party acquisitions can make strong economic sense to all of the parties involved, especially where the objective is taking the company private and avoiding the costs of remaining a publicly traded entity, transactions in which the controlling shareholder is the acquirer represent an opportunity for abuse. Controlling shareholders often have significant influence over the board of directors as well as over management; they may also have substantial nonpublic information regarding the company's operations.[7] The risk that a controlling shareholder will use this control and informational advantage to the detriment of minority shareholders in the context of acquiring the shares that it does not already own is significant. The danger to minority shareholders should be of particular concern considering that the current economic and political climate increasingly incentivizes controlling shareholders to privatize public companies that have depressed stock valuations.[8]

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shareholders exchange their shares for cash or debt, the transaction may be termed freezeouts, squeezeouts, or takeouts. *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 566 (4th ed. 2001).

[6] A unilateral tender offer is one initiated by an acquisition group without either the support or opposition of the target board of directors (exclusive of board members participating in the tender offer as acquirers), including tender offers that began as negotiated mergers where negotiations between the acquisition group and the board were terminated and the board expresses no opinion with respect to whether shareholders should or should not accept the tender that takes the place of the abandoned negotiated transaction.

[7] *See In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 427-28 (Del. Ch. 2002) (noting that before a controlling shareholder announces its intention to acquire the public shares of its subsidiary and the directors appointed to the subsidiary's board recuse themselves, this controlling shareholder will have access to non-public information about that subsidiary through the directors it appointed to the subsidiary's board).

[8] *See* Paul R. La Monica, *A Private Matter: With Stock Market in a Funk, More Public Companies Might be Looking to Go Private*, CNN/MONEY, Aug. 6, 2002 *at* http://money.cnn.com/2002/08/06/pf
/investing/q_private/index.htm (discussing current market conditions favoring taking public companies private where there is a controlling shareholder and citing the examples of Dave and Buster's current

The precipitous drop in share prices that has occurred between March 2000 and the end of the first fiscal quarter 2003 has created a particularly compelling reason for controlling shareholders to seek to acquire the portion of a company's shares they do not own where the underlying fundamentals of the company remain sound.[9] Such transactions can be structured either as mergers that are negotiated with the target's board of directors acting as an intermediary between the acquisition group and shareholders, or as tender offers made by acquirers directly to the other shareholders. In either case, such transactions threaten shareholders because they offer both the risk that a captive board will take no action to derail a below fair-value offer and the reality that no third party can, as a practical matter, make a more reasonable competing bid.[10]

Delaware law[11] addresses the risks posed to minority shareholders in companies controlled by large shareholders with a considerable degree of success where the transaction is structured as a negotiated merger.[12] However, where the acquirer chooses a tender offer structure, Delaware law has, until quite recently, left minority shareholders largely exposed to the risk that corporate directors will act in collusion with the controlling shareholder to the detriment of

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management-led buyout and potential going-private transactions by Martha Stewart Omnimedia and Charter Communications).

[9] As Morton Pierce, chairman of Dewey Ballantine's Mergers and Acquisitions Group, stated: "In an era where there's much greater scrutiny on public filings and the stock price is low enough to be attractive to a majority or significant shareholders, you're going to see companies being taken private." *Id.*

[10] To be successful, such a competing bid would need to be acceptable to the controlling shareholder, the very party against whom the bid would be competing. Therefore, the prospect of a competitive environment bringing market forces to bear will not serve as a safety net that ensures an offer approximates fair value.

[11] This article focuses on Delaware when discussing state corporate law and jurisprudence in recognition of that state's long standing as the preeminent jurisdiction governing relations between shareholders and the companies they own.

[12] *See Pure Res.*, 808 A.2d 421.

minority stockholders. During the past two years, the Delaware Chancery Court has issued rulings articulating a legal framework that generally accepts target board inaction in the face of an unfairly priced tender offer launched by a controlling shareholder.[13] While these recent decisions are arguably based on Delaware legal precedent distinguishing directorial duties in a merger context from those in a tender offer context, the decisions nevertheless illuminate a gap in the general duties of directors to protect minority shareholders when a tender offer structure is encountered.[14]

At the same time, the line of Delaware cases permitting director inaction in connection with unilateral tender offers also legitimizes as non-coercive a class of tender offer transaction that leaves shareholders no practical choice but to accept an offer's terms.[15] Permitting director inaction while accepting coercive tender offer structures leads to an environment in which increasing numbers of shareholders in controlled companies will see their ownership interests eliminated at unfair prices.[16] This phenomenon will initiate

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[13] *See, e.g.*, *In re* Siliconix, Inc. S'holders Litig., No. CIV. A. 18700, 2001 WL 716787 (Del. Ch. Jun. 21, 2001).

[14] *See generally Pure Res.*, 808 A.2d 421 (explaining why tender offers are coercive and therefore just as great a threat to shareholders as negotiated mergers).

[15] The rationale behind this framework, that tender offers are inherently different from merger transactions, has only recently begun to be questioned by the courts. Specifically, these cases found that unilateral tender offers in which the offeror does not guarantee that the tender offer will be followed by a short-form merger at the same price as the tender offer were not coercive. *See Siliconix*, 2001 WL 716787 at *16.

[16] As support for the position that coercive tender offers tend to cause equity holders to relinquish their shares at unfair prices, note that Martin Lipton recently addressed the value of board defensive measures in this context, pointing out that:

> [t]he poison pill has decisively shifted the battle for corporate control from the arena of the coercive tender offer to that of the proxy contest. When confronted with a poison pill, a hostile suitor may be forced to make its case by means of a proxy solicitation if it wishes to persuade target shareholders that it is truly in their best interests to accept the offer. . . . In [the case of various acquisition

a cycle in which the value of the shares in companies controlled by a majority shareholders will become ever more depressed due to the perceived risk that minority shareholders will be eliminated at an unfair price through a related-party tender offer.[17]

This article addresses the threat posed by unilateral tender offers initiated by controlling shareholders. First, the article will examine why it is particularly compelling today for majority shareholders to acquire the remaining stock in the public companies they control. Second, the article will address the process for taking a company private and the various deal structures that can be employed. Third, the article will review the standard of conduct governing directors in various related-party transactions. Fourth, the article will discuss both recent Delaware judicial decisions making it easier for directors to sit on the sidelines while controlling shareholders use the inherently coercive tender offer process to force minority shareholders into accepting below-value offers for their shares, and recent Delaware case law rejecting this trend. Finally, the article concludes by proposing significant changes to the rules governing directorial duties to minority shareholders in the context of controlling-shareholder initiated unilateral tender offers.

> transactions], the target board resisted a takeover, the acquiror commenced or announced the intention to commence a proxy contest, and the merger ultimately was consummated at a significantly higher price per share than that initially offered by the acquiror.

See Lipton, *supra* note 1, at 1058 n.81.

[17] *See* Abraham Bell & Gideon Parchomovsky, *The Integration Game*, 100 COLUM. L. REV. 1965 (2000) (describing distorted and inefficient outcomes caused by pressures on shareholders to tender). *See also* Lucian Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695, 1696 (1985) (discussing that coercive tender offers lead shareholders to sell shares at prices that they believe are less than the actual value of the shares).

II. CURRENT ECONOMIC CONDITIONS FAVORING GOING-PRIVATE TRANSACTIONS

During the last half of the 1990s, many companies were formed through venture investment and then taken public through initial public offerings (IPOs). Generally, only a relatively small percentage of the shares of these companies were sold to outside investors in the offering, with the majority of shares retained by founders, management, and early stage investors.[18] In many cases, these players were able to maintain a significant amount of influence with, and in some cases control over, the corporation's board of directors.[19]

While markets remained strong and stock valuations high, it served the interests of both companies and shareholders alike to keep these companies public. Being a public company provided access to capital from additional sales of stock as well as a certain degree of prestige. Since approximately March 2000, however, stock valuations have plummeted, significantly altering the economics of being a

[18] A study conducted by Professors at Binghamton University, Bentley College and Virginia Commonwealth University released in February 2000 showed that, with respect to 5,347 initial public offerings conducted between 1980 and 1994 meeting certain criteria, an average of 29.96 percent of the shares outstanding before each offering were sold at the offering. *See* Upinder S. Dhillon et al., *How Informative is Insider Selling at the IPO?* 6, 10 (Feb. 2000) (unpublished manuscript, on file with author) (addressing the relationship between insider selling of secondary shares at the initial public offering and underpricing and long-run stock returns).

[19] Research conducted by two Professors at the London Business School suggests that corporate insiders, who enjoy private benefits of control aside from realizing value from their shares, have an incentive to – and in practice do – underprice initial public offerings. This underpricing results in offerings that are oversubscribed and in which the shares are rationed, thereby limiting the size of other large shareholders that might otherwise challenge their control. *See* Michael Brennan & Julian Franks, *Underpricing, Ownership and Control in Initial Public Offerings of Equity Securities in the UK,* (Center for Economic Policy Research (CEPR), Discussion Paper No. 1211 (1995) (presented by Julian Franks on December 5, 1995 at a public discussion meeting sponsored by Merrill Lynch under the CEPR Corporate Membership program).

public company.[20] At the same time, recent disclosures of corporate fraud and malfeasance promise to retard a return to higher valuations for public companies.[21] Even companies with strong fundamental business models have been impacted, and there is now arguably a significant disconnect between operational performance and market valuation.[22] In fact, as of the first quarter of 2003, a trend has developed wherein private companies are being valued at higher multiples of revenue than their public company counterparts.[23]

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[20] Editorial, *Putting the Market in Perspective*, THE WASH. TIMES, Jan. 5, 2003, B-02, *available at* http://www.washtimes.com/op-ed/20030105-3195013.htm (noting that stock market losses have accelerated during each of the three years ending December 2002, with the Dow Jones industrial average losing 16.8 percent in 2002 alone – more than double its 7.1 percent fall in 2002 and its 6.2 percent decline in 2000). The editors further note that "[f]or the S&P 500, 2002 was the worst year since 1974. The tech-heavy Nasdaq composite plummeted 31.5 percent last year after having dropped 21.1 percent in 2001 and 39.3 percent in 2000. Not since the 1939-41 period has the broad-based S&P 500 declined three years in succession.").

[21] Flextronics CEO Michael Marks concluded, "[b]eing public is pretty depressing right now." Scott Herhold, *Brilliant Plan. Will It Work?*, BUS. 2.0 (Aug. 2002), at 20, *available at* http://www.business20.com/articles/mag/print/0,1643,42158,FF.html.

[22] Examples of companies that reported strong operational performance during 2002 and yet experienced significant share price declines that year abound. *See, e.g.* Cambridge Antibody Tech. (CAT), Investors Chronicle, Nov. 22, 2002 *available at* 2002 WL 102518241 (stating that "Cambridge Antibody Technology (CAT) may be viewed as one of the most promising plays in the biotech sector, but that hasnt [sic] stopped its share price falling 75 per cent over the past 12 months. This seems largely due to risk-averse investors fleeing the sector, as it's hard to find fault with CATs operational performance.").

[23] *See* Michael V. Copeland, *For Some Companies it Pays to be Private*, RED HERRING, at 66 (Feb. 20, 2003) (quoting Warren Haber, a partner with Mellon Ventures, as having recently commented that "[i]n this environment, it's definitely easier being a private company than a public company," and citing Mr. Haber as authority that "a number of mid-to late-stage private companies that are cash-flow positive [are] valued at revenue multiples twice that of their public counterparts," and including accompanying quotes and anecdotal information supporting this trend), *at* http://www.redherring.com/vc/2003/02/private022003.html.

These economic conditions mean that it can be financially rewarding for significant shareholders to take a public company private and then either operate it profitably as a private company, bring it public again through an IPO when markets recover, or sell the business in a negotiated private transaction. An example of the successful execution of this public-private-public formula can be found in the case of Duracell International.

In June 1988, Kraft, Inc. sold its battery subsidiary, Duracell, to an acquisition group comprised of buyout firm Kohlberg Kravis Roberts ("KKR") and members of Duracell's management.[24] The acquisition group paid approximately $1.8 billion for Duracell.[25] This equates to a value of approximately $5 per share,[26] adjusted in terms of shares outstanding at the time of Duracell's eventual 1996 acquisition by The Gillette Company ("Gillette"). KKR took Duracell public again in May 1991 in a stock offering that raised $518 million and valued the company at $1.5 billion. Then, in 1996, Gillette bought Duracell for $7.8 billion in a stock swap transaction.[27] This transaction valued Duracell at about $55 per share, as contrasted with the $5 per share price paid by the acquisition group just eight years earlier. Moreover, by the time of the Gillette transaction, KKR had already made approximately $1.2 billion from earlier sales of Gillette stock,[28] giving KKR an approximate thirty-nine

[24] See *20 Years of Buying and Selling Companies*, FORBES, Dec. 13, 1999, at 184, *available at* 1999 WL 28466878.

[25] About $1.45 billion of the acquisition price was financed by debt and the remaining $350 million was paid in equity. *See Building the Ark*, BUSINESS STANDARD, July 30, 2002, *at* http://www.business-standard.com/strategist/bookshelf.asp (on file with author).

[26] *See* David Usborn, *Gillette to Pay $7bn for Duracell*, THE INDEPENDENT – LONDON AT 21, Sept. 13, 1996, *available* at 1996 WL 10957127.

[27] *See generally 20 Years of Buying and Selling Companies*, *supra* note 24, at 184.

[28] *See* Usborn, *supra* note 26, at 21.

percent annual compounded return on investment.[29] One way to look at this transaction from KKR's perspective is that the $350 million KKR originally invested in Duracell ultimately returned $4.22 billion.

There are multiple reasons why the Duracell transaction was so successful, and many of these reasons are relevant to economic conditions today. While, as an independent company, Duracell was highly leveraged, burdened by a non-investment grade debt rating, and no longer able to readily access capital as it had under Kraft, the acquisition group concluded that the benefits of independence would still outweigh these negative considerations.[30] Independence let Duracell management focus on long-term growth and the development and introduction of innovative technologies rather than reporting short-term performance to public investors.[31]

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[29] *See* Aline Sullivan, *A Kinder, Gentler KKR Turns Its Buyout Attentions to Europe*, INT'L HERALD TRIBUNE, Apr. 10, 1994, at 19, *available at* 1999 WL 5110687.

[30] *See* Mike Wright et al., *Firm Rebirth: Buyouts as Facilitators of Strategic Growth and Entrepreneurship*, 15 ACAD. OF MGMT. 1 (2001), *available at* 2001 WL 17645265.

> When Duracell was still a part of Kraft Foods, Bob Kidder [then President of Duracell] and his management team had a hard time getting the needed attention from corporate management. They had to meet the bureaucratic requirements of corporate headquarters. This, in turn, impeded them from developing new innovations and strategies. Furthermore, Kidder and his colleagues seemed unable to convince corporate management about the new projects they thought Duracell needed to pursue. Given the mismatch between management's entrepreneurial ambitions and corporate bureaucracies, they sought a leveraged buyout so that their entrepreneurial mindset could be unleashed.

Id. Robert Kidder later stated that "as an independent company, we feel empowered and are committed to seize our significant growth opportunities." *Id.*

[31] Through innovation and improved marketing, Duracell's net income increased from a loss of $105 million in 1989 to a gain of $245 million in fiscal year 1996, while cash flow through that period increased at an

Taking an undervalued company private in a depressed financial market, operating it successfully for a number of years, and then taking it through a value realization event in more promising times is not a new model,[32] but it is a model for which current market conditions appear ideally suited. Corporate executives who have recently embraced the go-private solution include David Murdock, chief executive of Dole Food Co., who, on September 23, 2002, announced that he would pay $29.50 per share for the seventy-six percent of Dole stock not already owned by his family.[33] Additional examples abound.[34]

It is worth noting that there are several ways for public companies to reduce the expense of being publicly traded without executing a complete going-private transaction. One option for small companies is to de-list the company's stock from the securities exchange on which its shares are traded after reducing the total number of shareholders in the company to 300 or fewer.[35] However, this eliminates only a

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annual compounded rate of seventeen percent, as opposed to cash flow growth having been flat under Kraft. *See Building the Arc*, *supra* note 25.

[32] This is the model initiated by Silver Lake Partners in its leveraged acquisition of Seagate Technologies' disc-drive business in March 2000, after which Seagate Technologies was able to focus research and development efforts on the development of products that eventually allowed the company to return to profitability. *See* Herhold, *supra* note 21, at 22.

[33] While announced as a negotiated transaction in which a special committee of the Board would be formed to consider the offer's fairness, this could easily have been structured as a unilateral tender offer. *See* Courtney Schlisserman, *Dole Food Chairman Offers to Buy Company for $2.5 Billion,* BLOOMBERG NEWS, Sept. 23, 2002 (on file with author).

[34] For a discussion of going-private transactions involving entertainment company Dave & Buster's and chemical and mineral manufacturer International Specialty Products, see La Monica, *supra* note 8. *See also* Proxy statement of TEK DigiTel Corp. (July 3, 2001) (on file with author); Proxy statement of Infodata Systems, Inc. (Jan. 2, 2002) (on file with author) (describing offers to take those companies private).

[35] Tek DigiTel Corp., for example, in November 2001 filed a Form 15 with the Securities and Exchange Commission ("SEC") notifying the SEC that it was suspending its obligation to file periodic reports, including its quarterly and annual reports, and deregistering its common stock to save

portion of the total cost of remaining a public company; moreover, the potential for shareholder litigation is not wholly eliminated. On the other hand, true going-private transactions, in which all shareholders not affiliated with the acquisition group are eliminated,[36] are generally more attractive to controlling shareholders because of the additional cost savings and the elimination of litigation risk.

Several aspects of the current investment climate suggest that going-private transactions will be increasingly prevalent in the years ahead. First, the market capitalization of many companies is significantly less than it was only a couple of years ago. Between March 2000 and July 2002 public companies in the United States lost $7.7 trillion in market capitalization.[37] Moreover, while the Dow Jones Industrial Average rose nearly 500 points on July 24, 2002 alone, it has since fluctuated significantly, demonstrating that it is impossible to predict future market behavior. These

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on filing-related costs. In a press release dated November 9, 2001, Tek DigiTel Corp. indicated that its action was possible because of the low number of stockholders of record and necessitated by the nature and extent of the trading of its common stock and the company's financial condition. Management also reported that delisting would let management focus its attention and resources on aggressively exploring financial alternatives for the business. *See* TEK Digital Corporation form 8-K, *Current Report Pursuant to Section 13 or 15 of the Securities Exchange Act of 1934* (Nov. 9, 2001) (on file with author) (the SEC form incorporated the press release).

[36] The two part test set forth in Rule 13e-3(a)(3) of the Securities Exchange Act of 1934 governs such transactions. The first part of the test involves the purchase of, or tender offer for, any equity securities of the issuer by the issuer or an affiliate of the issuer, solicitations of proxies or consents subject to the proxy rules by the issuer or an affiliate of the issuer in connection with a merger or similar corporate transaction between the issuer and its affiliate or the sale of substantially all the assets of the issuer to its affiliate. The second part of which requires that the transaction have either a reasonable likelihood or purpose of directly or indirectly causing a class of equity securities listed on a national securities exchange or authorized to be quoted in an inter-dealer quotation system to be neither so listed nor so quoted. *See* 17 C.F.R. § 240.13E-3 (2003).

[37] *See generally* Justin Lahart, *The Crash of 2002,* CNN/MONEY, July 19, 2002, *at* http://money.cnn.com/2002/07/19/news/crash2002.

dramatic fluctuations demonstrate considerable investor uncertainty that does not bode well for small capitalization companies. Moreover, being a public company no longer means easy access to capital. Market skittishness today prevents most companies from raising cash through the issuance of new shares in secondary public offerings, and any indication by management of a willingness to trade equity for cash at current valuations is generally viewed as a sign of lost confidence in the long-term value of the company.[38] Finally, there is less prestige today inherent in being publicly traded than there was just in the late 1990s. This loss of prestige is particularly the case with respect to the NASDAQ market which led the rise in equity values during the late 1990s and has seen more than its share of recent decline.[39] Any benefit to being a public company in the eyes of suppliers, financiers, competitors and partners is significantly diminished; low stock prices could be seen by these parties as a sign of weakness that might serve as a basis questioning the viability of the enterprise.

Also driving the current trend toward going-private transactions is the fact that the cost of remaining public has increased and is likely to continue to increase in the near

[38] For example, in April 2002, Liberty Media Corporation reversed plans to buy back shares at a price of $13 per share. Press Release, Liberty Media, Liberty Media Corporation Terminates Cash Tender offer for 25 Million Shares of its Series A Common Stock and One Million Shares of Its Series B Common Stock (Apr. 16, 2002), *available at* http://www.shareholder.com/lmg-a/news/20020416-77566.cfm. While the reason for the cancelled buyback may well have been disclosure problems related to Liberty's then pending cable deals in Europe, shareholders responded by pushing Liberty's stock down from approximately $12 to $10 a share in the weeks immediately following the announcement of the decision. *Id.*

[39] NASDAQ experienced an approximate 31.6 percent drop from its 2002 high of over 1,900 in March 2002 to just under 1,300 in February 2003. The Dow Jones Industrial Average experienced a somewhat smaller 26.3 percent decrease from 10,500 in March 2002 to just under 8,000 in February 2003. *See* Bloomberg.com chart *at* http://quote.bloomberg.com/gcenter/gcenter.cgi?iquote=%5EINDU&PERIOD=1Y&equote1=&equote2=&equote3=&nasdaq=CCMP&EXCH=US&T=markets_gcenter99.ht&x=8&y=14 (last visited Feb. 21, 2003).

term due to a changing regulatory environment. Regulatory and compliance costs have increased and will continue to increase under new legislation and related U.S. Securities and Exchange Commission ("SEC") rules. On July 25, 2002, both houses of Congress[40] approved the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"),[41] which significantly increases the administrative cost and perceived risk to officers and directors of remaining a public company. While the impact of the Sarbanes-Oxley Act on corporate regulation and the concomitant increased risk to directors and officers may be more perceived than real, the impact will nevertheless be to further encourage officers to seek the relative safety of being a private company.[42]

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[40] Both the Senate and House reacted to a string of scandals including those of the Xerox Corporation, which paid a $10 million fine to the SEC in April 2002, reclassified $6.4 billion in revenue, and restated financial results for the previous five years, as well as those of Cendant, MicroStrategy, Waste Management, Enron and WorldCom. *See Xerox India Dogged by Payments to Fictitious Firms, Tax Evasion Allegations*, AGENCE FRANCE-PRESSE, July 22, 2002, *available at* 2002 WL 23562984 (discussing the Xerox accounting scandal and the disclosure in its annual report in July 2002 restating equipment sales from 1997 to 2001 by $6.4 billion). *See also Cable Notes*, 10 WARREN'S CABLE REGULATION MONITOR 42, Oct. 28, 2002, *available at* 2002 WL 8174499 (discussing a General Accounting Office report issued October 23, 2002 that recounts the circumstances under which sixteen companies, including Adelphia, Orbital, Enron, MicroStrategy and Xerox restated earnings and noting that WorldCom and Global Crossing also restated earnings that same year).

[41] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201(a), 116 Stat. 745, 771 (2002).

[42] The SEC adopted final disclosure and compliance rules on January 15, 2003 as mandated by the Sarbanes-Oxley Act. These rules set forth extensive new requirements, including that filing companies must comply with new code of ethics disclosure requirements by July 15, 2003. *See* SEC Release No. 33-8177 *at* http://www.sec.gov/rules/final/33-8177.htm (last visited Mar. 24, 2003). In addition, companies, other than small business issuers must comply with these same disclosure requirements for fiscal years ending on or after December 15, 2003. *Id.* The SEC also introduced a new Regulation G, which applies whenever a public company discloses material information that includes non-GAAP financial measures. *See* SEC Release No. 33-8176 *at* http://www.sec.gov/rules/final/33-8176.htm

A. The Benefits of Going Private

There are many benefits to be realized by going private in the current environment. Going private results in the elimination of significant costs,[43] including savings in executive time, legal expenses, accounting costs and filing fees associated with the filing of SEC Forms 3, 4, and 5,[44] and 8-K,[45] 10-K,[46] and 10-Q,[47] to name just a few. Moreover,

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(last visited Mar. 24, 2003); *see also* SEC Release No. 33-8182 *at* http://www.sec.gov/rules/final/33-8182.htm (last visited Mar. 24, 2003)

[43] While the actual cost of remaining a public company varies greatly depending on factors including the number of transactions engaged in by the company, the number of stock trades executed by officers and directors, and the cost of the accounting and legal services utilized by the company, one commentator has concluded that even a small public company can spend approximately $1 million a year on costs directly related to being a public company. *See* Joseph L. Johnson III & Andrew J. Weidhaas, *The Going-Private Transaction*, N.Y. L.J., Nov. 13, 2001.

[44] Every director, officer or owner of more than ten percent of a class of equity securities registered under Section 12 of the Securities Exchange Act of 1934 must file with the Commission a statement of ownership regarding such security. The initial filing is on Form 3 and changes are reported on Form 4. The Annual Statement of beneficial ownership of securities is on Form 5. The forms contain information on the reporting person's relationship to the company and on purchases and sales of such equity securities. Companies commonly pay the cost of filing these forms on behalf of officers and directors. *See* United States Securities Exchange Commission, Description of SEC Forms, Overview of the Most Common Corp. Filings, http://www.sec.gov/info/edgar/forms.htm#common (last visited Feb. 21, 2003).

[45] This is the "current report" that is used to report the occurrence of any material events or corporate changes which are of importance to investors or security holders and previously have not been reported by the registrant. It provides more current information on certain specified events than would Forms 10-Q or 10-K. *Id.*

[46] SEC Form 10-K and Form 10-KSB, in the case of a small business, are the annual reports that most reporting companies file with the SEC. They provide a comprehensive overview of the registrant's business. The reports must be filed within 90 days after the end of the company's fiscal year. *Id.*

[47] SEC Form 10-Q and Form 10-QSB, in the case of a small business, are reports filed quarterly by most reporting companies. They include unaudited financial statements and provide a continuing view of the

the filing costs to public companies will likely increase as a result of the Sarbanes-Oxley Act.[48]

Transforming the company into a private firm also opens certain opportunities to obtain capital financing. A barely public company may have ambitious expansion or operating plans but limited access to capital. However, if the company locates an investor, whether strategic or financial, that is willing to take the company private, that investor may be willing to finance expansion or operating initiatives. In addition, as discussed in the Duracell example above, going private may permit management to operate the company maximizing overall value, not simply aiming to satisfy analysts' consensus forecast for the next quarter's earnings.[49] Conversion from a public to a private firm may allow management greater flexibility to focus on research and development and to implement strategies with a long-term view toward corporation building.[50]

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company's financial position during the year. These reports must be filed for each of the first three fiscal quarters of the company's fiscal year and are due within 45 days of the close of the quarter. *Id.*

[48] *See* Rene'e B. Jones, *Year in Preview: New Law Brings Changes For Professional Services*, SAN DIEGO BUS. J. AT 5 (Jan. 6, 2003), *available at* 2003 WL 11771969 (noting the argument made by a local auditor that "[w]ithout Sarbanes-Oxley, [the auditor] believed audit fees would increase by about 25 percent above last year's costs, depending on the size of the company. [But that the] [r]ules for Sarbanes-Oxley could increase costs another 40 percent to 50 percent").

[49] John Holt, president and chief executive at Seattle's, The Cobalt Group Inc., a provider of Internet services to auto dealers and manufacturers that went private in November 2001, said he has a lot more time to bring in new customers and solve problems for current customers than he did when the company was public. "That's what I should have been doing. That's how we built the company in the first place," Holt stated. "But it's hard to do that when you're evangelizing with investors and analysts all the time." Holt also said that Cobalt employees are no longer distracted by the company's low stock price and can focus more on being productive. *See* Jeff Meisner, *Once on Wall Street, Going-private is Not Easy*, PUGET SOUND BUS. J., Mar. 15, 2002, *available* at http://www.bizjournals.com/seattle/stories/2002/03/18/focus5.html.

[50] In the case of Seagate Technologies, for example, being private gave the company flexibility to invest in research that resulted in its new

It may also be easier and cheaper, at least from a tax perspective, to extract cash dividends from a private company. After going private, owners may be able to convert the company to a limited liability company or a Subchapter S corporation[51] and avoid the double taxation that occurs at the corporate and personal levels when a corporate structure is used.[52] Recent legislative changes may make the prospect of a change in the form of incorporation particularly attractive. For example, the number of qualified shareholders that may own a Subchapter S corporation has now been increased from 35 to 75.[53]

B. The Impact of the Sarbanes-Oxley Act on the Cost of Remaining Public

Provisions of the Sarbanes-Oxley Act and related changes in the way accountants, insurance companies and securities analysts treat public companies will further increase the cost of remaining public. One significant change is that, under the Sarbanes-Oxley Act, an auditor can no longer provide non-audit services contemporaneously with providing audit services to a public company, which will likely increase the cost of the audits of every public company. In an attempt to strengthen auditor independence from corporate management, the Sarbanes-Oxley Act limits the scope of consulting services accounting firms can offer their public-company audit clients. Audit costs are likely to increase as a result because, whereas once profitable non-audit services

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Cheetah drives as well as to focus on core businesses that allowed it to regain profitability. *See* Herhold, *supra* note 21, at 22.

[51] An "S Corporation" is a small business corporation, as defined at Internal Revenue Code (the "Code") § 1361(a)(1) for which an election to be taxed under Subchapter S of the Code is in effect for the year. Generally, an S Corporation may have no more than 75 shareholders. *See* 33 Am. Jur. 2d *Federal Taxation* § 4552 (2002).

[52] *See* 33 Am. Jur. 2d *Federal Taxation* § 4000 (2002) (for how C Corporations are taxed). *See also* 33 Am. Jur. 2d *Federal Taxation* § 4621 (2002) (for how S Corporations are taxed).

[53] *See* The Small Business Job Protection Act of 1996, Pub. L. No. 104-188, §§ 1301-1317, 110 Stat. 1755, 1777-87 (1996).

served to supplement competitive audit fees, now auditors will need to make a profit from audit services alone.[54]

Another factor is that small public companies may find it difficult to comply with new requirements that auditors be hired and supervised entirely by independent directors. The Sarbanes-Oxley Act enhances the responsibility of public-company directors and senior managers for the quality of financial reporting and disclosure. Section 301 requires that outside auditors be appointed, compensated and supervised by an audit committee comprised entirely of independent directors.[55] The Sarbanes-Oxley Act also calls on the SEC to issue a rule directing that the national securities exchanges not list the shares of any company failing to meet this requirement.[56]

In addition, the fact that the chief executive officer ("CEO") and chief financial officer ("CFO") of every public company are now personally responsible for earnings restatements means that management will have an additional incentive to be more receptive to going-private proposals. Indeed, the Sarbanes-Oxley Act requires that CEOs and CFOs personally certify their company's annual and quarterly reports.[57] Section 304 of the Sarbanes-Oxley

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[54] Under the Sarbanes-Oxley Act, accounting firms are prohibited from providing public companies for whom they provide auditing services the following contemporaneous services: bookkeeping or services related to accounting records or financial statements of the company; financial information systems design and implementation; appraisals and valuation services; fairness opinions or contribution-in-kind reports; actuarial services; internal audit outsourcing services; management functions or human resources; broker/dealer or investment advisor or investment banking services; and legal services and expert services related to the audit. *See* Pub. L. No. 107-204, § 201(a), 116 Stat. 745, 771 (2002).

[55] *See id.* § 301.

[56] *See id.*

[57] The Sarbanes-Oxley Act requires that each periodic report containing financial statements filed by a public company pursuant to Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 be accompanied by a written statement by the chief executive and chief financial officers of the issuer, stating that the statements and disclosures

Act provides that, in the event a company is required to restate earnings as a result of misconduct, the CEO and CFO shall reimburse the company for any bonus or other incentive-based or equity-based compensation they received during the twelve-month period following the first filing of the document that is required to be restated as well as any profit they realize from sales of the company's securities during that period.[58]

Prohibitions on personal loans to officers and directors will also serve as an incentive to insiders to abandon the public company model. Under the Sarbanes-Oxley Act, public companies are prohibited from making loans to their officers or directors.[59] While existing loans are grandfathered -- so long as there is no material modification or renewal of credit to the existing loans[60] -- this provision means that public companies will be less flexible than private companies with respect to the manner in which they may compensate their executives.[61]

The requirement under section 403 of the Sarbanes-Oxley Act that certain changes in equity ownership be reported within two days, will further encourage migration of public companies to private status. Section 403 provides that stock trades by directors, officers and major shareholders be reported to the SEC within two days after the date of the

fairly represent, in all material respects, the operations and financial condition of the issuer. *See id.* § 302.

[58] *See id.* § 304.

[59] *See id.* § 402.

[60] *See* Pub. L. No. 107-204, § 402, 116 Stat. 745, 787-88 (2002).

[61] The rules against lending to executives will eliminate a popular and pervasive means of compensating senior management. *See* Ben White, *Stock Options Becoming Pay-Plan Dinosaurs? Image-Sensitive Firms Get Creative With Perks*, WASH. POST, Jan. 31, 2003, at E01, *available at* 2003 WL 10894320 (noting that "a study released last month by the Corporate Library, a shareholder activist group, found that over one-third of the nation's largest companies, as measured by market capitalization, have loaned cash to executives, with an average of $10.7 million per loan, and that current executive indebtedness totals $4.5 billion.").

transaction.[62] This short deadline will require diligent enforcement and monitoring by public companies.

The new requirement that analysts be able to demonstrate their independence from the companies they cover by issuing critical reports will impact public companies as well. The Sarbanes-Oxley Act seeks to limit and expose possible conflicts of interest affecting securities analysts.[63] This comes at a time when the cushy relationship between companies and the analysts at the banks providing investment banking services to them is unraveling.[64]

Increased SEC scrutiny will subject far greater numbers of public companies to expensive audits and investigations. The Sarbanes-Oxley Act increases the SEC's annual budget authorization from $481 million to $776 million for fiscal year 2003, including almost $100 million in funds dedicated to hiring at least 200 additional auditors.[65] The SEC may feel pressure to demonstrate to Congress the efficacy of this new corps by pursuing significantly increased numbers of audits and investigations.

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[62] *See* Sarbanes-Oxley Act § 403.

[63] *See* 148 Cong. Rec. S6363-02 (2002) (proposal of Sen. Sarbanes).

[64] The new-found willingness of investment banks to rebuff their once lucrative clients is illustrated by the July 15, 2002 action by Goldman Sachs analyst Jack Kelly changing his investment opinion on Tyco International, Ltd. to "not rated" from the recommended list. *See* Robin Ajello, Ed., *In Business This Week: Tyco and Goldman: Still Feuding?*, BUS. WEEK ONLINE, July 29, 2002, *at* http://www.businessweek.com/ magazine/content/02_30/c3793035.htm. Mr. Kelly covered Tyco for many years, during which time Goldman Sachs earned millions of dollars providing advice related to former Tyco Chairman Dennis Kozlowski's $60 billion acquisition spree to build one of the world's largest manufacturing conglomerates. Goldman Sachs also recently served as a key adviser on Tyco's plan to spin the company off into four units. While Mr. Kelly's move is unusual, it is not an isolated event as it comes shortly after another Goldman Sachs analyst issued a "not rated" report on Adelphia Communications Corp., citing accounting transparency issues. *See* George Mannes, *Questions Mount as Adelphia Plunges*, The Street.com Network on AOL (Apr. 3, 2002), *at* http://aol.thestreet.com/tech/georgemannes /10015724.html.

[65] *See* Sarbanes-Oxley Act § 601.

The cost of directors' and officers' ("D&O") liability insurance is likely to increase substantially for public companies as a result of the Sarbanes-Oxley Act. A recent report on D&O coverage by Willis Group Holdings, Ltd. concludes that companies with healthy balance sheets are experiencing increases of twenty-five to forty percent in the cost of the premiums for D&O insurance over the past year, while companies with financial troubles are seeing rates increase by as high as 300 to 400 percent.[66] In fact, even after companies pay these increased premiums, there is no guarantee that the insurance companies will pay on the policies.[67]

Proposed accounting changes may make existing price to earnings ("P/E") ratios appear artificially inflated. Several legislators, including Senators John McCain and Carl Levin, have proposed changes to the accounting rules that would treat option grants as expenses.[68] This would mean that companies using options grants to compensate employees would need to deduct options expenses from earnings. Merrill Lynch recently conducted a study that showed this accounting change would increase the average P/E ratio for the S&P 500 from 18.3 to 20.4 (measured at the time of the

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[66] *See* Christopher Oster, *D&O Insurance Is Supposed to Cover Management Mistakes, But not if Insurer is in Trouble, Too*, WALL ST. J., June 13, 2002, at C1.

[67] D&O insurance companies have attempted to avoid liability for paying in the event of a major corporate scandal. The Royal Insurance Co. of America and St. Paul Mercury Insurance Co., for example, did just this in the case of the Enron scandal. These were two of the companies that wrote policies for Enron's directors and officers. They claim they should avoid liability because Enron misled them. *See* Roy Harris, *Enron's D&O Insurers Get Wanderlust,* CFO.COM, Feb. 21, 2002 *at* http://www.cfo.com /printarticle/0,5317,6745,00.html.

[68] A bill, entitled "Ending the Double Standard for Stock Options Act, S. 1940" is cosponsored by Senators Levin, McCain, Fitzgerald, Durbin, Dayton and Graham and has been referred to the Senate Committee on Finance. For more information from Senator Levin on this measure, see Carl Levin, Stockoption, *at* http://levin.senate.gov/issues/stockoptions.htm (last visited Jan 5, 2003).

study),[69] possibly creating a basis for shareholders to push stock prices lower. Some companies have already voluntarily adopted this approach.[70]

C. The Financing of Going-Private Transactions in the Current Economy

While cash is scarce in the public securities markets, large pools of capital remain available for deployment by venture, private equity and buyout firms.[71] On July 16, 2002, The Blackstone Group, a leading buyout firm, announced it had raised $6.45 billion for its Blackstone Capital Partners IV fund, briefly surpassing even Thomas H. Lee Partners' $6.1 billion Fund V, previously the largest private equity fund ever raised.[72] Blackstone was then outmatched by J.P. Morgan Partners, which raised approximately $8 billion for its J.P. Morgan Partners Global Investors, although 80% of this fund was raised from affiliate J.P. Morgan Chase & Co.[73]

In fact, venture capital funds have huge amounts of uninvested capital, at least $40 billion and as much as $106

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[69] *See* Justin Lahart, *Bracing for an Earnings Hit*, CNN/Money, July 11, 2002 *at* http://money.cnn.com/2002/07/11/news/options.

[70] The Coca-Cola Company surprised Wall Street when, on Sunday, July 14, 2002, it announced that it will now expense the cost of all stock options it grants. The revised accounting treatment will begin with options granted in the fourth quarter of 2002. *See* Stephen Taub, *Coke to Treat Options as the Real Thing*, CFO.COM, July 15, 2002, *at* http://www.cfo.com/printarticle/0,5317,7452,00.html.

[71] That is not to say that financing for any particular going-private transaction will be easy to secure in the current market. In fact, the author recognizes that financing may be difficult to arrange for the buy-out of any companies except those with strong economic fundamentals, including a claim to current or near-term profitability.

[72] The Thomas H. Lee Partners Fund V as raised in connection with Putnam Investments in January 2001. *See* Colin C. Haley, *Thomas H. Lee Raises $6 Billion Fund*, BOSTON.INTERNET.COM (Jan. 25, 2001), *at* http://boston.internet.com/news/article.php/2001_570501.

[73] *See* Joe Christinat, *Buyout Fund-Raising Portions Shrink*, THOMPSON VENTURE ECONOMICS: BUYOUTS (Mar. 4, 2003), *at* http://www.ventureeconomics.com/vec/1031551052172.html.

billion, according to some estimates.[74] This money is generally not channeled toward the initial funding of companies, as it was in the late 1990s, but rather is trending toward later-stage investments. The acquisition of undervalued public companies, with their experienced management teams and proven ability to execute an IPO, will generally be very attractive to these funds. In fact, venture and private equity money is a key engine driving buyout transactions today,[75] just as the high-yield debt market was a driving force for leveraged buyouts in the 1980s.[76]

III. ALTERNATIVE STRUCTURES FOR GOING-PRIVATE TRANSACTIONS

A. Key Participants in a Going-Private Transaction

An important starting point in understanding the structure of the going-private transaction is recognizing the primary players and their roles. Management will play a critical role in many successful going-private transactions. Unless the company is to be immediately broken apart and its assets sold, it is critical that incumbent management join the acquisition group. Only current management will know if there has been any past corporate malfeasance; and even

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[74] *See* Nicholas Johnston, *Venture Cuts Reflect Fewer Opportunities*, WASH. POST, May 16, 2002, at E05.

[75] Venture fund interest in buyout transactions is not new but seems to be accelerating. Kleiner, Perkins, Caufield & Buyers, arguably the leading venture firm, lists on its website as its "Special Initiative," as of July 2002, a collaboration with Integral Capital Partners, an investment group that "typically invests between twenty and fifty percent of capital in private companies and buyout opportunities." *See KPCB Special Initiatives*, *at* http://www.kpcb.com/keiretsu/special.php (last visited Feb. 16, 2003).

[76] For a brief discussion of the differences between financing leveraged buyouts in the 1980s versus financing these transactions in the early 2000's, see John L. Graham and John J. Kelley III, *Tempted to Leave Wall Street; Old Economy Company Executives Examine Prospect of Going-private*, N.Y. L.J., May 1, 2000, at S4.

then due diligence will be required to uncover hidden problems with the operating business to the satisfaction of equity investors and lenders.

The controlling shareholder also plays a pivotal part, even if it has not initiated the transaction because its acquiescence to the transaction is required. There may or may not be a majority shareholder, but where one exists who is not a member of the acquisition group, the acquisition group would be well advised to extract a pledge of support from the majority shareholder prior to initiating an offer to acquire the company. Unless the controlling shareholder votes its shares in favor of the offer, the transaction will not be consummated.

An outside capital provider is also essential to many going-private deals. It is generally very difficult to borrow the entire amount needed to acquire a company, and some portion must therefore come in the form of an equity investment. Sources of outside equity capital vary and include specialized buyout funds, venture capitalists, private equity firms and strategic investors. One option for providing the cash component of the buyout capital is to bring in a firm that specializes in planning, financing and executing leveraged buyouts. In addition to providing the capital the company needs to grow, these firms can help craft an exit strategy or build up the company to a point where it can be taken public again.[77] Another option may be co-opting a strategic investor that has an interest in providing the company with an exit strategy.[78] Banks and other lenders

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[77] Major firms that provide buyout advice and capital, such as Warburg Pincus Equity Partners LP of New York City and Thayer Capital Partners in Washington, DC, will likely only be tempted by transactions involving a minimum valuation of around $25 million in equity value. In addition, buyout firms are likely to be more interested in doing deals with companies that can show they are close to profitability with "great revenue growth potential, good cash flow, and little debt." *See* Meisner, *supra* note 49.

[78] In the case of SAGA Systems, Inc., Software AG, the former parent, retained an equity interest in its former subsidiary and did, in fact, later reacquire the division. *See* Press Release, Software AG to Acquire SAGA Systems Inc. for US$360 Million: Establish a Significant North American

can also provide the leverage for the buyout by lending funds in the form of revolving debt, term debt, or mezzanine debt.[79]

The special committee of the board and its advisors also may play a central role in a related-party acquisition. Depending upon the deal structure selected, it may be necessary for the board of the target company to appoint a special committee comprised of independent directors to negotiate with the acquisition group and recommend to the larger board and the shareholders whether or not to accept the acquisition bid.[80] Where the deal structure compels the use of a special committee, the burden of showing that the transaction was unfair to shareholders is more likely to fall upon the complaining shareholders if the committee receives an opinion as to the fairness of the acquisition bid from a financial advisor of the committee's choosing.[81] In selecting a financial advisor, the special committee should be aware that any connection between the advisor and the company or members of the acquisition group will need to be disclosed to the shareholders and the SEC and could become the subject of subsequent shareholder litigation.[82] Particularly where

Platform for Accelerated Growth (Nov. 2, 2000), *available at* http://www.updatacapital.com/uci/press/0_27.htm.

[79] For a discussion of different kinds of bank debt utilized in buyout transactions, *see* RICK RICKERTSEN, BUYOUT 167-69 (American Management Association 2001).

[80] A tender offer does not require the appointment of a special committee as it is deemed a transaction directly between the acquisition group and individual shareholders. A negotiated merger transaction between the acquisition group and the company, however, will generally require the appointment of a special committee of independent directors where the acquisition group includes executives or directors of the company. *See In re* Home Shopping Network, Inc. Shareholders Litig., C.A. No. 12868, mem. op. at 29 (Del. Ch. May 19, 1993).

[81] *See* Michael J. Kennedy, *The Business Judgment Syllogism – Premises Governing Board Activity*, *in* TECHNOLOGY & EMERGING GROWTH M&AS 2002, at 294-295 (PLI Corp. Law and Practice Course, Handbook Series PLI Order No. B0-017V, 2002) (discussing that a properly advised special committee will generally be entitled to rely on the business judgment rule).

[82] *See* SEC Regulation M-A, Item 1005, Past Contacts, Transactions, Negotiations and Agreements, 17 C.F.R. § 229.1005 (2003).

in-house counsel is a member of the acquisition group, the special committee should retain outside counsel to ensure adequate representation and the perception among shareholders that legal advice is not biased in favor of the acquisition group.[83]

B. Choosing Between a Merger and Tender Offer

Before addressing unilateral tender offers it is important to recognize that they are but one way to structure a going-private transaction. From this perspective it is then possible to contrast the duties of directors under alternative transaction structures while comparing the similarity of each transaction's results.

One possibility for taking a company private is through a negotiated merger involving a transaction between the company and an entity formed by the acquisition group. If the acquisition group includes corporate officers or directors, the company will generally need to appoint a special committee of independent directors to negotiate the transaction, or else have the burden of showing that the transaction is entirely fair to minority shareholders.[84] Procedurally, the offer negotiated between the acquisition

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[83] *See* H. Peter Nesvold, *Going Private or Going for Gold: The Professional Responsibilities of the In-house Counsel During a Management Buyout*, 11 GEO. J. LEGAL ETHICS 689 (1998).

[84] Directors do not have the burden of proving that a merger in which they have a conflict of interest is entirely fair if the transaction is approved by a special committee of independent directors. *See* Andrew R. Brownstein et al., *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 609 (PLI Corp. Law and Practice Course, Handbook Series No. B0-01FF, 2002) ("The idea is for the special committee to preserve the integrity of the board's decision making process, which is presumptively tainted by self-interest, by simulating arm's-length negotiations. In a freeze-out merger, special committees are given the job of representing minority shareholders. They negotiate with representatives of the interested stockholders in an attempt to simulate the arm's-length bargaining process that would otherwise be absent in an interested party transaction, such as a parent/subsidiary merger.").

group and the special committee will be reflected in the Articles of Merger and a Plan of Merger, and shareholders will receive a proxy statement containing the information required by Schedule 14A and a proxy card, both of which must be filed with the SEC at the time they are sent to shareholders, before voting on the transaction.[85]

A second possibility, and the focus of this article, is the tender offer transaction. It is worth noting that there are several variations on tender offers. A tender offer involves the acquisition group making a direct offer to the public shareholders to acquire their shares. An advantage of this form of transaction from the perspective of shareholders is that shareholders generally receive payment faster than in a merger; whereas the SEC must first approve merger proxy statements before they can be delivered to shareholders, there is no need for prior SEC review before launching a tender offer.[86] The problem with a tender offer from the perspective of the acquisition group is that a sufficient number of shareholders may not accept the offer.

As a result, tender offers are commonly conditioned on the acquisition group's holding at least ninety percent of each class of the stock of a corporation following the close of the tender offer.[87] Ownership of at least ninety percent of

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[85] Report, *Changes in The Model Business Corporation Act Relating To Domestication and Conversion—Final Adoption*, 58 BUS. LAW. 219, 283 (2002) (discussing proposed changes to Model Business Corporation Act § 11.06. This section, as written, provides that "[a]fter a plan of merger or share exchange has been adopted and approved as required by this Act, articles of merger or share exchange shall be executed on behalf of each party to the merger or share exchange by any officer or other duly authorized representative.").

[86] *See* Paul S. Bird, *Developments in Spin-Offs, Sales of Divisions and Going-private Transactions, 33rd Annual Institute on Securities Regulation*, *in* 33RD ANNUAL INSTITUTE ON SECURITIES REGULATION, at 449 (PLI Corp. Law and Practice Course, Handbook Series PLI Order No. B0-0113, 2001).

[87] Many tender offers, including Unocal Corporation's October 2002 tender for Pure Resources, Inc. and Danaher Corporation's June 2001 tender for Lifschultz Industries, Inc. have included the 90% tender threshold. See Press Release, Unocal Increases Exchange Ration of Offer for Pure Resources Shares (Oct. 2, 2002), *available at*

the company's stock permits the acquisition group to complete a short-form merger without needing to hold a shareholder's meeting or solicit proxies from the perspective of the acquisition group.[88] The disadvantage to acquiring less than all of the company's stock through a tender offer from the perspective of the acquisition group is that non-tendering shares retain the right to challenge the amount of the offer through an appraisal proceeding.

The acquisition group can avoid the need to engage in a merger or conduct a tender offer under certain circumstances by using a reverse stock split in which fractional shareholders receive cash payments.[89] However, reverse

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http://www.unocal.com/uclnews/2002news/100202.htm. *See also* Press Release, Lifschultz Tender Offer Extended Through June 21st (June 21, 2001), *available at* http://www.danaher.com/html/pressroom /press_release.asp?Art=6.

[88] *See* DEL. CODE ANN. tit. 8, § 253 (2002).

[89] The Delaware Supreme Court recently affirmed that public companies may use reverse stock splits to reduce their number of shareholders in order to decrease the cost of complying with the federal securities laws with respect to those shareholders' accounts. *See* Applebaum v. Avaya, 812 A.2d 880 (Del. 2002) (note, however, that the transaction underlying this matter involved a reverse stock split followed immediately by a forward stock split of the same magnitude, with the result that the par value of each share remained the same after the transaction was completed, and also that the transaction did not cause the public company to delist from the exchange on which it was traded or otherwise cause it to *go private*). In such a transaction multiple shares, for example 10,000 shares, are exchanged for a single share. In this hypothetical, holders of less than 10,000 shares receive the value of their shares in cash, in such amount that, generally, no shareholder receives cash in respect of fractional share interests in an amount greater than the value of one full share of post-reverse-split stock. This effectively cashes out holders of less than 10,000 shares, with the result that the number of shareholders is reduced, perhaps below the 300-shareholder threshold that subjects the company to filing requirements under the Securities Exchange Act of 1934. Section 12g(4) of the Securities Exchange Act of 1934 provides, in part, that "[r]egistration of any class of security pursuant to this subsection shall be terminated in ninety days...after the issuer files a certification with the Commission that the number of holders of record of such class of security is reduced to less than three hundred

stock splits generally require approval by a majority of outstanding shares voting through the proxy solicitation process.[90] Additionally, under Delaware law, they can also trigger the requirement that the specific class or series of stock affected separately approve the reverse split.[91]

C. The Process of Going Private

The process for taking a company private largely hinges on the deal structure selected. In a transaction structured as a merger, the first step is generally for the acquisition group to make an offer to the board of directors of the company, which then establishes a special committee of independent directors to negotiate the offer with the acquisition group. However, in the case of a tender offer, the first public step is for the acquisition group to make an announcement, often through a newspaper advertisement, of its intention to make an offer to buy shares directly from shareholders.

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persons." *See* Securities Exchange Act of 1934 § 12g(4), 15 U.S.C. § 78l(g)(4) (2003).

[90] *See, e.g.*, *Applebaum,* 812 A.2d at 885 (in which shareholders were required to vote to authorize the board to proceed with a reverse stock split transaction).

[91] Unless a specific right to vote on a reverse stock split is provided for in the company's certificate of incorporation, stockholders have only the rights to vote on reverse stock splits provided for under Del. Gen. Corp. L. Section 242. *See* DEL. CODE ANN. tit. 8, § 242 (2002). Under Section 242(b)(1), an amendment to a company's certificate of incorporation to effect a reverse stock split requires the vote of the holders of a majority of the outstanding stock entitled to vote. A class or series is also required to approve the amendment under Section 242(b)(2) if the amendment would increase or decrease the aggregate number of shares of the class or series authorized, increase the par value of the shares of such class or series, or otherwise alter its preferences, powers and rights. In the case of a reverse stock split, the par value of the stock generally increases by the inverse of the ratio by which the shares are to be combined. Thus, in the scenario in which 10,000 shares are combined to become one share, if the original par value was $0.01, the par value would increase to $100.00. *See* Christopher L. Kaufman et al., *Smash-Down Financings, in* VENTURE CAPITAL 1991: FORMING THE FUND AND FINANCING ISSUES, at 351-52 (PLI Com. Law and Practice Course, Handbook Series PLI Order No. A4-4338, 1991).

Going-private transactions in which controlling shareholders are members of the acquisition group present a situation in which the opportunity for conflicts of interest is ripe. A party exercising control over directors and officers stands to profit from an acquisition transaction, and its interests diverge from those of other shareholders. For this reason, under Delaware law, transactions involving a controlling shareholder that are structured as a merger are required to meet the "entire fairness" test that has been articulated by the Delaware courts.[92] The entire fairness test breaks down into the two elements of fair dealing and fair price, and it requires that the calculus take into account all of the circumstances of the transaction.[93] Under this test, the burden of showing that the transaction was fair to minority shareholders rests initially with the directors of the company, but it shifts to any shareholders complaining about the fairness of the transaction as long as a properly functioning special committee of disinterested directors reviews and approves the merger proposal in advance. [94]However, this special committee must meet certain procedural requirements, including that it must have adequate time to fulfill its duty of due care and conduct due diligence. The special committee also cannot be subject to coercion at the hands of the acquisition group and must be truly independent.[95] While members of the special

[92] *See* Orman v. Cullman, 794 A.2d 5, 20 (Del.Ch. 2002) (articulating that one way for a plaintiff shareholder to overcome the burden of showing that the board did not exercise its business judgment, and instead put the burden on the board to show entire fairness, is to submit evidence that the transaction was a "merger between two corporations under the control of a controlling shareholder").

[93] *See* Corinne Bell et al., *Advising the Board of Directors*, *in* A GUIDE TO MERGER & ACQUISITION, at 216-217 (PLI Corp. Law and Practice Course, Handbook Series PLI Order No. B0-017V, 2002).

[94] *See id.*

[95] *Id.* at 217.

committee can be compensated, any benefit they receive in exchange for their services must be reasonable.[96]

Also in the merger context,[97] a separate financial advisor must be retained to assist the special committee in establishing a value for the company, provide advice regarding the financial soundness of going private, and assess the financial terms and financing of the transaction. The financial advisor will generally give a preliminary view of the fairness range. In selecting the advisor, the special committee should consider the advisor's recent material business relationships with the company and the acquisition group since these will need to be disclosed to shareholders.[98]

In order to ensure that it is viewed as a properly functioning special committee, the committee should be authorized to negotiate the terms of the merger, and not simply to be engaged to approve or disapprove the buyer's

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[96] Special committee and financial advisory fees must be reasonable. It is widely acknowledged that service on a special committee may require additional compensation. In litigation in connection with a proposed going-private transaction involving Deltek Systems, Inc. ("Deltek") filed by shareholders against six members of the Deltek board of directors in May 2002, one claim was that the members of the special committee retained options to acquire company stock that could be exercised after the going-private transaction. Deltek responded that "[b]ecause of the exercise prices of the options . . . and the fact that Deltek will be a private company with limited liquidity following the merger, there is no reason to believe that any member of the special committee [formed to negotiate the transaction] will exercise the options following completion of the going-private transaction, or that the options will have any value." *See* Item 15 of Amendment No. 3 to Deltek's Rule 13e-3 Transaction Statement on Schedule 13 E-3 on file with the SEC, *available at* http://www.sec.gov/Archives/edgar/data/1029299/000095015202004181/193317dsc13e3a.htm. It is best to avoid this issue by eliminating options for special committee members.

[97] As of 2002, a financial advisor must be retained in the tender offer context. *See generally In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 450 (Del. Ch. 2002) (requiring the disclosure of the financial advisor's work product to investors in the exchange-offer context).

[98] *See* SEC, Regulation M-A, Item 1015, Reports, Opinions, Appraisals and Negotiations, 17 C.F.R. § 229.1015 (2003) (discussing the requirements for Item 9 on Schedule 13E-3).

initial proposal.[99] The delegation of this authority from the board is critical to shift the burden to shareholders, as the committee must function in a manner which indicates that the controlling shareholder did not dictate the terms of the transaction and that the committee exercised real bargaining power at an arms-length.[100] The special committee may have different obligations with respect to the price it negotiates depending on whether the acquisition group already has a control block of company stock. If the acquisition group does hold a control block, then the task of the committee under Delaware law is not to obtain a control premium for the public shareholders but, simply to get the best price from the buyer for a non-controlling block of stock.[101]

In contrast, the board has not historically been required to appoint a special committee of independent directors where the transaction is structured as a tender offer rather than a merger, so long as the board takes no action to assist the acquisition group.[102] This scenario is addressed in greater detail in the discussion of the Delaware Chancery Court's decision in *In re Siliconix, Inc., Shareholders Litig.*, that follows.

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[99] *See* Bell, *supra* note 93, at 216.

[100] *See* Kahn v. Tremont Corp., 694 A.2d 422, 429 (Del. 1997). For this reason, the best practice is for the acquisition group to offer a fair price to start but to leave room to negotiate upwards with the special committee, which may help to show that the special committee successfully represented the interests of the shareholders.

[101] *See* Bird, *supra* note 86, at 452.

[102] Even after the Chancery Court's decision in *Pure Resources*, which sets forth the standard for ensuring that tender offers are non-coercive, that the target board need not appoint a special committee appears to continue to be the case. *See* 808 A.2d at 445.

IV. STANDARDS OF CONDUCT GOVERNING DIRECTORS

A. Mergers Versus Tender Offers

There are, as a practical matter, two ways to structure the acquisition of a public company. The first is for the group seeking to acquire the company (the "acquisition group") to negotiate the acquisition with the board of directors of the target company and thereby agree on terms that are then reflected in an agreement of merger between an entity owned by the acquisition group (the "acquisition subsidiary") and the target company.[103] If approved by the required percentage of shareholders, the merger transaction will be consummated, after which the acquisition group will either directly or indirectly own all of the equity interest in the target company.[104]

An alternative to engaging in a merger transaction involves the acquisition group making an offer directly to the public shareholders of the company to acquire their shares through a tender offer. The acquisition group is required to make extensive disclosures with respect to the tender offer through the filing of a Schedule TO.[105] There are a number

[103] Under Section 251(b) of the Delaware General Corporation Law ("DGCL"), the board is required to adopt a resolution declaring the terms of the merger agreement advisable. *See* DEL. CODE ANN. tit. 8, § 251(b) (2002). Under DGCL Section 251(c), the agreement is then submitted to shareholder for their approval. *See* DEL. CODE ANN. tit. 8, § 251(c) (2002).

[104] Direct or indirect ownership depends upon whether an acquisition subsidiary or other intermediary entity was used to consummate the transaction. Shareholders that did not vote in favor of the transaction will no longer own their shares but will have the right to petition the court of competent jurisdiction, which in Delaware will be the Court of Chancery, in an appraisal action seeking a higher valuation for their shares. *See* DEL. CODE ANN. tit. 8, § 262(a) (2002) (appraisal available only to shareholders that did not vote in favor of or consent to the merger or consolidation).

[105] *See* SEC, Rules and Regulations Under the Securities and Exchange Act of 1934, Schedule TO, Tender Offer Statement Under

of practical advantages for the acquisition group in conducting a tender offer rather than a merger transaction. First, shareholders that accept the tender offer will not have the right to seek an independent court appraisal of the value of their shares.[106] Second, a tender offer can be closed much more quickly than most merger transactions as there are no negotiations necessary with the target board of directors.[107]

Most tender offer transactions seek the same ultimate result as a negotiated merger transaction, which is complete ownership of the target company by the acquisition group. As a practical matter, this may be difficult to accomplish in the case of a widely held public company with a large number of individual shareholders. Therefore, many tender offer transactions are conditioned on the acquisition group owning at least ninety percent of the target company stock following the close of the tender offer so that the acquisition group can then conduct a short-form merger to eliminate the non-tendering shares.[108] In a short-form merger the merger can be accomplished by the execution and filing of a certificate of ownership and merger setting forth the board's resolution to merge.[109]

B. Standards for Judging Director Behavior in the Merger Context

As a general matter, the actions of directors are governed by the business judgment rule, which provides, at its most basic, that business decisions made by directors will be

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Section 14(d)(1) or 13(e)(1) of the Securities Exchange Act of 1934, 17 C.F.R. § 240.14d-100 (2003).

[106] *See* DEL. CODE ANN. tit. 8, § 262 (2002).

[107] In most cases, tender offer transactions can close as soon as twenty days after they are initiated. Rule 14e-1 under the Securities Exchange Act of 1934 provides that no tender offer shall be held open for less than twenty days from the date it was first published or sent to shareholders in order to prevent fraud, deception or manipulative practices. *See* 17 C.F.R. § 240.14e-1 (2003).

[108] Under Delaware law, short-form mergers are permitted pursuant to DGCL Section 253. *See* DEL. CODE ANN. tit. 8, § 253 (2002).

[109] *Id.*

presumed to be in the best interests of the company and its shareholders.[110] In order to avail themselves of the presumption of the business judgment rule, directors must comply with both their duty of due care and their duty of loyalty. At a minimum, the directors' duty of due care requires that they inform themselves sufficiently of the material facts so that they are capable of reaching an informed decision.[111] The duty of loyalty requires that directors be disinterested and independent and that they act in a way that is in the best interests of the corporation and its shareholders and avoid involvement in those transactions in which their economic interests diverge from those of the company.[112]

Therefore, in order to enjoy the presumption of the business judgment rule with respect to their decisions, directors must exercise due care and have neither economic nor other discernible interest in the transaction.[113] If directors fail to exercise this due care, they can be subject to

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[110] *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). One commentator describing the importance of the business judgment rule has opined that "[a] more academic reason for not acting hastily is that some deliberative time should allow the decision-maker(s) to test their decision against the principles of loyalty, efficiency and informational advantage." Kennedy, *supra* note 81, at 290.

[111] *Aronson v. Lewis* described this duty as "a duty to 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 requisite care in the discharge of their duties." 473 A.2d at 812.

[112] *See* Solash v. Telex Corp., 13 DEL. J. CORP. L. 1250 (Del. Ch. 1988), *available at* 1988 WL 3587.

[113] There are certain circumstances in which directors can have an economic interest in a transaction and yet not breach their duty of loyalty, but these circumstances are not germane to this discussion. Generally, although a director who uses his office to promote, advance, or effectuate a transaction that is in his personal financial interest has the burden of establishing his own good faith as well as the "most scrupulous inherent fairness" of the transaction, it is still technically feasible for the director to establish the entire fairness of the transaction and survive judicial review. *See* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1280 (Del. 1989). *See also* Kennedy, *supra* note 81, at 294 n.26.

personal liability with respect to the transaction.[114] If directors have an economic interest in the transaction that is in conflict with the interests of the company or its shareholders, they will be required to show that the transaction was entirely fair, a burden that includes both a showing that the transaction was economically fair to shareholders (the fair price element) and that the transaction was fairly timed, initiated, structured, negotiated, disclosed and approved (the fair dealing element).[115]

The business judgment rule has been applied in the merger context. In *Smith v. Van Gorkom*, a seminal case concerning the duties of directors in the case of an offer to acquire the company, the Delaware Supreme Court found that the directors failed to satisfy their duty of care when they did not take the time to consider all of the information relevant to the transaction.[116]

Likewise, merger transactions have been successfully challenged based upon the failure of the board of directors to meet its duty of loyalty.[117] Therefore, where a member of the board of directors has an interest in the transaction, and in order to avoid application of the entire fairness standard in later shareholder challenges to such a transaction, the board may appoint a special committee of disinterested directors.[118] Approval of a merger transaction by a special committee that meets its duty of due care, functions effectively and has the ability to not only consider the fairness of the acquisition

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[114] *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

[115] For a discussion of self-interested transactions and the requirement of showing "entire fairness," see Bell, *supra* note 93, at 215-17.

[116] 488 A.2d 858. In *Van Gorkom*, the board of directors approved an acquisition offer on one day's notice. In addition, the directors had neither read the merger agreement, nor sought a determination of the company's fair value. For a detailed discussion of *Smith v. Van Gorkom*, see Kennedy, *supra* note 81, at 292-93.

[117] *See, e.g.*, Solash v. Telex Corp., 13 DEL. J. CORP. L. 1250 (1988).

[118] *See, e.g.*, Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110 (Del. 1994).

offer but also negotiate the transaction with the acquisition group will generally satisfy the business judgment regarding their approval of the transaction.[119]

C. Standards for Judging Director Behavior in the Tender Offer Context

The decisions made by corporate directors have also been challenged in the context of third-party tender offers in which the directors sought to prevent a hostile bid from succeeding. The leading case discussing director duties in this context is *Unocal Corp. v. Mesa Petroleum Co.*[120] In *Unocal*, the court determined that the board was entitled to the benefits of the business judgment rule as a general matter but that, because the board faced the inherent conflict of being eliminated if the transaction succeeded, it would be required to show reasonable grounds for its determination that a risk of harm existed with respect to the company and that its response to this risk was proportional. The board could meet this standard by showing that it acted in good faith after reasonable investigation.[121]

In contrast, recent Delaware Chancery Court decisions illustrate that both the board of directors of a target company and the controlling shareholder of a company are absolved from their affirmative duties to minority shareholders in the context of a tender offer transaction if certain limitations on the behavior of the board of directors and the controlling shareholder are met. Specifically, where the board of directors of the target company takes no affirmative action to assist or promote the success of the acquisition group's tender offer, the Chancery Court has

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[119] In addition to the board of directors, controlling shareholders who make an offer to acquire the minority interest in a company also owe a duty to the minority shareholders in the context of a negotiated merger transaction. These duties include the duty to offer the minority shareholders a fair price for their shares.

[120] *See* 493 A.2d 946 (Del. 1985).

[121] *See id.* at 955.

articulated that the board of directors has no duty to review the offer or recommend to shareholders whether the offer is fair.[122]

Therefore, by properly structuring a tender offer to ensure it will be considered unilateral, a controlling shareholder can issue a tender offer to acquire the minority shares of the target company without having to negotiate the transaction price with the target company's board or special committee, and without triggering in the directors an affirmative duty to recommend to shareholders whether the tender offer is fair. Even if the acquisition group first attempts to negotiate a merger agreement with the special committee, it can later conduct a tender offer without triggering a requirement that the board take a position with respect to the fairness of the tender offer.

V. RECENT DELAWARE CASE LAW

Commentators have written that two recent Delaware Chancery Court decisions that distinguish between the fiduciary duties owed to minority shareholders in merger versus tender offer transactions, *Aquila* and *Siliconix*, "do not indicate a departure from Delaware's general policies."[123] And, while it may be true that "[n]othing in either decision purports to change the duties of directors in situations where board action is required,"[124] this does not mean that the decisions are insignificant. In fact, these cases draw a significant line between mergers and tender offers. This important distinction is highlighted by the even more recent decision of the Delaware Chancery Court in *Pure Resources*,

[122] *See In re* Siliconix, Inc. S'holders Litig., No. CIV. A. 18700, 2001 WL 716787 (Del. Ch. June 21, 2001) (permitting a special committee that remains neutral and makes no recommendation with respect to a tender offer to refrain from seeking a fairness opinion from its financial advisor under the doctrine that the controlling shareholder would not be obligated to offer a "fair" price for minority shares in any event).

[123] *See* Lipton, *supra* note 1, at 1050 n.53.

[124] *Id.*

in which the court set specific extra-legislative requirements on tender offers initiated by controlling shareholders.[125]

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

Siliconix is an important case not so much because it articulates new case law, but because it so strikingly contrasts the different fiduciary obligations directors face when considering essentially identical transactions when structured as tender offers versus mergers.

In *Siliconix*, the controlling shareholder initially announced an all-cash tender for the 19.6 percent of the shares in its subsidiary that it did not already own, offering a ten percent premium over the subsidiary's then market price per share. The subsidiary responded by forming a special committee comprised of two independent directors to negotiate the transaction with the controlling shareholder. Although the true independence of both directors appears questionable based on their long-standing business relationships with the controlling shareholder,[126] these two independent directors nevertheless rejected the controlling shareholder's initial all-cash offer.[127]

In response to the special committee's rejection of its initial all-cash tender offer proposal, the controlling shareholder launched a stock-for-stock tender offer without

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[125] 808 A.2d 421 (Del. Ch. 2002).

[126] In its decision, the court notes that one member of the special committee was the controlling shareholder's former attorney and that the other member had provided banking services to the controlling shareholder. Both members of the special committee were also personal friends of the chief representative of the controlling shareholder that was conducting the tender offer negotiations. The court found that the members of the special committee received a $50,000 fee and an additional undisclosed "special fee" to be determined at a later date. The court noted, however, that all of the directors other than the two chosen for the special committee were even more clearly conflicted. Finally, the special committee was found to have selected an independent financial advisor in Lehman Brothers and independent legal counsel in Heller, Ehrman, White & McAuliffe, neither of which had any connection with the controlling shareholder. *See Siliconix*, 2001 WL 716787 at *3.

[127] *Id.*

first seeking or obtaining the consent of the special committee. The stock-for-stock tender offer contained a "majority of the minority" provision requiring a majority of the non-affiliated shareholders to tender their shares in the tender offer[128] but also noted that, while the controlling shareholder intended to effect a short-form merger following a successful tender offer, there might be circumstances under which it would not do so.[129]

The special committee made the decision to remain neutral and made no recommendation with respect to the tender offer in the Schedule 14D-9[130] it caused the company to file with the SEC. The special committee also did not request that its financial advisor, Lehman Brothers, provide a fairness opinion with respect to the transaction, reasoning that once the process had changed from a negotiated transaction to a unilateral tender offer, the special committee did not need to consider whether the offer was fair to shareholders.

The *Siliconix* court began with the principle that a majority shareholder has no obligation to offer a particular, fair, price in a tender offer for minority shares, with the caveat that the offer cannot be "coercive in some significant

[128] One commentator has noted that the inclusion of this "majority of the minority" provision by the controlling shareholder in its tender offer was not a determining factor for the court, because the entire fairness standard would not be applied by a court at all in the tender offer context unless coercion or lack of disclosure on the part of the acquirer could be shown. *See* Elizabeth M. McGeever, *Avoiding Entire Fairness Review: The Tender offer Followed by the Short-form Merger: A Discussion of Unocal Exploration and Siliconix, in* SECURITIES LITIGATION: PLANNING AND STRATEGIES, at 430 (ALI-ABA Course of Study 2002).

[129] The court commented that the controlling shareholder's refusal to commit to a second step would not be considered coercive under Delaware law. *See Siliconix*, 2001 WL 716787 at *16 (citing *In re* Ocean Drilling & Exploration Co. Shareholders Litig., Consol. C.A. No. 11898, mem. op. at 15 (Del. Ch. Apr. 30, 1991) and *In re* Life Technologies, Inc. Shareholders Litig., C.A. No. 16513 at 9-11 (Del. Ch. Nov. 24, 1998)).

[130] Schedule 14D-9 is a solicitation/registration statement that must be filed with the SEC in connection with a tender offer. *See* 17 C.F.R. § 240.14d-9 (2003).

way."[131] The Delaware Chancery Court then distinguished the tender offer context from that of a merger transaction, explaining that in a tender offer a shareholder has the choice whether or not to accept the offer, and is therefore free to reject the offer and retain stock in the enterprise. In the merger context, the court reasoned that the negotiation is between the company itself and the acquirer with the shareholder given no direct decision making authority.[132]

The plaintiff shareholders in *Siliconix* argued that the board was required to take a position as to whether the shareholders should accept the tender offer and to inform shareholders of that decision and the reasons for it.[133] The court rejected this position, contrasting it with the duties of the board in the context of a merger. The court explained that in *McMullin v. Beran,*[134] a case with facts similar to those in *Siliconix* but in which the transaction was executed as a merger, the board had an affirmative duty to protect the interests of minority shareholders by ascertaining the subsidiary's value to assist shareholders in determining whether the offer was fair or whether to invoke their appraisal rights. However, the court acknowledged that, from the perspective of individual shareholders, if a short-form second-step merger were to be consummated following the tender offer, the end result would be identical to the result had the acquisition group elected to employ a single-step merger structure.

The court explained that "a board of directors which is given the critical role of initiating and recommending a merger to the shareholders traditionally has been accorded no statutory role whatsoever with respect to a public tender offer for even a controlling number of shares."[135] This is so, the court reasoned, because tender offers are viewed as sales

[131] *See Siliconix,* 2001 WL 716787 at *6.

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

[133] *See id.* at *8.

[134] 765 A.2d 910 (Del. Sup. 2000).

[135] *Siliconix,* 2001 WL 716787 at *7.

of individual private property, and not corporate transactions.[136]

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

In re Aquila, Inc., Shareholders Litigation[137] involved a tender offer initiated by a parent corporation for the twenty percent of its subsidiary's stock that it did not already own. The Delaware Chancery Court refused to issue a preliminary injunction against the transaction, finding that Delaware law does not impose a duty of entire fairness on a controlling stockholder making a non-coercive tender offer[138] where the minority shareholders have adequate information and time to make an informed decision whether to tender. The court also ruled that target company directors that sit on the parent corporation's board do not breach their fiduciary duties simply by making no recommendation with respect to the offer.[139]

Aquila demonstrates the Chancery Court's traditional position that, if all of the directors of a subsidiary are appointed by the controlling shareholder or otherwise fail the independence test, the board of directors is not required to express an opinion either for or against the tender offer. The board also does not need to have its financial advisor express an opinion with respect to the fairness of the offer for

[136] *See id.*

[137] 805 A.2d 184 (Del. Ch. 2002).

[138] The court found that the offer had a non-coercive structure because it had a "majority of the minority" provision according to which a majority of the minority shareholders had to tender their shares for the offer to succeed. The court noted the majority of the minority provision, stating that it constituted an "important safeguard for the shareholders of Aquila." *Aquila*, 805 A.2d at 188. *But see* McGeever, *supra* note 128, at 430.

[139] The court further found that these directors had no duty to appoint new "independent" directors to objectively evaluate the offer. *Aquila,* 805 A.2d at 191.

purposes of the Schedule 14D-9 filed by the company.[140] In *Aquila*, the board engaged a financial advisor to provide "an independent financial analysis of the offer" and published an "extensive summary" of that analysis in the Schedule 14D-9 sent to shareholders.[141] However, the board "did not ask its financial advisor to express an opinion on the fairness" of the offer.[142]

The *Aquila* court noted that shareholders' "opportunity to decide whether or not to tender is certainly valuable."[143] The court did not address, however, whether shareholders will have the resources available to make a reasonable determination of the value of such an opportunity. Most individual shareholders in public companies will not have the resources to engage their own investment bank.[144] In addition, the coercive nature of tender offers may prevent even financially sophisticated and well informed shareholders from acting in their own best interests.[145]

The *Aquila* court further reasoned that "[i]f the offer is successful, holders of [stock] who do not tender will receive

[140] *See Aquila*, 805 A.2d at 184 n.10 (discussing that it was not argued whether it was a breach of fiduciary duty to have failed to ask for a fairness opinion).

[141] Specifically, summary of the analysis conducted by the financial advisor, Blackstone Group LP, "consisted of a historical stock price performance analysis, a comparable transaction analysis, a comparable company analysis, a series of discounted cash flow analyses, a discounted dividend analysis, a pro forma merger analysis, and a relative contribution analysis." The court noted that these analyses "show that the price implied by the exchange ratio is at the low end of the range presented." The court also quoted the Schedule 14D-9 that "'Blackstone did not consider the relative merits of the Offer as compared to any other business plan or opportunity that might be available to Aquila.'" *Id.* at 189.

[142] *Aquila,* 805 A.2d at 189.

[143] *Id.* at 195.

[144] In the case of *Aquila*, however, eighty percent of the publicly owned shares were owned by ninety-four institutional investors. *See id.* at 87. However, the plaintiffs were individual shareholders, with none of the institutional investors joining the suit.

[145] This is a point developed to considerable extent by the Delaware Chancery Court in *In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421 (Del. Ch. 2002).

the same consideration as those who do or will be able to seek appraisal under Section 262 of the DGCL."[146] The *Aquila* court ultimately said that the stockholders "would still have to decide for themselves whether to tender or not."[147] The court noted that, even if independent directors were appointed to negotiate the transaction, "they could do little more than communicate their conclusion to the stockholders in the Schedule 14D-9 and recommend that they not tender."[148]

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

With *Pure Resources*, the Delaware Chancery Court refined the distinction between mergers and tender offers recognized in *Aquila* and in *Siliconix,* proposing specific guidelines that tender offers initiated by controlling shareholders must meet in order to avoid being subjected to an entire fairness review. However, even this decision, while recognizing the inherently coercive nature of tender offers, did not establish specific standards of conduct for directors with respect to recommending the fairness of a particular offer to minority shareholders.[149] In *Pure Resources*, the controlling shareholder initiated an offer to acquire the sixty-five percent of shares in its subsidiary that it did not already own in an "exchange offer" in which the controlling shareholder's stock would be issued in exchange for shares in the subsidiary.[150] The court determined that the offer should be enjoined primarily because it determined the offer to be "coercive" and because "material information relevant to the

[146] *Aquila*, 805 A.2d at 188.

[147] *Id.* at 195.

[148] *Id.*

[149] While the court ruled that the disclosure made to shareholders in the Schedule 14D-9 was insufficient, the court did not go so far as to require that directors take a position either for or against the offer. In fact, because the special committee recommended against tendering, this point was not at issue. *See Pure Res.*, 808 A.2d at 450.

[150] This article refers to the thirty-five percent stockholder as the controlling shareholder based on its status as the largest single shareholder and its significant board representation.

[stockholders'] decision-making process had not been fairly disclosed."[151]

The target company in *Pure Resources* responded to the proposed exchange offer by forming a special committee of directors to consider the offer and to negotiate with the controlling shareholder. This special committee was comprised of directors that the court appears to have accepted as having been independent to the extent that they were neither appointed by the controlling shareholder nor financially interested in the transaction other than as shareholders.[152] However, the larger board, which continued to include members appointed by the controlling shareholder, refused to increase the authority of the special committee beyond its delegated authority to retain independent advisors, take a position on behalf of the target company with respect to the offer, and negotiate with the controlling shareholder.[153]

In fact, the failure of the special committee to insist that its authority be extended to include the ability to introduce defensive measures such as a poison pill and seek alternative transactions appears to be the primary point of concern for the Chancery Court. The court noted that "[t]he most reasonable inference that can be drawn from the record is that the Special Committee was unwilling to confront [the controlling shareholder] as aggressively as it would have confronted a third-party bidder."[154]

Nevertheless, the special committee appears to have performed its core functions of hiring outside legal counsel and financial advisors and evaluating the transaction in a manner that meets the standards of conduct under Delaware law for a properly functioning committee of independent

[151] *See Pure Res.*, 808 A.2d at 425.

[152] *See id.* at 429-30.

[153] The special committee had wanted the board to delegate to it the full authority of the board under Delaware law, including the right to seek alternative transactions, evaluate the feasibility of a self-tender, and put in place defensive measures including a shareholder rights plan. *See id.* at 430.

[154] *Id.* at 431.

directors.[155] The special committee made counter-offers to the controlling shareholder, and these counter-offers were rebuked.[156] Thereafter, the special committee caused the Schedule 14D-9 prepared by the target company to reflect the board's recommendation that shareholders not tender into the offer.[157] Therefore, the board appears to have satisfied its obligations to negotiate with the acquisition group in good faith and become adequately informed regarding the valuation of the offer. As discussed in more detail below, however, the state court found that the directors' failure lay in their decisions not to include all of the details regarding the financial advice they relied upon in recommending shareholders reject the offer. This suggests that a director's duty in this context will not be satisfied where he simply blindly (or without giving justification) recommends against an acquisition bid.

The Chancery Court appears to have viewed this case in broad terms as an opportunity to address what it viewed as an inconsistency between the treatment of a controlling shareholder's fiduciary duties in the negotiated merger versus the tender offer context. The Chancery Court noted that the case "involves an aspect of Delaware law fraught with doctrinal tension: what equitable standard of fiduciary conduct applies when a controlling shareholder seeks to acquire the rest of the company's shares?"[158] The court then commented that there are two strands of Delaware authority addressing this issue, one applying to situations where a controlling shareholder negotiates a merger agreement with

[155] While the Chancery Court noted that the counsel retained by the special committee had a potential conflict of interest because it represented the controlling shareholder in an unrelated matter, the court appears to have deferred to the special committee's conclusion that this did not compromise the counsel's representation. *Id.* at 429.

[156] *See id.* at 432.

[157] *See Pure Res.*, 808 A.2d at 432.

[158] The court then proceeded to address this question by applying an equitable, as opposed to a statutory, analysis, concluding that controlling shareholders are unlikely to violate statutory guidelines in structuring a transaction. *See id.* at 433-34.

a target board to buy the minority stake and the other applying to situations where a controlling shareholder seeks to acquire the minority interest through a tender (or exchange) offer followed by a short-form merger.[159]

The court took issue with Delaware case precedent -- including *Siliconix* and *Aquila* -- to the extent that these cases distinguish between merger transactions and tender offer transactions initiated by a controlling shareholder. The court noted that the emphasis on protecting shareholders from unfairness in merger transactions while permitting tender offers to proceed without a fairness inquiry, so long as coercion or misinformation is not employed, represented an "incoherence in our law."[160] The court further discussed that, given the nature of transactions structured as tender offers, these forms of acquisitions are "arguably less protective than a merger" of shareholder interests,[161] particularly considering that a shareholder that fails to sell into a tender offer faces an uncertain future.[162]

The court found it inconsistent that a controlling shareholder would have no duty to pay a fair price for minority shares in the context of a tender offer, simply owing to the form of transaction utilized, and yet have the burden of showing the entire fairness of the transaction if the same minority shares were acquired through a negotiated merger transaction.[163] Specifically, the court questioned "whether

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[159] *Id.* at 435.

[160] *Id.* at 435-39.

[161] *Id.* at 435.

[162] *See id.* at 441-43 (discussing how shareholders facing a tender offer are confronted by a prisoner's dilemma in which there may be coercion manifested in their being forced to accept the lesser of two unsatisfactory choices: to tender into an unfair deal or be left the holder of illiquid shares).

[163] The court here noted that the Chancery Court's recent rulings in *Aquila* and *Siliconix,* followed the reasoning of the line of cases beginning with *Solomon v. Pathe Communications Corp.*, 672 A.2d 35 (Del. 1996) that "Delaware law does not impose a duty of entire fairness on controlling stockholders making a non-coercive tender or exchange offer to acquire shares directly from minority holders." *Pure Res.,* 808 A.2d at 438 (internal quotations omitted).

the mere fact that one type of transaction is a tender offer and the other is a negotiated merger is a sustainable basis for the divergent policy choices" and concluded that it is not.[164] The court also noted the inconsistency of a coercive tender offer launched by a third party likely being met by the erection of defensive measures by the incumbent board, whereas a tender offer launched by a controlling shareholder would be treated as a matter between that controlling shareholder and the minority shareholders unburdened even by the requirement that the offer be fairly priced.[165]

The Chancery Court concluded that the fiduciary requirement of showing entire fairness should not be imposed on a controlling shareholder launching a tender offer for minority shares, but only so long as the offer is not coercive. The court ruled that the law should consider a tender offer by a controlling shareholder as non-coercive 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[166] at the same price if it obtains more than 90% of the shares; and 3) the controlling stockholder has made no retributive threats."[167] The *Pure Resources* offer failed this three-pronged test because its "majority of the minority" provision

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[164] *See Pure Res.,* 808 A.2d at 443 (with Vice Chancellor Strine concluding by commenting that "I remain less than satisfied that there is a justifiable basis for the distinction between the [lines of cases addressing negotiated mergers and tender offers]"). In fact, the court noted, pragmatically, that if this distinction were allowed to continue then all controlling shareholders could simply choose to proceed using the tender offer versus the negotiated merger transaction structure. *See id.* at 442-43.

[165] *See id.* at 443-444 (questioning why minority shareholders should be free to receive tender offers from controlling stockholders but not the same identically structured tender offers from third parties).

[166] A § 253 merger means a merger between a parent company and one or more of its subsidiaries controlled by Section 253 of the Delaware general Corporation Law. *See* DEL. CODE ANN. tit. 8, § 253 (2002)

[167] *See id.* at 445.

was determined to be defective.[168] In addition, the court determined that the disclosures made by the special committee in the target's Schedule 14D-9 were insufficient because they did not provide sufficient detail with respect to valuation advice received from the company's financial advisors.[169] The court imposed no specific requirement that the board, or even the special committee, recommend for or against a tender offer.

VI. PROPOSALS FOR CHANGE

The requirement set forth in *Pure Resources* that controlling-party tender offers must meet that decision's test of non-coerciveness or else face an entire fairness review is a move in the right direction, but it must also be coupled with a requirement that the board of directors have an affirmative obligation to assist shareholders in evaluating the fairness of all unilateral tender offers. This article recognizes that current Delaware statutory and case law does not imbue directors with this responsibility. However, there are at least three ways to augment the duty of directors to provide substantive guidance to minority shareholders faced with such offers. They are through (i) a change in the interpretation of existing Delaware law by the courts, (ii) a change to the Delaware General Corporation Law itself and (iii) changes to the federal securities laws and regulations to augment the protection afforded to minority shareholders confronted with unilateral tender offers. Without these changes, shareholders will not have sufficient guidance in deciding whether or not to accept a tender offer and, perhaps

[168] *See id.* at 446 (the majority was defined to include stockholders who were affiliated with the controlling shareholder).

[169] The court articulated that form 14D-9 "omits material information" regarding the financial advisors' work, and even though Delaware courts are historically reluctant to require specific informational disclosures on SEC mandated forms, the shareholders were entitled to "a fair summary of the substantive work performed by the investment bankers." *See id.* at 449.

of equal importance, they will not have a clear opportunity to act in concert in rejecting an unfavorable bid.

A. Changing Equitable Standards Under Delaware Law

The degree to which Delaware law protects individual shareholders has changed over time, with the trend toward providing shareholders increased protection where changes in economic conditions require. The recent writings of Martin Lipton remind us that during the late 1970s and early 1980s a "new breed of hostile bids" occasioned an expansion of the obligations of directors in the context of hostile takeovers.[170] This change, triggered by the increasing popularity of an aggressive transaction structure that threatened to deprive minority shareholders of the full value of their property, is arguably analogous to the rising favor of unilateral tender offers with controlling shareholders.[171] Certainly, there is a similar risk to the interests of minority shareholders that should be addressed.

It is also worth noting that, like the determination that corporate boards should be empowered to act to thwart hostile takeovers,[172] the argument that directors should be required to express an opinion regarding the fairness of unilateral tender offers serves as a rejection, to some extent, of the efficient-market theory. This theory assumes that "tender offers are necessarily informed decisions that rationally reflect the supposed 'best' interests of all

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[170] Lipton, *supra* note 1, at 1040-41 (discussing that, during the late 1970's and early 1980's, academics opposed active board involvement in hostile takeovers in favor of adoption of a "'Rule of Passivity,' relegating directors to the role of passive observers proscribed from any action other than giving advice to the shareholders").

[171] Indeed, the Delaware Chancery Court has recently draw this comparison. *See In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 439 (Del. Ch. 2002) (holding that "[a]spects of this issue are reminiscent of a prominent debate that roared in the 1980s when hostile takeover bids first became commonplace").

[172] *See* Lipton, *supra* note 1, at 1042 (discussing of the theoretical underpinnings of the rejection of the "Rule of Passivity").

shareholders collectively."[173] However, the reality of a tender offer for the shares of a public company is that most individual shareholders will not have the capability or resources to evaluate an offer to the same extent, with the same level of sophistication and information as will an informed board of directors advised by competent legal and financial advisors. Also, shareholders will not necessarily act rationally when confronted with a tender offer because of the inherent coercive effect of the prisoner's dilemma.[174] The risk is that sufficient numbers of shareholders will tender to meet the tender offer threshold percentage with the result that those shareholders desiring not to tender will be left with illiquid stock that may or may not be acquired later, without interest, through a second-step merger, or perhaps seek additional value through an appraisal action.[175]

Therefore, as an initial matter, the Delaware Supreme Court should reject the distinction made in *Siliconix* and *Aquila* between mergers and tender offers and recognize the heightened standard applied in *Pure Resources* to controlling-party led tender offers. The Delaware courts should further require that a board faced with a unilateral tender offer form an independent committee to evaluate the offer according to the same standards to which the board would be subjected in the merger context. The form of these transactions should not control where the substantive result is identical to that of a negotiated merger transaction.

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[173] *See id.*

[174] As this author noted in an earlier article, "In certain situations, a board acting as an agent for the collective body of shareholders may arrive at a collectively rational solution where the individual shareholders acting discretely could only find an individually rational solution which is collectively irrational," Kimble C. Cannon & Patrick J. Tangney, *Protection of Minority Shareholder Rights Under Delaware Law: Reinforcing Shareholders as Residual Claimants and Maximizing Long-Term Share Value by Restricting Directorial Discretion*, 1995 COLUM. BUS. L. REV. 725, 745.

[175] It is likely that, faced with strong opposition to an offer by the board of directors, shareholders in a widely held corporation would have greater comfort rejecting the offer under the belief that sufficient numbers of their fellow shareholders would also follow the board's recommendation.

Finally, the special committee should be empowered and even required to take an affirmative position either for or against the tender offer and issue this opinion under the banner of the full board of directors, providing shareholders with a full record of their deliberations and the advice relied upon by the board. There are two reasons for this change. First, the board should take a position, including a position strongly against those offers that are unfair, so that individual shareholders can rally behind the board with the knowledge that they will likely not be left alone as part of a non-tendering, less-than-ten-percent minority likely to receive diminished value in a delayed or nonexistent second-step transaction. Second, increasingly sophisticated investors and market analysts should be provided the raw financial data on which the board relied so that this data can be subjected to public debate and the classic *antiseptic* effect that can only be provided by the light of day.

B. Changing the Delaware Code

Another possibility would be to address the unilateral tender offer issue through the state legislative process. With this in mind, a brief discussion of the extent to which Section 203 of the Delaware General Corporation Law ("Section 203") applies is in order. Section 203 limits the power of controlling shareholders to use tender offers to eliminate minority shareholders under certain circumstances.[176]

Specifically, under Section 203, a publicly traded company may not engage in a business combination with an entity that owns fifteen percent or more of the company's outstanding voting stock (defined as an interested stockholder) for three years after the date the stockholder became an interested stockholder unless either (i) the board approved the transaction that resulted in the stockholder becoming an interested stockholder, (ii) upon consummation of the transaction that resulted in the stockholder becoming an interested stockholder the stockholder owned at least

[176] DEL. CODE ANN. tit. 8, § 203 (2003).

eighty-five percent of the voting stock of the corporation, excluding shares owned by individuals who are both directors and officers of the company, or (iii) at or prior to the transaction that resulted in the stockholder becoming an interested stockholder the acquisition was approved by the board and authorized at a meeting by sixty-six and two-thirds percent of the outstanding voting stock not owned by the interested stockholder.[177]

Commentators have praised Section 203 for giving directors "the statutory power effectively to block potential transfers of control to substantial shareholders by refusing to approve a transaction."[178] However, Section 203 does not apply where the controlling shareholder has owned more than fifteen percent of the target company's stock for more than three years.[179] Other exceptions to Section 203 may also make it irrelevant to certain transactions, particularly where the target company's shares are not widely traded.[180] Significant additional protection of minority shareholders could be achieved by strengthening the protections afforded by Section 203 to specifically address the case of unilateral tender offers, including those made by a controlling shareholder that has owned its shares for longer than three years.

C. Augmenting Federal Securities Law

In addition to state statutory and case law, the federal securities laws and regulations provide a layer intended to protect minority shareholders in the contexts of both going-

[177] DEL. CODE ANN. tit. 8, § 203(a) (2003).

[178] Lipton, *supra* note 1, at 1050 (noting that "Section 203 is in effect a statutory pill that can be neutralized by a tender offer that attracts 85 percent of the shares").

[179] *See* DEL. CODE ANN. tit. 8, § 203(a) (2003).

[180] Section 203(b) sets forth a number of additional exceptions to the applicability of Section 203(a), including in the event the corporation does not have a class of stock listed on a national security exchange or if its shares are held of record by fewer than 2,000 stockholders. *See* DEL. CODE ANN. tit. 8, § 203(b)(4) (2002).

private transactions and tender offer transactions.[181] Certain of these laws and regulations could be amended to provide greater protection to shareholders in the context of unilateral tender offers. This increased protection could be justified on the basis that such transactions incorporate the coercive elements of both the tender offers and going-private transactions these federal securities law provisions are designed to address. However, it is important to note that the securities laws are primarily tasked to requiring informational disclosures from either the acquirer, the target company (which the federal securities laws generally refer to as the "issuer"),[182] or both, and they do not directly call upon the participants to meet any specific fiduciary standards of conduct toward shareholders.[183] So long as the required disclosure is accurate and complete, no violation of the securities laws will be found.[184]

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[181] The federal securities laws were amended in 1968 to add provisions regulating conduct in the context of going-private transactions and tender offers. These rules, set forth as §§ 13(d) - (e) and 14(d) - (f) of the Securities Exchange Act of 1934 (the "Exchange Act") are referred to collectively as the Williams Act. For a history of going-private and tender offer regulation under the federal securities laws, See LOSS & SELIGMAN, *supra* note 5, at 72.

[182] *See* Jennifer L. McDonough, *Electronic Media and the Federal Securities Laws: Perks, Pitfalls and Prudence*, 39 DUQ. L. REV. 823, 833-34 (2001) (discussing how, in the context of the delivery of information using electronic media, the SEC "is less concerned with the medium employed for disclosure than with the adequacy of the resulting disclosure," and noting "the purposes of the federal securities laws is [sic] to 'seek to promote fair and orderly markets by requiring the disclosure of material information that enables investors to make informed investment and voting decisions'").

[183] *See* Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 10 (1985) (Section 14(e) of the Securities Exchange Act of 1934 not intended to regulate substantive fairness of tender offers).

[184] This article does not suggest expanding this fundamental limitation to the scope of the federal securities laws. Rather, it takes the position that augmenting the disclosure requirements applicable to target company boards to require that they articulate an affirmative position with respect to all unilateral tender offers would diminish the coercive nature of unilateral tender offers and improve the information available to individual shareholders in determining whether to accept such offers.

The Williams Act added Sections 14(d) and 14(e) of the Securities Exchange Act to regulate tender offers and Sections 13(d) and 13(e) of the Securities Exchange Act to require certain disclosures in the context of going-private transactions.[185] Both the rules concerning tender offers and those addressing going-private transactions call on the board of directors of the target company to disclose information regarding their consideration of the acquisition offer, although in the context of tender offers that are not also going-private transactions the board may take the position that it is unable to recommend either for or against the offer.[186]

Under Rule 14e-2, target companies in a tender offer are required to disclose material information in an accurate and complete fashion, and are specifically required to inform shareholders of the target company's position on the offer, although the company is not required to take a position for or against the offer.[187] If the target board takes a position with respect to the transaction, it is required to state the reason for its position within ten business days after the tender offer was first published, sent, or given to security holders.[188]

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[185] Securities Exchange Act of 1934 §§ 13d-e, 14d-e, 15 U.S.C. §§ 78(d)-(f) (1982).

[186] Rule 14e-2 requires that the target's board advise the target's shareholders of the position the board takes with respect to the tender offer. This requirement is implemented by Rule 14d-9 and Schedule 14D-9. *See* SEC Rules and Regulations Under the Securities and Exchange Act of 1934, Position of a Subject Company With Respect to a Tender Offer, 17 C.F.R. § 240.14e-2 (2003).

[187] For a discussion of the requirement that the target board inform shareholders with respect to its position with regard to a tender offer, see John R. Gailey III, *A Critical Survey of Target Company Disclosure Obligations Under The Williams Act*, 59 TEMP. L.Q. 1189 (1986).

[188] This information is set forth in the Schedule 14D-9 that the Issuer is required to file with respect to a tender offer. It is worth noting that the target company can also send a "Stop, Look and Listen" letter prior to the target board taking a position in its Schedule 14D-9 requesting that shareholders not take any action until the target's board of directors has had an opportunity to study the tender offer and make a recommendation.

Under Rule 13e-3, both the target company and any of its affiliates engaged in a going-private transaction are required to file a disclosure statement.[189] This information is required to be filed on Schedule 13E-3 with the SEC. If the going-private transaction also involves a third-party tender offer, the information required by Schedule 13E-3 may be filed under cover of a Schedule TO,[190] which filing will then satisfy both the tender offer and going-private disclosure requirements.[191]

For a more detailed discussion of the securities filings required by the target and the acquisition group in the context of a tender offer, see Gary M. Brown & Christine L. Connolly, *Securities Law Implications of Mergers and Acquisitions*, *in* NUTS & BOLTS OF SECURITIES LAW 2002 (PLI Corp. Law and Practice Course, Handbook Series PLI Order No. B0-01AT, 2002).

[189] Rule 13e-4 further regulates transactions in which the company itself or an affiliate of the company repurchases its own shares through a self-tender offer. The requirement to file a Schedule 13e-3 is additional to filing the disclosure materials under any other applicable provisions. *See* SEC Rules and Regulations Under the Securities and Exchange Act of 1934, Tender Offers by Issuers, 17 C.F.R. § 240.13e-4 (2003). Thus, if a going-private transaction is accomplished through a self-tender offer, the company must comply with the requirements of both 13e-3 and 13e-4, although the disclosures can be combined in one Schedule 13e-4, which can incorporate the Schedule 13e-3 disclosures by reference.

[190] Schedule TO is the form of document required to be filed by persons engaging in a tender offer that would result in the bidders beneficially owning more than five percent of the class of securities for which the tender is made. *See* SEC, Rules and Regulations Under the Securities and Exchange Act of 1934, Schedule TO, Tender Offer Statement Under Section 14(d)(1) or 13(e)(1) of the Securities Exchange Act of 1934, 17 C.F.R. § 240.14d-100 (2003).

[191] Schedule TO's specific disclosure requirements refer to provisions of Regulation M-A. The Schedule TO must be filed with the SEC as soon as practicable on the date the tender offer commences. The acquisition group must then deliver a copy of the Schedule TO to the target company, to any other bidder that has filed a Schedule TO relating to a tender offer for the same class of securities, and to the applicable trading market. The Schedule TO must also be promptly amended to report material changes in the transaction and a final amendment must be filed to report the results of the tender offer. The information required to be disclosed in the Schedule TO depends on whether the transaction is an issuer tender offer, a third-party tender offer, or a going-private transaction. The disclosure

Schedule 13E-3 sets forth disclosure requirements that are significantly more substantive than the disclosure requirements set forth in Schedule 14D-9.[192] A company undergoing a Rule 13e-3 going-private transaction must disclose the purpose of that transaction, its likely effects, the reasons for its structure, and whether any alternatives to the proposed transaction exist.[193] Schedule 13E-3 also requires that the company disclose information relating to outside opinions on the value of the shares and the fairness of the transaction.[194] Most importantly, it requires the issuer to articulate whether the offer is fair and to "[d]iscuss in reasonable detail the material factors upon which" the belief concerning the fairness of the transaction was based and, "to the extent practicable, the weight assigned to each such factor."[195] The most substantive disclosure requirements are set forth in items seven through nine of Schedule 13E-3.[196] While there is no requirement under the federal securities

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items of Schedule TO direct the filer to the applicable items of Regulation M-A, which contains the disclosure requirements for each of Schedule TO, Schedule 13E-3 and Schedule 14D-9. In the case of a unilateral tender offer, we are most concerned with a going-private transaction because that is the form of transaction where the board of directors is most likely to have divided loyalties and to tend not to want to take a position with respect to an unfair offer price. *Id.*

[192] *See* SEC, Rules and Regulations Under the Securities and Exchange Act of 1934, Rule 13E-3 Transaction Statement Under Section 13(e) of the Securities Exchange Act of 1934, 17 C.F.R. § 240.13e-100 (2003). *See also* SEC, Rules and Regulations Under the Securities and Exchange Act of 1934, Solicitation/Recommendation Statement under Section 14(d)(4) of the Securities Exchange Act of 1934, 17 C.F.R. § 240.14d-101 (2003).

[193] These disclosure requirements are set forth as Items 7, 8 and 9 on Schedule 13E-3. *See* 17 C.F.R. § 240.13e-100.

[194] *See* Item 9 on Schedule 13E-3. *Id.*

[195] *Id.* (citing SEC Regulation M-A, Item 1014, Fairness of the Going-Private Transaction, 17 C.F.R. 229.1014 (2003)).

[196] While the disclosure items require extensive disclosure regarding the conduct of the issuer with respect to its consideration of the offer and its dealings with the offering parties, they do not requiring any specific behavior on the part of the filing parties. *See* Schedule 13E-3, 17 C.F.R. § 240.13e-100.

rules that issuers or their affiliates obtain fairness opinions, receive the approval of the independent members of the board of directors, or retain independent financial advisors, items seven through nine require that any actions the directors do take be fully disclosed. Perhaps most directly, item eight requires that each of the filing persons (whether they are the issuer or the affiliate) state whether they reasonably believe the transaction is fair or unfair to unaffiliated shareholders.[197] Significantly, under item eight, it is insufficient for the filing person to simply state that it has no opinion regarding whether the offer is fair.[198]

Rule 13e-3 governs a range of transactions between an issuer of securities (the target company) and its affiliates,[199] and its disclosure requirements will apply to a particular unilateral tender offer only if the individuals initiating the offer are determined to be affiliates of the issuer. Under Rule 13e-3(a)(1), an affiliate of an issuer is defined as "a person that directly or indirectly through one or more intermediaries controls, is controlled by, or is under common control with such issuer."[200] Under the federal securities laws, whether a party controls another party is largely a factual question.[201] Rule 144 of the Securities Act of 1933

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[197] Item 8 requires the party filing the schedule to state whether it "reasonably believes that the Rule 13e-3 transaction is fair or unfair" to parties not connected with the transaction. *See id.*

[198] *See* SEC Regulation M-A, Item 1014, Fairness of Going-Private Transactions (Instructions to Item 1014)(1), 17 C.F.R. § 229.1014 (2003).

[199] The list of transactions to which Rule 13e-3 applies are set forth at paragraph (a)(3)(i) of Rule 13e-3, including a tender offer for or request or invitation for tenders of any equity security made by the issuer of such class of securities or by an affiliate of such issuer at Rule 13e-3(a)(3)(i)(B). *See* SEC Rules and Regulations Under the Securities and Exchange Act of 1934, Going Private Transactions by Certain Issuers or Their Affiliates, 17 C.F.R. § 240.13e-3 (2003).

[200] The definition continues to clarify that a person who is not an affiliate at the commencement of a tender offer will not be deemed an affiliate of such issuer prior to the termination of the tender offer. *Id.* § 240.13e- 3(a)(1).

[201] Courts interpreting the definition of "control" have stated that whether a person occupies a control position does not turn on a single

defines "controls, or is controlled by, or is under common control with" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."[202] The generality and flexibility of these definitions of "control" means that any analysis of whether control exists in a particular situation is necessarily subjective and fact-based.

Whether a tender offer is considered a going-private transaction subject to Rule 13e-3 also may hinge on the action taken by the target board of directors in response to the offer. An issuer is required to comply with the disclosure requirements of Schedule 13E-3 only if that issuer or an affiliate of that issuer engages, directly or indirectly, in a Rule 13e-3 transaction.[203] The SEC, in responding to telephone inquiries, has noted that, in a going-private transaction subject to Rule 13e-3, the issuer will be considered to be engaged in the transaction, and will thus have to comply with the filing requirements of Rule 13e-3(d), (e) and (f), if the target board elects to recommend in favor of the transaction rather than to recommend against the

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factor such as stock ownership, but rather "depends upon the totality of the circumstances, including an appraisal of the influence of the individual has on the management and policies of a company." United States v. Corr, 543 F.2d 1042, 1050 (2d Cir. 1976).

[202] *See* SEC General Rules and Regulations, Securities Act of 1933, Registration, General Requirements, Definition of Terms. 17 C.F.R. § 230.405 (2003). Rule 12b-2 of the Securities Exchange Act of 1934 utilizes the same definition. *See* SEC Rules and Regulations Under the Securities Exchange Act of 1934, Regulation 12B: Registration and Reporting General, Definitions, 17 C.F.R. § 240.12b-2 (2003).

[203] Rule 13e-3(c)(1) of the Securities Exchange Act provides that it is unlawful for any company that files periodic reports under Section 15(d) of the Exchange Act, or any affiliate of such a company, "to engage, directly or indirectly, in a Rule 13e-3 transaction unless such issuer or affiliate complies with [the disclosure requirements] of this section." *See* 17 C.F.R. § 240.13e-3(c)(1) (2003).

transaction or remain neutral with respect to the transaction.[204]

A final means of protecting minority shareholders might be to require that, in all cases where the board is faced with a going-private transaction structured as a tender offer, the company comply with disclosure items seven through nine of Schedule 13E-3[205] even if the transaction is not technically classified as a going-private transaction. This would also eliminate a risk suggested by the above referenced quotation from the SEC that, faced with the possibility of being subjected to the disclosure requirements of Rule 13E-3,

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[204] *See U.S. Securities and Exchange Commission Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations – Third Supplement, July 2001, in* 33RD ANNUAL INSTITUTE ON SECURITIES REGULATION, at 845-46 (PLI Corp. Law and Practice Course, Handbook Series PLI Order No. B0-0113, 2001), in which the following exchange appears:

> Q: In a going-private transaction subject to Rule 13e-3, is the target company to a tender offer considered to be 'engaged' in the transaction pursuant to Rule 13e-3 if the target merely recommends the tender offer to its security holders, even where the target has not signed a business combination agreement with the offeror? A: Yes. If the affiliation between the offeror and target is sufficient to trigger Rule 13e-3, the staff believes that the favorable recommendation alone would be sufficient to cause the target to be 'engaged' in the going- private transaction. As a result, the target would have to comply with Rule 13e-3(d), (e) and (f). While the staff understands that the target has an obligation under Rule 14e-2 to make a statement with respect to the tender offer, the target is not required to recommend in favor of the offer. The target's choices are to recommend acceptance or rejection of the offer, express no opinion and remain neutral, or state that it is unable to take a position. Given the importance to security holders of their management's recommendation and the conflicted nature of the transaction, the staff believes the protections of Rule 13e-3 are warranted in these circumstances.

[205] *See* SEC, Rules and Regulations Under the Securities and Exchange Act of 1934, Rule 13E-3 Transaction Statement Under Section 13(e) of the Securities Exchange Act of 1934, 17 C.F.R. § 240.13e-100 (2003).

target boards will not recommend even offers that are squarely favorable to shareholders. The board's recommendation, if it is to have probative value upon which shareholders can rely, should be as free from such bias as is possible.

VII. CONCLUSION

Market conditions remain ripe through the first quarter of 2003 for knowledgeable corporate insiders, including managers and significant shareholders blessed with the benefit of board representation, to take undervalued companies private. In addition to the increased costs associated with Sarbanes-Oxley Act compliance, the magnitude of which is even now being debated in corporate boardrooms across America, the multi-pronged threats of war, renewed inflation and domestic terrorism continue to depress the share prices of many public companies.

In this climate, it may make economic sense, from the perspectives of both acquirers and public shareholders, to extract promising companies from increasingly turbulent financial markets by means of a going-private transaction. Nevertheless, due to the imbalance of information between insiders and public investors and the continued risk that individual investors will be coerced into accepting unfair consideration for their shares, independent board members, state judiciaries and federal securities regulators must remain ever vigilant to ensure full compliance with equitable standards of conduct and applicable statutory requirements.