ARTICLES

INTERNAL POISON PILLS

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Corporate law largely addresses three basic relationships: shareholder versus manager, shareholder versus non-equity investor, and majority shareholder versus minority shareholder. Ever since the pioneering work of Adolf Berle and Gardiner Means, a great deal of scholarly attention has been directed toward the first relationship. The second relationship earned its share of the limelight with the leveraged buyout trend of the 1980s. It is only in this decade, however, that the third relationship has taken center stage—in the wake of several incongruous Delaware cases and a flood of post-Sarbanes-Oxley freezeout mergers.

This scrutiny is certainly warranted, as the tension between majority and minority shareholders presents thorny concerns and has the potential to erode considerable social welfare. In essence, lawmakers must walk a tightrope between two alternative hazards. On the one hand, assigning too much power to minority shareholders can lead to a holdout problem where recalcitrant dissenters demand private tribute before blessing a decision (such as a merger). On the other hand, granting the majority untrammeled discretion to freeze out minority owners can promote tunneling or other abuses of power that will depress the ex ante value of a firm. Thus far, the law has addressed these concerns with disclosure obligations, special committees, judicial review of fiduciary duties, and appraisal rights. But the results are far from satisfying.

This Article offers a novel idea for governing the tension between majority and minority shareholders: an "internal poison pill." Borrowing conceptually from the famous shareholder rights plans created in the 1980s to address bullying external bidders, I show how an analogous (though economically distinct) financial instrument might be used by shareholders to navigate the twin internal governance tensions of holdout and expropriation. Two key features of this proposal distinguish it from alternative reforms: (1) It focuses on a privately enacted solution with room for contextual customization; and (2) it uses embedded option theory to construct an intermediate legal entitlement (as opposed to an extreme property or liability rule) for both majority and minority shareholders. If successfully scoped and swallowed, these internal poison pills could facilitate efficient freezeouts, chill coercive ones, supplant the awkward remedy of appraisal, and, ultimately, increase the ex ante value of firms by mitigating agency problems between majority and minority shareholders.

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Introduction

Large corporations harbor dark corners, and these shadows shelter a daunting collection of governance concerns. There are at least three problems. First, lazy or dishonest managers might use their control of a firm's daily operations to make poor decisions or steal that which rightfully belongs to shareholders.[1] Second, greedy shareholders may leverage their influence over managers to siphon wealth from other investors, such as lenders or preferred shareholders.[2] Third, a controlling majority shareholder,[3] again working through compliant managers, may wrongfully extract value from minority owners.[4] Corporate law tries, with varying degrees of success, to arrest the guns of all actors in this Quentin Tarantino–style standoff.

The first two contests—between manager and shareholder, and between shareholder and lender—have already been carefully dissected in the academic literature.[5] The agency problems are unsolved (and will likely remain impenetrable), but we now have a pretty good sense of the battlefield. It is only in this decade, however, that the

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1 Our modern study of the trouble between shareholders and managers dates back to the 1930s and the now-classic literature on the agency cost problem. These costs take many different forms, ranging from outright theft to less pernicious shirking to subtle suboptimal risk preferences. *See* Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 4–5 (1933) (establishing agency cost paradigm); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 308 (1976) (describing reduction in social welfare experienced due to divergent agent interests).

2 These problems are easily seen in the classic cat-and-mouse games between shareholders (as executed via obedient managers) and creditors. Shareholders will discover an agency scam—such as immediate distribution of a loan in the form of dividends or the issuing of incremental senior debt—and lenders will respond by plugging the dyke with another bond covenant in future offerings. *See, e.g.*, Daniel R. Fischel, *The Economics of Lender Liability*, 99 Yale L.J. 131, 133–40 (1989) (discussing shareholder-investor problems in lending relationships); Marcel Kahan & David Yermack, *Investment Opportunities and the Design of Debt Securities*, 14 J.L. Econ. & Org. 136, 138 (1998) (arguing that bond covenants are poor tools for mitigating agency costs arising from shareholder-creditor conflict).

3 In this Article, I use the terms "majority" shareholder and "controlling" shareholder synonymously.

4 *See, e.g.*, Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. Pa. L. Rev. 785, 785–86 (2003) (situating controlling shareholder problem in agency cost debate).

5 Indeed, the work in these areas is too comprehensive to cite in full. For a helpful collection of the relevant scholarship, see generally Jean Tirole, The Theory of Corporate Finance (2006).

third relationship—the civil war between majority and minority shareholders—has taken center stage.[6] Several incongruous Delaware cases, the rise of private equity, and a flood of post-Sarbanes-Oxley freezeout mergers have underscored the need for lawmakers to confront the governance problems presented in this context.

The tension between majority and minority shareholders is especially interesting because lawmakers must walk a tightrope between two alternative hazards. On the one hand, granting the majority untrammeled discretion can promote abuses of power that will depress the ex ante value of a firm. Controlling shareholders enjoy many strategies for fleecing minority investors,[7] but none are more potent than using a freezeout merger to take full ownership of the firm.[8] It is easy to see how an overly permissive freezeout policy might lower a firm's market value: Potential investors will fear that a controlling shareholder might price the merger at a ridiculously low level. This fear will, in turn, depress the upfront price that minority investors would be willing to pay for the stock.

On the other hand, assigning too much power to minority shareholders can lead to a holdout problem, with recalcitrant dissenters demanding private payouts before blessing a merger. Even if minority owners do not maintain an express veto over the transaction, generous remedial statutes or very strict standards of review present a risk of costly strike suits.

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[6] *See, e.g.*, Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1257–60 (2008) (describing governance concerns facing minority shareholders); Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 41–43 (2006) (describing conflicts between equity investors in venture capital context); Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 69–70 (2005) (emphasizing recent attention on conflict between majority and minority shareholders). This is not to say, of course, that the tension between majority and minority shareholders was ignored in earlier times. *See, e.g.*, Pepper v. Litton, 308 U.S. 295, 306 (1939) (describing "dominant or controlling stockholder[s] or group[s] of stockholders" as fiduciaries); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 723 (Del. 1971) (articulating fiduciary standards of review for controlling majority shareholders).

[7] They might, for example, leverage influence over the board of directors to receive plum management positions or favorable terms on a supply contract, thereby taking a disproportionate share of the firm's annual profits. Or they might sell control to a third party (at a price above prevailing market values) in order to capitalize the future benefits of ownership. Of course, a premium sales price might also reflect less sinister efforts, such as moving the shares to a higher value owner.

[8] *See* Gilson & Gordon, *supra* note 4, at 787–88 (describing private benefits gained by controlling shareholders as consequence of freezeout mergers). The mechanics of the freezeout merger, a process under which majority shareholders combine the firm with another wholly owned entity in order to wrest sole ownership, are discussed *infra* notes 32–33 and accompanying text.

Not all freezeout transactions amount to legally sanctioned theft. It is important to recognize that there are legitimate reasons to conduct these deals,[9] and excessive minority blocking power (de jure or de facto) may destroy social welfare by obstructing efficient mergers. The legal challenge, of course, is how to balance the dual extremes of minority holdout and majority expropriation.

Thus far, corporate law has dealt with the majority-minority governance problem, as it appears in the merger context, through a troika of regulatory policies. First, under federal securities law, firms undergoing a freezeout merger must disclose detailed financial information to all shareholders.[10] Second, these deals are subject to judicial review (often in Delaware) to determine whether the firm (through its managers) or the controlling shareholders (directly) have breached a fiduciary obligation to the minority owners. And third, dissenting shareholders may have the right to file an appraisal claim, which theoretically ensures—again through a judicial proceeding—that minority owners receive fair value for their shares. In a perfect world, these protections should act in concert to get the balance right.

Unfortunately, this three-part framework has not been very satisfying. Disclosure seems like a reasonable idea, but it often does not have much practical effect and is subject to loopholes. Judicial review of freezeout mergers is messy, at least in Delaware, because inconsistent standards attach to identical economic transactions. Courts will either adopt a strict "entire fairness" standard or award defendants the protection of the deferential "business judgment rule"—depending on whether the deal is structured as a statutory merger or a tender offer.[11] And the appraisal remedy has long been criticized as a weak cure due to its stringent (and outdated) procedural requirements and its protracted use of adversarial litigation to value shares.[12]

So if the current legal framework is not working, how should we deal with the freezeout problem? Are there other sensible ways to divide the levers of power between majority and minority shareholders to help deter abusive deals and facilitate sensible ones? And can we encourage firms to make reasonable tradeoffs themselves, using private contractual arrangements instead of costly judicial resources?

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9 *See infra* Part II.A (discussing theoretical rationale for allowing freezeouts).

10 SEC Rule 13e-3, 17 C.F.R. § 240.13e-3 (2009).

11 *See infra* Part I.C (discussing how standards of review differ with transactional form).

12 Moreover, recent events threaten to warp appraisal statutes far beyond their intended purpose—perhaps turning this remedy into a new vehicle for meritless strike suits rather than an effective tool for policing corporate governance. *See infra* note 101.

In this Article, I propose and analyze a new type of economic instrument for balancing the tension between majority and minority shareholders in the freezeout context.[13] I call it an "internal poison pill"—in obvious reference to the antitakeover device that famously sets the balance of power between target firms and third-party acquirers during an outside merger contest.[14] An internal poison pill is similar to its cousin in that it seeks to craft economic disincentives to the trampling of the rights of impacted shareholders (minority owners in this context) as a way of restoring balance to merger deliberations. Indeed, as I will show, a traditional "external" poison pill (with only slight modifications) might be used to address this problem, although this is not the approach that I ultimately recommend.

Instead, I argue that a more flexible, though weaker, "internal" pill can offer a better compromise than the conventional medicine.[15]

The focus of my proposed modification is on the power of redemption. The stock options in traditional pills are redeemable (for a nominal fee, perhaps a penny) at the sole discretion of the issuing firm's board of directors. This has the obvious benefit of forcing external acquirers to negotiate with the target board, instead of sidestepping this process through a direct tender offer to current shareholders. But centralizing the power of pill redemption in this manner also has some serious drawbacks: It can, for example, shield incumbent managers and directors from the discipline of corporate control markets or stymie efficient deals. This is especially true if poison pills are combined with staggered board charter provisions to brew an even more toxic potion. The thought of mounting a multi-year proxy contest to replace a staggered board—and only then redeeming the pill—is enough to scare off all but the most determined of acquirers.[16]

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[13] The primary focus is on tender offer freezeouts, as these involve direct sales between majority and minority shareholders and appear to be emerging as the dominant transactional strategy. It may be possible to construct an analogous regulatory regime for statutory merger freezeouts, although this would likely require modified back-end solutions such as private appraisal rights. This, however, is a topic for another day.

[14] The most familiar type of poison pill, or shareholder rights plan—what I call the "external" poison pill—is activated when a hostile bidder acquires a certain percentage of the target corporation's stock. At that point, the target's other shareholders gain an option to purchase additional stock at a discounted price, thereby diluting the acquiring party's ownership and making a takeover more costly. *See infra* Part III.A (discussing "external" poison pills as means to protect minority shareholders in freezeout contexts).

[15] Such a change might also have the benefit of making internal pills more palatable to majority shareholders, though, as we will see, they may still need a legal nudge to adopt the device. *See infra* Part III.D.3 (discussing legal reform as method of promoting internal pill adoption).

[16] *See, e.g.*, Guhan Subramanian, *Board Silly*, N.Y. TIMES, Feb. 14, 2007, at A27 ("If the target has a staggered board, a bidder must win two proxy contests, conducted more

By contrast, an internal poison pill (as envisioned here) would adopt a more nuanced redemption strategy. The main trick is to use embedded options[17] to qualify the pill's de facto veto power. For example, as part of the strike price to exercise the pill's discounted call option, minority shareholders could be required to write the triggering controller an embedded option setting a price under which the minority shareholders' poison pill rights could be redeemed. Economic incentives (what I call a "catch") should also be adopted to discourage the minority shareholders from demanding outrageous terms—such as requiring a redemption payment of $1,000,000 per share.[18] If designed correctly, these (admittedly more complex) securities might be used to elicit and compare the subjective values that each party places on a transaction. If the freezeout is a rip-off (because the majority has set an artificially low price), then the internal pill would have bite, and the minority holders could receive additional discounted shares[19]—or, more likely, the majority controller would not attempt the abusive freezeout in the first place.[20] If, on the other hand, a minority shareholder is simply stonewalling a sensible deal, he will be unwilling to put his money where his mouth is (for fear of springing the catch), and the majority owner can economically redeem the pill.[21]

More theoretically, using internal poison pills as a governance tool is a way to craft an intermediate legal entitlement that rests between the extreme options of granting dissenters veto power over the merger (a property right) or granting majority shareholders full

than a year apart, to gain control of the board and jettison the poison pill. No bidder in the modern era of takeovers has had the patience and persistence to do this.").

[17] By "embedded option," I mean an option that requires the party attempting to exercise it to write a *second* option as part of the exercise price (perhaps in addition to the standard monetary fee). This second option might serve a variety of purposes, including allowing the initial party to repurchase the rights granted under the first option for a newly set strike price. The use of an embedded option in this manner can thus serve as a vehicle for sequential bargaining. The exact mechanics are described and illustrated in more detail *infra* notes 124–25 and accompanying text.

[18] Strategies for positioning the catch will be described in some detail. The key intuition involves placing minority shareholders in a position where they do not know at the time they set their redemption price whether they will eventually be required to buy or sell at that price. In other words, a majority controller's power to eventually use an extreme price against the holder of the pill acts as a check on the minority shareholder's desire to overreach. *See infra* Part III.B.3 (explaining use of economic incentives to prevent minority shareholders from exaggerating subjective value of their shares).

[19] In other words, they would be able to write terms in the embedded redemption option that would be unattractive to the majority controller. For a concrete example, see *infra* Part III.C.1.

[20] Majority shareholders would not attempt abusive freezeouts if they anticipated that the effort would simply result in undesirable dilution through the pill.

[21] This scenario is illustrated *infra* Part III.B.2.

discretion to execute the merger by paying dissenters a judicially determined fine (a liability right). This work thus shows how we might parse the legal entitlements established by Calabresi and Melamed's famous "cathedral framework" much more finely in a corporate law context.[22]

One final question may have crossed your mind: Why would a majority shareholder ever sanction the adoption of an internal pill? There are at least two responses. First, firms or influential shareholders may wish to voluntarily adopt these instruments as a sort of precommitment device to convince minority investors that they will not steal wealth through future freezeouts, thereby possibly boosting the market price of the stock. One could imagine the Carl Icahns of the world buying up meaningful blocks of shares, insisting on the adoption of an internal pill, and cashing out on any resulting appreciation.[23] Second, lawmakers may be willing to use legislation to encourage, subsidize, or force internal pill adoption. For example, majority holders might be granted favorable standards of review for a transaction or awarded some other legal benefit (such as truncated appraisal rights) if they include an internal pill. In the extreme case, the courts could even promote or require the implementation of internal pills as part of the company's fiduciary obligation in the freezeout context. Facilitating the adoption of the internal pill with this legal carrot and stick would obviously require the cooperation of Delaware courts (and other lawmakers) on currently untested matters. But, as we will see, there are theoretical justifications for using the law in this manner.

The Article proceeds as follows. Part I makes the case for change by offering an overview and critique of the current legal framework surrounding freezeout mergers. In particular, it focuses on recent events impacting the appraisal remedy, demonstrating how the realities of modern securities markets are pushing appraisal statutes toward even greater incoherence. Part II turns to the theoretical ten-

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[22] *See, e.g.*, Ian Ayres & J.M. Balkin, *Legal Entitlements as Auctions: Property Rules, Liability Rules, and Beyond*, 106 YALE L.J. 703, 743–44 (1996) (describing auction mechanisms for parsing legal entitlements); Lee Anne Fennell, *Revealing Options*, 118 HARV. L. REV. 1399, 1411–16 (2005) (discussing concept of embedded options, primarily in property law context); Saul Levmore, *Unifying Remedies: Property Rules, Liability Rules, and Startling Rules*, 106 YALE L.J 2149, 2153–57 (1997) (exploring variety of intermediate property-liability rules). The cathedral framework—including intermediate rules—and its application to freezeout mergers is discussed more fully *infra* Part II.C.

[23] For a flavor of Mr. Icahn's shareholder populism and a discussion of efforts to impose corporate governance reforms that benefit firm shareholders, see Emily Parker, *The Weekend Interview with Carl Icahn: Corporate Hell-Raiser*, WALL ST. J., Nov. 15, 2008, at A9.

sions underlying freezeout mergers, arguing that the benefits of granting minority shareholders leverage over abusive transactions must be tempered to avoid incentivizing strike suits or creating deadweight litigation costs. It models this tension using the Calabresi and Melamed "cathedral framework" in order to pave the way for economic compromises that will form the core of my internal pill proposal. Part III presses the pill—first by showing how conventional poison pills can be adapted to address the freezeout context and then by exploring how intermediate property-liability entitlements might be used to craft a more balanced tablet of medicine. This Part finishes by examining the incentives of all parties to adopt and trigger an internal pill under various scenarios and by discussing alternative strategies to help wash the pill down. A brief conclusion summarizes the Article.

I
The Law (Briefly)

A. Framing the Majority-Minority Governance Problem

Any effective pooling of capital and labor requires at least some central control over the way that these assets will be deployed. It is impracticable to insist upon a unanimous vote of partners or shareholders every time a firm needs to, say, decide how many reams of paper to purchase or whether to bring in sushi or burgers for lunch. Corporations address this problem through delegation: Shareholders hand over big picture decisions to a board of directors which, in turn, passes on daily tasks to corporate officers. This means that a majority block of shareholders (typically retaining the power to elect the entire board) can often influence collective economic decisions to the exclusion of minority owners.

Historically, there were boundaries on the power of a majority to bind minority owners. Under early corporation statutes, fundamental transactions like mergers were subject to unanimous shareholder approval.[24] This ensured that a majority cabal could not band together to radically alter the essential asset composition of a firm. But it also meant that a single shareholder could hold out against a merger and seek side payments, or some other inducement, as the

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[24] These transactions were seen as the functional equivalent of taking property and thus were prohibited without the consent of every shareholder. *See* Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 Geo. L.J. 1, 11–12 (1995) (discussing historical enactment of appraisal laws); Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 Duke L.J. 613, 619 & n.29 (1998) (same).

price of voting yes on the deal.[25] This holdout problem may be less of a concern when firms have relatively few owners, and unanimous voting may serve as a plausible governance standard under closely-held circumstances.[26]

But as the typical corporate roster of shareholders grew longer (and more anonymous) during the first part of the 1900s, it soon became clear that securing one hundred percent of a broad shareholder vote was a Herculean task.[27] In response, state legislatures began to replace the unanimous voting requirement with majority[28] or supermajority requirements.[29] This immediately solved the holdout problem, but it also gave birth to a new anxiety: Majority shareholders could cram down transformational decisions on minority owners against their will. While some changes might be perfectly sensible,[30] others could be naked attempts to exploit majority control to

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25 Presumably, a prescient incorporator could have altered the unanimous voting default rule when founding the corporation, but this may have been viewed with some suspicion against the background norm of absolute shareholder consent.

26 Compare, for instance, the default voting requirement used for fundamental transactions in partnership law (which often governs entities with fewer owners than corporations). Under the Uniform Partnership Act (promulgated in 1914 and still used in roughly fifteen states) a unanimous vote of partners is still required for extraordinary decisions. *See* UNIF. P'SHIP ACT § 401 (amended 1997), 6 U.L.A. 133 (2001) (requiring unanimous consent for acts "outside the ordinary course of business of a partnership"). To be sure, absolute consensus can be difficult to obtain, even among a handful of partners: The case reporters are full of situations where a business gets trapped by the failure of its owners to agree on the right direction. *See, e.g.*, Prentiss v. Sheffel, 513 P.2d 949 (Ariz. Ct. App. 1973) (real estate dispute); Owen v. Cohen, 119 P.2d 713 (Cal. 1941) (bowling alley dispute).

27 *See* Thompson, *supra* note 24, at 12 ("The requirement of unanimity . . . became a substantial burden to enterprises seeking to adapt . . . .").

28 *See, e.g.*, MODEL BUS. CORP. ACT § 12.02(e) (2005) (imposing majority rule). The Model Business Corporation Act, promulgated in 1950 and since then continuously reviewed and revised, has significantly influenced state corporations law. *See id.* at xxii ("[As of 2005,] the Model Act is . . . the general corporation statute for 24 states and the source of many provisions in the general corporations statutes of states that have not adopted the Model Act in its entirety . . . .").

29 *See, e.g.*, VA. CODE ANN. § 13.1–718(D) (2006 & Supp. 2008) (requiring two-thirds of shareholders to approve merger transactions).

30 Indeed, it is worth remembering that majority shareholders can play a beneficial role in corporate governance by checking the separate agency problem between owners and managers. *See, e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 522 (1990) ("Shareholder voting . . . can become an important part of the multistrand web of imperfect constraints on managers . . . ."); Gilson & Gordon, *supra* note 4, at 785–86 (recognizing tradeoff between benefits of majority monitoring and costs of illegitimate majority expropriation); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 505 (1991) (noting that increase in concentration of institutional shareholding and decrease in tender offers made it "more rational for institutional shareholders to engage in management discipline").

steal from the minority. In short, fixing the holdout problem spawned agency trouble.[31]

Perhaps the most direct concern came in the form of freezeout mergers, which made the move to mainstream legitimacy in the 1950s and 1960s.[32] In a freezeout merger, the majority owner forms a separate company that is wholly owned by the majority shareholder and then merges the two companies to cash out the minority shareholders and take one hundred percent ownership. Assuming the majority shareholder effectively controls the board of directors, approval of the merger is a fait accompli: The majority shareholder tells both boards to support the deal and, by definition, enjoys the equity stake needed to vote the transaction through at both firms.[33]

Freezeout mergers are always a shock to initiates of corporate law, and many a jaw has dropped to proclaim, "You mean you can actually do that!" Yet, despite the gut reaction that something untoward is occurring, there is a justifiable rationale for using these transactions to break the minority holdout problem described above. Some efficient and desirable transactions—such as management buyouts or going-private transactions—will not occur if majority and minority shareholders must bargain to the death over any resulting synergies.[34] Drivers playing chicken occasionally crash.

Nonetheless, the perpetual power to call all shares is a valuable option, and freezeout mergers are a potent weapon in the hands of Machiavellian controllers.[35] Projects might be delayed and share

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[31] The agency cost problem arises, as it always does, with the separation of ownership and control: Majority shareholders take greater control of events affecting the minority holders' property. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior*, *Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308–09 (1976) (associating agency cost problems with separation of ownership and control). Of course, even before this legislative erosion of unanimous voting for mergers, majority shareholders may have held control over routine decisions (through the board and officers), giving them other avenues for levying agency taxes on minority owners.

[32] Florida first permitted freezeout mergers in the 1920s, but it was not until lawmakers revised the Delaware General Corporation Law and the Model Business Corporation Act that these transactions became widely accepted. *See* Elliott J. Weiss, *The Law of Take Out Mergers: A Historical Perspective,* 56 N.Y.U. L. REV. 624, 632, 648 (1981) (charting historical development in state merger laws).

[33] These deals were obviously not possible in the earlier era of unanimous shareholder consent, as every minority holder retained a veto over the freezeout.

[34] This problem is analyzed in more detail *infra* Part II.A (describing minority holdout problem and challenge of distinguishing good faith minority investor claims from extortionate ones).

[35] *See, e.g.*, Gilson & Gordon, *supra* note 4, at 786 (arguing that "[t]he potential for overreaching by controlling shareholders is greater from freeze-outs than from sales of control"). A strain of cases—including, most famously, *Perlman v. Feldmann*, 219 F.2d 173, 175–76 (2d Cir. 1955)—has tried to address the expropriation problem by imposing broad fiduciary obligations on the way that a majority shareholder deals with minority

prices might be depressed in order to execute a buyout on the cheap and steal from the minority owners.[36] Concerned that the pendulum was swinging too far the other way, state and federal lawmakers have erected three distinct legal frameworks as a sort of counterweight: disclosure, judicial review, and the appraisal remedy. Regrettably, however, these tools to protect minority shareholders have grown complex and do not always accomplish their stated goals. In some cases, they are even threatening to spin out of control. The balance of this Part examines and critiques each of these three legal doctrines.

B. Disclosure Obligations

In 1979, the Securities and Exchange Commission (SEC) adopted Rule 13e-3 to address the risk of exploitative freezeout mergers.[37] Like most of our securities laws (at least those pre-Sarbanes-Oxley), the emphasis was on disclosure. The SEC's philosophy was to arm minority shareholders with information that would help them determine whether a cash freezeout was in their best interest and whether the announced price was fair.[38] Under Rule 13e-3, controlling shareholders must send minority owners a report describing the purpose of the transaction and explaining why a freezeout is better than alternative strategies for meeting these objectives.[39] They must also send information on the firm's recent financial performance, current and historical share prices, and the fairness opinion commissioned for the transaction.[40]

This rule seems reasonable on its face, but it is questionable whether it has much practical effect.[41] Minority shareholders with a small stake in the firm are unlikely to pay much attention to the reports. Those with more meaningful economic interests may already

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shareholders. This idea is difficult to reconcile with majority-owner property rights, however, and the broad sweeping language of *Perlman* has not infiltrated the mainstream of corporate law. Barring a sale to looters or some related anomaly, majority owners are generally free to sell their stake for a control premium without much fear of a direct fiduciary duty lawsuit. *See, e.g.*, STEPHEN M. BAINBRIDGE, CORPORATE LAW 172 (2d ed. 2009) (stating that "controlling shareholders are free to dispose of their stock as they see fit" except under certain circumstances, such as sale to looters or sale involving fraud); Gilson & Gordon, *supra* note 4, at 793–94 (arguing that by early 1990s *Perlman* was replaced with rule that "in general, a controlling shareholder can sell control at a premium that is not shared with non-controlling shareholders").

36 *See infra* Part II.B (illustrating potential for social welfare losses).

37 SEC Rule 13e-3, 44 Fed. Reg. 46,736, 46,736 (Aug. 8, 1979) (codified at 17 C.F.R. pt. 240); 17 C.F.R. § 240.13e-3 (2009).

38 The disclosure rules should thus be understood as a companion tool to the judicial review and appraisal proceedings described *infra* Part I.C–D.

39 17 C.F.R. § 240.13e-3(d)(1).

40 *Id.*

41 This is, of course, an empirical matter, and I am unaware of any study on point.

possess this information, discount the purported justifications, and conduct their own investigation into the adequacy of payout.[42] And, importantly, a determined majority owner can sidestep this entire disclosure process simply by structuring the freezeout as a stock exchange, instead of a cash deal. By doing this, he sheds the need to comply with Rule 13e-3[43] yet retains the ability to harm minority owners via unfavorable exchange ratios.[44] And, in any event, having a tall pile of financial reports will not help ill-treated minority shareholders unless they can seek some remedy or injunction for an abusive merger—which brings us to the next topic, judicial review of freezeout transactions.

C. Procedural Protections and Judicial Review

A fundamental tension between form and substance runs through corporate law: How should lawmakers treat transactions that use different legal structures to accomplish identical economic goals? Courts sometimes focus on substance, synchronizing disparate doctrines to ensure that lawyers cannot exploit technical loopholes to receive preferred legal treatment for their transactions.[45] In other cases, however, lawmakers respect the form of a transaction—under a

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[42] Indeed, they would be wise to do so, as the SEC does not apparently require the fairness opinion to come from an independent investment banker. *See* SEC Div. of Corp. Fin., Manual of Publicly Available Telephone Interpretations, Going Private Rules and Schedule 13e-3 para. 2, http://www.sec.gov/interps/telephone/cftelinterps_goingprivate.pdf (last visited July 20, 2009).

[43] *See* 17 C.F.R. § 240.13e-3(g)(2)(iii) (exempting disclosure obligations if freezeout consideration involves majority owner's, or any publicly listed, stock); Gilson & Gordon, *supra* note 4, at 828 n.172 (discussing Rule 13e-3's exemption from disclosure requirements of transactions where minority shareholders receive parent stock).

[44] Recent case law in Delaware may be closing this loophole by reinstating disclosure requirements for stock exchange freezeouts through judicial redefinition of what constitutes a noncoercive majority offer. *See In re* Pure Res., Inc. S'holders Litig., 808 A.2d 421, 445 (Del. Ch. 2002) (requiring majority shareholders to include detailed disclosures related to transaction in order for deal to be deemed noncoercive). This is important because if a freezeout is found to be "coercive," the majority owner is obligated to sell at a "fair" price. *See* Solomon v. Pathe Commc'ns Corp., 672 A.2d 35, 39–40 (Del. 1996) (examining tender offer freezeouts); Gilson & Gordon, *supra* note 4, at 817–18, 827–28 (analyzing *In re Pure Resources*, 808 A.2d 421).

[45] This attempt at legal harmonization often arises, for example, in corporate tax law. Corporate acquisitions may receive differential tax treatment, for instance, depending on whether they are structured as asset sales, stock sales, or statutory mergers.

philosophy of "independent legal significance"[46]—even if this means that economic twins receive unequal treatment.[47]

In Delaware, the law of freezeout mergers falls into the latter camp: Form is king. Courts subject some deals to entire fairness review, while other transactions sidestep this scrutiny and enjoy the relative freedom of the business judgment rule. The critical dividing line is whether the freezeout is structured as a statutory merger or as a tender offer to minority shareholders.[48] Thus, to understand the current balance of power between majority and minority shareholders, we need to take a quick journey through this looking glass of judicial review. (A number of excellent recent articles discuss this disjointed jurisprudence,[49] so I will be brief.)

1. Statutory Mergers

The traditional way to freeze out minority shareholders has been through statutory merger. After a controlling shareholder expresses interest in a deal, the firm's board will typically establish heightened governance procedures to assess the offer. For example, it may appoint a special committee (SC) of independent directors to evaluate the proposal and negotiate on behalf of minority shareholders.[50] Likewise, the deal may be conditioned on an approval vote of a

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46 The doctrine of independent legal significance holds that transactions structured under one strand of law remain valid even if this leads to economic results that would be barred under another corner of law. *See, e.g.*, Orzeck v. Englehart, 195 A.2d 375, 377 (Del. 1963) ("[A]ction taken in accordance with different sections of that law are acts of independent legal significance even though the end result may be the same under different sections.").

47 For example, amendments to preferred stock rights that would be barred under state corporate statutes (without the requisite preferred shareholder vote) can sometimes be accomplished via merger. *E.g.*, Bove v. Cmty. Hotel Corp., 249 A.2d 89, 91–98 (R.I. 1969) (permitting elimination of right to cumulative preferred dividends through "merger device," which only requires approval by two-thirds of preferred shareholders under merger statute, when identical amendment would require unanimous approval by preferred shareholders under general corporation law).

48 *See* Subramanian, *supra* note 6, at 7 (distinguishing each transaction and resulting standard of judicial review).

49 *See, e.g.*, Gilson & Gordon, *supra* note 4, at 817–27 (discussing doctrinal inconsistencies relating to freezeout transactions and describing potential convergence between standards governing freezeout mergers and freezeout tender offers); Faith Stevelman, *Going Private at the Intersection of the Market and the Law*, 62 BUS. LAW. 775, 846–47 (2007) (pointing to unresolved ambiguities in freezeout doctrine); Subramanian, *supra* note 6, at 11–22 (discussing doctrinal inconsistencies between stautory freezeouts and tender offer freezeouts).

50 The use of special committees arose when the Delaware Supreme Court hinted that vetting the transaction with an independent negotiating body would provide "strong evidence that the transaction meets the test of fairness." *See* Weinberger v. UOP, Inc., 457 A.2d 701, 709 n.7 (Del. 1983) ("Although perfection is not possible, or expected, the result here could have been entirely different if [the board] had appointed an independent nego-

majority of minority shareholders (MOM condition), though a funny quirk of the case law means that there is no real incentive for firms to use both an SC and a MOM condition.[51] If the requisite approval of boards and shareholders at both target and acquirer is obtained then the merger is consummated under state law. Practically speaking, these votes are often a formality (assuming accommodating SC or MOM votes), as the majority controller sits on both sides of the table.

What happens if, notwithstanding the purported procedural protections, a minority shareholder dislikes the transaction or believes that the merger consideration is too low? He has two broad options: (1) File a lawsuit alleging that the deal amounts to a breach of fiduciary duty (discussed below); or (2) seek appraisal rights (discussed in Part II.D). If heightened governance procedures were not employed and a lawsuit is filed, then courts will subject the deal to entire fairness review because freezeouts are seen as a self-dealing transaction.[52] If, however, the target firm used an independent SC or nonwaivable MOM vote, then the burden of proof shifts to the plaintiff, though the freezeout must still meet a standard of entire fairness.[53]

The upshot of this legal framework, then, is that a majority shareholder pursuing a merger-based freezeout faces the highest echelon of judicial review no matter what type of procedural protections are established for minority owners. Some commentators and judges dislike this result, arguing that courts should adopt deferential business judgment review if the board runs the deal through an SC[54] or takes more aggressive action to vet the deal.[55] But thus far, Delaware

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tiating committee of its outside directors to deal with [the majority shareholder] at arm's length.").

51 Specifically, *either* the use of an SC or a MOM condition will shift the burden of proof to the plaintiff in the event of a lawsuit. Doing *both*, however, provides no additional benefit to the defending firm. *See In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 634, 642–44 (Del. Ch. 2005) (bemoaning lack of incentives to hold MOM vote); Subramanian, *supra* note 6, at 16–17 ("[C]ombination of the two procedural protections provides no further benefit to the controlling shareholder in terms of standards of judicial review.").

52 *See Weinberger*, 457 A.2d at 710 (applying entire fairness test to freezeout transaction).

53 *See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994) ("[W]hen an interested cash-out merger transaction receives the informed approval of a majority of minority stockholders or an independent committee of disinterested directors, an entire fairness analysis is the only proper standard of judicial review."). As mentioned *supra* note 51, there is no incentive for a firm to use both an SC and a MOM condition.

54 *See, e.g.*, *In re* Trans World Airlines, Inc. S'holders Litig., No. 9844, 1988 WL 111271, at *7 (Del. Ch. Oct. 21, 1988) (holding that business judgment rule should be used if SC approved freezeout), *abrogated by Kahn*, 638 A.2d at 1117.

55 *See* Subramanian, *supra* note 6, at 55–64 (advocating business judgment protection if firm uses *both* SC and binding MOM voting condition).

courts have been unwilling to lighten the standard of review for statutory merger freezeouts.[56]

2. *Tender Offer Freezeouts*

Starting in 2001, Delaware opened another route for majority controllers looking to consummate freezeouts on less onerous terms. Instead of using the traditional statutory merger provisions, a controlling owner can simply announce a tender offer to all minority shareholders. The offer will usually be conditioned on the majority holder receiving ninety percent of the shareholder vote, since surpassing that threshold unlocks the use of a short-form merger to take over the last slice of the firm (without the need for additional shareholder approvals).[57] Because the controller is directly propositioning the minority shareholders, Delaware courts have held that this transaction does not involve corporate self-dealing, and thus, there is no need to conduct an entire fairness review of the tender offer consideration.[58] Indeed, the corporation itself does not technically act on these offers—other than to issue a Schedule 14D-9 recommendation to the minority holders.[59] The Delaware Supreme Court has also stated that entire fairness review is not appropriate for the back-end short-form merger: That transaction enjoys the protection of the business judgment rule, with appraisal constituting the only remedy for objecting minority shareholders.[60] Finally, a majority shareholder will not

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[56] One chancery court opinion has argued strongly, but only through dicta, that a change along these lines is needed. *See In re* Cox Commc'ns, 879 A.2d at 642–44 (advocating for presumptive application of business judgment rule when controller's proposed merger is "subject from inception to negotiation and approval of the merger by an independent special committee *and* a Minority Approval Condition"). This aspect of the opinion is discussed more fully *infra* note 147 and accompanying text.

[57] *See* DEL. CODE ANN. tit. 8, § 253 (2001); MODEL BUS. CORP. ACT § 11.05 (2005).

[58] *See* Solomon v. Pathe Commc'ns Corp., 672 A.2d 35, 37, 39 (Del. 1996) (holding that tender offer from majority to minority shareholders is not subject to entire fairness review); *In re* Siliconix Inc. S'holders Litig., No. 18700, 2001 WL 716787, at *6–8 (Del. Ch. June 21, 2001) (declining to apply entire fairness review to tender offer freezeout).

[59] Schedule 14D-9 recommendations, often developed by an independent SC, are used to inform minority owners that the board approves, rejects, is neutral to, or is unable to take a position on the announced tender offer. They are due soon after the announcement of a tender offer, which may leave the board scant time to launch a detailed examination of the proposal. *See* 17 C.F.R. § 240.14d-9 (2009) (outlining requirements); Guhan Subramanian, *Post-*Siliconix *Freeze-Outs: Theory and Evidence*, 36 J. LEGAL STUD. 1, 3 (2007) (discussing tender offers and Schedule 14D-9 requirements).

[60] *See* Glassman v. Unocal Exploration Corp., 777 A.2d 242, 246–48 (Del. 2001) (adopting business judgment rule for short-form mergers, under which minority shareholders are cashed out without shareholder vote).

breach her fiduciary duties to minority shareholders so long as the tender offer is deemed "noncoercive."[61]

Assembling these puzzle pieces, it should immediately become clear that majority shareholders can now use a tender offer to accomplish the exact same economic result as a statutory merger—taking one hundred percent ownership of the firm—without suffering through an entire fairness review by the court. Simply by conducting a tender offer freezeout instead of a merger freezeout, the controller can use legal form over substance to lighten judicial inquiry into the fairness of the transaction. To be sure, minority owners do decide whether to sell their shares in the tender offer. But many believe that this decision is not made with a free hand since minority holders face an implicit threat of retaliation for noncompliance, including the possibility that the deal will simply be recast as a statutory merger.[62] Scholars have recognized this doctrinal inconsistency and urged the adoption of a unified legal theory to govern freezeouts.[63] But the Delawarian disconnect persists. Indeed, the real mystery is why some freezeouts continue to be structured as statutory merger transactions.[64]

Maybe, however, all of this distress is for naught. After all, no matter how the transaction is implemented, a dissenting shareholder can always assert an appraisal claim, as this right attaches to both statutory and short-form mergers.[65] This brings us, then, to the final topic

[61] The *Pure Resources* case elaborates on the requirements needed to bless a tender offer as noncoercive: (1) The offer should include a nonwaivable MOM condition; (2) the controller should agree to complete a short-form merger, on substantially similar terms, promptly after reaching the ninety percent voting threshold; (3) the controller should make "no retributive threats"; (4) independent directors should be afforded enough time to react to the tender offer and issue a recommendation, typically after they have hired independent professional advisors to evaluate terms; and (5) minority shareholders should receive adequate information disclosures to judge the tender offer. *In Re* Pure Res., Inc. S'holders Litig., 808 A.2d 421, 445 (Del. Ch. 2002).

[62] *See* Subramanian, *supra* note 6, at 25–26 (arguing that tender decision does not provide an adequate substitute for "vigorous bargaining").

[63] *See, e.g.*, Gilson & Gordon, *supra* note 4, at 827–34 (advocating for resolution of "difference between the availability of a class appraisal remedy in freeze-out mergers and freeze-out tender offers"); Subramanian, *supra* note 6, at 55–64 (advocating for standard of judicial review that "would create incentives for controllers to provide adequate procedural protections to the minority, regardless of the transactional form used").

[64] *See* Subramanian, *supra* note 6, at 22 (suggesting that majority controller has few incentives to conduct merger-based freezeout); Subramanian, *supra* note 59, at 21–24 (finding that significant portion of freezeouts are still conducted as statutory mergers and that these latter deals receive higher premiums than tender-offer freezeouts). The answer may lie in the inconsistent experience of professional advisors to these transactions. Alternatively, controllers may not wish to put any decision-making power (i.e., whether to tender) into the hands of minority shareholders.

[65] Del. Code Ann. tit. 8, § 262 (2001 & Supp. 2008).

in our troika of freezeout-related laws: Can appraisal backstop inadequate disclosure obligations and inconsistent judicial review by guaranteeing minority shareholders some measure of fair value for their shares? Unfortunately, the short answer is no. And the long answer is even worse: Appraisal rights may be starting to distort corporate governance in a way that the early lawmakers who enacted these statutes never anticipated.

D. Appraisal Rights

Appraisal statutes permit minority shareholders to dissent from a merger or related fundamental change[66] and receive a judicially determined fair value of their shares. The idea maintains some appeal, but appraisal has not worked very well in practice. For the past fifty years, it has been derided by commentators as illogical,[67] a "last-ditch check on management improvidence,"[68] and a "remedy of desperation."[69] Empirical analysis also seems to confirm the irrelevance of appraisal rights.[70] Nevertheless, appraisal statutes persist as an avenue for minority shareholders to object to a merger or related fundamental transaction.[71] There is evidence that the number of claims has risen in recent years, and the context for filing appraisal claims continues to evolve as the Delaware courts interpret and reinterpret the flawed text of the statutes. Before turning to contemporary events, however, it is worth unpacking the history of appraisal litigation, as this is intimately braided with broader corporate governance struggles between majority and minority shareholders.

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66 Triggering mechanisms for appraisal are inconsistent across jurisdictions. Every state grants appraisal rights for merger transactions, many offer the remedy when a firm sells "substantially all of [its] assets," and some trigger the rights when the corporate charter is amended. Thompson, *supra* note 24, at 9, 14–15 (discussing how appraisal statutes have changed over time); *see also*, Paul G. Mahoney & Mark Weinstein, *The Appraisal Remedy and Merger Premiums*, 1 AM. L. & ECON. REV., 239, 243–45 (1999) (describing appraisal statutes).

67 Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 237–38 (1962).

68 Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 304 (1974).

69 Melvin Aron Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CAL. L. REV. 1, 85 (1969).

70 *See* Mahoney & Weinstein, *supra* note 66, at 272 (concluding that empirical results show very little impact on premiums when appraisal rights are available for public firm mergers).

71 For representative statutes, see, for example, DEL. CODE ANN. tit. 8, § 262 (2001 & Supp. 2008); MODEL BUS. CORP. ACT § 13.02(a) (2005).

1. Appraisal as an "Emergency Exit" from Majority Rule

State lawmakers awarded appraisal rights to shareholders during the first few decades of the 1900s, apparently as a quid pro quo for the elimination of unanimous shareholder consent requirements.[72] On paper, this legal compromise was thought to sidestep holdout problems (brought on when dissenters demanded side payments to approve fundamental transactions) while also protecting minority owners from having a raw deal crammed down their throats. In other words, appraisal was viewed as an emergency exit from majority rule: The company was free to make the change, but minority owners had a way out if they did not like the shift in direction.[73]

The appraisal remedy is not self-executing, however, and shareholders have to navigate a variety of procedural hurdles before reaching the emergency exit. For example, statutes typically require dissenters to perfect appraisal rights by voting against a merger (or at least not voting for the deal)[74] and by notifying the firm that they intend to seek appraisal.[75] After the vote there are additional requirements: Dissenters may need to file a demand with the firm (sometimes including their estimate of a fair share price)[76] and deposit their shares with the corporation.[77] In Delaware, each dissenting shareholder must file her own lawsuit; there is no provision for sharing liti-

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[72] Recall that prior to this change, corporations were generally prohibited from consummating a fundamental transaction, such as a merger, without the unanimous consent of shareholders. *See* Thompson, *supra* note 24, at 14–15 (discussing historical rationale for appraisal); Wertheimer, *supra* note 24, at 614–15 (same). State legislatures began to replace the unanimity requirement with more modest voting hurdles in the early 1900s. *See* William J. Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 AM. B. FOUND. RES. J. 69, 86–90 (describing elimination of unanimous shareholder voting requirements for some corporate transactions). Appraisal statutes were enacted, in turn, to provide minority shareholders with an escape hatch from deals they considered unwise. Joseph L. Weiner, *Payment of Dissenting Stockholders*, 27 COLUM. L. REV. 547, 548 n.7 (1927) (cataloging at least twenty states with appraisal remedy); Wertheimer, *supra* note 24, at 618–19 (discussing origins of appraisal remedy). It is worth noting, however, that appraisal statutes were not always enacted in concert with the removal of unanimous shareholder voting requirements. In some cases, appraisal measures lagged the franchise amendments by ten or twenty years, casting some doubt on the direct connection between these two developments. *See* Thompson, *supra* note 24, at 14 & n.52 (noting gap between reversal of unanimity requirements and enactment of appraisal statutes).

[73] *See* Mahoney & Weinstein, *supra* note 66, at 245 (describing early justification for appraisal as escape from asset transformation); Manning, *supra* note 67, at 240 (same).

[74] *E.g.*, Model Bus. Corp. Act § 13.21(a)(2) (requiring dissenting shareholders to withhold support for merger).

[75] *Id.* § 13.21(a)(1). Arguably, these requirements are necessary so management can plan for the likely cash outlay to dissenters.

[76] This is less common. For one example, see 15 PA. CONS. STAT. ANN. § 1578 (West 1995).

[77] *E.g.*, MODEL BUS. CORP. ACT § 13.23.

gation expenses via a class action.[78] In other jurisdictions, the firm itself initiates the proceedings.[79]

Unfortunately for dissenting shareholders, most appraisal statutes do not put time on their side. It can take years for a court to determine the fair value of disputed stock. During this period, dissenters may not close out their positions and may earn unsatisfactory returns on a judgment.[80] Even worse than this long path to judgment, some courts (including those in Delaware) have historically used faulty rules for calculating the fair price of the stock.[81]

2. *Appraisal as a "Towering Skyscraper of Rusted Girders"*

Given these limitations, it should perhaps not be surprising that early appraisal rights were a dud. Who wants to lock up money at simple interest through a long trial in the hope that a judge will bump up the sales price by a few dollars? Isn't life much easier for dissenters who simply dump the stock on the market when their firm announces a rotten merger and move on to a different investment? Better to leave by the front door than struggle your way toward an emergency exit. To be sure, this is not much of an option for close corporations and other thinly traded securities. By the middle of the twentieth century, however, an academic consensus had nevertheless crystallized that appraisal rights were something of a sideshow—a doctrine for clever deal lawyers to "get around," rather than a meaningful lever for corporate governance.

The spearhead of this movement was undoubtedly Bayless Manning, a Yale law professor who launched his influential critique of

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[78] Del. Code Ann. tit. 8, § 262(e) (Supp. 2008).

[79] *E.g.*, Model Bus. Corp. Act § 13.30 (requiring corporation to commence proceedings within sixty days of disputed valuation).

[80] *See* Thompson, *supra* note 24, at 42 & n.182 (describing historical Delaware case law permitting use of simple interest on appraisal judgment). In 2007, however, the Delaware statute was modified to set an interest rate equal to the Federal Reserve discount rate plus 5%, compounded quarterly, for the period running from the date of the merger through the payment of a judgment. Del. Code Ann. tit. 8, § 262(h) (Supp. 2008).

[81] Historically, Delaware embraced the "Delaware block" method of valuation—a weighted average of premerger market value, capitalized earnings value, and net asset value. The rule had the advantage of relative methodological certainty but the disadvantage of awarding judgments that bore little resemblance to financial reality. This was all changed, of course, in 1983 with the important case of *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983). *See infra* note 94 and accompanying text (describing *Weinberger*'s effects on valuation methods). There are further valuation concerns, however, such as whether to include any impact on value from the contemplated merger and whether to use a "minority discount." *See, e.g.*, Lawrence A. Hamermesh & Michael L. Wachter, *The Short and Puzzling Life of the "Implicit Minority Discount" in Delaware Appraisal Law*, 156 U. Pa. L. Rev. 1 (2007) (exploring appraisal valuation nuances related to minority ownership).

the remedy in 1962.[82] He took apart appraisal statutes with a volley of arguments, exposing as folly any hope that these laws might improve corporate governance.[83] The procedural hurdles were an easy target, but Manning went further, showing how firm managers could often negate appraisal rights simply by repositioning the deal as an asset sale, reverse merger, or some other form-over-substance alchemy.[84] As such, appraisal rarely offered a meaningful check on majority rule. The emergency exit was only available when the majority felt like unchaining the door.

Even more damning, however, was Manning's criticism of the basic logic underlying appraisal. Why, he puzzled, should minority owners enjoy the legal right to exit the firm during a merger (or in a handful of other contexts), yet remain "trapped" in the countless other situations where they dislike an act by the majority? Why is there no right to jump ship during a bankruptcy filing, a massive dividend distribution, dissolution, or some other key event? Without a principled way to explain the narrow domain of appraisal rights, Manning concluded that these statutes were symptomatic of a decaying body of corporate law—reduced, in his words, to a "towering skyscraper[ ] of rusted girders, internally welded together and containing nothing but wind."[85]

Following Manning's harsh critique, many lawmakers watered down appraisal to reduce the apparent nuisance risk of the remedy. About half of the states, for example, eliminated appraisal rights (under most circumstances) when a firm traded on a national exchange or had more than 2000 shareholders.[86] Likewise, there was

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[82] Manning, *supra* note 67.

[83] Manning identified at least four problems that gut the appraisal remedy: (1) inconsistent triggers for obtaining appraisal rights; (2) awkward procedural requirements for perfecting appraisal; (3) a long and expensive path to judgment; and (4) room for rampant disagreement about the true value of dissenters' shares. *Id.* at 231, 233, 258–59.

[84] *Id.* at 258–59; *see also* Thompson, *supra* note 24, at 17, 33 (describing use of triangular mergers to eradicate appraisal rights and failure of de facto merger doctrine to reinstate them).

[85] Manning, *supra* note 67, at 245 n.37.

[86] *See, e.g.*, DEL. CODE ANN. tit. 8, § 262(b)(1) (Supp. 2008) ("[N]o appraisal rights under this section shall be available for the shares of any class or series of stock, which stock . . . were either (i) listed on a national securities exchange or (ii) held of record by more than 2,000 holders . . . ."). This type of provision is known as a "market exception." *See* Mahoney & Weinstein, *supra* note 66, at 244 (citing Arizona and Florida statutes as examples). Market exceptions were passed under the assumption that minority shareholders would not face liquidity constraints and could simply sell their shares if they disliked a forthcoming merger. *See, e.g.*, Ernest L. Folk, III, The Delaware General Corporation Law: A Commentary and Analysis 391 (1972) (noting market exception to be based on theory that "if the appraisal remedy provides a judicially created market for dissenting stockholders, such a device is unnecessary where there is already a substantial

a movement to get rid of appraisal rights for shareholders of the acquiring firm when a merger did not generate substantial dilution.[87] The reported cases on appraisal battles, never a robust body of law, withered. Many wrote off the remedy for dead.[88]

3. *The* Weinberger *Revival*

In 1983, however, the Delaware Supreme Court pulled appraisal off its funeral pyre and shocked the remedy awake. The vehicle for this change was *Weinberger v. UOP*,[89] a landmark dispute involving the use of a freezeout merger to eliminate minority shareholders.[90] For a brief period starting in 1977, a firm wishing to conduct a freezeout merger in Delaware needed to cite a business justification for the transaction.[91] The *Weinberger* court overruled this business purpose test just six years later, ushering in a new era of freezeout mergers.[92] In exchange, the court promoted appraisal as the appropriate remedy for unhappy minority shareholders[93] and modernized the valuation methodology used to set a fair price for the stock.[94]

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trading market"). The rights were reinstated in many states, including Delaware, for freezeouts paying nontradable securities as the merger consideration. Mahoney & Weinstein, *supra* note 66, at 244 (citing DEL. CODE ANN. tit. 8, § 262(b)(2)).

87 The typical test was whether the transaction would "result in any change in the surviving shareholders' shares and . . . result in an increase of shares beyond twenty percent or some other threshold." Thompson, *supra* note 24, at 22.

88 *See, e.g.*, FOLK, *supra* note 86, at 373 ("[I]t would not be surprising to see [the appraisal right] eliminated altogether."); Brudney & Chirelstein, *supra* note 68, at 304 (noting how some authors have described appraisal as "technical . . . expensive . . . uncertain . . . and, in the case of a publicly held corporation, . . . unlikely to produce a better result than could have been obtained on the market"); Eisenberg, *supra* note 69, at 85 (deeming appraisal to be "a remedy of desperation"); Mahoney & Weinstein, *supra* note 66, at 251 ("Appraisal nearly vanished from the public company landscape during the 1960s and 1970s . . . .").

89 457 A.2d 701 (Del. 1983).

90 *Id.* at 703.

91 *See* Singer v. Magnavox Co., 380 A.2d 969, 979–80 (Del. 1977) (imposing short-lived business justification requirement in Delaware).

92 457 A.2d at 715. For additional background on the history of freezeout mergers, see generally Weiss, *supra* note 32.

93 This, in turn, has renewed the question of whether appraisal is the *exclusive* remedy for disaffected minority investors. Some states have hinted as much. *See* Thompson, *supra* note 24, at 44 n.201 (cataloging thirteen state court decisions that deem appraisal to be exclusive remedy). Others, like Delaware, leave the door open for alternative claims, such as breach of fiduciary duty. *Id.* at 44, 46–48.

94 *See Weinberger*, 457 A.2d at 712–13 (declaring that "Delaware block" method of valuation will "no longer exclusively control" appraisal and other valuation cases). The court insisted that this outdated rule should be replaced with any legitimate valuation methodology used by the financial community. *Id.* at 713. Such a change should be welcomed as promoting accuracy through modern finance, though it also opens the door to wide gaps in reported value between the litigants. *See, e.g.*, Cede & Co. v. Technicolor, Inc., No. 7129, 1990 WL 161084, at *1 (Del. Ch. Oct. 19, 1990) (plaintiff's expert valued

These reforms, perhaps combined with an increase in freezeout mergers, soon led to a new wave of appraisal proceedings. Instead of being used as an exit strategy for minority shareholders disturbed by the firm's move into a new line of business, however, appraisal became a governance tool to counter the threat of majority oppression through freezeout. The revival of appraisal is easily demonstrated by comparing the work of Joel Seligman with that of Robert Thompson. In 1984, Professor Seligman examined the reported state cases on appraisal for the decade prior to *Weinberger*; he found just nineteen reported decisions.[95] Professor Thompson, conducting a similar empirical analysis for the post-*Weinberger* decade, discovered that the number of appraisal cases had jumped to 103.[96] Furthermore, more than eighty percent of these cases involved freezeout mergers; appraisal was only used a handful of times in a nonfreezeout context.[97]

But does the renewal of appraisal in the wake of robust freezeout activity mean that the remedy is achieving its policy goals? An empirical study by Paul Mahoney and Mark Weinstein suggests that the answer is no, at least for publicly traded firms.[98] The authors compare merger premiums for transactions where appraisal is available with those where it is not and conclude that appraisal seems to have no effect whatsoever on target shareholder gains.[99] In short, the appraisal remedy may add little above the alternative strategy of filing a fiduciary duty lawsuit.

This apparent failure of appraisal to serve as a shield for minority shareholders may be the logical result of several different factors. First, the procedural hassles identified by Professor Manning and others are often still in place.[100] Second, plaintiffs are still not allowed

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stock at $62.75; defendant's expert valued it at $13.14). In Delaware, the market-out exception was also modified to allow appraisal rights when a freezeout paid difficult-to-trade securities as the merger consideration. *See supra* note 86 and accompanying text.

[95] Joel Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829, 829 n.3 (1984).

[96] Thompson, *supra* note 24, at 25.

[97] *Id.* at 25–26.

[98] Mahoney & Weinstein, *supra* note 66, at 242–43.

[99] *Id.* However, the authors do find "some evidence" that appraisal rights exacerbate minority shareholder holdout problems. *See id.* at 272 ("There is some evidence of a negative effect [on shareholder returns] in transactions involving self-interested managers.").

[100] *See supra* notes 74–81 and accompanying text (describing procedural hurdles to appraisal remedy). Some states, following the lead of the Model Business Corporation Act (MBCA), have tried to ease these burdens. For example, the MBCA alters the timing of when dissenters are paid, allowing them to immediately receive whatever the firm is willing to concede as a fair price and thus leaving only the dissenter's incremental estimate of fair value hostage to the delay and uncertainty of litigation. *See* MODEL BUS. CORP. ACT § 13.25 (2005).

to join in class actions. Third, the inner plumbing of many appraisal statutes harkens back to earlier eras unconcerned about expropriation by freezeout.[101]

E. Synthesis

So where does this three-part approach to the regulation of freezeouts leave us? Unfortunately, not in a very good place. Disclosure obligations may provide minority investors with helpful information, but Rule 13e-3 lacks the teeth to halt abusive transactions. Dissenters can file a fiduciary duty lawsuit challenging the transaction, but the muddled Delaware case law in this area now grants majority shareholders the practical power to evade heightened review by using a tender offer freezeout. And the appraisal remedy continues to suffer from towering procedural hurdles and drawn-out valuation proceedings. Taken together, these cracking legal edifices are not always enough to check the plotting of greedy controlling shareholders.

Can we do better than this? Certainly the answer is yes. We can tinker with the standards of judicial review, or we can use the law to support private solutions such as the internal poison pill that I will advocate in Part III. But before championing new solutions to the freezeout problem, it is important to have a clear normative theory relating to the pros and cons of these transactions. Accordingly, the next Part turns to a comprehensive discussion of minority holdout and majority expropriation in order to identify why corporate law should bother injecting itself into internal governance battles of majority and minority shareholders.

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[101] *See* Thompson, *supra* note 24, at 28–52 (criticizing application of old laws to new context and concluding that "the transformation of appraisal into a remedy for self-dealing does not easily fit with existing appraisal statutes"). Recent developments in Delaware illustrate yet another problem: Voting, settlement, and clearing procedures for stock trades have become much more complex—to the point where some parts of the appraisal remedy no longer make sense. *See In re* Appraisal of Transkaryotic Therapies, Inc., No. 1554-CC, 2007 WL 1378345, at *3 (Del. Ch. May 2, 2007) (allowing beneficial owners to maintain appraisal claims even though they bought shares after record date for voting and could not easily trace their shares to those voting against—or abstaining from—merger). *Transkaryotic* presents the possibility that post-announcement plaintiffs can buy up chunks of stock, insist that the unvoted shares were the "ones" they purchased, and threaten to launch a drawn-out appraisal proceeding unless side payments are made. This problem is a variant of the "empty voting" phenomenon. *See* Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 823–49 (2006) (showing how modern trading practices and products can lead to disconnect between control rights and financial interests); *see also* Henry T.C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343 (2007) (expanding upon earlier work in this area).

II
The Illness

What is the appropriate role of corporate law in supervising the relationship between majority and minority shareholders? This is a tricky question, but one that should be addressed before crafting a response to the doctrinal discord discussed in Part I. It is one thing to say that our current laws are not working as intended; it is quite another to prescribe reforms. For that, we need a theory of what freezeout law should strive to accomplish.

For some, a tempting starting point might be to posit that corporate law should just butt out and let shareholders negotiate their own relationships. If everyone is willing to cede dictatorial power to a majority, then so be it; if initial shareholders want to insist on unanimous shareholder consent for mergers, then fine. But just a cursory amount of reflection suggests that these negotiations may not be very meaningful and, indeed, are unlikely to ever take place. The indefinite life and vast owner base of many corporations impose insurmountable transaction costs, and a churning roster of shareholders may mean that what sounded fine a year ago disgusts current owners. If nothing else, then, there can be social gains from establishing a sensible default rule regime for the freezeout problem.

But there is an even stronger case for change. Competing shareholder incentives in freezeout mergers pose a serious risk of deadweight loss through destructive decisions that forego or delay value-enhancing opportunities. There is a specific legal entitlement to award here: the right to take ownership of the entire firm. It is problematic to grant minority shareholders untrammeled power to block these transactions, as gadflies may leverage this power into holdup demands. But taking the opposite approach—by awarding majority controllers unilateral discretion to complete the merger with a judicially determined fine (such as appraisal)—raises tricky agency cost problems and may distort corporate investment decisions. This Part illustrates these competing challenges more fully and asks whether there might be an intermediate theoretical model for parsing the freezeout entitlement.

A. Stricken by Minority Holdout

The first problem is simple to state: Minority shareholders may abuse any governance power they receive by threatening to veto or hinder a sensible freezeout transaction unless they receive special payment. It only takes a few selfish individuals with overly rosy opinions of the deal synergies to spoil an entire transaction. Indeed, this is a classic illustration of the holdout problem, and it was the motivating force behind the elimination of unanimous shareholder voting requirements for mergers in the first decades of the twentieth century.[102]

There are really two separate problems that might cause efficient deals to be abandoned: asymmetrical information and a fight for the spoils. Suppose, for instance, that a going-private freezeout would actually generate $1,000,000 in expected synergies. And suppose (counterfactually in most cases) that the transaction were subject to unanimous shareholder consent. The first problem is that even if a single minority shareholder holds out because of a false belief—due to information asymmetry—that synergies are worth $2,000,000, the deal will fail despite being profitable. Thus, inefficient behavior can result from asymmetrical information even when no one is being greedy. The second problem relates to how the synergies should be divided among multiple dissenters, even in the absence of asymmetrical information. If two minority shareholders threaten to object to the above transaction, they may each refuse to budge from an individual demand of $750,000, again forcing the freezeout to fail. This is simply a failed game of chicken.

But a tenacious minority shareholder does not need an explicit veto right to hold up a transaction. Any legal entitlement—such as the right to file a fiduciary duty or appraisal lawsuit—might be used to mount a strike suit that taxes the merger gains. The plaintiff minority shareholders are, in effect, playing a game of chicken by looking to wring out a settlement greater than what they deserve but less than the defendant majority shareholders' cost of fighting the suit. It is a familiar problem: Well-intentioned legal protections form petri dishes for bogus lawsuits[103] and may deter marginally valuable freezeouts.

The challenge, of course, is that some minority investor claims have merit. Yet it is difficult under our current regulatory framework to distinguish bona fide lawsuits from extortionate ones. As Professor Manning nicely puts it: "The appraisal statutes may be viewed either as a bulwark for the rights of the minority, or as a lubricant to speed the spread of majoritarianism. Of course the statutes might do both, depending upon their administration and their application."[104] Said

102 *See supra* notes 24–31 and accompanying text (outlining history of elimination of unanimous shareholder voting requirements).

103 Much has been said about this problem, for example, in the context of both shareholder derivative lawsuits and securities litigation. *See, e.g.*, Stephen J. Choi, *Do the Merits Matter* Less *After the Private Securities Litigation Reform Act?*, 23 J.L. ECON. & ORG. 598, 599–600 (2007) (discussing effects of reform efforts in securities law on nuisance litigation).

104 Manning, *supra* note 67, at 230.

differently, we may not be in a world of minority blackmail, but rather in one of majority burglary.

B. A Bad Case of Majority Oppression

It should be quite obvious by now how majority shareholders can turn unchecked freezeout power into a siphon for sucking wealth from minority investors: If you simply price a cash merger below the actual value of the shares, every dollar of the difference drops from the minority's pocket into yours.[105] If investors and courts cannot easily discern and block this five-finger discount, the threat of majority expropriation should translate into a lower ex ante price for the stock. One can construct a well-diversified investment portfolio without purchasing shares in majority-controlled firms, so why buy into a situation where the largest owner can punch you in the gut?[106]

Herein lies the legal challenge: If a court could easily determine whether a freezeout's price were fair simply by comparing the offer to a preannouncement stock ticker, then it could draw upon efficient capital markets theory to block abusive deals. But if the preannouncement price is depressed by the possibility of a future freezeout rip-off, then it becomes much more difficult for courts to know whether an offer is in fact fair. A premium over yesterday's Wall Street close might still be woefully inadequate.[107]

Some commentators claim that we should not worry so much about this problem.[108] After all, if minority investors initially *buy*

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[105] More specifically, this straightforward abuse, sometimes termed a "tunneling transaction," is accomplished in the following manner: First, a majority block of shareholders forms a new corporation, entirely owned by the cabal; and second, the majority owners allow the new firm to buy the old one at an unreasonably low price. The net result: The majority block takes over all of the underlying assets, and the minority owners receive less than they should. *See, e.g.*, Simeon Djankov et al., *The Law and Economics of Self-Dealing* (Nat'l Bureau of Econ. Research, Working Paper No. W11883, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=864645 (describing tunneling and examining legal regimes in different countries for preventing it).

[106] Alas, the situation is even more complex. In addition to this risk of freezeout expropriation, a large shareholder brings a theoretical benefit: She will have a greater incentive to guard against agency abuses from corporate officers and directors, and the monitoring of investments will typically benefit all shareholders, as minority investors free ride on the efforts of controlling shareholders. *See* sources cited *supra* note 30. Weighing the expropriation risks against the monitoring benefits raises interesting empirical questions beyond the scope of this Article. The inquiry is challenging, maybe indeterminate.

[107] *See, e.g.*, Daniel R. Fischel, *The Appraisal Remedy in Corporate Law*, 1983 Am. B. Found. Res. J. 875, 876 (focusing on ex ante price of shares and role of appraisal); Mahoney & Weinstein, *supra* note 66, at 247 (discussing reasons why ex ante share prices might be depressed).

[108] *See, e.g.*, A.C. Pritchard, *Tender Offers by Controlling Shareholders: The Specter of Coercion and Fair Price*, 1 Berkeley Bus. L.J. 83, 103 (2004) (discounting these concerns as zero-sum transfers).

their shares at a discount (due to the threat of coercive freezeouts), then they should not complain too loudly when the extortion actually occurs.[109] Markets have already priced in this risk. To be sure, minority owners purchasing shares before a specific legal change that enables freezeouts (such as the lenient standard of review that Delaware awarded tender offer transactions in 2001[110]) may experience a one-time loss in wealth. But after that, the game is known, and a defeated-expectations argument should fail.[111] According to this line of reasoning, any allocational inefficiencies vanish as the dust settles, and we should not bother with the issue.

Unfortunately, however, the problem gets worse when coupled with the majority's ability to control or influence ongoing investment decisions. There is a serious risk of deadweight distortions—in addition to the zero-sum wealth transfers from minority to majority shareholders—when majority controllers can time the freezeout decision. These distortions may take on a variety of forms, and they are far more pernicious (from an economic point of view) because real money is being burned, not simply shunted to a different owner.

Consider a simple example involving the timing of a new investment. Imagine a project is worth $20 million (in net present value terms) if conducted today but only $18 million if delayed until next year.[112] On these facts, the obvious decision is to break ground immediately. Nevertheless, a 60% controlling owner might rationally cause a deferral in order to take all of the smaller pie, rather than a slice of the larger one.[113] This is obviously undesirable from an efficiency point of view: The $2 million difference is deadweight loss.

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[109] *Id.*

[110] *See supra* Part I.C.2 (discussing availability of tender offer freezeouts and subsequent lighter judicial inquiry in Delaware).

[111] *Id.*; *see also* ROBERT CHARLES CLARK, CORPORATE LAW § 12.2.1, at 505–07 (1986) (on relevance of defeated expectations in corporate law); Subramanian, *supra* note 6, at 26 (describing defeated expectations argument).

[112] This might be true for a variety of reasons, including expected customer demand, competitor entry, regulatory change, and so on. There is ample evidence that managers pay serious attention to this timing question when executing a new investment, in part because launching or postponing an investment may bring additional real option value. *See* Tom Copeland & Peter Tufano, *A Real-World Way to Manage Real Options*, HARV. BUS. REV., Mar. 2004, at 90, 91 (reporting that 2001 survey revealed 27% of CFO's "always or almost always" used option theory to guide business decisions); Thomas E. Copeland & Philip T. Keenan, *How Much Is Flexibility Worth?*, MCKINSEY Q., 1998 no. 2, at 38, 41, 43 (discussing importance of investment timing).

[113] To complete the simple math (which ignores the time value of money for simplicity): $0.6 * 20 = 12 < 18$. Again, the situation really boils down to an information asymmetry problem where minority investors (or courts) lack full information on a firm's investment possibilities and are thus unable to determine the relative net present value of

There are other variants of this problem. A majority owner can "slash her own tires" by reducing the value of the company to obtain a lower freezeout price before rebuilding the business.[114] Alternatively, she can take the firm private for personal gain even if this results in negative synergies.[115] The main point is simply that freezeout policy can do far more harm than merely sanctioning a one-off expropriation: The power and incentives of a majority shareholder to game these transactions impose a substantial risk of social loss. This provides the primary motivation for using the rule of law to regulate freezeouts or to encourage sensible private ordering in this area.

But exactly what rights should be awarded to each side? To recap, the fundamental challenge underlying freezeout transactions (and, more generally, the broader relationship between majority and minority shareholders) is that a court cannot easily determine which of three alternative worlds best describes any given dispute: (1) a benevolent world where both parties simply have an honest disagreement about the value or desirability of a freezeout; (2) a Hobbesian world where rights given to majority controllers are used to steal; or (3) a similarly bleak world where minority investor protections become tools for blackmail.

For this reason, I think the freezeout problem can be fairly recast as a subjective valuation problem. If we could hook majority shareholders and minority plaintiffs up to machines and determine whether they were lying about their subjective share valuations, it would be fairly easy to distinguish the real cases from the bogus ones. Unfortunately—or, perhaps fortunately—we do not yet have a reliable brain scanner to accomplish this task. But there is another way to approach the problem.

C. Reframing Freezeouts as a Cathedral Problem

Except for the ubiquitous Coase Theorem,[116] there may be no more famous law and economics framework than Guido Calabresi and Douglas Melamed's "view of the cathedral."[117] This line of scholarship—dealing with the design, allocation, and transfer of legal enti-

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an investment now versus an investment later. This argument is inconsistent, therefore, with the strong form of the efficient capital markets hypothesis.

114 *See* Subramanian, *supra* note 6, at 33–34 (making this and other more general points about economic distortions resulting from majority expropriation).

115 *Id.* at 35 (describing how "gains from the tender offer would subsidize the negative consequences of going private, even though overall social welfare is higher if the company remains publicly traded").

116 R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

117 Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

tlements—shows how rights can be protected through property rules or liability rules.[118] Property rules vest the legal entitlement in one party, who may then sell that entitlement to another party if she wishes (but she cannot be required to sell it). Liability rules, by contrast, allow the second party to force the first party to sell the entitlement at a judicially-determined price. Under either rule, the entitlement should end up with the party who values it most.

The freezeout problem can be perfectly mapped onto the cathedral framework by viewing the right of minority shareholders to block a freezeout (or, alternatively, the right of a majority controller to conduct one) as a legal entitlement. A property rule would unconditionally award minority owners this right—which is effectively what the unanimous merger voting requirements of the early 1900s accomplished.[119] A liability rule, by contrast, shifts the entitlement to the majority owners, conferring untrammeled discretion to complete the merger by paying dissenters a judicially determined price under appraisal. The switch from unanimous shareholder voting to majority rule with appraisal rights can thus be understood as a move from a property regime to a liability regime for freezeouts.

A vast literature explores and amplifies Calabresi and Melamed's cathedral framework,[120] and my objective here is not simply to pile on another application. Rather, the model is helpful in the freezeout context because recent work in this area has started to show how it is possible to parse legal entitlements even more finely.[121] Instead of adopting a strict property or liability rule for freezeouts, we should

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118 *Id.* at 1092.

119 *See supra* notes 24–26 and accompanying text (discussing how early corporation statutes required unanimous shareholder approval for fundamental transactions).

120 *See, e.g.*, Lucian Arye Bebchuk, *Property Rights and Liability Rules: The Ex Ante View of the Cathedral*, 100 MICH. L. REV. 601 (2001) (offering ex ante perspective on allocation of entitlements); Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 HARV. L. REV. 713 (1996) (providing economic analysis of desirability of property and liability rules); James E. Krier & Stewart J. Schwab, *Property Rules and Liability Rules: The Cathedral in Another Light*, 70 N.Y.U. L. REV. 440 (1995) (providing general overview of property and liability rules and critiquing standards of analysis); Daphna Lewinsohn-Zamir, *The Choice Between Property Rules and Liability Rules Revisited: Critical Observations from Behavioral Studies*, 80 TEX. L. REV. 219 (2001) (criticizing trend favoring liability rule protection of entitlements over property rules); A. Mitchell Polinsky, *Controlling Externalities and Protecting Entitlements: Property Right, Liability Rule, and Tax-Subsidy Approaches*, 8 J. LEGAL STUD. 1 (1979) (considering relative merits of each approach in externality situation). It is worth noting that in a Coasean world of frictionless contracting, the initial assignment of the entitlement is irrelevant, as parties will bargain to the efficient result. *See* Kaplow & Shavell, *supra*, at 720 (making this point in property/liability context).

121 *See* sources cited *supra* note 22 (discussing various legal entitlements in corporate law context).

consider intermediate strategies where embedded options[122] are used as a form of mechanism design[123] to award partial rights to each side. If successful, this compromise might help to balance the dual concerns of holdout and expropriation by smoking out the concealed subjective valuations that form the heart of the freezeout problem.

The main idea is to replace a naked entitlement with one bearing an obligation to write affected parties their own option as an additional part of the exercise price for the entitlement.[124] For example, a factory may be given a liability entitlement to pollute on neighboring land, but only if it writes the neighbor an option to purchase this entitlement at a strike price reflecting the factory's valuation of this right.[125] In other words, a privileged party is not just an option taker but also an option maker. This means that those displaced by the exercise of an entitlement may be allowed (and may be willing) to "buy back" the right under certain conditions. The ultimate goal is to move away from judicial determination of an entitlement's value by encouraging the parties to set private mechanisms (embedded options) that elicit their relative subjective values. That is, laws are used not to allocate or price an entitlement, but rather to persuade private parties to expose their subjective valuations.

Let me turn back to the freezeout context, starting with a common illustration. Many parents know the cake-cutting trick: Janie and Johnny are sure to fight over the division of leftover cake. So Janie gets to cut, and Johnny gets first pick. In this way, Janie's entitlement to divide is tempered by the option that she must "write" Johnny as she exercises her cutting rights.[126] This elementary form of mechanism design can be extended to freezeouts. A majority con-

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122 The basic mechanics of an embedded option are explained *supra* note 17.

123 Mechanism design is an economic discipline where rules are established to promote specific outcomes, even as individual agents in the system take only self-interested actions. Scholars have begun to consider whether this approach might be used in relation to legal entitlements. *See, e.g.*, Joseph Farrell, *Information and the Coase Theorem*, 1 J. ECON. PERSP. 113, 117–19 (1987) (discussing use of mechanism design theory to reach "first-best outcome" for property rights through bargaining process stripped of "strategic holdout problems"). For a foundational discussion of mechanism design, see generally Eric S. Maskin, *The Theory of Implementation in Nash Equilibrium: A Survey*, *in* SOCIAL GOALS AND SOCIAL ORGANIZATION 173 (Leonid Hurwicz et al. eds., 1985).

124 *See* Fennell, *supra* note 22, at 1407–09 (discussing theoretical benefits of qualifying options with embedded options in this manner).

125 *Id.* Of course, it is important to include mechanisms that prevent the factory from setting an astronomically high strike price that exceeds its subjective value for the entitlement simply to negate the embedded option. *Id.* at 1408. To address this problem, I adopt a "catch" feature in the internal poison pill described below.

126 Fennell discusses some nuances relating to how the cake game might reveal private information related to individual attributes of value (such as how much the cutter values big frosting flowers). *Id.* at 1420–24.

troller can conduct a freezeout merger, but he must first grant minority investors an option to buy out *his* controlling interest at the offered price. By analogy, the controller cuts the cake (when setting the price) and the minority investors choose which piece to take (whether to buy or sell at that price). Forcing the controller to behave in this manner would block below-market pricing by the controller since a lowball price would be used by minority shareholders to buy out the controlling shareholder on the cheap.

This strategy is indeed used, on occasion, in the buy-sell agreements of closely held entities. But several problems likely preclude its effectiveness in many freezeout settings. First, minority investors will often face capital constraints and may be hard pressed to obtain the cash needed to exercise a call option on a large firm. Second, buying into a large-scale deal may upend investor diversification goals by introducing too much unique risk (at least temporarily) into their private portfolios. In short, it is difficult to imagine most minority shareholders playing the high-stakes poker that would be required under the cake-cutting regime.

Fortunately, however, there are some related strategies for using embedded options to craft customized legal entitlements on a smaller scale. As we will see, a majority controller might be allowed to complete the freezeout, but only upon writing an option for minority shareholders to take back this right under certain conditions. Or, minority shareholders might be given the power to block the merger (either directly or through poison pills rendering the freezeout uneconomical to the controller), but only if they, in turn, are willing to write an option for the majority holder to redeem this right.

This use of embedded options, then, is the theoretical model that will guide my recommended terms for internal poison pills. But before describing how these embedded option pills would work in detail, let me first turn to the use of conventional poison pills in the freezeout context. After all, there is no reason why existing pills, with some slight procedural tinkering and accommodating judicial opinions, could not also be used to address the freezeout problem. Indeed, such an approach would enjoy an advantage of familiarity.

III
The Medicine

A. "External" Poison Pills and Freezeouts

In the spring of 1982, the world of corporate mergers changed forever. Martin Lipton, name partner at the then-seventeen year old law firm of Wachtell, Lipton, Rosen & Katz, and his colleagues were struggling to find an ironclad strategy for defending clients against hostile takeovers. Eventually, they hit upon a new class of preferred stock—euphemistically called a shareholder rights plan, more directly termed a "poison pill"—that would water down the economic interests of hostile bidders when they bought more than a certain percentage of the stock. With the Delaware Supreme Court's blessing of this novel security three years later,[127] poison pills have shifted the balance of power to a target firm's board, giving them the practical ability to block any unwanted merger. And the pill remains deadly; no one seems to have swallowed it.

The hallmark of this external poison pill is discriminatory dilution. When the triggering ownership threshold is crossed, all other shareholders enjoy the right to buy additional common stock at a discounted price. But the acquiring blockholder forfeits this option, keeping only his current quantity of shares. The economic effect, then, is to shrink the acquirer's ownership percentage, pushing back the finish line that he must cross to take control of the firm.[128] It is certainly conceivable that a determined acquirer might trigger the pill, take the economic hit, and continue on with a successful effort to buy the firm,[129] but, thus far, this has not happened. When a firm implements a pill, potential acquirers are effectively forced to either negotiate with the board (who can typically redeem the pill for an insignificant fee) or launch a proxy contest to replace the directors.[130]

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[127] *See* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1353–55 (Del. 1985) (permitting use of poison pill).

[128] To take a simple numerical example, suppose a firm has one hundred shares of stock, owned in equal proportion by ten shareholders (i.e., ten shares each). The firm adopts a pill awarding shareholders the right to buy ten new shares for a very small price (that I ignore here) if the pill is triggered by a blockholder acquiring twenty percent ownership. One of the shareholders then buys out a colleague, triggering the pill. She retains just twenty shares, while the other eight shareholders can double their ownership to a collective 160 shares. The ownership percentage of the acquirer thus drops immediately from 20% to 11.1% (twenty divided by 180)—a painful result for the blockholder. There are many more sophisticated flavors of poison—including dead-hand pills and recurring dilution triggers—but these extensions are beyond the scope of this Article.

[129] This strategy is most plausible when the pill sets a low trigger threshold because an acquirer would suffer less dilution. *See* William J. Carney & Leonard A. Silverstein, *The Illusory Protections of the Poison Pill*, 79 NOTRE DAME L. REV. 179, 186–88 (2003) (noting that because poison pill can only "dilute the investment that a bidder has already made when it crosses the threshold that triggers the rights," low threshold is "hardly enough to deter a determined bidder"). On the other hand, a pill might contain multiple triggers to repeatedly dilute a dogged acquirer and to render the attrition strategy even more unpalatable.

[130] This latter strategy is often confounded by the presence of staggered board charter provisions that turn the proxy contest into a multiyear affair. *See supra* note 16 and accompanying text (outlining extensive process involved in implementing pill when target board has staggered board).

External poison pills were designed to prevent a hostile third-party acquirer from taking over a firm. But they might also be used, with only slight modifications, to protect minority shareholders in the freezeout context. Such an approach has the crude (but nevertheless real) benefit of precedent: We know how courts have historically dealt with this line of pills and have reason to expect that they will be upheld.

In order to adapt external pills to the freezeout problem, the power to adopt and rescind a pill would presumably need to be transferred from the full board to a special committee of independent directors (SC). The pill might have a higher trigger threshold of 50 or 60%—as it would be directed at preventing a majority controller from conducting the freezeout—but even a traditional, lower threshold trigger would work. The real point is to arm the SC with a bulletproof veto so it can hold meaningful negotiations with the majority shareholder and then redeem the pill if fair terms are met.

But transplanting a poison pill in this manner raises at least three important questions. First, can a full board delegate the power to adopt and rescind the pill to the smaller SC? Second, should the full board be required to do so in order to comply with its fiduciary obligations? And third, if the SC adopts a pill during negotiations but fails to reach an agreement, can the full board (at the behest of the majority owner) step back in to grab the reins of power and redeem the pill?

The answer to the first question appears to be yes—at least in Delaware. Section 141(c) of the Delaware General Corporation Law sets a clear default rule allowing a majority of directors to establish a committee of one or more directors.[131] This subset of the full board "shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation."[132] The statute goes on to list a few exceptions to this general power of delegation—such as the right to adopt or repeal a corporate bylaw—but these exceptions would not typically impact the use of a pill.[133] Thus, unless this default rule is explicitly overruled by

[131] Del. Code Ann. tit. 8, § 141(c)(1) (2001) ("The board of directors may, by resolution passed by a majority of the whole board, designate 1 or more committees, each committee to consist of 1 or more of the directors of the corporation.").

[132] *Id.*

[133] *Id.* This analysis is complicated by the presence of two different provisions in this statute—one applying to firms incorporated before July 1, 1996 and one applying to firms incorporated on or after that date. *Id.* Both of these provisions seem consistent, however, with a full board's ability to delegate pill adoption power to a committee. The modern provision, section 141(c)(2), only prohibits the delegation of board approval rights for matters that also require shareholder approval and for the delegation of bylaw amendment

a firm's certificate of incorporation or bylaws, it seems to follow that an SC can receive the power of the pill.

Indeed, the Chancery Court, in a very messy dispute between Lord Conrad Black and Hollinger International, supported the delegation of pill adoption power to an SC.[134] The *Hollinger* facts spin a long and complicated soap opera; for our purposes, the critical part of the dispute involves the formation of a Hollinger SC that was empowered to negotiate a potential merger with Barclays and adopt a poison pill as leverage if necessary.[135] The SC eventually did exactly that,[136] and Lord Black (one of the Hollinger directors who was excluded from the SC) sued to annul the pill.[137] The court sensibly rejected Black's arguments as incompatible with existing Delaware precedent on the use and legality of the pill.[138] More to the point, the case can be understood as supporting the right to delegate pill adoption power to an SC; there is no explicit statement to this effect, but this is a clear and obvious implication of the case.[139] The court did not have reason

powers. The older provision, section 141(c)(1), has a longer list of proscribed matters. But it expressly allows (through a complicated exception to the exception) a board committee to fix the preferences (including conversion rights) of shares so long as these shares have been authorized in an earlier board resolution. Likewise, this section of the code denies the SC authority to issue stock unless there has been prior approval via resolution, bylaw, or incorporation certificate. Therefore, any delegation of pill adoption power for pre-1996 firms would need an accompanying full-board resolution authorizing the contemplated class of preferred stock and granting the SC power to issue this stock, should the SC decide to put in a pill. Failure to take these steps might expose the SC of a pre-1996 firm to charges that the action was ultra vires.

134 *See* Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1082–89 (Del. Ch. 2004), *aff'd* 872 A.2d 559 (Del. 2005) (discussing adoption of poison pill by subset of full board).

135 *Hollinger*, 844 A.2d at 1053–54. The deal was closer to a freezeout than it may seem because Lord Black was the majority shareholder of Hollinger, through several holding companies, and he was encouraging the merger. *Id.* at 1028–29.

136 *Id.* at 1056.

137 Black's main argument was that Delaware corporate law did not sanction the imposition of a pill because it would effectively bar the sale of his majority block. This was true because a sale by Black (the ultimate controlling shareholder of Hollinger) would trigger the pill, unless he broke his control block into smaller chunks and sold to multiple buyers. *Id.* at 1082. The underlying reasons for the feud between Black and the members of the SC related to allegations of theft and improper conduct by Black. Black's attempted revenge apparently involved a sale of Hollinger and a clearing out of the hostile directors; he thus objected vehemently to the adoption of a poison pill. In the alternative, he contended that the SC did not satisfy its *Unocal* duties when it adopted the pill. *Id.* These duties, famously established in the case of *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), state that defensive measures, such as a poison pill, must comprise a proportional response to a reasonably identified threat.

138 *Hollinger*, 844 A.2d at 1082–89. Similarly, it held that the *Unocal* argument was simply wrong in light of the dispute's context and the subcommittee's careful deliberations. *Id.* at 1084–87.

139 It is conceivable that a court might distinguish the *Hollinger* case on the admittedly egregious facts of Black's misbehavior and ban or limit the delegation of pill adoption

to determine whether the SC could redeem the pill (if it had concluded favorable negotiations), but presumably the answer would be yes. If an SC can swallow the pill, it is only logical to permit the same committee to cough it back up.

This leads directly to the second question: If an SC formed to negotiate a potential freezeout can be armed with pill adoption power, does this mean that the SC *must* receive this weapon to comply with the board's fiduciary obligations? Such an argument may seem tempting, but recent Delaware case law insists that the answer is no. A dissenting minority shareholder made this exact argument in *In re Pure Resources Shareholder Litigation*,[140] claiming that the Pure board, which was evaluating a tender offer freezeout proposal by its sixty-five percent shareholder Unocal, failed to meet its fiduciary obligations when it did not give the SC authority to install a pill.[141] The chancery court smiled at the argument,[142] but it ultimately concluded that mandating SC pill adoption discretion was not the best policy decision.[143] Instead, the *Pure* court erected a series of hurdles that the majority's tender offer would need to clear before the transaction could be blessed by business judgment protection.[144] Taken together, then, the resolution of these two questions sanctions a regime of director autonomy: A board can delegate the power of the pill to an SC, but it need not do so to comply with Delaware's fiduciary standards.

All this becomes moot, however, if the full board is allowed to redeem a pill adopted by the SC upon failed negotiations with the majority controller. The whole exercise becomes meaningless—a simple procedural whitewash to slap over freezeouts without sacrificing negotiating leverage. Professor Subramanian made a similar point, arguing that judicial uncertainty surrounding the use of conven-

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power to an SC in a conventional freezeout setting. But there is not a principled legal distinction here, and I find this outcome unlikely.

140 808 A.2d 421 (Del. Ch. 2002).

141 *Id.* at 446. Moreover, the dissenting plaintiff argued that the full board's decision not to confer pill adoption power to the SC should be subjected to an intrinsic fairness review—which would have effectively supplanted the business judgment standard that would have otherwise applied to this tender offer freezeout. *Id.*

142 *Id.* at 446 ("That argument has some analytical and normative appeal, embodying as it does the rough fairness of the goose and gander rule.").

143 *Id.* ("I am reluctant . . . to burden the common law of corporations with a new rule that would tend to compel the use of a device that our statutory law only obliquely sanctions and that in other contexts is subject to misuse, especially when used to block a high value bid that is not structurally coercive.").

144 *See supra* note 61 (announcing five requirements necessary to bless offer as noncoercive).

tional poison pills to fix the freezeout problem renders this path undesirable:

> Because the controller typically controls the target's board, it might rescind the pill over the objection of an obstinate SC and then proceed unilaterally with its tender offer to the minority. There has not been enough experience with pills in the context of controlled companies to know whether a controller could or would do this. But the unclear legal rules that would govern this sort of maneuvering suggest that a pill deployed by an SC might be mere window dressing, to be pulled by the controller at the moment the SC puts up a fight.[145]

For this reason, Subramanian turns away from a poison pill solution and advocates the reformation of existing Delaware case law. He would reverse or modify several marquee freezeout cases in order to harmonize the standard of review between statutory merger and tender offer freezeouts.[146] Such an approach has merit and would be consistent with the general corporate framework used for external acquisitions.

But the problem is that Delaware has now painted itself into a jurisprudential corner. Who is going to launch a legal battle to challenge earlier precedent and establish a sensible review framework when business judgment protection can currently be obtained simply by mounting a tender offer? Vice Chancellor Strine recognized this problem in another recent opinion, using dicta to practically beg some future plaintiff to challenge earlier case law.[147] Yet, such a legal strategy would be quite a gamble given the high stakes that often sit at the center of the table during freezeout mergers. Why spend your money to crack this jurisprudential logjam when there is an easier path to complete the transaction?

It may therefore be more practical to start over with new case law relating to the delegation of pill adoption and redemption power to an SC in the freezeout context. A straightforward holding annulling or hindering (through heightened judicial review) the power of the full board to redeem the pill—assuming that an SC has adopted the pill in

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[145] Subramanian, *supra* note 6, at 58.

[146] *Id*. at 63–64. Specifically, he advocates: (1) an intrinsic fairness standard if no procedural protections are adopted; (2) a shifting of the burden of proof to the plaintiff if an SC is established *or* if the deal is subject to a nonwaivable MOM condition; and (3) use of the business judgment rule if both of these procedural steps are taken.

[147] Vice Chancellor Strine colorfully calls this the "Jurisprudential Elephant in the Corner." *See In re* Cox Commc'ns, 879 A.2d 604, 642–48 (Del. Ch. 2005) (describing incongruous standards of judicial review for freezeouts, bemoaning fact that court in this case is "not presented with an opportunity to evolve the common law in this area because the incentives . . . make a frontal challenge to the existing regime irrational for defendants," and hinting at jurisprudential opening that future plaintiffs should rush toward).

a kosher manner[148]—would solve most of the judicial uncertainty and establish pills as a viable bulwark against coercive freezeouts. This should not be viewed as a controversial holding: If the SC is empowered to install the pill, then logically it is also the group to enjoy sole redemption power. A full board, for example, cannot easily reverse the decisions or actions of an SC in other properly decided matters—such as whether to raise a CEO's salary, fire the auditors, or address allegations raised in a shareholder's derivative lawsuit.[149] The harder question, of course, is how to encourage the full board to grant a poison pill prerogative to its SC in the first place—an issue I take up below.[150]

Before turning to this topic, however, it is important to consider a strong, perhaps damning, argument against the use of conventional pills in the freezeout context: They are too powerful. Enormous trust would be vested in the SC, and this group may have incentives to block sensible deals, pushing us back into a world of holdout.[151] The effective veto right granted by the pill may cause the SC to stymie efficient freezeouts—either because the members overestimate the synergies created by the deal or, more wickedly, because they wish to retain their board seats by poisoning the transaction.[152] In this sense, the medicine may be worse than the cure. The extent of these abuses cannot be resolved by armchair theorizing, of course, and the net benefit (or harm) of using a pill in this context is ultimately an empirical question. It is analogous to the perennial debate on whether conventional pills add value to a firm by increasing the ultimate acquisition premium or destroy value by decreasing the probability of the firm receiving a takeover bid in the first place.[153]

In summary, it is certainly possible that an external pill—with only slight procedural tinkering and an accommodating judiciary—can moderate the freezeout problem. But the awesome power of conventional pills makes it worth asking whether there is another way for-

148 That is, following an appropriate board delegation of this power.

149 *See, e.g.*, Zapata Corp. v. Maldonado, 430 A.2d 779, 785–86 (Del. 1981) (allowing independent SC latitude to terminate shareholder derivative lawsuits); Auerbach v. Bennett, 393 N.E.2d 994, 996 (N.Y. 1979) (same, albeit with less judicial supervision than in Delaware).

150 *See infra* Part III.D (describing three reasons to implement internal poison pill).

151 The opposite problem is also possible: The SC may fall captive to the broader board and redeem pills when it should not. This poses a related problem, of course, for solutions insisting on independent board approval as a prerequisite for business judgment protection.

152 *See* Subramanian, *supra* note 6, at 57–58.

153 *See, e.g.*, John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 279–80 (2000) (questioning empirical research in this area).

ward, perhaps one that uses the embedded options discussed in Part II to temper reliance on a benevolent SC.

B. Customized "Internal Pills"

Come back, for a minute, to the fundamental challenge of freezeouts: How should the law allocate the legal entitlement to take full ownership of a firm in a way that mitigates the dual hazards of holdout and expropriation? One ideal strategy might be to grant a blocking right to minority shareholders by handing them the explosive power of a poison pill[154] but simultaneously to give a majority shareholder the power to defuse this bomb when there would be incremental value from the freezeout. In other words, the goal is to induce a binding and *real* (not exaggerated) valuation from minority shareholders that would alter the price controllers must pay to buy the entire firm. The procedures and economic incentives of this "internal" pill are more complex than those of a conventional pill; the easiest way to understand how it would work is to set out the basic design and then work through sequential examples.

Start with the most elementary of freezeout scenarios. A firm is divided among thirty-one owners: a majority controller with seventy shares and thirty minority owners, each holding one share. The controller wants to conduct a freezeout and offers $55 per share ($5 above the prevailing market price of $50), conditioned on the tender of at least twenty shares, which would unlock the use of a short-form merger to buy the other shares. Some subset of the minority owners resist this transaction, arguing that the shares are worth more. One of two things is happening: (1) $55 is a fair price and the dissenters are jockeying for more than they deserve; or (2) the shares really are worth more (perhaps because the market price is depressed by threat of expropriation), and the controller is attempting to pay less than she should.

Historically, the 70% owner enjoyed a unilateral option to execute the merger—subject only to the dissenting shareholders' willingness to file a fiduciary duty lawsuit or seek appraisal rights.[155]

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[154] Of course, the use of a poison pill is not the only possible way to grant blocking power to minority shareholders. For instance, lawmakers could return to a unanimous merger voting requirement, yet temper this right by allowing a majority controller the option to overturn or buy back a negative vote under certain conditions. Such a move would likely have greater consequences, however, and may unintentionally interfere with third party merger transactions. The use of the pill is consistent with current practice and allows for customized contractual adjustments.

[155] The shortcomings of these protections are discussed *supra* Part I. Each shareholder would presumably decide whether the expected payoff from either of these actions (that is, the probability of success multiplied by the expected, and discounted, recovery) exceeds

Suppose, however, that the firm has now put in an "internal" poison pill—either before the freezeout was initiated or during the course of SC negotiations. This pill contains three main features: the primary call, the embedded redemption option, and the catch.[156]

1. *The Primary Call*

Each shareholder receives the right—typically through the issuance of convertible preferred stock—to obtain additional common shares for a discounted price (which I will assume here to be zero for simplicity) if the pill is triggered through a control acquisition (i.e., the contemplated freezeout).[157] The pill discriminates against the triggering acquirer, however, and she is precluded from exercising her primary call. So far, then, the pill operates exactly like the "flip-in" feature of a conventional poison pill by making it painfully expensive for the controller to trigger the rights. If five shareholders sell their shares to the controller, for instance, the collective stake of the other twenty-five owners doubles to fifty shares, hamstringing the controller's position.[158]

2. *The Embedded Redemption Option*

Importantly, however, the internal pill also includes an embedded redemption option. Before suffering any dilution, the controller enjoys an opportunity to disarm the pill by redeeming the preferred stock rights. Any minority shareholder seeking to exercise the primary call must pay a price (in addition to the discounted strike price): He must write a return option to the triggering controller allowing her to redeem the pill by purchasing his common stock at a price set by that minority holder. For example, "pushover" shareholder A may set a price of $56, "average" shareholder B may set a price of $60, and "hardball" shareholder C may set a price of $100. If the controller is willing to buy any (or all) of these shares at those stated prices, then

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the anticipated costs of pursuing a claim (again discounting future outlays). In this example, the dissenters hold relatively meaningful blocks of shares (as opposed to an alternative scenario where 3000 dissenters each hold 0.01% of the firm), but the economics may still not merit the hassles of litigation. If, for example, a minority holder has a 15% discount rate, thinks the case will cost $2.50 per share in upfront expenses, will take three years to complete, enjoys a 70% chance of victory, and will garner a $60 valuation, it would not be worth bringing the claim: $-2.5 + [(0.7 \times 5) \div (1.15)^{\wedge 3}] = -0.2$.

156 The discussion here is illustrative and should not be understood as the only way to design a workable pill. There are undoubtedly other strategies for constructing pills with dual incentives using related principles of mechanism design.

157 I also assume here that each share of common stock receives one share of preferred stock that can, in turn, be exchanged for one additional share of common stock if the pill is triggered. It is possible, of course, to adjust these ratios.

158 Specifically, the controller drops from a 75% owner to a 60% owner ($75 \div 125 = 0.6$).

the attached poison pill flip-in right expires. Of course, the controller is not obligated to redeem; she simply possesses that option.

The goal of this second feature is to elicit an honest statement from the minority shareholder of her valuation that can be compared to the controller's value from the freezeout. If the shares in this example are really worth $60 (and shareholder B knows this),[159] then B can set his reservation price at $60 through the pill redemption option. The majority controller can then work her way up from the lowest to the highest redemption price and decide whether to buy a 90% stake, which would trigger short-form merger rights. (There is another important ramification of exceeding this 90% threshold, which I will discuss momentarily.)

3. The Catch

There is one final problem that has perhaps already crossed your mind. What prevents all minority holders from acting like shareholder C, selfishly demanding a very high redemption price in order to keep their pill armed, thereby blocking the merger? Indeed, greedy shareholder D could set a redemption price of $1,000,000 to virtually assure himself that the controller will not redeem his pill. The third feature of our internal pill, then, needs to address this problem by placing a "catch," or ceiling, on a minority shareholder's temptation to exaggerate subjective value.

This potential solution comes from an above-mentioned insight of mechanism design: In order to elicit honest valuations, the minority holder must be placed under a veil of ignorance—unaware of whether he will have to buy or sell at his stated price.[160] In this context, there are various ways to drape the veil over minority holders, but perhaps the easiest strategy is simply to attach further consequences (again, through the exercise requirements of the primary call option) to each dissenting shareholder's price statement.

Specifically, to mitigate the greedy shareholder problem, the internal pill should contain one last feature: If the majority controller reaches or exceeds the 90% ownership threshold (or, conceivably, some other preset target), then all remaining preferred stock dissolves, and the controller gains the right (but not the obligation) to *sell*

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[159] This is a major assumption, of course, but one that we must make before a minority shareholder will pursue any available remedy—including the current options of appraisal and fiduciary lawsuits.

[160] *See* Fennell, *supra* note 22, at 1418–20 (describing problems that could arise if parties fail to divide stated valuations from transactional consequences).

shares to each remaining minority shareholder[161] at exactly the price that each minority shareholder just demanded in the redemption option.[162] This is really just a conditional put option with the price set at the dissenter's stated valuation.

Giving the controller the protection of this catch should discourage minority dissenters from naming outrageous redemption terms. The controller will begin to buy shares (and simultaneously redeem pills) from minority holders—starting at the lowest named price and working her way up to a 90% (or more) stake. She can then force a sale of extra shares on greedy overreachers. In our earlier example, the controller might buy at least ninety-one shares and sell that one extra share to shareholder D for $1,000,000.[163] Or, more likely, the threat of releasing the catch would preclude shareholder D from setting an outrageous redemption price in the first place. After any catch sales are executed, the controller can complete the short-form merger to take unified control.

This three-part internal pill is summarized in Figure 1. It may seem overly complicated, but working through a few short scenarios should quickly expose the inner gears and springs of the idea.

C. Scenario Analysis

1. Scenario 1: Preventing Majority Expropriation

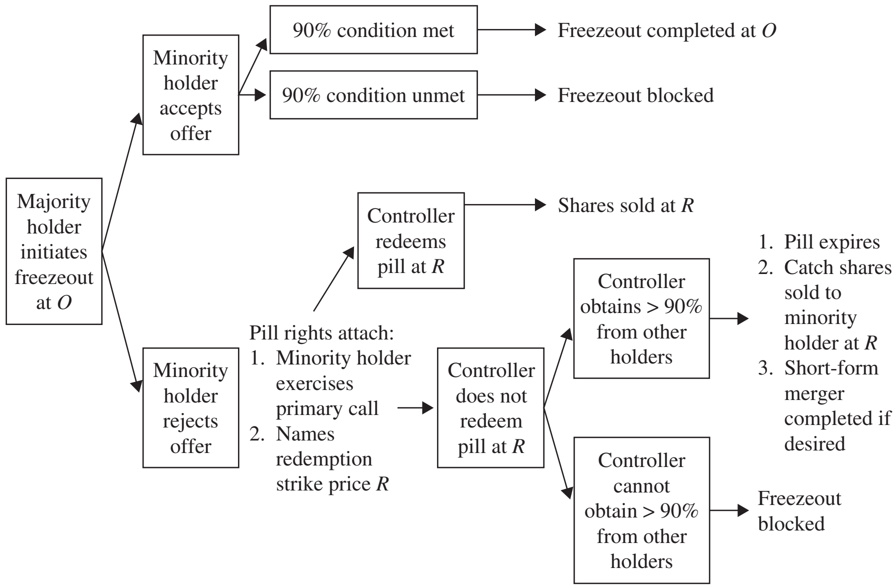
Consider first how this pill would undercut the incentives of a majority controller to expropriate wealth from minority shareholders. The facts are exactly as above, with two additional revelations. First, the freezeout transaction creates no incremental wealth (or even

[161] This dissenter repurchase obligation would typically be limited to one share per exercised call option—though this ratio could be adjusted by pill designers if they wished to ratchet up the expected cost of overreaching.

[162] Alternatively, the catch might work by granting a controller the difference between the clearing price (that is, the price needed to reach 90% ownership) and the "caught" minority holder's stated valuation in the embedded option (multiplied by the total number of options exercised by the minority owner) without transferring any actual shares. As we will see in the scenario analysis, this approach is slightly more complicated but has some administrative and practical benefits.

[163] Alternatively, the controller might decide to purchase only ninety shares, abandon the short-form merger, and sell the ninetieth share back to shareholder D for $1,000,000. Related to this, another design possibility is to have the catch sale occur after the short-form merger. In the main example, I assume that the short-form merger will take place after the catch sale, requiring a majority controller to purchase more than 90% of the stock to spring the catch *and* retain enough stock for the short-form merger. This approach has the advantage of leaving the controller with complete ownership of the firm after the dust settles. It is also conceivable, however, that the catch could be written to spring after the short-form merger is completed, removing any need for the controller to purchase extra shares but also leaving the firm with a minority owner after the merger (at least temporarily).

FIGURE 1. SUMMARY OF INTERNAL POISON PILL MECHANICS



destroys value through negative synergies). Second, the fair price of each share is $60—that is, the controller is trying to steal $5 from each minority holder.[164]

How will the minority shareholders respond? Assuming that they recognize the ploy (a required assumption for any legal remedy in this context), these investors should be willing to exercise the primary call option and name a redemption price somewhere between $55 and $60.[165]

To illustrate, suppose that no shareholder agrees to tender; all thirty dissent and demand a redemption price of $60. Now it is up to the majority controller to respond. Because less than twenty shareholders have accepted the offer, the majority controller is free to walk away from the deal without buying the additional shares to trigger the pill.[166] If this happens, then the pill has worked, and the abusive freezeout is blocked. The controller could also press ahead by redeeming twenty shares at $60, annulling the pill, and cashing out the other holders.

164 Again, this scenario is inconsistent with the strong form of the efficient capital markets hypothesis but is consistent with weaker forms of the theory.

165 With perfect information on share value, they will demand $60; otherwise, a bargaining range may ensue.

166 Recall that this minimum threshold was inserted into the initial tender offer as a condition of completion.

One open question is what price the controller would need to pay to these last ten shareholders to comply with the noncoercive standards articulated in *Pure*.[167] Arguably, a controller should be required to cash out the final dissenters at the highest paid redemption price (in this case $60). If so, there is no fun in this game for the controller: She will have paid full price for all of the shares. In short, the pill gives an informed minority the power to just say no and block abusive freezeouts.

2. *Scenario 2: Preventing Majority Expropriation with Heterogeneous Dissenters*

One possible problem arises, however, if minority shareholders do not have a good grasp of how much the shares are worth. This may be true if they hold small stakes, lack the knowledge or skill to value the company, or face the losing side of an information asymmetry problem. Of course, the shareholders would also not pursue an appraisal claim or fiduciary duty lawsuit under these circumstances. But the analysis of the pill's effectiveness does grow more complicated when we introduce dissenter heterogeneity—especially if some minority shareholders conservatively shave down their valuation demands to avoid the catch.[168]

Suppose all thirty shareholders again dissent, but ten name a redemption price of $58, ten seek $59, and ten demand $60. The controller may again elect to walk away, but now there is money to be had. The controller could redeem the lowest twenty shares, cash out the last ten shareholders in a short-form merger and still pocket $40.[169] The pill's blocking power therefore depends on the ability of a critical mass of dissenters to recognize the amount of theft—though, of course, the pill might still operate to mitigate expropriation when there are information asymmetries.

And note that if just one dissenter switches from $59 to $60, many of these ill-gotten profits fall away. Eleven dissenters enjoy the power

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[167] *See supra* note 61 and accompanying text (discussing legal requirements of noncoercive tender offers).

[168] This problem may be partially mitigated if some minority shareholders recognize the abuse and publicly implore the other minority holders to stand firm. This may be more likely to happen in close corporations where current shareholders have personal relationships. However, it is dangerous to generalize here, as the casebooks are filled with stories of dysfunctional close corporations where minority shareholders do not trust each other.

[169] $10 \times (60 - 58) + 20 \times (60 - 59) = 40$. This calculation assumes again that the final group would need to be cashed out at $59 (the highest actual redemption price) to meet *Pure* standards. If they could be cashed out for less, the majority's profits from expropriation increase even further. If appraisal rights continue to attach to the transaction, however, then the controller's expected profits may shrink.

to protect themselves and receive the full \$60; the others pay a small price for their timidity.[170]

3. *Scenario 3: The Temptation for Dissenters To Overreach During Majority Expropriation*

In the prior scenario, the ten dissenters demanding \$60 should be upset. They recognized exactly what was going on but were unable to stop the expropriation because the other twenty shareholders did not stand their ground. What happens if the final group of ten anticipates this problem and demands a redemption price of \$70—hoping that ratcheting up the stakes above fair value will prevent the theft? It should be easy to see that this would not change anything: The controller buys her twenty shares and cashes out the "angry ten" as before.

If, however, we tinker just slightly with the number of dissenters who are willing to overreach, then this strategy might indeed work to block all expropriation—though it also introduces a heightened risk of loss for the angry dissenters. To illustrate, suppose that nine dissenters demand \$58, nine dissenters demand \$59, and twelve dissenters overreach at \$70. The economics of appropriation no longer make sense for the controller; she would lose \$93,[171] and the abusive deal is again blocked.

But this is a dangerous game. If we scale back our overreaching dozen to an overreaching half-dozen (say three shareholders switch to \$58 and three switch to \$59), then the results change dramatically as the catch is sprung. The controller redeems the twelve shares priced at \$58 and the twelve shares priced at \$59. She now has four shares to spare, and guess who gets burned? The controller will sell those shares to four overreachers, buy all ten outstanding shares back in the short-form merger, and net a tidy profit of \$86.[172] The four overreachers lose \$12 each (\$11 on the catch, and \$1 on the short-form expropriation) and would have been better off playing a safer hand.

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170 Specifically, the controller's profits fall to $10 \times (60 - 58) + 9 \times (60 - 59) + 11 \times (60 - 60) = 29$.

171 $9 \times (60 - 58) + 9 \times (60 - 59) + 12 \times (60 - 70) = -93$. Again, this assumes a short-form merger is conducted at the highest redemption price.

172 This can be divided into profit from expropriation ($12 \times (60 - 58) + 18 \times (60 - 59)$) and profit from the catch ($4 \times (70 - 59)$), which add up to a total of 86 ($42 + 44 = 86$). (\$59 is used as the basis for the shares sold in the catch since that is the assumed price of the short-form merger.) The damage is even greater if the pill is written to allow the controller to execute the short-form merger first and then spring the catch on all six overreachers. *See supra* note 163 (noting various design possibilities for catch features and analyzing impact of different designs).

For this reason, it takes a bold dissenter to go above market price, and each dissenter's best individual strategy may be to simply name the price that he really thinks the shares are worth. As we have seen, this will successfully block an abusive freezeout only if enough dissenters are aware of the abuse. But it gives every individual shareholder power to protect himself from expropriation in a manner that is much easier to pursue than current legal remedies.

4. *Scenario 4: A Different Sort of Majority Expropriation—Fishing for Overreachers and the Safeguard of Optional Exercise Rights*

There is one last scenario to consider before we turn from the expropriation problem to the holdout problem. Could a conniving majority controller use a different strategy to harm minority holders by launching a freezeout bid, even with little desire to buy the full firm, in order to force dissenting shareholders to write the controller a bundle of options? In other words, could an opportunistic majority shareholder attempt to snare dissenters in the catch feature of an internal pill? For example, suppose that the firm in the above example is really worth $55 per share (not $60). Is there any reason to believe that the controller would launch a zero-surplus bid (at $55) simply to trap minority holders on the exercise of their pill rights?

This is a theoretical possibility, but the problem is unlikely to arise for two reasons. First, a minority shareholder is always protected by stating his real valuation in the embedded redemption option. If the dissenting shareholder states $55, then there is no reason for the majority controller to buy a share at this price and resell it for no gain. And if the dissenter states a real subjective value of $56, then he should not feel too bad when forced to buy another share at this price.

Second, it is important to remember that the poison pill's primary call feature is optional. No shareholder can be forced to exercise the conversion right. A dissenting shareholder can, therefore, simply refuse to bite on the line by not seeking to exercise the poison pill (with or without tendering the common stock). This optionality should mitigate a controller's temptation to fish for overreachers.

5. *Scenario 5: Selfish Minority Dissenter(s) and the Holdout Problem*

Now let us turn to consider how a poison pill can discourage a greedy minority shareholder from holding out against a sensible deal in the pursuit of excessive rents. The facts of the scenario continue as before but with three modifications. First, the majority owner now offers \$60—a \$10 premium over current prices, reflecting the full standalone value of the stock. Second, the deal will result in incremental synergies of \$5 per share but only if the freezeout is completed. And finally, one dissenting shareholder wishes to block the deal and threatens to insist on a \$100 pill redemption price unless the controller makes a side payment of, say, \$30.

It should be easy to see by now that the holdout shareholder's threat is empty. The controller can easily call his bluff because she knows that an exercise price of \$100 will trip the catch, allowing the controller to profit from the holdout shareholder's high redemption demand.[173] In short, the power of one shareholder to hold out against the deal evaporates: He cannot put his money where his mouth is.

Does anything change if five shareholders try this strategy? No, the controller simply buys up the other twenty-five shares, springs the catch on the recalcitrant five, conducts a short-form merger, and laughs all the way to the bank.

6. *Scenario 6: Selfish Minority Holdout with Significant Collusion*

There is obviously a limit, however, to this story. What happens if fifteen shareholders collude—threatening to demand the \$100 pill redemption price unless they are paid \$30? Now the controller faces a real problem: She cannot buy enough shares to spring the catch on the selfish minority holders. In this situation, she may have to make the side payments ($30 \times 15 = 450$) in order to complete the merger and realize the freezeout synergies ($100 \times 5 = 500 > 450$). Indeed, if the minority dissenters demand more than \$30, this sensible deal may not go through.[174]

It is important, therefore, to acknowledge that internal pills have limits. They will not block a holdout if enough dissenting shareholders are able to collude in their demands for tribute.[175] For this reason, internal poison pills may be less effective for close corporations—where a handful of minority holders might conceivably engage

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[173] Continuing the example, if the dissenter does carry through on the threat and the rest of the shareholders tender at \$60, then the controller can sell another share to the holdout dissenter for a \$40 profit, annul the pill, and cash out the dissenter in a short-form merger.

[174] For example, if the fifteen shareholders each insist on \$35 (instead of \$30), the required side payments would dwarf the deal synergies ($15 \times 35 = 525 > 500$), and the deal would collapse unless the parties were able to renegotiate the dissenters' demands. Of course, barring information asymmetries, even fully colluding shareholders have incentives to preserve a sensible deal, as something is better than nothing.

[175] Of course, a significant minority of shareholders has always been able to resist tender offer freezeouts or mount realistic appraisal threats, so this problem is not new.

in gamesmanship through collusion. In the public firm context, however, widespread coordination of this type would be fairly rare and difficult to maintain. Minority shareholders have less reason to trust the announcements of other minority holders and may even fear that they are being set up. A high demand is risky, and no one will go wrong by sticking with his or her personal assessment of fair value. Collusion strategies generally grow increasingly unstable as the number of players increases; even a close corporation with thirty or forty shareholders may be a legitimate candidate for an internal pill. In short, collusion should only be a minor concern.

7. *Scenario 7: Well-Intentioned (Though Self-Interested) Parties Bargain Over Deal Synergies*

Now consider a final scenario (maybe unlikely, but hopefully more common than academics seem to admit): The freezeout has real synergistic value, and all parties are simply bargaining for their share of the gains. How will the adoption of a poison pill affect the division of spoils?

This scenario is illustrated by continuing with several numbers from above: The shares currently trade at \$50, the controller offers a freezeout at \$60 (the standalone value), and the total value with synergies is \$65. Each minority holder would like to get his fair share of the deal, including the synergy value, but the worst outcome from everyone's perspective is a failed deal. How will the bargaining unfold?

The answer depends, as usual, on what each side knows about the freezeout synergies. If most shareholders are accurately informed, they can push for \$65 as the pill redemption price. The controller will eventually accede to this demand and everyone will get his share of the synergies—including the controller who would retain the motivation to sponsor the deal.[176] If some minority shareholders overreach, then we are back in scenario five or six: The deal will go through with reduced controller gains unless there is substantial collusion among the minority holders. If some minority shareholder does not pursue (or fully value) their synergies, then the deal will again go through—but the controller enjoys more surplus.[177]

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176 Whether minority shareholders should be entitled to share in post-deal synergies is, in fact, a tricky question that sometimes surfaces in appraisal valuation. *See, e.g.*, Hamermesh & Wachter, *supra* note 81, at 30–33 (analyzing whether third party synergies should be included in appraisal valuation).

177 If many shareholders do not seek or fully value the synergies, it is possible the controller will profit from the internal pill catch feature.

8. *Synthesis*

To quickly summarize, the mechanism design strategies employed by the internal pill can mitigate the twin freezeout abuses of expropriation and holdout. By providing minority dissenters with an easy way to ask for their subjective value, the pill protects against majority theft. Conversely, by requiring these dissenters to potentially put their money where their mouths are (by not knowing ex ante whether they will end up selling or buying at their stated price), the pill discourages minority blackmail of sensible deals.

The internal pill is not perfect. As we have seen, information asymmetry may still allow majority holders to steal some value. And minority collusion may work to block some sensible deals from taking place. Finally, there are real costs to implementing this device: The procedural rules and incentives are complicated and would take time to explain and operationalize.

But these complexities should not prove fatal. Indeed, the power of a private solution is that each party has an incentive to take self-interested action that, in the aggregate, will lead toward the socially optimal outcome. Under the right circumstances, the entitlement of a controller to complete the merger is executed when, and only when, the value from the deal exceeds the collective value of dissenting minority holders. If successful, this idea would not only provide genuine relief for oppressed shareholders, it would also slash the legal costs needed to obtain the "right" results and would generate ex ante increases in the value of majority-owned firms.

D. Swallowing the Pill

Even if the internal pill works as designed, it is fair to ask why a firm would ever wish to implement one. Indeed, we might expect majority owners to resist vehemently any effort to water down their current freezeout prerogative with a more restrictive governance regime. Yet there are at least three possible reasons to adopt the pill: (1) It may be in the majority's economic interest to do so as a form of precommitment that would increase the value of the company's stock; (2) private gadfly shareholders or advisory organizations may lobby for the pill; or (3) the law could evolve to encourage or require firms to adopt internal pills. This Section briefly discusses each motivation in turn.

1. *By Private Adoption*

It is possible to tell a story where self-interested controllers implore their boards to adopt internal poison pills as a precommitment device designed to boost share prices. Recall that investors may discount the value of some majority-owned firms to reflect a risk of future abusive freezeouts.[178] Devious majority owners may be willing to live with this discount, biding their time until they can maximize the value of their freezeout.

On the other hand, a majority shareholder with no intention of expropriating minority wealth may be understandably frustrated by the discounted market price. If she could only publicly signal her commitment to minority governance rights, then the value of her firm should rise, to the benefit of everyone. Yet any public announcement to this effect, no matter how loud or passionate, would presumably be dismissed as cheap talk by the market.

An internal poison pill, however, might offer the benevolent majority controller a powerful tool for signaling her intentions, thereby distinguishing her firm from those run by opportunistic controllers. In other words, the pill serves as a precommitment device through which the majority controller makes a credible promise not to fleece minority shareholders.[179] Because minority holders now have an ironclad way to mitigate abusive freezeouts, the controller's signal would no longer be seen as cheap talk. If prices have indeed been weighed down by fear of majority expropriation, the ballast is now cut.

If precommitment is in the self-interest of some large shareholders, however, then why have not more majority-controlled firms adopted traditional poison pills to block the possibility of a freezeout? It is difficult to say, but one answer may be that the benefits of precommitment through a traditional pill are often outweighed by the risk of missing future synergies through a value-enhancing (as opposed to opportunistic) freezeout. Another possibility is that the signal sent by a traditional pill is undermined by investor belief that a board can simply redeem the pill whenever the controller decides to spring an abusive deal.

If either of these explanations rings true, then internal pills may indeed act as a superior form of precommitment. The softening of the pill may encourage more majority shareholders to prescribe the

178 *See supra* notes 105–07 and accompanying text (discussing potential for abusive freezeouts of minority shareholders by majority and resulting depression of ex ante share prices).

179 For a helpful discussion of precommitment economics in corporate law, including an analysis of the precommitment effects of external poison pills, see generally Stephen M. Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 J. Corp. L. 1 (2003). For a more theoretical analysis, see generally Thomas C. Schelling, *Enforcing Rules on Oneself*, 1 J.L. Econ. & Org. 357 (1985), which identifies and analyzes strategies and rules for constraining future personal behavior.

medicine—knowing that sensible deals will be harder for minority holders to block. And moving the power of redemption from the board to individual shareholders makes the precommitment much more powerful and irrevocable.

2. *Under External Market Pressure*

Indeed, it is possible to extend this story by imagining a situation where activist investors like Carl Icahn "ride to the rescue" by identifying firms prone to abusive freezeouts, buying a meaningful stake, agitating for the adoption of an internal pill, and selling at a gain after the pill increases the firm's value by eliminating the risk of majority expropriation. Likewise, hedge fund and private equity managers may contemplate this sort of strategy to generate quick returns.

Furthermore, even if individual shareholders or institutional investors were unwilling to spend time on these reforms, it is possible that external organizations (such as proxy advisors) would agitate for this type of change. We currently live in a world where governance reform has taken center stage, and a wide variety of firms now make a living rating the governance of public corporations and lobbying for change.[180] It would be ironic for many of these organizations to advocate poison pills; they typically excoriate the devices. But the purpose of internal pills is to mitigate majority governance abuses, not entrench current managers. Accordingly, independent advisory firms may begin to celebrate companies that adopt this device.

The external pressure would be welcome in that it could provide a market-based solution to a difficult problem. Yet it would be naive to expect that everyone would do the right thing; some boards may resist any sort of pill in order to appease Machiavellian controllers. If so, more direct legal action might be required to nudge firms toward the adoption of internal pills.

3. *Through Legal Reform*

The final way to promote internal pill adoption is through legal reform. Obviously there are a number of possibilities here, ranging from statutory amendments to the general corporate law to nuanced judicial opinions that take a specific context into consideration. What exactly can sympathetic lawmakers do to promote internal pills? I will quickly sketch three exploratory possibilities—with the caveat that

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[180] *See, e.g.*, Stephen J. Choi et al., *Director Elections and the Influence of Proxy Advisors* (N.Y. Univ. Ctr. for Law, Econ. & Org., Law & Econ. Research Paper Series, Working Paper No. 08-22, 2008), *available at* http://ssrn.com/abstract=1127282 (presenting results of proxy advisor study and effects of their recommendations on shareholder voting).

any changes along these lines are likely to have additional, possibly unanticipated, effects.

One possibility is to offer a more lenient standard of review for a freezeout transaction if the deal takes place with the protection of an internal pill. For instance, the intrinsic fairness standard that governs statutory freezeouts could be relaxed to a business judgment rule if an internal pill has been adopted. Likewise, the judicial requirements for business judgment protection in tender offer freezeouts (recently promulgated in *Pure*)[181] could be relaxed when there is an internal pill. In both circumstances, the justification for this more lenient standard is that the majority has taken steps to arm dissenting shareholders with real power to protest inadequate offers such that judicial intervention and oversight is less necessary.[182]

A second possibility for legal reform is to cancel or modify appraisal rights in the limited situation where a freezeout transaction is attempted by a firm with an internal pill. The move is again defensible in that private parties should not need a judicial mechanism for determining fair value if individual shareholders can simply state their reserve price during the course of pill redemption negotiations. And certainly this could prove to be a valuable carrot for boards considering the adoption of an internal pill—especially if firms are worried about the possibility of runaway appraisal risk.[183] On the other hand, there would still be a role for appraisal rights if we believe that information asymmetries will cause some minority holders to understate their price demands.[184]

A third possibility moves from the carrot to the stick: Courts could redefine a board's fiduciary obligations to include consideration or adoption of an internal pill. Failure to adopt a reasonably balanced pill—or, more gently, failure to explain convincingly why such efforts were not considered—could be viewed as a breach of loyalty or care. This is obviously a harsher whip; thus far, Delaware courts have been unwilling to mandate the delegation of pill adoption power to an SC

181 *See supra* notes 61, 140–44 and accompanying text (explaining Delaware Chancery Court's ruling in *In re Pure Resources Shareholder Litigation*, 808 A.2d 421, 445 (Del. Ch. 2002), and listing requirements for noncoercive tender offer to obtain business judgment protection).

182 Such a change would have the additional administrative benefit of freeing up judicial resources from weighing tricky transactional notions of fairness, though this should not play into the primary regulatory decision.

183 *See supra* note 101 (discussing recent Delaware case allowing beneficial owners to maintain appraisal claims even though their shares could not be easily traced to those voting against merger).

184 Recall that this can lead to a situation where a handful of fully informed minority holders receive less than their demanded price. *See supra* note 169 and accompanying text.

during freezeout negotiations.[185] Yet the more balanced nature of an internal pill might make courts slightly more comfortable imposing this sort of requirement on a board during the exceptional circumstances that surround a freezeout.

These three ideas certainly do not exhaust the possibilities for legislative and judicial encouragement of internal pills, but they illustrate how lawmakers can play a greater role in striking the balance between majority and minority governance interests. In any event, substantive legal reform in this area would require much more careful analysis, and I offer these ideas only as preliminary thoughts on the matter.

Conclusion

One of the more exciting developments in economic theory posits that incentive-molding rules can corral parties toward optimal social ends strictly by appealing to their rational self-interest. If these ideas can be put into practice, it may become possible for policymakers to craft intermediate legal entitlements—somewhere in between the property and liability rules of Calabresi and Melamed—that promote welfare-enhancing substantive outcomes at a streamlined administrative cost.

This Article draws from mechanism design theory to address the thorny corporate law problem of allocating shareholder power during freezeout merger transactions. Specifically, I propose a novel security, the internal poison pill, as a tool for finessing the dual hazards of majority expropriation and minority holdout. The goal is to grant minority shareholders the practical power to block lowball freezeouts while making it prohibitively expensive for them to extract private tribute from synergistic deals. If successfully designed and implemented, this innovation could replace the current awkward remedies of disclosure, judicial review, and appraisal with customized private ordering.

The device is not flawless, however, and inside information or colluding dissenters may undermine the effects of an internal pill. Moreover, powerful controlling shareholders could resist adoption efforts. But there are strong theoretical justifications for promoting internal pills as an improved form of governance. Lawmakers should consider donning the white coat of pharmacists in order to improve the incentives that influence the ongoing balance between public and private corporate status.

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[185] *See supra* notes 140–44 and accompanying text (explaining Delaware Chancery Court's decision in *Pure* refusing to mandate adoption of pill).