NOTE

INTERESTED DIRECTOR TRANSACTIONS AND THE (EQUIVOCAL) EFFECTS OF SHAREHOLDER RATIFICATION

"The question is," said Alice, "whether you *can* make words mean so many different things."[1]

I. INTRODUCTION

The legal consequences of shareholder ratification are in a state of "unhealthy uncertainty."[2] Absent a shareholder vote ratifying a questionable action, Delaware corporation law dictates entire fairness in director and controlling shareholder self-interested transactions.[3] Directors may, however, submit a proposal to shareholders asking them to ratify an action that involves an interested transaction.[4] When a

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[1]LEWIS CARROLL, THE ANNOTATED ALICE: ALICE'S ADVENTURES IN WONDERLAND AND THROUGH THE LOOKING GLASS 269 (1960).

[2]*See* 2 MODEL BUSINESS CORP. ACT ANN. ch. 8, subch. F, at 8-387 (3d ed. 1995) (introductory comment to purposes and special characteristics of subchapter F). The reporters of the Model Business Corporation Act account for the diverse conglomeration of case law and absence of consistent authority because of differing judicial attitudes and varying levels of comprehension concerning the subject matter. *See also* Norwood P. Beveridge, Jr., *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 DEPAUL L. REV. 655, 658 (1992) ("The rules in the area of interested director contracts are poorly understood and are in need of clarification.").

[3]*See* 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.9, at 4-209 (2d ed. 1990 & Supp. 1995); DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 131 (4th ed. 1993); 1 ERNEST L. FOLK, III ET AL., DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS § 144.5.3, at § 144:16 (3d ed. 1995).

[4]Through common usage, the term "ratification" has been adopted to describe all situations where shareholders vote to approve corporate action, regardless of whether the vote is required for the action to meet legal standards. *In re* Wheelabrator Technologies, Inc. Shareholders Litig., 663 A.2d 1194, 1201-02 n.4 (Del. Ch. 1995) (*Wheelabrator III*). But, in the pure sense, the term "ratification" refers to stockholder approval of board action where such approval is not legally required to effectuate the action. *See* Williams v. Geier, 671 A.2d 1368, 1379 n.24 (Del. 1996) (en banc). There are many situations in which a director may call upon the shareholders to ratify an action. Cases involving these situations are the focus of this note. Generally, although not legally required since the transaction could be consummated without shareholder approval, ratification serves as indicia of fairness or an added layer of legitimacy to the transaction. *See* Marciano v. Nakash, 535 A.2d 400, 404 (Del. 1987) (loans between corporation and shareholder directors); Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979)

majority of disinterested shareholders vote to ratify the transaction, the question becomes whether such approval insulates the transaction from a challenge based on the self-interest or otherwise affects the standard of review a court will apply to the transaction.[5] Arguably, ratification should add to the certainty of business transactions and protect directors from claims alleging a breach of the fiduciary duty of loyalty. Unfortunately, the legal effect of ratification is a confusing and unresolved issue in Delaware corporate law.[6]

(shareholder ratification of a stock option plan). For an explanation of shareholder ratification, see *Wheelabrator III*, 663 A.2d at 1201-02 n.4.

Distinguishable from ratification are those situations where shareholders are called upon to vote where a shareholder vote is statutorily required to effectuate the corporate action. *See* DEL. CODE ANN. tit. 8, §§ 211 (1991) (election of directors), 242 (amendments to the articles of incorporation), 251-258, 263 (mergers and consolidations), 271 (sales of all or substantially all of the assets of the corporation), & 275 (dissolution). Shareholder approval in these instances is not technically ratification since it is statutorily required. The Delaware Supreme Court has recently opined that a vote pursuant to an organic, statutory act should be termed according to its statutory usage - either "vote in favor" or "stockholder approval." *Williams*, 671 A.2d at 1379. This note does not discuss votes that are statutorily required to effectuate an organic change. For a discussion of stockholder approval in these situations, see *id.* at 1377-84.

[5]*Cf.* Melvin A. Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 1002 (Summer 1988) (questioning the effect of approval by disinterested directors).

[6]The Delaware Supreme Court most recently visited the ratification issue in early 1996. In *Williams v. Geier*, the court, sitting en banc, addressed the effect of a statutorily required shareholder vote. The court, noting that ratification was not implicated, stated, "We put to one side those cases, not relevant here, where stockholders are called upon to ratify action which may involve a transaction with an interested director or where the transaction approved by the board may otherwise be voidable." *Williams*, 671 A.2d at 1379. In a footnote, the court briefly summarized Delaware's current ratification doctrine as follows:

> Transactions which are voidable, as distinct from those which are void, may in some circumstances, be ratified. The key to upholding an interested transaction is the approval of some neutral decision-making body. Under 8 Del. C. § 144, a transaction will be sheltered from shareholder challenge if approved by either a committee of independent directors, the shareholders, or the courts. *We express no opinion on the question whether a "duty of loyalty claim" may or may not be ratified.* Delaware law relating to the approval of interested director transactions and ratification principles may differ in certain respects from that advanced in 1 American Law Inst., Principles of Corporate Governance pt. 5, § 5.01 et seq., at 199-382 (1994).

Williams, 671 A.2d at 1379 n.23 (citations omitted) (emphasis added). The court noted that it was not addressing ratification and also declined to comment on a recent ratification decision by the court of chancery. *Id.* (citing *In re* Wheelabrator Technologies, Inc. Shareholders Litig., 663 A.2d 1194 (Del. Ch. 1995)). Perhaps even more instructive on the unsettled state of the law are the diametrical views of the majority and the dissent regarding the effect of shareholder approval. *See id.* at 1379, 1385-86.

This confusion is not a recent phenomenon, but is the product of decades of judicial efforts to develop a common law ratification doctrine.[7] Although a unified approach never materialized, treatment of interested director transactions was ostensibly crystallized in the ratification criteria of the Delaware General Corporation Law section 144.[8] However, the patchwork judicial interpretation of the interested director statute indicates that section 144 has not been dispositive regarding the effects of ratification.[9] Speaking only to the voidability of the transaction, section 144 fails to address the consequences of ratification.[10] Despite the absence of a consistent and predicatible ratification doctrine, the certain starting point of analysis is the oft-quoted phrase, "the entire atmosphere is freshened and a new set of rules is invoked where a formal approval has been given by a majority of independent, fully informed stockholders."[11] While this phrase provides guidance, the paramount question remains - what are these new rules?

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[7]*See* Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994) (holding that entire fairness is the exclusive standard of review when examining the propriety of an interested merger by a controlling or dominating party); Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) (noting that ratification permits invocation of the business judgment rule); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985) (holding that minority stockholder ratification shifts the burden of proving unfairness of a parent-subsidiary merger to the plaintiffs); Michelson v. Duncan, 407 A.2d 211, 219 (Del. 1979) (opining that approval of voidable acts extinguishes any claim or lawsuit based on prior lack of authority); Gottlieb v. Heyden Chem. Corp., 91 A.2d 57, 58 (Del. 1952) (noting that where there has been ratification, the court will look into the transaction only far enough to see whether the terms are so unequal as to amount to waste); *In re* Wheelabrator Technologies, Inc. Shareholders Litig., 663 A.2d 1194, 1201-02 n.4 (Del. Ch. 1995) (summarizing and clarifying existing ratification precedent); Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490, 500 (Del. Ch. 1990) (stating that in a parent-subsidiary merger, ratification shifts the burden of entire fairness to the shareholders); Saxe v. Brady, 184 A.2d 602, 609 (Del. Ch. 1962) (finding that burden is on stockholders to convince the court that the challenged transaction amounts to waste of corporate assets); Lewis v. Hat Corp. of Am., 150 A.2d 750, 753 (Del. Ch. 1959) (holding that stockholder ratification of corporate action, which is not per se void, renders such action immune from minority stockholder attack); Gerlach v. Gillam, 139 A.2d 591, 593 (Del. Ch. 1958) (stating that "where a majority of fully informed stockholders ratify action of even interested directors, an attack on the ratified transaction normally must fail"); Kaufman v. Shoenberg, 91 A.2d 786, 791 (Del. Ch. 1952) (stating that absent shareholder approval, transaction is only valid if the corporation has received legal consideration); Kerbs v. California E. Airways, Inc., 90 A.2d 652, 656 (Del. Ch. 1952) (holding that a waste standard applies).

[8]DEL. CODE. ANN. tit. 8, § 144 (1991). For a discussion of the statutory safe harbor provision, see *infra* notes 30-42 and accompanying text.

[9]*See generally* Beveridge, *supra* note 2, at 670-73 (discussing burdens of proof when an interested transaction has been approved).

[10]*See infra* Part II.B.

[11]Smith v. Van Gorkom, 488 A.2d 858, 890 (Del. 1985); Fliegler v. Lawrence, 361 A.2d 218, 221 (Del. 1976); *Gottlieb*, 91 A.2d at 59.

Under the fiduciary paradigm, plausible arguments can be made for a number of approaches. Courts have found that the result of ratification can be to completely foreclose judicial scrutiny of the transaction, to shift the burden of proof within the entire fairness test, or to invoke a less exacting standard of review such as the business judgment rule limiting review to questions of waste.[12]

Recognizing the ambiguous nature of the law, Delaware courts have recently addressed the effect of shareholder ratification.[13] Despite efforts to develop a consistent doctrine, Delaware's ratification landscape remains convoluted. Much like an Alice-in-Wonderland world where words take on many meanings or have no meaning at all, the courts are concluding that shareholder ratification has not one meaning, but many.[14] Depending on the nature of the challenged transaction, ratification may mean claim extinguishment, burden shifting, business judgment rule protection, or nothing at all.[15]

This note discusses the effects of ratification and provides a critical analysis of Delaware's current ratification doctrine. Interested director transactions and Delaware's conflict-of-interest statute is the focus of Part II. Part III addresses the shareholder vote and the proper mechanisms for effectuating a valid vote. Part IV discusses the consequences of ratification, including the competing standards of review and the approaches courts have been employing. Recent Delaware cases and the current efforts to organize the ratification landscape are discussed in Part V. Part VI provides an overview of other ratification models. Part VII evaluates Delaware's ratification rubric and recommends an alternative to the current fragmented state of the law. Finally, Part VIII concludes the discussion of the treatment of shareholder ratification of directors' interested transactions under Delaware corporation law.

II. THE DUTY OF LOYALTY AND INTERESTED DIRECTOR TRANSACTIONS

It is a long-established principle in Delaware corporation law that directors of a corporation owe the corporation and its shareholders an

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[12]*See* Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 456-57 (1993).

[13]*See In re* Santa Fe Pac. Corp. Shareholder Litig., 669 A.2d 59 (Del. 1995); Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110 (Del. 1994); *In re* Wheelabrator Technologies, Inc. Shareholders Litig., 663 A.2d 1194 (Del. Ch. 1995).

[14]*See e.g.*, CARROLL, *supra* note 1.

[15]*See infra* part V for the discussion of Delaware's treatment of shareholder ratification.

"uncompromising" duty of loyalty.[16] Chief Justice Layton described this duty in *Guth v. Loft, Inc.*, in what remains the classic articulation:

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. . . . A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.[17]

The duty mandates that directors refrain from self-dealing and place the interests of the corporation and its shareholders over any personal interest the directors may possess that is not equally shared by the stockholders.[18] Essentially, "directors should not use their corporate position to make a

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[16]Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939). *See also* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995) (*Cede III*) (adopting a two-part materiality test to determine when evidence of a given director's self interest is sufficient to overcome the presumption of director loyalty); Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 43 (Del. 1993) (stating that the directors' fundamental duty of loyalty extends equally to board conduct in the sale of corporate control); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (finding that directors who hold dual or multiple directorships, as in a parent-subsidiary context, owe the same duty to both corporations and must exercise this duty in light of what is best for both companies); Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964) (using corporate funds to repurchase stock to perpetuate control of the corporation could amount to self-dealing).

[17]*Guth*, 5 A.2d at 510.

[18]Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) (*Cede II*), *modified on reh'g in part and reh'g denied in part*, 636 A.2d 956 (Del. 1994), *and dismissed on remand, sub nom.* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984). *See also* 1 BALOTTI & FINKELSTEIN, *supra* note 3, § 4.9 (discussing general principles of loyalty and self-dealing); BLOCK ET AL., *supra* note 3, at 124-38 (discussing the duty of loyalty). The duty also extends to officers of a corporation and to controlling shareholders. *E.g.*, *Cede II*, 634 A.2d at 361.

personal profit or gain or for other personal advantage."[19] Notwithstanding this fundamental precept, interested director transactions are prevalent in today's corporate environment.[20]

A. *Interested Director Transactions*

The classic examples of director self-interest arise when a director appears on both sides of a transaction or the director receives a personal financial benefit in the transaction that is not equally shared by the shareholders.[21] These conflicts-of-interest typically arise in three situations. First, when two corporations have interlocking directorates,

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[19]ABA Corporate Laws Committee, *Corporate Director's Guidebook*, 49 BUS. LAW. 1247, 1254-55 (1994).

[20]Beveridge, *supra* note 2, at 657. In his article, Professor Beveridge provides a chart of the Fortune 25 largest U.S. Industrials. The chart shows that 11 of the corporations allow directors to transact business with the corporation. Eleven of the corporations have also implemented golden parachute plans and/or poison pill provisions. *Id.* at 657-58 n.13. *See also* Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 858-59 nn.1-4 (1993) (discussing application of and reactions to poison pill plans). Professor Grundfest indicates that as of December 1990, 52% of the Business Week 1000 companies, 56% of the Fortune 500 companies, and 68% of the Fortune 200 companies had adopted poison pill plans. *Id.* at 858 n.2. Golden parachute plans are termination agreements providing financial benefits for managers and directors upon a change in corporate control. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 178 n.5 (Del. 1986). Poison pill provisions have many manifestations but are generally plans where shareholders are given the right to have their equity interest bought out by the company at a large premium on the occurrence of an event, e.g., more than 15% of the outstanding stock is accumulated by a single investor. *Id.* at 180. While director transactions, golden parachute plans and poison pill provisions do not always indicate conflict-of-interest problems, they do provide fertile opportunity for duty of loyalty claims by shareholders. *See, e.g.*, Marciano v. Nakash, 535 A.2d 400 (Del. 1987) (discussing a corporation's half owner's claim that other half of owner's loans to corporation constituted self-dealing); *In re Santa Fe Pac. Corp.*, No. 13,587 (Cons.), [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,845, at 93,083 (Del. Ch. May 31, 1995), *reprinted in* 20 DEL. J. CORP. L. 1104 (1995) (noting that shareholders claimed that directors breached their duty of loyalty by adopting and undertaking a joint tender offer, repurchase program, poison pill, and termination fee), *aff'd in part and rev'd in part, remanded*, 669 A.2d 59 (Del. 1995); Kramer v. Western Pac. Indus., Inc., No. 8675 (Del. Ch. Nov. 7, 1986), *reprinted in* 12 DEL. J. CORP. L. 1087 (1987) (recognizing a claim that directors breached their fiduciary duties in granting golden parachute plans has validity).

[21]*Cede II*, 634 A.2d at 362; *see also* Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993) (stating that "[a] director is considered interested where he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders"); Gilbert v. El Paso Co., 575 A.2d 1131, 1146 (Del. 1990) (discussing the plaintiff's self dealing claim); *Pogostin*, 480 A.2d at 623 (stating that "[d]irectorial interest exists whenever divided loyalties are present"); *Weinberger*, 457 A.2d at 710 (requiring a director who stands on both sides of a transaction to prove good faith and inherent fairness).

the director serving on both boards may confront a conflict when the corporations have some interrelated activity.[22] The second type can be categorized as self-dealing and occurs when a director is involved in a transaction with his corporation and is able to negotiate a favorable transaction due to his inside position with the company.[23] The third situation occurs when a director receives a personal benefit from supporting a transaction and that benefit is not received equally by the shareholders.[24] Clearly, a profusion of situations exist where a director may engage in an interested transaction in which he is confronted with duty of loyalty issues.[25]

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[22]*See generally* Andrew G.T. Moore, *The "Interested" Director or Officer Transaction*, 4 DEL. J. CORP. L. 674 (1979) (discussing the treatment of interested director transactions in Delaware corporate law jurisprudence).

[23]*See generally* Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425, 481 (1993) (discussing various types of director conflicts). Professor Mitchell describes these types of conflicts as transactions that a corporation would normally have with a third party. It is only the fiduciary's position with the company that allows him the opportunity to transact with the corporation in a favorable position rather than what should be arm's-length negotiation. *Id.*

[24]*Cede II*, 634 A.2d at 362. The *Cede* case provides an example of director self interest devoid of self dealing. MacAndrews & Forbes Group, Inc. (MAF) was seeking to acquire Technicolor, Inc. by a tender offer and second step cash-out merger. *Id.* at 349. MAF did not control Technicolor, nor did the two companies share directors. The self interest arose from the merger itself. The self interest involved, *inter alia*, the payment of a finder's fee to a Technicolor director if the deal closed. The director also engaged in stock transactions based on non-public information related to the forthcoming merger in which he stood to profit financially if the deal was finalized. *Id.* at 358 n.24.

[25]Examples of situations where a director may engage in an interested transaction that implicates duty of loyalty concerns include:

> sales and purchases of property of all sorts, contracts between the corporation and an officer or director, compensation of officers and directors, loans or an issue of stock or stock options to such persons, and corporate mergers where a director stands on both sides of the transaction. Director interest may also exist where determinations with respect to indemnification are made (unless displaced by the specific provisions of section 145), and where determinations are made with respect to maintaining suits by the corporation against persons allegedly injuring it.

1 FOLK ET AL., *supra* note 3, § 144.3 (citations omitted); *see also* David S. Ruder, *Duty of Loyalty — A Law Professor's Status Report*, 40 BUS. LAW. 1383 (1985) (analyzing the duty of loyalty). Professor Ruder recognizes that the following substantive areas may also implicate duty of loyalty concerns:

> dealings by a corporate parent with its subsidiaries, majority shareholder injury to minority shareholders in corporate acquisition and reorganization transactions, excessive compensation, use of corporate funds to perpetuate control, sale of control at a premium, insider trading, corporate opportunities, competition by corporate officers and directors with their corporation, and fiduciary obligations in bankruptcy.

Any director who partakes in a self-interested transaction, or who stands on both sides of a transaction and does not base his or her decision entirely on the corporate merits of the transaction, or who receives a substantial benefit from supporting the transaction that is not equally shared by the stockholders will be considered an interested director.[26] The board then violates its duty of loyalty when it votes to approve an interested transaction and one or more interested directors participates in the vote, or the independence of the uninterested directors is materially affected by the self-interest of those who are interested.[27] Therefore, directors should be wary of participating in self-interested transactions since individuals "have lost their fortunes and lost their companies because of a failure to perceive the type of duty and the high standards that Delaware inexorably requires of those who stand in the fiduciary relationship of a director to a Delaware company."[28] Conversely, interested transactions may not be inherently detrimental to a corporation or its shareholders; therefore, statutory procedures exist in Delaware corporation law to allow for some interested director transactions.[29]

Id. at 1386-87.

[26]*Cede II*, 634 A.2d at 362. In the trilogy of *Cede* cases, the Supreme Court of Delaware and the chancery court refined the standard of proof required to demonstrate when self-interest that does not involve self-dealing constitutes a breach of the duty of loyalty. Refining the parameters of self-interest and independence, the supreme court explained that an interested director is one who receives a "substantial benefit from . . . [a] transaction." *Id.* An independent director is one who bases his or her decision solely "on the corporate merits of the transaction and is not influenced by personal or extraneous considerations." *Id.* To allege a breach of the duty of loyalty, the plaintiff first must show "the materiality of a director's self-interest to the *given* director's independence." *Cede III*, 663 A.2d at 1167 (summarizing *Cede II*, 634 A.2d at 363). Once this "actual person" test is satisfied, the plaintiff must next show that the self-interested director[s] tainted the independence of the board in a way that "deprived the stockholders of a 'neutral decision-making body.'" *Id.* at 1167, 1170 (quoting Oberly v. Kirby, 592 A.2d 445, 467 (Del. 1991)).

[27]1 BALOTTI & FINKELSTEIN, *supra* note 3, § 4.9. The board engages in "improper directorial conduct" when it approves a transaction that benefits "one or more directors who participate in the board's approval. *Id.* at 4-205. The board violates its duty of loyalty when its independence is materially affected by actual and material self-interest of one or more of the individual directors. *Cede II*, 634 A.2d at 363. Normally, there is a presumption that the directors and the board acted with disinterestedness and independence. *Cede II*, 634 A.2d at 362. Where actual self-interest exists and it affects the majority of the board, the presumption that the board acted loyally is rebutted. *See, e.g.*, Paramount Communications, Inc. v. QVC Network Inc., 637 A.2d 34, 42 n.9 (Del. 1994).

[28]Moore, *supra* note 22, at 679 (citing Guth v. Loft, Inc., 5 A.2d 503 (Del 1939)).

[29]*Oberly*, 592 A.2d at 467 (discussing DEL. CODE ANN. tit. 8, § 144 (1991), and the general principal of ratification or approval of interested transactions by a neutral decision-making body).

B. *Delaware's Safe Harbor Statute - Section 144*

Early common law was intolerant of a director's self-interest.[30] However, by the 1930s states were recognizing that self-interested transactions were not inherently detrimental to the corporation and began enacting corporate conflict-of-interest statutes.[31] The Delaware General Assembly enacted a conflict-of-interest statute in 1967 that has not been amended since 1969.[32] Section 144 provides "a limited safe harbor for corporate boards to prevent director conflicts of interest from voiding corporate action."[33] The limited safe harbor provides that corporate actions shall not be invalidated on grounds of director self-interest if the conflict is: (1) disclosed to and approved by a majority of disinterested members of the board or a committee of disinterested directors; (2) disclosed to and approved by a majority of the shareholders; or (3) reviewed by a court and the court determines that the transaction is "fair as to the corporation at the time it is authorized, approved or ratified, by the board of directors."[34] Ultimately, approval by some neutral decision-

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[30]Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36 (1966) (stating that interested director transactions were voidable at common law regardless of their fairness or approval by a disinterested body). *Cf.* Beveridge, *supra* note 2, at 659 (discussing the origin of self-interested transactions). Professor Beveridge argues that historically, interested director transactions were not automatically voidable. *Id.* at 659-60. He relies on treatises from the late nineteenth century that state, "'There is no necessary impropriety in a contract between a director and the corporation, if the latter is represented by other agents. On the contrary, such contracts are, in many instances, the natural result of circumstances, and are justified by the approved usages of business men [sic].'" *Id.* at 659 (citations omitted).

[31]Douglas M. Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375, 385 (1988). Professor Branson explains that the three-pronged common law test consisting of full disclosure, disinterested director approval, and fairness was modified by these new statutes into a two part disjunctive test. Under most conflict of interest statutes, an interested transaction may be approved upon disclosure and approval *or* a judicial finding of fairness. *Id.*

[32]Act of July 3, 1967, ch. 50, § 144, 56 Del. Laws 151, 170 (1967), *as amended by* ch. 148, § 7, 57 Del. Laws (1969) (codified as amended at DEL. CODE. ANN. tit. 8, § 144 (1991)).

[33]*Cede II*, 634 A.2d at 365.

[34]DEL. CODE. ANN. tit. 8, § 144 (1991) reads:

> (a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if:

making body removes the interested director cloud and the transaction cannot be invalidated solely because an interested director is involved.[35] While the third component contemplates that even a fair transaction must be ratified by directors or shareholders, the Delaware Supreme Court has held that section 144 validation of interested transactions is not exclusive and "the sole forum for demonstrating intrinsic fairness may be a judicial one."[36]

On its face, section 144 applies only to contracts between a corporation and one or more of its directors, or to transactions between two corporations that have interlocking directorates or where the directors have a financial interest in the other corporation.[37] While the concepts embodied in entire fairness scrutiny have been codified by section 144, it does not provide the only validation procedure for interested transactions; ratification principles apply equally to transactions that fall outside the scope of the statutory provisions.[38] For example, if the self-interest arises from the transaction itself in that a director receives a benefit from supporting a transaction, but has no other financial interest

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> (1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or
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> (2) the material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or
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> (3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.
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> (b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.

Id.

[35]*Flieger*, 361 A.2d at 222.

[36]*Marciano*, 535 A.2d at 404 (noting that shareholder deadlock prevented ratification).

[37]DEL.CODE. ANN. tit. 8, § 144(a).

[38]Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1371 n.7 (Del. 1995) (noting the entire fairness test is codified in DEL CODE. ANN. tit. 8, § 144(a)(3)); *Marciano*, 535 A.2d at 403 (holding that § 144 does not provide the only validation standard for interested transactions); *Wheelabrator III*, 663 A.2d at 1203 (noting that the result of shareholder ratification of an interested transaction is the same under cases decided under § 144 and cases not decided under the section).

or relationship with the party who is promoting the transaction, section 144 is not directly applicable.[39] Nonetheless, there have been many cases focusing on self-interested transactions that were not decided under section 144,[40] and courts have determined that the key to upholding an interested transaction, regardless of the applicability of the safe harbor provision, is the approval of some neutral decision-making body.[41] Consequently, while the ratification rules were for the most part codified, the principals of section 144 will apply to all self-interested transactions, including those where the statutory provisions are not directly applicable.[42]

III. EFFECTUATION OF A FULLY-INFORMED SHAREHOLDER VOTE

Clearly, "[t]he legal imprimatur of a shareholder ratification cannot arise out of a staged and essentially meaningless vote."[43] When determining the validity of a shareholder vote, courts will review both the nature of the underlying interested transaction and the procedural aspects of the vote.[44] The essential elements of an effective vote are: (1) the act must be voidable and not void, and (2) the ratification must be fairly accomplished.[45] The fairness of the vote rests on whether the transaction was approved by an independent majority of the shareholders and the vote was free of coercion.

A. *Void Verses Voidable Acts*

Void acts include those acts which can be classified as a gift or waste of corporate assets, *ultra vires*, or fraudulent.[46] If an act is deemed

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[39] *E.g.*, *Cede III*, 663 A.2d at 1174. In *Cede*, the self-interest was based in a finder's fee a director would receive if the proposed merger was effectuated. The director was not transacting business with his or her corporation nor did the director have any financial interest in the acquiring corporation. The self-interest was based solely in the completion of the merger transaction.

[40] See *Citron*, 584 A.2d at 501, for a collection of cases that were not decided under § 144 but where the courts applied the same analysis as used under § 144 analysis.

[41] *E.g.*, *Oberly*, 592 A.2d at 467 (applying § 144 ratification concepts to a nonstock corporation).

[42] *See, e.g.*, *Cede III*, 663 A.2d at 1169-70 (analogizing § 144 to the two-part materiality test).

[43] *Williams*, 671 A.2d at 1387 (Hartnett, J., and Horsey, J. (Retired), dissenting).

[44] *See generally* 1 FOLK ET AL., *supra* note 3, § 144.5.2 (discussing the validity of stockholder ratification).

[45] *E.g.*, *Michelson*, 407 A.2d at 218.

[46] *Michelson*, 407 A.2d at 218-19; *see also Pogostin*, 480 A.2d at 626 (noting that in

void, it serves as an exception to the defense of shareholder ratification and can be cured only by a unanimous shareholder vote.[47] Conversely, voidable acts may be ratified by a majority shareholder vote.[48] Voidable acts are those acts which are performed in the interest of the corporation but beyond the authority of management and are not classified as being void.[49] Opponents of a ratified transaction will attack the validity of the vote by claiming that the transaction was void and not susceptible to cure by less than unanimous stockholder consent.[50] If the court determines that the act is voidable and thus susceptible to cure, the court will next appraise the validity of the vote to determine whether it was fairly accomplished.[51]

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order to challenge a ratified transaction, plaintiffs must show that the "[p]lan itself is so devoid of a legitimate corporate purpose as to be a waste of [corporate] assets"); Keenan v. Eshleman, 2 A.2d 904, 909 (Del. 1938) (asserting what double payment for management services constitutes a fraud); Schreiber v. Carney, 447 A.2d 17, 24 (Del. Ch. 1982) (explaining that vote buying was historically viewed as fraud since it was a deceit which operated prejudicially upon the property rights of another); *Saxe*, 184 A.2d at 610 (stating that judicial review of corporate waste claims, such as compensation arrangements, is limited to "discovering whether what the corporation has received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid").

[47]*Michelson*, 407 A.2d at 219 ("[O]nly where a claim of gift or waste of assets, fraud or *ultra vires* is asserted that a less than unanimous shareholder ratification is not a full defense."); *Kerbs*, 90 A.2d at 656 (gifts of corporate assets "will not be cured by stockholders' ratification unless such ratification was unanimous"); Weiss v. Rockwell Int'l Corp., No. 8811, 1989 Del. Ch. LEXIS 94, at *8 (Del. Ch. July 19, 1989), *reprinted in* 15 DEL. J. CORP. L. 777 (1990), *aff'd per curiam*, 574 A.2d 264 (Del. 1990) ("In such cases only unanimous shareholder ratification is a complete defense."); *Schreiber*, 447 A.2d at 26 (noting that "waste of corporate assets is incapable of ratification without unanimous stockholder consent").

[48]*See, e.g.*, *Van Gorkom*, 488 A.2d at 890; *Michelson*, 407 A.2d at 218-19; *Gerlach*, 139 A.2d at 593; *Kerbs*, 90 A.2d at 655 (noting that where a majority of fully informed stockholders ratify action, attack on the ratified transaction normally must fail).

[49]*Michelson*, 407 A.2d at 219.

[50]Stockholders' ratification of a voidable act will be effective unless the action can be defined as void. *See Kerbs*, 90 A.2d at 655. The list of cases is extensive where shareholder plaintiffs were seeking relief from an otherwise valid shareholder vote by claiming that a ratified transaction is void and not voidable. *See, e.g.*, *Pogostin*, 480 A.2d at 625 (claiming arrangement for executive compensation was so devoid of a legitimate business purpose as to be a waste of corporate assets); *Schreiber*, 447 A.2d at 23 (arguing that vote-buying is either illegal or constitutes a fraud); *Kerbs*, 90 A.2d at 655-57 (urging that the stock option plan amounts to a gift of corporate assets to executives); *Saxe*, 184 A.2d at 610 (alleging compensation paid under advisory contract was a waste of corporate assets).

[51]*Michelson*, 407 A.2d at 218; *Weiss*, No. 8811, 1989 Del. Ch. LEXIS 94, at *10, *reprinted in* 15 DEL. J. CORP. L. at 777 (finding that the transaction was not per se void and so the claim rested only on the validity of the ratification).

B. *Full Disclosure*

Directors are under a fiduciary duty to fully and fairly disclose all material information within the board's control when seeking shareholder action, and accordingly, the paramount consideration when examining the validity of a shareholder vote is whether the shareholders were fully informed.[52] Full disclosure obligations attach not only to all the facts and circumstances surrounding the deal,[53] but effective ratification can occur only if shareholders are fully informed of the consequences of their vote.[54] The burden of proving that a "fully informed electorate" approved the transaction rests on the party who is claiming that the ratification is valid.[55]

The essential question is whether an omission or misrepresentation is material.[56] The legal standard of disclosure relating to materiality was adopted from the federal securities laws and was recently summarized in *Arnold v. Society for Savings Bancorp, Inc.:*

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused a reasonable investor to change his vote. What the standard does contemplate is a showing of

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[52]Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270, 1277 (Del. 1994); *Cede II*, 634 A.2d at 372; *In re* Tri-Star Pictures, Inc. Litig., 634 A.2d 319, 333-34 (Del. 1993); Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992); Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 845-48 (Del. 1987); *Van Gorkom*, 488 A.2d at 890; *Weinberger*, 457 A.2d at 703; Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 n.2 (Del. Ch. 1988).

[53]Shell Petroleum, Inc. v. Smith, 606 A.2d 112, 114 (Del. 1992); Lynch v. Vickers Energy Corp., 383 A.2d 278, 279 (Del. 1977).

[54]Yiannatsis v. Stephanis, 653 A.2d 275, 280 (Del. 1995). In *Yiannatsis*, two stockholders that comprised the majority sought the approval of business transactions by the third shareholder. *Id.* at 280. The court questioned the competency of the minority shareholder to understand the result of the transactions he approved and focused on two procedural issues. *Id.* First, the court stated that the documents the shareholder signed must not be flawed. *Id.* Second, the fact that the shareholder could not speak English, had only a seventh grade education and was suffering from Multiple Sclerosis would indicate that it was not reasonable to assume that he was competent in business transactions. *Id.* The court held that the majority shareholders did not satisfy their burden of proving ratification by the minority and thus the interested transaction would be subject to judicial entire fairness scrutiny. *Id.*

[55]*Yiannatsis*, 653 A.2d at 280 (citing 1 FOLK ET AL., *supra* note 3, § 144.5.2.3); *see also Van Gorkom*, 488 A.2d at 893 (holding that defendants bear the burden of proving valid shareholder ratification).

[56]*Rosenblatt*, 493 A.2d at 944-45.

> substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[57]

Ultimately, materiality requires that the board balance the potential benefits of disclosure against the potential harm of a particular disclosure.[58] While the duty of disclosure does not demand that minute details or inherently unreliable information be released, directors cannot base disclosure decisions on their subjective perspective. Instead, the directors must consider what would be material from the viewpoint of the reasonable shareholder.[59]

C. *Approval by a Majority of Disinterested Shareholders*

Another condition that tests the efficacy of a shareholder vote is whether approval is received from a majority of the independent shareholders.[60] While the safe harbor provisions do not statutorily require approval by a majority of the independent shareholders, Delaware courts have implied that a majority of disinterested shareholders is required to approve an interested transaction.[61] Independent shareholders are those

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[57]*Arnold*, 650 A.2d at 1277 (quoting TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976)). In *Lynch v. Vickers*, the Delaware Supreme Court explained that the purpose of the "duty of candor " in corporate law was akin to that in securities law since the objective "is to prevent insiders from using special knowledge which they may have to their own advantage and to the detriment of the stockholders." *Lynch*, 383 A.2d at 281. The duty enunciated in *TSC Indus.* was fully adopted by the Delaware Supreme Court in *Rosenblatt*, 493 A.2d at 944. In 1992, the term "duty of candor" lost favor and the Delaware Supreme Court adopted the term "duty of disclosure" to represent directors' disclosure obligations. *Stroud*, 606 A.2d at 84.

[58]*Arnold*, 650 A.2d at 1279.

[59]*Id.* at 1277; Zirn v. VLI Corp., 621 A.2d 773, 779 (Del. 1993).

[60]*See, e.g.*, *Gottlieb*, 91 A.2d at 59. The oft-quoted language of *Gottlieb* states, in part, that "formal approval [must be] given by a *majority of independent*, fully informed stockholders." *Id.* (emphasis added).

[61]*See Fliegler*, 361 A.2d at 221 ("The purported ratification . . . would not affect the burden of proof in this case because the majority of shares voted [were by interested shareholders.]"); *see also* Robert A. Wachsler, Inc. v. Florafax Int'l, Inc., 778 F.2d 547, 552 (10th Cir. 1985) ("[F]ollowing Delaware common law, only the disinterested shareholders are capable of 'freshen[ing]' the atmosphere after corporate self dealing.") (citing *Fliegler*, 361 A.2d at 221); O'Neill v. Davis, No. 87-C4789, 1990 U.S. Dist. LEXIS 1280, at *9-10 (N.D.

shareholders who are disinterested in the transaction at issue.[62] In majority dominated companies, if the minority shareholders could be adversely affected by the interested transaction, especially when a dominant or controlling shareholder stands to benefit from the transaction, directors should be concerned that the minority shareholders receive fair treatment.[63] A "majority of the minority" voting provision, while not required, may add to the transaction's fairness.[64] Courts look favorably upon such protective provisions because otherwise, in corporations where a majority stockholder controls, the minority stockholders have essentially lost the power to influence corporate direction.[65] Since the key to upholding an interested transaction is the approval of some "neutral decision-making body," majority-dominated companies should enlist a "majority of the minority" voting structure where the majority is interested.[66]

D. *Absence of Coercion*

Board action that coerces shareholders to vote in favor of a transaction is problematic and will limit the efficacy of the shareholder

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Ill. Feb. 2, 1990) ("Although § 144(a)(2) on its face does not require approval by disinterested shareholders, the Delaware Supreme Court has given it that gloss.").

[62]*Lewis*, 150 A.2d at 752 n.3.

[63]ABA, *supra* note 19, at 1256.

[64]*See Kahn*, 638 A.2d at 1116 (recognizing that approval of a merger from an informed vote of a majority of the minority stockholders is not a legal prerequisite); Van de Walle v. Unimation, No. 7046, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,834, at 99,023, 99,033 (Del. Ch. Mar. 16, 1991), *reprinted in* 17 DEL. J. CORP. L. 390, 413 (1992) (The absence of a "majority of the minority" vote does not establish a breach of duty. "The ultimate question is always whether the terms of the self interested transaction, taken as a whole, were fair."); Jebwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 599 (Del. Ch. 1986) (finding that not structuring a transaction to accord the minority veto power does not establish a breach of duty but is a factor in determining whether fairness was accorded to the minority).

[65]The Delaware Supreme Court has commented favorably on the inclusion of protective provisions but has not conclusively stated the effect of employing such provisions when interested transactions are at issue. Although techniques such as supermajority voting provisions and majority of the minority requirements may not automatically validate a shareholder vote, protective provisions will weigh heavily on the court's determination on the fairness of the vote and ultimately the fairness of the underlying transaction. *See QVC*, 637 A.2d at 42 n.12 ("Although we express no opinion on what effect the inclusion of any such stockholder protective devices would have had in this case, we note that this Court has upheld [provisions limiting board representation by the majority stockholder."]); *see also Cede II*, 634 A.2d at 366 n.35 (citing cases where the board employed techniques that restricted the influence of an interested director and questioning whether the defendant could have removed an interested director taint by utilizing one such provision).

[66]*See, e.g.*, *Oberly*, 592 A.2d at 467.

vote.[67] An effective shareholder vote ratifying action must be free from coercion in that it is both "meaningful and voluntary."[68] Management coercion is an amorphous concept, but it generally occurs in either the disclosures or the actual terms or circumstances under which the proposal is made.[69] Management may omit material facts or disclose certain information to improperly "encourage" shareholders to vote in favor of the interested transaction.[70] Full disclosure is central to a valid shareholder vote, but when the board discloses or omits information to obscure the real reasons behind an action, or to pressure the shareholders into accepting management's terms, the disclosure or nondisclosure is coercive.[71]

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[67]*See In re Santa Fe*, 669 A.2d at 68; Paramount Communications Inc. v. Time Inc., 571 A.2d 1140, 1154 (Del. 1990) ("[M]anagement actions that are coercive in nature or force upon shareholders a management-sponsored alternative to a hostile offer may be struck down as unreasonable and nonproportionate responses."); Lacos Land Co. v. Arden Group, Inc., 517 A.2d 271, 277 (Del. Ch. 1986) (finding that a threat made by a shareholder involving opposition of any future board recommendations unless the proposal was approved was coercive).

[68]*Williams*, 671 A.2d at 1387 (Hartnett, J., and Horsey, J. (Retired), dissenting).

[69]Eisenberg v. Chicago Milwaukee Corp., 537 A.2d 1051, 1056 (Del. Ch. 1987). Recognizing that the term coercion is difficult to define, one court noted.

> [F]or purposes of legal analysis, the term "coercion" itself — covering a multitude of situations — is not very meaningful. For the word to have much meaning for purposes of legal analysis, it is necessary in each case that a normative judgment be attached to the concept ("inappropriately coercive" or "wrongfully coercive[,]" etc.). But, it is then readily seen that what is legally relevant is not the conclusory term "coercion" itself but rather the norm that leads to the adverb modifying it.

Katz v. Oak Indus., Inc., 508 A.2d 873, 880 (Del. Ch. 1986).

[70]*See. e.g., Lacos Land*, 517 A.2d at 279. The court enjoined a recapitalization plan that was authorized by a shareholder vote because it found that the vote was "fatally flawed" by the threats of one Mr. Biskin. *Id.* at 273-74. Briskin served on the board, was the chief executive officer and a shareholder. *Id.* at 274. He instituted a dual common stock voting structure to maintain his control position with the company. *Id.* To encourage the board to approve the plan and shareholders to ratify it, he made veiled and express threats that if the plan was not approved he would oppose certain transactions that the board considered in the company's best interest. *Id.* at 277. *See also Eisenberg*, 537 A.2d at 1059 (asserting that self-tender was coercive since the offer to purchase was materially misleading because it portrayed cost savings as a purpose of the offer when, in fact, the offer was made due to a drastic drop in the market price of the stock).

[71]*Lacos Land*, 517 A.2d at 277. This problem is especially pronounced in transactions involving tender offers. *See, e.g., Lynch*, 383 A.2d at 281, *rev'g*, 351 A.2d 570 (Del. Ch. 1976) (tender offer failed to disclose critical facts); *Eisenberg*, 537 A.2d at 1056 (tender offer omitted information regarding the true purpose of the offer); Joseph v. Shell Oil Co., 482 A.2d 335, 342 (Del. Ch. 1984) (tender offer failed to disclose that facts regarding probable oil reserves were withheld from appraiser).

Coercion problems also arise in the actual terms or circumstances of the transaction.[72] Courts have recognized that this is an intrinsic danger in the parent-subsidiary context.[73] The parent, as the controlling or dominating stockholder, "has the inherent potential to influence, however subtly, the vote of minority stockholders in a manner that is not likely to occur in a transaction with a noncontrolling party."[74] Absent protective provisions, minority votes amount to nothing more than mere formalities and the minority shareholders have no real influence over the board.[75] Even if the minority is protected by a "majority of the minority" or a supermajority voting provision, the perception that the majority may retaliate against an unfavorable vote outcome may coerce the minority into supporting the controlling shareholder's interests.[76] The perception of coercion is so great in the parent-subsidiary context that courts generally assume that minority shareholders who ratify an interested transaction need procedural protections beyond full disclosure and afford them extra protection by applying entire fairness scrutiny to such transactions.[77] Courts will carefully scrutinize board action that may be designed to motivate a favorable outcome to ascertain and ensure that shareholders exercised their voting powers in an environment free from coercion.[78]

IV. CONSEQUENCES OF A FULLY-INFORMED SHAREHOLDER VOTE

Once a voidable transaction is validly ratified, the question becomes - what is the effect of ratification on the interested transaction?[79]

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[72]This type of coercion affects elements of a transaction including the timing of the transaction, the terms of the transaction, or a management response to a threat. *E.g.*, *Time*, 571 A.2d at 1154 ("We have found that even in light of a valid threat, management actions that are coercive in nature or force upon shareholders a management-sponsored alternative to a hostile offer may be struck down as unreasonable . . . .").

[73]*See Kahn*, 638 A.2d at 1116; *Citron*, 584 A.2d at 502; *Rosenblatt*, 493 A.2d at 937.

[74]*Citron*, 584 A.2d at 502.

[75]*QVC*, 637 A.2d at 42. *See also supra* note 60 and accompanying text.

[76]According to this rationale, the minority will go along with the majority's wishes since retaliation of some sort could ensue if the minority was in fact bold enough to vote in their own interest. Such retaliation could include a cessation of dividend payments or a cash-out merger at an unfavorable rate. *Kahn*, 638 A.2d at 1116.

[77]*Id.* at 1116-17. *See infra* part V.C. for a discussion of the standard of review applied in parent-subsidiary mergers.

[78]*In re Santa Fe*, 669 A.2d at 68.

[79]Chancellor Allen recognized that

> [t]he principal area of unclarity in recent years has centered on the appropriateness of a particular form of judicial review when an allegedly independent entity has been interposed between [a fiduciary] and the

Since section 144 does not dispositively address the result of shareholder ratification, both courts and commentators have deduced various conclusions.[80] Ratification may create a binding transaction and foreclose or limit a court's scrutiny of the fairness of the transaction.[81] Conversely, some courts find that approval "merely removes an 'interested director' cloud . . . and provides against invalidation of an agreement 'solely' because such a director or officer is involved."[82] According to this view, ratification removes the per se voidability of the transaction but preserves the right of a shareholder to seek *de novo* judicial review of fairness.[83] The third alternative is that "[a]pproval or ratification by fully-informed, disinterested directors or shareholders is sufficient under Delaware law to invoke the business judgment rule."[84] This view supports the opinion that formal approval given by a majority of independent, fully-informed shareholders acts to freshen the entire atmosphere and invokes a new set of rules.[85] As illustrated by the divergence of case law and legal

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> effectuation of a transaction in which it is interested (i.e., committees of allegedly disinterested directors or majority of minority vote provisions).

Cinerama, Inc. v. Technicolor, Inc., No. 8358, 1991 Del Ch. LEXIS 105 (Del. Ch. June 21, 1991) (revised June 24, 1991), *reprinted in* 17 DEL. J. CORP. L. 551 (1992), Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993) (Cede II), *modified on reh'g, in part, reh'g denied, in part,* 636 A.2d 956 (Del. 1994), *and dismissed, on remand, sub nom.* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134 (Del. Ch. 1994), *aff'd,* 663 A.2d 1156 (Del. 1995). While Chancellor Allen was happy not to "reenter that thicket," this note attempts to summarize Delaware's recent jurisprudence on the issue.

[80]Beveridge, *supra* note 2, at 671 (commenting that when a statute fails to address who carries the burden of proving the fairness of the transaction, the courts are left with the responsibility of determining the effect of the statute).

[81]*See generally* Kenneth B. Davis, Jr., *Approval by Disinterested Directors,* 20 J. CORP. L. 215, 230-31 (1995) (questioning the effect of DEL. CODE. ANN. tit. 8, § 144); Michael P. Dooley, *Two Models of Corporate Governance,* 47 BUS. LAW. 461, 489 (1992) (pondering the function and purpose of the word "solely" in the statute).

[82]*Fliegler,* 361 A.2d at 222; *See also, e.g., Citron,* 584 A.2d at 501 (addressing validation of interested director transactions); *Rosenblatt,* 493 A.2d at 937 (discussing interested director transactions).

[83]*See generally* 1 FOLK ET AL., *supra* note 3, § 144.4, at § 144:6 (explaining a shareholder's right to seek *de novo* review of a ratification); Branson, *supra* note 31, at 386-87 (explaining statutory modification of the common law disclosure test); Dooley, *supra* note 81, at 489 (defining "solely" in the context of § 144).

[84]1 BALOTTI & FINKELSTEIN, *supra* note 3, § 4.9, at 4-207. The authors recognize, however, that case law is divided on the question of when courts will subject an approved transaction to entire fairness scrutiny). *Id.* at 4-214. *See also* BLOCK ET AL., *supra* note 3, at 185-88 (discussing interested transactions other than parent-subsidiary mergers).

[85]*Gottlieb,* 91 A.2d at 59; *see also Van Gorkom,* 488 A.2d at 889 (explaining shareholder ratification); *Michelson,* 407 A.2d at 219 (noting that vote must be fully informed); *In re* Wheelabrator Technologies, Inc., No. 11,495 (Cons.), [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,489, at 97,554, 97,560 (Del. Ch. Sept. 6, 1990) (*Wheelabrator I*) (Jacobs,

commentary, the effect of shareholder ratification is an unsettled issue.[86] Although courts and commentators disagree on the consequences of ratification, approval substantially affects both the burden of proof and the judicial standard of review.[87]

A. *Burdens of Proof and the Competing Standards of Review*

A standard of review is the test a court will apply when it reviews an interested transaction to determine whether the fiduciary has violated a duty.[88] The burden of proof defines which party carries the evidentiary burden of establishing each element of the claim by a preponderance of credible evidence.[89] Which standard of review and who has the burden of proof will depend on whether the directors' actions are protected by

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V.C.) (stating that a majority of fully informed shareholders can remove the taint from an interested director transaction), *reprinted in* 16 DEL. J. CORP. L. 1653, 1655 (1991); *Weiss*, No. 8811, 1989 Del. Ch. LEXIS 94, at *8, *reprinted in* 15 DEL. J. CORP. L. at 777, *aff'd per curiam*, 574 A.2d 264 (Del. 1990) (stating that a valid shareholder ratification cures any defect in the transaction); *In re* Trans World Airlines, Inc. Shareholders Litig., No. 9844, 1988 Del. Ch. LEXIS 139, at *19 (Del. Ch. Oct. 21, 1988), *reprinted in* 14 DEL. J. CORP. L. 870, 883-84 (1989) (explaining that a majority of fully informed shareholders may validate an interested transaction).

[86]The internally inconsistent language of Stroud v. Grace, 606 A.2d 75 (Del. 1992), is the paradigm of the uncertain effects of shareholder ratification. In *Stroud*, minority shareholders contested the validity of charter amendments and bylaws that were approved by 78% of the shares entitled to vote. *Id.* at 78, 81. In discussing the effect of the shareholder ratification on the minority's claims, the court stated: "Under Delaware law a fully informed shareholder vote in favor of a disputed transaction ratifies board action in the absence of fraud." *Id.* at 82. "In the absence of fraud, a fully informed shareholder vote in favor of even a "voidable" transaction ratifies board action and places the burden of proof on the challenger." *Id.* at 83. "In the absence of proof by plaintiffs that the disclosures were misleading or inadequate, or that the actions of the board involved fraud, waste or other misconduct which were not ratified by unanimous vote of the stockholders, this ends the matter." *Id.* at 84. The court continued by stating that "it is well-settled that 'an attack' on a fully informed majority decision to ratify a disputed action or transaction 'normally must fail.'" *Id.* at 90. "[A]fter finding that the shareholder vote was fully informed, and in the absence of any fraud, waste, manipulative or other inequitable conduct, that should have ended the matter on basic principals of ratification." *Id.* at 92. An argument could easily be made that the opinion stood for claim extinguishment, burden shifting or a change in the standard of review, depending on which phrase was relied on. The court ultimately ruled that the ratifying vote shifted the burden of proof to the minority to prove the transaction was unfair. *Id.* at 90.

[87]Beveridge, *supra* note 2, at 673.

[88]*See* Eisenberg, *supra* note 12, at 437 ("A *standard of review* states the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief.").

[89]*Cinerama*, No. 8358, 1991 Del. Ch. LEXIS 105, at *29, *reprinted in* 17 DEL. J. CORP. L. at 569.

the business judgment rule or subject to entire fairness scrutiny.[90] This is often a pivotal question; since the invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the standard of review is sometimes considered outcome determinative.[91]

1. The Business Judgment Rule

The business judgment rule, although relatively modern in corporate law jurisprudence,[92] is rooted in the fundamental principal that the business and affairs of the corporation are managed by or under the direction of the board of directors.[93] The rule recognizes that directors, and not the shareholders or the courts, possess the expertise to manage the business and their managerial decisions should be entitled to significant deference.[94] It creates "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."[95] Accordingly, if a business decision can be attributed to any rational business purpose, the court "will not substitute its own notions of what is or is not sound business judgment."[96]

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[90]*See, e.g., Cede II*, 634 A.2d at 358 ("The pivotal question in this case is whether the Technicolor board's decision . . . was protected by the business judgment rule or should be subject to judicial review for its entire fairness.").

[91]Nixon v. Blackwell, 626 A.2d 1366, 1375 (Del. 1993). The court noted, however, that application of the entire fairness rule does not always implicate liability of the interested party. *Id. See also* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1279 (Del. 1988) (stating that determination of the standard of review can be outcome determinative); AC Acquisitions v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del Ch. 1986) ("[T]he determination of the appropriate standard of judicial review frequently is determinative of the outcome of derivative litigation."). *Cf. Cede III*, 663 A.2d at 1162 (remanding a case for review under entire fairness does not establish liability).

[92]Chancellor Allen recognized that the burgeoning use of the business judgment rule is a relatively recent phenomenon. *Cinerama*, No. 8358, 1994 Del. Ch LEXIS 178, at *23. He traced the manifestation of the term in opinions and his research revealed that in the decade of 1943-52, the term was used in 16 reported opinions. The appearance of the term grew in each subsequent decade and from 1983 to 1992, the term was used in 620 reported opinions. *Id.* at *23 n.9.

[93]This principle is codified in Delaware's General Corporation Law. Section 141 reads in pertinent part, "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." DEL. CODE. ANN. tit. 8, § 141(a) (1991).

[94]*QVC*, 637 A.2d at 42 (citing *Aronson*, 473 A.2d at 812).

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

[96]Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

Protection of the business judgment rule can normally only be claimed by disinterested and independent directors whose conduct meets the tests of business judgment.[97] However, the essential element is that the business decision be made by a "disinterested and independent corporate decision maker."[98] Consequently, an interested director transaction could be subject to business judgment rule protection if it was approved by either a committee of independent directors or a majority of independent shareholders.[99]

2. The Entire Fairness Test

When a plaintiff rebuts the presumption of the business judgment rule and establishes that a director has divided loyalties and has tainted the board's independence, the burdens and standards of the entire fairness test are implicated.[100] The invocation of the entire fairness standard is a significant event for the defendant since the burden of proof shifts to the board to show that the interested transaction was entirely fair to the corporation and its shareholders.[101] The two principle aspects of entire fairness are:

> [F]air dealing and fair price. The former embraces questions of when the transaction was timed, how it was

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[97]The Delaware Supreme Court "has defined 'disinterested directors' as those directors that 'neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally.'" *Williams*, 671 A.2d at 1377 (quoting *Aronson*, 473 A.2d at 812). The court has defined independent to mean "that a 'director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.'" *Id.* (quoting *Aronson*, 473 A.2d at 816).

[98]*Nixon*, 626 A.2d at 1376.

[99]*Id.* at 1376 n.7; *Oberly*, 592 A.2d at 467; *See also Van Gorkom*, 488 A.2d at 872-73 (discussing the applicability of the business judgment rule in the context of a cash-out merger); *Aronson*, 473 A.2d at 812 (noting that if director interest is present in a transaction, and the transaction is not approved by a majority of disinterested directors, the business judgment rule is not applicable); *Fliegler*, 361 A.2d at 221 (discussing validation of interested director transactions by a committee of independent directors or a majority of independent shareholders). *See generally* BLOCK ET AL., *supra* note 3, at 129 ("[W]here the interested director transaction falls within the ambit of the governing safe harbor provision, the transaction will be reviewed by the courts pursuant to business judgment rule criteria.").

[100]*Cinerama*, No. 8358, 1991 Del. Ch. LEXIS 105, at *31, *reprinted in* 17 DEL. J. CORP. L. at 570; *see also Weinberger*, 457 A.2d at 710 ("When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.").

[101]*Cinerama*, No. 8358, 1991 Del. Ch. LEXIS 105, at *35, *reprinted in* 17 DEL. J. CORP. L. at 572.

> initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.[102]

The final determination of entire fairness is inevitably fact intensive, and the directors must present cumulative evidence to show that they discharged their fiduciary duties in the best interest of the corporation.[103] The directors' burden of demonstrating a transaction's entire fairness is not insurmountable, but it is undeniable that the invocation of the entire fairness test is often determinative of the board's substantive liability.[104]

V. DELINEATING THE IMPACT OF A FULLY-INFORMED SHAREHOLDER VOTE

Nearly a half-century has passed since the Delaware Supreme Court announced that "the entire atmosphere is freshened and a new set of rules invoked where formal approval has been given by a majority of independent, fully informed stockholders."[105] Recently, Delaware courts have been reconciling precedent and defining the meaning of this phrase.[106] Interestingly, the courts have not embraced one unified approach but have concluded that shareholder ratification has different meanings in different situations. Fifty years later, this amorphous phrase has grown to mean claim extinguishment, business judgment rule

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[102] *Weinberger*, 457 A.2d at 711 (citations omitted).

[103] *Cede III*, 663 A.2d at 1163.

[104] *Id.* (noting that shifting the burden from the business judgment rule to the entire fairness standard does not create liability *per se* but recognizing that the standard of review is frequently outcome determinative); *Nixon*, 626 A.2d at 1376 (recognizing application of entire fairness scrutiny does not implicate liability but it is often determinative of the outcome of the litigation).

[105] *Gottlieb*, 91 A.2d at 59.

[106] *See In re Santa Fe*, 669 A.2d at 67; Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110 (Del. 1994); *In re* Wheelabrator Technologies, Inc. Shareholders Litig., 663 A.2d 1194 (Del. Ch. 1995).

protection, burden shifting within the entire fairness test, and finally, nothing at all.

A. *Claim Extinguishment*

There are two circumstances where a shareholder claim is extinguished by virtue of a fully-informed vote.[107] The first situation occurs when the board acts in good faith, but exceeds its *de jure* authority.[108] A valid shareholder vote, even after an action based on the transaction is filed, will relate back to cure the unauthorized act.[109] In *Michelson v. Duncan*, the plaintiff brought a shareholder derivative suit seeking to set aside stock options granted by the board and provided to key employees, including the officers and directors of the corporation.[110] The plaintiff claimed that the board exceeded its authority in granting the options.[111] In response to this claim, the directors sought and obtained subsequent ratification of the plan from less than a unanimous shareholder vote.[112] The Delaware Supreme Court summarized the effect of the vote as follows:

> It is the law of Delaware, and general corporate law, that a validly accomplished shareholder ratification relates back to cure otherwise unauthorized acts of officers and directors.
>
> . . . .
>
> If shareholders have approved an otherwise voidable act, their approval extinguishes any claim for losses based on prior lack of authority of the directors to undertake such action.[113]

The *Michelson* court clearly explained that shareholder claims that are premised on lack of director authority will be extinguished by shareholder

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[107] *Wheelabrator III*, 663 A.2d at 1202.

[108] *Michelson*, 407 A.2d at 218-19. Examples cited in *Michelson* where the board exceeded its *de jure* authority include situations where the board fixed or increased the compensation the directors would receive and where the board granted a stock option plan for key executives. *Id.* (citing 5 WILLIAM M. FLETCHER, CYCLOPEDIA OF CORPORATIONS § 2139 (perm. ed. rev., Timothy P. Bjur & Dennis Jensen eds., 1976)).

[109] *Id.* at 219.

[110] *Id.* at 214.

[111] *Michelson*, 407 A.2d at 216.

[112] *Id.* If a unanimous vote was obtained, transactions involving gifts or waste of corporate assets, fraud, or *ultra vires* could be ratified. *Id.* at 219.

[113] *Id.* at 219-20.

ratification, and such ratification may relate back to cure prior invalidity unless the ratification procedure proved to be lacking in fairness or was procedurally defective.[114]

The second circumstance where a shareholder vote can extinguish a claim is where the directors approve a transaction without reaching "an informed business judgment."[115] In *Smith v. Van Gorkom*, the court rationalized that the Board's lack of due care in approving a merger resulted in the creation of a voidable act, rather than a void act, and accordingly, the merger could be sustained if approved by a majority shareholder vote.[116] In *Van Gorkom*, however, the court found that the Board's lack of valuable knowledge should have been disclosed to the shareholders and since it was not disclosed, the shareholder vote approving the merger was not fully-informed.[117] It follows that the rule in Delaware is "a fully informed shareholder vote ratifies a challenged transaction and operates to extinguish any claim that the directors breached their fiduciary duty of care in connection with that transaction."[118]

B. *Invocation of the Business Judgment Rule*

In 1995, the Delaware Court of Chancery decided *In re Wheelabrator Technologies, Inc. Shareholders Litigation*[119] and clarified the effect of a shareholder vote ratifying an interested transaction that does not involve a controlling shareholder.[120] In cases involving

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[114]*Id.* at 220. The claim in *Michelson* was not considered extinguished at the summary judgment stage because the court found that the plaintiff's complaint did state a claim for gift or waste of corporate assets. The plaintiff argued that the options lacked any consideration and accordingly, they were not voidable, but void. *Id.* at 214-15.

[115]Van Gorkom, 488 A.2d at 889; *Wheelabrator III*, 663 A.2d at 1202; *In re Santa Fe*, No. 13,587 (Cons.), [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,845, at 93,089, *reprinted in* 20 DEL. J. CORP. L. at 1117, *aff'd in part, rev'd in part, and remanded*, 669 A.2d 59 (Del. 1995).

[116]*Van Gorkom*, 488 A.2d at 889.

[117]*Id.* at 890 (finding that the board lacked adequate information indicative of the intrinsic value of the company).

[118]*In re Santa Fe Pacific Corp.*, No. 13,587 (Cons.), [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,845, at 93,089, *reprinted in* 20 DEL. J. CORP. L. at 1117.

[119]663 A.2d 1194 (Del. Ch. 1995).

[120]*Id.* at 1205. Prior to this proceeding, the plaintiffs moved for a preliminary injunction challenging the merger. The court denied that motion in *In re* Wheelabrator Technologies, Inc. Shareholders Litig., No. 11,495 (Cons.), [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,489, at 97,554, 97,561 (Del. Ch. Sept. 6, 1990) (*Wheelabrator I*), *reprinted in* 16 DEL. J. CORP. L. 1653, 1669 (1991), and the shareholders voted to approve the merger. After the merger was consummated, the plaintiffs filed a complaint seeking declaratory relief,

interested transactions between a corporation and its directors, between two corporations that have interlocking directorates, or where the directors of one corporation have an interest in the other corporation, approval by a majority of fully-informed, disinterested shareholders invokes "the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction."[121]

Wheelabrator Technologies, Inc. (Wheelabrator) was engaged in the business of providing trash-to-energy services and developed facilities for the energy, environmental, and industrial markets.[122] Waste Management, Inc. (Waste) was engaged in providing hazardous waste management and environmental services to commercial, industrial and municipal customers both in the United States and abroad.[123] To take advantage of their complimentary assets and abilities, the companies negotiated a transaction wherein Waste received twenty-two percent of Wheelabrator's outstanding shares in exchange for certain Waste assets.[124] In addition to becoming Wheelabrator's largest shareholder, Waste was entitled to elect four of the eleven Wheelabrator directors.[125]

As the relationship progressed, the parties discussed various ways to realize the full potential of their strategic alliance and they eventually concluded that a merger would best satisfy both parties' business needs.[126] Discussions began in late 1989, and the parties entered intensified discussions on March 22, 1990.[127] The companies' representatives engaged in detailed and aggressive bargaining throughout the following week.[128] On March 30, 1990, agreement on the final details of the merger was reached and on this same day, Wheelabrator's board met and

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compensatory relief, rescissory damages or rescission of the merger. On the defendant's 12(b)(6) motion to dismiss, the court dismissed some of the plaintiffs claims, and the remaining ones were adjudicated in this summary judgment proceeding. *In re* Wheelabrator Technologies, Inc. Shareholders Litig., No. 11,495 (Cons.), 1992 Del. Ch. LEXIS 196 (Del. Ch. Sept. 1, 1994).

[121] *Wheelabrator III*, 663 A.2d at 1203 (quoting *Marciano*, 535 A.2d at 405 n.3).

[122] *Wheelabrator I*, No. 11,495 (Cons.), [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,489, at 97,554, *reprinted in* 16 DEL. J. CORP. L. at 1656.

[123] *Id.*

[124] *Wheelabrator III*, 663 A.2d at 1197.

[125] *Id.*

[126] *Wheelabrator I*, No. 11,495 (Cons.), [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,489, at 97,555, *reprinted in* 16 DEL. J. CORP. L. at 1657. Part of the impetus for seeking a merger was that Waste acquired a refuse-to-energy facility in West Germany and was concerned with conflict of interest problems the Waste appointed directors may face if Wheelabrator decided to enter the European market. *Id.*

[127] *Wheelabrator III*, 663 A.2d at 1197.

[128] *Id.*

unanimously voted to approve and recommend the merger to the shareholders.[129] On July 30, 1990, the companies issued a joint proxy statement to Wheelabrator's stockholders discussing and recommending the merger for approval. At a special shareholder's meeting held on September 7, 1990, the merger was approved by a majority of the disinterested shareholders.[130]

The plaintiffs' class action suit alleged that the Wheelabrator directors: (1) violated their duty to disclose all material facts relating to the transaction in the proxy statement,[131] (2) breached their duty of care,[132] and (3) breached their duty of loyalty in that a majority of Wheelabrator's eleven directors had a conflict of interest that prevented them from seeking the best possible price for the shareholders.[133] The directors claimed that the plaintiffs' claims were extinguished by the fully-informed shareholder vote approving the merger.

The court of chancery first found that the directors did not breach their duty of disclosure.[134] Then because the shareholder vote approving the merger was fully informed, the court noted that the effect of the vote was to extinguish the duty of care claims.[135] The court next analyzed the effect of the fully-informed shareholder vote on the duty of loyalty claims and dismissed the defendants' contention that shareholder approval automatically extinguishes duty of loyalty claims.[136] Duty of loyalty claims can involve transactions between the corporation and its controlling shareholder, transactions between a director and the corporation, or, as was the case in *Wheelabrator*, transactions between the corporation and another entity in which the corporation's directors have

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[129] *Id.* at 1197-98.

[130] *Id.* at 1198. As an interested Wheelabrator shareholder, Waste refrained from voting its shares on the merger transaction. *Id.*

[131] *Wheelabrator III*, 663 A.2d at 1198. The duty of disclosure claim alleged that the proxy statement misrepresented that: (1) the merger negotiations lasted one week when the essential terms were actually agreed on the first day; (2) Wheelabrator negotiated and succeeded at gaining concessions from Waste, but in fact, Waste dictated the merger terms; and (3) Wheelabrator's board carefully considered the merger before approving and recommending it but in fact, the board did not act with care. *Id.* at 1198-99.

[132] *Id.* at 1196. The plaintiffs contended that the Wheelabrator directors failed to investigate merger alternatives, did not adequately consider information regarding Waste's potential liabilities, should have appointed a special negotiating committee, and failed to consider the transaction with due care. *Id.* at 1199.

[133] *Id.* at 1196-97.

[134] *Id.* at 1199-200.

[135] *Wheelabrator III*, 663 A.2d at 1200.

[136] *Id.* at 1201. The court stated that the proposition was supported by existing case law; but, since 1990, the law had changed and the older precedents no longer provided good law. *Id.*

a financial interest.[137] In the latter two situations, the court relied on section 144(a)(2) and found that shareholder approval of the interested transaction invokes the business judgment rule thereby limiting judicial review to issues of gift or waste.[138] The court noted that the result was the same in interested transaction cases not decided under section 144 and stated, "Where there has been independent shareholder ratification of interested director actions, the objecting stockholder has the burden of showing that no person of ordinary sound business judgment would say that the consideration received for the options was a fair exchange for the options granted."[139] Accordingly, shareholder ratification of interested transactions that do not involve a transaction between a controlling shareholder and the corporation has the effect of invoking business judgment as the standard of review and placing the burden of proof on the plaintiffs.[140]

C. *Burden Shifting*

In cases involving transactions between the controlling shareholder and the corporation, courts will apply the entire fairness test, but place the burden of proof on the plaintiffs to show that the transaction was unfair.[141] These cases typically involve parent-subsidiary mergers[142] that have been approved by a majority of the minority shareholders, but also include other types of transactions where the controlling shareholder is an interested party.[143] Ostensibly, applying enhanced scrutiny to controlling

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[137]*Id.* at 1203.

[138]*Id.* (citing *Marciano*, 535 A.2d at 405 n.3).

[139]*Wheelabrator III*, 663 A.2d at 1203 (quoting *Michelson*, 407 A.2d at 224).

[140]*Id.* at 1205.

[141]*Id.* at 1204.

[142]*See* Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985); Weinberger v. UOP, Inc., 457 A.2d 701 (Del 1983); Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490 (Del. Ch. 1990).

[143]*See* Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110 (Del. 1994) (43.3% shareholder attempting a cash-out merger of minority shareholders' equitable interests); Stroud v. Grace, 606 A.2d 75 (Del. 1992) (majority shareholders, who were all family members, voted on a charter amendment that gave the majority shareholder right of first refusal in buying any company shares offered to unrelated persons); *In re* Trans World Airlines, Inc. Shareholders Litig., No. 9844 (Cons.), 1988 Del. Ch. LEXIS 139 (Del. Ch. Oct. 21, 1988) (controlling shareholder seeking to acquire 90% of the company's voting stock). In *Trans World Airlines*, the court stated that a properly employed shareholder vote would invoke the business judgment rule and would shift the burden to the plaintiffs to show that the interested transaction infringed upon the rights of the minority shareholders. *Id.* at *19. This view has been dismissed in subsequent decisions. *E.g. Citron*, 584 A.2d at 501 (noting that subsequent case law confirms that the court's business judgment rule analysis in *Trans World Airlines* was erroneous).

shareholder transactions serves an important function of limiting the potential of any coercive power the controlling party has over the minority.[144] The belief is that the "controlling stockholder relationship has the inherent potential to influence" the minority since the transaction is proposed by the party in control, and that party will remain in control regardless of the outcome of the vote and could seek retaliation upon the minority if the outcome of the vote is disfavorable.[145] In 1994, The Delaware Supreme Court unequivocally stated that the "exclusive standard of judicial review" for interested transactions involving a controlling or dominating shareholder is entire fairness.[146]

In *Kahn v. Lynch Communications Systems, Inc.*, Alcatel USA Corporation (Alcatel) was attempting to acquire Lynch Communications Systems, Inc. (Lynch) by offering Lynch shareholders cash in exchange for their shares.[147] Alcatel was found to be Lynch's *de facto* controlling shareholder due to its exercise of control over Lynch's business decisions, designation of five (out of eleven) of Lynch's directors, and ownership of 43.3% of Lynch's outstanding stock.[148] Consequently, as controlling shareholder, Alcatel owed fiduciary duties to the other Lynch shareholders. Additionally, because it stood on both sides of the transaction, Alcatel had the burden of demonstrating the entire fairness of the transaction.[149]

When the court recognized that Alcatel's merger proposal was unanimously approved by an independent committee, an issue arose as to what effect approval, by either independent directors or shareholders, had

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[144]*See, e.g., Citron*, 584 A.2d at 502 (noting that "[e]ven where no coercion is intended, shareholders voting on a parent-subsidiary merger might perceive that their disapproval could risk retaliation of some kind by the controlling shareholder").

[145]*Id.* Possible methods of retaliation could include the cessation of dividend payments or a cash-out merger where the minority shares would be eliminated for cash, perhaps at a lower price than otherwise would have been paid. *Id.*

[146]*Kahn*, 638 A.2d at 1117 (primarily discussing interested cash-out mergers).

[147]*Id.* at 1113. Alcatel was essentially attempting a cash-out merger with Lynch, although Lynch was entertaining alternatives such as a third party acquiror, a repurchase of Alcatel's shares, or the adoption of a shareholder rights plan. In a cash-out merger, also referred to as freeze-out, squeeze-out, and take-out mergers, the majority forces the minority shareholders to exchange their shares for cash or other securities, effectively eliminating the minority's interest and concentrating equitable ownership with the controlling or majority shareholder. BLOCK ET AL., *supra* note 3, at 92 ("When directors are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."). For a discussion of *Kahn*, see Jeffrey J. Clark, Comment, Kahn v. Lynch Communication Systems, Inc.: *A Major Step Toward Clarifying the Role of Independent Committees*, 20 DEL. J. CORP. L. 564 (1995).

[148]*Kahn*, 638 A.2d at 1114-15.

[149]*Id.* at 1115 (citing *Weinberger*, 457 A.2d at 710).

on the interested transaction.[150] In referring to prior cases that discussed the coercive nature of controlling or dominating shareholder transactions and the "unchanging nature of the underlying 'interested' transaction,"[151] the court stated that "even minority shareholders who have ratified a . . . merger need procedural protections" which would be provided by the "more stringent entire fairness standard of judicial review."[152] The court summarized the effect of ratification as follows:

> The initial burden of establishing entire fairness rests upon the party who stands on both sides of the transaction. However, an approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff. Nevertheless, even when an interested cash-out merger transaction receives the informed approval of a majority of minority stockholders or an independent committee of disinterested directors, an entire fairness analysis is the only proper standard of judicial review.[153]

Summarily, the court explained that the function of a shareholder vote on controlling shareholder interested transactions was to shift the burden of proving the transaction was unfair to the plaintiffs. However, that burden will not be shifted until the court is satisfied that the interested transaction was indeed subject to a valid shareholder vote.[154]

D. *A Vote With No Effect*

The Delaware Supreme Court most recently commented on the effect of a fully-informed shareholder vote in the 1995 decision *In re*

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[150]*Kahn*, 638 A.2d at 1115. The court discussed the differing views that have been espoused including that approval shifts to the plaintiff the burden of demonstrating that the transaction was unfair and that approval invokes the business judgment rule as the applicable standard of review. *Id.*

[151]*Id.* at 1116-17.

[152]*Id.* at 1117 (quoting *Citron*, 584 A.2d at 502). *Kahn* defined these protections as ones that extend beyond those afforded by full disclosure of all material facts. *Id.*

[153]*Id.* (citations omitted).

[154]*Cf. Kahn*, 638 A.2d at 1117-21 (noting that the burden ultimately did not shift to the plaintiffs because the "independent" committee was not truly independent, fully informed, nor had the freedom to negotiate at arm's length).

Santa Fe Pacific Corp. Shareholder Litigation.[155] The court held that a shareholder vote on a merger could not operate to ratify unilateral board action in a contest for control, and effectively remove such action from enhanced judicial scrutiny.[156] The Delaware Supreme Court refused to categorize the *Unocal v. Mesa Petroleum Co.*[157] and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[158] claims as arising under the duty of care or the duty of loyalty, thus avoiding the application of existing ratification approaches.[159] Instead, the court focused on the underlying purposes of enhanced scrutiny during the sale of control and concluded

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[155]669 A.2d 59 (Del. 1995).

[156]*In re Santa Fe*, 669 A.2d at 67. Normally, a board is accorded the protection of the business judgment rule when managing the affairs of the corporation. However, during contests for control, directors are considered to be confronted with an inherent conflict of interest "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders." Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995) (quoting Unocal v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del 1985)). Because of this inherent conflict, before the board is accorded business judgment rule protection for any tactics it may have implemented to defend against a takeover, the board carries the burden of demonstrating: (1) that it reasonably perceived a threat to corporate policy and effectiveness, and (2) the defensive response was reasonable to the threat posed. *Id. See generally* Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 249 (1989) (describing the Delaware courts disarmament of the conflict between standards of review in defensive tactics cases). A court will also apply enhanced scrutiny to ascertain that shareholders receive the best price available for their equity when the board approves a transaction resulting in a change of control of the corporation. *QVC*, 637 A.2d at 42; *Revlon*, 506 A.2d at 184.

[157]493 A.2d 946 (Del. 1985). Claims under *Unocal* arise when a board implements defensive measures in response to a threat of corporate control. *QVC*, 637 A.2d at 42. *See also Unitrin*, 651 A.2d at 1372 n.9 ("Unocal's standard of enhanced judicial scrutiny is proper whenever the record reflects that a board of directors took defensive measures in response to a 'perceived' threat to corporate policy and effectiveness which touches upon issues of control."); *Time*, 571 A.2d at 1154-55 (finding that *Unocal* is a flexible analytical tool but board actions may be struck down if they are coercive or "cram down" on shareholders a board-sponsored alternative to a hostile takeover).

[158]506 A.2d 173 (Del. 1986). The Delaware Supreme Court recognized that the board's responsibilities under *Unocal* change upon recognition that the company is up for sale. *Id.* at 182. Once a company is for sale, the board's role changes "from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." *Id.* The ultimate object of the directors must be to sell the corporation to the highest bidder. *Id. See also QVC*, 637 A.2d at 44-48 (defining that a change of control occurs when a majority of a target corporation's stock becomes vested in a single person, entity or group); *Mills Acquisition*, 559 A.2d at 1288 ("[I]n a sale of corporate control the responsibility of the directors is to get the highest value reasonably attainable for the shareholders.").

[159]*See In re Santa Fe*, 669 A.2d at 67 (insisting that *Revlon* and *Unocal* cannot easily be categorized as cases involving the duties of care or loyalty and thus should not involve ratification approaches implemented in such cases).

that the claimed breaches of the duties imposed by *Revlon* and *Unocal* were not extinguished by the fully-informed shareholder vote approving the merger.[160]

The challenged transaction was a merger of Santa Fe Pacific Corporation (Santa Fe) into its favored suitor, Burlington Northern, Inc. (BNI).[161] A third party suitor, Union Pacific Corporation (Union Pacific), was also interested in acquiring Santa Fe and an extended bidding contest ensued among the three entities.[162] BNI and Santa Fe initiated merger discussions during the summer of 1993, but these negotiations soon became stagnant.[163] Seven months later the companies renewed negotiations and agreed on a stock-for-stock merger in June 1994.[164] In October 1994, Union Pacific representatives met with Santa Fe's Chairman and CEO and proposed a stock-for-stock merger that would provide the Santa Fe shareholders with approximately a thirty-three percent higher value than the proposed BNI merger.[165] The following day, the Santa Fe board rejected the Union Pacific offer, and within two weeks, BNI and Union Pacific produced improved competing offers for Santa Fe's consideration.[166] Noticing a lack of interest on behalf of Santa Fe's board, Union Pacific announced a cash tender offer for 57.1% of Santa Fe's stock, to be followed by a second step merger where each remaining Santa Fe share would receive Union Pacific stock in a stock-for-stock exchange.[167] In response, Santa Fe's board recommended that shareholders not tender their stock, and proceeded to adopt a poison pill plan.[168] This plan provided that if ten percent of Santa Fe's common stock was accumulated by any bidder other than BNI, the stockholders would have the right to exchange their stock for either stock or property

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[160] *Id.* at 67-68.

[161] *In re* Santa Fe Pac. Corp., No. 13,587 (Cons.), [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,845, at 93,084, *reprinted in* 20 DEL. J. CORP. L. at 1108.

[162] *Id.* at 93,085-93,086, *reprinted in* 20 DEL. J. CORP. L. at 1111.

[163] *Id.* at 93,085, *reprinted in* 20 DEL. J. CORP. L. at 1110.

[164] *Id.*

[165] *In re Santa Fe Pac. Corp.*, No. 13,587 (Cons.), [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,845, at 93,085-93,086, *reprinted in* 20 DEL. J. CORP. L. at 1111. The value of the BNI merger amounted to $13.50 per Santa Fe share. The value of the Southern Pacific merger amounted to $18 per Santa Fe share. Union Pacific also indicated its willingness to offer a higher price and to take steps to ease Santa Fe's concerns that the merger may meet regulatory problems. *Id.*

[166] *Id.* at 93,085-93,086, *reprinted in* 20 DEL. J. CORP. L. at 1111-12. The reasons cited by the board for rejecting the offer included: regulatory concerns, inadequacy of the price, and commitments to BNI that would not allow them to consider another offer. *Id.* at 93,085, *reprinted in* 20 DEL. J. CORP. L. at 1111.

[167] *Id.* at 93,086, *reprinted in* 20 DEL. J. CORP. L. at 1112.

[168] *Id.*

having twice the value.[169] Despite Union Pacific's efforts to make its offer more attractive, Santa Fe's board continued to advise against the tender offer and advised Union Pacific that the company was not for sale.[170] Throughout December, Santa Fe and BNI renegotiated merger terms and, in January, disseminated a proxy statement.[171] In February, the shareholders approved the merger by greater than a seventy percent majority.[172]

The plaintiff shareholders alleged, *inter alia*, that (1) the Board breached its duty under *Revlon* to seek the best value reasonably available by failing to inform themselves of alternatives to the BNI merger, failing to adhere to fair bidding procedures, and not negotiating fairly with Union Pacific by favoring BNI over Union Pacific; (2) the Board's defensive response to Southern Pacific's offers violated *Unocal*; and (3) the Board did not fully disclose all material facts to the shareholders regarding the merger negotiations.[173] The defendants contended that all material information was fully and fairly disclosed to the shareholders prior to the shareholder vote, and the ultimate effect of the vote was to extinguish all claims against the directors for breach of their duties of care and loyalty.[174]

On appeal from the chancery court's order granting the defendant's motion to dismiss, the Delaware Supreme Court found that the directors did not violate their duty of disclosure.[175] Moreover, the fully-informed shareholder vote did not ratify the Board's unilateral decision to implement defensive tactics against Union Pacific.[176] In focusing on the purposes of enhanced judicial scrutiny, the court found that "an 'assiduous . . . concern about defensive actions designed to thwart the essence of corporate democracy by disenfranchising shareholders'" and the "overriding importance of voting rights" would not permit a vote on a merger to shield unilateral board action from enhanced judicial

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[169] *In re Santa Fe*, No. 13,587 (Cons.), [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,845, at 93,086, *reprinted in* 20 DEL. J. CORP. L. at 1112.

[170] *Id.* at 93,086, *reprinted in* 20 DEL. J. CORP. L. at 1113.

[171] *Id.* at 93,086, *reprinted in* 20 DEL. J. CORP. L. at 1113.

[172] *Id.* at 93,087, *reprinted in* 20 DEL. J. CORP. L. at 1114. During this time, Union Pacific revised its offer and announced it would purchase all outstanding Santa Fe shares for $18.50 per share. The Santa Fe board continued to advise shareholders not to tender. *Id.* at 93,086, *reprinted in* 20 DEL. J. CORP. L. at 1113.

[173] *In re Santa Fe*, 669 A.2d at 65.

[174] *In re Santa Fe*, No. 13,587 (Cons.), [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,845, at 93,087, *reprinted in* 20 DEL. J. CORP. L. at 1114.

[175] *In re Santa Fe*, 669 A.2d at 67.

[176] *Id.* at 67-68.

scrutiny.[177] Accordingly, even when a majority of stockholders approve a merger, the court will review the transaction under enhanced scrutiny to "assure that stockholders vote . . . in an atmosphere free from undue coercion."[178] The court further found that the actual subject of the vote was not the defensive measures but whether Santa Fe should merge with BNI at all.[179] Since the shareholder vote did not explicitly approve the Board's implementation of the defensive tactics, the court refused to find that the vote approving the merger ratified the Board's antecedent unilateral defensive actions.[180]

VI. CURRENT TRENDS IN ALTERNATIVE MODELS

A. *The Principles of Corporate Governance*

The American Law Institute's *Principles of Corporate Governance* (*ALI Principles*)[181] provides the leading alternative to the widely followed standards developed by Delaware case law.[182] Part V is entitled "Duty of Fair Dealing" and addresses basic conflict-of-interest principles.[183] Notably, Part V of the *ALI Principles* avoids the term "duty of loyalty" and deals only with pecuniary interest self-dealing, such as purchase and sale transactions, leases, furnishing services, and issuing and receiving loans.[184] Under section 5.02, which addresses director transactions with

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[177] *Id.* (citations omitted).

[178] *Id.* at 68. The court was referring to the possibility that had the Santa Fe shareholders been given the option of voting for a Southern Pacific merger, perhaps they would not have approved the BNI merger. The court opined that the defensive measures were used to prevent a shareholder vote for a Southern Pacific merger and thus, the defensive measures took full effect prior to the vote on the BNI merger. *Id.* at 68 & n.4.

[179] *In re Santa Fe*, 669 A.2d at 68.

[180] *Id.* The Delaware Supreme Court next addressed the *Revlon* and *Unocal* claims under enhanced judicial scrutiny and found that the plaintiffs did state a claim under *Unocal*. *Id.* at 70-72.

[181] 1 AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 5.01-5.16, at 199-382 (1994).

[182] John C. Coffee, Jr., *Derivative Litigation Under Part VII of the ALI Principles of Corporate Governance: A Review of the Positions and Premises*, C852 ALI-ABA 89, 93 (1993).

[183] PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 181, §§ 5.01-5.16, at 199-382.

[184] Marshall L. Small, *The Duty of Fair Dealing*, C973 ALI-ABA 53, 57 (1994). The purpose of adopting the term "duty of fair dealing" was to create a proper label for the obligations of a person "who acts with a pecuniary interest in a matter"; those obligations have previously been mislabeled as duties of loyalty. *Id.* Conflict of interest situations addressed in other sections of the PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 181, include compensation (*id.* § 5.03), use of corporate position, information or property (*id.* §§ 5.04,

the corporation, a director who enters into a transaction with the corporation has the burden of proving that the transaction is entirely fair.[185] However, the transaction in question will be upheld if conflict disclosure is made by that director *and* the transaction is fair; *or*, in the alternative, it is authorized or ratified by disinterested shareholders *and* does not constitute waste.[186] Essentially, the *ALI Principles* provide that after full disclosure, a majority of disinterested shareholders can approve in advance, or later ratify, an interested transaction and the consequence of such a vote will be that the transaction will be scrutinized under a waste standard.[187] Where there has been advanced authorization or ratification by disinterested shareholders, the burden is on the party attacking the transaction to show that there has been a waste of corporate assets.[188] Although fair dealing issues relating to directors and

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5.11), corporate opportunities (*id.* §§ 5.05, 5.12), competition with the corporation (*id.* § 5.06), and transfer of control (*id.* §§ 5.15, 5.16).

[185]PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 181, § 5.02. *See generally* Marshall L. Small, *Conflicts of Interest and the ALI Corporate Governance Project - A Reporter's Perspective*, 48 BUS. LAW. 1377, 1381 (1993) (explaining that § 5.02 transactions should be approached more cautiously).

[186]PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 181, § 5.02(a). *See generally* Beveridge, *supra* note 2, at 679 (explaining ratification of a self-interested director transaction).

[187]Small, *supra* note 184, at 61-64. Disclosure obligations are discussed in PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 181, § 1.14. The interested director must disclose relevant information, *id.* § 1.14(b), but need not volunteer maximum or minimum amount willing to pay or accept unless there are special circumstances. *Id.* § 1.14 cmts. There are liberal provisions that allow for corrective disclosure and ratification of the defective disclosure. *Id.* §§ 5.02(c), 5.05(d). Section 1.16 requires that a majority of votes cast be by shareholders who are not interested. Advance authorization occurs when the transaction is entered into conditioned upon approval by a disinterested majority. *Id.* § 5.02(a)(2)(B). Ratification occurs after the transaction has been consummated. *Id.* § 5.02(a)(2)(C).

[188]PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 181, § 5.02(b). Some commentators view the waste standard as essentially the same standard as business judgment. *E.g.*, Small, *supra* note 176, at 61. Others view it as a counterpart to the business judgment rule. Eisenberg, *supra* note 12, at 457.

The waste standard enunciated in the *ALI Principles* is comparable with the Delaware corporation law waste standard. *Compare* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 181, § 1.42 stating:

> A transaction constitutes "waste of corporate assets" if it involves an expenditure of corporate funds or a disposition of corporate assets for which no consideration is received in exchange and for which there is no rational business purpose, or, if consideration is received in exchange, the consideration the corporation receives is so inadequate in value that no person of ordinary sound business judgment would deem it worth that which the corporation has paid.

with the Delaware waste standard, found in *Kaufman*, "no person of ordinary sound business judgment would say that the consideration received [by the corporation] was a fair exchange

compensation decisions;[189] use of corporate property, information, or position;[190] usurpation of corporate opportunities;[191] and competition with the corporation[192] are treated in other sections of Part V, the result of shareholder approval or ratification is the same as in section 5.02 - judicial scrutiny is limited to determining whether the party attacking the transaction has met the burden of proving that the transaction amounts to a waste of corporate assets.[193]

B. *The Model Business Corporation Act*

The Model Business Corporation Act (MBCA) attempts to draw a "bright-line statutory" approach to dealing with transactions that involve a director's conflicting interest.[194] Under section 8.61, a court is precluded from reviewing an interested transaction that has been approved by a shareholder majority.[195] Shareholder action can occur at any time, either before or after the transaction, but is effective only if a fully-informed, disinterested majority votes to approve the director's conflicting interest transaction.[196] The "bright-line" that has been drawn by the MBCA forecloses judicial review of the transaction's fairness in exchange for additional transactional certitude.[197] The result of properly accomplished shareholder ratification is to extinguish any claim an objector may have regarding the transaction based on a director's interest. One justification noted for the MBCA's approach is that "having a

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for [what the corporation] granted. *Kaufman*, 91 A.2d at 791.

[189]PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 181, § 5.03.

[190]*Id.* § 5.04.

[191]*Id.* § 5.05.

[192]*Id.* § 5.06.

[193]*See generally* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 181, §§ 5.01-5.06 (discussing the court's role in shareholder claims involving waste of corporate assets).

[194]2 MODEL BUSINESS CORP. ACT ANN. ch. 8, subch. F, at 8-386 to 8-388 (3d ed. 1995) (introductory comment to directors' conflicting interest transactions).

[195]*Id.* § 8.61. This section reads in pertinent part:

> A director's conflicting interest transaction may not be enjoined, set aside, or give rise to an award of damages or other sanctions, in a proceeding by a shareholder or by or in the right of the corporation, because the director, or any person with whom or which he has a personal, economic, or other association, has an interest in the transaction, if: . . . (2) shareholders' action respecting the transaction was at any time taken in compliance with section 8.63 . . . .

Id.

[196]*Id.* § 8.63, at 8-414.

[197]*See* Branson, *supra* note 31 at 387-90 (criticizing the American Bar Association's initiative to limit the operation of the duty of loyalty).

'conflict of interest' is not something one is 'guilty of'; it is simply a state of affairs. Indeed, in many situations, the corporation and the shareholders may secure major benefits from a transaction despite the presence of a director's conflicting interest."[198]

Section 8.61 provides a true safe harbor in that the corporate transaction and the interested director are immunized against claims based on the conflicting interest if the procedures are followed.[199]

At first blush, the MBCA's safe harbor seems to provide an enormous amount of protection. However, the force of section 8.61 is somewhat undermined by the statute's narrow definition of "conflicting interest transactions."[200] The statute applies only to situations in which a transaction exists. Accordingly, in situations where there is no transaction but a conflicting interest, there is no available safe harbor and

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[198] 2 MODEL BUSINESS CORP. ACT ANN. at 8-387 (introductory comment to directors' conflicting interest transactions).

[199] *Id.* at 8-398 to 8-399 (official comment to § 8.60).

[200] *See id.* § 8.60(1). This section provides in pertinent part:

> "Conflicting interest" with respect to a corporation means the interest a director of the corporation has respecting a transaction effected or proposed to be effected by the corporation (or by a subsidiary of the corporation or any other entity in which the corporation has a controlling interest) if
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> (i) . . . [T]he director knows . . . that he or a related person is a party to the transaction or has a beneficial financial interest in or so closely linked to the transaction and of such financial significance to the director or a related person that the interest would reasonably be expected to exert an influence on the director's judgment if he were called upon to vote on the transaction; or
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> (ii) the transaction is brought . . . before the board of directors of the corporation for action, and the director knows . . . that any of the following persons is either a party to the transaction or has a beneficial interest in or so closely linked to the transaction and of such financial significance to the person that the interest would reasonably be expected to exert an influence on the director's judgment if he were called on to vote on the transaction: (A) an entity (other than the corporation) of which the director is a director, general partner, agent, or employee; (B) a person that controls one or more of the entities specified in subclause (A) or an entity that is controlled by, or is under common control with, one or more of the entities specified in subclause (A); or (C) an individual who is a general partner, principal, or employer of the director.

Id. See also id. § 8.60(2) stating:

> "Director's conflicting interest transaction" with respect to a corporation means a transaction effected or proposed to be effected by the corporation (or by a subsidiary of the corporation or any other entity in which the corporation has a controlling interest) respecting which a director of the corporation has a conflicting interest.

common law rules apply.[201] In this respect, the drafters have created an anomaly in that the "unhealthy uncertainty" reflected in case law and differing judicial attitudes that they ostensibly excluded from conflict transaction analysis becomes essential in the MBCA's treatment of interested transactions.[202]

VII. A CRITICAL ANALYSIS OF SHAREHOLDER RATIFICATION UNDER EXISTING DELAWARE LAW

The perceived danger surrounding self-interested transactions justifies the application of a strict standard of review to interested transactions that have not been approved by a neutral decision-making body.[203] Nonetheless, as recognized by courts and commentators alike, self-interested transactions are not inherently detrimental to a corporation or its shareholders and may, in fact, be integral to a corporation's efficient operation or its very survival.[204] Recognizing that "fair" interested transactions are acceptable and perhaps beneficial despite their underlying conflict, the question that beckons is whether a court has any legitimate interest in reviewing a transaction that, after full disclosure, has been approved by a majority of disinterested shareholders. If the board supports an interested transaction and the majority of disinterested shareholders determine that it is in their best interest to approve the transaction, even if it lacks in substantive fairness, should a court have the authority to interfere with the shareholders' decision? Courts should acquiesce to the shareholders' majority voice since the question is

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[201]Examples where self-interest may exist absent a transaction include: usurpation of corporate opportunity, appropriation of corporate assets or use of inside information, competition with the corporation, encouraging "no action" on part of the corporation, unilateral board action, business decisions, policy decisions, defensive actions, and transactions between a parent company and a subsidiary. *See* 2 MODEL BUSINESS CORP. ACT ANN. 8-398 to 8-400, 8-403. The reporters note that these situations lie outside the ambit of subchapter F and common law rules should control these matters. *Id.* at 8-392.

[202]2 MODEL BUSINESS CORP. ACT ANN. 8-387 (comment on purposes and special characteristics of subchapter F).

[203]*See, e.g.*, Eisenberg, *supra* note 12, at 451.

[204]*See* 2 MODEL BUSINESS CORP. ACT ANN. at 8-387 (comment on purposes and special characteristics of subchapter F) ("[I]n many situations, the corporation and the shareholders may secure major benefits from a transaction despite the presence of a director's conflicting interest."); *Oberly*, 592 A.2d at 467 (opining that as long as the transaction is fair and the fiduciary relationship is not betrayed, self-interest is not inherently wrong); Mitchell, *supra* note 23, at 489 (explaining that loans made by a 50% stockholder in *Marciano* were made as a last resort and were necessary for the company's continued vitality); ABA, *supra* note 19, at 1282-83 (explaining that it is not the self-interest that is improper, but the manner in which the board handles a conflict-of-interest that may become problematic).

ultimately one of internal corporate monitoring, economic efficiency, and predictability in corporate actions.[205]

Traditionally, shareholders had two devices that allowed them to protect their investment. They could sell their stock or they could exercise their voting rights.[206] Until recently, the equilibrium between these two choices favored the "Wall Street Rule" which expresses that a dissatisfied shareholder could sell his shares but basically could not effectuate a corporate change with his vote.[207] The shareholder vote was seen as "an empty ritual" partly because of shareholder collective action problems,[208] the limitations of proxy voting, and the power the directors exercised over the voting process.[209] However, corporate ownership is shifting from individual investors to institutional investors.[210] The

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[205]*See, e.g.*, 2 MODEL BUSINESS CORP. ACT ANN. at 8-387 to 8-388 (comment on purposes and special characteristics of subchapter F).

[206]*Blasius*, 564 A.2d at 659 (explaining that investors typically could sell or vote to replace the directors if they perceived inadequate business performance).

[207]*See generally* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1288 (1991) (discussing the cost of institutional monitoring of investments versus the cost and feasibility of trading their large holdings).

[208]Collective action problems arise when corporate actions that would be taken by one owner become more cumbersome in a corporation when there is more than one owner. The problems are exacerbated when shares are dispersed among hundreds, thousands or millions of equity holders. There are generally three categories of collective action problems: free-rider problems, communication and coordination problems, and rational apathy problems. The essence of these problems is that while it would be best for all shareholders to contribute to a collective good, such as disciplining management or voting against a self-interested proposal, if the cost of participating to a shareholder is greater than the perceived benefit, that shareholder will refrain from contributing. Ultimately, some shareholders will benefit unequally from the efforts of others while others have to contribute disproportionately to the effort. Additionally, some shareholders may see that their individual vote is unlikely to affect the outcome of a proposal so they do not carefully evaluate the proposal and blindly "vote with management." *See generally* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 U.C.L.A. L. REV. 811, 821-22 (1992) (noting that the incentive to vote increases with the number of shares owned and when there is more diversification by the corporation); Grundfest, *supra* note 20, at 908-09 (discussing that only a coalition of shareholders holding at least 10% of the corporation's equity will derive benefits that exceed the costs of shareholder activism).

[209]*See generally* Eisenberg, *supra* note 12, at 456 ("[I]t is hard to be confident that shareholders who are sent a proxy statement that includes a proposal for the approval of [a self-interested] transaction will both study and fully understand the relevant issues."); Grundfest, *supra* note 20, at 866 (noting that shareholder meetings were viewed as empty rituals); Marsh, *supra* note 30, at 49 (recognizing that shareholders have little power to negotiate and are limited to reject or accept the deal that was negotiated for them by the interested director).

[210]*See* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991) (discussing the rise of institutional investors and the possible impact on corporate governance).

percentage of equity owned by institutional investors has skyrocketed in the past decade and is now at fifty-three percent in the largest one hundred corporations in terms of stock market value.[211] Historical problems associated with collective action by a widely dispersed group of shareholders has been somewhat ameliorated by the increase of these institutional investors.[212] The new tension between liquidity (exit) and control (voice) is now favoring control since "exit" for institutional shareholders has become more difficult.[213] Accordingly, the trend is toward greater and more effective use of shareholder voice.[214] The Delaware Supreme Court recognized this trend when it recently stated that "[i]nstitutions are more likely than other shareholders to vote at all, more likely to vote against manager proposals, and more likely to vote for proposals by other shareholders."[215] The evolution of the institutional investor should result in courts allowing for more independent shareholder oversight and monitoring of corporate activity.[216]

This view that shareholders should have "real" voting power finds additional support in the fact that Delaware courts are extremely aggressive about protecting shareholders' voting rights.[217] In *Blasius*

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[211]*See* Coffee, *supra* note 208, at 1291. Other interesting statistics provided by Professor Coffee indicate that institutional investors control 86% of Amoco, 82% of General Motors Corporation, 74% of Mobile Corporation, and 70% of Citicorp. *Id.*

[212]William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 280 (1992).

[213]Coffee, *supra* note 208, at 1288-89. According to Professor Coffee, institutional investors own large unmarketable blocks of stock and must accept substantial price discounts in order to liquidate their holdings. This results in "exit" becoming more costly and "voice" becoming less costly. *Id. See also* Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 126 (1994) (describing that the increasing costs of selling stock to "exit" has made the new strategy of "voice" more desirable).

[214]*See generally* Black, *supra* note 209 (providing numerous examples of the power of institutional voice to influence the direction of corporate policy and to affect specific corporate action).

[215]*Unitrin*, 651 A.2d at 1382 (quoting Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 U.C.L.A. L. REV. 895, 925 (1992)).

[216]Allen, *supra* note 213, at 280.

[217]*See, e.g.*, Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988). In *Blasius*, the court emphasized the importance of shareholder voting stating:

> Delaware courts have long exercised a most sensitive and protective regard for the free and effective exercise of voting rights. This concern suffuses our law, manifesting itself in various settings. For example, the perceived importance of the franchise explains the cases that hold a director's fiduciary duty requires disclosure to shareholders asked to authorize a transaction of all material information in the corporation's possession, even if the transaction is not a self-dealing one.
>
> A similar concern, for credible corporate democracy, underlies those cases that

Industries, Inc. v. Atlas Corp., the court of chancery stressed the importance of the shareholder franchise to the legitimacy of corporate directorial power by stating:

> It has, for a long time, been conventional to dismiss the stockholder vote as a vestige or ritual of little practical importance. It may be that we are now witnessing the emergence of new institutional voices and arrangements that will make the stockholder vote a less predictable affair than it has been. . . . [W]hether the vote is seen functionally as an unimportant formalism, or as an important tool of discipline, it is clear that it is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own.[218]

If a shareholder vote is critical to the fundamental theory of the corporation, why then does Delaware law allow courts to ignore the majority's voice and to create an elaborate rubric under which to "evaluate" a ratified transaction? It appears that a strong shareholder voice is emerging and courts should accord deference to the decisions made by these owners of the corporation.

One argument that has been made for a court retaining some level of review is that minority shareholders should be protected from "unbridled majority rule."[219] This view rests on a constitutional model of the relationship between corporations and corporate law.[220] Proponents of this view see the duty of loyalty as an irreducible minimum or core that a majority cannot take away, including the ratification of interested

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> strike down board action that sets or moves an annual meeting date upon a finding that such action was intended to thwart a shareholder group from effectively mounting an election campaign.
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> The cases invalidating stock issued for the primary purpose of diluting the voting power of a control block also reflect the law's concern that a credible form of corporate democracy be maintained.
>
> Similarly, a concern for corporate democracy is reflected (1) in our statutory requirement of annual meetings, and (2) in our consent statute . . . .

Id. at 659-60 n.2 (citations omitted). *See also* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) (invalidating the board's attempt to delay a shareholders' meeting for inequitable purposes).

[218]*Blasius*, 564 A.2d at 659 (citations omitted).

[219]Branson, *supra* note 31, at 393.

[220]*Id.* at 390 (citing MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 1 (1976)).

transactions.[221] Such restrictions limit the majority's ability to self-deal and to expropriate to itself the minority's share of the profits.[222] If the transaction was ratified by disinterested shareholders, the minority need not be concerned about the potential of the majority to engage in self-dealing. Additionally, Delaware law clearly recognizes that "a stockholder with an equitable right to a majority of corporate stock [has a] right to a proportionate voice and influence in corporate affairs . . . ."[223]

It seems inequitable that in the corporate realm, a stockholder would receive greater benefits and rights from his minority shares than a majority shareholder would receive from his majority shareholdings. The real threat of manipulation is not from the majority, but from the small shareholders who can "free ride" while the majority shareholders shoulder the burden of corporate monitoring - a term dubbed the "exploitation of the great by the small."[224] Perhaps under a constitutional analogy this phenomenon would better be phrased the "tyranny of the minority." It is only when a "free-riding" minority is dissatisfied with the outcome of a corporate action that, instead of accepting its minority position, or more plausibly, liquidating its shares and exiting from the undesirable (and consensual) relationship, it seeks protection from the court to undo what the majority has voted to do. The minority's best protection is not the courts of equity but the free market.[225]

Accordingly, a shareholder should be precluded from bringing an action against an interested transaction that has been ratified by a fully-informed, disinterested majority. Delaware courts should adopt a bright-line rule providing that fully-informed shareholder ratification extinguishes claims based on the presence of self-interest in a transaction between a director or controlling shareholder and the corporation. This approach is currently used by the Delaware courts when evaluating duty

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[221] *Id.*

[222] *Id.* at 394.

[223] *Blasius*, 564 A.2d at 661.

[224] Black, *supra* note 209, at 871 (quoting MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 29 (2d ed. 1971)). Professor Black notes that small shareholders are already frozen out of corporate governance decisions. The fact that a majority is functioning as overseers benefits the minority as the majority bears the cost of their own governance. *Id.*

[225] *See* Branson, *supra* note 31, at 395-96. *E.g.*, Michael C. Jenson & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (arguing that the free market is the superior regulator and market forces monitor management and prevent abuses more effectively than can judges).

of care claims under corporate law and also finds support under the Model Business Corporation Act.[226]

This approach does not abdicate duty of loyalty violations, but rather shifts the entire fairness analysis to focus on procedural elements rather than substantive issues.[227] If a transaction has been approved by a majority of disinterested shareholders, the only claims a court should properly consider are motions concerning the validity of the ratification itself.[228] A court should examine the underlying ratification to determine whether: (1) the act was voidable and not per se void; (2) all material information was fully disclosed; (3) a majority of disinterested shareholders approved the transaction; and (4) there was no coercion by management or a controlling shareholder in the voting process.[229] If the procedural elements of effectuating a valid vote have been met, the courts should acquiesce to the majority's voice. The minority's rights will be adequately protected if the procedural prerequisites of a valid vote have been followed.

This view coincides with two recent Delaware Supreme Court decisions. The court when deciding *In re Santa Fe Pacific Corp. Shareholder Litigation*.[230] did not address the effect of ratification on the

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[226]Section 8.61 of the Model Business Corporation Act adopts a position that precludes a court from reviewing an interested transaction that has been approved by a shareholder majority. Ratification, if accomplished properly, extinguishes any claim an objector may have regarding the transaction based on a director's interest. 2 MODEL BUSINESS CORP. ACT ANN. § 8.61(b)(2). Contrary to the Model Business Corporation Act, the *Principles of Corporate Governance* do not support a claim extinguishment theory. Ratification serves to lower the standard of review from an entire fairness analysis to a lower standard, for example:

> In the case of compensation (5.03), appropriation of a corporate opportunity (5.05), and competition with the corporation (5.06), if there has been requisite approval or ratification by disinterested directors or shareholders, the standard is the less stringent standard of the business judgment rule. If there has been authorization or ratification by disinterested shareholders, another less stringent standard is applicable: whether there has been a waste of corporate assets.

PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 181, at 202 (introductory note to Part V, "Duty of Fair Dealing"). The Delaware Supreme Court has recognized that "Delaware law relating to the approval of interested director transactions and ratification principles may differ in certain respects from that advanced in . . . [the] *Principles of Corporate Governance* . . . ." *Williams*, 671 A.2d at 1379 n.23.

[227]Arguably, the courts have already been emphasizing a procedural focus to fairness. *See* Mitchell, *supra* note 23, at 455.

[228]*See, e.g.*, *Weiss*, No. 8811, 1989 Del. Ch. LEXIS 94, at *10-19, *reprinted in* 15 DEL. J. CORP. L. at 782-83 (reviewing proxy disclosure claims), *aff'd per curiam*, 574 A.2d 264 (Del. 1990); *Gerlach*, 139 A.2d at 593 (determining if stockholders were fully-informed to effectively ratify the transaction).

[229]*See supra* part III.A.-D.

[230]669 A.2d 59 (Del. 1995).

Unocal and *Revlon* claims because the shareholder vote was not on the defensive tactics but on a subsequent merger proposal. A shareholder vote cannot ratify an action that is not the subject of the vote.

Perhaps even more supportive is the court's decision in *Williams v. Geier*.[231] Although *Williams* involved a shareholder vote that was necessary to implement an organic statutory change,[232] the court's brief discussion of ratification supports the claim extinguishment argument. The court quoted with approval that "[t]he key to upholding an interested transaction is the approval of some neutral decision-making body. Under 8 Del. C. § 144, a transaction will be sheltered from shareholder challenge if approved by either a committee of independent directors, the shareholders, or the courts."[233] Following this rule, the focus of analysis should be on the approval process. The court noted that the validity of the shareholder vote was dependant upon full and fair disclosure and the absence of coercion.[234] However, since neither director interest nor independence was implicated in the case, a majority of the minority vote was not needed.[235]

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[231]671 A.2d 1368 (Del. 1996).

[232]In *Williams*, the court was careful to distinguish shareholder ratification of an interested director transaction from shareholder approval necessary to achieve an organic, statutory change:

> We put to one side those cases, not relevant here, where stockholders are called upon to ratify action which may involve a transaction with an interested director or where the transaction approved by the board may otherwise be voidable. Our analysis here involves an entirely different application of the Delaware General Corporation Law — namely, the effect of corporate action which, in order to become operative, requires and receives both approval by the board of directors and the stockholders.

Williams, 671 A.2d at 1379 (citations omitted). The difference between the two types of votes was emphasized perhaps because of the confusion in precedent. The plaintiff, Williams, relied on *Fliegler* to argue that a "majority of the minority" vote was needed to effectuate the change. The court noted that William's reliance was misplaced and stated:

> The statutory scheme in Fliegler was based upon 8 Del. C. § 144 — the interested director transaction statute. In the case at bar, an entirely different statutory scheme is involved — namely, an amendment to the certificate of incorporation under 8 Del. C. § 242. Those are two statutory frameworks of independent legal significance.

Williams, 671 A.2d at 1381 n.29. After *Williams*, it is clear that the effect of ratification under § 144 and a shareholder vote necessary to effectuate a statutory change may differ. While the *Williams* decision greatly clarified the effect of a shareholder vote, the court left unanswered and unaddressed the legal consequences of ratification. *See id.* at 1379 ("We express no opinion on the question whether a 'duty of loyalty claim' may or may not be ratified.").

[233]*Williams*, 671 A.2d at 1379 n.23 (citing *Oberly*, 592 A.2d at 467).

[234]*Id.* at 1379-84.

[235]*Id.* at 1382.

Following the reasoning of the *Geier* court and adapting it to ratification principles, an interested transaction should be protected from shareholder challenge if ratified by a majority of the minority shareholders following full and fair disclosure and if no coercion existed. With these procedural safeguards in place, the decision to permit interested director transactions should rest with the majority of disinterested shareholders and not with the minority shareholders. As the Delaware Supreme Court noted in *Williams*, "[T]he Delaware General Corporation Law is a broad enabling act which leaves latitude for substantial private ordering . . . . Therefore, the stockholders control their own destiny through informed voting. This is the highest and best form of corporate democracy."[236]

VIII. CONCLUSION

Delaware case law concerning the legal consequences of shareholder ratification lacks coherence and calls for clarification. Section 144 of the Delaware General Corporation Law recognizes the importance of providing a mechanism to allow for stockholder ratification of interested director transactions. Unfortunately, the many meanings imputed to the concept of ratification have rendered the shareholder vote an enigma.

Courts should acknowledge that interested transactions are lawful and proper if structured to provide for fully-informed shareholder approval of the transaction. Indeed, the certainty of such transactions may prove important to the corporation's survival. The emergence of the institutional investor has resulted in a more organized, independent and forceful voice in corporate governance. Courts should defer to the majority voice of the owners of the corporation and protect the minority shareholders through available procedural safeguards. Accordingly, a transaction that has been ratified by a majority of disinterested shareholders should be conclusive and unreviewable.

An unified claim extinguishment approach promotes certainty of corporate transactions and provides directors with an ascertainable method of cleansing interested transactions. Claim extinguishment demonstrates that interested transactions are not necessarily improper, but it is the manner in which the board discloses and presents the conflict and the informed vote of the shareholders that determines the validity of the transaction. This method has been adopted by the Delaware courts for

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[236] *Id.* at 1381.

duty of care violations and appears to be the trend in alternative corporate proposals. Shareholder ratification should have only one meaning - claim extinguishment.

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