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TRANSFERS OF CONTROL AND THE QUEST FOR EFFICIENCY: CAN DELAWARE LAW ENCOURAGE EFFICIENT TRANSACTIONS WHILE CHILLING INEFFICIENT ONES?*

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INTRODUCTION

At first glance, few corporate law principles seem to be better established than the widely prevailing rule that a controlling shareholder may receive a control premium for its shares.[1] From a comparative law perspective, however, this consensus may seem surprising, because the United States stands virtually alone in failing to accord minority shareholders any presumptive right to share in a control premium.[2] Yet,

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[1]For the generalization that U.S. law today normally permits the sale of control at a premium, see ROBERT C. CLARK, CORPORATE LAW § 11.4, at 478 (1986). *See also* 1 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.16, at 373 (1992) (discussing sales of control and its effects on controlling and minority shareholders). This topic is an ancient and possibly overwritten theme in corporate law. Among the standard articles are: William D. Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965) (stating that minority shareholders should be given an equal opportunity to sell their stock on the same terms as the sale of the controlling block); Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CAL. L. REV. 1072 (1983) (discussing the positive and negative effects of an "equal treatment rule" in internal and third party transactions); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982) (arguing that those who produce a gain should be allowed to keep it, subject to the constraint that other parties to the transaction be "at least as well off as they were before the transaction"); Robert W. Hamilton, *Private Sale of Control Transactions: Where We Stand Today*, 36 CASE W. RES. L. REV. 248 (1986) (discussing the U.S. rule and the support it has received from economists as well as the recognized exceptions to this rule); Thomas L. Hazen, *The Sale of Corporate Control: Towards a Three-Tiered Approach*, 4 J. CORP. L. 263 (1978) (analyzing the different rules applied to control sales and proposing that the rule ultimately applied be determined by the type of corporation involved in the transaction); Saul X. Levmore, *A Primer on the Sale of Corporate Control*, 65 TEX. L. REV. 1061 (1987) (reviewing DAVID C. BAYNE, THE PHILOSOPHY OF CORPORATE CONTROL: A TREATISE ON THE LAW OF FIDUCIARY DUTY (1986)).

[2]To fully document this claim would itself require an article. Nonetheless, the following items of evidence are offered in support of this generalization. European law

from an economic perspective, the permissive U.S. rule is not surprising because economists generally agree that economic efficiency is promoted by privately negotiated control transfers at premiums not offered to minority shareholders.[3]

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strongly discourages partial bids and often imposes a buyout requirement on the control buyer under which it must buyout the minority shareholders at the same price as paid to the control seller. *See* Deborah A. DeMott, *Comparative Dimensions of Takeover Regulation*, 65 WASH. U. L.Q. 69 (1987) (discussing takeover regulations in the U.S., Great Britain, Canada, and Australia). For example, in Britain, the Panel on Take-Overs and Mergers has adopted the City Code on Take-Overs and Mergers, which requires the Panel to approve any partial tender offer, precluding a tender for more than 30% and less than 100%. *Id.* at 93-94. A minority of the shareholders must approve any offer within this range. *Id.* Additionally, Rule 34 of the City Code requires any person who acquires 30% or more of the voting securities of the target to offer to buy out the remaining shareholders at the highest price paid by the acquiring person or its associates within the preceding 12 months. *Id.* at 94-95. This buyout requirement is intended to ensure that "all shareholders . . . will share equally in any premium paid by a buyer so long as at least thirty percent of the company's shares are sold." *Id.* at 95. Belgian law has somewhat similar provisions, requiring that minority shareholders, who are bought out, must receive the same terms as those given the control block. *See* Robert Wtterwulghe, *Takeover Bids in Belgium*, 5 J. COMP. BUS. & CAPITAL MARKET L. 41, 48 (1983) (examining Belgian law regarding takeover bids). However, this provision appears not to be effectively implemented. *Id.* Outside of Europe, there are few examples of law explicitly dealing with control premiums; however, those statutes that do address the issue generally implement some form of equal opportunity. DeMott, *supra*, at 100-09. Canadian corporate law tends to resemble that of the United States, but deviates in its treatment of control premiums. *Id.* at 99. Under the Ontario statute, an offeror must make a "takeover bid" to all the corporation's shareholders equally, unless certain limited exemptions apply. *Id.* at 100. One exemption permits private purchases from 14 or less persons, but even in this case if the buyer acquires more than 20 of the target's voting stock, it must make a follow-up offer to all shareholders if a premium has been paid. *Id.* Quebec has a similar statute, which also intends to ensure the sharing of control premiums. *See id.* at 100-03. Under Australian law, any acquisition of 20% or more of voting securities must be through a general offer to all shareholders or a regulated stock exchange bid. *Id.* at 108-09. Under Brazilian law, anyone proposing a control transfer is required to offer similar terms to all shareholders and not to engage in specific negotiations with any individual shareholder. *See* Modesto Carvalhosa, *The Brazilian Experience with Respect to Tender Offers*, 3 J. COMP. CORP. L. & SECS. REG. 103, 104-05 (1981) (discussing the regulation of tender offers in Brazil).

[3]*See, e.g.*, Lucian A. Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 1994 Q. J. ECON. 957 (comparing the "market rule" of the U.S. with the "equal opportunity rule" of other nations); Hamilton, *supra* note 1, at 252-62 (outlining economists' view that sales governed by the U.S. rule increase efficient transactions); Benjamin Hermalin & Alan Schwartz, *Buyouts in Large Companies*, 25 J. LEGAL STUD. 351 (June 1996) (recommending that minority shareholders should be entitled to no more than "the preinvestment market value" of their shares on any subsequent squeeze-out merger); Marcel Kahan, *Sales of Corporate Control*, 9 J.L. ECON. & ORGANIZATION 368 (1993) (positing that the U.S. rule allows for more efficient transfers than the equal opportunity rule, especially when higher fractions of shares are sold).

The puzzling fact that this presumptively efficient rule is accepted only in the United States is compounded by a further puzzle: the rule is only followed some of the time.[4] A number of amorphous exceptions to the general rule exist, which seem chiefly to apply when the percentage of shares held by the control seller is low.[5] Close students of U.S. corporate law have suggested a possible explanation: because both efficient and inefficient control transfers are possible, the standard exceptions to the general rule may have been tailored to exclude precisely those transactions most likely to be inefficient transfers in which the control acquirer intends to exploit the private benefits of control.[6] Professor Einer Elhauge, the leading exponent of this provocative theory, calls this interpretation of the case law, as will this article, the "triggering thesis."[7]

Although appealing, the triggering thesis is still vulnerable to some obvious criticisms: First, cases requiring a control seller to share the control premium with other shareholders are very few in number and none are recent.[8] In comparison, inefficient control transfers appear to be a recurring and relatively common phenomena.[9] Thus, the distinct

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[4]*See* Einer Elhauge, *The Triggering Function of Sale of Control Doctrine*, 59 U. CHI. L. REV. 1465, 1467 (1992) (analyzing the recognized exceptions to the general rule).

[5]*Id.* (noting the ambiguity and open-ended nature of these exceptions, which can, "if read broadly, easily engulf the general rule"). "[S]cholars are in widespread agreement that, as currently formulated, the [general rule] is 'confused' and 'chaotic' . . . . The problem is that the [rule] lacks any coherent principles or policies that might guide the resolution of these ambiguities and suggest limits to the exceptions." *Id.* at 1481.

[6]*See* Elhauge, *supra* note 4, at 1465 (discussing the conflicting legal doctrines applied to control sales and proposing that the triggering approach be employed because it incorporates the positive attributes of each doctrine). Elhauge suggests that the triggering approach should be applied to sales of control instead of the doctrines currently proposed by academics. *Id.* at 1466-67. Two schools of thought exist regarding the sale of control phenomenon. The "equal sharing" approach dictates that noncontrolling shareholders should *always* have the right to share in control sales at premium prices. *Id.* at 1465; *see also* Andrews, *supra* note 1, at 505 (discussing the "equal opportunity" rule). The "deregulatory approach" proposes that noncontrolling shareholders should *never* share in premium control shares. Elhauge, *supra* note 4, at 1486-93; *see also* Easterbrook & Fischel, *supra* note 1, at 698 (supporting a deregulatory approach and suggesting that "unequal division" of gains from control transfers increase wealth). See Kahan, *supra* note 3, at 368, for a critique of the triggering approach.

[7]Elhauge, *supra* note 4, at 1502-32.

[8]Relatively recent cases have, however, rejected the claim that noncontrolling shareholders must be given the same opportunity to sell at the same premium. *See, e.g.*, Martin v. Marlin, 529 So.2d 1174, 1177 (Fla. Dist. Ct. App. 1988); Shoaf v. Warlick, 380 S.E.2d 865, 867 (S.C. Ct. App. 1989).

[9]*See* discussion *infra* notes 196-208 and accompanying text. Negative stock price returns, on the date that a transaction is announced, is one measure of a prospectively inefficient transaction. Industrial organization economists have been far more skeptical than

possibility surfaces that this body of law simply may not matter very much. A second problem with the triggering thesis as a public policy is the high risk that it imposes on the control seller, who may be required to surrender the control premium it received if the transaction is later deemed inefficient. The difference may often be a marginal one, thus, making the penalty seemingly disproportionate and the seller a *de facto* insurer for the buyer's subsequent conduct. In reality, control transactions do not neatly subdivide into two categories (efficient and inefficient), but combine elements of each. Thus, the triggering thesis inevitably leads to a remedy that is sometimes underinclusive while other times overinclusive.

As a result, although this article agrees with Professor Elhauge's important claim that corporate law should seek to distinguish inefficient from efficient control transfers, it doubts that such an attempt can be successfully implemented by using the sale of control doctrine, as well as its exceptions, as the vehicle by which to classify control transactions. In truth, control transactions can be both, motivated in part by efficiency-promoting justifications and in part by the inefficient desire of the control seeker to consume the private benefits of control. Precisely for this reason, prophylactic rules that attempt to discourage entire classes of transactions are potentially overbroad and dangerous, particularly when implemented through retrospective litigation.

But what is the alternative? This article will argue that a more effective technique is to allocate the control premium between an efficient component (i.e., that portion paid based on efficient-promoting motives) and an inefficient component (i.e., that portion paid to consume the private benefits of control). This recognizes that in any transaction both motives may be present to varying degrees. In short, public policy should attempt to classify the premium, not the transaction, thus, avoiding the all-or-nothing problems associated with relying on the exceptions to the sale of control doctrine. Such a more discriminating allocation could be attempted either in an appraisal proceeding or, more importantly, at the time the control acquirer attempts to acquire the remaining minority interest in the corporation in a squeeze-out transaction. The goal would

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financial economists about the efficiency of mergers and acquisitions. Professor Caves summarizes their views with the generalization that "ex post evidence on the efficiency of mergers . . . amounts to a convincing rejection of the presumed efficiency of mergers." *See* Richard E. Caves, *Effects of Mergers and Acquisitions on the Economy: An Industrial Organization Perspective*, *in* Lynn E. Browne & Eric S. Rosengren, THE MERGER BOOM 149, 150 (Federal Bank of Boston 1987). *See also* DAVID J. RAVENSCRAFT & F.M. SCHERER, MERGERS, SELL-OFFS AND ECONOMIC EFFICIENCY 220-21 (1987) (stating that European mergers have "exhibited little or no tendency to raise profitability and/or efficiency").

be to assure minority shareholders that the "fair price" promised them by existing Delaware precedents protected them from any diminution in value in a squeeze-out merger because of the payment of the control premium.[10]

The mechanics of this approach will be postponed until later; however, its key doctrinal attraction is that it is based on principles already latent in the Delaware case law. That is, Delaware law entitles minority shareholders in appraisal proceedings to their proportionate value in the existing enterprise. Although appraisal proceedings are an unwieldy remedy that smaller shareholders infrequently elect, this concept of proportionate value can be generalized to apply to other contexts as well. In this light, this article seeks to offer an integrated rationale by which principles developed in the context of Delaware appraisal proceedings can be reconciled with the better known Delaware precedents dealing with the fiduciary duties of a controlling shareholder who is seeking to acquire the remaining minority interest. Ultimately, the purpose of this effort is to achieve the same goals as those sought by the triggering thesis: namely, to encourage efficient transactions and chill inefficient ones.

To approach this goal, this article will begin by examining the triggering thesis from a broader-angled perspective. Its focus will expand beyond the doctrinal law on control premiums to a broader set of both state and federal legal rules that expose control seekers who pay control premiums to the danger that they will be forced to overpay in order to acquire complete ownership. The initial purpose of this survey will be to evaluate the degree to which these rules do or can perform the function of distinguishing efficient transactions from inefficient ones.

Among the legal rules that may inhibit an acquirer from paying a control premium that it is unwilling to offer to the noncontrolling shareholders, four stand out:

(1) the valuation standard in appraisal, which may or may not subject the minority's shares to a minority discount;[11]

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[10]The result is to create a disincentive for the acquirer to pay a premium for reasons unrelated to expected increases in the total value of the corporation because the acquirer will be forced to overpay in order to eliminate the minority. To illustrate, if the acquirer paid $10 per share for the 25% block held by a controlling shareholder in a corporation with an $8 per share intrinsic value, in order to exploit the "minority" by merging them out at $5 per share, the court could enjoin any merger below $8 per share.

[11]For recent decisions rejecting minority discounts, see Brown v. Allied Corrugated Box Co., 91 Cal. App. 3d 477, 486 (Cal. Ct. App. 1979) (holding that a minority shareholder, seeking involuntary dissolution, cannot receive less than the dissolution would result in merely because a controlling shareholder invokes a buyout remedy); Cavalier Oil Corp. v. Hartnett,

(2) the post-*Weinberger* case law in Delaware that requires a controlling shareholder to deal fairly with the minority shareholders if it decides to eliminate them in a cash-out merger;[12]

(3) the "best price" rule of the Williams Act that *sometimes* entitles the minority to receive the same premium paid to the control seller;[13] and

(4) the related "going private" rules adopted by the SEC under the Williams Act that strongly encourage the control seeker to offer the same control premium to all shareholders on equivalent terms.[14]

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564 A.2d 1137 (Del. 1989) (criticizing minority discounts as penalizing the minority while affording a windfall to the majority); Johnson v. Hickory Creek Nursery, 521 N.E.2d 236 (Ill. App. Ct. 1988) (refusing to apply a minority discount when it is "assumed" by the remaining shareholders, causing a substantial pro rata share increase for the remainder); Eyler v. Eyler, 492 N.E.2d 1071 (Ind. 1986) (holding that minority discounts are inapplicable to valuation of stock in divorce proceedings where the husband and wife own 90.2% of the outstanding shares); Woodward v. Quigley, 133 N.W.2d 38, 43 (Iowa 1964), *modified*, 136 N.W.2d 280 (Iowa 1965) (rejecting minority discounts to ensure that the minority receives the "real" value of their stock); *In re* McLoon Oil Co., 565 A.2d 997, 1004-05 (Me. 1989) (stating that use of minority discounts in valuation results in a transfer of wealth to the majority from the minority, encouraging squeeze-outs); Rigel Corp. v. Cutchall, 511 N.W.2d 579 (Neb. 1994) (holding that minority discounts cannot be considered when determining the value of a dissenting minority's shares in order for that group to be fully compensated); Friedman v. Beway Realty Corp., 87 N.Y.2d 161, 167 (N.Y. 1995) (rejecting minority discounts because they deprive the minority of their "proportionate interest in going concerns," violate the theory of equal treatment in buyouts, and encourage oppression by the majority) (citations omitted).

Nonetheless, some decisions continue to recognize minority discounts in appraisal proceedings. *See* Hernando Bank v. Huff, 609 F. Supp. 1124 (N.D. Miss. 1985), *aff'd*, 796 F.2d 803 (5th Cir. 1986); Perlman v. Permonite Mfg. Co., 568 F. Supp. 222 (N.D. Ind. 1983), *aff'd*, 734 F.2d 1283 (7th Cir. 1984); Atlantic States Constr., Inc. v. Beavers, 314 S.E.2d 245 (Ga. Ct. App. 1984); Independence Tube Corp. v. Levine, 535 N.E.2d 927 (Ill. App. Ct. 1989); Moore v. New Ammest, Inc., 630 P.2d 167 (Kan. Ct. App. 1981). A few decisions have even accepted minority discounts in buyout cases. *See* McCauley v. Tom McCauley & Son, Inc., 724 P.2d 232 (N.M. Ct. App. 1986).

[12]*See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993) (applying the entire fairness standard, as formulated in *Weinberger*, to claims arising from a cash-out merger); Weinberger v. UOP, Inc., 457 A.2d 701, 714-15 (Del. 1983) (holding that the entire fairness of a merger is shown by proving *both* fair dealing and fair price).

[13]*See* 17 C.F.R. § 240.14d-10 (1995). Section 14d-10 provides in pertinent part:

> (a) No bidder shall make a tender offer unless:
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> (1) The tender offer is open to all security holders of the class of securities subject to the tender offer; and
>
> (2) The consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer.

Id.; see also *infra* notes 35-60 and accompanying text which further analyze this provision.

[14]*See* 17 C.F.R. § 240.13e-3(g) (1995); see also *infra* text and accompanying notes 47-70 for a discussion of this provision.

Although the aggregate impact of these rules is uncertain, they could, in theory, counterbalance or even outweigh the impact of a state law rule that formally permits the control seller to monopolize the control premium.[15] If so, the prevailing rule on control premiums might have less actual impact than generally thought because the collective effect of federal law and these other state law rules offset its permissive approach. This dissonance between the prevailing rule authorizing control premiums and the various rules that undercut such may help explain and minimize the seeming disparity between U.S. law and that of most other nations on this topic.[16] More importantly, it hints that U.S. law may well already attempt to distinguish between efficient and inefficient control transfers, even if the existing sale of control doctrine does not adequately perform this function.

Tempting as this hypothesis may seem, it is premature to conclude that the broader U.S. law somehow distinguishes efficient from inefficient control transactions. First, no invisible hand exists to coordinate the distinct legal doctrines which this article will survey; rather, they are applied by different courts at different times with different goals in mind. Second, no strong consensus exists as to which types of control transactions are most or least likely to promote efficiency; nor is there agreement as to whether any class of transactions is sufficiently suspect as to merit chilling. Finally, the triggering thesis is not easily testable. At best, it is highly debatable whether the transactions that are discouraged under a specified legal regime, particularly one with inconsistent legal rules, would have been efficient or inefficient.

Thus, this article's starting point is to assume that the best unifying rationale for the various doctrines associated with control transfers is to distinguish efficient from inefficient transactions[17] and then ask how this goal can best be implemented.

Any such attempt at doctrinal integration requires that we look at two related contexts which are usually analyzed separately: (1) the sale of control transaction, and (2) the squeeze-out merger. In the first context, proponents of an "equal opportunity" rule have debated for decades with the advocates of control premiums.[18] Today, the consensus

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[15]See *supra* note 1 and accompanying text for commentary which discusses this general position.

[16]See *supra* notes 1-2 for a compilation of authorities highlighting the distinction between U.S. law and that of foreign jurisdictions.

[17]For a similar view, see Elhauge, *supra* note 4, at 1465-67 (noting that control doctrines must be integrated to optimize efficient transactions).

[18]See generally Elhauge, *supra* note 4, at 1465 for a general summary of these conflicting views.

view is that the latter have largely won because they have shown that an equal opportunity rule, entitling all shareholders to the same premium, will deter a greater number of efficient than inefficient transactions.[19] In the second context, the primary issue has been the price that the controlling shareholder must pay to eliminate the minority in a squeeze-out merger. Is it enough to pay simply the existing market price of the stock? Or must the controlling shareholder pay more, possibly even including some portion of the gains that it expects to realize after excluding the minority? Regardless of the context, the policy question remains the same: will any proposed rule deter more efficient transactions than inefficient transactions?

The fact that these contexts are linked proves little unless one can suggest an integrated answer. As a starting point toward such an answer, this article begins with the normative principle that the shareholders should be entitled to their proportionate interest in the corporation, absent any discount for minority status. This principle has long been followed by Delaware[20] and was recently adopted in New York appraisal proceedings.[21] However, even in Delaware, the concept is only partially recognized because it is viewed as a valuation principle and not a basis for broader class-wide relief.[22] Because appraisal proceedings are relatively uncommon, particularly in comparison to actions challenging the fairness of a merger, the rule against minority discounts is well-established,[23] but effectively of minimal significance.

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[19]*See* Kahan, *supra* note 3, at 369. See also Bebchuk, *supra* note 3, for the view that the net balance would be to discourage more efficient transactions than inefficient ones. See also Hermalin & Schwartz, *supra* note 3, at 355-56, for the argument that current legal rules over-reward minority shareholders, even without adopting an equal opportunity rule.

[20]*See* DEL. CODE ANN. tit. 8, § 262 (1995); *see also* Cavalier Oil Corp. v. Hartnett, 564 A.2d 1137 (Del. 1989) (rejecting minority discounts and entitling minority shareholders to a proportionate share in value of the firm).

[21]*See* Friedman v. Beway Realty Corp., 87 N.Y.3d 161 (N.Y. 1995).

[22]Sometimes the disparity is alarming between what the minority receives in an appraisal proceeding and what it receives in a *Weinberger*-style action to enjoin the merger. In Selfe v. Joseph, 501 A.2d 409 (Del. 1985), the attempt of the Royal Dutch Shell Group to merge out the last 5.4% interest in Shell Oil Company was enjoined, and as a result the merger price was raised from $58 to $60. *See In re* Shell Oil Co., 607 A.2d 1213, 1216 (Del. 1992). However, in the follow-up appraisal proceeding, those shareholders who elected appraisal received $71.20 per share plus interest. *Id.* at 1215.

[23]See *supra* note 11 and accompanying text for a discussion of cases which disallow minority discounts; *see also* Charles Murdock, *The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares*, 65 NOTRE DAME L. REV. 425, 473 (1989) (discussing state court views on minority discounts); Robert B. Heglar, Note, *Rejecting the Minority Discount*, 1989 DUKE L.J. 258 (noting the trend in case law which rejects minority discounts).

In principle, this rule could easily be generalized and extended to the *Weinberger* proceeding.[24] Under *Weinberger*, Delaware courts permit minority shareholders to challenge a squeeze-out merger when they allege that they have been treated unfairly.[25] In such proceedings, the controlling shareholder must demonstrate two elements: fair dealing and fair price.[26] Thus, as a doctrinal matter, it would be simple to equate "fair value" in appraisal with "fair price" under *Weinberger*.[27] If this were done, a transaction in which a shareholder did not receive his or her proportionate share in the existing value of the corporation would be actionable both in a damages action and, in appropriate cases, by means of injunction.

The assertion of such a generalized rule, without more, will encounter objections because it is both controversial and ambiguous. First, it is controversial because the legitimacy of the control premium implies to many the inevitability of compensating minority discounts.[28] Second, ambiguity arises because the concept of proportionate value is not self-defining. As a concept, proportionate value has fuzzy edges, and ambiguity is costly because it exposes many transactions to attack under an ill-defined standard.

Thus, any proposed answer must be relatively precise and must not sweep overbroadly so as to discourage efficiency-promoting transactions. Although the issue of the possible overbreadth of any proposed remedy can be postponed, the assumed linkage between the control premium and the minority discount must be faced at the outset because it is central to whether efficiency-enhancing transactions will be discouraged. To illustrate the problem, it is useful to begin with a simple example to which this article will periodically return. Assume that a control acquirer, who has paid a premium to the controlling shareholder, shortly thereafter seeks to follow up its *de facto* acquisition of control with a squeeze-out merger of the remaining shareholders. This acquisition will trigger the appraisal statute in the corporation's jurisdiction of incorporation. To the extent that there cannot be any minority discount in the appraisal court's determination of "fair value," the ability of an acquirer to pay a control

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

[25]*Id.*

[26]*Id.* at 711-15.

[27]Today, the concept of "fair price" has been defined only in exceedingly general terms. *See infra* notes 246-49 and accompanying text. Conversely, the term "fair value" is subject to a special statutory limitation. *See* DEL. GEN. CORP. LAW § 262(h) (1995); *In re Shell Oil*, 607 A.2d at 1218. *See also infra* text and accompanying note 268 (discussing the fair value requirement of DEL. GEN. CORP. LAW § 262(h)).

[28]*See, e.g.*, Heglar, *supra* note 23, at 269.

premium at the earlier first-step control acquisition stage seems at least marginally restricted. Specifically, let us assume that the "intrinsic value" of the corporation is $20 per share[29] and that the new controlling shareholder acquired a 50% controlling block by paying $30 per share for this block.[30] If the acquirer now seeks to use this 50% control block to impose a squeeze-out merger on the minority stockholders, it logically will wish to pay no more than $10 per share to the remaining minority shareholders.[31] Yet, if all minority shareholders were to exercise their appraisal remedy, they could seemingly demand their proportionate share in the firm's value, which is $20 per share. A judicial decision to award $20 per share would in turn raise the average price per share for the entire acquisition to an uneconomic $25 per share.

The point of this example is that any definition of the firm's "fair value" in appraisal which seeks to award proportionate value seems inconsistent with the payment of any significant control premium, *unless the acquirer anticipates significant synergies from the acquisition that justify paying a price greater than the firm's "intrinsic value" as a free-standing entity.*

This last "unless" clause is critical because it separates a transaction that creates wealth from one that merely transfers it. When an acquirer is willing to pay a premium to some shareholders plus proportionate value to the remainder, this willingness signifies that it views the acquisition as a value-enhancing one.[32] When the acquirer is not so willing, the possibility surfaces that the acquisition may be simply a wealth transferring one. For example, assume that the intrinsic value of a hypothetical firm is still $20 per share, but that the acquirer is willing to pay $30 per share for the first 50% and $20 per share for the remaining 50%. In this case, the acquirer must anticipate that wealth will be created as a result of the acquisition because it is paying an average cost of $25 per share. But when the same acquirer offers $28 per share for the first 50%, in the hopes of paying only $10 per share for the remaining 50% in the same company, the same conclusion does not

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[29]For this purpose, assume also that this intrinsic value represents both the corporation's "going concern" value and its liquidation value and excludes any synergistic gain that the acquirer expects to realize by combining or consolidating the corporation with another firm or business.

[30]In other words, the controlling shareholder received a 50% control premium over the $20 per share intrinsic value.

[31]It would be willing to pay more than $10 per share only if it expects synergistic benefits from the merger; in such a case, the firm will have a value to the acquirer greater than its intrinsic value to its former shareholders.

[32]*See* Elhauge, *supra* note 4, at 1484.

necessarily follow. In this circumstance, it may only be seeking to transfer wealth from the minority shareholders to itself.

Some will dismiss this argument as simply a "fairness" claim, but it can be articulated equally as well in efficiency terms. To the extent that the law permits uncompensated wealth transfers, the law creates unproductive uncertainty and leaves the minority's property rights inadequately defined. Thus, legal rules that permit such wealth transfers are not only arguably unfair, but also inefficient because they increase agency costs, chiefly by permitting managers and insiders to exploit asymmetric information about the firm's value.

Part I of this article will evaluate the inventory of legal doctrines by which courts review and regulate control transactions doctrines. Here, the focus will be on the differing scope and potential utility of these doctrines as a means by which to distinguish efficient from inefficient transactions.

Part II will examine the likelihood of inefficient control transfers. Based in part upon data which suggests that the stock prices of publicly held corporations declines as a controlling block is assembled,[33] this article disagrees with the view advanced by some economists that fair value should be defined simply in terms of the stock market price prior to the announcement of the buyout.[34] Indeed, it is insufficient for the case law simply to reject minority discounts, as Delaware decisions have clearly done, because the stock market price inherently builds a minority discount into the corporation's stock price in some settings. Hence, an unbiased estimator of firm value must be sought in those circumstances where the structure of share ownership affects firm value. Part II will also consider the economic arguments both for and against a proportionate value standard.

Part III addresses the problems of implementation. Here, the key issue is how to define proportionate value in settings where asymmetric information is inherent. The proposed answer to this problem should be familiar for the Delaware lawyer. When the use of asymmetric information is unlikely, as in an arm's-length transaction between unaffiliated parties, a strong presumption should favor the "fairness" of the value approved by the board of directors. However, in cases involving insiders seeking to take the firm private, the burden should be on the insider to demonstrate that proportionate value has been offered.

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[33] *See* Karen Wruck, *Equity Ownership Concentration and Firm Value*, 23 J. FIN. ECON. 3, 4 (1989). See also *infra* text and accompanying notes 196-207 for a discussion of the Wruck study.

[34] *See* Hermalin & Schwartz, *supra* note 3.

Finally, Part III will consider what proportionate value should mean when the potential for synergy leads insiders to seek to expel the public shareholders.

In sum, this article does not seek to challenge the rule that a seller may receive a control premium, but it does seek to focus on whether the legitimacy of the control premium has any necessary corollary for the valuation of minority shares.

PART I. THE BARRIERS TO CONTROL PREMIUMS

Few, if any, U.S. cases have held that control premiums could not be paid. Rather, the disincentives to their payment have been implicit and indirect. Among them, the following obstacles stand out:

A. *The Williams Act and the Equal Opportunity Concept*

1. Rule 14d-10

Promulgated by the SEC in 1986 under the Williams Act, Rule 14d-10 (Equal Treatment of Security Holders) codifies an incomplete "equal opportunity" rule by requiring that a tender offer be "open to all security holders of the class of securities subject to the tender offer."[35] More importantly, this section specifies that "[t]he consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer."[36] This latter obligation is known as the "best price rule," and it has an express foundation in the Williams Act.[37] Rule 14d-10 is also collaterally supported by Rule 10b-13, which forbids purchases outside the tender offer "from the time such tender offer . . . is publicly announced or otherwise made known . . . until the expiration of the period . . . ."[38] In effect, the Williams Act is read by the SEC to mean that the bidder cannot buy outside the tender offer once it has begun, must keep the tender offer open to all, and must pay the highest price paid to any holder to all who tender.

At first glance, both rules seem easily avoidable because neither prohibits a control purchase made days before the announcement, nor

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[35]*See* 17 C.F.R. § 240.14d-10 (1995). *See generally* Hazen, *supra* note 1, at 278-81 (discussing § 240.14d-10).

[36]17 C.F.R. § 240.14d-10 (1995).

[37]17 C.F.R. § 240.14d-10 (1995).

[38]*See* 17 C.F.R. §240.10b-13 (1995).

days after, the expiration of a tender offer.[39] However, the reach of Rule 14d-10 should not be underestimated because it may apply when an apparently private transaction is made contingent on the consummation of the tender offer. The best illustration of this potential reach is supplied by a recent Ninth Circuit decision, *Epstein v. MCA, Inc.*[40] In *Epstein*, the chief executive officer and chief operating officer of MCA, Inc. each entered into special side deals just hours before the announcement of a $6.1 billion tender offer by Matsushita Electric Industrial Co., Ltd. (Matsushita) for MCA, Inc. (MCA).[41] Specifically, Matsushita reached a separate agreement with MCA's chairman and chief executive officer, Lew Wassermann, under which Wassermann would exchange his MCA shares for preferred stock in a wholly-owned subsidiary of Matsushita (MEA Holdings).[42] Matsushita also agreed to fund MEA Holdings by contributing 106% of the tender price paid to other shareholders multiplied by the number of MCA shares Wassermann exchanged.[43] Under the terms of this agreement, Wassermann was assured eventual redemption of his preferred stock[44] plus an attractive dividend over the interim in a transaction that qualified as a tax-free reorganization.[45]

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[39]*See, e.g.*, Kahn v. Virginia Retirement Sys., 13 F.3d 110 (4th Cir. 1993), *cert. denied*, 114 S. Ct. 1834 (1994) (holding that Rule 14d-10 does not reach purchases made two days before the announcement of the tender offer); Hanson Trust PLC v. SCM Corp., 774 F.2d 47 (2d Cir. 1985) (refusing to integrate purchases made hours after the cancellation of a tender offer).

[40]50 F.3d 644 (9th Cir. 1995), *rev'd on other grounds*, Matsushita Elec. Indus. Co. v. Epstein, 116 S. Ct. 873 (1996); *see also* Field v. Trump, 850 F.2d 938, 943-46 (2d Cir. 1988), *cert. denied*, 489 U.S. 1012 (1989) (rejecting defendants' contention that the transaction amounted to two separate tender offers rather than an integrated single offer where the bidder called off its tender offer and later reinstated it).

[41]*Epstein*, 50 F.3d at 647.

[42]*Id.* at 647-48 & n.2.

[43]*Id.* at 648.

[44]*Id.* The MEA shares were also made redeemable on the death of Wassermann or his wife, but in no event earlier than five years after the date of exchange. *Id.*

[45]*Epstein*, 50 F.3d at 648. Unlike Wassermann, the other shareholders sold their stock to Matsushita for cash in a taxable transaction. *Id.* Sidney Sheinberg, MCA's chief operating officer, was also involved in deals similar to that of Wassermann. *Id.* Pursuant to Matsushita's $71 per share offer, Sheinberg received $83,754,085. *Id.* Upon Matsushita's accepting the shares, Sheinberg received an additional $21 million for unexercised stock options. *Epstein*, 50 F.3d at 648.

Following the Wassermann and Sheinberg transactions, former MCA shareholders filed suit in the United States District Court for the Central District of California, alleging that Matsushita violated SEC Rule 14d-10 by treating Wassermann and Sheinberg differently than the other shareholders in the tender offer. *Id.* In deciding whether Rule 14d-10 was violated, the court, on appeal, had to consider whether Wassermann received greater consideration than

Not only was this side deal entered into on the morning of the announcement of Matsushita's tender offer, but it was scheduled to close (and did close) minutes after Matsushita accepted the shares tendered in its tender offer.[46] More importantly, both sides conditioned their obligations to perform on the consummation of the offer.[47] In this manner, Wassermann got the benefit of the "best price" in the tender offer because he would automatically free-ride on any price improvement made by Matsushita to its tender offer.[48] In turn, Matsushita avoided making a large and illiquid investment in MCA if it failed to gain control. Finally, Wassermann obtained special tax benefits that would not have been available if he had received the same cash consideration as the other shareholders.

Despite the clearly interwoven relationship between the Wassermann transaction and the public tender offer, Matsushita argued that Rule 14d-10's prohibitions end the moment that the bidder accepts the tendered shares.[49] The Ninth Circuit panel rejected this rigid time frame,[50] but proposed a counter-theory that is potentially open-ended: "If

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the plaintiff-shareholders or consideration which was never offered to the plaintiffs. *Id.* at 654.

[46]*Id.* at 653.

[47]*Id.* at 653-56. The agreement between Wassermann and Matsushita was conditioned on four factors. First, neither party was obligated to perform if any of the terms of the tender offer failed. *Id.* at 653. Second, the Wassermann deal was required to occur "immediately following" acceptance of the tender offer. *Id.* Third, the amount Matsushita was to contribute to MEA Holdings was conditioned on the tender price. *Id.* Fourth, the redemption value of Wassermann's preferred stock was required to be equivalent to the tender price. *Epstein*, 50 F.3d at 653.

[48]For example, this would occur if a rival bidder made a higher offer. The redemption value was set at the tender price. Thus, if Matsushita were forced to improve its tender offer, it would also have to improve its redemption price and its funding of the MEA Holdings preferred stock. *Id.* at 653.

[49]*Epstein*, 50 F.3d at 654. Focusing on timing, Matsushita argued that the Wassermann deal fell beyond the reach of Rule 14d-10 because it "closed *after* the tender offer expired." *Id.*

[50]*Id.* The court rejected Matsushita's argument, finding that Rule 14d-10, like other securities laws, does not dictate a rigid timing requirement. *Id.* Aside from finding that the text of 14d-10 lacked any reference to timing, the court also noted that the history of the rule negated any timing arguments. *Id.* at 655. In reviewing the history of the rule, the court found its focus to be the "equality of treatment" among shareholders and not the timing of the actual transaction. *Id.*

> We therefore reject Matsushita's timing argument. Indeed, if adopted, it would drain Rule 14d-10 of all its force. Under Matsushita's reading, even the most blatantly discriminatory tender offer — in which large shareholders were paid twice as much as small shareholders — would fall outside Rule 14d-10's prohibition, so long as the bidder waited a few seconds after it accepted all of the tendered shares before paying the favored shareholders. . . [Rule 14d-10] cannot be so easily circumvented.

an ostensibly private agreement that pays a particular shareholder a sum greater than the tender price is deemed a part of the tender offer, the tender offer does not end, by definition, until that agreement is performed."[51]

After *Epstein*, the operative question becomes whether the private "transaction was an integral part of [the] . . . tender offer".[52] The *Epstein* court adopted a functional test to answer this question. Although the court stated it would clearly be overbroad to assert simply that "a private purchase of stock and a public tender offer are both part of a single plan of acquisition,"[53] purchases that are conditioned on the success of the offer or that are automatically enhanced by increases in the tender offer price do seem likely to be integrated with the tender offer under *Epstein*. For the control seeker, *Epstein* implies that attempts to make conditional purchases in order to avoid the danger of acquiring a large and illiquid investment without control are fraught with danger because they may violate Rule 14d-10.

On a policy level, however, there seems to be nothing inherently objectionable about the bidder's goal of avoiding an illiquid, noncontrolling investment. The tender offer is, itself, a mechanism designed to confer precisely this protection against acquiring only a noncontrolling block because the bidder can always specify a minimum tender condition in its offer. Although the bidder probably could have protected itself by other means,[54] it is possible that future persons in the position of Mr. Wassermann would be unwilling to accept the transaction, except on a contingent and tax-free basis. To this extent, economists

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Id. Thus, the court's analysis focused on whether the Wassermann agreement was an "integral part" of the primary tender offer. *Id.*

[51] *Id.* at 656 n.19.

[52] *Id.* at 655.

[53] *Epstein*, 50 F.3d at 656. In formulating its rationale, the court noted that stock transactions which occur before or after a tender offer do not violate Rule 14d-10 "provided that all material terms of [such a] transaction stand independent of the tender offer." *Id. See also* Kahn v. Virginia Retirement Sys., 13 F.3d 110 (4th Cir. 1993), *cert. denied*, 114 S. Ct. 1834 (1994) (holding that Rule 14d-10 was not violated by a bidder's unconditional private purchase of target's shares two days prior to the announcement of tender offer). Other decisions have also refused to integrate pre- and post-tender offer private purchases with the tender offer. *See* Kramer v. Time Warner, Inc. 937 F.2d 767, 778-79 (2d Cir. 1991); Hanson Trust PLC v. SCM Corp., 774 F.2d 47 (2d Cir. 1985).

[54] For example, Matsushita could have purchased an option on Wassermann's stock, thus enabling it to avoid any stock purchase if its tender offer was unsuccessful. The option price could have been set sufficiently high as to assure Wassermann an attractive return, even if Matsushita did not exercise the option.

would argue that all shareholders, as well as economic efficiency, suffer because Rule 14d-10 precludes price discrimination among shareholders.

Although this criticism goes to the heart of Rule 14d-10 and, if accepted, implies that an equal opportunity rule would be undesirable, it affords a policy justification for closely construing the rule and holding it to precise time limits. In a post-*Epstein* case, the Seventh Circuit, in a decision written by Judge Frank Easterbrook, has done exactly this.[55] In *Lerro v. Quaker Oats Co.*,[56] the plaintiffs claimed that payments made to a controlling shareholder of the target company, ostensibly in connection with the modification of a distributorship agreement, actually constituted consideration received by the controlling shareholder.[57] This transaction fell within Rule 14d-10, thus allowing other shareholders to become entitled to an equal amount from the bidder.[58] Although factual distinctions were obvious that suggested that the payments were not made pursuant to the tender offer, but were a substitute for the controlling shareholder's rights under an exclusive distributorship agreement, the district court found it easier to assume, for purposes of a motion to dismiss, that the disputed payments were made for the controlling shareholder's shares.[59] Even in this event, it said, the case still had to be dismissed "because the Distributor Agreement had been signed before the tender offer began and therefore fell outside Rule 14d-10(a)(2), which requires only that the bidder pay every tendering investor the 'highest consideration paid to any other security holder *during* such tender offer.'"[60] Agreeing with the district court's analysis, Judge Easterbrook provided a policy justification for it:

> Purchases near in time to a tender offer, but outside it, may be essential to transactions that all investors find beneficial. Controlling shareholders often receive indirect or non-monetary benefits and are unwilling to part with their stock (and hence with control) for a price that outside investors find attractive. At the same time, potential bidders may be unable to profit by paying everyone the price essential to separate the insiders from their shares. . . . Treating the Williams Act as a mandate for an identical price across the

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[55]*See* Lerro v. Quaker Oats Co., 84 F.3d 239 (7th Cir. 1996).

[56]84 F.3d 239 (7th Cir. 1996).

[57]*Id.* at 240.

[58]*Id.*

[59]*Id.* at 241.

[60]*Quaker Oats*, 84 F.2d at 241 (quoting 17 C.F.R. § 240.14d-10(a)(2) (1995) (emphasis added)).

> board — as opposed to an identical price for all shares acquired in the offer — would make all investors worse off.[61]

Based on this rationale, an equal opportunity rule never makes sense, and, even as so confined, Rule 14d-10 seems undesirable. But even Judge Easterbrook would apparently impose some limits:

> Doubtless there are limits to the use of a follow-up merger as a means to deliver extra compensation. Suppose Quaker Oats had promised [the controlling shareholder] $14 for each share he tendered during the offer, plus another $6 for each of these shares one month later. Just as tax law requires 'boot' to be treated as a gain received from the sale of stock, securities law treats 'boot' as a payment during the tender offer.[62]

This exception for "boot" creates ambiguities even under the Seventh Circuit's narrow construction of Rule 14d-10. Potentially, modifications to stock options, agreements relating to golden parachutes, or incentive compensation could fall within it if the agreement is reached during the pendency of the tender offer.

Ultimately, the tension between *Epstein* and *Quaker Oats* not only frames a central policy issue (i.e., the desirability of an equal opportunity rule), but also reveals the potential vulnerability of the existing sale of control doctrine. A modest enlargement in the definition of "tender offer" could overwhelm the existing doctrine by allowing Rule 14d-10 to sweep earlier or subsequent private purchases within its "best price" rule. At several points in the past, such broader definitions of "tender offer" have come close to adoption by the SEC.[63]

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[61] *Id.* at 243. Judge Easterbrook gives an example under which the firm's stock is trading for $20 and insiders who hold 30% would not sell for less than $30, while the bidder believes the entire firm is worth $25 per share. *Id.* On these facts, he opines that "if the acquirer could pay $30 to the control group before the bid commences and acquire the rest of the stock at $22 per share, for an average price of $24.40 . . . [e]veryone is better off." *Id.* Ignored by this example is the possibility that the insider's claimed refusal to sell for less than $30 was feigned or that proportionate value was greater than $22 per share.

[62] *Lerro*, 84 F.3d at 245.

[63] Harold Williams, an SEC chairman, suggested that an acquisition of 10% of a class of equity securities should be defined as a tender offer. *See* Letter of Harold M. Williams, Chairman of Securities Exchange Commission, to Senator William Proxmire, *reprinted in* [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,453 (Feb. 14, 1980). Two years later, the SEC's Advisory Committee on Tender Offers recommended a 20% threshold at which closely connected purchases would be deemed a tender offer. *See* Statement of John S.R. Shad,

2. Rule 13e-3

The Williams Act's preference for an equal opportunity rule is even more evident in the "going private" rules that the SEC has adopted under section 13(e) of the Securities Exchange Act of 1934.[64] Essentially, Rule 13e-3 creates a strong disincentive to paying control premiums when the acquirers intend to follow up such purchases and acquire the remaining shares. This is achieved by carving out an exemption from its rigorous disclosure requirements for a two-step tender offer and follow-up merger transaction in which the acquirer agrees at the outset to pay the same price in the follow-up merger as it paid in the front-end tender offer. Specifically, this exception requires that both

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Chairman of SEC, before Hearings of the House Committee on Telecommunications, Consumer Protection & Finance Concerning Recommendations of the SEC Advisory Committee on Tender Offers, [1984 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 83,511, at 86,679 (Mar. 28, 1984).

[64] *See* 17 C.F.R. § 240.13e (1995). Rule 13e provides:

When a person other than the issuer makes a tender offer for, or request or invitation for tenders of, any class of equity securities of an issuer subject to section 13(e) of the Act, and such person has filed a statement with the Commission pursuant to § 240.14d-1 and the issuer has received notice thereof, such issuer shall not thereafter, during the period such tender offer, request or invitation continues, purchase any equity securities of which it is the issuer unless it has complied with both of the following conditions:

(a) The issuer filed with the Commission eight copies of a statement containing the information specified below with respect to the proposed purchases:

(1) The title and amount of securities to be purchased, the names of the persons or classes of persons from whom, and the market in which, the securities are to be purchased, including the name of any exchange on which the purchase is to be made;

. . . .

(3) The source and amount of funds or other consideration used or to be used in making the purchases, and if any part of the purchase price or proposed purchase price is represented by funds or other consideration borrowed or otherwise obtained for the purpose of acquiring, holding, or trading the securities, a description of the transaction and the names of the parties thereto; and

(b) The initial statement shall be accompanied by a fee payable to the Commission as required by § 240.0-11.

(c) The issuer has at any time within the past 6 months sent or given to its equity security holders the substance of the information contained in the statement required by paragraph (a) of this section: *Provided, however,* That any issuer making such purchases which commenced prior to July 30, 1968 shall, if such purchases continue after such date, comply with the provisions of this rule or before August 12, 1968.

Id.

steps be affected on the same or "substantially similar" terms pursuant to a preannounced plan and within a prescribed one year time period.[65] In effect, the control seeker is given a choice: (1) offer all shareholders the same terms from the outset and effect both steps within one year, or (2) pay a control premium and accept costly and intrusive governmental regulation as well as potential liability for disclosure violations.[66]

Viewed from a policy perspective, the SEC's preference for equality has one serious drawback. Although its rules have great potential bite, they do not begin to frame a standard that distinguishes efficient transactions from inefficient ones. This is clearest in the *Epstein* case, where the financial liability was potentially significant, but the transaction seemed an efficiency promoting one in which a foreign acquirer would take over and recapitalize a declining U.S. firm.[67] The SEC's premise seems not to be that it was blocking inefficient transactions, but that it was blocking none because the bidder does not need to price discriminate. Although this is debatable, the SEC's "equal opportunity" rules clearly do not perform the triggering function contemplated by Professor Elhauge.[68] At most, its rules only discourage unequal sharing of the control premium in cases where the efficiency gains from unequal sharing would be modest.

B. *Control Seller Liability: Still Alive But Flickering*

Despite the general rule that a controlling shareholder is free to sell at a premium not available to the other shareholders, there remains a miscellaneous assortment of instances in which sellers who receive a control premium can be held liable. Most fall under the following headings:

1. Sales to "Looters"

The classic exception to the general rule arises when the seller had reason to suspect that its buyer planned to "loot" the company.[69]

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[65] 17 C.F.R. § 240.13e-3(g) (outlining the exceptions to Rule 13e-3).

[66] *Id.* Of course, it is possible to make privately negotiated control purchases in advance of the tender offer at a premium when appropriate, full disclosure occurs. However, it remains uncertain whether the staff would seek to deny the availability of Rule 13e-3(g) in such a case.

[67] *See* Epstein v. MCA, Inc., 50 F.3d 644 (9th Cir. 1995), *rev'd on other grounds*, 116 S. Ct. 873 (1996); *see also supra* notes 40-54 (discussing the *Epstein* case).

[68] *See* Elhauge, *supra* note 4, at 1523-32 (discussing the triggering theory).

[69] *See, e.g.*, DeBraun v. First W. Bank & Trust Co., 120 Cal. Rptr. 354 (Cal. Ct. App.

Delaware law has long used a "reasonable suspicion" standard, which is triggered by the "existence of facts that would give rise to suspicion by a reasonably prudent person."[70] In short, actual knowledge of an improper purpose is not required, but the duty of care that a controlling shareholder must observe can apparently be "breached only by grossly negligent conduct."[71]

2. Sales of Office

If the seller holds a block too small to carry control by itself and receives an obvious control premium, courts may infer that the seller has actually sold a corporate office, which is impermissible conduct for a fiduciary.[72] The result is an uncertain body of law that seeks to determine when the seller holds *de facto* "working control" by virtue of

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1975) (holding that a majority shareholder has a duty of due care and reasonable investigation when a control purchaser intends to loot the corporation). For a review of the case law regarding looting, see Elhauge, *supra* note 4, at 1467-68; Hamilton, *supra* note 1, at 263 & n.37; F. Hodge O'Neal, *Sale of a Controlling Corporate Interest: Bases of Possible Seller Liability*, 38 U. PITT. L. REV. 9, 16-23 (1976).

[70]*See* Harris v. Carter, 582 A.2d 222, 233-34 (Del. Ch. 1990) (discussing the seller's duty to the corporation in control sales where looting occurs).

[71]*Id.* at 236.

[72]*See, e.g.*, *In re* Caplan, 246 N.Y.S.2d 913 (N.Y. App. Div.), *aff'd*, 198 N.E.2d 908 (N.Y. 1964) (stating that "the management of a corporation is not the subject of trade and cannot be bought apart from actual stock control"); *see also* CLARK, *supra* note 1, at 480-81 (discussing the sale of office concept); Alfred Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986, 997-98 & n.33 (1956-1957) (stating that "[i]n situations where officers and directors have made a sale of particular jobs or of the machinery of control unaccompanied by the sale of shares . . . the courts have uniformly held the sellers accountable for the sums received"). Although sales of office are "per se illegal," courts allow control sellers to install the control buyer's nominees into corporate positions as part of the sale agreement. Elhauge, *supra* note 4, at 1469. Since the buyer would ultimately be allowed to vote in his nominees, regulation of such really serves no purpose and deters control sales. *Id.* at 1469-70. However, this rule is problematic because it is difficult to determine what percentage of the stock constitutes a control block. *Id.* at 1470. Aside from the "working control" rule applied in New York, other courts require that the control block sold represent over 50% of the voting stock in order for the transaction to be valid. *Id.* Both of the tests are plagued by advantages and disadvantages. Proponents of the latter test argue that the existence of working control is both difficult and costly to establish. Elhauge, *supra* note 4, at 1469. However, the wholly preclusive nature of the latter rules for buyers with less than 50% can be just as costly as the working control rule. *Id.* These buyers would now have to pay for a special or wait for an annual meeting to purchase control while also risking noncontrol for some time. *Id.*

its stock ownership.[73] New York courts have found the seller of a 3% block liable,[74] yet wavered at 9.7%.[75]

3. "Constructive Looting": Diversions of Business Opportunities and Nonprofit Maximizing Behavior

The hardest group of cases to classify are those in which the seller had reason to know that its buyer would run the business in a manner that would thereafter be less profitable to the noncontrolling shareholders.[76] The best known example of this category is *Perlman v. Feldmann*,[77] in which a controlling shareholder of a steel manufacturer sold his block to a consortium of steel users who appeared to have been seeking a captive source of supply during a period of acute scarcity caused by the Korean War.[78] Although the company was subject to wartime price controls, the controlling seller, who was also the CEO, had effectively evaded them by demanding interest-free loans from his customers.[79] Finding that the control seller had sold "for personal gain corporate advantages to be derived from a favorable market situation,"[80]

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[73]*See* Essex Universal v. Yates, 305 F.2d 572, 577 (2d Cir. 1962) (applying the working control rule in sales of office). *See also* Elhauge, *supra* note 4, at 1469-73 (discussing sales of office as an "amorphous" exception to the equal sharing rule).

[74]*See, e.g., In re* Caplan, 246 N.Y.S.2d 913 (N.Y. App. Div. 1964).

[75]*See, e.g.*, Carter v. Muscat, 251 N.Y.S.2d 378 (N.Y. App. Div. 1964) (noting that a stable percentage of stock is not "continuously[ ] sufficient to maintain control," even if it had been deemed sufficient for many years prior).

[76]*See* Elhauge, *supra* note 4, at 1473-80 (discussing the diverted business opportunity exception).

[77]219 F.2d 173 (2d Cir. 1955).

[78]*Id.* at 174-75. C. Russell Feldmann, the principal defendant, was both the president and chairman of the board of Newport Steel Corporation. *Id.* at 174. The derivative suit in this case arose out of the sale of Newport stock to the Wilport Company. *Id.* at 175. The plaintiffs, who were minority shareholders of Newport, argued that the sale of their interest resulted in illegal gains for the defendants. *Id.* at 174-75. The alleged illegal gains were caused by the inclusion of a corporate asset in the purchase price of the stock. *Id.* at 174-75. Essentially, the plaintiffs asserted that the defendants needed to account to the "nonparticipating" shareholders for their shares of the profits that were derived from the corporate asset. *Id.* at 175.

[79]*Id.* at 177. The controlling seller of the stock was also the company's CEO. *Id.*

[80]*Id.* at 176.

> We do not mean to suggest that a majority stockholder cannot dispose of his controlling block of stock to outsiders without having to account to his corporation for profits or even never do this with impunity when the buyer is an interested customer, actual or potential, for the corporation's product. But when the sale necessarily results in a sacrifice of this element of corporate good will and consequent unusual profit to the fiduciary who has caused the

the Second Circuit held that the seller must share the control premium he had received with the minority shareholders.

Perlman has long been the darling of the law school nursery, because it involves a host of collateral issues.[81] Despite its appeal for academics, there remains considerable doubt that *Perlman* would be followed today.[82] At the least, it seems questionable that a court would hold a control seller to a negligence standard. Instead, a court might require some standard of scienter approaching actual knowledge, at which point the seller could be seen as an aider and abetter in the buyer's intended fiduciary abuse.

4. Diverted Offers

Another traditional category which has divided the courts involves offers that were originally made to the corporation, but which the controlling shareholder converts into an offer for its own shares.[83] For example, a corporate acquirer might offer either to buy a crown jewel asset or to merge with the target corporation, at the same premium to all shareholders. In response, the controlling shareholder might substitute its own proposal to sell only its own shares, thereby diverting the premium to itself. Some cases have found a breach of fiduciary duty on these facts,[84] while others have not.[85]

> sacrifice, he should account for his gains. So in a time of a market shortage, where a call on a corporation's product commands an unusually large premium, in one form or another, we think it is sound law that a fiduciary may not appropriate to himself the value of this premium.

Id. at 178.

[81]For example, should the measure of damages be the noncontrolling shareholders' proportionate share of the premium or the foreseeable loss that the seller caused the corporation?

[82]*See* Easterbrook & Fischel, *supra* note 1, at 715-19; Elhauge, *supra* note 4, at 1474-75 (discussing *Perlman* critically). *See also* Andrews, *supra* note 1, at 505 (discussing the *Perlman* decision in the context of his proposed equal opportunity rule).

[83]*See* Elhauge, *supra* note 4, at 1475.

[84]*See* Brown v. Halbert, 76 Cal. Rptr. 781 (Cal. Ct. App. 1969) (holding that a majority stockholder has a duty to fully disclose all aspects of a sale of the majority stock where the price is unavailable to the other stockholders); Commonwealth Title Ins. & Trust Co. v. Seltzer, 76 A. 77, 79 (Pa. 1910) (stating that "the mere fact that the means used to accomplish the unlawful end would, if standing alone, be lawful in themselves will not save such officer from responsibility to account for profits thus made by him which otherwise might have gone into the coffers of his corporation").

[85]*See, e.g.*, Tyron v. Smith, 229 P.2d 251 (Or. 1951) (holding that the majority, although directors, can sell their stock for any price without disclosing to the other stockholders the terms of the sale, so long as they act in good faith). *See also* Treadway Cos. v. Care Corp., 638 F.2d 357, 375-78 (2d Cir. 1980) (finding that a director has no duty to promote the

The Delaware law on this issue seems particularly complicated. This complexity is illustrated by a series of recent Delaware decisions in the *Thorpe v. CERBCO, Inc.*[86] litigation. In the *CERBCO* cases, plaintiffs sought to enjoin Robert and George Erikson, two controlling shareholders, from selling their controlling stock in CERBCO, Inc.[87] at a 700% premium over the market price of CERBCO's publicly traded stock.[88] Plaintiffs alleged that the buyer had initially sought not to acquire control of CERBCO, but to buy CERBCO's stock in a partially-owned subsidiary, Insituform East, Inc. (East), which CERBCO controlled.[89] The Eriksons allegedly responded by offering their own control block in CERBCO for sale.[90] Although this planned sale by the Eriksons was abandoned, plaintiffs still pursued the case, alleging that the defendants had caused CERBCO to sacrifice a lucrative corporate opportunity by seeking to convert a corporate sale of its East stock into a personal sale by the Eriksons of their own CERBCO stock.[91]

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interests of all shareholders in its transactions with third parties nor does it need to account to the other shareholders for profits derived from such dealings).

[86]No. 345, 1995, 1996 Del. LEXIS 144 (Del. Apr. 10, 1996), *aff'd in part, rev'd in part* Thorpe v. CERBCO, Inc., No. 11,713, 1993 Del. Ch. LEXIS 257 (Del. Ch. Oct. 29, 1993), *reprinted in* 19 DEL. J. CORP. L. 942 (1994), *reh'g denied*, Thorpe by Castleman v. CERBCO, Inc., 676 A.2d 436 (Del. 1996). For the earlier and lengthy history of this case, see Thorpe v. CERBCO, Inc., 611 A.2d 5 (Del. Ch. 1991) (denying motion to dismiss); Thorpe v. CERBCO, Inc., No. 11,713, [1993-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,447 (Del. Ch. Jan. 26, 1993), *reprinted in* 18 DEL. J. CORP. L. 1196 (1993) (granting motion for partial summary judgment); Thorpe v. CERBCO, Inc., No. 11,713, 1993 Del. Ch. LEXIS 257 (Del. Ch. Oct. 29, 1993), *reprinted in* 19 DEL. J. CORP. L. 942 (1994). Eventually, the case was dismissed after trial. Thorpe v. CERBCO, Inc., No. 11,713, 1995 Del. Ch. LEXIS 96 (Del. Ch. Aug. 9, 1995), *reprinted in* 21 Del. J. Corp. L. 339 (1996), *rev'd in part, aff'd in part*, No. 345, 1995, 1996 Del. LEXIS 144 (Del. Apr. 10, 1996).

[87]*CERBCO*, 611 A.2d at 8. The Eriksons served as directors of CERBCO as well as majority stockholders. *Id.* Prior to the institution of this litigation, the following facts occurred. In 1982, CERBCO underwent recapitalization, creating Class A and B common stock. *Id.* at 7. The Class B stock was convertible and had greater voting power than the Class A stock. *Id.* Although the recapitalization did not actually increase the Eriksons' control over CERBCO, it did increase their ownership of Class B stock to 80%. *CERBCO*, 611 A.2d at 7.

[88]*CERBCO*, No. 11,713, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,447, at 96,493, *reprinted in* 18 DEL. J. CORP. L. at 1198.

[89]*CERBCO*, 611 A.2d at 7-8. In 1985, CERBCO gained control of Insituform East. *Id.* at 7. Insituform also recapitalized, creating Class B common stock. *Id.* at 8. In 1990, the Eriksons agreed to sell their Class B stock for $24.24 per share. *Id.* However, the market value for this stock remained at $3 per share. *CERBCO*, 611 A.2d at 8. As a result of this transaction, the shareholder plaintiffs sued the Eriksons alleging that they breached their fiduciary duty by directing a corporate opportunity which belonged to CERBCO. *Id.*

[90]*Id.* at 8.

[91]*CERBCO*, No. 11,713, 1993 Del. Ch. LEXIS 257, at *10, *reprinted in* 19 DEL. J. CORP. L. at 955.

Ultimately, Chancellor Allen found, and the Delaware Supreme Court agreed, that the defendants had breached their fiduciary duties as CERBCO directors in their handling of the corporate opportunity.[92] However, Chancellor Allen further found that this breach of duty "neither caused any injury to CERBCO nor resulted in no substantial gain to the defendants."[93] Because the sale of East would have required shareholder approval as a sale of substantially all CERBCO's assets, Chancellor Allen concluded that the Eriksons, voting as shareholders, could have permissibly blocked it.[94]

Alternatively, Chancellor Allen reasoned that the defendants' power to sell their shares at a premium "afforded" them "with a veto power over [the] ways in which CERBCO itself might satisfy [the buyer's] business purpose."[95] This latter articulation is ambiguous and, in the view of the Delaware Supreme Court, came perilously close to treating the "right to pursue a control premium . . . [as absolving defendants] from any liability for the breach of fiduciary duty in the process."[96] Finding this too broad a proposition to accept, it partially reversed Chancellor Allen, agreeing with him that the defendants could act in their own self-interest by voting to block the sale, but still finding that damages could be awarded for their breach of fiduciary duty and further ruling that the defendants must "disgorge any benefits emanating from . . . that breach."[97]

At a minimum, *Thorpe v. CERBCO, Inc.* suggests that a controlling shareholder's right to veto desirable corporate transactions is not unlimited and does not "supersede the duty of loyalty owned by control persons."[98] The net effect is uncertain, because although Delaware directors must make full disclosure under *CERBCO*, controlling shareholders can still seemingly act to block a lucrative transaction for self-interested reasons.

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[92]*CERBCO*, No. 345, 1995, 1996 Del. LEXIS 144, at *3.

[93]*CERBCO*, No. 11,713, 1995 Del. Ch. LEXIS 96, at *3, *reprinted in* 21 DEL. J. CORP. L. at 342.

[94]*Id.* at *4, *reprinted in* 21 DEL. J. CORP. L. at 342. Even in the plaintiffs' estimation, CERBCO's East stock "constituted 68% of CERBCO's 1990 assets" and so represented a sale of substantially all its assets. *Id.* at *32-33, *reprinted in* 21 DEL. J. CORP. L. at 355. Thus, under § 271, shareholder approval was required for this sale of substantially all the firm's assets. DEL. CODE ANN. tit. 8, § 271 (1995).

[95]*CERBCO*, No. 11,713, 1995 Del. Ch. LEXIS 96, at *5, *reprinted in* 21 DEL. J. CORP. L. at 342.

[96]*CERBCO*, No. 345, 1995, 1996 Del. LEXIS 144, at *8.

[97]*Id.* at *3.

[98]*Id.* at *9.

5. Discrimination

In virtually every U.S. jurisdiction, it is axiomatic that shares of the same class must be treated equally in the payment of dividends or in the distribution of assets on liquidation, absent a contrary agreement or charter provision.[99] Normally, this rule is not a barrier to the payment of a control premium because it applies only to the corporation, itself, while the control premium is paid by the control purchaser who is typically not a fiduciary to the other shareholders. Yet, cases can arise in which the corporation becomes so involved in the payment of the premium that its own conduct arguably violates the principle of equality among shares of the same class. The best illustration of this is a New York case, *Beaumont v. American Can Co.*[100] American Can entered into a memorandum of intent to merge with Associated Madison Companies, Inc. (Madison).[101] Under the intended agreement, forty-five percent of the Madison shares would receive cash, while the remainder would receive securities of American Can.[102] After signing this agreement, American Can bought thirty-four percent of Madison's common stock from five institutional investors at $15 per share.[103] American Can then issued its own shares, valued at $12.61, in exchange for the vast majority of the publicly held shares.[104] Finding this differential to amount to discrimination against the public shareholders, the New York court found that the minority shareholders were also entitled to receive the higher $15 price.[105]

The key to this possibly surprising decision seems to have been that the target corporation (Madison) knew that the amount of cash consideration to be paid by the acquirer was limited.[106] Thus, by entering into the memorandum agreement, it participated in the disproportionate allocation of the merger premium to certain favored shareholders.[107] In

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[99]*See In re* Sea-Land Corp., 642 A.2d 792, 800 n.10 (Del. Ch. 1993) (stating that "all shares of the same type, series, or class are, by definition, equal"); Bank of N.Y. Co. v. Irving Bank Corp., 536 N.Y.S.2d 923, 925 (N.Y. 1988) (noting that all shares within the same class are equal); *see also* 1 ERNEST L. FOLK, III ET AL., FOLK ON THE DELAWARE CORPORATION LAW § 151.3, at 151:13 (Supp. 1995) (noting that "stockholders have the right to share in the profits of the company and in the distribution of its assets on liquidation").

[100]538 N.Y.S.2d 136 (N.Y. 1988).

[101]*Id.* at 137.

[102]*Id.*

[103]*Id.*

[104]*Beaumont*, 538 N.Y.S.2d at 137.

[105]*Id.*

[106]*Id.*

[107]*Id.*

effect, the court saw the facts as if the acquirer gave the cash to the target corporation, which then selectively distributed it among its own shareholders. The practical lesson of *Beaumont* is not to involve the corporation in the allocation of any premiums to only some of its shareholders.

Beaumont also suggests that corporations should be disallowed from formally approving or acquiescing in such a procedure. For practitioners, the problem with the decision is the uncertainty it creates about when mere knowledge by the issuer corporation will be deemed sufficient acquiescence or involvement in the acquirer's conduct so as to trigger *Beaumont*'s severe rule. Without explicitly rejecting *Beaumont*, Delaware courts have distinguished its facts and expressed skepticism about its application outside New York.[108]

C. *Appraisal Rights*

Typically, an acquirer of a controlling block will follow up its first-step acquisition with a squeeze-out merger, usually for cash.[109] Under Delaware law, such an acquisition will normally trigger appraisal rights.[110]

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[108]*See, e.g.*, Priddy v. Edelman, 679 F. Supp. 1425 (E.D. Mich. 1988), *aff'd*, 883 F.2d 438 (6th Cir. 1989) (applying Delaware law and holding that a stockholder does not have a fiduciary duty to the corporation unless it is the controlling stockholder); *In re Sea-Land*, 642 A.2d at 800-01 (distinguishing the *Beaumont* case and holding that the fiduciary duty of equal treatment is not breached by a disparate agreement *unless* the board approves it). In Thorpe v. CERBCO, Inc., No. 11,713, 1993 Del. Ch. LEXIS 257 (Del. Ch. Oct. 29, 1993), *reprinted in* 19 DEL. J. CORP. L. 942 (1994), Chancellor Allen reversed his own prior determination and found that the use of corporate processes to facilitate the sale of control stock was not improper, even though the controlling stockholders breached their fiduciary duty of loyalty by failing to disclose the offer to the board. *Id.* at *24-39, *reprinted in* 19 DEL. J. CORP. L. at 953-64. Although this decision seems in considerable tension with *Beaumont*, its continuing force seems questionable in light of the Delaware Supreme Court's remand of the case on other grounds. *See* Thorpe v. CERBCO, Inc., No. 345, 1995, 1996 Del. LEXIS 144 (Del. Apr. 10, 1996). Indeed, use of corporate processes for personal purposes seems in serious conflict with the Delaware Supreme Court's rationale in *Thorpe*.

[109]*See* Easterbrook & Fischel, *supra* note 1, at 723-33 (discussing freeze-out mergers).

[110]*See* DEL. CODE ANN. tit. 8, § 262 (1991 & Supp. 1992). The "market exception" in § 262(b)(2) will not apply in such a case, unless the consideration paid the minority consists of shares in another corporation. If the consideration is cash or debt securities or privately traded stock, the dissenters will be entitled to appraisal.

An appraisal proceeding "is intended to provide shareholders who dissent from a merger, on the basis of inadequacy of the offering price, with a judicial determination of the fair value of their shares." *Cavalier Oil*, 564 A.2d at 1142 (citing Cede & Co. v. Technicolor, Inc., 542 A.2d 1182, 1186 (Del. 1988); *Weinberger*, 457 A.2d at 714). *See also* Easterbrook & Fischel, *supra* note 1, at 722 (discussing appraisal in the context of freezeouts and case law which accompanies this subject); Angie Woo, *Appraisal Rights in Mergers of Publicly-Held*

More importantly, leading Delaware precedent indicates that in appraisal proceedings, minority shareholders should receive their "proportionate interest" in the corporation without any deduction for minority discounts.[111] The Delaware Supreme Court made this point emphatically in *Cavalier Oil Corp. v. Harnett*,[112] where it wrote:

> The application of a discount to a minority shareholder is contrary to the requirement that the company be viewed as a "going concern" . . . . More important, to fail to accord to a minority shareholder the full proportionate value of his shares imposes a penalty for lack of control, and unfairly enriches the majority shareholders, who may reap a *windfall* from the appraisal process . . . .[113]

Delaware Corporations: Something Old, Something New, Something Borrowed, and Something B.L.U.E., 68 S. CAL. L. REV. 719 (1995) (discussing the appraisal remedy in Delaware).

[111]*See, e.g., Cavalier Oil*, 564 A.2d at 1144-45 (rejecting minority discounts in valuation during appraisal proceedings); Tri-Continental Corp. v. Battye, 74 A.2d 71, 72 (Del. 1950) (stating that a "stockholder's proportionate interest in the corporate enterprise is . . . the true or intrinsic value of his stock which has been taken by the merger"). *See also* Heglar, *supra* note 23, at 266-80 (arguing that the minority discount is repugnant to the appraisal remedy's goals of fulfilling expectations and protecting against unfairness).

[112]564 A.2d 1137 (Del. 1989). Prior to this case, much litigation and factual history surrounded the parties' relationship. William J. Hartnett, Tom J. Billman, and Clayton C. McCuistion were investors on Equity Programs Investment Corporation (EPIC), which purchased model homes from builders for "lease-back purposes." *Id.* at 1139. A variety of subsidiaries emerged from EPIC, including EPIC Mortgage, Inc. (EMI), which serviced the mortgages on all EPIC's properties. *Id.* In 1983, Community Savings and Loan, Inc. (CSL) merged with EMI. *Id.* CSL was controlled by McCuistion and Billman. *Cavalier Oil*, 564 A.2d at 1139. Hartnett was offered nonconvertible, nonvoting preferred CSL shares in exchange for his stock; however, he refused this offer. *Id.* at 1140. During negotiations with Hartnett, Billman and McCuistion effected an agreement between EMI and another EPIC subsidiary, EPIC Mortgage Servicing, Inc. (EMSI). *Id.* EMI agreed to perform EMSI's business, gaining considerable EMSI profit. *Id.* In 1984, EMSI merged with Cavalier Oil Corporation. *Id.* Hartnett rejected Cavalier's offer, choosing instead to assert his appraisal rights, which resulted in the decision that is discussed. *Cavalier Oil*, 564 A.2d at 1139.

[113]*Id.* at 1145 (emphasis added). Hartnett's claims centered on the value assigned to his shares, not the actual validity of the merger. *Id.* at 1143. On appeal, Cavalier argued that the chancery court erred by excluding a minority discount from the value of Hartnett's EMSI stock. *Id.* at 1144. Cavalier asserted that Hartnett's *de minimis* 1.5% interest should be included when valuing his stock. *Id.* In determining the fair value of a dissenter's shares, the court applied the test derived in *Weinberger*, which allows consideration of "all relevant factors." *Cavalier Oil*, 564 A.2d at 1142-43. This analysis has specifically narrowed the test to focus on both fair dealing and fair price. *Id.* at 1144. However, prior to determining the shareholder's "proportionate interest," the court must first determine the value of the corporation as an "operating entity." *Id.* Referring to the chancery court, the court noted that the objective of appraisal is to "value the *corporation* itself, as distinguished from a specific

But what exactly is the "windfall" that the court has in mind in *Cavalier Oil*? From the context in which the phrase is used, it seems evident that the Delaware Supreme Court believed that if minority shareholders receive less than their proportionate interest in the company, valued as a going concern, then the majority shareholder will receive an illicit "windfall."[114] But to say this, implies that an acquirer who pays a control premium is not entitled to fully realize it. That is, the controlling shareholder can exercise the power and prerogatives that accompany *de facto* control, but cannot force the minority shareholder to accept a compensating discount in appraisal, even though the market might trade the minority's shares at such a discount. This view treats the control premium as a privilege, not a right. Essentially, the control premium becomes something one can pay or receive, but without any corollary that the minority's shares are thereby legally affected. The incentives created by such an approach are analyzed in Part II.

D. *Entire Fairness: The Continuing Availability of Rescissionary Relief*

Under Delaware law, the appraisal remedy is not exclusive when a controlling shareholder seeks to squeeze-out the remaining minority shareholders in a merger. Since the 1983 decision in *Weinberger v. UOP, Inc.*,[115] Delaware decisions have recognized that the controlling shareholder must bear the burden of proving the "entire fairness" of such a transaction.[116] If, however, the terms of a squeeze-out merger are negotiated by an independent committee, it is well settled that the plaintiffs face the formidable burden of proving the substantive unfairness of the transaction.[117]

In 1994, this perception of the plaintiff's burden was dramatically changed by the Delaware Supreme Court's decision in *Kahn v. Lynch*

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fraction of its *shares* as they may exist in the hands of a particular shareholder." *Id.* Applying this reasoning, the court rejected the minority discount, finding that the inclusion of such would not result in a true and fair determination of the dissenting shareholders "proportionate interest." *Cavalier Oil*, 564 A.2d at 1145.

[114] *Id.* at 1145.

[115] 457 A.2d 701 (Del. 1983).

[116] *Id.*

[117] *See* Rabkin v. Olin Corp., No. 7547 (Consolidated), [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,255, at 96,160, 96,164 (Del. Ch. Apr. 17, 1990), *reprinted in* 16 DEL. J. CORP. L. 851, 861-62 (1991), *aff'd*, 586 A.2d 1202 (Del. 1991); Citron v. E.I. DuPont de Neumours & Co., 584 A.2d 490, 500-02 (Del. Ch. 1990). See also Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110 (Del. 1994), and Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983), for a discussion of the burden shifting analysis invoked by Delaware courts.

Communication Systems, Inc.[118] In *Lynch*, a forty-three percent controlling shareholder sought to acquire the remaining equity interest in Lynch Communication Systems, Inc. (Lynch).[119] Lynch's management had earlier resisted an Alcatel demand that Lynch acquire an indirect Alcatel subsidiary.[120] In response, Alcatel sought to buy out the remaining fifty-seven percent that it did not hold.[121] Lynch's board then appointed a committee of independent directors to evaluate the Alcatel offer.[122] The committee balked at Alcatel's offer of $14 per share, instead seeking a price of $17 per share.[123] Subsequently, Alcatel raised its bid in a series of stages to $15.50 per share, but then dug in its heels.[124] When Lynch's independent directors continued to balk at the improved price, Alcatel indicated its readiness to make a hostile tender offer at $15.50.[125] Faced with this ultimatum and seeing no feasible alternative, Lynch's board backed down and approved a cash-out merger at $15.50 per share.[126]

Interpreting these facts to mean that Alcatel had "threatened" Lynch with a hostile offer, thereby "depriving" the Independent Committee of an effective "power to say no,"[127] the Delaware Supreme Court held that the burden of proving entire fairness did not shift to the plaintiff, even though Lynch's independent committee was disinterested.[128] The precise

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[118]638 A.2d 1110 (Del. 1994) (*Lynch I*), *aff'd on remand*, 669 A.2d 79 (Del. 1995) (*Lynch II*).

[119]*Id.* at 1112-13. The controlling shareholder was the U.S. subsidiary of Alcatel, the French telecommunication conglomerate. *Id.* Lynch Communication Systems manufactures electric telecommunication equipment, which is then sold to telephone companies. *Id.*

[120]*Id.* at 1112-13.

[121]*Id.* at 1113.

[122]*Lynch I*, 638 A.2d at 1113.

[123]*Id.*

[124]*Id.*

[125]*Id.*

[126]*Lynch I*, 638 A.2d at 1113.

[127]*Id.* at 1120.

[128]*Id.* at 1120-21. Prior to deciding *Lynch*, the effects of these cases were somewhat skewed in Delaware. In *Weinberger*, the court established that a controlling shareholder, standing on both sides of a transaction, has the burden of proving that the transaction is entirely fair. *Weinberger*, 457 A.2d at 710. However, if an independent and disinterested committee approves a transaction, the burden of proof can be interpreted differently. *Lynch I*, 638 A.2d at 1117. Under these circumstances, Delaware courts view the burden as shifting to the plaintiff. *Id.* Thus, applying the entire fairness standard, the court focused its burden analysis on whether the special committee (1) was truly independent and fully informed, and (2) had the freedom to negotiate at arm's length. *Id.* at 1118-21. The court noted that this case-by-case analysis is extremely fact specific. *Id.* at 1120. The court further noted that the presence of an independent committee can help a shareholder defend a lawsuit; however, it is not by itself proof of a procedurally fair merger. *Id.* (citing Rabkin v. Philip A. Hunt Chem. Corp.,

scope of *Lynch* can be reasonably debated. In its simplest reading, a fiduciary gets nothing more than a shift in the burden of proof from approval by a disinterested board; however, a fiduciary will not even be entitled to this shift if it "threatens" or "dominates" the independent committee.[129] Alternatively, it is possible that future decisions may construe the case more narrowly, applying it only when there has been "domination" of the board or committee.[130]

Lynch does not directly address the issue of fair price, but it clearly contemplates an independent committee that will negotiate earnestly to receive the highest price that it can, undeterred by any "threat" from its controlling shareholder.[131] In doing so, it creates an apparent standoff: the monopolistic buyer confronts the monopsonistic seller, and the outcome of these negotiations becomes uncertain even in theory. Thus, any visible deference given by the independent committee to the controlling shareholder is likely to prevent a shift in the burden of persuasion to the plaintiff.

Over the long-run, the real significance of *Lynch* may be that it solves the problem of rational apathy that has long confounded the appraisal remedy. That is, although individual shareholders may not elect appraisal, it is predictable that a class action will be commenced on their behalf in the case of the most significant "going private" transactions. Thus, if the same substantive legal standards apply in these parallel settings, they will be enforced under *Lynch*, even if they are more likely to be honored in the breach in the appraisal context. As a result, the bidder loses the incentive to underpay that today exists because some significant percentage of the shareholders will predictably not accept the costs incident to the appraisal remedy.

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498 A.2d 1099, 1106 & n.7 (Del. 1985)). Carefully scrutinizing the facts surrounding the merger, the court found that the independent committee was unable to negotiate at arm's length due to Alcatel's threats of a hostile tender offer. *Id.* at 1121. Thus, the court held that the independent committee's actions did not simulate that of a "third party transaction," precluding shifting of the entire fairness burden to the plaintiff. *Id.*

[129]*Lynch I*, 638 A.2d at 1121. "The record reflects that the ability of the Committee effectively to negotiate at arm's length was compromised by Alcatel's threats to proceed with a hostile tender offer if the $15.50 price was not approved by the Committee and the Lynch board." *Id.*

[130]In *Lynch I*, the Delaware Supreme Court started from the premise that a fiduciary duty is owed only when the shareholder "owns a majority interest in or *exercises control* over the business affairs of the corporation." *Id.* at 1113 (citing Ivanhoe Partners v. Newmount Mining Corp., 535 A.2d 1334, 1344 (Del. 1987)). It found, however, "that Alcatel did exercise control over Lynch's business decisions." *Id.* at 1114-15.

[131]*Id.* at 1119-22.

The possible implications of uniting *Lynch* and *Cavalier Oil* into a single integrated standard are best illustrated by reference to our earlier example, in which the intrinsic value of a company is $25 per share, but the public trading price of the minority stock is $20 per share and a fifty percent control block has been recently purchased for $30 per share.[132] Assume now that the controlling shareholder seeks to effect a squeeze-out merger at some cash price nominally above the market price, for example, $21 per share. Under *Cavalier Oil*, those minority shareholders who elect their appraisal remedy would be entitled to $25 per share, and, if *Lynch* requires a similar standard, the use of a merger price below $25 would entitle the minority to injunctive relief.

Although such a scenario raises economic and policy issues that will be assessed shortly, it more immediately raises a doctrinal problem. Recent Delaware decisions suggest that the above described hypothetical transaction will be deemed fair, even if a third party has offered a higher price.[133] As next discussed, these cases can arguably be read to imply that those who pay a control premium acquire a property right that limits both the rights and powers of minority shareholders *and* independent directors.

E. *The Rights of a Control Person: The Delaware Case Law*

The Delaware law on control is not a seamless web. Potentially discordant strands exist that could lead Delaware law to evolve in a contrary direction from that suggested by *Lynch*. One of the most problematic decisions in any attempt to assess the overall Delaware law on control is *Mendel v. Carroll*.[134] In *Mendel*, the Carroll family, who controlled between forty-eight percent and fifty-two percent of the stock of Katy Industries, Inc. (Katy), sought to eliminate the "minority" interest.[135] A committee of independent directors was appointed and initially resisted because the Carroll family's first offer of $22 per share was $2 below the corporation's stock market price on the date the offer

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[132]*See supra* notes 29-32 and accompanying text for reference to this example.

[133]*See, e.g.*, Mendel v. Carroll, 651 A.2d 297 (Del. Ch. 1994); Freedman v. Restaurant Assocs. Indus., Inc., [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,502 (Del. Ch. Oct. 16, 1987), *reprinted in* 13 DEL. J. CORP. L. 651 (1988).

[134]651 A.2d 297 (Del. Ch. 1994).

[135]*Id.* at 298-300. The Carroll family founded Katy Industries. *Id.* In 1992, they agreed to purchase all publicly-held shares of Katy as well as all non-Carroll shares of the company. *Id.* The squeeze-out in this case is extremely similar to that of the *Lynch* case discussed previously.

was made.[136] The Carroll family later raised its offer to the market price of $24, but the independent directors continued to insist on $26.[137] Eventually, a merger agreement was reached at $25.75; however, on the announcement of the deal, a third party surfaced, offering $28 for all of Katy's outstanding shares.[138] After further developments, the third party decreased its offer to $27.80,[139] conditioning the offer on Katy's board granting the third party bidder a stock lockup equal to 1.8 million shares at the merger price in order to dilute the Carroll family's control.[140] When Katy's outside counsel reported that there was legal uncertainty about the validity of such a proposed lockup, Katy's board backed away from the third party offer.[141]

In due course, the now hostile third party brought suit, alleging that the board could not facilitate a merger with its controlling shareholder at a price below that offered by a third party bidder.[142] "*Revlon* duties," it said, applied.[143] The simplest answer to this claim might have been that *Revlon* duties arise only when there is a sale of control. Because the Carroll family had always held control of Katy, *Revlon* did not seem applicable.[144] Chancellor Allen chose, however, to address the issues more broadly, by asking whether the controlling shareholder had a duty to self-sacrifice, subordinating its interests to those of the minority by

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[136]*Id.* at 300. The stock price rose to $24 per share during the months between the offer and proposal. *Id.* Under the reasoning of *Lynch*, it is arguable that the Carroll offer might even qualify as a "threat."

[137]*Id.*

[138]*Mendel*, 651 A.2d at 299-301. The third party, Rosecliff Pensler Partners, L.P., contacted Katy's chairman regarding the offer in September 1993. *Id.* at 300-01. Following this offer, a special committee advised the board that it could no longer endorse the Carroll merger. *Id.* At this time, it was again noted that the Carrolls would not sell their shares, thus, precluding a merger with Pensler. *Id.*

[139]*Id.* at 302.

[140]*Id.* at 306. The result of this stock lockup would be to dilute the Carroll family's control. *Id.* The uncertain legality of this transaction was consistently noted by the special committee throughout the negotiations. *Id.*

[141]*Id.* at 302-03.

[142]*Mendel*, 651 A.2d at 302-03.

[143]*See id.* at 303-04. *See also* Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., 508 A.2d 173 (Del. 1986) (holding that directors have a duty to maximize the value of its corporation's stock by obtaining the best price at its sale). The plaintiffs argued that the "*Revlon* duties" were invoked by the board's decision to accept the Carroll merger. *Mendel*, 651 A.2d at 303. These duties oblige the board to "maximize the current value of [the] shares." *Id.* In this case, maximization could only occur by accepting Pensler's offer, regardless of the fact that it dilutes Carroll's ownership. *Id.*

[144]*Mendel*, 651 A.2d at 304-07.

selling its shares in the merger at a price it considered unattractive.[145] He framed the issue with his customary succinctness:

> Plaintiffs see in the Carroll Group's unwillingness to sell at $27.80 or to buy at that price, a denial of plaintiff's ability to realize such a price, and see this as an exploitation or breach of duty. This view implicitly regards the $27.80 per share price and the Carroll Family Merger price of $25.75 as comparable sorts of things. But they are legally and financially quite different. *It is, for example, quite possible that the Carroll $25.75 price may have been fair, even generous, while the $27.80 Pensler price may be inadequate.*[146]

Chancellor Allen's point cannot be denied that controlling shares have a higher value than the minority or "public" shares traded in the market.[147] Logically, the third party bidder would have had to pay a control premium to acquire control, while the control group could expect to pay less to acquire the remaining noncontrolling shares.[148]

True as this fact may be, it only states, rather than resolves, the normative issue: can the minority shareholders be forced to accept the lower of two rival bids on the ground that a controlling shareholder need not match the price offered by a rival bidder? When can the board take action to protect the minority? The first question is easier to answer than the second. Although Delaware would clearly entitle controlling shareholders to refuse to vote for a merger that deprived them of their control premium,[149] it is less clear when or why the board of directors is

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[145] *Id.* The plaintiffs assumed that the minority shareholders were being "exploited" by the controlling shareholder because the Pensler offer would have increased the latter's stock value. *Id.* When such exploitation is present, the board may act to protect the minority, even when such protection dilutes the controlling shareholder. *Id.*

[146] *Id.* at 304.

[147] *Id.* at 305. The court noted that the Carrolls already had control because they owned between 48 and 52% of the stock. *Id.* Thus, the per share prices of the Pensler and Carroll offers were different in that the former involved sale of complete control while the latter solely involved the purchase of noncontrolling stock. *Id.*

[148] *Mendel*, 651 A.2d at 305.

[149] In Thorpe v CERBCO, Inc., No. 345, 1995, 1996 Del. LEXIS 144 (Del. Apr. 10, 1996), defendants, who were both directors and controlling shareholders of a Delaware corporation, were found to have breached their duty of loyalty by usurping a corporate opportunity. *Id.* However, because the opportunity would have required a shareholder vote for its acceptance, Chancellor Allen had found that the defendants were entitled to block acceptance in their capacity as shareholders. *Id.* On appeal, the Delaware Supreme Court

required to respect their preference. In addition, if the acquisition of *de facto* control entitles the controlling shareholder to force through the lower-priced merger, this power co-exists uneasily with the principle that shareholders are entitled to their proportionate interest in the firm. Unless qualified, *Mendel*'s logic might suggest that minority discounts can re-enter the scene by a far more important door than *Cavalier Oil* closed.

Clearly, much then depends on how we read *Mendel*. The narrow legal issue in *Mendel* was only whether the Katy board was justified in refusing to issue a dilutive option to the hostile bidder that would enable it to obtain control, despite the implacable opposition of the Carroll group.[150] This request for extraordinary relief could have been denied on any of a variety of narrow or technical grounds.[151] Instead, Chancellor Allen wrote broadly that "the Katy board could not, consistent with its fiduciary obligations to all of the stockholders of Katy Industries, have issued the dilutive option for the purpose sought in this instance."[152] In short, not only did the board not have any obligation to issue the proposed option, it also lacked the right to do so.

When then would a board be entitled to issue such a dilutive option to an outsider? In both an earlier decision[153] and in *Mendel*, Chancellor Allen has recognized that such an issuance to an outside control seeker could sometimes be justified.[154] In *Mendel*, he suggests that the board must be seeking "to protect the minority from plain overreaching" or a "threatened serious breach of fiduciary duty by the controlling stock[holder]" to support such an extraordinary action.[155] Although it is

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accepted the logic of Chancellor Allen's position that shareholders are entitled to act in their own self-interest, but still held that the defendants were liable to disgorge profits and to pay certain compensatory damages attributable to their fiduciary breach. *See supra* notes 86-98 and accompanying text. This result may suggest a narrower definition of the shareholder's right to pursue its own self-interest than contemplated in *Mendel*.

[150]*Mendel*, 651 A.2d at 304.

[151]For example, the board might simply have relied upon the advice of counsel that there were legal uncertainties concerning their power to grant the option that made it advisable to, under the circumstances, prefer the lower-priced but more secure offer from the Carroll group.

[152]*Id.* at 307. Although a board may issue a dilutive stock option to protect an exploited minority, the board has no duty "to deploy corporate power *against* the majority stockholders, in the absence of a threatened serious breach of fiduciary duty by the controlling stock[holder]." *Id.* at 306.

[153]*See* Freedman v. Restaurant Assocs. Indus., Inc., [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,502 (Del. Ch. Oct. 16, 1987), *reprinted in* 13 DEL. J. CORP. L. 651 (1988) (finding that a board was not compelled to dilute a controlling shareholder, but could do so in pursuit of a proper corporate purpose).

[154]*Mendel*, 651 A.2d at 306.

[155]*Id.*

understandable that the court chose to be somewhat vague on this score, these terms give little indication of where the tipping point lies between "plain overreaching" and justifiable insistence on one's rights as a controlling shareholder. Reading *Lynch*, one could easily gain a sense that a controlling shareholder who asks the board's independent committee to accept the lower of two offers might be engaged in just such "plain overreaching". Still, the Delaware Supreme Court's ultimate resolution of that litigation found that the controlling shareholder's terms were fair to the minority, notwithstanding its "threat."[156]

Perhaps the best way to locate this tipping point is to focus on the amount that the *Mendel* court would award to the minority shareholders as fair value, if they had dissented from the cash-out merger and exercised their right of appraisal. Our earlier analysis concluded that minority shareholders in such circumstances should be entitled to proportionate value in the corporation, valued as a going concern.[157] Logically, the minority's entitlement seems no different when the focus shifts from appraisal to the premerger context that *Mendel* and *Lynch* address.[158] Thus, if the minority is entitled to their proportionate interest in the appraisal proceedings, consistency suggests that they should be afforded the same entitlement in an injunctive proceeding based on *Lynch*. Indeed, in economic terms, the basic difference between these two contexts is simply that between a liability rule and a property rule.[159]

This proposed compromise, that the minority should be entitled to proportionate value, rather than equal opportunity, reconciles *Mendel* and *Lynch* in a manner that both permits the controlling shareholder to receive a premium and protects the minority from the imposition of a *de facto* minority discount. To illustrate its operation, assume, as before, that a fifty percent control block exists in a publicly held corporation in which the "minority shares" trade at $20 per share. Assume further that "proportionate value" in this case would be $25 per share.[160] On these

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[156]*See* Kahn v. Lynch Communication Sys., Inc. 669 A.2d 79 (Del. 1995) (holding that cash-out merger satisfied the entire fairness standard).

[157]*See supra* notes 24-84 and accompanying text. This presumption did not include any synergy gains that a combination of the two firms may produce.

[158]*See supra* notes 118-56 and accompanying text for a discussion of the *Lynch* and *Mendel* cases.

[159]*See generally* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972) (discussing various legal rules and suggesting their integration); David Cohen, Comment, *Valuation in the Context of Share Appraisal*, 34 EMORY L.J. 117 (1985) (classifying shareholder remedies in terms of liability rules versus injunctive rules).

[160]The $25 valuation is based on all possible valuation standards but excludes any synergy gains that a combination of the corporation with another entity might produce.

facts, if an outside bidder offered $28 per share for the minority shares on the condition that a dilutive stock option would shift control to it, the existing controlling shareholder could ask the board to prefer its lower $25 per share offer. Conversely, if the controlling shareholder responded with a $23 offer, a price below the $25 proportionate value, this would constitute "plain overreaching" and would justify the board in granting the option.

But if it is understandable that the controlling shareholder could prefer its own self-interest, why must the board defer to it? Chancellor Allen's view may have simply been that a dilutive stock option is a questionable tactic when employed against a party that has legitimately gained control.[161] If we assume that the Carroll family held fifty percent or more of the stock, it is clear that issuance of the option would have diluted their majority position. But what if they held only *de facto* control with a very solid thirty-five percent voting block and no other large holder? Here, it seems harder to justify why a dilutive option should have been impermissible, although certainly not mandatory, if the board had desired to foment a bidding contest between the Pensler group and the Carroll family. Indeed, there are strong arguments that this is precisely what the board should do to protect the 65% "minority" on these revised facts.

In essence, Chancellor Allen's approach in *Mendel* seems to treat the acquisition of control as creating a right and not simply a privilege. However, it is only a limited right: namely, the right of the controlling stockholder to monopolize the discounted value of expected synergy gains. Yet, the control holder may still be required to respect the minority's right to their proportionate value in the existing company's intrinsic value.

From a policy perspective, this position would encourage efficient transactions, while chilling inefficient ones. In effect, the selling shareholder could pocket that portion of the control premium which reflects special synergies or efficiencies from the acquisition, but it cannot reduce the minority's share below a proportionate interest in the pre-existing value of the firm. Thus, it remains normatively troubling.[162]

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[161]Decisions such as Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971), and Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988), can be read to deny the board the power to preempt a voting contest, but no shareholder vote was impending in *Mendel*. Corporate action that seeks to dilute control has also been disfavored in Delaware. *See* Frantz Mfg. Co. v. EAC Indus., Inc., 501 A.2d 401 (Del. 1985). However, *Frantz* involved an attempt to undo a takeover that had seemingly already passed control to a new control group. *Id.*

[162]It is, of course, uncertain that the *Mendel* court would have found the board disabled

Even this parsimonious definition of the minority's rights will dissatisfy those economists who would prefer a legal rule that gives public shareholders nothing more than a nominal value over the prior public trading price of the minority shares.[163] Any greater entitlement, they argue, will deter some efficiency-promoting transactions.[164] However, the foregoing proportionate standard would deter some inefficient transactions, specifically those where the acquirer intends not to realize new synergies, but only to realize private benefits of control greater than those enjoyed by the incumbent control holder.[165] The possible incentive effects of these alternative formulas will be analyzed in more detail in Part II.

F. *An Initial Policy Assessment*

Although commentators have primarily focused on the effects of the state law doctrine that generally permits control premiums, this section has argued that the incentive effects of this rule are likely to be overshadowed by other legal doctrines, such as appraisal rights, the availability of injunctive or damage actions based on *Weinberger* and *Lynch*, and SEC rules under the Williams Act. Collectively, these doctrines tend to discourage the payment of a control premium, at least when the intent is to eliminate the minority, because they *may* entitle the minority to a similar price that is at least reasonably related to what the control seller received.

Still, even if these rules chill control premiums, they do not necessarily discourage inefficient control transactions. One obvious gap exists: they do not discourage a partial acquisition of a controlling block that is not followed by a take-out merger or other transaction that eliminates the minority. Arguably, these transactions represent potentially

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from issuing a stock lockup to attract a higher bidder in a case where the control group held less than a majority of the voting stock. To do so seems unjustified, because it effectively presumes that the other shareholders surrendered their claim to have the board act in their best interest by encouraging an auction. In the case of a majority control group, it at least can be said that an auction disfavors the interests of a majority of the shareholders.

[163] *See* Hermalin & Schwartz, *supra* note 3, at 351 (proposing that minority shareholder should be awarded only the preinvestment price of their interest as an appraisal price).

[164] *Id.* at 362.

[165] An acquirer considers two types of benefits prior to purchasing a control block. Michael J. Barclay & Clifford G. Holderness, *Private Benefits from Control of Public Corporations*, 25 J. FIN. ECON. 371, 373-74 (1989). First, the acquirer will consider the amount of dividends and other cash flows to be received by all shareholders based on their interest in the company. *Id.* Second, the acquirer will evaluate the private benefits it will receive as a result of the transaction. *Id.*

the most inefficient category of control transactions because the new buyer has a greater incentive to exploit the private benefits of control when it does not anticipate acquiring the remaining minority interest. Yet, because such a private transaction neither triggers appraisal nor involves corporate action, none of the principles enunciated in *Lynch*, *Weinberger*, or *Cavalier Oil* are typically implicated by such a partial acquisition. Only those antique cases dealing with looting or the sale of corporate office seem to apply in this context.[166] With minimal planning and some cosmetics, the skillful practitioner can probably sidestep this obstacle.

Indeed, it could be argued that by discouraging back-end "going private" mergers, the SEC's rules, particularly Rule 13e-3, encourage partial acquisitions in which the acquirer is more likely to exploit the private benefits of control because the SEC has made it more costly to pursue the synergy gains that require full integration of the two firms.[167] This argument can easily be overstated, however, because it is increasingly becoming dated. A fifteen to twenty percent purchaser, who acquired a dominant board position from the seller incident to its purchase of the seller's controlling stock, could once expect to maintain control of the corporation. This prospect has increasingly become attenuated. The rise of the institutional investor has resulted in a new concentration of share ownership,[168] reducing the costs of collective action and making the likelihood of control exploitation by a small holder increasingly remote.

Of course, a larger block, for example, over thirty percent, still carries *de facto* control; yet, as the acquirer is forced to assemble a larger block to gain control, the private benefits of control dissipate correspondingly.[169] Put simply, while a ten percent shareholder who misappropriates corporate funds steals ninety percent of its resulting gains from the other shareholders, a thirty percent shareholder effectively misappropriates only seventy percent from the others and thirty percent from itself. Similarly, the larger and more costly the controlling block

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[166]*See supra* notes 70-72 and accompanying text for a brief discussion of sales of office and its relevant case law.

[167]Hazen, *supra* note 1, at 278-81 (discussing federal securities laws governing sales of control).

[168]For an overview of the institutional investor's impact on corporate governance and the new concentration in share ownership, see John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837 (1994).

[169]Bebchuk, *supra* note 3, at 986. *See also* Barclay & Holderness, *supra* note 165, at 384 (noting that few private benefits result from a large block once such holder dominates the board).

that must be assembled to enjoy the private benefits of control, the smaller the likely gains from exploitation of such private benefits (i.e., excessive compensation or unfair self-dealing) will look in relation to this initial acquisition cost. In short, the market's evolution may have created its own partial remedy against attempts to acquire the minimum controlling block necessary to exploit the private benefits of control.

A more serious criticism that can be levelled at the SEC's implicit equal opportunity norm is that it may discourage some efficiency-enhancing transactions.[170] To illustrate, let us return to a variant of the example used earlier: assume that a fifty percent block in a firm with an intrinsic value of $20 per share is acquired at the premium price of $30 per share. If the acquirer of this block now proposes a squeeze-out merger, those minority shareholders who dissent should be able to obtain $20 per share in an appraisal proceeding under those Delaware appraisal cases that reject minority discounts.[171] If all minority shareholders were to exercise their appraisal remedy, it would cost the acquirer an average price of $25 per share to acquire all the equity in this firm. This implies, in turn, that the acquirer will only pay the $30 per share control premium if it anticipates that under its management it can increase the value of the acquired business from $20 per share to more than $25.[172]

On these facts, a proportionate value rule may screen out some inefficient transactions,[173] but it blocks some efficient ones as well. The downside of this rule comes into clearer focus if we assume that the acquirer views the target in its hands as worth more than its stock market value of $20 per share, but less than $25 per share. For example, if the value of the target to the acquirer were $23 per share due to synergistic gains that depend on its improved management, the acquirer would be unable to effect this efficiency-promoting transaction if the incumbent management held out for a price for its 50% block in excess of $26 per share. The incumbent management might logically hold out because it

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[170]Bebchuk, *supra* note 3, at 960 (comparing the equal opportunity rule with the market rule in the context of efficiency); Elhauge, *supra* note 4, at 1490 (summarizing the various theories as to why equal opportunity discourages efficient transactions). It has been asserted that an equal opportunity rule deters efficient transfers because it forces the majority to forego any advantages a control sale should bring. Bebchuk, *supra* note 3, at 972.

[171]*See supra* notes 111-15 and accompanying text.

[172]Virtually all commentators concur in this analysis. *See, e.g.*, Brudney, *supra* note 1, at 1124 (noting that acquirers only pay premiums if they believe the corporation's value will increase or they intend to "appropriate" some of the minority's assets).

[173]Basically, it discourages those acquirers who might plan to suspend dividends, pay excessive salaries or otherwise engage in unfair self-dealing *precisely* in order to make the back-end price fall from $20 to a lower price.

valued the private benefits of control at $26 per share or higher. As a result, if the acquirer must pay $20 to the fifty percent "minority" shareholders and anything above $26 per share to the controlling shareholder, for a weighted average price of $23 per share, the efficiency-enhancing transaction is blocked.

The real point here is that the foregoing argument proves too much because it can even be used to justify transactions that pay the minority less than the market value for their shares. One, therefore, cannot frame public policy looking only to whether a proposed rule maximizes the incentives to bidders. The critical question instead becomes the relative balance between the efficient versus inefficient transactions that are discouraged by a proposed rule. Here, economists have largely agreed that an equal opportunity rule will, on balance, discourage more efficient transactions than inefficient ones.[174] However, these criticisms apply with considerably less force to a rule entitling the minority shareholder to proportionate value, rather than equal sharing. As a result, the relative balance of efficient versus inefficient transactions discouraged will be different. However, some efficient transactions will clearly be chilled.[175]

Two policy justifications can be advanced for a proportionate interest rule that cannot be as easily used to support an equal opportunity rule. First, the focus of such a rule is more directly aimed at deterring inefficient transactions in which the purchaser of control hopes to drive down the market price by some oppressive tactic in order to achieve a cheaper back-end merger that eliminates the minority. An equal opportunity rule overcorrects this problem by entitling the minority to a price that may be above the firm's intrinsic value; however, a proportionate interest rule focuses more modestly and appropriately on simply barring potentially inefficient transactions.[176] Second, a proportionate interest rule should chill efficient transactions only when either (1) the private benefits of control to the control seller are very high, or (2) the synergistic gains anticipated by the control seeker are

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[174]*See* Bebchuk, *supra* note 3; Hermalin & Schwartz, *supra* note 3; Kahan, *supra* note 3.

[175]Assume for example, that the intrinsic value is $20 per share, the current market price is $18, and that the control seller will not sell its 25% block for less than $23 per share. The control acquirer can still pay this $23 price and also offer a small premium ($19) to the other 75% of the shareholders, thereby paying an average price of $20. However, if the acquirer were required to pay $20 to all other shareholders, as a proportionate value rule would require, this transaction could become unattractive because now the average price would become $20.75. If it did not anticipate synergistic gains greater than 75¢ a share, the acquirer could not rationally consummate this transaction.

[176]Elhauge, *supra* note 4, at 1486 (noting that a right to a proportionate share provides a "prophylactic incentive structure that self-deters non-productive sales of control").

relatively modest.[177] The first condition will rarely apply because empirical evidence shows that the private benefits of control represent a relatively modest percentage of firm value in the United States.[178] The second condition can arise more frequently, but it implies that the efficiency loss in such a case will also be correspondingly modest.

More importantly, considerable evidence also suggests that bidders tend to overestimate the synergistic gains from acquisitions.[179] Indeed, acquirers may overpay so systematically that in the view of some commentators the stock market has come to expect overpayment.[180] If such a tendency toward overpayment exists, the fact that a proportionate interest rule would constitute a mild disincentive may not be harmful. Uniquely, it would discourage transactions in which even the acquirer saw only modest gains from the acquisition.

By definition, a proportionate interest rule will not block transactions in which the bidder expects synergy gains substantially in excess of the control premium demanded by the control seller. If the private benefits of control average less than five percent of the value of the corporation's equity,[181] control sellers, although they will seek a higher premium, should be willing to settle for a premium in this range.[182] Hence, a proportionate interest rule would not block transactions in which the expected synergies greatly exceed this level.[183]

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[177]A proportionate value rule will chill an acquisition if the control seller demands a large premium and the control buyer anticipates little synergistic gain from the acquisition. As in *supra* note 175, assume that intrinsic value is $20 per share, and the buyer believes that the enhanced value of the firm under its management will rise only to $22 (or 10%). It cannot now pay a premium price of $25 per share to a 50% control seller, because this would raise the weighted average price to $22.50 under a proportionate interest rule.

[178]One study estimates the private benefits of control at 3 to 4% of the equity value of the corporation. *See* Barclay & Holderness, *supra* note 165. On this basis, if we assume that a corporation's intrinsic value and market price are both $20, then the private benefits of control would justify a premium of less than $1.

[179]*See* Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597 (1989) (discussing conflict between the *ex post* evidence of minimal gains from acquisitions versus the stock price evidence suggesting substantial *expected* gains). *See also* sources cited *supra* note 9 (discussing the inefficient results of mergers).

[180]Black, *supra* note 179, at 597-99.

[181]For this estimate, see Barclay & Holderness, *supra* note 165, at 371.

[182]In fact, one study found the average control premium in the case of publicly held companies to be 5.44%. *See* Ronald C. Lease et al., *The Market Value of Control in Publicly-Traded Corporations*, 11 J. FIN. ECON. 439 (1983).

[183]A proportionate interest rule does not force the sharing of synergy gains, but only requires that an above-market price be paid when market value is below intrinsic value. Such a circumstance may result when either the seller has been exploiting the private benefits of control or the buyer is expected to.

Only transactions in which the expected efficiency gains were very modest, if they existed at all, can run afoul of such a rule.

PART II. THEORY AND EVIDENCE: A CLOSER LOOK AT THE POSSIBILITY OF INEFFICIENT CONTROL TRANSFERS

A. *The Limited Empirical Data on Control Premium Transactions*

There has been surprisingly little empirical work on the impact of a sale of a control block on minority shareholders; yet, the work that has been done clearly shows that such a sale can have either a positive or negative impact on the value of the outstanding minority shares. In the best known study,[184] Professors Holderness and Sheehan examined a sample of the 114 New York or American Stock Exchange listed companies in which an individual or entity owned between 50.1% and 95% of the outstanding common stock.[185] From this sample, they were able to identify thirty-one companies that announced a sale of a majority block between 1978 and 1982.[186] Measuring the cumulative abnormal returns to the common stock of these companies, they found that on average the minority shares in this sample earned statistically significant abnormal returns of (1) 7.3% over the period from the day before the announcement day through the end of the announcement day, and (2) 12.8% over the thirty-day period beginning twenty days before the announcement and extending until ten days after the announcement.[187]

At first glance, such data seems to clearly imply that the acquisition of a control block benefits the minority.[188] But at least two major qualifications must be noted that interfere with any such simple policy conclusion. First, the meaning of this data is clouded by the market's expectation that the control sale would be followed by a tender offer at a similar premium for the minority shares. In fact, in at least ten of these thirty-one cases, the announcement of the majority block sale was accompanied by the announcement of a simultaneous tender offer for the minority stock.[189] Such an event would obviously dominate the

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[184] *See* Clifford B. Holderness & Dennis P. Sheehan, *The Role of Majority Shareholders in Publicly Held Corporations*, 20 J. FIN. ECON. 317 (1988).

[185] *See id.* at 320. Holderness and Sheehan identified 650 publicly traded companies having a majority shareholder but studied only the 114 traded on the NYSE or the AMEX.

[186] *Id.* at 327-30.

[187] *Id.* at 328.

[188] *See* Elhauge, *supra* note 4, at 1500 (discussing the Holderness and Sheehan study and suggesting that minority shares increase in value when a control block is sold).

[189] *See* Holderness & Sheehan, *supra* note 184, at 328.

market's reaction to the majority block sale. Ignoring these ten cases, the reduced subsample of twenty-one cases still earned statistically significant returns of 5.5% on the announcement day and 9.4% over the thirty day period.[190] Nonetheless, it is unclear that the exclusion of those cases, in which there was a simultaneous announcement of a tender offer, adequately corrects for the strong possibility that the market's reaction to the majority transfer may have been influenced by its expectation that a tender offer at a premium for the minority shares was likely. Such an expectation would obviously bias upward the market's reaction to the majority block transfer.

More importantly, the Holderness and Sheehan study also reveals that the market's reaction to a transfer of control can be negative with the price of the public shares declining. Although 65% of the thirty-day period observations for the thirty-one company sample were positive, a nontrivial 35% of the cases, in which the returns were not positive,[191] still results. This finding seems especially counter-intuitive in view of the likelihood of an above-market tender offer being eventually associated with the controlling block sale.

The second problem with the Holderness and Sheehan study is that it focused only on the stock price reaction to a majority block transfer.[192] Thus, it could not examine the market's response to the sale of a controlling block that fell below a majority or its reaction to the slower assembly of a control block through multiple smaller purchases from noncontrolling shareholders. Logic suggests that the market's reaction to such transactions would more frequently be negative. Because the purchaser of a majority block is acquiring more shares than it needs to obtain effective control, such majority block transactions are less likely to be motivated by a desire to obtain "private" benefits, not available to others, from the control relationship. The higher the percentage of the stock that the control seeker buys, the greater the likelihood that it expects the value of the company to increase, and the less the likelihood that the control seeker is motivated by a desire to obtain private benefits.[193] The logic of this proposition rests on the obvious truth that one has no incentive to steal from oneself. If one is buying control to "loot" the company, then one wants to buy as little stock as possible

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[190] *Id.* at 330.

[191] *Id.* at 328. Nineteen percent of the one-day announcement day returns were negative in this same 31 company sample. *Id.* One suspects that the percentages would be higher for the 21 company sample that results from subtracting out the 10 cases involving simultaneous tender offers.

[192] This study only analyzed the transfer of blocks in excess of 50.1%. *Id.* at 327.

[193] Elhauge, *supra* note 4, at 1509-11.

because the stock value after such wealth expropriations should decline.[194] A 100% owner, of course, has no incentive to "loot" because it would be the victim of its own crime.[195] The anecdotal evidence about Victor Posner and other controversial raiders is consistent with this hypothesis: they tend to remain the minority, although controlling, and seldom buy all the stock, unless they have depressed its value and can purchase at a large discount.

More than anecdotal evidence supports this hypothesis that the assembly of a control block by a shareholder who does not seek complete ownership will elicit a negative stock market reaction. In an extensive empirical study, Professor Karen Wruck found that firm value generally increased with greater ownership concentration.[196] Breaking her data down, she found that increases in ownership concentration enhanced firm value "when the level of ownership concentration is high or low."[197] However, in the middle range, there was a negative correlation.[198] Additionally, when private sales of equity were used to transfer control to the purchaser, or even simply to "put the purchaser on the board of directors," the stock price impact was again negative.[199]

The simplest explanation for these findings is that significant shareholders reduce agency cost problems and enable shareholders to hold managers accountable, thus causing firm value to rise.[200] Firm value tends to increase with ownership concentration until the point that the large shareholder is able to credibly threaten to seize control itself.[201] Once control has been acquired, further increases in ownership concentration are deemed desirable by the market because they are

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[194] *Id.*

[195] *Id.* at 1485. "Looters are not looking for special synergies; they can search for the cheapest opportunity to buy control over a lootable corporation." *Id.* at 1510.

[196] *See* Wruck, *supra* note 33, at 3.

[197] *Id.* at 23.

[198] *Id.*

[199] *Id.*

[200] *See* Wruck, *supra* note 33, at 14-16. As the following passage indicates, however, this conclusion is dependent on the interests of such shareholders being aligned with management:

> The effect of a change in ownership concentration on firm value depends on the market's assessment of its effect on resource allocation within the firm, and the probability of a takeover. For a particular firm, value increases if the change in ownership more closely aligns manager and shareholder interests. Firm value falls if the private sale allows entrenchment, creating a concentrated ownership structure that fosters the misallocation of resources and effectively blocks attempted takeovers.

Id. at 14-15 (citations omitted).

[201] Elhauge, *supra* note 4, at 1487-88.

perceived to reflect a desire by the controlling shareholder to buy out the remaining minority shareholders, rather than leaving them locked into an illiquid investment.

A second study further corroborates the tendency for firm value to fall as ownership concentration nears the point where a shareholder group threatens to acquire control. Focusing on the aggregate percentage held by insiders, Professors Morck, Shleifer, and Vishny[202] found that firm value seemed to increase when the total ownership held by the board rose to five percent, but thereafter fell as the level rose to twenty-five percent, and then rose again in the relatively few cases where board ownership rose above this level.[203] They interpreted their data to support the thesis that agency costs were reduced as board ownership rose to five percent, but thereafter the risk of managerial entrenchment overcame the agency cost reduction effect.[204] At the twenty-five percent level, however, managerial control seemed assured, and further ownership increases after this point did not heighten the risk of managerial entrenchment, but rather increased the prospect of a profitable buyout.[205]

This evidence does not support a simple generalization that control transfers are good or bad for minority shareholders. In general, majority block purchases do seem to benefit minority shareholders, but there are also instances of negative market reactions as well.[206] More importantly, the gradual seizure of control appears to reduce the value of the minority shares, at least until it becomes clear that the control seeker is likely to pursue the remaining minority interest. Transfers of nonmajority controlling blocks have been less studied, but may be even more likely to elicit a negative market reaction.[207]

No simple public policy conclusion emerges from this evidence that can be uniformly applied. But once the possibility of control transfers that reduce the value of the minority shares is recognized, the

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[202]*See* Randall Morck et al., *Management Ownership and Market Valuation: An Empirical Analysis*, 20 J. FIN. ECON. 293 (1988).

[203]*Id.* at 311.

[204]*Id.* at 311-14.

[205]*Id.*

[206]Wruck, *supra* note 33, at 3 (discussing market increases and decreases associated with private and public sales, respectively).

[207]Wruck finds that on average the announcement of a private sale of equity by the company is associated with a 4.5% increase in the shareholder wealth of the nonparticipating shareholders. *See* Wruck, *supra* note 33, at 3. However, such private sales by the company show the approval of the corporation's board of directors and thus do not bear on the issue of the market's reaction to secondary sales.

relevance of the protections afforded by a proportionate value rule at least becomes clearer.

B. *The Simple Economics of Sales of Corporate Control*

When there is a change of control, the value that thereafter flows to the shareholder group can change in one of two general ways.[208] First, future cash flows (FCF) can increase or decrease as a result of (1) better or worse management, or (2) enhanced or decreased synergies, either operating or financial.[209] Second, some corporate value can be diverted to the new controlling shareholder as a private benefit of control — either more or less than was diverted by the prior controlling shareholder.[210] The net effect of a control change on the shareholders depends on whether the aggregate change in these two components is positive or negative; that is, does the increase (if any) in FCF exceed the increase (if any) in the private benefits of control (PBC) that the new controller diverts to itself? Potentially, a new controller could increase its consumption of the private benefits of control while still improving management so that the minority shareholders would benefit. For the public or minority shareholder, the value of the corporation (CV) can be expressed in a simple formula as the amount of future cash flows (FCF) minus the consumption of private benefits: CV = FCF - PBC.

One implication of this perspective is that there is no inherent control premium. The amount that a control seeker will pay to the outgoing control holder depends on how much more profitably the buyer believes it can manage the firm's assets and how much it believes it will consume in terms of the private benefits of control.[211] Thus, our earlier example in which the company's public shares traded at $20 while the controlling shares were assumed to be worth $30 needs to be updated. The more a prospective bidder believes that it can improve the firm's future cash flows (FCF), the greater the premium it will be willing to pay for control. If it does not believe it can improve FCF, the most logical

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[208]The analysis in this section borrows from Lucian Bebchuk. *See* Bebchuk, *supra* note 3, at 957.

[209]*Id.*

[210]Elhauge, *supra* note 4, at 1497-98. In addition to simple theft or misappropriation, the term "private benefits of control" includes subtler elements, such as unfair self-dealing, excessive compensation, or usurpation of corporate opportunities. *See generally* Barclay & Holderness, *supra* note 165, for a discussion of private benefits in control transfers. Barclay and Holderness argue that control premiums can be used to estimate the amount of private benefits the acquirer will receive as a result of ownership. *Id.* at 375.

[211]Barclay & Holderness, *supra* note 165, at 375-95.

reason that it will pay a premium is to increase its consumption of private benefits (PBC).[212] When the value of the public shares rises in the wake of a control block acquisition, this reflects the market's judgment that (a) FCF will increase under the new controller, (b) the consumption of PBC will decrease, or (c) the combination of the changes in the two variables will be positive. Conversely, when the value of the public shares declines in the wake of the control block sale, the reverse is true, but the market most likely expects the consumption of PBC to increase.

Some have estimated that, in the case of public corporations in the United States, the private benefits of control amount on average to between three to four percent of equity value of the corporation.[213] Although this estimate may be no more than a crude approximation, it contrasts surprisingly with the evidence on the size of control premiums. Although some studies of closely held corporations find the premium in this context to be very large,[214] a study of publicly held firms found the more modest average control premium to be only 5.44%.[215] On this basis, in the case of public corporations, the private benefits of control could account for the majority of the average control premium.[216] Conversely, assuming the accuracy of this data, it would be more difficult for the private benefits of control to explain control premiums in the case of private companies, where they seem to average between fifty and seventy percent.[217]

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[212]Brudney, *supra* note 1, at 1124. *See also* Barclay & Holderness, *supra* note 165, at 375-76 (stating that private benefits of control are "the most likely explanation for the substantial premiums paid for large-percentage blocks"). Other reasons may also support the payment of control premiums. *Id.* at 375, 381-82. Barclay and Holderness hypothesize that control purchasers either have "superior knowledge" regarding a company's value or that such purchasers merely overpay for control. *Id.* at 381-82.

[213]Barclay & Holderness, *supra* note 165, at 395.

[214]*See* Larry G. Meeker & O. Maurice Joy, *Price Premiums for Controlling Shares of Closely Held Bank Stock*, 53 J. BUS. 297 (1980). These studies found the premiums to be between 52 and 72%, depending on the class of the company. *Id.* at 298.

[215]*See* Lease et al., *supra* note 182, at 469.

[216]This is so because the average 5.44% premium only marginally exceeds the typical value of the private benefits of control. *See supra* text accompanying note 213.

[217]*See* Meeker & Joy, *supra* note 214 (finding premiums to range between 52 and 72%). Barclay and Holderness estimate that the private benefits of control equalled 3-4% of equity value applied only to public corporations. *See supra* text accompanying note 216.

C. *The Case for Proportionate Value*

A number of commentators have focused on the criteria that should define the optimal appraisal remedy.[218] They have largely agreed that an overly generous remedy will deter efficient transactions, while a remedy that undercompensates dissenting minority shareholders will produce both an inefficient allocation of corporate assets and increase the cost of capital to corporations over the long run.[219] From an *ex ante* perspective, the more the minority fears transactions structured by the majority, which expropriate their proportionate share in the corporation, the less they will be willing to pay for equity in corporations that are subject to such risks. Thus, at least to the extent that the controlling shareholder expects to raise capital by selling equity, it too will share an interest in an adequate appraisal remedy that deters uncompensated wealth transfers.[220]

This perspective leads quickly to the realization that stock market value alone cannot be the standard for determining fair value in circumstances where a controlling shareholder is cashing out the minority.[221] The stock price, particularly in an efficient market, inherently factors in the likelihood that the majority will overreach the minority.[222] Moreover, it will factor into the stock price not only the past loss caused by the selling controller, but also any expectation of future expropriations by a new controlling shareholder.[223] As a result, as one commentator has phrased it, "[T]he greater the misconduct by the majority, the less they need to pay for the minority's shares."[224] Minority discounts only compound this problem by adding a further discount to the stock price. These court-imposed discounts are arguably redundant

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[218]*See, e.g.*, Andrews, *supra* note 1, at 505 (promulgating the equal opportunity rule); Daniel R. Fischel, *The Appraisal Remedy in Corporate Law*, 1983 AM. B. FOUND. RES. J. 875 (discussing the appraisal remedy but proposing that it increases the value of all shares); Heglar, *supra* note 23, at 258 (evaluating minority discounts and concluding that they are both practically and theoretically inefficient, thus warranting their total rejection by the courts); Murdock, *supra* note 23 (evaluating alternative remedies for minority stockholders and the concept of valuation); Zenichi Shishido, *The Fair Value of Minority Stock in Closely Held Corporations*, 62 FORDHAM L. REV. 65 (1993) (discussing valuation methods employed by the courts); Woo, *supra* note 110 (analyzing the *Cinerama* decision and evaluating the Delaware appraisal remedy).

[219]Brudney, *supra* note 1, at 1124.

[220]Even those who normally argue that unequal allocations of corporate gains can be efficient concede this point. *See* Fischel, *supra* note 218, at 880.

[221]*See* Cohen, *supra* note 159, at 145.

[222]*See* Fischel, *supra* note 218, at 890 (noting that the market price is generally influenced by the transaction being dissented from).

[223]*Id.*

[224]Murdock, *supra* note 23, at 487.