APPLYING A NEW REGULATORY FRAMEWORK TO INTERESTED TRANSACTIONS BY MINORITY SHAREHOLDERS

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ABSTRACT

This Article explores the standards of review that apply to corporate conflict of interest transactions under Delaware Corporate Law. The first Section of this Article discusses Delaware General Corporation Law (DGCL) section 144 which deals with conflict of interest transactions by corporate directors and officers. The Article goes on to recommend that the statute be amended to include that once the provisions of section 144 are satisfied, the transaction is cleansed of conflicted interest on the part of the directors and officers and the business judgment rule will apply over the more burdensome entire fairness standard. Additionally, this Article discusses conflict of interest transactions by controlling shareholders and summarizes the holdings left behind by Weinberger and its progeny. This Article also discusses the third category of corporate conflict of interest transactions that involve minority shareholders. Both Weinberger and DGCL section 144 explicitly deal with conflict of interest transactions by directors and officers or controlling shareholders. Therefore, there is a lack of adequate regulation of conflict of interest transactions by minority shareholders, namely minority activist shareholders. To fill this void in Delaware Corporate Law, this Article recommends amending section 144 to include interested minority shareholders. This amendment would subject interested minority shareholder transactions to the entire fairness standard of review unless one of the prongs of DGCL 144 are satisfied. If an interested transaction by a minority shareholder satisfies section 144 through either the approval of 1) a fully informed independent negotiating committee or 2) an informed majority of the minority shareholder vote, the deferential business

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judgment rule will regulate the transaction. Similarly, if an interested transaction by a minority shareholder is determined to be entirely fair under section 144(a)(3), no further judicial scrutiny will be applied. Due to the influence that minority activist shareholders may exert over a corporation's board, an increase in shareholder protections and a comparatively heightened standard of review than the currently enforced business judgment rule is necessary. Additionally, to further improve disclosure requirements, this Article recommends an amendment be made to Item 404 of Schedule 14A to include interested minority shareholders as one of the parties held to heightened disclosure requirements.

INTRODUCTION

Delaware General Corporation Law (DGCL) section 144 deals with interested director and officer transactions by laying out three avenues to protect an interested director transaction from being automatically void or voidable solely due to a director's self-interest. Section 144 lists three ways in which an interested director can protect a transaction, but it does not explicitly say what happens when an interested director meets the requirements of the safe harbors. However, certain Delaware cases have held that once section 144 is satisfied, the court will apply the business judgment rule. This effect gives substantial deference to the business judgment of the directors by putting the burden on the plaintiff shareholders to rebut the presumption by showing that the directors' actions constituted gross negligence.

In addition to interested director transactions, Delaware law regulates self-dealing transactions of controlling shareholders. However, rather than apply the business judgment rule standard, as the court has applied when the requirements of section 144 are met, Delaware courts subject self-dealing transactions by controlling shareholders to entire fairness review. The entire fairness standard of review is much more plaintiff-friendly than the business judgment rule because it requires the defendant, in most cases, to prove that the transaction was procedurally and substantively fair.[1] By requiring the controlling shareholder to jump over a few more hurdles in proving the transaction was entirely fair, the standard protects minority shareholders from being squeezed-out or coerced into a suboptimal or unfair deal.

Though there is regulation for interested director and self-dealing controlling shareholder transactions, there is no statute that specifically deals with conflict of interest transactions by minority shareholders. Minority shareholders must exercise substantial influence over a corporation to be considered a controller and be subject to entire fairness review. But section 144, and *Weinberger v. UOP, Inc. (Weinberger)* and its progeny, allow minority shareholders to go substantially unregulated when they engage in conflict of interest transactions but do not exercise sufficient control over the corporation to be considered a controller.

The first Section of this Article will evaluate the terms and conditions of section 144, the problems with the statute, and recommend that the business judgment rule apply to interested director transactions when 144(a)(1) or 144(a)(2) are satisfied. Additionally, it will recommend that an interested director transaction be ratified once it satisfies the fairness test invoked under 144(a)(3). The second Section of this Article will discuss the seminal case of *Weinberger* and its progeny, and how the entire fairness standard of review is applied to self-dealing transactions by both de facto and de jure controlling shareholders. It will also discuss the implications of the three-part test suggested by *Weinberger* that would allow an interested controlling shareholder transaction to survive entire fairness review. The paper will discuss the holdings left behind by *Weinberger* and its progeny that allow an interested transaction by a controller to be reviewed under business judgment when the controller: 1) obtains the affirmative approval of an independent negotiating committee; 2) fully discloses all material information; and 3) obtains affirmative approval by the majority of minority shareholders.

1. *But see* Kahn v. M&F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014) (shifting the standard of review to business judgment when the merger was conditioned on independent-director negotiations and approval and the approval of a majority of the minority shareholders).

This Article will then discuss three approaches that can be taken to regulate conflict of interest transactions by minority shareholders. It will also recommend a standard of review that should regulate these transactions and will conclude by advocating that the subset of interested transactions by minority shareholders be included under section 144. Finally, this Article will recommend an increase in disclosure requirements by legislatively amending Item 404 of Schedule 14A to include interested minority shareholders..

I. REGULATING INTERESTED PARTY TRANSACTIONS UNDER DELAWARE LAW

A. *Background on Section 144*

Prior to the enactment of Delaware General Corporation Law (DGCL) section 144, interested director transactions could become void or voidable solely because of a director's self-interest. The underlying assumption was that interested directors are unable to act in the best interests of the corporation's shareholders when exercising their vote. Upon the realization that interested director transactions may be advantageous to a corporation, section 144 was brought into effect.[2] The purpose of section 144 was to allow interested director and officer transactions that pursue advantageous corporate opportunities to withstand automatic nullification.[3] Section 144 operates to allow directors and officers to engage in self-interested transactions by listing three ways in which a transaction can be "cleansed" of conflicted interest. The first prong of section 144 enumerates the specific interested transactions to which it applies. The rest of the statute lists the safe harbors and the requirements that must be met for those provisions to effectively protect the interested transaction from being void or voidable. Therefore, before analyzing the three ways in which section 144 will protect an interested director transaction, it is important to first determine which director transactions Delaware corporate law considers to be interested and

2. *See* Melvin Aron Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 997 (1988) (stating that interested director transactions can be beneficial to a corporation where "[a] director or senior executive might own a commodity for which there [is] no good market substitute or might be willing to give better terms than could be obtained on the market.").

3. *See, e.g.*, Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d. 150, 185 (Del. Ch. 2005) (satisfying one of the three requirements enumerated in section 144 only means that a transaction is not void or voidable solely based on the existence of a conflict of interest); Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976) (indicating that section 144 "merely removes an 'interested director' cloud when its terms are met and provides against invalidation of an agreement 'solely' because such a director or officer is involved.").

which of these interested transactions fall within the safeties of 144.

B. *Defining Interested Director and Officer Transactions*

Under Delaware corporate law, interested director transactions can encompass several scenarios where a director: usurps a corporate opportunity; stands on both sides of a transaction; deals with the corporation itself; or, derives a non-ratable financial benefit.[4] A director's self-interest can also be implicated where execution of a deal causes the director's promotion or hiring by a corporate counterparty in a merger.[5]

However, 144 does not apply to the entire range of director self-dealings. Instead, the text of 144(a) states:

> (A) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose . . .[6]

The first prong of the statute operates to explicitly limit its application to transactions where a director or officer is: 1) transacting with the corporation itself; 2) standing on both sides of the transaction as a director or officer of the corporation and the entity with which it is transacting; or 3) where the director has a strong financial interest from which he expects to derive a personal financial benefit.[7] This does not mean that the earlier discussed examples of interested director transactions are not considered to be interested under Delaware law. Rather, section 144 will not apply to those transactions and the deal will remain voidable. Moreover, section 144

4. *See* Pfeffer v. Redstone, 965 A.2d 676, 690 (Del. 2009) (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)) (finding that interested transactions exist when a director operates on both sides of a transaction or derives a financial benefit that is not ratably obtained by stockholders generally).

5. *See* Blake Rohrbacher, John Mark Zeberkiewicz & Thomas A. Uebler, *Finding Safe Harbor: Clarifying the Limited Application of Section 144*, 33 DEL. J. CORP. L 719, 726 (2008) (explaining that section 144 may not necessarily apply to interested transactions arising "whe[n] a director approves a merger between the corporation and a third-party bidder with the hope . . . that the third-party bidder will name the director as the CEO of the surviving corporation . . . unless the director were found to have a 'financial interest' in the acquiring company.").

6. DEL. CODE ANN. tit. 8, § 144(a) (2006).

7. *Id.*

applies solely to directors and officers. If a director or officer is not involved in the deal, then the safe harbors of section 144 will not apply.[8] However, if a director is engaged in a transaction in one of the three circumstances enumerated in section 144(a), the transaction will not be automatically void or voidable if it satisfies one of the safe harbors listed. Once a director engages in an interested transaction, the next step of the analysis requires assessing the conditions required to satisfy one of the three safe harbors.

1. Analysis of Section 144(a)(1)

The first safe harbor is 144(a)(1), which protects an interested director transaction from invalidation upon the good faith approval of a majority of fully informed disinterested directors.[9] This section states:

> [T]he material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum.[10]

This prong bundles together a few requirements that must be satisfied before the safe harbor will apply. First, the allegedly interested director must be interested in one of the ways listed in section 144(a).[11] Second, the material facts of the conflict or relationship of the interested director or officer must be fully disclosed to disinterested directors.[12] Third, the directors reviewing the transaction must qualify as "disinterested."[13] Finally, the disinterested directors must have acted in good faith when reviewing the transaction.[14]

The first part of this test establishes that section 144 will only apply if the directors are found to be interested in one of the following ways: 1) by transacting with the corporation itself; 2) by standing on both sides of the transaction as a director or officer of the corporation and the entity with which it is transacting; or 3) where the director has a strong financial interest

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8. *See* Cooke v. Oolie, No. 11134, 2000 WL 710199, at *44 n.39 (Del. Ch. May 24, 2000) (holding that section 144 does not apply because the directors neither sit on both sides of the potential transaction nor do they have a financial interest in the counterparty corporation).

9. DEL. CODE ANN. tit. 8, § 144(a)(1).

10. *Id.*

11. *See id.* (listing interested transactions as those in which the director interacts with the corporation itself, stands on both sides of the transaction, and has a strong financial interest).

12. *Id.*

13. *Id.*

14. *Id.*

from which she expects to derive a personal financial benefit.[15] Once a director is interested, the second question is whether the material facts of the conflict or relationship of the interested director or officer were fully disclosed to the disinterested directors. Delaware courts have repeatedly found a fact material when there is a substantial likelihood that a reasonable shareholder, in deciding how to vote, would consider it to be important.[16] Therefore, section 144 does not require that an interested director disclose every detail that led up to the transaction under review.[17] Instead, this section requires that a disinterested director at minimum have all information about a director's interest in the transaction that would assume actual significance in their decision to approve the deal.[18]

Once the material facts are disclosed to disinterested directors, courts determine whether the directors reviewing the transaction are, in fact, disinterested. To be considered disinterested, a director must be able to exercise his or her own independent business judgment in approving the transaction.[19] "The exercise of discretion and independent judgment implies that one has authority to make an independent choice, free from immediate direction or supervision."[20] Additionally, to establish disinterest, directors should inform themselves of all material information that can reasonably be obtained before exercising their business judgment.[21] In determining director independence in demand futility cases affected by director conflicts of interest, courts consider whether the directors are under the control of the

15. *Id.*; *see Pfeffer*, 965 A.2d at 690 (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)) (concluding that a transaction is interested when a director stands on both sides of the deal or derives a financial benefit which is not obtained by the stockholders generally). *But see* Oberly v. Kirby, 592 A.2d 445, 468 (Del. 1991) (indicating that large share ownership where self-interest may be involved may not necessarily be enough to create a conflict of interest among directors where the director with controlling shares does not obtain a financial benefit which stockholders do not).

16. Gantler v. Stephens, 965 A.2d 695, 710 (Del. 2009).

17. *See* McMillan v. Intercargo Corp., No. 16963, 1999 Del. Ch. LEXIS 95, at *32 (Del. Ch. May 3, 1999) (finding that a board is not required to disclose "all of the . . . bends and turns in the road" which led to the final agreement).

18. *See Gantler*, 965 A.2d at 710 (defining the materiality standard).

19. *See Eisenberg*, *supra* note 2, at 1002 (stating that "[a] factually disinterested director would be one who had no significant relationship of any kind with either the subject matter of the self-interested transaction, or the director or senior executive who is engaging in the transaction, that would be likely to affect his judgment.").

20. *Discretion and Independent Judgment*, JUSTIA, https://www.justia.com/dictionary/discretion-and-independent-judgment.html (last visited Mar. 1, 2018); *see also* In re Walt Disney Co. Derivative Litig., 731 A.2d 342, 356 (Del. Ch. 1998) (finding that the directors were unable to exercise their independent business judgment because they reported to and worked under the influence of the chairman of the board who was interested in the transaction).

21. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

interested directors or have personal interests that would prevent them from objectively assessing the transaction.[22] The requirement that a disinterested director approve an interested director deal assumes that disinterested directors can better represent shareholder interests because they have "no skin in the game."

Notably, though section 144(a)(1) requires that a majority of disinterested directors approve an interested transaction, it does not require that disinterested directors constitute a quorum for their approval to cleanse a transaction.[23] Section 144(b) adds that disinterested directors are not required to constitute a quorum for board meetings. This additional section was likely added because approval of self-dealing transactions by disinterested directors or shareholders originally posed problems for companies when a majority of the directors had a financial interest in the deal and so could not count toward satisfying a quorum. Additionally, Delaware courts have suggested that the approval by the majority of disinterested directors must be obtained at a formal board meeting for the safe harbor to apply.[24] Section 144(b) therefore appears to relax the quorum requirement for board meetings to have full legal effect by allowing interested directors to be included to constitute a quorum.

Finally, section 144(a)(1) requires that courts determine whether the disinterested directors acted in good faith in approving the transaction. To make this assessment, courts first determine what counts as approval in good faith. The American Law Institute's Principles of Corporate Governance §4.01 defines "good faith" where a director acts without a conflict of interest, exercises well-informed business judgment, and rationally believes that the business judgment is in the best interest of the corporation.[25]

A director is also found to have acted in good faith where he or she is "mindful of their duty to act in the interests of the corporation, and unswayed by loyalty to the interests of their colleagues . . . ."[26] A director or officer may have failed to act in good faith where he intentionally acts with motivations other than advancing the best interests of the corporation,

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22. Brehm v. Eisner, 746 A.2d 244, 256 (citing *Aronson*, 473 A.2d at 814).

23. DEL. CODE ANN. tit. 8, § 144(a)(1); *Quorum*, BLACK'S LAW DICTIONARY, https://thelawdictionary.org/quorum/ (last visited March 1, 2018) ("When a committee, board of directors, meeting of shareholders, legislative or other body of persons cannot act unless a certain number at least of them are present, that number is called a 'quorum.' In the absence of a rule setting the quorum requirement, a quorum will consist of a majority of those who are entitled to act.").

24. *See* Lewis v. Fuqua, 502 A.2d 962, 970 (Del. Ch. 1985) (finding that section 144 did not apply even though the transaction was approved because the approval did not take place at a formal board meeting).

25. PRINCIPLES OF CORP. GOVERNANCE § 4.01(a) (AM. LAW INST. 1994).

26. In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 756 n.464 (Del. Ch. 2005).

violates or intends to violate the law, or demonstrates a conscious disregard for his duties by failing to act when faced with a known duty to act.[27]

Additionally, courts find a lack of good faith where an independent or disinterested director makes a decision without first conducting a reasonable investigation into the matter.[28] A finding of gross negligence would be required to find that the board of directors breached their duty of good faith.[29]

2. Analysis of Section 144(a)(2)

If a transaction does not obtain the good faith approval of a majority of fully informed disinterested directors, directors may seek protection under section 144(a)(2). Section 144(a)(2) requires that the material facts as to the director or officer relationship or interest in the transaction be disclosed or known to the shareholders voting on the transaction.[30] It also requires that the contract or transaction be approved by a good faith vote of the shareholders.[31]

This section overlaps with the full disclosure of material facts requirement in section 144(a)(1). However, section 144(a)(2) mandates disclosure of material facts to all shareholders entitled to vote on the transaction. Therefore, under this safe harbor, the transaction is cleansed not by the approval of disinterested directors exercising their business judgment, but instead by the majority of shareholders who are entitled to vote on the transaction.

Information asymmetry arises where a board solicits shareholder approval to cleanse a transaction and a corporate insider's knowledge of corporate deals and their conflicted interests are substantially greater than that of the corporation's shareholders. Accordingly, directors have a fiduciary duty to fairly and fully disclose all material facts before a shareholder vote commences.[32] If shareholders lack the entire scope of

27. *Id.*

28. *See* Sutherland v. Sutherland, 958 A.2d 235, 242 (Del. Ch. 2008) (holding that the special litigation committee acted in bad faith when their analysis failed to properly investigate and disclose material facts in their recommendation to dismiss a shareholder derivative action).

29. *See* Smith v. Van Gorkom, 488 A.2d 858, 881 (Del. 1985) (holding a director liable for the breach of the duty of care because he was grossly negligent in arranging a merger transaction); Andersen v. Mattel, Inc., No. 11816-VCMR, 2017 Del. Ch. LEXIS 12, at *13 (Del. Ch. 2017) (finding that directors act in bad faith when their actions are motivated by harm, or taken with indifference to the harm that will result from action or inaction). By including DGCL §102(b)(7)) in the corporation's charter, directors have a complete waiver for acts of negligence or gross negligence. However, §102(b)(7)) does not apply to officers.

30. DEL. CODE ANN. tit. 8, § 144(a)(2) (2006).

31. *Id.*

32. "The burden rests on the party relying on stockholder approval to establish that the

material information surrounding a corporate deal, their votes are deemed to be uninformed and, consequently, void.[33] Therefore, a director's failure to disclose all material information regarding their conflict of interest to the corporation's shareholders will leave the transaction uncleansed and the safe harbor will not apply.[34]

The corporate waste doctrine is another circumstance where the power of the shareholders to affirm a self-dealing transaction through a majority vote under section 144(a)(2) is limited.[35] Corporate waste occurs when assets are given away without consideration, or when those assets are exchanged for something so disproportionately small as to lie beyond the range at which any reasonable person would be willing to make the trade. Under the corporate waste doctrine, even a majority vote cannot protect wildly unbalanced transactions that irrationally dissipate corporate assets. Only a unanimous shareholder vote can ratify a transaction constituting corporate waste.[36]

3. Analysis of Section 144(a)(3)

The third and final safe harbor that may rescue an interested director transaction from voidability is section 144(a)(3). To satisfy section 144(a)(3), the interested transaction must be "fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the stockholders."[37] Even where state law permits interested director transactions that are ratified by the majority of stockholders or disinterested directors on the board and the transaction is not ratified, the transaction will not be voidable if it is intrinsically fair.[38]

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approval resulted from a fully informed electorate and that all material facts relevant to the transaction were fully disclosed." Williams v. Geier, 671 A.2d 1368, 1379 (Del. 1996); Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983); Yiannatsis v. Stephanis, Del. Supr., 653 A.2d 275, 280 (1995); Van Gorkom, 488 A.2d at 893.

33. *Weinberger*, 457 A.2d at 703.

34. *See* Lewis v. Fuqua, 502 A.2d 962, 970 (Del. Ch. 1985) (finding that section 144 did not apply because the approval by a majority of stockholders did not take place after full disclosure of all material facts regarding the director's interest in the transaction).

35. Saxe v. Brady, 184 A.2d 602, 605 (1962); Keenan v. Eshleman, 2 A.2d 904 (1938); *see* Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) (stating that "[i]n all events, informed, uncoerced, disinterested shareholder ratification of a transaction in which corporate directors have a material conflict of interest has the effect of protecting the transaction from judicial review except on the basis of waste").

36. *See Williams*, 671 A.2d at 1380 (finding that a majority of shareholders voting to approve an interested transaction constitutes ratification except in circumstances of corporate waste where a unanimous shareholder vote is required).

37. DEL. CODE ANN. tit. 8, § 144(a)(3).

38. Marciano v. Nakash, 535 A.2d 400, 401 (Del. 1987).

In determining whether a transaction is fair to the corporation, courts evaluate the procedures of the transaction and the substantive terms of the deal, much like the common law test for entire fairness. In determining whether a deal is procedurally fair, courts assess factors such as: when the transaction was timed; how it was initiated, structured, negotiated, and disclosed to the directors; and how the director and shareholder approval was obtained.[39] Additionally, a transaction is more likely to be found procedurally fair if the deal is conducted at arm's length, using an independent negotiating committee to review the transaction.[40]

The inquiry into fair price is more quantitative, focusing on the economic and financial considerations of the transaction. Such consideration includes: "assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of the company's stock."[41] Though courts—likely for simplicity's sake—categorize the test for entire fairness into procedural and substantive evaluations, the test is not bifurcated. Rather, all issues must be examined on the whole.[42] Additionally, the burden for establishing entire fairness is borne by the corporate fiduciary who stands on both sides of the transaction.[43]

In 2007, a Delaware Chancery Court attempted to enumerate the processes it took to determine the entire fairness of an interested director transaction under section 144(a)(3). In *Valeant Pharmaceutical International v. Jerney* (*Valeant*), the court applied entire fairness review to an interested director transaction when the directors failed to obtain approval by either a majority of disinterested directors under section 144(a)(1) or a majority of shareholders under section 144(a)(2).[44] The transaction involved an attempt by the company's former director and president to pay large cash bonuses to board members.[45] Interested members of management initiated the transaction, and the terms of the payout were not negotiated. Moreover, everyone involved had an interest in the transaction. Even outside experts relied on misleading information which was provided to them by a CEO who stood to gain the most from the deal.[46] The court could not find anything about the process to support a finding of fairness and ultimately held that the

39. 921 A.2d 732, 748 (Del. Ch. 2007).

40. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (holding that the transaction was not procedurally fair because the interested party failed to deal at arm's length through an independent negotiating committee and failed to disclose material information).

41. Oliver v. Bos. Univ., No. 16570-NC, 2006 Del. Ch. LEXIS 75, at *79 (Del. Ch. Apr. 14, 2006) (citing *Weinberger*, 457 A.2d at 711).

42. *Id.* at *80 (citing *Weinberger*, 457 A.2d at 711).

43. *Valeant*, 921 A.2d at 746.

44. *Id.*

45. *Id.* at 748.

46. *Id.*

bonus payment scheme was not procedurally fair.[47]

Though the bonus payment plan in *Valeant* was procedurally unfair, the court still assessed the fairness of price. The court stated that even when the processes used to effectuate a deal are unfair, a price that is "so fair" can reel an interested transaction back within the realm of entire fairness.[48] The court indicated that a transaction that was procedurally unfair can still survive entire fairness review where the pricing terms of the transaction can be vindicated by "reference to reliable markets or by comparison to substantial and dependable precedent transactions."[49] Therefore, reliable markets and dependable precedent of the company's transactions are two metrics the court uses to determine whether a deal is substantively fair.[50]

The court attempted to evaluate transactional precedent by scrutinizing the company's "event bonus" policy.[51] Bonuses had been awarded at least twice in the past in extraordinary circumstances of success.[52] However, the court did not find the current circumstance of a spin-off to be comparatively extraordinary to warrant another bonus payment.[53]

Additionally, while courts generally allow directors to exercise their discretion as to what constitutes a fair price, the "proof of fair price will generally require a showing that the terms of the transaction fit comfortably within the narrow range of that discretion, not at its outer boundaries."[54] The directors in *Valeant* exercised their broad grant of discretion by valuing the bonus payment at two-percent of the total value of the spin-off.[55] The court referred to reliable market pricing used by the company's assumed Initial Public Offering (IPO) value to determine that the directors abused their discretion by valuing the bonus payments at an egregiously high price.[56] Because the bonus payments were deeply flawed with self-interest and were valued at a price exceedingly higher than fair market value, the bonus transaction satisfied neither the procedural nor substantive fairness standards

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47. *Id.* at 736.

48. The court uses a sliding scale approach to determine whether a transaction is entirely fair. If a transaction is procedurally unfair, a finding of substantive fairness may balance out the scale enough for the court to find that the transaction satisfies entire fairness review. *See id.* at 748 (qualifying that "where the pricing terms of a transaction that is the product of an unfair process cannot be justified by reference to reliable markets or by comparison to substantial and dependable precedent transactions, the burden of persuading the court of the fairness of the terms will be exceptionally difficult.").

49. *Id.*

50. *Id.*

51. *Id.* at 749.

52. *Id.*

53. *Id.*

54. *Id.* at 749.

55. *Id.* at 750.

56. *Id.*

under section 144(a)(3).

C. *Regulating Controlling Shareholder Conflicts of Interest Under Weinberger*

Delaware law also regulates self-dealing transactions involving controlling shareholders. In these transactions courts apply the entire fairness standard of review.[57] Courts have not applied the business judgment presumption as the default rule because that standard implies that directors are fully capable of protecting the interests of the corporation and its shareholders.[58] Conversely, conflict of interest transactions between a director and a corporation lose the presumption that director's will protect the interests of others.[59]

The entire fairness standard operates much like section 144(a)(3) in that it requires a finding of fair process and fair price before a transaction can be ratified. Notably, the existence of a controlling shareholder does not automatically require entire fairness review.[60] Rather, transactions where a controlling shareholder engages in self-dealing trigger this higher threshold of judicial scrutiny.

In the seminal case *Weinberger v. UOP, Inc.* (*Weinberger*), Weinberger, a former minority shareholder of UOP, brought a class action suit against UOP, requesting rescission of a cash-out merger between UOP, Inc. (UOP) and Signal, Inc. (Signal) which Weinberger claimed was unfair.[61] The court automatically applied the entire fairness standard to the proposed merger between UOP and Signal because Signal was an interested controlling shareholder standing on both sides of the deal as a buyer and seller of UOP.[62]

Signal became a controlling shareholder of UOP when it acquired 50.5% of UOP's outstanding stock, while the other 49.5% was owned by retail investors.[63] Signal was also operating on both sides of the transaction because Signal elected six out of the thirteen members sitting on UOP's

57. 457 A.2d 701, 710 (Del. 1983); Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 110 (Del. 1952).

58. Donald E. Schwartz, *Delaware General Corporation Law - A Commentary and Analysis*, 58 CORNELL L. REV. 625, 628 (1973).

59. *Id.*

60. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 722 (Del. 1971) (applying the business judgment rule where action taken by a controlling shareholder did not constitute self-dealing and affected all shareholders proportionately).

61. *Weinberger*, 457 A.2d at 703.

62. *Id.* at 710.

63. *Id.* at 704.

board, five of which were either directors or employees of Signal.[64] A conflict of interest existed because Signal was attempting to purchase the remaining 49.5% of UOP stock while at the same time representing the corporation in the sale of the company as a majority shareholder.[65] In applying the entire fairness standard the court ultimately held that the merger was unfair because UOP failed to disclose material information to its shareholders and outside directors that a price in excess of what Signal ultimately offered would have been reasonable for Signal to pay for the outstanding shares of UOP.[66]

In controlling shareholder transactions, section 144 is inapplicable because the statute solely applies to interested transactions involving directors and officers. In *Weinberger*, it was Signal, the controlling shareholder, making the decisions. However, because Signal elected some of its directors to the board of UOP, UOP did have interested directors in addition to an interested controlling shareholder. But the court focused on the controlling shareholder element here because the directors of UOP were acting under the control of Signal. Therefore, the outcome of *Weinberger* suggests that once a controlling shareholder is involved, the corporation can satisfy the following three conditions to fulfill their burden of proving that a transaction is entirely fair.[67] The corporation with the interested controlling shareholder must: 1) set up an independent negotiating committee to negotiate on behalf of the corporation against the majority shareholder; 2) fully disclose all material information; and 3) have the transaction approved by a majority of the minority shareholders. *Weinberger* indicates that if these three elements are not satisfied, the transaction will fail the entire fairness standard of review.[68]

The common law entire fairness standard seen in *Weinberger* is similar to the aforementioned fairness test elicited under section 144(a)(3) in that the test is composed of two concepts: fair dealing and fair price.[69] Fair dealing

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64. *Id.*

65. *Id.*

66. *Id.* at 710.

67. When the merger is conditioned upon the approval of a "majority of the minority" stockholder vote, and approval is obtained, the standard of review remains entire fairness, but the burden of proof shifts to the plaintiff to prove that the transaction was unfair. Kahn v. Lynch Comm. Sys., 638 A.2d 1110, 1116 (1994); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937-38 (1985); *Weinberger*, 457 A.2d at 710.

68. *See Weinberger*, 457 A.2d at 710 (finding that defendants failed to set up an adequate independent negotiating committee and failed to fully disclose all material information to shareholders before subjecting them to a vote on the transaction).

69. "The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the stockholders." DEL. CODE ANN. tit. 8, § 144(a)(3) (2006).

involves the timing, initiation, negotiation, and structure of the transaction.[70] Alternatively, fair price deals with economic and financial considerations, including: assets, market value, earnings, future prospects, or any other elements that affect the inherent value of a company's stock.[71]

In *Weinberger*, the court first suggests that to survive entire fairness review, UOP needed to set up an independent negotiating committee that would deal with Signal, the controlling shareholder, at arm's length.[72] However, UOP failed to set up an adequate independent negotiating committee to negotiate on its behalf with the controlling shareholder and instead had UOP's CEO, a long-time standing employee of Signal, negotiate the merger on behalf of UOP.[73] Had UOP created an independent negotiating committee to deal at arm's length with Signal, the result here may have been different.[74]

Additionally, both UOP and Signal, as the controlling shareholder, failed to fully disclose all material facts of the transaction to the minority shareholders of UOP.[75] In attempting to acquire UOP through a merger, Signal instructed two employees, who also sat on the board of UOP, to conduct a feasibility study assessing the possibility of acquiring the remaining 49.5% of UOP's shares.[76] In the feasibility study, these two employees concluded that Signal would make a beneficial investment if Signal paid any price up to $24 per share to acquire the remaining 49.5% of UOP's shares.[77] Signal, however, never disclosed this report to the shareholders of UOP.[78] Instead, Signal proposed to pay $21 per share as fair value even though the feasibility report quoted that a price of $24 per share was reasonable for UOP to request.[79] This price differential led to a loss of nearly $17 million for the minority shareholders of UOP.

Furthermore, the CEO of UOP retained Lehman Brothers to render a fairness opinion as to the $21 per share price offered to the minority shareholders.[80] Lehman Brothers only had three business days to assess the

70. *Weinberger*, 457 A.2d at 711.

71. In *Weinberger* the court discards the Delaware block method for determining value and instead allows proof of value using any techniques or methods which are generally considered acceptable in the financial community. *Id.* at 713.

72. *Id.* at 711.

73. *Id.* at 705.

74. *See* Harriman v. E. I. Du Pont de Nemours & Co., 411 F. Supp. 133, 142 (Del. 1975) (creating a special negotiating committee substantiated the courts finding of procedural fairness through arm's length negotiations).

75. *Weinberger*, 457 A.2d at 705.

76. *Id.*

77. *Id.*

78. *Id.* at 707.

79. *Id.*

80. *Id.* at 706.

fairness of the offer price, ultimately concluding that the $21 per share offer was a fair value.[81] However, neither the UOP shareholders nor UOP's outside directors were fully informed of the quick speed at which this valuation was conducted.[82] Therefore, UOP, along with Signal as the controlling shareholder, failed to disclose all information to UOP's shareholders in two material respects that would have undoubtedly altered their voting decision.

Finally, although UOP managed to obtain approval from the majority of the minority shareholders, the court found the vote to be invalid as the shareholders did not have all material information disclosed to them in order to make a fully informed vote on the merger transaction.[83] The court found the merger transaction to be unfair and found Signal to have breached its fiduciary duty of fair dealing with the minority shareholders.[84]

The court in *Weinberger* indicated three ways in which an interested transaction by a controlling shareholder can survive entire fairness review. However, because these steps were not satisfied, the transaction in *Weinberger* failed entire fairness review.[85] Therefore, the court never elaborated on what happens if the corporation satisfies all three requirements.

In 2014, the Supreme Court of Delaware shed some light on what happens when the three prongs of *Weinberger* are satisfied. In *Kahn v. M&F Worldwide Corp.* (*M&F Worldwide*), controlling shareholder MacAndrews & Forbes Holdings, Inc. (MF) orchestrated a going private merger with M&F Worldwide Corp. (MFW), a holding company.[86] Because the merger transaction involved an interested controlling shareholder, the deal should have been subject to entire fairness review, as in *Weinberger*. However, the Supreme Court applied a new standard, consistent with *Weinberger* and its progeny, that allowed the interested transaction by MF, the controlling shareholder, to be reviewed under the business judgment rule. The court held that rather than apply the entire fairness standard, the business judgment rule will be the appropriate standard of review if, but only if, several steps

81. *Id.* There is no specified amount of time that is required for fairness opinions to be legitimate. However, courts generally apply a reasonableness standard to investment banks, particularly looking for facts that indicate the bank did more than just "rubber stamp" the fairness opinion. *Fairness Opinions: Liability Issues an Investment Bank Should Consider – Part One*, Bloomberg Law Reports — Corporate and M&A Law (BNA) Vol. 5, No. 23 (2011), https://www.lw.com/upload/pubcontent/_pdf/pub4356_1.pdf.

82. *Weinberger*, 457 A.2d at 708.

83. *Id.* at 703.

84. *See id.* at 709 (stating that majority shareholders have a duty to deal fairly with minority shareholders).

85. *Weinberger*, 457 A.2d at 702.

86. 88 A.3d 635, 638 (Del. 2014).

are taken: 1) the procession of the transaction depends "ab initio" on approval by both a special committee and a majority of the minority shareholders; 2) the special committee is independent; 3) the special committee is empowered to freely select its own advisors and to definitively say no; 4) the special committee meets its duty of care in negotiating a fair price; 5) the vote of the minority is informed; and 6) there is no coercion of the minority shareholders.[87]

Although the *M&F Worldwide* decision lists six factors, these six factors can be collapsed into three requirements that mirror the roadmap enumerated in *Weinberger*: full disclosure, majority of the minority approval, and an independent negotiating committee. Because MF preconditioned the merger on the approval of both a fully informed and adequately empowered independent special committee, and an informed and uncoerced vote of the majority of the minority stockholders, the business judgment rule applied.[88] The court states that *M&F Worldwide* is consistent with *Weinberger*, *Kahn v. Lynch Communications Systems, Inc.* (*Kahn v. Lynch*), and their progeny.[89] Therefore, unless both procedural protections for the minority stockholders are established prior to trial, the appropriate judicial standard of review would continue to be entire fairness, with the possible shift in the burden of proof.[90] Other cases lend further credence to this supposition. The court in *In re Cox Communications, Inc.* (*In re* Cox) held that business judgment review was proper when a freeze-out merger was: 1) approved by an independent committee; and 2) conditioned on approval by "a majority of the minority stockholders".[91] If not, or if there is doubt about one of the requirements, the appropriate standard is entire fairness.[92] Additionally, *In re CNX Gas Corporation Shareholders Litigation* (*In re* CNX) establishes that the business judgment rule will apply once a two-step tender offer freeze-out transaction satisfies the three safeguarding minority shareholder conditions: full disclosure, independent negotiating committee, and the majority of the minority shareholder approval.[93] Therefore, in applying *M&F Worldwide* to *Weinberger*, the standard of review would have shifted from entire fairness to business judgment if the controlling shareholder, UOP, had created an adequate and

87. *Id.* at 639.

88. *Id.* at 638.

89. *Id.*

90. *Id.* at 646; *see* Kahn v. Lynch Comm. Sys., 638 A.2d 1110, 1117 (Del. 1994) (shifting the burden of proof to the plaintiff to prove the transaction was not entirely fair after the transaction have been approved by an independent committee of directors or an informed majority of the minority shareholders).

91. 879 A.2d 604, 606 (Del. Ch. 2005).

92. *Id.*

93. 4 A.3d 397, 400 (Del. Ch. 2010).

independent special committee and fully disclosed all material information to its shareholders before the majority of the minority voted to approve the transaction.

Finally, in a recent Delaware Chancery Court case, *In re EZCORP Inc. Consulting Agreement Derivative Litigation* (*In re EZCORP*), a shareholder brought a derivative suit against the board of directors on a breach of fiduciary duty claim and against the controlling shareholder on aiding and abetting the director defendants in breaching their fiduciary duties.[94] The controlling shareholder, Cohen, was a minority shareholder with high-vote shares which gave him control over EZCORP while owning only 5.5% of the company's equity.[95] Cohen engaged in conflict of interest transactions as a controlling shareholder by receiving a non-ratable benefit in the form of EZCORP's long history of advisory service agreements with entities affiliated with Cohen, and Cohen's incentive to obtain returns at the expense of paying out dividends.[96] The court found the appropriate standard of review in conflict of interest transactions by a controlling shareholder to be the business judgment rule when the controller agrees up front that the transaction will not go forward unless it is conditioned upon both 1) the affirmative recommendation of an independent negotiating committee; and 2) the affirmative vote of a majority of the minority shareholders unaffiliated with the controller.[97] This case, along with the those prior mentioned, reiterates and solidifies *Weinberger's* roadmap to lowering the standard of review to business judgment when an interested controlling shareholder is involved.

In comparison to the business judgment rule, often invoked once section 144 is satisfied,[98] an increased level of scrutiny is applied to interested transactions by controlling shareholders. The *Weinberger* three-step test requires that all three factors be satisfied — the independent negotiating committee, full disclosure, and the majority of the minority shareholder approval — for the transaction to survive entire fairness review. Compare this with interested director transactions under 144 where a director only must satisfy one of the three listed requirements, not all three, before the business judgment rule will apply.[99]

The requirement that corporations with interested controlling

94. No. 9962-VCL WL 301245, at *22 (Del. Ch. Jan. 25, 2016).

95. *Id.* at *5.

96. *Id.* at *97.

97. *Id.* at *33.

98. *See* Cooke v. Oolie, No. 11134, 2000 WL 710199, at *44 (Del. Ch. May 24, 2000) (applying the business judgment rule standard of review when section 144(a)(1) or 144(a)(2) has been satisfied and the director or officer is not the majority shareholder).

99. The statute does not indicate that the business judgment rule automatically applies, however, courts often find this to be the appropriate standard once 144 is satisfied. *Id.*

shareholders jump over more hurdles to receive the deferential business judgment review reflects a policy attempt to protect minority shareholders. When a controlling shareholder is involved in a transaction, directors and officers of the corporation may be pressured or coerced to act in favor of the controlling shareholder and against the best interests of the corporation. Entire fairness is a substitute for the dual protections of a disinterested board and shareholder approval because either can be undermined by the influence of the controller.[100] By requiring arm's length negotiations through an independent negotiating committee, full disclosure, and approval by a majority of minority shareholders, the court prevents coercion and manipulation from clouding the judgment of the corporate entity.

II. RESOLVING THE AMBIGUITIES IN THE CURRENT REGULATORY FRAMEWORK

A. *Resolving the ambiguities in DGCL 144*

Assessing the ways in which courts have interpreted and applied the provisions of section 144 highlights the many imperfections of the statute. First, section 144 appears to omit important words that courts have subsequently interpreted into the statute, begging the question whether these additions were within the legislators' original intent. Second, the statute leaves unanswered what happens once an interested director satisfies one of the three safe harbors. Is the transaction ratified? Is it subject to additional judicial scrutiny? If it is still to be subjected to judicial scrutiny, which standard or test should apply?

Though Delaware law generally attempts to create enabling and descriptive statutes rather than prescriptive statutes, the ambiguity of section 144 has courts struggling to give it a clear meaning and straightforward application. Therefore, a vague enabling statute should not be left vague for judges to project and entertain their subjective interpretations, as this leads to inconsistent judicial rulings and unpredictability for corporate directors. Instead, these problems should be addressed and resolved to more narrowly tailor the statute and facilitate more consistent adjudication.

1. Clarifying the Ambiguities in 144(a)(1)

The first ambiguity of the statute is found in section 144(a)(1). Section 144(a)(1) is a safe harbor for interested director transactions that protects the statute from voidability with approval by a majority of fully informed

100. Kahn v. M&F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014).

disinterested directors acting in good faith.[101] However, if a corporation has only one disinterested director, will a corporation be able to use section 144(a)(1) to cleanse an interested director transaction? Or, is more than one independent director required at all times. The statute is unclear on this point. However, in *In re CNX* , a sole independent director negotiated on behalf of CNX with the controlling shareholder, Consol, who was attempting a two-step merger freeze-out.[102] Though this case did not involve an interested director and therefore did not invoke section 144, the case may imply how the uncertainty in section 144(a)(1) should be interpreted. If an independent director is qualified in the eyes of the court to impartially negotiate on behalf of the corporation, a sole disinterested director should also be able to cleanse an interested director transaction under section 144(a)(1).[103]

2. Clarifying the Ambiguities in 144(a)(2)

As discussed earlier, section 144(a)(2) protects interested director transactions from voidability when a fully informed majority shareholder vote approves the deal.[104] The statute explicitly requires that shareholders be fully informed of all material information regarding the director's interests in a transaction and that they approve the transaction in good faith.[105] The statute does not explicitly state the threshold voting requirement for shareholder approval. However, courts have read the statute to require approval from a majority of disinterested shareholders in order to satisfy the threshold.[106]

Shareholder disinterest would consist of the fully informed uncoerced

101. DEL. CODE ANN. tit. 8, § 144(a)(1) (2006).

102. Consol was the controlling shareholder of CNX Gas, owning 83.5% of CNX stock. In re CNX Gas Corp. S'holders Litig., 4 A.3d 397, 401 (Del. Ch. 2010).

103. *Id.* An independent director is not synonymous with a disinterested director. The two terms overlap substantially but are not identical. An independent director is always disinterested; however, a disinterested director may not always be independent. "The term 'independent director' means a director who does not have employment, family, or other significant economic or personal connections to the corporation other than serving as a director. It is often used interchangeably with the term 'disinterested director,' which means a director who, for purposes of voting on a specific transaction or arrangement with the corporation, does not have an economic or personal interest in that transaction or arrangement." Bruce Davis, *Director Independence and Corporate Governance*, BUSINESS LAW TODAY (2010), https://www.americanbar.org/publications/blt/2010/11/training_tomorrow.html.

104. DEL. CODE ANN. tit. 8, § 144(a)(2) (2006).

105. *Id.*

106. *See* Gottlieb v. Heyden Chem. Corp., 91 A.2d 57, 59 (Del. 1952) (stating that "the entire atmosphere is freshened and a new set of rules invoked where formal approval has been given by a majority of independent, fully informed stockholders.").

vote of the majority of shareholders entitled to vote.[107] While the safe harbor provision does not statutorily require approval by a majority of the disinterested shareholders, Delaware courts interpreting section 144(a)(2) have concluded that the condition is implicit in the requirement that shareholders vote to approve the transaction in good faith.[108]

In *Lewis v. Vogelstein*, Mattel Inc. (Mattel) adopted a stock compensation plan for its outside directors which entitled the directors to a one-time option grant of 15,000 shares of Mattel common stock.[109] The compensation plan was ratified by a shareholder vote, and a shareholder suit was brought by Harry Lewis on a breach of fiduciary duty claim.[110] The court held that "[i]n all events, informed, uncoerced, disinterested shareholder ratification of a transaction in which corporate directors have a material conflict of interest has the effect of protecting the transaction from judicial review except on the basis of waste."[111] The court read disinterest into the statute by invalidating the shareholder vote because nearly two-thirds of the shareholders were interested in the transaction.[112] Reading the statute in this way exacerbates the power of minority votes and protects against the circumstance where a majority of the shares are held by interested directors. Courts are focused on excluding conflicted or interested voting and ensuring that a neutral party decides whether to approve the deal.[113] As the court stated in *Oberly v. Kirby*, "[t]he key to upholding an interested transaction is the approval of some neutral decision-making body."[114] Ratification by disinterested shareholders is also an important requirement due to the complications involved with shareholder voting, such as: collective voting, cross-holdings, vote-buying, uninformed voting, and

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107. *See* Lewis v. Vogelstein, 699 A.2d 327, 335 (Del. Ch. 1997) (finding that a shareholder vote would be invalid if the majority of the shareholders who ratified the transaction had conflicted interests).

108. Cement Masons Local 780 Pension Fund v. Schleifer, 61 N.Y.S.3d 190 (N.Y. Sup. Ct. 2017); *see also* In re Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 615 n.19 (Del. Ch. 2005) (indicating that "[t]he reference to the approval of stockholders being made in 'good faith' in [section] 144(a)(2) might be read as imposing a requirement on an interested party to the transaction that its approving vote as a stockholder to refrain from using its voting power to push through a transaction unfair to the corporation and correspondingly overgenerous to the interested party.").

109. *Vogelstein*, 699 A.2d at 329.

110. *Id.*

111. *Id.* at 336.

112. *See id.* (requiring approval by disinterested shareholders to ratify an interested director transaction).

113. *See* Fliegler v. Lawrence, 361 A.2d 218, 221 (Del. 1976) (finding that section 144(a)(2) warrants a reading of "disinterest" due to circumstances where a majority of the shares that voted to approve the transaction were owned by interested directors).

114. 592 A.2d 445, 466-67 (Del. 1991).

controlling shareholders.[115] Shareholders are not homogenous. Instead, they have competing interests and diverging views on what wealth maximization looks like.[116]

The Delaware legislature wanted to emphasize the importance of good faith and fair dealing, specifically including the phrase "good faith" as a requirement of section 144(a)(2).[117] This intent can only be effectuated when the vote disqualifies interested votes. Therefore, the statute should be amended to explicitly allow for an interested director transaction to be cleansed only when it has been ratified by a majority of "disinterested" shareholders. Although Delaware courts already read this language into the statute, by going one step further and including it in the text, the legislature can better effectuate its legislative intent. This amendment will also provide more clarity and predictability for corporate directors and more consistent adjudication.

3. Applying a Standard of Review

Finally, courts diverge as to what happens when a transaction satisfies the requirements of section 144 because the statute fails to prescribe the standard of review that should apply upon compliance with its safe harbors. The crux of the dispute is whether an interested director transaction that satisfies section 144 should then be subject to the business judgment rule or entire fairness review. The original purpose and explicit language of section 144 indicates that the statute operates merely to shelter interested transactions from being void solely because of the director's lack of impartiality.

Contrary to the Chancery Court's finding in *Lewis v. Vogelstein*, the statute fails to protect the transaction from any further judicial scrutiny once the safe harbors of sections 144(a)(1) or 144(a)(2) are satisfied.[118] Professor

115. *See* Grant M. Hayden and Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445, 499-500 (2008), https://scholarlycommons.law.hofstra.edu/cgi/viewcontent.cgi?article=1166&context=faculty_scholarship (discussing the lack of homogeneity among shareholders due to the diverging interests between minority shareholders and "majority shareholders, shareholders with disproportionate voting rights, members of voting trusts, bribed shareholders, hedged shareholders, sovereign wealth funds, and employee and management shareholders.").

116. *Id.* at 500.

117. DEL. CODE ANN. tit. 8, § 144(a)(2) (2006).

118. *See Vogelstein*, 699 A.2d at 329 (holding that "[i]n all events, informed, uncoerced, disinterested shareholder ratification of a transaction in which corporate directors have a material conflict of interest has the effect of protecting the transaction from judicial review except on the basis of waste."); *Fliegler*, 361 A.2d at 222 (Del. 1976) (rejecting defendant's argument for broad immunity under 144 and stating that nothing in the statute completely removes an interested director transaction from judicial scrutiny).

Ernest Folk, in his commentary and analysis of section 144, notes that, "[t]he validating effect does not go beyond removing the spectre of voidability . . . ."[119] But it should. The high approval threshold required by section 144 indicates that the statue should do more than simply protect the transaction from voidability. In fact, courts have held that, absent a finding of corporate waste, satisfying the requirements of section 144 should invoke the business judgment rule standard of review.[120]

In *Benihana of Tokyo, Inc. v. Benihana, Inc.* (*Benihana*), the court applied the business judgment rule after an interested director transaction received the approval of disinterested directors under 144(a)(1).[121] The court found business judgment to be the appropriate standard of review because the board possessed all material information on the transaction that was sufficient to render a neutral and untainted approval.[122] Additionally, the court in *Marciano v. Nakash* further added that "approval by fully-informed disinterested directors under section 144(a)(1), or disinterested stockholders under section 144(a)(2), permits invocation of the business judgment rule."[123] The court here applied the business judgment rule because evidence showed that the self-dealing transaction was a legitimate and beneficial deal for the corporation.[124]

Case law clearly indicates that once sections 144(a)(1) or 144(a)(2) are complied with, the transaction shall be reviewed under the business judgement rule. This is the appropriate result that should follow. But, further, section 144 should be amended to include explicit language stating that the business judgment rule will apply once section 144 is satisfied. This amendment would result in more certainty and predictability in corporate transactions.

Some commentators argue that satisfying the safe harbors of section

119. Rohrbacher, *supra* note 5, at 724 (citing Ernest L. Folk, II, in THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS 82 (2d. 1972).

120. Benihana of Tokyo, Inc. v. Benihana, Inc., 906 A.2d 114, 120 (Del. 2006); Cede & Co. v. Technicolor, 634 A.2d 345, 366 n.34 (Del. 1993); Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987).

121. *See Benihana*, 906 A.2d at 120 (finding that once the transaction receives the approval of disinterested directors, the court will apply the business judgment rule in reviewing the transaction); *see also* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (stating that the business judgment rule "is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company.").

122. *Benihana*, 906 A.2d at 121; *see also Technicolor*, 634 A.2d at 366 n.34 (holding that the three safe harbors of section 144 operate to remove the "interested director cloud" and bring the transaction within the review of business judgment).

123. *Marciano*, 535 A.2d at 405.

124. *Id.* at 401.

144 can still subject a transaction to the entire fairness standard of review.[125] Stating that section 144 was originally created for the sole purpose of protecting an interested director transaction from voidability and therefore has a very narrow, limited scope.[126] As Delaware Supreme Court Justice Moore stated in his *Unocal Corp. v. Mesa Petroleum Co.* (*Unocal*) opinion, "[O]ur corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs. Merely because the [Delaware] General Corporation Law is silent as to a specific matter does not mean that it is prohibited."[127] Recent case law, discussed above, has adapted to evolving concepts in applying the business judgment rule once sections 144(a)(1) and 144(a)(2) are satisfied. The landscape of corporate law has changed since the enactment of section 144 in 1967, suggesting that there is no need to narrowly construe section 144 solely because it is consistent with its original purpose.

Additionally, business judgment should apply because section 144's safe harbors exhaustively remove the taint of director interest from a transaction. Entire fairness review is intended to act as a substitute for the dual protections of a disinterested board and shareholder approval because both can be undermined by the influence of an interested controlling party.[128] However, these dual protections are not necessary in the case of interested director transactions. The good faith approval of a majority of disinterested directors effectively removes the interested director from the decision-making role. Therefore, section 144(a)(1) alone, through the requirement of good faith, full disclosure, and approval by a majority of disinterested directors, ensures a fair assessment of what is best for the corporation and its shareholders. The interested director does not have effective control over the disinterested directors, which would be necessary to undermine this requirement.

The same is true for section 144(a)(2). The requirement that a majority of disinterested directors approve an interested transaction should satisfy courts that the transaction was free of coercion and director interest. Because the interested director cannot control the votes of the corporation's shareholders, the vote is presumed to be free of director self-interest. Additionally, even if a director owns a substantial amount of the corporation's outstanding shares, he or she will not be able to vote those shares in attempting to satisfy section 144(a)(2). Delaware law effectively

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125. See Rohrbacher, *supra* note 5, at 744 (stating that section 144 does not have an impact on whether the interested transaction will be subject to entire fairness review or the business judgment rule).

126. *Id.* at 746-47.

127. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 957 (Del. 1985).

128. Kahn v. M&F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014).

strips the interested director from voting their shares in two ways. First, the courts have continuously interpreted section 144 to require that a majority of disinterested shareholders approve the transaction. Second, the explicit language of the text requires that the majority of shareholders approve the transaction in good faith. If any number of interested director shares are used to meet the majority approval threshold, the approval fails to satisfy the necessary good faith requirement. Therefore, if a transaction is free of suspicion and self-interest, the statute should lower the standard of review to business judgement.

Alternatively, under section 144(a)(3) there should be no additional judicial scrutiny applied to a transaction that satisfies the requirements for entire fairness. The conditions of section 144(a)(3) require that an interested director carry the burden of proving that "[t]he contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the stockholders."[129] Therefore, a non-disclosing interested director can remove the cloud of interest from a transaction by proving the entire fairness of the deal.[130] The burden that the interested director carries would appear to be the same under section 144(a)(3), as under prior case law, of proving the entire fairness of a questioned transaction which had been approved or ratified by the directors or shareholders.[131]

These amendments to section 144 would clarify the statute and allow for more accurate and uniform judicial decision-making. These changes may even deter many unwarranted challenges to interested director transactions through the certainty of a clear statutory intent. Furthermore, the amendments would allow for more predictability in corporate decision-making by providing directors and officers with a clear roadmap on how to successfully structure and cleanse an interested transaction.

When comparing the tests applied by Delaware courts to interested party transactions, one can gain perspective into the substantial overlap between the two. Specifically, the *Weinberger* test is nearly a mirror image of the test laid out in section 144. Both tests try to simulate both arm's length negotiations in interested transactions and the uncoerced and fully informed approval by a majority of the minority shareholders. The main difference is that *Weinberger* requires all three prongs to be satisfied before the business judgment rule will apply, whereas section 144 requires satisfying only one of three provisions to lower the standard of judicial scrutiny.

The requirement that controlling shareholders, and not directors, jump

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129. DEL. CODE ANN. tit. 8, § 144(a)(3) (2006).

130. Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987); DEL. CODE ANN. tit. 8, § 144(a)(2) (2006).

131. DEL. CODE ANN. tit. 8, § 144(a)(2) (2006); Rohrbacher, *supra* note 5, at 725.

through all three hoops to receive deferential review suggests that conflicting shareholder incentives call into question the effectiveness of gaining the approval of the majority of the minority shareholders. This is an accurate suspicion as interested controlling shareholders may compromise corporate decision-making to a greater extent than do interested directors or officers. For example, controlling shareholders may occupy a uniquely advantageous position through their ability to elect directors. This may cause current directors to feel pressure to conform to keep their seat on the company's board. There is also the fear that independent directors feel a stronger allegiance to a controller, rather than to the corporation and its public stockholders. Therefore, when a controlling shareholder is involved, courts require the controller to condition the procession of the transaction on the approval by a special committee, full disclosure, and a majority of minority stockholders vote to obtain business judgment review.

However, *Weinberger* and section 144 both leave behind a substantial ambiguity: what standard of review should apply to interested transactions by minority shareholders, particularly minority activist hedge funds. Section 144 does not include minority shareholders within its regulation, as it explicitly applies to interested director and officer transactions. Additionally, the *Weinberger* roadmap applies solely to controlling shareholders and does not suggest what standard should apply when minority shareholders engage in interested transactions.

III. REGULATING INTERESTED MINORITY SHAREHOLDERS

A. *Background on Minority Shareholders*

Section 144 and the *Weinberger* roadmap facilitate regulation of interested party transactions under Delaware law. However, these two regulatory frameworks fail to regulate any interested transactions by individuals who are neither directors nor officers nor controlling shareholders of a corporation. The Delaware code and case law remain silent on the issue of regulating conflict of interest transactions by minority shareholders. The lack of regulation for interested minority shareholder transactions may be due to the assumption that minority shareholders are powerless. However, minority shareholders are not powerless. The current decrease in stock ownership by retail investors and the increase in shares held by institutions has led to a substantial increase in the voting power of minority shareholders.[132] In fact, activist investors and hedge funds are

132. *See* SULLIVAN AND CROMWELL, 2016 U.S. SHAREHOLDER ACTIVISM REVIEW AND

among the most influential minority shareholders.

Activist hedge funds and investors such as Carl Icahn, Bill Ackman, and Nelson Peltz may not have direct and sufficient control over the board of directors to the extent that they would be considered a controller under contemporary law, nor do they own more than 50% of the corporation's stock.[133] However, minority activist shareholders can still put persuasive pressure on the board to act in ways most favorable to the fund's position. Activist investors have increasingly pressured managers into pursuing corporate transactions varying from the issuance of dividends, share repurchases, the sale of assets, or the sale of the entire corporation.[134] In many instances, activist investors, as minority shareholders, uniquely benefit from these transactions.[135] It is questionable whether this benefit is at the expense of the long-term value of the firm and its shareholders, and whether the market should consider minority shareholder activists to be controllers.

The current market approach is that a 5% ownership stake is a sufficient threshold for minority shareholders to be able to exert sufficient influence over a board to be considered a controller.[136] This threshold is also consistent with the filing of Schedule 13D with the SEC which is required when a person or persons obtain the beneficial ownership of more than 5% of a voting class of a company's registered stock, and are holding the stock with non-passive intent.[137] Under Schedule 13D Item 6, if a minority shareholder accumulates 5% of beneficial stock ownership, the shareholder is required to disclose any "contracts, arrangements, [or] understandings . . . with respect to any securities" of the company.[138] Additionally, under Item 4, the minority shareholder would be required to indicate its true intents and

ANALYSIS 3 (2016), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_2016_U.S._Shareholder_Activism_Review_and_Analysis.pdf [hereinafter Sullivan and Cromwell] (highlighting the higher level of voter participation by institutional investors over retail investors with only 28% of retail-held shares voted compared to 91% of institutional owned shares voted in 2016).

133. "Activist shareholder defines an individual investor or institutional investor, such as an activist hedge fund, that purchases a non-controlling minority stake of the voting class of a public company's equity securities to effect changes within the target company. Activist investors do not own, control or manage the corporations in which they invest. Instead, they rely on the support of institutional investors and pension funds to exert influence and exercise their shareholder rights." Activist Investor Definition, CARRIED INTEREST, https://www.carriedin.com/activist-investor/.

134. Iman Anabtawi & Lynn A. Stout, *Fiduciary Duties for Activist Shareholders*, 60 STANFORD L. REV. 1255, 1256 (2008).

135. *Id.*

136. J.P. Morgan, *The Activist Revolution: Understanding and Navigating a New World of Heightened Investor Scrutiny*, 6 (2015), https://www.jpmorgan.com/jpmpdf/1320693986586.pdf.

137. 17 C.F.R. § 240.13(d)–101 (2017).

138. *Id.*

purposes in accumulating the stock.[139]

However, the disclosure of hedging short positions, and positions in a proposed merger counterparty, are not explicitly required.[140] It is often the case that activist hedge funds own less than 7%.[141] Activist hedge funds have even shown to be effective while owning 1% or less of shares outstanding and would therefore not be required to file Schedule 13D.[142] Because activist hedge funds cannot directly control the vote of the corporation, they instead exert control through threats of a proxy fight or aggressive public relations campaigns generally directed at the board of the target corporation.[143] Activist hedge funds also engage in other shareholder campaigns, including: "publicly disclosing letters to target companies, issuing press releases, proposing precatory or binding shareholder proposals, running 'vote no' campaigns against incumbent directors, calling special meetings or taking actions by written consent."[144] Activist shareholders such as Icahn, Ackman, and Peltz also put pressure on the board of directors through stock accumulation, shareholder proposals, public communications, proxy contest solicitation, and unsolicited offers and takeovers.

Activist minority shareholders can engage in various forms of interested transactions. First, activist shareholders and institutions are focused on profit maximization and short swing profits. Therefore, activist shareholders can buy a block of common stock in the target corporation and vote the shares while at the same time hedging away economic interest in the stock through derivatives contracts.[145] Second, activist shareholders can take a negative economic position in the firm by shorting its stock and then profiting by advocating for changes that will drive down the stock price.[146] The effect of

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139. Thomas W. Briggs, *Conflicts of Interest and Full Disclosure*, 32 J. OF CORP. L. 701 (2007), http://go.galegroup.com/ps/i.do?p=LT&u=nellco_penn&id=GALE|A167030885&v=2.1&it=r&sid=LT&asid=6ec3fc1b.

140. *Id.*

141. *Id.*; *see also* Sullivan and Cromwell, *supra* note 132, at 2 (finding that in ownership campaigns launched in 2015, the median percentage ownership of the activist group was less than 7%, and for companies with a market cap of $20 billion, ownership was less than 3%).

142. See J.P. Morgan, *supra* note 136, at 7 (indicating that sixty percent of campaigns that target $25 billion-plus market cap companies are initiated by activists who own less than a 1% stake in the corporation).

143. Martin Lipton, *Dealing with Activist Hedge Funds and Other Activist Investors*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE AND FIN. REG. (January 26, 2017), https://corpgov.law.harvard.edu/2017/01/26/dealing-with-activist-hedge-funds-and-other-activist-investors/. *See also* Sullivan and Cromwell, *supra* note 132, at 6 (finding that companies which launch activist campaigns generally do not hold enough stock to play a direct and determinative role in voting).

144. Sullivan and Cromwell, *supra* note 132, at 15.

145. Anabtawi, *supra* note 134, at 1258.

146. *Id.*

these actions is negative and results in the separation of voting rights and economic interests. Hedge funds can also engage in an interested transaction with the director of the target corporation as a principal of the hedge fund. Finally, activist shareholders can be interested in merger transactions when they are transacting as both a target shareholder and the bidder.

Shareholder advocates argue that activist shareholders, by targeting weak companies and curing corporate governance inefficiencies, maximize value by giving voice to minority shareholders who are not as able to use their governance rights to control problems within the corporation.[147] They are of the view that activist shareholders generally increase efficiency in corporate governance by replacing CEO's and board members, or by correcting underperformance occurring through the target corporation's misuse of free cash flows.[148]

Conversely, commentators defending the centrality of the board of directors take the position that "hedge funds are impatient investors, whose interventions are directed at boosting a target's short-term stock price, potentially at the expense of long-term value creation, rather than at bringing about increased managerial accountability."[149] They criticize hedge funds for too readily jumping into the internal functioning of a corporation when there is a decline in short-term earnings before knowing whether this decline is the result of a long-term value maximizing investment that hasn't paid off yet or poor management.[150]

However, a study conducted by Lucian Bebchuk, Alon Brav, and Wei Jiang documents evidence of the lack of short-term gains at the expense of long-term value maximization in activist hedge fund campaigns. Using a dataset of approximately 2,000 activist hedge fund interventions between 1994–2007, they found that on average, the operating and stock performance of target corporations continued to increase even five years after the start of the hedge fund activism.[151] The study also found that in the instances of interventions that constrain long-term investments by increasing leverage, reducing investments, and adversarial interventions employing hostile tactics, improvements in operating performance followed during the five-

147. Martijn Cremers, Saura Masconale & Simone M. Sepe, *Activist Hedge Funds and the Corporation*, 94 WASH. U. L. REV. 261, 264 (2016).

148. Alessio M. Pacces, *Hedge Fund Activism as a Conflict of Entrepreneurship*, CLS BLUE SKY BLOG (Feb. 22, 2017), http://clsbluesky.law.columbia.edu/2017/02/22/hedge-fund-activism-as-a-conflict-of-entrepreneurship/.

149. Cremers, *supra* note 147, at 264.

150. *Id.* at 265.

151. Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1094-95 (2015), https://www8.gsb.columbia.edu/financialstudies/sites/financialstudies/files/files/Jiang_Long-term%20effects%20of%20hedge%20fund%20activisim.pdf.

year period after the intervention.[152] They also failed to find adverse long-term effects asserted by the opponents of hedge fund activism.

Additionally, in 2015 and 2016, the potential consequences of shareholder activism on the long-term firm value was brought to the attention of a number of large institutional investors.[153] In fact, in 2015, "BlackRock sent letters to CEOs of large-cap companies urging them not to take short-term actions, such as buybacks and increased dividends, that may satisfy the demands of short-term activists but that impair long-term value."[154] Additionally, in 2016 BlackRock sent more letters urging companies to devise a strategy for creating long-term firm value to counter activist demands for actions prioritizing short-term benefits.[155]

Additionally, interested activist hedge funds acting as both bidder and stockholder have beneficial effects for corporations in the merger context. The existence of an activist hedge fund can decrease frictions associated with the entrenchment of management.[156] Additionally, target managers may prioritize self-interested gains over shareholder gains in mergers.[157] Therefore, by threatening to replace target management, activist funds can decrease the likelihood of this type of self-dealing and allow shareholders to receive higher premiums in merger transactions.[158]

However, a negative implication of involving interested activist hedge funds in a merger transaction is that the average takeover premium offered by activist bidders is 22.5% lower than that offered by third-party bidders.[159] Additionally, activist hedge funds may bid on a target firm to simply "put it in play."[160] This action increases the probability that the corporation will be subject to an eventual takeover.[161]

Minority shareholders can effectuate substantial change in a corporation with a minimal ownership stake. Therefore, in *Fiduciary Duties for Activist Shareholders*, Lynn A. Stout and Iman Anabtawi suggest that the fiduciary duty of loyalty should be extended to interested hedge fund activists in the same way that it attaches to interested transactions by a

152. *Id.*

153. Sullivan and Cromwell, *supra* note 132, at 9.

154. *Id.* at 5.

155. *Id.*

156. Nicole M. Boysona, Nickolay Gantchevb, & Anil Shivdasanib, *Activism Mergers*, J. OF FIN. ECON. (forthcoming) (Oct. 31, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2677416.

157. *See id.* at 18 (discussing a study conducted by Hartzell, Ofek, and Yermack (2004) finding that acquisition premiums are lower in amount when target managements received an added personal benefit).

158. *Id.*

159. *Id.* at 20.

160. *Id.* at 23.

161. *See id.* at 2 (finding a close interrelation between activism and takeovers).

director or controller.[162] It is worth briefly considering applying the fiduciary duty of loyalty in this manner, where the shareholders would be able to directly sue the board or the interested activist hedge fund for equitable relief. However, the fiduciary duty of loyalty would be difficult to apply as nearly all activist hedge funds are interested in one way or another. Because nearly all activist hedge funds are interested in a transaction, the effect of this recommendation could result in increased shareholder litigation against both directors and officers and activist minority shareholders.

Interested minority shareholders should be subject to a higher standard of review and oversight than the business judgment rule. However, there are ways to achieve this goal that don't involve attaching fiduciary duties to interested minority shareholders. Therefore, in opposition to Stout and Anabtawi's recommendation, this Article argues against the extension of fiduciary duties. This Article proceeds by explaining the current regulatory framework of interested minority shareholder transactions and elaborating on three potential alternative regulatory regimes.

B. *Three Alternatives to Regulating Interested Minority Shareholders*

The recent debate over shareholder activism has left little doubt that more attention should be paid to how corporate law regulates interested transactions by minority shareholders, particularly activist investors and hedge funds. There are three approaches that can be taken to effectively regulate interested minority shareholders. The first option is to leave it as is where the board of directors oversees the conflicts of interest in the transaction and exercises their good faith and independent business judgment in approving or denying the deal. The second option is to include minority shareholders in section 144. Under section 144, the transaction would be subject to entire fairness review, but the board would have the opportunity to use one of the three safe harbors to obtain business judgment review. The third option is to apply *Weinberger*, where the transaction is initially subject to entire fairness review unless the board, after full disclosure, obtains the approval of both an independent negotiating committee and the majority of minority shareholders.

1. Continuance of Contemporary Law

Currently, interested minority shareholder transactions are not highly regulated, nor are they scrutinized to the same degree as are interested

162. *See* Anabtawi, *supra* note 134, at 1256 (arguing that the rules of fiduciary duties that have been applied to directors and officers and controlling shareholders should also be applied to activist minority shareholders).

director and controlling shareholder transactions. Interested transactions by minority shareholder investors and activist hedge funds are instead left to the oversight and business judgment discretion of the board of directors. Shareholders who believe there is a conflict of interest on the side of an activist shareholder have minimal recourse in suing the board for knowingly disregarding a conflict of interest.[163] Additionally, the plaintiff shareholders will likely lose this battle — the board's decisions will be scrutinized under the business judgment rule, a standard that is often outcome determinative for directors.[164]

The current system of regulation seems to have benefits for both shareholders and the corporation. Data shows that the market generally reacts positively after the announcement of activist campaigns by 2–3% when compared to the broader market.[165] Additionally, with the lower standard of review, activist investors may be more willing to launch campaigns. If it were the case that an interested transaction by minority shareholders would be subject to entire fairness on a breach of the fiduciary duty of loyalty, minority shareholders, such as activist investors and hedge funds, may not be as willing to launch campaigns when the probability of success is lower, and the possibility of shareholder litigation higher.

Additionally, activist shareholders most commonly target struggling corporations, with the intent to raise profits by improving the internal organization and capital structure of the corporation.[166] With only the intent to forestall an activist hedge fund attack, a company is recommended to regularly review its business strategy and its governance and executive compensation issues.[167] The mere threat of an activist hedge fund poking its head behind the corporation's proverbial curtain may force companies to operate more efficiently. Therefore, an increased level of judicial scrutiny would likely result in fewer benefits afforded by shareholder activism.

However, leaving interested minority shareholder transactions to the oversight of the board may not be the best practice. There are many ways in which a board may be coerced by the minority shareholder or feel immense pressure to adequately make decisions in the best interests of the corporation

163. For example, RBC was trying to have the company sold when it wasn't a good time to sell because it was advantageous for the bank to use their position with their client to get the benefit with the buyers of a different company in a different deal. *See* RBC Capital Mkts., LLC v. Jervis, 129 A.3d 816, 827 (Del. 2015) (holding that the board breached its fiduciary duty of loyalty by not better monitoring the conflict of interests that existed on behalf of RBC).

164. Latham and Watkins, *Business Judgment Rule Applies to Merger Approved by Informed, Disinterested Stockholders*, CLIENT ALERT NEWS FLASH, (Oct. 6, 2015), https://m.lw.com/thoughtLeadership/LW-Delaware-Supreme-Court-decision-KKR.

165. J.P. Morgan, *supra* note 136, at 3.

166. *Id.* at 9.

167. *Id.* at 5.

and its shareholders. This problem could arise in situations where an activist threatens to launch a proxy fight to remove directors from the slate. Directors would then be interested in maintaining their position at the corporation and would allow a disproportionately beneficial transaction to go forward. Additionally, directors who are the direct targets of aggressive public media campaigns may be coerced into taking certain actions in haste and would therefore become inappropriate overseers and ultimate decision-makers on these transactions.[168]

2. Regulate Interested Minority Shareholders and Hedge Fund Activists Under Weinberger et. al.

The second alternative would be to include interested activist shareholders within the framework of *Weinberger* and its progeny. This method would operate by applying entire fairness review by default to the board's decision to approve a transaction with an interested minority shareholder. The board could escape the high standard of review by: 1) fully disclosing all material information, 2) obtaining the approval of an independent special committee, and 3) obtaining the approval of a majority of the remaining minority shareholders.

Because activist minority shareholders would be included to satisfy the majority of minority requirement in *Weinberger*, this test would take away the conflicted minority shareholders' right to vote on the transaction. The effect would be to allow for a truly cleansed and unconflicted majority of the remaining minority vote. Once these three requirements are satisfied, the court should not automatically ratify the transaction, but should instead apply the business judgment rule. This method would treat the interested minority shareholder transaction like interested controlling shareholder transactions by initially subjecting it to entire fairness review unless the transaction, after full disclosure by the board, obtains the good faith approval of an independent special committee and the majority of the minority shareholders whom are unaffiliated with the controller.[169] Additionally, this approach

168. *See* Sullivan and Cromwell, *supra* note 132, at 9 (explaining that an SSGA's study found that pressure from activist shareholders may put pressure on companies to pursue short-term benefits over long-term value and that settlement agreements done in haste and without sufficient consultation with shareholders divest long-term shareholders of expressing their views).

169. The entire fairness standard of review is not strictly limited to merger transactions. Entire fairness also applies to any transaction between a controller and the controlled corporation where the controller receives a non-ratable benefit. In re EZCORP Inc. Consulting Agreement Derivative Litig., No. 9962-VCL, 2016 Del. Ch. LEXIS 14, at *33 (Del. Ch. Jan. 25, 2016). Courts have additionally applied the entire fairness standard to controlling shareholders' management-services agreements, loans, non-competition payments, and third-

would do the most to protect the remaining minority shareholders from the adverse effects of profit-maximizing activist investors. However, considering the beneficial changes that minority shareholders and activist hedge funds can bring about in a suffering corporation, subjecting them to entire fairness review when Weinberger is not satisfied may be too strict a standard.

Choosing a standard of review in many instances is outcome determinative.[170] Entire fairness is the highest standard of review in corporate law. The standard is applied in the controlling shareholder context "as a substitute for the dual statutory protections of disinterested board and stockholder approval, because both protections are potentially undermined by the influence of the controller."[171] Therefore, entire fairness is a daunting standard that often results in a finding of board liability.[172] Under entire fairness review the self-dealing party is "required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."[173] However, applying entire fairness to interested minority shareholder transactions can have the negative effect of interfering with a deal that should get done or altering the structure of the deal.[174]

Minority activist investors and hedge funds are essentially always interested to some degree. Applying entire fairness to the entire spectrum of interested activist hedge fund transactions that do not satisfy *Weinberger* could forbid necessary changes and beneficial transactions from surviving judicial review. Additionally, activist investors are generally not as dangerous as controlling shareholders are.

A controlling shareholder has powers that are not shared to the same degree by minority shareholders with small ownership stakes. For instance, controlling shareholders may occupy a uniquely advantageous position from which they can extract differential benefits from the corporation at the expense of minority stockholders. And, independent directors may owe or

party "brokering" payments. *See* T. Rowe Price Recovery Fund, L.P. v. Rubin, 770 A.2d 536, 552-55 (Del. Ch. 2000) (applying the entire fairness standard to enjoin management-service agreements); Marciano v. Nakash, 535 A.2d 400, 403-05 (Del. 1987) (holding that the principle of per se voidability for interested transactions does not necessarily nullify transactions if they are intrinsically fair); Bomarko, Inc. v. Int'l Telecharge, Inc., 794 A.2d 1161, 1177–83 (Del. Ch. 1999), aff'd, 766 A.2d 437 (Del. 2000) (applying entire fairness to undisclosed "brokering" fees).

170. *See* Mills Acquisition Co. v. MacMillan, Inc., Del. Supr., 559 A.2d 1261, 1279 (Del. 1988) (quoting AC Acquisitions v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. 1986).

171. Kahn v. M&F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014).

172. Solomon v. Armstrong, 747 A.2d 1098, 1113, n.39 (Del. Ch. 1999).

173. Weinberger v. UOP, Inc., 457 A.2d 701, 702 (Del. 1983).

174. An example of entire fairness altering the structure of the deal would be for an interested party to go through a tender offer rather than a merger because the tender offer would involve fewer fiduciary obligations.

feel a more wholesome allegiance to a controller, rather than to the corporation and its public stockholders or minority shareholders.

Additionally, there is a legitimate concern regarding the dynamic between the board of directors and a controlling shareholder. For example, if a controller owns 50% plus one vote of company stock and does not like the current board, the controller has the unique advantage of voting not to reelect members of the board at the next board election. This advantage is not so readily obtained by minority shareholders with low ownership stakes.

It is further suspicious whether a special committee really replicates an arm's length negotiation. For instance, where a controller owns 70% of company stock and makes a public tender offer for the remaining 30% at a 20% premium over the market value of the shares, the shareholders' reaction to the offer of a 20% premium for their shares is no longer indifference. In this scenario, the public tender offer will result in a substantial portion of the remaining 30% of shares moving out of the hands of the traditional investors and into the hands of the controller. Independent directors are now in the position where they need to apply their business judgment in good faith but at the same time receive continuous communication from shareholders to get the deal done. These circumstances place substantial pressure on independent directors even with the best intentions to fight with the controller over an incremental premium, with shareholders not wanting to be protected but simply wanting the transaction approved. In effect, controlling shareholders can create a controlled mentality with the independent negotiating committee.

This circumstance does not occur to the same degree with minority activist shareholders who do not own such a large ownership stake and do not exercise the same extent of control over the board. Therefore, applying entire fairness to interested transactions by a controller is a fitting approach by the Delaware courts. Because minority shareholders and the board of directors are not prone to the same degree of control by minority activist shareholders, applying entire fairness is not a necessary substitute for the "dual statutory protections of disinterested board and stockholder approval."[175] Applying a lower standard of review than entire fairness would have more benefits for all parties in the transaction.

3. Regulate Interested Minority Shareholders and Hedge Fund Activists Under DGCL Section 144

The final alternative regulation would be to amend section 144 to

175. *M&F Worldwide Corp.*, 88 A.3d at 644.

include minority shareholders within the text of the statute. This approach would allow the board of directors to use the safe harbors of section 144 to escape entire fairness review by gaining the approval of 1) a majority of disinterested directors or 2) a majority of disinterested shareholders, or 3) by proving that the transaction is entirely fair.[176] The inclusion of interested minority shareholders in section 144 would enable the board to cleanse a transaction that may benefit the corporation and its shareholders were it not tainted by self-interest. However, a similar precaution may exist as with controlling shareholders. Courts seem to be concerned that when a controlling shareholder can potentially exert enough control over a board of directors, the transaction should require the additional approval of a majority of minority shareholders.[177]

The thought process may be the same here. Though section 144(a)(2) may be sufficient to cleanse a transaction of self-interest by requiring the approval of a majority of disinterested shareholders, it can be argued that the approval of a majority of disinterested directors under 144(a)(1) may not be enough. Though this may be a problem with controlling shareholders, this prong could satisfactorily cleanse an interested transaction by a minority shareholder because they do not have the same degree of control over the board of directors as do controlling shareholders.

Therefore, the suggestion of this Article is to include interested minority shareholders in section 144 of the DGCL. Amending section 144 to include minority shareholders would allow for more flexibility in boardroom decision-making than would entire fairness review and would increase shareholder protections in comparison to the current regulatory regime. Increasing shareholder protections while also allowing for a more easily achieved lowering of the standard of review is justified in these circumstances. Interested minority shareholders, such as activist investors and hedge funds can have much needed beneficial effects on target companies by bringing about valuable changes to profit deficient firms.

Additionally, targets of hedge fund activism may have a higher incidence of being acquired due to the launch of activism campaigns as an acquisition proposal.[178] This is sometimes beneficial to a corporation where an activist hedge fund induces third-party overpayment.[179] And, interested

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176. DEL. CODE ANN. tit. 8, § 144 (2006).

177. *See M&F Worldwide Corp.*, 88 A.3d at 638 (applying entire fairness review to interested controller buyout transactions unless "the merger is conditioned *ab initio* upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders.").

178. *Boysona*, *supra* note 156, at 7.

179. *Id.* at 8. "Greenwood and Schor (2009) suggest that bidders may overpay when an activist is present, which makes the target more receptive to an acquisition and increases the probability that a transaction is consummated."

minority activist hedge funds sometimes bid for firms with the main intention of bringing in a third-party who will overpay to acquire the firm.[180] Additionally, value-enhancing operational and financial policies are positively associated with the announcement of a takeover bid by activist hedge funds, even if the bid is ultimately unsuccessful.[181]

However, an interested merger takeover by an activist hedge fund can have negative implications as well. Where an activist hedge fund is the offeror in a merger takeover, the target company oftentimes receives a lower acquisition premium than would be obtained by an outside bidder.[182] Activist investors and hedge funds also have more power than do outside bidders to push through a takeover offer by using a proxy contest to overcome board resistance.[183] Therefore, activist shareholders can attempt to conduct or facilitate bids for merger takeovers while owning a minority stake in the ownership of a corporation. Because activist investors and hedge funds are profit-maximizing institutions with interested positions that stand on both sides of a merger transaction as a bidder and shareholder, business judgement should not be the default rule. Instead, the default level of scrutiny should be heightened to entire fairness while providing the board of directors with the three safe harbors of section 144. The test would optimally allow for increased shareholder protections, while allowing corporations to receive the beneficial results of minority shareholder hedge fund activism.

An additional benefit to having interested minority activist investors surpass section 144 would be an increase in the disclosure afforded by these parties in interested transactions. Minority activist hedge funds that do not acquire more than 5% of a voting class of a company's equity securities are not required to file a Schedule 13D. Therefore, their intentions in purchasing stock remain unknown to the corporation and its shareholders until the 5% threshold is exceeded. This test would also resolve the problem that 13D does not explicitly require short positions and hedges to be disclosed in interested transactions. If an activist hedge fund wants to obtain business judgment review, this standard highly motivates the fund to disclose all material information about its short positions and hedges that convey interest in the transaction so that plaintiffs cannot attack the legitimacy of the deal

180. *See id.* at 5 (finding that a high incidence of activist hedge fund takeover offers result in positive returns because activist hedge funds pick firms for which third-party acquirers may overpay).

181. *Id.* at 4.

182. Activism mergers with third-party bidders have cumulative abnormal returns (CARs) that are 8% higher than those obtained in non-activism mergers, whereas offers by activist hedge funds result in 18% lower CARs relative to those in nonactivism mergers. Activist bidders offer lower acquisition premiums and sustain far higher rejection rates than third-party bidders. *Id.*

183. *Id.* at 8.

on these grounds.

Finally, to supplement this test in improving disclosure requirements, an amendment can be made to Item 404 of Schedule 14A to include interested activist hedge funds as one of the parties requiring heightened disclosure. Item 404 requires heightened disclosure of material information regarding transactions that deal with a controller, a related person, or promoters.[184] However, minority shareholders, such as activist investors and hedge funds, may not fall into any of these categories. By amending Item 404 to make a fourth category including interested transactions by these minority shareholders, these actors would be statutorily required by the federal securities laws to disclose their interest in a transaction. These minority shareholders would also be required to disclose any hedging or interested positions, the dollar amount at stake in the transaction, and material contracts with outside third-parties.

Sunlight is the best disinfectant. By amending DGCL section 144 and Item 404 of Schedule 14A to include minority shareholders, shareholders and the board of directors will be best prepared to act in a way most beneficial to the corporation and its shareholders.

184. *See* 17 C.F.R. § 229.404 (2008) (requiring the disclosure of material information such as dollar amount of the transaction, related person's interest in the transaction, dollar amount of interested value in the transaction, etc.).

CONCLUSION

Delaware corporate law is rightfully suspicious of the fairness of a transaction when an interested party with sufficient control is involved. Through DGCL section 144 and *Weinberger* and its progeny, directors or officers and controlling shareholders involved in interested transactions are initially subject to entire fairness review. Such scrutiny attempts to weed out self-dealing transactions with illegitimate and improper intent. There are, however, a few ambiguities in the current law of regulating interested transactions that need to be resolved. First, section 144 should evolve from a 1967 statute that merely protects an interested director or officer transaction from voidability to one that operates to lower the level of judicial scrutiny from entire fairness to business judgment review. Therefore, the statute should be amended to include that once an interested director or officer satisfies one of the three safe harbors enumerated, the transaction will be subject to business judgment review. The effect will be to increase clarity in the court room and predictability in structuring transactions for the corporate board room.

Second, *Weinberger* and its progeny are judge-made laws applying to interested transactions by controlling shareholders. *Weinberger* sets out three methods by which a board or controlling shareholder can survive entire fairness review. But, the case itself fails to indicate what happens once a defendant satisfies the three-part test. Subsequent case law, particularly *M&F Worldwide*, has created substantively identical tests that once satisfied, allow an interested controller transaction to be subject to business judgment review. Therefore, this Article recommends an interpretation of *Weinberger* consistent with *M&F Worldwide*, lowering the standard of review to business judgment once an interested controlling shareholder transaction is approved by an independent special committee, fully disclosed, and approved by a majority of minority shareholders.

Additionally, directors, officers, and controlling shareholders are not the only parties that engage in interested transactions. Minority shareholders, especially activist hedge funds, often engage in interested transactions with the corporation as well. However, Delaware statutory law and case law has only attached fiduciary duties and increased judicial scrutiny to interested transactions by the former category and have left interested minority shareholder and activist hedge fund transactions nearly unregulated. This Article advocates that minority activist shareholders and hedge funds should be subject to a higher level of judicial scrutiny than business judgment review to afford for greater shareholder protection and increased disclosure in self-dealing transactions. This test would involve amending DGCL section 144 to include minority shareholders. This test would then subject interested minority shareholder transactions to entire fairness review while affording the board of directors the three safe harbors of section 144 to lower the standard of review to business judgment. This threshold would effectively increase disclosure requirements and encompass some minority shareholders that slip through the cracks of Schedule 13D.

The final recommendation of this Article is to further increase the disclosure requirements of minority shareholders, particularly activist hedge funds that engage in interested transactions. Heightened disclosure can be achieved through an amendment to include interested minority shareholders as a fourth party in Item 404 of Schedule 14A. This would have the beneficial effect of requiring the disclosure of all material facts related to an activist hedge fund's self-dealing in the transaction. Through this heightened disclosure requirement shareholders and the board of directors would have all of the material information needed to make a more informed vote on the transaction.