

5-1-2004

Fiduciary Duties of Directors in the Context of Going-private Transactions to the Minority Shareholders under Delaware Law

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FIDUCIARY DUTIES OF DIRECTORS IN THE CONTEXT OF GOING-PRIVATE
TRANSACTIONS TO THE MINORITY SHAREHOLDERS UNDER DELAWARE LAW

by

YUAN WANG

(Under the Direction of Professor Charles R. T. O'Kelley)

ABSTRACT

This thesis discusses the different fiduciary duties and standards of review imposed by Delaware laws on the directors to the minority shareholders in the going-private transactions structured either as a merger or as a tender offer voluntarily initiated by the controlling shareholders.

In the context of a merger, the disinterested and independent directors will face a duty of care and be subject to the business judgment rule. For the interested or dependent directors, they will bear a duty of loyalty and be bound to the entire fairness standard accordingly.

In the case of a tender offer, currently the Delaware courts impose no fiduciary duties on the directors. This thesis thus makes a proposal to ask for Delaware Court to impose the evaluation and recommendation duty on the directors to the minority shareholders as soon as possible so as to better protect those shareholders.

INDEX WORDS: Fiduciary duties, Standards of review, Directors, Minority Shareholders, Going-private transactions, Controlling shareholders, Merger, Tender offer and Delaware

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A Thesis Submitted to the Graduate Faculty of The University of Georgia in Partial Fulfillment
of the Requirements for the Degree

MASTER OF LAW

ATHENS, GEORGIA

2004

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CHAPTER 1

INTRODUCTION

The recent increase in merger and acquisition activities in China has focused more Chinese law professionals' attention on the protection of those involved minority shareholders. As corporate directors are viewed as the fiduciaries of the corporation, it seems proper and necessary for them to be subject to a pervasive fiduciary duty when they exercise their broad powers over corporate property and processes. However, except for few provisions with a simple mention on that issue,¹ almost no theories or specified statutes in Chinese corporate law discuss the problem. Contrastingly, in the American corporate setting, the fiduciary duty of directors, as a product of case law, has already been developed into a broad body of rules governing directors' pursuit of individual interests at the expense of corporation for which they work.²

In the United States, due to a substantial uniformity in the so-called common law of corporations, courts of one state may borrow freely from the jurisprudence developed by courts in other states.³ Because Delaware is the home of more than half of the country's largest

¹ Zhonghua Renmin Gongheguo Gongsifa (Corporation Law of the People's Republic of China) art. 59-62, (1999), Falv Fagui Huibian (2003).

² William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 26 [DEL. J. CORP. L.] 859, 861 (2001) ("Over the course of the twentieth century, the mandatory features of the statutory law gradually decreased. Statutes became increasingly elegant and flexible, continuously moving away from a mandatory or prescriptive model and ever closer to a pure contractual or enabling model. As a consequence, what emerged as a counterpoint to the evolution of the enabling model of corporation law was the second key function of the law of corporations: the *ex post* judicial review of the actions of corporate officers and directors, measured by fiduciary principle. Fiduciary review imported into corporate law the centuries-old equity tradition that subjected the conduct of fiduciaries to judicial supervision. The fiduciary duty of corporate officers, directors, and controlling shareholders has been a protean concept that has generated much of what is novel and interesting in modern corporation law...").

³ Charles R.T. O'Kelley & Robert B. Thompson, *Corporations and Other Business Associations Cases and Materials* 141 (4th ed. 2003).

corporations,⁴ the state plays a dominant role in shaping corporate law and represents the preeminent American corporate law jurisdiction.⁵ On the broad issue of fiduciary duties, Delaware courts have also developed many judicial rules to define the bounds of directors' potential liability for misconduct in carrying out official duties, many of which are routinely cited by courts of other jurisdictions.⁶ As for the directorial fiduciary duties in the take over context specially, the two periods of heightened merger activities in the 1990s⁷ pushed Delaware Supreme Court to reevaluate its treatment of directorial discretion in that context to address more accurately the risks borne by shareholders, especially those stemming from the directorial conflicts of interest.⁸

The going-private transaction is one type of transactions which frequently involves with directorial conflicts of interest. In these transactions, the controlling shareholder, often the acquirer, with substantial nonpublic information regarding the company's operations, generally has significant influence over the board of directors.⁹ The risk that a controlling shareholder will

⁴ *Id.*

⁵ *Id.*

⁶ See, e.g., *Peller v. Southern Co.*, 911 F.2d at 1536 (affirming district court's "assumption that Georgia would follow Delaware caselaw"); *Lady v. Amsterdam*, 815 F.2d 925, 929 (3d Cir. 1987) ("finding no Pennsylvania case in point, the district court predicted that Pennsylvania would follow the law of Delaware").

⁷ Kimble C. Cannon & Patrick J. Tangney, *Protection of Minority Shareholder Right under Delaware Law: Reinforcing Shareholders as Residual Claimants and Maximizing Long-term Share Value by Restricting Directorial Discretion*, 1995 [COLUM. BUS. L. REV.] 725, n.1 ("...The first period, led by the Paramount Communications/Viacom Corporation merger in 1993, has promulgated a considerable body of case law commenting on directors' duty to shareholders. At the time, it was noted that the 1993 merger activity had resulted in a 'banner year for plaintiffs seeking to hold corporate boards accountable. . . .' (Karen Donovan, *Corporate Directors Take Beating From Del. Supreme Court*, [NAT'L L. J.], Dec. 27, 1993-Jan. 3, 1994, at 17.) The more recent period of merger activity has been much more dramatic, but has not yet had time to ripen into judicial doctrine. The 1995 has seen an 'avalanche of merger and acquisition activity, led by the takeover bids for Capital Cities-ABC by Walt Disney, for CBS by Westinghouse and, most recently, for Turner Broadcasting by Time Warner. . . .' (David Osborne, *View from New York: Wall Street Cashes in on Merger Mania*, [THE INDEPENDENT], Oct. 2, 1995, at 21). Indeed, with the third quarter of 1995 alone seeing \$ 125.2 billion in takeovers, 1995 is posturing to be the biggest year for takeovers in history.").

⁸ *Id.* at 727.

⁹ Kimble Charles Cannon, *Augmenting the Duties of Directors to Protect Minority Shareholders in the Context of Going-Private Transactions: The Case for Obliging Directors to Express a Valuation Opinion in Unilateral Tender Offers after Siliconix, Aquila and Pure Resources*, 2003 [COLUM. BUS. L. REV.] 191, 194.

use this control and information advantage to the detriment of minority shareholders when acquiring their shares is rather significant.¹⁰ Therefore, compared to a hostile third-party merger and acquisition against which the board often takes defensive measures, such going-private transactions as those launched by the controlling shareholders on a voluntary basis, should raise more concerns of the board as well as the court regarding the protection of the minority shareholders.

Thus, although many going-private transactions have emerged in the response to the hostile acquisitions, which have led to a corresponding development of many central concepts to define appropriate directorial behavior, including the classic duties of loyalty and due care owed by the directors to the company generally and shareholders specially,¹¹ this article will focus on the analysis on the directorial fiduciary duties arising from the going-private transactions initiated by the controlling shareholders in a voluntary context. It addresses the different fiduciary duties undertaken by directors to the minority shareholders in the context of going-private merger versus unilateral tender offer under current Delaware laws. First, this article will introduce the main forms and corresponding standards of review regarding fiduciary duties. Second, it will outline the background, characteristics, and forms of going-private transactions. Third, the article will review the fiduciary duties stemming from the going-private mergers structured by the controlling shareholders. Fourth, it will examine the directorial duties under a unilateral tender offer based on the recent cases in Delaware. After discussion of the differences in these directorial duties, this article will propose some changes to the rules governing directorial duties to the minority shareholders in a controlling-shareholder initiated unilateral tender offer.

¹⁰ *Id.*

¹¹ See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Unitrin, Inc. v. American Gen. Corp. (In re Unitrin, Inc.)*, 651 A.2d 1361; *Katz v. Chevron Corp.* (1994) 22 Cal. App.4th 1352, [27 Cal. Rptr. 2d 681].

CHAPTER 2

FIDUCIARY DUTIES

A. General Introduction and Historical Background

As stated over 250 years ago, fiduciary duties were described by the Lord Chancellor in *Charitable Corp. v. Sutton*,¹² “by accepting of a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence.”¹³ In the words of the United States Supreme Court in *Briggs v. Spaulding*,¹⁴ the most frequently cited of the early American decisions involving fiduciary obligations in the corporate context, directors must act as would “ordinarily prudent and diligent men ... under similar circumstances, and in determining that ... the usages of business should be taken into account.”¹⁵ These common-law-based fiduciary obligations form the bedrock of the corporate governance law today.

Within the current governance law, the directorial fiduciary duties are a main part. Because the directors are the individuals to charge with the responsibility for managing corporate affairs,¹⁶ they shall accordingly owe fiduciary duties to the corporation they serve and its shareholders.¹⁷

Generally speaking, the directorial fiduciary duty in the corporate setting has two quite different functions. First, it instructs directors to be absolutely fair and candid in pursuing personal interests. Second, it describes the bounds of acceptable conduct for directors in carrying

¹² 2 Atk. 400 (1742).

¹³ *Id.* at 406.

¹⁴ 141 U.S. 132 (1891).

¹⁵ *Id.* at 152; *see also* *Bowerman v. Hamner*, 250 U.S. 504, 511-12 (1919).

¹⁶ O’Kelley & Thompson, *supra* note 3, at 221

¹⁷ Dennis H. Block, Nancy E. Barton & Stephen A. Radin, *The Business Judgment Rule Fiduciary duties of Corporate Directors* 1 (4th ed. 1993 & Supp. 1995).

out their individual and collective duty to manage the corporation.¹⁸ Both functions raise a core issue—how optimally to reduce the possibility that directors will favor personal interests over the corporation’s interests.¹⁹ Generally, these fiduciary obligations are distinguished as the duty of care and the duty of loyalty. In simplest terms, the duty of care requires that directors exercise the care that a reasonably prudent person would exercise under similar circumstances, and the duty of loyalty prohibits self-dealing.²⁰

In addition to the aforementioned common law development of the principles defining fiduciary duties, many states have codified standards to govern the general conduct of directors.²¹ With over forty percent of the corporations listed on the New York Stock Exchange and over fifty percent of Fortune 500 companies incorporated in the state,²² the Delaware court system, often viewed as “the Mother Court of corporate law,”²³ as well as the Delaware state legislature again make a great contribution in this aspect.

B. Fiduciary Duties in Delaware

a. Main Categories of Fiduciary Duties

Under Delaware, the fiduciary duties imposed on the directors have been divided primarily into two categories. The first category involves directors’ **duty of care**. In effect, prior to the

¹⁸ O’Kelley & Thompson, *supra* note 3, at 221.

¹⁹ *Id.*

²⁰ *Id.*

²¹ *See, e.g.*, Cal. Gen Corp Law § 309 (a); N.Y. Bus. Corp. Law § 717; Va. Stock Corp. Act § 13.1-690; Del. Gen. Corp. Law § 141.

²² R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations F-1* (2nd ed. 1990 & Supp. 1992)

²³ *Kamen v. Kemper Fin. Servs., Inc.*, 908 F.2d 1338, 1343 (7th Cir. 1990); *see also* *NCR Corp. v. American Tel. & Tel. Co.*, 761 F. Supp.475, 499 (S.D. Ohio 1991) (“the decision of Delaware courts are often persuasive in the field of corporate law”); *Detwiler v. Offenbecher*, 728 F.Supp. 103, 147 n.17 (S.D.N.Y. 1989) (“Michigan courts look to Delaware law as a guide for adjudicating matters involving corporate law”).

1980s, that duty received little or no notice in Delaware.²⁴ Instead, directors were presumed (all but conclusively) to have acted as reasonable persons would.²⁵ After 1985, however, with the Delaware Supreme Court's description of the business judgment rule as a "presumption" of regularity since 1984,²⁶ the duty of care emerged in Delaware as an independently enforceable obligation and has become one of the typical categories of cases with which courts applying fiduciary principles must deal.²⁷

The second category—**duty of loyalty** is involved in the directors' malfeasance such as self-dealing, executive compensation that exceeds the fair value of the services provided, usurpation of a business opportunity that might have benefited the corporation, acceptance of bribes in exchange for making certain decisions, and so forth. The duty of loyalty is rigorously enforced by requiring the directors to justify any of those acts as intrinsically fair.²⁸

b. To Whom the Directors Owe the Fiduciary Duties

The classic approach maintains that the directors owe the fiduciary duties to the corporate entity and not to the individual shareholders.²⁹ Nonetheless, the Delaware Supreme Court stated in *Revlon* that the directors owe their fiduciary duties to the corporation and its shareholders.³⁰ The academics' views on this issue are also divided. Some commentators hold that in some special circumstances, the directors shall owe those directorial duties to both the corporation and

²⁴ Allen, Jacobs & Strine, *supra* note 2, at 862.

²⁵ *Id.*

²⁶ Grover C. Brown, Michael J. Maimone & Joseph C. Schoell, *Director and Advisor Disinterestedness and Independence under Delaware Law*, 23 [DEL. J. CORP. L.] 1157, 1161(1998) ("It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.").

²⁷ Allen, Jacobs & Strine, *supra* note 2, at 862.

²⁸ See *Alcott v. Hyman*, 208 A.2d 501, 507 (Del. 1965); See also *Michelson v. Duncan*, 407 A.2d 211 (Del. 1979).

²⁹ See, e.g., O'Kelley & Thompson, *supra* note 3, at 222 ("Normally, directors owe fiduciary duties to the corporation, not to individual shareholders.").

³⁰ *Revlon Inc. v. MacAndrews and Forbes Holdings*, 506 A. 2d 173, 179 (Del. 1986).

its shareholders.³¹ Others though follow the classic approach and still maintain that “there are important circumstances in which the managers and corporation owe fiduciary duties directly to the corporation’s shareholders.”³²

Since the share, which is the fungible ownership unit of a corporation, entitles the holders to a pro rata right to share the corporation’s profits, net assets, and the voting power, the shareholders are accordingly equipped with a basic power to elect annually the corporation’s directors and approve fundamental changes in the corporation’s governing rules or structure.³³ Thus, under circumstances where the shareholders’ basic rights will be materially affected, it seems reasonable to entitle a shareholder to pursue a proper legal remedy for his own interests. However, it is through the corporation that the shareholders can enjoy their basic rights and bear their investment risks. To that extent, the corporations, in those very circumstances with direct impact on shareholders’ basic rights, will perform as a fiduciary of its shareholders and be subject to the relevant duties accordingly. Matters such as mergers, dissolution, charter amendment, and substantial asset sales of the corporation that generally require the shareholders’ prior action or consent probably constitute the important or special circumstances addressed by those aforementioned commentators.

Since the board of directors is the management body as well as the fiduciary of the corporation, the question arises as to whether the directors will automatically owe the fiduciary duties directly to the corporate shareholders under the circumstances where the corporation undertakes a direct fiduciary duty to its stockholders. This question is left open. However,

³¹ See Block, Barton & Radin, *supra* note 17; See also Robert W. Hamilton, *The Law of Corporations in a Nutshell*, 303 (1987) (“...with the restriction, that the directors can become directly liable to single shareholders in certain circumstances.”)

³² See O’Kelley & Thompson, *supra* note 3, at 222.

³³ *Id.* at 137.

pursuant to the case law and statutory provisions of Delaware, the answer is likely in the positive.

In the merger circumstances, the comment to Delaware General Corporation Law section 251 states: “Where a cohesive group of stockholders with majority voting power is irrevocably committed to the merger transaction, effective representation of the financial interests of the minority shareholders imposes upon the board an affirmative responsibility to protect those minority shareholders' interests.”³⁴ In *Sealy Mattress Co. v. Sealy, Inc.*,³⁵ the court held that a director may not abdicate his or her fiduciary duty to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders by leaving the decision to approve or disapprove the agreement to the stockholders alone.³⁶

In the case of corporate dissolution, as the shareholders are the lawful owners of the corporation, and once a decision is made to sell the company, they deserve the primary benefit of the exercise of the board's fiduciary duties.³⁷ In *Revlon*,³⁸ the Delaware Supreme Court stated that once it became “inevitable” that the target company would be sold, the directors of the target had a fiduciary duty to do what was best for the shareholders of the target.³⁹

³⁴ Del. Code Ann. Tit. 8 § 251 Notes (2003).

³⁵ 532 A.2d 1324 (Del. Ch. 1987).

³⁶ *Id.* at 1339.

³⁷ Harvey L. Pitt, *On the Precipice: A Reexamination of Directors' Fiduciary Duties in the Context of Hostile Acquisitions*, 15 [DEL. J. CORP. L.] 811, 879; *See also* Reder, *The Obligation of a Director of a Delaware Corporation to Act as An Auctioneer*, 44 [BUS. LAW] 275, at 278-79 (1989) (“The directors are responsible only to the shareholders when it becomes clear to the directors that the corporation as an effective business entity will not survive in recognizable form. From the moment the directors perceive that clarity, their role shifts from beneficent fiduciaries for a wide range of constituencies to auctioneers with the solitary goal of achieving the highest price for shareholders.”).

³⁸ 506 A.2d at 182 (Del. 1986).

³⁹ *Id.*; *See also In re Holly Farms Corp. Shareholders Litig.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) P94,181, at 91,641, 91,643 (Del. Ch. 1988) (directors' duty is to get the highest price at a sale for the benefit of shareholders); *and* *Doskocil Cos. v. Griggy*, No. 10,095, slip op. at 1 (Del. Ch. 1988) (“directors have a fiduciary duty to obtain best possible price for stockholders”), *reprinted in* 14 [DEL. J. CORP. L.] 682, 684 (1989); *and* *Freedman v. Restaurant Assocs. Indus., Inc.*, [1987-88 Transfer Binder] [FED. SEC. L. REP.] (CCH) P93,502, at

In the case of charter amendment and substantial asset sales where the stockholders' action is needed, Delaware certainly has recognized that the directors have a fiduciary duty of disclosure to stockholders.⁴⁰

From this discussion, it is apparent that the directors owe the fiduciary duties directly to the minority shareholders in some important contexts, particularly in the case of mergers.

C. Standards of Review in Delaware

a. General Introduction of Standards of Review

Since 1985, unprecedented development in both the capital and the international product market created the environment for Delaware court to develop a body of rules to impose legal order upon the directors' action, especially in the context of corporate takeovers.⁴¹ The end result was the articulation by Delaware courts of the standards of review in cases⁴² respecting the takeovers.

In corporate law, a judicial standard of review is a verbal expression that describes the task a court performs in determining whether actions taken by corporate directors violated their fiduciary duties.⁴³ Similarly, Delaware's standards of review reflect significant value judgments of Delaware's courts regarding the utility of permitting greater or lesser insulation of director conduct from judicial scrutiny.

97,214, 97,218 (Del. Ch. Oct. 16, 1987) (directors' duty is to maximize the amount to be received by shareholders); *Edelman v. Freuhauf Corp.*, 798 F.2d 882, 885 (6th Cir. 1986) (board is obligated to "negotiate the best deal for the shareholders"); *and Interco*, 551 A.2d at 803 ("The board's duty is to act . . . so as to encourage the best possible result from shareholders' point of view."); *and In re Fort Howard Corp.*, No. 9991, slip op. at 29-30 (board's duty is to seek best transaction available), *reprinted in* 14 [DEL. J. CORP. L.] at 719.

⁴⁰ Symposium, *Corporate Law in the Twenty-first Century: The Practitioners' Prognosis*, 25 [DEL. J. CORP. L.] 161, 170 (2000).

⁴¹ Allen, Jacobs & Strine, *supra* note 2, at 866.

⁴² *See, e.g.*, *Smith v. Van Gorkom*, 488 A.2d 858 (Del 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) and *Blasius Industries, Inc. v. Atlas Corp.* 564 A.2d 651 (Del. Ch. 1988).

⁴³ Allen, Jacobs & Strine, *supra* note 2 at 867.

Generally, standards of review function to:

(i) provide judges with a practical and logical framework to determine whether corporate directors have fulfilled their duties in a particular context and the appropriate remedies if they have not; (ii) avoid needless complexity that creates opportunities for inefficient processing of cases that have little likelihood of ultimate success; and (iii) be aligned with the public policies that animate the corporate law by providing incentives for directors to act in a manner most likely to advance corporate and stockholder interests, and by deferring to outcomes reached through effective intracorporate dispute resolution mechanisms.⁴⁴

Based on these functions, two primary standards of judicial review have developed under Delaware law. These standards include (i) the business judgment rule, which is a gross negligence standard of review for claims that directors are liable for damages caused by their inattention—a standard that would require a plaintiff to prove both a breach of the duty and the fact and extent of any damages caused by the breach; and (ii) a rehabilitated entire fairness standard to address duty of loyalty claims.⁴⁵

b. Business Judgment Rule

The business judgment rule

“is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of the discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.”⁴⁶

This standard of review reflects the Delaware courts’ great deference to the directors, since they have greater expertise with regard to business matters and are more familiar with the

⁴⁴ *Id.* at 869-870

⁴⁵ *Id.* at 865.

⁴⁶ *Aronson v. Lewis*, 473 A. 2d 805 (Del. 1984).

business of the company than the judges. Thus, the courts generally will not second-guess the directors' decisions, as long as the decision-making process is unaffected by fraud or other negative influences.

However, not every director's action may be protected by the business judgment rule. Generally, to be protected by the business judgment rule, five criteria must be satisfied: (i) a business decision; (ii) disinterestedness; (iii) due care; (iv) good faith; and (v) no abuse of discretion or waste of corporate assets.⁴⁷ Therefore, the business judgment rule shields directors from liability when the foregoing five elements are present, and at the same time, the business judgment rule creates a presumption in favor of the directors that each of the elements of the rule has been satisfied.⁴⁸

Accordingly, a plaintiff seeking to establish a breach of the duty of care first must establish facts sufficient to overcome the business judgment rule's presumption that the directors acted with due care.⁴⁹ If the plaintiff is able to do so, the burden of proof shifts to the directors to prove that they did in fact act with the requisite degree of care. Gross negligence and an uninformed directors' decision⁵⁰ may overcome the business judgment rule's presumption regarding the due care. However, even if such presumption is rebutted, and the directors cannot establish they acted with the requisite degree of care, the plaintiff will ultimately prevail on a duty of care claim only if he can establish the other elements required to prove liability, including proximate causation, damages and/or the necessity for injunctive relief.⁵¹

⁴⁷ See Block, Barton & Radin, *supra* note 17, at 20.

⁴⁸ *Id.* at 53.

⁴⁹ See, e.g., Spiegel v. Buntrock, 571 A.2d 767, 774 (Del. 1990) and Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

⁵⁰ Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

⁵¹ See Block, Barton & Radin, *supra* note 17, at 54-55.

Thus, the business judgment rule affords directors with a great protection in cases where only the duty of care has been implicated rather than in cases involving self-dealing, waste, fraud, or any other illegality or ultra vires conduct, all of which will be judged under the entire fairness standard.

c. Entire Fairness Standard

Normally, duty of care and duty of loyalty claims against directors are under different standards of review. In particular, the standards of review to be applied depend upon the threshold inquiry into whether there is a conflicting interest.⁵² If disinterested directors exercise their independent judgment in good faith, the only issue will be whether the directors have breached their duty of care. Thus, the directors will not be charged with any violation of loyalty, and they will not be required to undertake any defense or carry any burden of proof until the plaintiff has presented the evidence adequate to rebut the presumption of the business judgment rule.

Claimed breaches of the duty of loyalty, on the other hand, are reviewed under the far more exacting standard—entire fairness. This standard of review is required largely as a matter of policy. Specially, it is assumed that a board that is not conflicted is motivated to achieve the highest transaction price the market will permit, and in those circumstances where the directors' and shareholders' interests are aligned, there is no reason for courts to engage in a substantive review of the board's decision.⁵³ In contrast, where a majority of the board is conflicted, i.e., where a majority have personal interests in the transaction that are adverse to the interest of the shareholders, it cannot be presumed that the board will be motivated to achieve the best interests

⁵² Allen, Jacobs & Strine, *supra* note 2, at 874.

⁵³ *Id.* at 875.

for the corporation and shareholders in effectuating a given transaction.⁵⁴ Therefore, in conflict transactions that implicate the directors' duty of loyalty, the court imposes upon the directors the burden of showing that the transaction is entirely fair as to both process and price, and engages in the most searching review of the substance of the board's decision.⁵⁵ Though the application of the entire fairness standard does not represent per se liability on the directors, the director's burden to demonstrate intrinsic fairness in such a transaction is a heavy burden and not easily satisfied. Therefore, the entire fairness standard is only applied to the circumstances where the directors breach their loyalty duty.

d. Directors' Personal Liabilities under Different Fiduciary Duties

As stated above, fiduciary duties have a basic function, through a personal liability imposition, to optimally reduce the possibility that directors will favor personal interests over the corporation's interests.⁵⁶ During the mid-1980s, a widespread perception developed that corporate directors faced an increased likelihood of being held liable for monetary damages. This perception, coupled with sharply rising defense costs⁵⁷ resulted in many directors to be unwilling to perform on corporate boards or to merely confine their official duties to the regular and non-risk management affairs of the corporation.

Following the 1985 decision of the Delaware Supreme Court in *Smith v. Van Gorkom*,⁵⁸ which held directors liable for breaching the duty of care, Delaware, and then virtually all other states, amended their corporate codes to allow corporations to eliminate director liability for

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ See O'Kelley & Thompson, *supra* note 3, at 221.

⁵⁷ See Block, Barton & Radin, *supra* note 17, at 942.

⁵⁸ 488 A.2d 858 (Del. 1985).

monetary damages for breaches of the duty of care.⁵⁹ Specially, Delaware General Corporation Law section 102(b)(7) provides:

“A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under section 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit...”⁶⁰

Therefore, section 102(b)(7) provides that in Delaware the directors suffer no monetary damages arising from the breaches of their due care but shall bear the corresponding responsibility for their breaches against the duty of loyalty if the corporation chooses to adopt these provisions in its articles of association or bylaw. Thus, even if the directors are found to have violated their duty of care, they only take liability in guise rather than suffer an actual monetary loss. However, if the directors are found to have breached their loyalty duty, they will be personally liable for monetary damage. Due to the great difference in the monetary liability imposition depending on the type of breach, characterizing alleged directorial misconduct as violating the duty of care or loyalty is always a key issue in the cases regarding fiduciary duties.

⁵⁹ Mark J. Loewenstein, *Shareholder Derivative Litigation and Corporate Governance*, 24 [DEL. J. CORP. L.] 1 (1999).

⁶⁰ Del. Code Ann. tit. 8§102(b) (7) (2003).

CHAPTER 3

INTRODUCTION OF GOING-PRIVATE TRANSACTIONS

A. Current Economic Conditions Favoring Going-private Transactions

a. Historical Background

During the last half of the 1990s, many companies were formed through venture investment and then taken public through initial public offerings (IPOs).⁶¹ However, due to the plummeted stock valuations since March 2000⁶² and the issuance of Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act”),⁶³ which significantly increases the administrative costs and perceived risks to directors of remaining a public company,⁶⁴ more directors and controlling shareholders have been encouraged to seek the relative safety and a higher revenue value of being a private company.⁶⁵

The common method for the controlling shareholders to pursue a good financial rewarding through effectuating a going-private transaction is to firstly take a public company private and then either to operate it profitably as a private company and bring it back to public again through

⁶¹ Cannon, *supra* note 9, at 198.

⁶² *Id.*

⁶³ H.R. 3763, 107th Cong. (2002) (enacted).

⁶⁴ 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 Jan. 28, 2004). 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> (last visited Jan. 28, 2004); See also SEC Release No. 33-8182 at <http://www.sec.gov/rules/final/33-8182.htm> (last visited Jan. 28, 2004).

⁶⁵ See Michael V. Copeland, *For Some Companies it Pays to be Private*, [Red Herring], at 66 (Feb. 20, 2003) (“in this environment, it’s definitely easier being a private company than a public company,” and “a number of mid-to late-stage private companies that are cash-flow positive are valued at revenue multiple twice that of their public counterparts” at <http://www.redherring.com/vc/2003/02/private>).

an IPO when markets recover, or to sell the business in a negotiated private transaction.⁶⁶ An example of the successful execution of this public-private-public formula can be found in the case of Duracell International.⁶⁷

One of the reasons that type of a formula can achieve a great success is that taking an undervalued company private in a depressed financial market can make the corporate management focus on long-term growth and development and introduction of innovative technologies rather than reporting short-term performance to public investors.⁶⁸ Thus, after a successful operation for a number of years as a private company, bringing a corporate back to the financial market in more promising times may not only maximize the application of the corporate management sources but also bring significant financial rewards to the controlling shareholders as well. Not surprisingly then, more corporations have recently embraced the go-private solution including Dole Food Co., entertainment company Dave & Buster's, Chemical and mineral manufacturer International Specialty Products, TEK DigiTel Corp., and Infodata Sustems, Inc.⁶⁹

⁶⁶ Canon, *supra* note 9, at 200.

⁶⁷ *Twenty years of Buying and Selling Companies*, [Forbes], Dec. 13, 1999, at 184

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. The acquisition group paid approximately \$ 1.8 billion for Duracell. This equates to a value of approximately \$ 5 per share, 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. 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, giving KKR an approximate thirty-nine percent annual compounded return on investment. 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.

⁶⁸ 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 annual compounded rate of seventeen percent, as opposed to cash flow growth having been flat under Kraft. *See Building the Arc*, Business Standard, July 30, 2002, at <http://www.business-standard.com/strategist/bookshelf.asp>

⁶⁹ Canon, *supra* note 9, at n.34.

b. Benefits of Going-private Transactions

At present, the market capitalization of many companies is significantly less than it was only a couple of years ago.⁷⁰ Being a public company no longer means easy access to capital. Moreover, today there is less prestige inherent in being publicly traded than there was just in the late 1990s.⁷¹ Any benefit to being a public company in the eyes of issuers, suppliers, financiers, and public investors has significantly diminished since the explosion of the scandals regarding Enron, World Com, and Nortel. Under these circumstances, the advantages of going-private seem more substantial to the controlling party.

Additionally, the significant costs that come along with remaining as a public company, such as executive fees, legal expenses, accounting costs, and SEC filing and Reporting fees, will drop greatly.⁷²

As a general rule, going-private transactions, like a parent-subsidary merger provide benefits for the continuing enterprise where the value of the combined entity is greater than the value of the separate concerns.⁷³ Such gains accrue due to streamlined management, tax benefits, reduced competition, asset shifting, and overall economies of scale among others.⁷⁴ To take executive costs as an example,⁷⁵ going-private may allow management greater flexibility to focus on

⁷⁰ *Id.* at 203.

⁷¹ *Id.* at 204.

⁷² Joseph L. Johnson III & Andrew J. Weidhaas, *The Going-Private Transaction*, [N.Y. L.J.], Nov. 13, 2001. ("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.")

⁷³ Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 [YALE L.J.] 698, 706 (1982) ("A freeze-out of minority shareholders in a long standing subsidiary will produce gains if the value of the combined entity is greater than the sum of the separate values of the parent and the subsidiary.").

⁷⁴ Peter D. Santori, *Virginia Bankshares v. Sandberg: the Supreme Court Injects Federalism into the Implied Private Right of Action for Breach of Securities and Exchange Commission Rule 14a-9. A Taste of Things to Come?*, 17 [DEL. J. CORP. L.] 1007, 1018 (1992).

⁷⁵ See *supra* note 67 for a discussion of executive costs in the context of *Duracell* case noted above.

research and development and to implement strategies with a long-term view toward corporation building so as to maximize the overall value of the company, rather than to simply aim to satisfy the public investors in a short term. To give another example from the tax perspective, it may also be easier and cheaper to extract cash dividends from a private company.⁷⁶ After going-private, owners may be able to convert the company to a limited liability company or a subchapter S corporation⁷⁷ and avoid the double taxation that occurs at the corporate and personal levels when a corporate structure is used.⁷⁸

Another benefit of a going-private transaction also emanates from the law of agency.⁷⁹ As companies go private, the friction between the principal (the stockholders) and agent (the corporate directors) is eliminated⁸⁰ because there are no minority shareholders remaining in the corporation. This reduced friction translates into lower agency costs and, therefore, higher returns to the investor.⁸¹

B. Structure of Going-private Transaction

a. Key Participants in a Going-private Transaction

An important starting point in understanding the structure of the going-private transaction is to recognize the primary players and their roles. There are three key participants in going-private transactions.

⁷⁶ Canon, *supra* note 9, at 208.

⁷⁷ An "S Corporation" is a small business corporation, as defined at Internal Revenue 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).

⁷⁸ *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).

⁷⁹ Santori, *supra* note 74, at 1018.

⁸⁰ *Id.*

⁸¹ *Id.*

First, the board of directors, as the management body of the company, will play a critical role in many successful going-private transactions. Since only that current board will know best of the various conditions of the corporation, including its assets status, the mid-term or long-term operation plans, the approximate share value, the past corporate malfeasance, and so forth.

Second, the controlling shareholder plays a pivotal role, 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.⁸² Unless the controlling shareholder votes its shares in favor of the offer, the transaction will not be consummated.

Third, 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, the board of the target company may be required to appoint a special committee⁸³ comprised of independent directors to negotiate with the acquisition group and recommend to the larger board and the shareholders whether to accept the acquisition bid.⁸⁴ Where the deal structure compels the use of a special committee and where such committee properly discharges its duties such as to receive an opinion regarding the fairness of the acquisition bid from a financial advisor of the committee's choosing,

⁸² Canon, *supra* note 9, at 215.

⁸³ Dennis J. Block et al. *The Duty of Loyalty and the Evolution of the Scope of Judicial Review*, 59 [BROOK. L. REV.] 65, 65 (“Enormous changes have occurred in the governance of public companies, including changes in the composition of boards of directors resulting in more disinterested and independent boards and the utilization of specialized board committees consisting of disinterested and independent directors to address conflict-of-interest transactions and related issues.”)

⁸⁴ See *In re Home Shopping Network, Inc. Shareholders Litig.*, C.A. No. 12868, at 29 (Del. Ch. 1993). (“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.”).

Delaware courts will be to impose upon the shareholders challenging the transaction the burden of showing that the transaction was unfair.⁸⁵

b. Two Main Methods of Structuring Going-private transactions

There are two main ways to structure the going-private transaction. The first is the commonly adopted merger. The second is so-called tender offer.

(a) Mergers

A statutory merger is a transaction whereby two or more corporations are combined into one of the corporations, usually referred to as the surviving corporation. When the merger is effected, the legal existence of all constituent corporations other than the surviving corporation ceases.⁸⁶ In a consolidation, the surviving entity is not one of the constituent corporations as in merger but, rather, a newly created consolidated corporation.⁸⁷ By operation of law, the assets and liabilities of all constituent corporations pass to that surviving corporation.⁸⁸

Deciding whether to vote for a merger is one of the basic rights of all shareholders of the corporation. Therefore, generally, most states including Delaware require the board of directors to first adopt a plan of merger with specified terms and to present that plan to the shareholders. After the requisite shareholders' approval, the plan shall be filed with the state corporations

⁸⁵ See *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997) (“Ordinarily, in a challenged transaction involving self-dealing by a controlling shareholder, the substantive legal standard is that of entire fairness, with the burden of persuasion resting upon the defendants. The burden, however, may be shifted from the defendants to the plaintiff through the use of a well functioning committee of independent directors. Regardless of where the burden lies, when a controlling shareholder stands on both sides of the transaction the conduct of the parties will be viewed under the more exacting standard of entire fairness as opposed to the more deferential business judgment standard.”); See also Michael J. Kennedy, *The Business Judgment Syllogism - Premises Governing Board Activity*, [TECHNOLOGY & EMERGING GROWTH M&AS 2002], at 294-295 (discussing that “a properly advised special committee will generally be entitled to rely on the business judgment rule”).

⁸⁶ O’Kelley & Thompson, *supra* note 3, at 581.

⁸⁷ *Id.*

⁸⁸ *Id.*

commissioner.⁸⁹ Once the merger becomes effective as set forth in the plan, the terms apply to all shareholders, even those who voted against that merger plan.⁹⁰

Generally, the group seeking to acquire the company (the “acquisition group”) will first negotiate with the board of directors of the target company and agree on terms that are then reflected in an agreement of merger.⁹¹ 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.

However, as for going-private mergers in which controlling shareholders are the members of the acquisition group, a situation arises where the possible conflicts of interest are involved. In light of the controlling shareholders’ dominance over directors and officers and standing to pursue interests diverging from those of other shareholders in an acquisition transaction, Delaware laws state that transactions involving a controlling shareholder that are structured as a merger are required to meet the “entire fairness” test.⁹² Under this test, the burden of showing that the transaction was fair to minority shareholders rests initially on the controlling shareholders and the interested directors of the company. In order to shift the burden of proof on those shareholders challenging the fairness of the transaction, the board of the target corporation often appoints a special committee of disinterested directors to review and approve the merger

⁸⁹ *Id.*

⁹⁰ *See* Del. Code Ann. tit. 8§262(a) (2003) (“Appraisal is available only to shareholders that did not vote in favor of or consent to the merger or consolidation...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. But nothing in this section expressly states that appraisal is an exclusive remedy.”); *See also* *Andra v. Blount*, 772 A.2d 183 (Del. Ch. 2000); *Loeb v. Schenley Indus., Inc.*, 285 A.2d 829 (Del. Ch. 1971).

⁹¹ 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; Under DGCL Section 251(c), the agreement is then submitted to shareholder for their approval.

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).

proposal in advance.⁹³ Though the mere formation of a special committee cannot always shift the burden of proof,⁹⁴ the board of the target corporation still pins its hope on such committee's action through the whole transaction. Therefore in a going-private merger, the special committee may often play a critical role as will be further discussed in Part III.

(b) Tender offers

An alternative to engaging in a merger transaction is tender offer. In the 1960's, tender offers, which already had been in use in England, became an increasingly popular method for corporate control in the United States.⁹⁵ Interestingly, however, indeed the very term "tender offer" is undefined.⁹⁶ Generally, the "conventional" tender offer was described in the House Report of the Committee on Interstate and Foreign Commerce, for the hearings on the proposed Williams Act,⁹⁷ which was adopted in 1968 in response to the growing use of cash tender offers as a means for achieving corporate takeovers.⁹⁸ That report described "tender offers" as "normally consist[ing] of a bid by an individual or group to buy shares of a company—usually at a price above the current market."⁹⁹ In defining "tender offer," the case law followed the Williams Act's legislative history, which made it clear that the Williams Act was not intended to be restricted to conventional tender offers but rather was meant to encompass all methods of

⁹³ 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 Brown, Maimone & Schoell, *supra* note 26, at 1164.

⁹⁵ Carl. Kanter, *Tender Offers Making and Meeting Them* 9 (1st ed. 1979)

⁹⁶ Michael Bradley & Michael Rosenzweig, *Defensive Stock Repurchases*, 99 [HARV. L. REV.] 1378, at Note 12. ("In 1979, the Commission proposed a definition of the term, see Securities Exchange Act Release No. 16,385, 44 Fed. Reg. 70,349 (1979) (proposed SEC rule 14d-1(b)), but the proposal was never adopted." See also proposed Tender Offer Improvements Act of 1980, S. 3188, 96th Cong., 2d Sess., 126 CONG. REC. 14,059 (1980), *reprinted in* 542 [SEC. REG. & L. REP.] (BNA) Spec. Supp. 21-22 (Feb. 27, 1980) (proposing statutory definition of "tender offer").

⁹⁷ 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1988).

⁹⁸ Piper v. Chriscraft Industries, Inc., 430 U.S. 1, 22 (1977)

⁹⁹ Kanter, *supra* note 95, at 12.

takeovers sought to be achieved by a large-scale stock purchase program.¹⁰⁰ Regardless of which definition of “tender offer” is most accepted, to be sure, Congress, the Commission, and the courts commonly understand the concept to be a limited, conditional public invitation to all target shareholders to tender their shares at a particular price (usually a premium).¹⁰¹

A certain tender offer in the context of going-private transactions often involves the acquisition group making an offer directly to the public shareholders of the company to acquire their shares. The acquisition group is required to make extensive disclosures with respect to the tender offer through the filing of a Schedule TO.¹⁰²

The tender offer is a powerful tool¹⁰³ not only because its consummation generally takes less time than a merger since neither prior SEC review¹⁰⁴ nor first approval or recommendations from the board of directors towards the tender offer is required but also because the possible resulting short-form merger following the close of the tender offer.¹⁰⁵ 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

¹⁰⁰ Lipton, *Open Market Purchases*, 32 [BUS. LAW.] 1321 (1977); *See also* Smallwood v. Pearl Brewing Co., 489 F.2d 579, 596-97 nn. 21 & 22 (5th Cir.).

¹⁰¹ Note, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934*, 86 [HARV. L. REV.] 1250, 1251-52 (1973); Aranow & Einhorn, *Essential Ingredients of the Cash Tender Invitation*, 27 [BUS. LAW.] 415 (1972); *see also* Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. [PA. L. REV.] 647, 662-67 (1984).

¹⁰² *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).

¹⁰³ Arthur Fleischer, Jr. & Alexander R. Sussman, *Takeover Defense Volume 1 1997 Supplement*, 9-3 (5th ed. 1997).

¹⁰⁴ Paul S. Bird, *Developments in Spin-Offs, Sales of Divisions and Going-private Transactions in 33rd Annual Institute on Securities Regulation*, at 449 (PLI Corp. Law and Practice Course, Handbook Series PLI Order No. B0-0113, 2001).

¹⁰⁵ *See* Del. Code Ann. tit. 8 § 253 (2003); *See also* Canon, *supra* note 9, at 218-219 (“Ownership of at least ninety percent of 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.”).

then conduct a short-form merger to eliminate the non-tendering shares¹⁰⁶ and finally reach the same result as a negotiated merger transaction.

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 a public announcement, often through a newspaper advertisement, of its intention to make an offer to buy shares directly from the shareholders. Under Delaware law, the fiduciary duties in those two deal structures imposed on the directors are different, and similarly, the applied standards of review and the burden of proof are also distinguishable. The question regarding the directorial fiduciary duties in the context of going-private transactions is thoroughly discussed in the following section.

¹⁰⁶ See Del. Code Ann. tit. 8 § 262 (2003).

CHAPTER 4
DIRECTORIAL DUTIES IN THE CONTROLLED GOING-PRIVATE
MERGERS UNDER DELAWARE LAW

Since the merger is both the most commonly used measure in going-private transactions and at the same time, “it is also the most important event occurring in a small corporation’s life,”¹⁰⁷ the fiduciary duties borne by the directors in this context is often a hot topic among the commentators¹⁰⁸ as well as the courts.¹⁰⁹ Because this article is limited in its scope to the context of going-private mergers initiated by the controlling shareholders for a regular business purpose rather than for a response to a hostile acquisition, the question of how to impose the potential directorial duties is further complicated with the mixing of those two opposing elements, the merger and the existing fiduciary duties owed by controlling shareholders to the minority shareholders due to that controlling interest. As a starting point, under Delaware law, the standard of review applied in “a merger by a controlling or dominating shareholder” may be distinguished from that applied in a common merger. Thus, defining who constitutes a controlling shareholder is the preliminary issue which must be decided first in order to ascertain the proper stand of review applied to the going-private merger context.

¹⁰⁷ SEC v. Geon Industries, Inc., 531 F.2d 39, 47-48 (CA2 1976).

¹⁰⁸ See, e.g., generally, Martin Lipton, *Pills, Polls, and Professors Redux*, 69 [U. CHI. L. REV.] 1037 (2002); 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; 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).

¹⁰⁹ See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) and *Blasius Industries, Inc. v. Atlas Corp.* 564 A.2d 651 (Del. Ch. 1988).

A. How to Distinguish a “Controlling Shareholder”

A “controlling shareholder” is “a shareholder who is in a position to influence the corporation’s activities because the shareholder either owns a majority of outstanding shares or owns a smaller percentage but a significant number of the remaining shares are widely distributed among many others.”¹¹⁰ Under Delaware law, controlling shareholders like the directors and officers, owe fiduciary duties to the corporation’s shareholder body as a whole, including minority shareholders,¹¹¹ due to their exercise of the controlling shareholder’s power.

As to whether a controlling shareholder exists, the number of owned shares is not always a decisive element. The Delaware Supreme Court has held that “a shareholder who owns less than 50% of a corporation’s outstanding stock does not, without more, become a controlling shareholder of that corporation... For a dominating relationship to exist in the absence of controlling stock ownership, a plaintiff must allege domination by a minority shareholder through actual control of corporate conduct.”¹¹² Therefore, we may conclude that domination and control may be the result of either (1) ownership of or the unrestricted power to vote more than fifty percent of the corporation’s outstanding voting securities or (2) actual control over a majority of the corporation’s board of directors or other managing body.¹¹³ With regard to the second criteria, there is no a specified threshold in share number to determine whether or not the control exists, it requires the court to conduct a case by case fact-review to determine that question.

¹¹⁰ Black’s Law Dictionary, Bryan A. Garner ed., 1380 (7th ed. 1999).

¹¹¹ See, e.g., *Simons v. Cogan*, 549 A.2d 300, 304 (Del. 1988); *Singner v. Magnavox Co.*, 380 A.2d 969, 976-77 (Del. 1977), *overruled on other grounds by* *Weinberger v. Uop, Inc.* 457 A.2d 701 (Del. 1983); *Sterling v. Mayflower Hotel Corp.*, 93 A. 2d, 107, 109-10.

¹¹² *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 70 (Del. 1989).

¹¹³ Block, Barton & Radin, *supra* note 17, at 152.

B. Standards of Review in the Controlled Going-private Mergers

a. Related Statutory Rules and Cases in Delaware

The Delaware legislature has codified many of the rules to govern the duties of directors and the controlling shareholders to the minority shareholders in the context of a merger. In addition, in order to better clarify those rules, they are also accompanied with many notes based on the related cases.

The main rules that cover mergers, consolidations, and conversions are from Sections 251 through 266 of the Delaware General Corporation Law.¹¹⁴ Of those sections, Sections 251, 253 and their supplemented case-based notes are the main statutory sources to address issues such as the fiduciary duties, standards of review, and burdens of proof.

(a) Section 251 and Case-based Notes

Section 251 mainly covers mergers or consolidations of Delaware domestic corporations and limited liability companies.¹¹⁵ In its case-based notes, Section 251 generally mentions the fiduciary duties owed to the minority shareholders and the related burden of proof arising from a going-private merger.

It states: “Mergers which present a classic ‘going-private’ transaction, with the majority having complete control over the timing of the ‘squeeze play’ on the public stockholders...call for the strictest observance of the law of fiduciary duty¹¹⁶...Where a cohesive group of stockholders with majority voting power is irrevocably committed to the merger transaction, effective representation of the financial interests of the minority shareholders imposes upon the

¹¹⁴ DEL. Code Ann. Tit. 8 §§ 251-266 (2003)

¹¹⁵ DEL. Code Ann. Tit. 8 §251 (2003)

¹¹⁶ DEL. Code Ann. Tit. 8 §251 (2003), Notes; *See also* Roland Int'l Corp. v. Najjar, 407 A.2d 1032 (Del. Supr. 1979), overruled on other grounds, 457 A.2d 701 (Del. Supr.1983).

board an affirmative responsibility to protect those minority shareholders' interests; the board cannot abdicate its fiduciary duties to the minority by leaving it to the stockholders alone to approve or disapprove the merger agreement where stockholders already combine to establish a majority of the voting power that makes the outcome of the stockholder vote a foregone conclusion.”¹¹⁷

Except for the previous mentions of “the strictest observance of fiduciary duties”¹¹⁸ and board’s fiduciary duty to the minority shareholders in the coercive situation,¹¹⁹ the notes of Section 251 address the burden of proof issue as “[a] corporate majority stockholder and the directors of the subsidiary as nominees of the majority stockholder occupy, in relation to the minority, a fiduciary position in dealing with the subsidiary’s property and bear the burden of establishing the fairness of a merger plan, and it must pass the test of careful scrutiny by the courts.”¹²⁰

(b) Section 253 and Case-based Notes

Compared with Section 251, Section 253 is more specialized in addressing issues such as a going-private merger structured by the controlling shareholders, like the one between the parent corporation and the subsidiary or subsidiaries.¹²¹

With regard to the applied standards of review, its case-based notes state: “The exclusive standard of judicial review in examining the propriety of an interested cash-out merger

¹¹⁷ DEL. Code Ann. Tit. 8 §251 (2003), Notes; *See also* *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. Supr. 2003).

¹¹⁸ *See supra* note 116.

¹¹⁹ *See supra* note 117.

¹²⁰ DEL. Code Ann. Tit. 8 §251 (2003), Notes; *See also* *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 93 A.2d 107 (Del. Ch. 1952); *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. Supr.1977), overruled on other grounds by *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. Supr.1983); *Young v. Valhi, Inc.*, 382 A.2d 1372 (Del. Ch. 1978).

¹²¹ DEL. Code Ann. Tit. 8 §253 (2003).

transaction by a controlling or dominating shareholder is entire fairness.¹²² In parent-sub subsidiary merger transactions the issues are those of fairness—fair price and fair dealing.”¹²³ As for the burden of establishing the fairness, the statutory notes state: “In a parent-sub subsidiary merger context, shareholder ratification operates only to shift the burden of persuasion, not to change the substantive standard of review which should be entire fairness; nor does the fact that the merger was negotiated by a committee of independent, disinterested directors alter the review standard.”¹²⁴

b. Applied Standards of Review in the Controlled Going-private Merger

From the Delaware statutory rules and those notes arising from the relevant cases, we may find that the standard of review applied in a going-private merger by a controlling shareholder (including a parent-sub subsidiary merger) is entire fairness standard. The burden of proof to establish such entire fairness is on the controlling shareholders standing on both sides of the transaction through control of the corporate machinery.

However, should the very entire fairness standard as addressed in sections 251, 253, and the case-based notes shall be applied, in the context of such a controlled merger, to all the involved fiduciaries to the minority shareholders, including the controlling stockholders, the members of a special committee composed of those independent and disinterested directors and the managers? That question, though rarely discussed, seemingly cannot be disregarded in our analysis about the issue of the directorial fiduciary duty to the minority shareholders.

¹²² DEL. Code Ann. Tit. 8 §253 (2003), Notes; *See also* Kahn v. Lynch Communication Sys., Del. Supr. 638 A.2d 1110 (1994).

¹²³ DEL. Code Ann. Tit. 8 §253 (2003), Notes; *See also* Bershad v. Curtiss-Wright Corp., Del. Supr. 535 A.2d 840 (1987).

¹²⁴ DEL. Code Ann. Tit. 8 §253 (2003), Notes; *See also* Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490 (Del. Ch. 1990).

C. Directorial Duties in the Controlled Going-private Merger

As previously mentioned, in a controlled going-private merger, there are at least three kinds of fiduciary duties to the minority shareholders borne by three different types of corporate fiduciaries. The first category of fiduciary is the controlling shareholders;¹²⁵ the second is the directors,¹²⁶ and the third is the managers or the corporation officers.¹²⁷

It is well reflected in many cases in Delaware,¹²⁸ that in a going-private merger structured by the controlling shareholder, the business judgment rule protection is precluded, and the controlling shareholders have the burden of demonstrating the fairness of that transaction.¹²⁹ It is almost impossible not to arouse any doubt in a reasonable person's mind about the fairness of most general transactions where a party not only stands on both sides but also has a controlled voting power, let alone in such a critical one as the merger. Therefore, it is persuasive to regard the fiduciary duties of a controlling shareholder arising from the controlled going-private merger as a duty of loyalty and impose an entire fairness standard accordingly. That is also deeply rooted in the above analysis on Delaware statutory rules and related cases.¹³⁰ However, the fiduciary duties on those controlling shareholders are not equal to those on the involved director if he is fully independent and disinterested as a member of the special committee.¹³¹

¹²⁵ See, e.g., *Simons v. Cogan*, 549 A.2d 300, 304 (Del. 1988); *Singner v. Magnavox Co.*, 380 A.2d 969, 976-77 (Del. 1977), *overruled on other grounds by* *Weinberger v. UOP, Inc.* 457 A.2d 701 (Del. 1983); *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 109-10.

¹²⁶ See Block, Barton & Radin, *supra* note 17; Hamilton *supra* note 31; O'Kelley & Thompson, *supra* note 3, at 222.

¹²⁷ O'Kelley & Thompson, *supra* note 3, at 222. The officers' fiduciary duties are beyond the scope of this article and therefore will not be discussed.

¹²⁸ See, e.g., *Simons v. Cogan*, 549 A.2d 300 (Del. 1988); *Singner v. Magnavox Co.*, 380 A.2d 969 (Del. 1977), *overruled on other grounds by* *Weinberger v. UOP, Inc.* 457 A.2d 701 (Del. 1983); *Sterling v. Mayflower Hotel Corp.*, 93 A.2d, 107.

¹²⁹ See Block, Barton & Radin, *supra* note 17, at 151.

¹³⁰ See *supra* text of Part III B.

¹³¹ In this article, we don't mean a fully independent and disinterested director shall bear a duty of loyalty in the context of a going-private merger structured by a controlling shareholder only because he doesn't perform like a

a. Duties of Disinterested Directors as the Special Committee Member

(a) Disinterestedness and Independence

As discussed above, the special committee of the board often has a central role in the controlled going-private merger and is usually comprised of disinterested and independent directors to represent and protect the interests of the minority shareholders¹³² through a negotiation with the controlling shareholders and a recommendation to the shareholders of whether to accept the bidder's offer.

The disinterestedness requirement under Delaware law mainly means that director has no personal interests in the related transaction.¹³³ The personal interest has often been described as "either a financial interest or entrenchment on the part of the directors."¹³⁴ Further, to create a reasonable doubt as to the director's disinterestedness, such interest must be material.¹³⁵ Therefore, in assessing whether the director is interested, the Delaware court must consider facts bearing on the significance or magnitude of the conflicting financial interests at stake.¹³⁶

The director's independence requires that he is not "dominated or otherwise controlled by an individual or entity interested in the transaction¹³⁷ and does not adopt "a direction of corporate conduct comporting with the wishes or interests of the controlling person or entity."¹³⁸ As

member of the special committee. That we combine the fiduciary duties of a disinterested director and that of a member of the special committee together is mainly for 2 reasons: one is that it is a common way for the disinterested directors, through the special committee, to participate in such a transaction and the other is to avoid a tautology.

¹³² Brown, Maimone & Schoell, *supra* note 26, at 1164.

¹³³ Grobow v. Perot, 539 A.2d 180, 188-89 (Del. 1988).

¹³⁴ *Id.* at 188.

¹³⁵ See, e.g., Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 595 n.7 (Del. Ch. 1986); see also Cede & Co., 634 A.2d at 364.

¹³⁶ Rothenberg, No. 11,749, slip op. at 9, *reprinted in* 21 [DEL. J. CORP. L.] at 317.

¹³⁷ Grobow, 539 A.2d at 189 (citing Aronson, 473 A.2d at 815-16); see also Bodkin, No. 13,770, slip op. at 9, *reprinted in* 22 [DEL. J. CORP. L.] at 1164

¹³⁸ Kaplan v. Centex Corp., 284 A.2d 119, 123 (Del. Ch. 1971); see also Pogostin v. Rice, 480 A.2d 619, 626 (Del.

“control” and “domination” are difficult terms to define with precision, Delaware courts explain such terms to require “actual control” from the interested director or controlling shareholders to that disinterested director.¹³⁹ In determining the existence of “actual” control, courts have suggested that directors who are employees of the corporation shall be excluded from serving on special committees because that employment can make the directors “beholden” to the interested directors or the controlling stockholders.¹⁴⁰ As explained by the Delaware Court of Chancery, in the context of a “parent-subsiary” merger, where the members of the subsidiary’s board were employees of the parent, the directors were deemed to be “beholden” to the parent. That is, as key employees of the parent corporation, those directors were entitled, indeed obligated, to demonstrate their loyalty to their employer whose directions they were bound to follow, but having assumed the position of directors of the subsidiary that also had other stockholders, those defendants became fiduciaries for the minority shareholders with a concomitant affirmative duty to protect the interests of the minority, as well as the majority, stockholders.¹⁴¹

Although courts have suggested that a special committee formed to negotiate with an interested fiduciary should be comprised of non-employee directors,¹⁴² the failure to comply with this suggestion may not “cause the transaction to be invalidated, provided that there are countervailing procedural safeguards, such as the arm’s length and adversarial negotiations, adequately calculated to protect the shareholders’ interests.”¹⁴³ In *Rosenblatt v. Getty Oil Co.*,¹⁴⁴

1984).

¹³⁹ *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1267 (Del. 1989).

¹⁴⁰ See *Iseman v. Liquid Air Corp.*, No. 9694, slip op. at 7 (Del. Ch. 1989), *reprinted in* 15 [DEL. J. CORP. L.] 1041, 1047 (1990); *In re Formica Corp. Shareholders Litig.*, No. 10,598 (Cons.), 1989 Del. Ch. LEXIS 27, at 35-36 (Del. Ch. Mar. 22, 1989); *see also, e.g.*, *Freedman v. Restaurant Assocs. Indus.*, No. 9212, slip op. at 21 (Del. Ch. Oct. 16, 1987), *reprinted in* 13 [DEL. J. CORP. L.] 651, 663 (1988).

¹⁴¹ *Sealy Mattress Co. of N.J. v. Sealy, Inc.*, 532 A.2d 1324, 1337-38 (Del. Ch. 1987).

¹⁴² See *In re MAXXAM, Inc.*, 659 A.2d at 774; *Iseman*, No. 9694, slip op. at 7, *reprinted in* 15 [DEL. J. CORP. L.] at 1047; *In re Formica Corp. Shareholders Litig.*, No. 10,598 (Cons.), 1989 Del. Ch. LEXIS 27, at 30 (Del. Ch. 1989).

¹⁴³ *In re Formica Corp.*, 1998 Del. Ch. LEXIS 27, at 36 n.14 (Del. Ch. 1998).

¹⁴⁴ 493 A.2d 929 (Del. 1985).

the Delaware Supreme Court, notwithstanding the presence of employee directors on the special committee, still recognized that adequate countervailing procedure safeguarding calculated to protect the interests of the public stockholders.¹⁴⁵

Simply stated, the existence of an employment relationship between a director and the corporation is not a dispositive fact in determining whether a disinterested director was controlled or dominated by an interested fiduciary. The existence of the employment agreement, however, creates the “potential” for dependence and such potential (where coupled with additional facts) could result in a court deciding that a disinterested director was controlled or dominated by the interested fiduciaries.¹⁴⁶

(b) The Role of the Special Committee

The Delaware Courts have recognized the special committee as “an acceptable surrogate for the energetic, informed and aggressive negotiation that one would reasonably expect from an arm’s-length adversary.”¹⁴⁷

Simply stated, where a special committee emulates “that arm’s length process,” the interests of public stockholders are protected.¹⁴⁸ Thus, numerous decisions of Delaware courts have described the duties of a special committee where such committee is created and empowered to conduct “arm’s-length” negotiations with an interested party.¹⁴⁹

As explained by the Delaware Courts, that arm’s length process should assure that the controlled transaction be “accomplished only on terms fair to the public shareholders and

¹⁴⁵ *Id.* at 937-43.

¹⁴⁶ Brown, Maimone & Schoell, *supra* note 26, at 1175.

¹⁴⁷ *In re Trans World Airlines, Inc. Shareholders Litig.*, No. 9844 (Cons.), slip op. at 18 (Del. Ch. 1988), *reprinted in* 14 [DEL. J. CORP. L.] 870, 884 (1989).

¹⁴⁸ *Id.* (citing *Weinberger*, 457 A.2d at 701 n.7).

¹⁴⁹ *See Mendel v. Carroll*, 651 A.2d 297, 305 (Del. Ch. 1994); *Kahn v. Lynch Communications Sys.*, 638 A.2d 1110, 1119 (Del. 1994), *aff’d*, 669 A.2d 79 (Del. 1995); *In re First Boston, Inc. Shareholders Litig.*, 1990 Del. Ch. Lexis 74, at *20-21 (Del. Ch. 1990).

representing the best available terms from the shareholders' point of view.”¹⁵⁰ In the context of a controlled going-private merger, the Delaware court requires those independent and disinterested director members of the special committee “to say no to any transaction that is not fair to those shareholders and is not the best transaction available.”¹⁵¹ In addition, according to the court, “it is not sufficient for such directors to achieve the best price that a controlling shareholder will pay if that price is not a fair price. Nor is [if] sufficient to get a price that falls within a range of ‘fair values’ somehow defined, if the controlling shareholder (or another) would pay more.”¹⁵² The final result the special committee shall pursue through its power is to say no “to force the controlling shareholder to choose among the options of implementing a frank self-dealing transaction at a price that knowledgeable directors have disapproved, to improve the terms of the transaction or abandon the transaction.”¹⁵³

Pursuant to the foregoing Delaware statutory rules and case law,¹⁵⁴ however, the presence of a committee of independent, disinterested directors in the context of a going-private merger operates only to shift the burden of persuasion, not to change the substantive standard of review, which should be entire fairness. Therefore, except for a practical and possible protection for the interests of those public shareholders, another primary function of the special committee in the controlled merger is to shift the burden of proof from the controlling shareholders to the stockholders challenging the fairness of the merger.¹⁵⁵

Nonetheless, the mere formation of a special committee by the corporate fiduciaries is not enough to shift the burden of proof. A precondition to that is a fact-intensive inquiry into

¹⁵⁰ *Mendel*, 651 A.2d at 306 (citing *Lynch Communications Sys.*, 638 A.2d at 1119).

¹⁵¹ *In re First Boston, Inc. Shareholders Litigation*, Fed. Sec. L. Rep. (CCH) P95, 1990 Del. Ch. Lexis 74, at *20-21 (Del. Ch. 1990)

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *See supra* Part III B.

¹⁵⁵ *See Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997).

whether the special committee is truly independent, fully informed, and has the freedom to negotiate at arm's length.¹⁵⁶ “Unless the controlling or dominating shareholder can demonstrate that it has not only formed an independent committee but also replicated a process as though each of the contending parties had in fact exerted its bargaining power at arm's length, their burden of proving fairness will not shift.”¹⁵⁷

In addition to the required burden on the controlling shareholder to demonstrate the disinterestedness and independence of the committee, the committee itself also must establish that the decision is made on the “fully informed”¹⁵⁸ base and arm's length. In a 1997 decision, the Delaware Supreme Court held that the special committee failed to satisfy its fully-informed burden because two members of the three person committee did not attend the informational meetings with the committee's advisor and thus failed to involve themselves in the committee's functions with the requisite level of “care, attention and sense of responsibility” required of them.¹⁵⁹ In order to demonstrate they are fully-informed, the directors will often rely upon the consultation of legal and financial advisors, which also has become a common component of a court's assessment of such directors' conduct.¹⁶⁰

(c) The Applied Standard of Review

As the surrogate of the minority shareholders, a committee of the disinterested and independent directors must undertake the corresponding fiduciary duties. However, the question arises as to which standard of review shall be applied to those directors. Because it is in the

¹⁵⁶ Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110, 1120-21 (Del. 1994) (quoting *Weinberger*, 457 A.2d at 709-10 n.7).

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ Kahn v. Tremont Corp., 694 A.2d 422, 430 (Del. 1997), (quoting Aronson, 473 A.2d at 816).

¹⁶⁰ *Id.* at 429-30.

context of a going-private merger structured by the controlling shareholder where the minority shareholders need more protection than those in other conflicting-interest transactions as well as because Delaware courts have identified the entire fairness standard to apply in such a context regardless of whether there is a formation of the special committee, shall the standard of review to the fiduciary duties on those disinterested and independent directors but be entire fairness standard as well? The answer to this not fully-discussed question¹⁶¹ is in the negative for the following reasons. First, the entire fairness standard as established by the Delaware courts¹⁶² is applied to the controlling shareholders but is not explicitly employed to the committee composed of those truly disinterested and independent directors. Had the entire fairness standard been applied to those directors, the effect would be to treat the independent committee members in the exact same way as to those interested and controlled directors for whom the applied standard of review is entire fairness.¹⁶³ This would raise a great unfairness between those two very different sorts of directors.

In addition, to apply the entire fairness standard to the conduct of those director members is contradictory against the conduct assessment for the committee, described by the Delaware courts as to whether such directors' conduct is "truly independent, fully informed, and have the freedom to negotiate at arm's length."¹⁶⁴ Moreover, the great difficulty of satisfying the requirements of the entire fairness standard practically makes it impossible for those directors to

¹⁶¹ Why such a question is not discussed much by either commentators or the courts? The reason perhaps is that little practical significance to the minority shareholders. Generally, in a claim to challenge a controlled merger, the stockholder plaintiff prefers to challenge the fiduciary duties of those controlling shareholders directly due to their capability to make a monetary remedy as well as that entire fairness standard. The challenges made by the stockholder plaintiff against the independence, disinterestedness or fully-informed status of those director committee members are mainly for the purpose to avoid a shifting of the burden of proof on him to demonstrate the unfairness of the whole transaction.

¹⁶² See *supra* note 124.

¹⁶³ See, e.g., *Weinberger v. UOP, Inc.*, 457 A. 2d 701, 710 (Del. 1983); *Nixon v. Blackwell*, 626 A. 2d 1366, 1375-76 (Del. 1993); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989); *Puma v. Marriott*, 283 A. 2d 693, 695 (Del. Ch. 1971).

¹⁶⁴ *Kahn v. Lynch Communications Sys., Inc.*, 638 A.2d 1110, 1120-21 (Del. 1994) (quoting *Weinberger*, 457 A.2d at 709-10 n.7).

demonstrate the satisfaction of their fiduciary duties to the minority shareholders. In addition, the entire fairness standard also requires directors to prove that they have not breached their duty of loyalty, but if they cannot meet this burden, then they will be personally liable.¹⁶⁵ Due to the high risk of monetary liability for their failure to establish the entire fairness of the whole transaction, the disinterested directors will probably not want to be members of the committee. As a result, the failure to create a committee may obstruct the controlling shareholders to process such a merger transaction.¹⁶⁶ Even where such a merger is still processed, who shall protect the interests of the minority shareholders best remains an open issue.

Third, imposing the same burden of proof on the disinterested directors as the one imposed on the controlling shareholders and interested or dependent director, to demonstrate the entire fairness of the merger transaction is to totally frustrate the rationality and necessity in the creation of such a committee. The application of that standard itself, at the beginning, creates a doubt in the disinterestedness and independence of those directors. Seemingly, the creation of that committee cannot at all achieve the purpose to best protect the interests of the minority shareholders. Besides, such a doubt almost denies the controlling shareholders' demonstration of the disinterestedness and independence of those director committee members and thus the burden of proof can never be shifted at all.

Finally, in Delaware case law, the standard of review applied to the directors in the context of merger is not always entire fairness standard. The landmark is the well known "*Unocal* Standard"¹⁶⁷ in which the Delaware Supreme Court established that directors are entitled to business judgment rule protection after overcoming an initial burden of showing "first, that they

¹⁶⁵ See *supra* note 60.

¹⁶⁶ See Brown, Maimone & Schoell, *supra* note 26, at 1157-58. ("This trend towards utilizing disinterested and independent directors is based upon, among other things, the great deference courts give to decision makers who are capable of making an impartial business decision."); See also *Rales v. Blasband*, 634 A.2d 927, 937 (Del. 1993).

¹⁶⁷ See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A. 2d 946 (Del. 1985).

had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and second, that the defensive measure decided upon was reasonable in relation to the threat posed.”¹⁶⁸ Therefore, the entire fairness standard is not automatically applied to the directors in the merger context. Moreover, compared with the general duty of care on the directors to the corporation that requires the directors to achieve the best interests for the corporation on an informed basis, in good faith and the honest belief,¹⁶⁹ the duties of the special committee as to protect the best interests of the minority shareholders independently, fully informed, and at arm’s length¹⁷⁰ are very alike. Therefore, in the case law, the Delaware courts also support that the standard of review imposed on the committee by those disinterested and independent shareholders shall be the business judgment rule if they have discharged their duties properly.¹⁷¹

In *In re First Boston, Inc, Shareholders Litigation*,¹⁷² Chancellor Allen stated:

“...where independent directors pursue the goal [to pursue best interests of the public shareholders and a fair transaction that is the best transaction available] independently, in good faith and diligently, their decision, deserves the respect accorded by the business judgment rule.”¹⁷³ Further, he concluded, “I regard it as extremely unlikely that liability could be established against the non-interested directors based upon an inadequacy of the price or otherwise.”¹⁷⁴

In summary, the fiduciary duties imposed on the committee by those disinterested and independent directors are duty of care and their conducts shall be subject to the review under the business judgment rule.

¹⁶⁸ *Id.* at 955.

¹⁶⁹ See *Aronson v. Lewis*, 473 A. 2d 805 (Del. 1984); *Brown, Maimone & Schoell*, *supra* note 26.

¹⁷⁰ *In re First Boston, Inc. Shareholders Litigation*, Fed. Sec. L. Rep. (CCH) P95, 1990 Del. Ch. Lexis 74, at *20-21 (Del. Ch. 1990).

¹⁷¹ The reasoning adopted by Chancellor Allen in *First Boston*, 1990 Del. Ch. Lexis 74, at *20-21 (Del. Ch. 1990) was embraced by the Delaware Supreme Court. *Kahn v. Lynch Communications Sys.*, 638 A.2d 1110, 1119-21 (Del. 1994).

¹⁷² Fed. Sec. L. Rep. (CCH) P95, 1990 Del. Ch. Lexis 74 (Del. Ch. 1990).

¹⁷³ *Id.*

¹⁷⁴ *Id.*

b. Fiduciary Duties of Interested or Dependent Directors

(a) The Applied Standard of Review

Once the directors in the controlled going-private merger transaction are viewed as interested or dominated, their fiduciary duty, the same as that of the controlling shareholder, is the duty of loyalty and their conducts shall be subject to the review under entire fairness standard.

For the interested directors, the fairness doctrine is invoked either where the director takes advantage of the corporation, by planning and consummating that merger directly with the corporation in an unfair manner or at an unfair price¹⁷⁵ or according to Delaware courts, “where directors are under any influence which sterilizes their discretion” or are dominated or controlled by or beholden to an individual or entity interested in the transaction at issue.¹⁷⁶ Thus, in the context of a going-private merger transaction by the controlled shareholder, when directors are interested, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain¹⁷⁷ with those controlling shareholders, and so the guiding theoretical principle to counter this problem is fairness.¹⁷⁸

For the dominated or controlled directors, since they are particularly prone to view themselves as serving at the pleasure of the controlling shareholder¹⁷⁹ during the negotiation, they are in the psychologically difficult position of pressing the very parties to whom they probably owe their seats on a board,¹⁸⁰ the Delaware courts often evince skepticism about the weight to be accorded to the opinions of those directors and will not be satisfied until they find,

¹⁷⁵ Eric G. Orlinsky, *Corporate Opportunity Doctrine and Interested Director Transactions: A Framework for Analysis in an Attempt to Restore Predictability*, 24 [DEL. J. CORP. L.] 451, 513 (1999).

¹⁷⁶ Grobow v. Perot, 539 A.2d 805, 812 (Del. 1988).

¹⁷⁷ Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

¹⁷⁸ Orlinsky, *supra* note 175.

¹⁷⁹ Elliott J. Weiss, *Balancing Interests in Cash-out Mergers: The Promise of Weinberger v. UOP, Inc.*, 8 [DEL. J. CORP. L.] 1, 52-3 (1983).

¹⁸⁰ *Id.* at 53.

upon a close scrutiny, that a fair dealing has occurred.¹⁸¹ Similarly, once upon those director members of the committee are proven either interested or dominated, the business judgment rule cannot protect them any more.

Therefore in the context of a controlled going-private merger, any involved interested or dependent directors shall be subject to an entire fairness review and bear a duty of loyalty to those minority shareholders. Once the directors cannot demonstrate entire fairness, they face the possibility of personal liability for any minority shareholders' economic damage arising from their breach of the loyalty duty pursuant to section 102 (b)(7) of the Delaware General Corporation Law.¹⁸²

(b) Fair Dealing and Fair Price

When directors assume a position that involves dual loyalties as previously discussed, the final method of insulating them from a liability is to prove that transaction is fair and reasonable to the corporation.¹⁸³ While there is no exact rule for determining what “fairness” means,¹⁸⁴ and while each court must determine on a case-by-case basis whether a transaction is fair to the corporation, there are several tests and many factors that provide guidance.

As established by the Delaware Supreme Court, “entire fairness” entails a demonstration of both fair dealing and fair price:

¹⁸¹ Weinberger v. UOP, Inc., 457 A.2d 701(Del. 1983)

¹⁸² Del. Code Ann. tit. 8 §102(b)(7)(2003).

¹⁸³ DEL. Code Ann. Tit. 8 § 144 (a)(3)(2003)

¹⁸⁴ See, e.g., Shlensky v. South Parkway Bldg. Corp., 166 N.E.2d 793, 801 (Ill. 1960); See also some commentators have criticized the fairness standard for its unpredictability. J.A.C. Hetherington, *Trends in Legislation for Close Corporations: A Comparison of the Wisconsin Business Corporation Law of 1951 and the New York Business Corporation Law of 1961*, 1963 [WIS. L. REV.] 92, 149-50; Susan Webber, *Arkansas Corporate Fiduciary Standards—Interested Directors' Contracts and the Doctrine of Corporate Opportunity*, 5 [ARK. L. REV.] 39, 46 (1982).

“Fair dealing embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. Fair price relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.”¹⁸⁵

Fair dealing may be also regarded as the procedural prong with fair price to be viewed as the substantive prong.¹⁸⁶ Under the procedural prong of fair dealing, the Court analyzes each of the listed elements in determining fairness and upheld minority suits where one of the factors has been missing.¹⁸⁷ The most important component of fair dealing is the duty of “complete candor.”¹⁸⁸ That duty requires directors’ disclosure of all material facts regarding merger transactions to the minority shareholders.¹⁸⁹ This duty complements the duty of directors to be informed fully so as to inform the shareholders.¹⁹⁰ If shareholders are not fully informed, approval by a shareholder majority cannot be granted deference under the entire fairness test.¹⁹¹

Fair price, the substantive prong of the entire fairness test, takes into account appraisal remedy¹⁹² as well, which substitutes a traditional judicial determination of “reasonable price” for a privately negotiated price.¹⁹³

¹⁸⁵ Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983).

¹⁸⁶ Cannon & Tangney, *supra* note 7, at 735.

¹⁸⁷ *Id.* at 736.

¹⁸⁸ See, e.g., Lynch v. Vickers Energy Corp., Inc., 383 A.2d 278 (Del. 1977); see also Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983); see Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367-68 (Del. 1993).

¹⁸⁹ Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985).

¹⁹⁰ See, e.g., Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

¹⁹¹ Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

¹⁹² DEL. CODE ANN. tit. 8 § 262(h)(2003).

¹⁹³ Heilbrunn v. Sun Chem. Corp., 150 A.2d 755, 758 (Del. 1959) (“The appraisal right is given to the stockholder in compensation for his former right at common law to prevent a merger.”); See Calabresi & Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 [HARV. L. REV.] 1089, 1092 (1972) (“The appraisal remedy replaces an entitlement protected by a property rule, which allows individual parties to bargain so as to maximize price, with an entitlement protected by a liability rule, which allows a purchaser to acquire property at an ‘objectively determined value’ reached by a court.”).

In *Weinberger*,¹⁹⁴ the Court noted that even a price above market can reflect unfair discrimination against the minority stockholders because the controlling shareholders can recoup any per-share loss after the acquisition. As such, the controlling shareholders can structure the transaction so as to shift the costs disproportionately to the minority.¹⁹⁵ In dictum, the Court strongly supported “two basic approaches to valuation: a comparative analysis of the premium paid over market in ten other tender offer-merger combinations, and a discounted cash flow analysis.”¹⁹⁶

Since the adoption of the entire fairness test in *Weinberger*, Delaware courts have used the substantive fairness prong broadly.¹⁹⁷ The Court therefore appears to be more concerned with the presence of substantive fairness than procedural fairness. While the Delaware Court has demonstrated the importance of examining all aspects of the issue as a whole,¹⁹⁸ both procedural prong of fair dealing and substantive prong of fair price will work together in the court’s determination of any issues regarding the entire fairness.

¹⁹⁴ *Weinberger*, 457 A.2d at 712.

¹⁹⁵ *Id.* at 709.

¹⁹⁶ *Id.* at 712.

¹⁹⁷ *Cannon & Tangney*, *supra* note 7, at 739.

¹⁹⁸ *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

CHAPTER 5
DIRECTORIAL FIDUCIARY DUTIES IN THE CONTROLLED
GOING-PRIVATE TENDER OFFER

As mentioned at the beginning, this article addresses the directorial fiduciary duties in a going-private transaction by a controlling shareholder but in a voluntary context rather than in a coercive situation where a hostile acquisition has threatened. Therefore, the directorial duties on how to act to block or defeat an unfriendly bidder are not covered in this article. Instead, this article focuses on the directors' duties to the minority shareholders arising from an inside tender offer under Delaware law.

A. General Principles and Elements in a Tender Offer Context

Under Delaware law, a tender offer made by a controlling shareholder for the minority's shares shall be subject to two conditions: a non-coercive transaction and an adequate disclosure to the minority shareholders.¹⁹⁹

Non-coerciveness requires that the tender offer transaction shall not leave the shareholders any practical choice but to accept an offer's term.²⁰⁰ A tender offer is also regarded as coercive where the tendering shareholders are "wrongfully induced by some act of the defendant to sell

¹⁹⁹ Marc I. Steinberg *Short-form Mergers in Delaware*, 27 [DEL. J. CORP. L.] 489, 492-93 (2002).

²⁰⁰ *In re Siliconix, Inc, Shareholders Litigation*, 2001 Del Ch. LEXIS 83, at 16 (Del. Ch. 2001).

their shares for reasons unrelated to the economic merits of the sale”²⁰¹ if such wrongful acts “influence in some material way” the shareholder’s decision to tender.²⁰²

In *In re Pure Resource*,²⁰³ the non-coerciveness in a tender offer is further developed as “1) the offer is subject to a non-waivable majority of the minority tender condition; 2) the controlling stockholder promises to consummate a prompt section 253 merger²⁰⁴ at the same price if it obtains more than 90% of the shares; and 3) the controlling stockholder has made no retributive threats.”²⁰⁵

The full disclosure requirement demands that all material facts surrounding the tender offer shall be accurately disclosed to the minority shareholders of the target company.²⁰⁶ A fact is deemed material if there is a “substantial likelihood that its disclosure would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”²⁰⁷ Nonetheless, Delaware law does not require disclosure of “all available information” simply because available information “might be helpful.”²⁰⁸ In a tender offer proceeding, the plaintiff has the burden of demonstrating materiality.²⁰⁹ Therefore, in a dispute over whether there has been full disclosure, the issue becomes whether there is a reasonable probability that a material omission or misstatement has been made “that would make a reasonable shareholder more likely to tender his shares.”²¹⁰

²⁰¹ *Ivanhoe Partners v. Newmont Mining Corp.*, 533 A.2d 585, 605 (Del. Ch. 1987), *aff’d.*, 535 A.2d 1334 (Del. Supr. 1987); *Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d at 1051, 1061.

²⁰² *Ivanhoe Partners v. Newmont Mining Corp.*, 533 A.2d at 605-06

²⁰³ *In re Pure Resources, Inc., Shareholders Litigation*, 808 A.2d 421 (Del. Ch. 2002).

²⁰⁴ A section 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 (2003)

²⁰⁵ *In re Pure Resources, Inc., Shareholders Litigation*, 808 A.2d 421, 445 (Del. Ch. 2002).

²⁰⁶ *Malone v. Brincat*, Del. Supr., 722 A. 2d 5, 11 (1998); *Stroud v. Grace*, Del. Supr., 606 A. 2d 75, 84 (1992); *Lynch v. Vickers Energy Corp.*, Del. Supr., 383 A. 2d 278 (1978).

²⁰⁷ *In re Siliconix, Inc, Shareholders Litigation*, 2001 Del Ch LEXIS 83, at 36 (citing *Skeen v. Jo-Ann Stores, Inc.*, Del. Supr. 750 A.2d 135, 143).

²⁰⁸ *Skeen v. Jo-Ann Stores, Inc.*, Del. Supr. 750 A.2d 135, 143.

²⁰⁹ *Loudon v. Archer-Daniels-Midland Co.*, Del. Supr. 700 A.2d 135, 143 (1997).

²¹⁰ *Ocean Drilling*, 1991 Del. Ch. LEXIS 82, at 11 (Del. Ch. 1991).

Unlike mergers, since there are few specified codes²¹¹ to regulate tender offer,²¹² the related case law thus plays a critical role in our analysis on the fiduciary duties imposed on the directors in the context of a going-private tender offer launched by the controlling shareholders.

B. Directorial Fiduciary Duties

a. Recent Related Delaware Cases

The following cases, all decided by the Delaware courts in this century, illustrate the particular fiduciary obligations directors face in the context of a tender offer, which are totally different from those in a going-private merger situation.

(a) The Fiduciary Duties on Disinterested and Independent Directors — *In re Siliconix, Inc., Shareholders Litigation*²¹³

In *Siliconix*, the controlling shareholder initially announced an all-cash tender for 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, and the special committee rejected the controlling shareholder's initial all-cash offer.²¹⁴

In response to the rejection of its initial all-cash tender offer proposal, the controlling shareholder launched a stock-for-stock tender offer to the non-affiliated shareholders without

²¹¹ *In re Siliconix, Inc., Shareholders Litigation*, Del. Ch. LEXIS 83, at 27 (Del. Ch. 2001) (“...the corporation law statutes were basically designed in a period when large scale public tender offers were rarities”).

²¹² DEL. Code Ann. Tit. 8 §251 (2003), Notes (“A tender offer is distinct from a merger, and does not implicate the requirements and protections of this section...Tender offers are fairly common in back-end mergers, but a successful tender offer merely results in the purchase of the stock, not the assets, of a corporation.”); *See also* Texaco Ref. & Mktg., Inc. v. Delaware River Basin Comm’n, 824 F. Supp. 500 (Del. 1993), *aff’d*, 30 F.3d 1488 (3d Cir. 1994).

²¹³ *In re Siliconix, Inc., Shareholders Litigation*, Del. Ch. LEXIS 83 (Del. Ch. 2001).

²¹⁴ *Id.* at 6-12.

first seeking or obtaining the consent of the special committee. It contained a “majority of the minority” provision requiring a majority of those shareholders to tender their shares 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.²¹⁵

The special committee made the decision to remain neutral and made no recommendation with respect to that tender offer. It also did not request its financial advisor to 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.²¹⁶

In the proceeding, the *Siliconix* court’s reasoning began with the principle that a majority shareholder had no obligation to offer a particular, fair price in a tender offer for minority shares, with the caveat that the offer could not be “coercive in some significant way.”²¹⁷ The Court then distinguished the tender offer context from that of a merger transaction, explaining that in a tender offer, a shareholder had the choice of whether or not to accept the offer, and was therefore free to reject the offer and retain stock in the enterprise. In the merger context, the court reasoned that the negotiation was between the company itself and the acquirer with the shareholder given no direct decision-making authority.²¹⁸

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.²¹⁹ The court rejected this argument and contrasted it with the

²¹⁵ *Id.* at 12-16.

²¹⁶ *Id.* at 17-18.

²¹⁷ *Id.* at 22.

²¹⁸ *Id.* at 25-27.

²¹⁹ *Id.* at 28-29.

duties of the board in the context of a merger. The court explained that in *McMullin v. Beran*,²²⁰ 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.²²¹ However, in tender offer context, "a board of directors ...traditionally has been accorded no statutory role whatsoever with respect to a public tender offer for even a controlling number of shares"²²² because tender offers "are viewed as sales of individual private property and not as corporate transactions."²²³

(b) The Fiduciary Duties on Interested or Dependent Directors —*In re Aquila, Inc., Shareholders Litigation*²²⁴

In re Aquila, Inc., Shareholders Litigation involved a tender offer initiated by a parent corporation for its subsidiary's stock that it did not already own. The Delaware Chancery Court denied the shareholders' motion since Delaware law does not impose a duty of entire fairness on a controlling stockholder making a non-coercive tender offer²²⁵ where the minority shareholders are adequately informed. The court also ruled that target company directors even appointed by the controlling shareholder or otherwise failing the independence test did not breach their fiduciary duties simply by not making recommendation with respect to the offer or failing to appoint the independent directors to express an opinion on the fairness.²²⁶

²²⁰ Del. Supr. 765 A.2d 910 (2000).

²²¹ *In re Siliconix, Inc., Shareholders Litigation*, 2001 Del. Ch. LEXIS 83, at 30 (citing *McMullin v. Beran*, 765 A. 2d at 920 and 922).

²²² *In re Siliconix, Inc., Shareholders Litigation*, Del. Ch. LEXIS 83, at 26-27 (Del. Ch. 2001).

²²³ *Id.* at 27.

²²⁴ 805 A. 2d 184 (Del. Ch. 2002).

²²⁵ *Id.* at 188.

²²⁶ *Id.* at 190 - 91.

The *Aquila* Court reasoned that due to a real or potential conflict of interests in connection with the transaction, all directors of the subsidiary determined not to make a recommendation on the offer.²²⁷ Then the court further reasoned that the stockholders “would still have to decide for themselves whether to tender or not”²²⁸ and in addition, here the shareholders’ opportunity to decide whether or not to tender was certainly valuable.²²⁹ Therefore, the independent directors “could do little more than communicate their conclusion to the stockholders in the Schedule 14d-9 and recommend that they not tender.”²³⁰

(c) Development in the Fiduciary Duties Applied in the Tender Offer Context — *In re Pure Resources, Inc., Shareholders Litigation*²³¹

The court in *Pure Resources* determined that the offer initiated by the controlling shareholder should be enjoined primarily because it determined the offer to be “coercive” and because “material information relevant to the stockholders’ decision-making process had not been fairly disclosed.”²³² In *Pure Resources*, the controlling shareholder initiated an offer to acquire the shares in its subsidiary that it did not already own in an exchange offer. The target company 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 independent directors, but the larger board still with members appointed by the controlling shareholder, refused to increase the authority of the special committee beyond its

²²⁷ *Id.* at 190.

²²⁸ *Id.* at 195.

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ 808 A. 2d 421 (Del. Ch. 2002).

²³² *Id.* at 425.

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.²³³

Then, the special committee performed its core functions of hiring outside legal counsel and financial advisors and evaluating the transaction.²³⁴ After the counter-offers made by the special committee were rejected by the controlling shareholder,²³⁵ the special committee made a not-to-tender recommendation to the shareholders.²³⁶ However, the state court thereafter found that the directors failed to include all of the details regarding the financial advice they relied upon in recommending shareholders to reject the offer.²³⁷

In dictum, the Court in *Pure Resources*, through a discussion on Delaware precedent cases including *Siliconix* and *Aquila*, again addressed such issues as the different treatments to a controlling shareholder's fiduciary duties in the negotiated merger and the tender offer context. It 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 was not employed, represented the "incoherence in our law."²³⁸ 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 had the burden of showing the entire fairness of the transaction if the same minority shares were acquired through a negotiated merger transaction.²³⁹

Finally, 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

²³³ *Id.* at 430.

²³⁴ *Id.* at 429.

²³⁵ *Id.* at 432.

²³⁶ *Id.*

²³⁷ *Id.* at 449.

²³⁸ *Id.* at 435.

²³⁹ *Id.* at 438.

shares, but only so long as the offer was not coercive pursuant to the three-pronged test.²⁴⁰ The *Pure Resources* offer failed this test and was thus determined to be defective.²⁴¹ In addition, the court determined that the disclosures made by the special committee were insufficient because they did not provide sufficient detail with respect to valuation advice received from the company's financial advisors.²⁴² However, finally the court imposed no specific requirements for the board, or even the special committee, to recommend for or against a tender offer.

c. Summary for the Directorial Fiduciary Duties in Tender Offers

From the analysis of these cases, we may follow the trail of Delaware courts to delineate the current fiduciary duties that the directors face in the context of a going-private tender offer led by a controlling party.

From *Siliconix*²⁴³ and *Aquila*,²⁴⁴ the court imposed no liability on both directors, the interested and disinterested, either for their neutral status in making no recommendation whether to tender into the offer to the minority shareholders or for their failure to consult with a financial professional. Those cases suggest that the Delaware courts leave great room to the shareholders to decide by themselves in that “individual private property sale.”²⁴⁵ The directors, as the third party to such a sale, seemingly are not obligated to do anything. However, in *Pure Resources*,²⁴⁶ the court not only refined the distinction between mergers and tender offers recognized in *Aquila* and in *Siliconix*, proposing specific guidelines that tender offers initiated by controlling

²⁴⁰ *Id.* at 445.

²⁴¹ *Id.* at 448.

²⁴² *Id.* at 449.

²⁴³ Del. Ch. LEXIS 83 (Del. Ch. 2001).

²⁴⁴ 805 A. 2d 184 (Del. Ch. 2002).

²⁴⁵ Del. Ch. LEXIS 83, at 27 (Del. Ch. 2001).

²⁴⁶ 808 A. 2d 421 (Del. Ch. 2002).

shareholders must meet in order to avoid an entire fairness review²⁴⁷ but also explicitly specified that by no means obvious that simply because a controlling stockholder proceeds by way of a tender offer that the target's directors fell outside the constraints of fiduciary duty law.²⁴⁸ Nonetheless, though the *Pure Resources* court defined that the directors' duties were not satisfied where they simply blindly (or without giving justification) recommended against an acquisition bid,²⁴⁹ it failed to further establish the specific standards of conduct for directors with respect to recommending the fairness of a particular offer to the minority shareholders.²⁵⁰

In the context of the going-private tender offers, the controlling shareholders directly make an offer to the public shareholders of the company to tender their shares. Under those circumstances, if the directors did not need to make any recommendations to the minority shareholders as to how to vote on a tender offer, the directors would almost perform no other significant obligations to the minority shareholders. Thus, the failure to establish a specific standard regarding directors' liability to make a recommendation in the context of the going-private tender offer almost amounts to leaving open the issue of directorial fiduciary duties in a tender offer. Therefore, there seemingly are no clear duties or standards of review imposed on the directors in the context of tender offers as those in a merger situation under the current Delaware law. To some degree, however, it seems that *Pure Resources* predicts the Delaware courts' trend to establish the specific conduct standards for the directors in the tender offer context as it has done in a merger situation. Maybe in the near future, there will emerge a specified fiduciary duty system, especially respecting the tender offer contexts in Delaware.

²⁴⁷ Canon, *supra* note 9.

²⁴⁸ 808 A. 2d 421, 441 (Del. Ch. 2002)

²⁴⁹ *Id.* at 449.

²⁵⁰ *Id.* at 450.

CHAPTER 6
DISTINCTIONS BETWEEN DIRECTORIAL FIDUCIARY DUTIES IN
MERGERS VS. TENDER OFFERS

A. Inconsistency of Directorial Duties between Mergers and Tender Offers

As noted above, the directorial fiduciary duties to the minority shareholders in the context of a controlled going-private transaction are distinguishable from the duties owed by the disinterested or independent directors and those interested or controlled by the dominating shareholders. In a merger context, the disinterested and independent directors only bear a duty of care, and the applied standard of review shall be the business judgment rule.²⁵¹ While for those controlled or interested directors, they shall bear a duty of loyalty to the minority shareholders, and the only way for them to discharge all of their fiduciary obligations is to prove an entire fairness in that transaction.²⁵²

In contrast, in a tender offer case, the current Delaware statutory and case law do not imbue directors with a responsibility to assist shareholders in evaluating the fairness of those unilateral tender offers. Therefore, though the most recent case²⁵³ does not fully deny fiduciary duties on the directors only because of a controlling stockholder proceeds by way of a tender offer, the court still fails to establish specified standards of conduct for directors with respect to recommending the fairness of a particular offer to minority shareholders²⁵⁴ and fails to identify explicitly the standard fiduciary duties the directors face and the related standards of review

²⁵¹ *Supra* text of Part III C 1.

²⁵² *Supra* text of Part III C 2.

²⁵³ *In re Pure Resources, Inc., Shareholders Litigation*, 808 A. 2d 421 (Del. Ch. 2002).

²⁵⁴ *Id.* at 450.

applied in such a context. Therefore, compared the different fiduciary duties borne by the directors in the context of mergers versus tender offer, it is undisputable that the courts focus their attention more on that directorial fiduciary duty issue in the context of mergers than that in the tender offers.

The reasons for such a great distinction, as noted above, are multiple. On a statutory level, the corporation law statutes were basically designed in a period when large scale public tender offers were rarities.²⁵⁵ On a more conceptual level, tender offers essentially represent the sale of shareholders' separate property, and such sales—even when aggregated into a single change in control transaction—require no “corporate” action and do not involve distinctively “corporate” interests.²⁵⁶ In addition, the tender offer is rarely regarded as an important or special circumstance where the directors shall bear the fiduciary duties directly to the shareholders.²⁵⁷ Therefore, on the traditional aspect of the case law, the Court regards that the free choice of the minority shareholders to reject the tender offer provides sufficient protection²⁵⁸ already, and the directors can do little more than communicate their recommendation to the stockholders,²⁵⁹ which still leaves the shareholders themselves to make a final decision whether to tender or not.

Nonetheless, how to protect the minority shareholder interests in an unfairly priced unilateral tender offer, with the board's inaction on one hand but the controlling acquirer's domination and informational advantages on the other hand, shall raise more concerns and attentions from the public.

²⁵⁵ *In re Siliconix, Inc. Shareholders Litigation*, Del. Ch. LEXIS 83, at 27 (Del. Ch. 2001).

²⁵⁶ *TW Services, Inc. v. SWT Acquisition Corp.*, 1989 Del. Ch. LEXIS 19, at *34 (Del. Ch. 1989) (footnotes omitted).

²⁵⁷ *Supra* text of Part I B 2.

²⁵⁸ *In re Siliconix, Inc. Shareholders Litigation*, Del. Ch. LEXIS 83, at 23 (Del. Ch. 2001).

²⁵⁹ *In re Aquila, Inc., Shareholders Litigation*, 805 A. 2d 184, 195 (Del. Ch. 2002).

B. The Proposal and the Related Reasons

a. The Proposal

Through a comparison between directorial fiduciary duties in the controlled going-private transactions structured as mergers versus tender offers, we may find a feeble and vague fiduciary duty system applied in the tender offer context under current Delaware laws. In order to better protect the minority shareholders' interests in the context of controlling party initiated tender offers, this article proposes Delaware courts to establish an affirmative obligation to the directors to assist shareholders in evaluating the fairness of those tender offers as soon as possible and to apply the same levels of fiduciary duties and standards of review on the directors as those applied in the merger context.

b. The Related Grounds for that Proposal

In effect, the minority shareholders require more protection in the context of tender offers than in the mergers, but the directors have been accorded no statutory role under such a circumstance. Therefore, in order to well protect the minority shareholders' interests, the aforesaid proposal, based on the following grounds, is both necessary and rational.

(a) The Controlling Shareholders' Preference to the Tender Offers

Most tender offer transactions may practically seek the same ultimate result to eliminate the minority shareholders as a negotiated merger transaction through a short-form merger,²⁶⁰ if the

²⁶⁰ Del. Code Ann. tit. 8 § 253 (2003) (“(a) In any case in which at least 90% of the outstanding shares of each class of the stock of a corporation . . . is owned by another corporation . . ., the corporation having such stock ownership may . . . merge the other corporation . . . into itself . . . by executing, acknowledging and filing, in accordance with § 103 of this title, a certificate of such ownership and merger setting forth a copy of the resolution of its board of

controlling shareholder may own at least ninety percent of the target company stock following the close of the tender offer.

However, applying such a short-form merger through a means of the tender offer, the controlling shareholders, upon satisfying the requirement of full disclosure and non-coerciveness, generally need not be subject to an entire fairness review,²⁶¹ which shall be applied in the identical transaction but structured by mergers even with the operation of the special committee of the fully disinterested and independent directors. Besides, under Delaware laws, absent fraud or illegality, appraisal is the exclusive remedy available to a minority shareholder who objects to a short-form merger,²⁶² but in mergers, minority shareholders are also entitled to other remedies.²⁶³

Although a tender for all shares likely followed by a short-form merger may be viewed in substance as one overall merger effort, the Delaware courts still have declined that invitation on two reasons—first, because Delaware law has recognized the tender followed by the short-form merger as separate events, and second, because there is no guarantee of any acquirer to complete the backend merger.²⁶⁴ The courts' general attitudes as well as the statutorily defined simplified

directors to so merge and the date of the adoption; provided, however, that in case the parent corporation shall not own all the outstanding stock of . . . the subsidiary corporation . . . the resolution . . . shall state the terms and conditions of the merger, including the securities, cash, property, or rights to be issued, paid, delivered or granted by the surviving corporation upon surrender of each share of the subsidiary corporation. . . (d) In the event that all of the stock of a subsidiary Delaware corporation . . . is not owned by the parent corporation immediately prior to the merger, the stockholders of the subsidiary Delaware corporation party to the merger shall have appraisal rights as set forth in § 262 of this title”).

²⁶¹ *In re Siliconix, Inc, Shareholders Litigation*, Del. Ch. LEXIS 83, at 22 (Del. Ch. 2001) (“as a general principle, our law holds that a controlling shareholder extending an offer for minority-held shares in the controlled corporation is under no obligation, absent evidence that material information about the offer has been withheld or misrepresented or that the offer is coercive in some significant way, to offer any particular price for the minority-held stock.”); *See also In re Ocean Drilling & Exploration Co. Shareholders Litig.* (“*Ocean Drilling*”), 1991 Del. Ch. LEXIS 82, *9-10 (Del. Ch. 1991); *See also Solomon v. Pathe Communications Corp.*, 672 A.2d 35, 40 (Del. Supr. 1996).

²⁶² *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001).

²⁶³ *See, e.g., Andra v. Blount*, 772 A. 2d 183 (Del. Ch. 2000); *Loeb v. Schenley Indus., Inc.*, 285 A. 2d 829 (Del. Ch. 1971).

²⁶⁴ *In re Siliconix, Inc, Shareholders Litigation*, Del. Ch. LEXIS 83, at 33 (Del. Ch. 2001).

procedures²⁶⁵ to the tender offers and short-form mergers may encourage those reasonable controlling shareholders to increase the use of such two-step mergers.²⁶⁶

(b) Needs for More Protection to Minority Shareholders in Tender Offers

Traditionally, in the context of tender offer, shareholders of Delaware corporations are free to accept or reject the tender based on their own evaluation of their best interests,²⁶⁷ but most shareholders do not have the resources available to make a reasonable determination of the value of such an opportunity since they will not have their own investment bank.²⁶⁸ Without the assistance from directors to retain the financial consultant, it is hard for the general individual shareholder to decide whether the offer is fairly priced.

Besides the evaluation disadvantage, the shareholders also face other problems. In *Pure Resources*,²⁶⁹ the court discussed that given the nature of transactions structured as tender offers, these forms of acquisitions were “arguably less protective than a merger” of shareholder interests,²⁷⁰ particularly considering that a shareholder that failed to sell into a tender offer faced an uncertain future.²⁷¹ Except for such an uncertain future, the minority shareholders in the

²⁶⁵ *In re Unocal Exploration Corp. S'holders Litig.*, 793 A.2d 329, 338 & n.26 (Del. Ch. 2000) (stating that when controlling stockholder consummates a short-form merger under 8 Del. C. § 253 that is not preceded by any prior transaction subject to entire fairness review, plaintiff is relegated to the appraisal remedy in the absence of “fraud, gross overreaching, or other such wrongful conduct” or misdisclosures; otherwise, the statute’s authorization of a simplified procedure for effecting such mergers would be undermined by the imposition of an equitable requirement of fair process).

²⁶⁶ Steinberg, *supra* note 199.

²⁶⁷ *In re Life Technologies, Inc. Shareholders Litig.* (“*Life Technologies*”), Del. Ch. C.A. No. 16513, Lamb, V.C. (Nov. 24, 1998) (Bench ruling transcript at 4.); *In re Marriott Hotel Properties II Limited Partnership Unitholders Litig.*, 2000 Del. Ch. LEXIS 17, at *63-64 (Del. Ch. 2000).

²⁶⁸ In the case of *Aquila* (805 A.2d 184 (Del. Ch. 2002)), however, eighty percent of the publicly owned shares were owned by ninety-four institutional investors. However, the plaintiffs were individual shareholders, with none of the institutional investors joining the suit.

²⁶⁹ 808 A. 2d 421(Del. Ch. 2002).

²⁷⁰ *Id.* at 435.

²⁷¹ *Id.* at 441-443 (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).

context of a controlling shareholder launched tender offer even face more disadvantages than those in a hostile tender offer initiated by the third party.²⁷² Since in the latter, the unfriendly third party likely will be faced with defensive measures implemented by the incumbent board, whereas in the former case, the tender offer will be treated as a matter between that controlling shareholder and the minority shareholders and thus will be unburdened even by the requirement that the offer be fairly priced.²⁷³ It shall be further noted that the more controlling and informational advantages enjoyed by that controlling shareholders in the tender offers alone are adequately significant to the detriment to those minority shareholders.²⁷⁴

(c) Impacts of the Federal Statute on the Minority Shareholders' Protection

Though this article discusses only the fiduciary duties arising from the going-private transactions under Delaware law, the negative impact of some federal statutes on the individual shareholders may also arouse an urgency to provide more protection to those minority shareholders from the state-level. With the enactment of the Private Securities Litigation Reform Act of 1995,²⁷⁵ which seeks to combat perceived abuses in securities class action litigation,²⁷⁶ it is more difficult for individual shareholders to file a suit to protect their own interests under the federal laws. Therefore, the need to give more protection from the state laws to the shareholders is more significant than before. Fiduciary duties, a traditional area of state laws shall perform its functions well to reduce the possibility that directors or majority shareholders will favor personal benefits over the corporation's or the minority shareholders' interests.

²⁷² *Id.* at 443-444.

²⁷³ *Id.*

²⁷⁴ Canon, *supra* note 9 at 194.

²⁷⁵ SENATE; Report 104-98; 104th Congress 1st Session; S. 240.

²⁷⁶ B. Scott Daugherty, *Uncharted Waters: Securities Class Actions in Texas after the Securities Litigation Uniform Standard Act of 1998*, 31 [ST. MARY'S L. J.] 143, 147 (1999).

In the context of a controlling shareholder launched tender offer, under current Delaware law, the minority shareholders can not either have an entirely fair transaction as assured in a merger or legally require the directors to make a recommendation of a fairness which is well conducted in mergers and in a coercive tender offer initiated by a third party. Further, with an increased difficulty to file a private litigation under federal laws, the minority shareholders in a controlled going-private tender offer need more protection from the directors, from the state courts and from the state statutes.

c. How to Realize that Proposal

In order to couple those unilateral tender offers with the requirement that the directors must have an affirmative obligation to assist shareholders in evaluating the fairness of those offers, the Delaware courts must first 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 may further require the directors under such circumstances to form an independent committee to evaluate the offer in much the same way they do in a merger context. That special committee should be not only empowered with the 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 but also authorized to take an affirmative position either for or against the tender offer, issue its opinion on behalf of the full board of directors and provide shareholders with a full record of their deliberations and the advice relied upon by the board.²⁷⁷ Those rights to empower the directors to “say no”²⁷⁸ to those offers that are unfair will call for more attention and further consideration of general

²⁷⁷ *In re Pure Resources, Inc., Shareholders Litigation*, 808 A. 2d 421 (Del. Ch. 2002).

²⁷⁸ *In re First Boston, Inc. Shareholders Litigation*, Fed. Sec. L. Rep. (CCH) P95, Del. Ch. 1990 Lexis 74, at *20 (Del. Ch. 1990).

shareholders to decide whether to tender their shares. It may also announce to those non-tendering individual shareholders that they are not alone since the board is behind them. Even for those non-tendering shareholders as part of a less-than-ten-percent minority, such “to-say-no” power will help eliminate their worries of receiving a diminished value in a short-term transaction, since the financial record the board relied on will help them to smooth their pursuit for the appraisal rights. Besides, to require the board to offer shareholders with a full record of their deliberations and the advice may better satisfied with the “full disclosure”²⁷⁹ requirement as well as leave the raw financial data to the investors and thus subjected it to a public debate.

The fiduciary duties imposed on the directors in the evaluation of the fairness of the offer in the context of a controlling-party-led tender offer shall be according to the same standards to which the directors would be subjected in the merger context since that fiduciary duty system is well developed from Delaware’s precedent in the merger contexts. In addition, to follow the same fiduciary duty system may also well solve the “inconsistency”²⁸⁰ of law in the context of the tender offers versus mergers. Therefore, in the tender offer contexts, those interested and dependent shareholders shall also bear the duty of loyalty, which will be subject to entire fairness review, and those disinterested and independent shareholders shall take the duties of care and be protected by the business judgment rule.

²⁷⁹ *Malone v. Brincat*, 722 A.2d 5, 11 (Del. Supr.1998); *Stroud v. Grace*, 606 A.2d 75, 84 (Del. Supr.1992); *Lynch v. Vickers Energy Corp.*, 383 A.2d 278 (Del. Supr. 1978).

²⁸⁰ *In re Pure Resources, Inc., Shareholders Litigation*, 808 A.2d 421, 438 (Del. Ch. 2002).

CHAPTER 7

CONCLUSION

The Delaware court's decision in *Pure Resources*²⁸¹ that the controlling-party tender offers must meet that three-prong test²⁸² of non-coerciveness or else face an entire fairness review signifies the trend in the law toward providing shareholders with increased protection. It may be predicted that in the near future, it will be possible for Delaware courts to establish some specified standards with respect to the directors' obligation in evaluation of fairness in a tender offer led by the controlling shareholder to those minority shareholders.

The directorial fiduciary duty system with respect to the protection towards shareholders in the context of the going-private transactions under current Delaware law structure, though with some defects, still confers a bulk of good ideas to the Chinese corporate law field in how to establish and develop its own fiduciary duty system in the future.

Though in China, at present the fiduciary duties are not well enumerated, with the increase in the employment of the going-private transactions structured either by mergers or by tender offers, the stronger needs to protect the interests of those minority shareholders will push our own fiduciary duty system to emerge, to develop, and to work well as soon as possible.

²⁸¹ 808 A. 2d 421 (Del. Ch. 2002).

²⁸² *Id.* at 445.

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