Corporate Control and the Limits of Judicial Review

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Companies with a dual-class structure have increasingly been involved in high-profile battles over the reallocation of control rights. Google, for instance, sought to entrench its founders' control over the corporation by recapitalizing from a dual-class into a triple-class structure. The CBS board, in contrast, attempted to dilute its controlling shareholder by distributing a voting-stock-dividend that would empower minority shareholders to block a merger it perceived to be harmful. These cases raise a fundamental question at the heart of corporate law: What is the proper judicial response to self-dealing claims regarding reallocations of corporate control rights?

This Article shows that the reallocation of control rights raises an inevitable tradeoff between investors' protection from agency costs and the controller's ability to pursue its idiosyncratic vision, making the value of different allocations of control rights both firm-specific and individual-specific. It is thus inherently impossible to create objective valuation models for reallocation of control rights. The impossibility of creating reliable valuation models sets the limits of judicial review: The legal tools long used by Delaware courts to adjudicate conflicts over cash-flow rights, such as entire fairness review, are fundamentally incompatible with the adjudication of conflicts over reallocations of control rights. This Article explores the policy implications of this insight and suggests that courts treat reallocations of control rights as questions of charter interpretation as to who has the power to decide on reallocations of control rights, and avoid reviewing the discretion to use that power. Courts should enforce the decision of the parties as to reallocations of control rights and apply the business judgement rule where the charter is silent.

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INTRODUCTION

In April of 2012, Google's board approved a proposal amending Google's charter to authorize the issuance of a new class of nonvoting Class C stock.[1] Prior to this proposed recapitalization, Google's capital structure was comprised of one-vote-per-share Class A shares, primarily held by public shareholders, and ten-votes-per-share Class B shares, primarily held by Google's founders, Larry Page and Sergei Brin.[2] Under this dual-class structure,[3] Google had the

[1] Steven D. Solomon, New Share Class Gives Google Founders Tighter Control, NY Times: DealBook (Apr. 13, 2012), https://dealbook.nytimes.com/2012/04/13/new-share-class-gives-google-founders-tighter-control/.

[2] See Google Inc., Annual Report (Form 10-K), Third Amended and Restated Certificate of Incorporation art. 4 §2(a)(ii)-(iii), (b) (Ex. 3.01) (Feb. 11, 2012); see also Paul Lee, Protecting Public Shareholders: The Case of Google's Recapitalization, 5 Harv. Bus. L. Rev. 281, 283 (2015).

[3] For a brief explanation of dual-class structures, see infra notes 65--70 and accompanying text. For a review of the empirical literature on dual-class structures, see Renée Adams & Daniel Ferreira, One Share-One Vote: The Empirical Evidence, 12 Rev. Fin. 51 (2008). More recently, scholars in the debate have focused on the need to set time limits on these structures. See, e.g., Lucian A. Bebchuk & Kobi Kastiel, The Untenable Case of Perpetual Dual-Class Stock, 103 Va. L. Rev. 585 (2017) (analyzing the role of time in the effectiveness of the dual-class structure);

ability to raise capital, incentivize employees, and acquire other corporations, by issuing Class A shares, while preserving control over the company in the hands of Class B shareholders. However, this strategy faced an upper limit——if enough Class A shares were issued, *eventually* the voting power of Class B shares would be diluted to the point of the founders losing control over the company.[4]

Google's authorization of Class C shares entitled to economic rights but devoid of any voting rights was a strategic response to this unwelcome hiccup: After the recapitalization, Google would be able to issue as many Class C shares as it deemed necessary for business purposes, without ever threatening to dilute the founders' control.[5] This move, therefore, reallocated *control rights* from the public shareholders to the company founders, and enabled the founders to keep their control over the company even as it continues to issue new shares. Of course, the recapitalization required board approval and a shareholder vote to amend the company's charter.[6] But these procedures offered little meaningful protection, because Page and Brin held a majority of voting rights. Thus, the charter amendment could be, and was in fact, approved with the two founders' votes, and against the objection of Class A common shareholders—even though Page and Brin were clearly self-interested.[7]

Robert J. Jackson, Perpetual Dual-Class Stock: The Case Against Corporate Royalty, CLS Blue Sky Blog (Feb. 16, 2018), http://clsbluesky.law.columbia.edu/2018/02/16/perpetual-dual-class-stock-the-case-against-corporate-royalty/ ("In America, we don't inherit power, and we don't hold power forever. We fought a war against that system, and the good guys won."); Tian Wen, Comment, You Can't Sell Your Firm and Own It Too: Disallowing Dual-Class Stock Companies from Listing on the Securities Exchanges, 162 U. Pa. L. Rev. 1495, 1497 (2014) (calling on "Congress and the stock exchanges" to "revisit the use of [dual-class] capitalization structures in the United States").

[4] Settlement Hearing and Rulings of the Court, In re Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 6735045, at *6 (Del. Ch. Oct. 28, 2013) ("If Google, in the normal course of things, continues to do those things, then the pressure will be on the founders to either, frankly, step up to the plate and buy more actual normal equity in which the voting rights are aligned with the cash flows that are available to the public investors."). To understand the intuition here, assume that at the start there were 100 Class A shares and 100 Class B shares. Since Class B has 10 times the votes, the founders will have 1000 votes and the public will only have 100 votes (almost 91% of the voting rights is in the hands of the founders). But if over time the number Class A shares increases in number and reaches 1000 shares, then both classes of shares will have 1000 votes (only 50% of the voting rights will accrue to the founders). From now on, any increase in the number of Class A shares will leave the founders with less than 50% of the votes.

[5] Google Settlement Means Stock-Split Can Proceed, CBS News: Moneywatch (June 17, 2013), https://www.cbsnews.com/news/google-settlement-means-stock-split-can-proceed/ ("By creating a new class of non-voting shares, Google will be able to keep rewarding other employees with more stock and financing potential acquisitions of stock without undermining the voting power of Page and Brin.").

[6] See generally Geeyoung Min, Shareholder Voice in Corporate Charter Amendments, 43 J. Corp. Law. 289, 294 (2018) ("Under both the Model Business Corporation Act and the corporate law of all 50 states, including the Delaware General Corporation Law, amending a corporate charter requires both directors' and shareholders' approvals.").

[7] Steven Davidoff Solomon, Google's Stock Settlement May Not Do Much for Shareholders, NY Times: DealBook (Sept. 11, 2013), https://dealbook.nytimes.com/2013/09/11/googles-stock-settlement-may-not-do-much-

Class A shareholders swiftly responded to the recapitalization by bringing a breach of fiduciary duty lawsuit in Delaware.[8] The plaintiffs argued that the recapitalization was a form of "self-dealing" that should be reviewed under Delaware's long-standing regime of entire fairness.[9] The Google defendants, however, claimed that the decision ought to receive the deferential business judgment protection.[10] Ultimately, the parties settled the dispute on the eve of the trial,[11] and thus, the Google litigation left unanswered the key doctrinal question[12] as to whether entire fairness, business judgment, or some intermediate level of scrutiny is the appropriate standard of review for "midstream" reallocations of control rights—that is, changes to a company's existing allocation of control rights.[13]

Subsequent to the Google settlement, several other dual-class firms announced midstream recapitalizations from dual-class to triple-class structures. First, Facebook and InterActiveCorp (IAC) proposed to create a new class of nonvoting stock through a charter amendment.[14] However, after being targeted with suits by their respective shareholders, who argued that these recapitalizations amounted to unfair self-dealing, both Facebook and IAC withdrew their proposed recapitalization plans.[15] Another company adopted an even more cautious approach following the shareholders' self-dealing argument, and structured the recapitalization *ex ante* in a way that

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for-shareholders/ ("Only about 12.7 percent of Google's Class A stockholders . . . voted in support of issuing the Class C stock. That's a pretty poor showing by any measure."); Paul Lee, Protecting Public Shareholders: The Case of Google's Recapitalization, 5 Harv. Bus. L. Rev. 281, 284 (2015) ("On June 21, 2012, an overwhelming 85.3% of Class A shareholders voted against the proposal at the annual shareholders' meeting, demonstrating that the recapitalization would have failed a majority-of-the-minority.").

[8] See Plaintiffs' Opening Pre-trial Brief, In re Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 2728583 (Del. Ch. Jun. 10, 2013).

[9] Id. at 32 ("Self-dealing is present where, as here, special benefits from a potential transaction flow to the controller.").

[10] See infra note 91 and accompanying text.

[11] Jamie Santo, Google Settles Stock-Split Suit on Eve of Trial, Law 360 (Jun. 17,2013), https://www.law360.com/articles/450580/google-settles-stock-split-suit-on-eve-of-trial; Settlement Hearing and Rulings of the Court, In re Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 6735045, at *30 (Del. Ch. Oct. 28, 2013) ("We settled on the eve of trial, literally on the eve of trial.").

[12] See Settlement Hearing and Rulings of the Court, In re Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 6735045, at *38 (Del. Ch. Oct. 28, 2013) (describing the case as "interesting and novel" such that then-Chancellor Strine thought "it would be hazardous for anyone to predict how it would have come out").

[13] For a fuller discussion of the difference between initial allocations of control and midstream reallocations of control, see infra note 60 and accompanying text.

[14] See Facebook Apr. 2016 Proxy Statement, https://www.sec.gov/Archives/edgar/data/1326801/000132680116000053/facebook2016prelimproxysta.htm; IAC 14A (Nov. 2, 2016), http://ir.iac.com/static-files/409d5e1a-a42c-4af9-a6ed-8dd9ad20feb4.

[15] See infra note 100 and accompanying text.

complied with the entire fairness review.[16] Lastly, the board of CBS Corporation (CBS), also a dual-class company, recently proposed to unilaterally reallocate control rights from the controlling shareholder to the public shareholders—rather than, as its predecessors had done, from the public shareholders to the controller. In the face of what it viewed as a merger proposal that would harm the company, the board announced its plan to dilute the controller by distributing voting shares as a stock-dividend to all classes of shares (voting and non-voting) thereby empowering the minority shareholders to block the merger.[17] Yet again, the resulting suit ended in settlement.[18]

These cases raise a fundamental question at the heart of corporate law: What is the appropriate standard of review for conflicts over the reallocation of control rights at controlled companies?[19] This question has not been explored,[20] and it is far from an obscure academic inquiry. Recapitalizations like Google's are likely to recur as controlled companies that go public continue to employ multi-class share structures, thereby increasing the likelihood of future recapitalizations and other midstream reallocation of control rights.[21] Yet, while a long line of Delaware case law has addressed disputes over various forms of midstream reallocations of control rights,[22] the

[16] See IRA Tr. FBO Bobbie Ahmed v. Crane, No. CV 12742-CB, 2017 WL 7053964, at *4 (Del. Ch. Dec. 11, 2017); see also infra notes 101--106 and accompanying text.

[17] See Press Release, CBS, CBS Board of Directors Declares Dividend to Protect and Give Voting Power to Stockholders (May 17, 2018), investors.cbscorporation.com/news-releases/news-release-details/cbs-board-directors-declares-dividend-protect-and-give-voting See CBS Corp. v. National Amusements, Inc., No. 2018–0342–AGB, 2018 WL 2263385, at *2 (Del. Ch. May 17, 2018). The plan will dilute the controlling owner from 79% voting power to about 20%.

[18] See Press Release, CBS, CBS Corporation and National Amusements Announce Resolution of Governance Disputes and Transition to New Leadership (Sept. 9, 2018), http://investors.cbscorporation.com/news-releases/news-release-details/cbs-corporation-and-national-amusements-announce-resolution; see also CBS Corp., Current Report (Form 8-K), Settlement and Release Agreement (Ex. 10(a)) (Sept. 9, 2018), https://www.sec.gov/Archives/edgar/data/813828/000119312518269601/d622048dex10a.htm.

[19] By controlled company, this Article refers to those companies whose shareholder base is such that there is one shareholder that owns a majority of the company's voting stock.

[20] In his article on hostile takeovers, Ron Gilson argued that courts lack competence to determine whether it is 'fair' to leave control with management or the bidder. See Ronald J. Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819, 825-826 (1981). Gilson, however, does not address conflicts over the reallocation of control rights in *controlled* companies. Moreover, he explains that the problem with fairness review of control contests is that courts lack the competence to review what are essentially business decisions. See id. at 827 (arguing that such fairness inquiry "raises the same issue of judicial competence which justifies a restrictive judicial role with respect to the duty of care"). By contrast, this Article posits that the problem is the absence of acceptable methodologies for valuing control rights.

[21] See Blair Nicholas & Brandon Marsh, Dual-Class: The Consequences of Depriving Institutional Investors of Corporate Voting Rights, Harv. L. School Forum on Corp. Law and Governance (May 17, 2017), https://corpgov.law.harvard.edu/2017/05/17/dual-class-the-consequences-of-depriving-institutional-investors-of-corporate-voting-rights/ (noting a continuing trend of "issuing dual-class or multi-class stock).

[22] See infra section I.B.

Delaware courts have not yet adopted a clear approach concerning the standard of review that applies to these reallocations of control rights.[23]

This Article argues that the current legal framework that governs controlling shareholders' self-dealing[24]—the entire fairness analysis—cannot and should not be applied to conflicts over the reallocation of control rights. Entire fairness review explicitly requires courts to make an objective determination of the "fair price" of the transaction at issue.[25] Economists have developed valuation models for many types of cash-flow rights, like specific assets and entire companies, that aid courts in determining fair price.[26] However, similar economic models for valuing the reallocation of control rights simply *do not exist*.[27] Moreover, this Article posits that developing an economic model that objectively values the reallocation of corporate control rights is an inherently futile task because the value of control rights is firm-specific and individual-specific. Economic theory is capable of abstracting away from specific attributes of an asset (such as a factory) in order to approximate the value of that asset. Yet economic theory could not abstract away from the specific firm and the specific personality of a controller (such as Mark Zuckerberg or Sergei Brin) without excluding from the valuation analysis the very specific characteristics that make control valuable in that particular controller's hands.[28] We show that the allocation of control rights raises an

[23] Even if parties to recapitalization litigations continue to settle their disputes, the correct standard of review remains central for *bargaining* at the settlement stage. In particular, uncertainty in the case law risks not only inaccurate assessments of the strength of cases, but also increased aversion to pursuing midstream recapitalizations at all. For instance, Facebook not only paid a huge sum of money in attorney fees, but *also* withdrew its recapitalization altogether. It is the latter distortion in the settlement process that poses the greatest danger. See infra note 100.

[24] See infra section I.A. CBS was an exceptional case that did not raise concerns for self-dealing by a controlling shareholder but rather a conflicted action by the board.

[25] Under so-called "entire fairness" review, defendants face the burden of establishing both a (1) fair price for the disputed transaction and (2) fair process ("fair dealing") followed by the defendant board in considering and approving the disputed transaction. See Weinberger v. UOP, 457 A.2d 701, 771 (Del. 1983).

[26] See infra section I.A.1.

[27] A look at the table of content of the leading corporate finance textbooks reveals that there is no chapter about valuation of control rights. See, e.g., Richard A. Brealey, Stewart C. Myers, Franklin Allen, Principles of Corporate Finance (12th ed. 2017); Stephen A. Ross, Randolph W. Westerfield, Bradford D. Jordan, Fundamentals of Corporate Finance (12th ed. 2018). The available studies attempting to overcome the absence of a method to evaluate control rights either by focusing on elements that can easily translate to cash flow analysis—such as capital and operational improvements from change of control—or by measuring market pricing of control rights without offering any independent model. Section II.B.2 infra analyzes the use of these elements and explains in detail why existing methods do not even purport to value the effect of control by a specific individual over a specific company.

[28] See infra section II.B.; cf. Zohar Goshen & Richard Squire, Principal Costs: A New Theory for Corporate Law and Governance, 117 Colum. L. Rev. 767, 811 (2017) ("If firms were identical and the parties who owned and managed them were interchangeable, then any reallocation of control rights between investors and managers would

inevitable tradeoff between investors' protection from agency costs and the controller's ability to pursue its idiosyncratic vision,[29] thus making the value of different allocations of control rights both firm-specific and individual-specific.

Without a reliable valuation model, Delaware's entire fairness framework breaks down: Not only will *ex post* judicial determinations of "fair price" be impeded by the impossibility of reliably pricing corporate control rights, but also *ex ante* attempts to secure minority shareholder approval will be thwarted by the lack of a reliable valuation backstop.[30] Negotiating in the shadow of the law is impossible when the parties cannot reliably estimate how a court will determine a fair price.

In light of the impossibility of valuing control rights——and consequent courts' inability to apply entire fairness review——how should courts regulate conflicts over reallocation of control rights? Delaware should resolve control rights conflicts by determining which party, as a matter of contractual interpretation, has the authority to reallocate control rights under the company's charter.[31] The parties—controlling shareholders and minority shareholders—are best left to agree ex ante on the voting rule that will govern midstream reallocations of control rights. Therefore, courts' principal task should be to determine whether the controller can reallocate control rights without receiving the approval of the minority shareholders. Delaware courts should then defer to the arrangements on which the parties had initially agreed, and forego any attempt to evaluate the fairness of reallocation of control rights.[32] As long as the charter grants the controller the power to reallocate control rights, courts should apply the business judgment rule to a controller's choice to recapitalize. All other methods will fail in the absence of objective valuations.[33]

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increase one type of cost and decrease the other type by equal amounts. . . . It is only when firms have different attributes that differences in governance structures matter, as each firm aims at finding its optimal structure.").

[29] See Zohar Goshen & Assaf Hamdani, Corporate Control and Idiosyncratic Vision, 125 Yale L.J. 560 (2016) [hereinafter Goshen & Hamdani, Idiosyncratic Vision]. This paper assumes that entrepreneurs value control because it allows them to pursue their vision. For other explanations for why control of public corporations may be valuable to controllers, see Ronald Gilson, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, 119 Harv. L. Rev. 1641 (2006).

[30] See infra section III.A.1.

[31] See infra section III.B.

[32] Applications of contract law principles are not uncommon in the corporate law space. In particular, the rights of bondholders in Delaware have traditionally been resolved as a matter of contract interpretation. See, e.g., Dale B. Tauke, Should Bonds Have More Fun: A Reexamination of the Debate Over Corporate Bondholder Rights, 1989 Colum. Bus. L. Rev. 1, 8 ("In determining what rights and protections holders of publicly issued bonds of solvent corporations have against adverse corporate action, courts have traditionally looked to contract law.").

[33] For a consideration of how each of Delaware's existing standards of review would fail in the context of control rights, see infra Part III.A.

In defending this view, this Article argues that the approach not only avoids costly litigation and the valuation issues implicated by control rights, but also encourages clear drafting of the initial allocation of control rights in the corporate charter. And where the charter is silent, courts should craft a default rule that balances the potential loss of idiosyncratic vision (which results from giving the minority reallocation authority) with the potential increase of agency costs (which results from giving the controller reallocation authority).[34] More specifically, Delaware's longstanding pre-Google precedents, studies of market performance, and changing market realities in companies' shareholder base all weigh in favor of choosing a default rule that protects against the loss of idiosyncratic vision by granting controllers business judgment rule protection in decisions of midstream reallocations of control.[35]

The implications of our analysis are not limited to reallocation of control rights.[36] Delaware critically relies on fiduciary duties and judicial review under the entire fairness standard to govern self-dealing and other conflicts-of-interest at both controlled and widely held companies. However, courts' ability to perform this important task depends on the availability of accepted methods of valuation. Therefore, when no such methods exist, corporate law should resort to other measures.

The remainder of this Article proceeds as follows: Part I discusses the Delaware case law on resolving cash-flow and control rights disputes in controlled companies. While Delaware has developed a clear, sophisticated governing regime to adjudicate cash-flow rights, in the case of control rights conflicts, Delaware has struggled and ultimately been inconsistent in its approach. Part II explains this inconsistency by demonstrating the inevitable tradeoff that underlies the allocation of control rights. Moreover, Part II explains why developing a reliable methodology for valuing reallocations of control right is a futile task that will make the application of Delaware's existing corporate law regime impossible. In light of the foregoing insights, Part III considers how courts should approach conflicts over control-rights in controlled companies and ultimately proposes that these conflicts be resolved through interpretation of the company charter.

[34] See infra Part II.

[35] See infra Part III.B.2.

[36] Delaware relies on judicial review under the entire fairness standard as the principal mechanism to govern self-dealing and other conflicts-of-interest at widely held and controlled companies. However, as shown in Part II, courts' ability to perform this important task critically depends on the availability of accepted methods of valuation. Therefore, when no such methods exist, corporate law should resort to other measures.

I. CASH-FLOW RIGHTS, CONTROL RIGHTS, AND CORPORATE LAW

An important goal of corporate law is to protect public investors in controlled companies from opportunistic self-dealing by a controlling shareholder.[37] Delaware relies on its expert courts to restrict self-dealing, and these courts have developed a sophisticated doctrinal framework for that purpose.[38] This Part describes the application of this framework to two types of disputes that may arise between controllers and minority shareholders: (1) disputes concerning the allocation of cash-flow rights; and (2) disputes concerning the allocation of control rights. Midstream recapitalizations fall in the latter category. While courts and commentators have emphasized the need to constrain self-dealing, they have not examined the distinction between conflicts over cash-flow rights and control rights and its implications.

This Article introduces this distinction and examines its application in Delaware law. Section I.A explains that Delaware courts have generally applied the entire fairness standard of review to conflicts over cash-flow rights. Section I.B shows that Delaware courts that were asked to address conflicts over control rights have not followed a uniform approach, thereby creating uncertainty over the law governing those conflicts. The structure and overview in this Part not only illuminates some of the more puzzling pieces of Delaware's corporate law doctrine, but also frames our argument that the legal tools that govern the reallocation of cash flow rights should not apply to reallocations of control rights.

A. Cash-Flow Rights

Cash-flow rights determine who will receive a corporation's economic value, such as its profits and capital gains, as well as how much value they will receive and when they will receive it.[39] Disputes over the allocation of cash-flow rights in controlled companies arise when the

[37] See Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, & Andrei Shleifer, The Law and Economics of Self-Dealing, 88 J. Fin. Econ. 430–31 (2008) (describing the increasing emphasis of academics on corporate self-dealing over the last twenty years); Ronald J. Gilson & Alan Schwartz, Constraints on Private Benefits of Control: Ex Ante Control Mechanisms versus Ex Post Transaction Review, 169 J. Inst. Theor. Econ. 160, 180-81 (2013) (arguing that ex post judicial review of transactions with controlling shareholders or their affiliates is superior to ex ante limits on dual-class and other leveraged control structures).

[38] For a critique of the proposed European regime on self-dealing transactions, see Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (With a Critique of the European Commission Proposal)* 16 EUR. BUS. ORG. L. REV. 1 (2015).

[39] Goshen & Hamdani, Idiosyncratic Vision, supra note 29, at 578.

controlling and minority shareholders disagree as to the proper allocation of value precipitated by the business. Generally speaking, cash-flow rights conflicts involve either *a transaction* in which the controller stands on one side and the controlled corporation on the other, or *an action* taken by the corporation which results in reallocation of discernable economic value from the minority to the controller (both cases are commonly referred to as self-dealing).[40] For instance, minority shareholders and a controller might dispute whether the price offered to minority shareholders by the controller in a so-called "freezeout" merger was fair;[41] or they might dispute whether an asset sold to, or acquired from, the corporation by the controlling owner was priced fairly.[42]

In Delaware, the regime that governs self-dealing is the entire fairness standard.[43] In practice, however, controlling shareholders engaging in self-dealing have a choice: They can either submit the transaction to a judicial evaluation of its fairness or forgo such judicial review by voluntarily agreeing to a set of procedural conditions. Depending on the controller's decision,[44] Delaware courts will apply one of two alternative frameworks to cases of self-dealing involving cash flows:[45] (1) Entire Fairness review, or (2) review under the voluntary *MFW* conditions, which require the approval of both the majority of the minority shareholders and a special independent

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[40] Cash-flow rights conflicts in corporate actions arise in a wider variety of forms than cash-flow rights conflicts in transactions. One example of such a form was recently discussed by Jesse Fried. See generally Jesse M. Fried, Powering Preemptive Rights with Presubscription Disclosure, (European Corporate Governance Institute, Working Paper No. 418/2018, 2018) (discussing, in relevant part, the transfer of value that occurs when companies issue warrants, options that permit the holder to buy the underlying stock at a predetermined time and price, and one among a group of stockholders does not exercise the warrant).

[41] Guhan Subramanian, Fixing Freezeouts, 115 Yale L.J. 2, 9 (2005) ("In a merger freezeout, the controlling shareholder establishes a wholly owned corporation; the target board (typically dominated by the controller) approves the merger; and the shareholders of the target (again, dominated by the controller) approve the transaction.").

[42] See, e.g., Americas Mining Corp. v. Theriault, 51 A.3d 1213, 1218 (Del. 2012) (discussing a challenge by minority shareholders to the company's acquisition of its controller's 99.15% interest in another company on the grounds that the acquisition was at an inflated price); In re Straight Path Commc'ns Inc. Consol. Stockholder Litig., No. CV 2017-0486-SG, 2018 WL 3120804, at *8 (Del. Ch. June 25, 2018) (discussing, in relevant part, an allegation by minority shareholders that controlling shareholder had breached his fiduciary duties by selling certain of the company's intellectual property assets for $6 million to settle an indemnification claim, when existing consent decree had valued the assets at $50 million).

[43] See infra section I.A.1.

[44] As is made clear below, a controller's decision involves considering a variety of factors. Controllers are encouraged to structure their deal with the *MFW* protections, because it entitles them to a more deferential standard of review. However, procedural protections inevitably involve time, effort, and costs. Moreover, controllers may not be able to secure the approval of the majority of the minority and/or the special independent committee, both of which are required for *MFW*, and so controllers may decide it makes more sense to force the transaction upon the minority and have a court determine its fairness.

[45] A third alternative in which the entire fairness review applies but with a shift in the burden of proof is also possible. See Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994). This alternative is not discussed because it does not add any insight to the discussion above.

committee in order to effectuate a self-dealing transaction.[46] Section I.A.1. discusses the first of these frameworks, while section I.A.2 discusses the second.

1. Entire Fairness Review

The Delaware courts normally apply the entire fairness standard to cases of self-dealing. Traditionally, under the entire fairness standard, a controlling shareholder bears the burden of proving the transaction's fairness. Reviewing a transaction under "entire fairness" expressly requires scrutiny not only of the process by which a transaction took place ("fair dealing"), but also of the *price* of the transaction itself ("fair price").[47] Effectively, this means that in controlled companies, the controller is free to *force* a self-dealing transaction on the minority,[48] so long as this transaction is subsequently subjected to an objective valuation of its fairness.[49]

Entire fairness review is fundamentally reliant upon the ability and competence of a third party——in this case, the Delaware courts——to perform an objective valuation of the disputed transaction. Given the need to determine fair price, Delaware courts faced with cash-flow disputes are routinely tasked with establishing the objective value of entire companies, business divisions, specific assets, and so on, in order to determine the appropriate payment owed to the dissenting minority shareholders.[50] To do so, courts rely on valuation models, developed by economists for

[46] See Kahn v. M & F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014).

[47] See, e.g., Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985) ("[T]he concept of fairness has two aspects, fair dealing and fair price, both of which must be examined together in resolving the ultimate question of entire fairness."). Note, however, that more recent decisions have allowed for controlling shareholders, under certain conditions, to either shift the burden of entire fairness to the party challenging the transaction, or reduce the standard of review to business judgment. See Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994) (describing the conditions required for shifting the burden of entire fairness); Kahn v. M & F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014) (describing the conditions required for reduction to business judgment review).

[48] For expositional convenience, this Article disregards the potential role of the board when its approval is required for self-dealing transactions. The extent to which boards—even without the judicial review—can be relied upon to resist powerful controllers is beyond the scope of this paper. See also Lucian A. Bebchuk & Assaf Hamdani, Independent Directors and Controlling Shareholders, 165 U. Pa. L. Rev. 1271 (2017).

[49] Zohar Goshen, The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality, 91 Cal. L Rev. 393, 426 (2003) ("[I]f challenged in court, the interested shareholder must demonstrate both fair dealing and a fair price to satisfy the 'entire fairness' test.").

[50] See R. Scott Widen, Delaware Law, Financial Theory and Investment Banking Valuation Practice, 4 N.Y.U. J.L. & Bus. 579, 579 (2008) ("Delaware courts have developed a surprisingly large body of law regarding the proper analytics for valuing businesses. Most of this law has been developed in the context of adjudicating appraisal rights of dissenting shareholders in corporate M&A or going-private transactions.").

the pricing of assets,[51] such as the Discounted Cash-Flow ("DCF") model.[52] Applying valuation models is challenging for most courts, as it requires at least some understanding of financial theory. Despite non-trivial challenges to performing an objective valuation of the multifaceted assets and companies involved in conflicted transactions, Delaware courts, with their unique mastery of financial valuation techniques developed by economists, have been quite successful at applying the entire fairness review to cash-flow disputes in controlled companies.[53]

To be sure, Delaware courts might disagree with the valuation methods offered by parties to the litigation or with the inputs that should be used in a specific case.[54] Delaware courts also have occasionally rejected the valuation conclusions of parties to a litigation and instead conducted an independent valuation.[55] Yet, despite these disagreements, courts do not devise their own methodologies for valuing cash flow rights.[56] As we shall argue in the next Parts, the fact that no financial technique can credibly value *control rights* undermines courts' competence to adjudicate conflicts over the reallocation of these rights.

2. Voluntary MFW Conditions

Under Delaware law, controlling shareholders that wish to avoid costly litigation and the uncertainty associated with judicial "fairness" review can *voluntarily* condition the execution of a

[51] Timothy A. Luehrman, What's It Worth?: A General Manager's Guide to Valuation, Harv. Bus. Rev., May–June 1997 (recounting the development of the DCF model "as best practice for valuing corporate assets" and discussing the different ways companies use the model).

[52] See Weinberger v. UOP, Inc., 457 A.2d 701, 712–13 (Del. 1983) (embracing the use of "any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court" in the valuation context and including DCF models as part of those techniques).

[53] See, e.g., William A. Groll & David Leinwand, Judge and Banker—Valuation Analyses in the Delaware Courts, 116 Penn St. L. Rev. 957, 959 (2012) ("The plaintiffs' bar and the Delaware courts have become quite sophisticated in reviewing valuation analyses and are thoroughly conversant in the related, highly technical financial arcana."); Widen, supra note 50, at 581 ("Delaware courts have become increasingly sophisticated in their understanding of business valuation techniques.").

[54] See, e.g., In re Appraisal of DFC Glob. Corp., No. CV 10107-CB, 2016 WL 3753123, at *1 (Del. Ch. July 8, 2016), rev'd sub nom. DFC Glob. Corp. v. Muirfield Value Partners, L.P., 172 A.3d 346 (Del. 2017) ("In this opinion I conclude that the most reliable determinant of fair value of DFC's shares is a blend of three imperfect techniques: a discounted cash flow model incorporating certain methodologies and assumptions each expert made and some of my own, the comparable company analysis respondent's expert performed, and the transaction price.").

[55] In re ISN Software Corp. Appraisal Litigation, C.A. No. 8388-VCG, 2016 WL 4275388, at *6 (Del. Ch. Aug. 11, 2016) (rejecting the valuations of the testifying experts and opting instead to adjust the inputs to the DCF model per the court's judgment).

[56] For a discussion of the Delaware courts choosing between various valuation methodologies developed by economists, see, e.g., Samuel C. Thompson, Jr., A Lawyer's Guide to Modern Valuation Techniques in Mergers and Acquisitions, 21 J. Corp. L. 457, 463 (1996); Rutheford B. Campbell, Jr., The Impact of Modern Finance Theory in Acquisition Cases, 53 Syracuse L. Rev. 1, 38 (2003).

conflicted transaction upon receiving the support of both the majority of the minority and a negotiating "special committee" of independent and disinterested directors (together, known as the *MFW* conditions). When these conditions are met, Delaware courts do not apply entire fairness review. Instead, current Delaware law will apply the highly deferential business judgment rule and avoid scrutiny of the transaction.[57] In these cases, therefore, Delaware courts tend to focus more on whether the minority shareholders were fully informed and uncoerced when voting upon the transaction than on the technical elements of a particular DCF valuation which are used to establish the fairness of the price.[58] Thus, the efficiency of the voluntary *MFW* conditions in cash-flow disputes is largely a product of the ability of minority shareholders and the "special committee" to competently value a transaction and avoid bargaining failure in cases where a transaction would be value-creating.

B. Control Rights

This section turns to conflicts over control rights and demonstrates that unlike in the context of cash-flow rights, Delaware courts have been inconsistent in their resolution of these conflicts. Control rights are, broadly stated, rights to decide on the business direction of a company, ranging from day-to-day operational to strategic management decisions.[59] In controlled companies, control rights provide the controlling shareholder with the right to decide the company's direction. Conflicts over control rights, like conflicts over cash flow rights, arise either when a controller

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[57] See Kahn v. M & F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014) ("[B]usiness judgment is the standard of review that should govern mergers between a controlling stockholder and its corporate subsidiary, where the merger is conditioned ab initio upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders."). Importantly, Delaware courts have made clear that the deferential standard of review is only available in cases where the transaction is conditioned on the relevant approvals *ab initio*. See, e.g., In re Synutra Int'l, Inc. S'holders Litig., No. 2017-0032-JTL, 2018 WL 705702, at *2 (Del.Ch. Feb. 02, 2018) ("The first prong of the [*M&F Worldwide*] framework requires that 'the merger is conditioned ab initio upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders.'" (quoting *M&F Worldwide*, 88 A.3d at 644)); In re Books-A-Million, Inc. S'holders Litig., No. 11343-VCL, 2016 WL 5874974, at *8 (Del. Ch. Oct. 10, 2016) (reiterating the ab initio requirement and holding that it is satisfied where the controlling shareholder's offer letter conditioned the transaction on the required approvals and fulfilled the conditions).

[58] See Itai Fiegenbaum, The Geography of MFW-Land, 41 Del. J. Corp. L. 763, 796--97 (2017) (describing *MFW*'s "dual approval mechanism" as one "grounded in the efficacy of the positive endorsement by two qualified decisionmakers" and "believed to produce comparable benefits to intrusive judicial review in guaranteeing the best price possible for minority stockholders").

[59] Goshen & Hamdani, Idiosyncratic Vision, supra note 29, at 565 ("Control matters because business ideas take time to implement. This ongoing process requires numerous decisions, ranging from day-to-day management issues to major strategic choices.").

participates in a transaction where she stands on one side of the transaction and the controlled company stands on the other, or when an action is taken by the corporation and it has the effect of reallocating control rights either from the minority to the controller or vice versa. Importantly, this Article does not consider conflicts that arise at the initial allocation of control rights when the company goes public or when investors decided to provide capital, but rather focuses on conflicts that arise from changes to an existing allocation of control rights, midstream changes.[60]

Section I.B.1 discusses the earlier cases in which Delaware courts have applied the deferential business judgment rule, while section I.B.2 discusses the more recent cases in which Delaware courts have moved in the direction of applying the very demanding entire fairness review. Given the two diverging sets of case law, Delaware's existing framework for determining whether reallocations of control rights deserve the scrutiny reserved for self-dealing is incoherent.

1. Business Judgment Rule

In applying the business judgment rule to midstream governance changes, Delaware courts must find that the challenged action taken by the corporation did not amount to "self-dealing," regardless of the disparate effect it might have on the controlling owner and the minority shareholders.[61] To find this, the reviewing court must conclude that the controller did not receive *something* "to the exclusion of, and detriment to, the minority."[62] Once such a determination is made, then the business judgment rule applies.[63] Perhaps because of the *appearance* of an equal pro-rata legal effect in control rights conflicts, some courts have applied the business judgment rule even when charter amendments clearly resulted in the reallocation of control rights to the controlling shareholder.[64] Indeed, at times, Delaware courts have recognized that the disparate

[60] See generally Yu-Hsin Lin, Controlling Controlling-Minority Shareholders: Corporate Governance and Leveraged Corporate Control, 2017 Colum. Bus. L. Rev. 453, 458, 486 (2017) (defining the "midstream" stage as the "post-IPO stage" and describing the Google and Facebook recapitalizations as "midstream changes").

[61] See Weinberger v. UOP, 457 A.2d 701, 710 (Del. 1983) ("The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.").

[62] Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721–22 (Del. 1971).

[63] Id. at 20 (holding that intrinsic fairness applies only when a controlling shareholder engages in self-dealing, and that "[s]elf-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary.").

[64] See Goshen & Hamdani, Idiosyncratic Vision, supra note 29, at 606 n.141 (discussing the difficulties of identifying self-dealing in control rights conflicts).

economic effects of a corporate decision pose a *practical* conflict, but have determined that such a conflict is *legally* irrelevant and thus applied the business judgment rule in their review. The discussion below summarizes, in chronological order, Delaware's treatment of three of these midstream changes—namely, dual-class recapitalizations, tenure voting recapitalizations, and amendments relating to board representation.

Dual-Class Recapitalization. In a dual-class recapitalization, a public company that has one class of shares switches to a dual-class structure.[65] The controlling shareholder is typically left holding the class of shares with superior voting rights and the public shareholders are left holding those shares with inferior voting rights.[66] The dual-class recapitalization results in reallocation of control rights from minority shareholders to the controlling shareholder, because it allows the controllers to maintain control without holding the majority of the company's cash-flow rights.[67]

Delaware courts, however, did not review these evidently conflicted recapitalizations under the entire fairness standard. For instance, in *Société Holding Ray D'Albion S.A. v. Saunders Leasing System, Inc.*,[68] a minority shareholder of Saunders Leading System, Inc., challenged a recapitalization plan which proposed to convert all existing stock into a class of stock with one-vote per share (high-voting shares) and then issue a stock dividend to all holders of that class in the form of a share with one-tenth-of-a-vote per share (low-voting shares). Arguing that the plan

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[65] See Anita Anand, Governance in Dual Class Share Firms, Annals of Corp. Governance (forthcoming) (manuscript at 9), https://ssrn.com/abstract=3104712 ("'Dual-class shares' and 'multi-voting shares' are generic terms that refer to a type of capital structure in a public or private corporation. The structure involves the issuance of two or more different classes of shares whereby one class (the 'superior' class) has more voting rights than shares held, while the other class (the 'subordinate' class) has fewer voting rights relative to the shares held. As a result, holders of the superior class of shares own a greater proportion of voting rights without having as much equity invested as the subordinate shareholders."); see also supra note 3 and accompanying text.

[66] See Jeffrey N. Gordon, Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice, 76 Cal. L. Rev. 3 (1988).

[67] Richard S. Ruback, Coercive Dual-Class Exchange Offers, 20 J. Fin. Econ. 153, 153 (1988).

[68] See Société Holding Ray D'Albion S.A. v. Saunders Leasing Sys., Inc., No. 6648, 1981 WL 15094, *1--*3 (Del. Ch. Dec. 16, 1981). For a similar case, *see,* Weiss v. Rockwell Int'l Corp., Civil Action No. 8811, 1989 WL 80345, at *1 (Del. Ch. July 19, 1989). In *Weiss*, a class of Rockwell's shareholders challenged a charter amendment that created a new class of ten-votes-per-share stock, which would be distributed pro-rata as a dividend to existing shareholders. The court acknowledged that because the amendment dictated that most transfers of the new shares result in the shares dropping from ten-votes-per-share to one-vote-per-share, its effect was to "cause disproportionate voting power to become concentrated significantly in the hands of Rockwell's long term stockholders." Id. Moreover, because of an employee Savings Plan which included 30% of Rockwell's outstanding stock, the defendant directors were alleged to form part of those "long term shareholders" who would benefit from the amendment. Id. Though the Court acknowledged, as the proxy materials had, that one possible outcome of such a plan was to entrench the position of the controllers and prevent takeovers, it ultimately found that the plaintiffs had failed to show that the amendment was not "a valid corporate act." Id. at *3.

was designed to achieve "the perpetuation of control" by the controller's family—who would be able to retain majority voting power without the corresponding cash flow rights holdings, by selling the newly distributed low-voting shares—the plaintiff asked the court for a restraining order to prevent the plan.[69] Though the court acknowledged that the controllers had fiduciary duties to the minority shareholders, it ultimately found that the plan was "fair to minority stockholders," in the colloquial sense of the term, and denied the plaintiff's request.[70] Such a fast, deferential ruling suggests that the court did not find the case to be one involving self-dealing.

Tenure Voting Recapitalization. Tenure voting is a regime where shares held for a certain period of time are granted superior voting rights over those that have been held for a shorter length of time.[71] In a tenure voting recapitalization, a company amends its charter midstream to provide for voting rights that change based on the length of time for which the share is held.[72] Since public shareholders frequently trade their shares,[73] and the controlling shareholder holds the control block for a long period of time,[74] a tenure voting recapitalization, much like a dual-class recapitalization, practically results in the controlling shareholder holding shares with higher voting power than the minority shareholders. In other words, a tenure voting recapitalization reallocates control rights to controlling shareholders by increasing the relative voting power of controlling shareholders.

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[69] *Saunders Leasing Sys. Inc.*, 1981 WL 15094, at *1.

[70] Id. at *3. To be clear, it must be emphasized that the determination that the plan was "fair" was not part of an entire fairness valuation, but rather a legal determination of the contractual effects of the plan.

[71] See David J. Berger et al., Tenure Voting and the U.S. Public Company, 72 Bus. Law. 295, 297 (2017) ("Tenure voting rewards long-term investors with additional votes per share."); see also Marco Becht et al., Loyalty Shares with Tenure Voting - A Coasian Bargain? Evidence from the Loi Florange Experiment (European Corp. Governance Inst. Working Paper No. 398, 2018) (discussing "loyalty shares" in France, which "confer multiple voting rights as a function of the holding period"); Lynne Dallas & Jordan M. Barry, Long-Term Shareholders and Time-Phased Voting, 40 Del. J. Corp. L. 541, 548 (2015) (describing "time-phased voting" arrangements as arrangements that "accord long-term shareholders more votes per share than they accord short-term shareholders").

[72] Berger et al., supra note 71, at 305 ("A company that recapitalizes its shares under a tenure-voting plan would give long-term shareholders more votes per share than short-term shareholders."). In a tenure voting recapitalization, all of the existing shares may be decreased in voting power, such that they must be held for the specified period to gain voting power, *or* all of the existing shares may be increased in voting power (or retain a high voting power), such that as soon as they are sold, their voting power decreases and they must be held for the specified period of time by the new holder to regain voting power. Id.

[73] Id. at 298 ("Beginning in the early 1980s, with the rise of the takeover boom, [the average holding period of public-company stocks] began to decline. By 1990, the period had fallen to about two years, and by the mid-2000s it was less than a year. By some accounts, the average holding period in 2015 for individual stocks across all U.S. markets was about seventeen weeks.").

[74] Dallas & Barry, supra note 71, at 548 (noting that "[b]ecause controlling shareholders are generally long-term shareholders," tenure voting "enhances their voting power relative to their percentage of share ownership….[and] allows the controlling shareholders to reduce their ownership in their firms while maintaining control").

In *Williams v. Geier*,[75] minority shareholders challenged a controlled company's tenure voting charter amendment after it had been recommended by the board and approved by the controlling shareholders. The amendment granted all existing shares ten votes, but provided that once a share was sold, its voting rights would drop to one vote; the share would regain its ten votes only if held for a period of three years. Given the trading differences between public shareholders and controlling shareholders discussed above, by merely holding onto some of their existing shares, the controllers could preserve control over the corporation without necessarily holding a majority of the company's cash-flow rights.[76] Pointing to this consequence, the plaintiffs argued that the amendment be reviewed under the entire fairness standard.

However, the Delaware Supreme Court held that the business judgment rule applies to tenure voting recapitalizations. The majority opinion recognized the unique benefit that the amendment conferred on the controllers—allowing them to sell some of their holdings without relinquishing control—but concluded that the disparate economic impact of the changes did not amount to self-dealing.[77] By contrast, the dissenting judges urged that the charter amendment should be subject to full judicial scrutiny under the entire fairness standard because it conferred "substantial benefits on the majority shareholders."[78] The dissent noted that "the charter amendments worked fundamental changes in the governance" of the company by giving "the Geier Family shareholders control not only over the future composition of the Board, but over the strategic long-term planning of the company."[79]

Board Representation. Charter amendments that affect the frequency with which board members are up for election have also been reviewed under the business judgment rule, in *eBay Domestic Holdings, Inc. v. Newmark.*[80] Craigslist's charter provided for a cumulative voting

[75] Williams v. Geier, 671 A.2d 1368 (Del. 1996).

[76] Id. at 1378.

[77] See id. ("[T]here was on this record: … no non-pro-rata or disproportionate benefit which accrued to the Family Group on the face of the Recapitalization, although the dynamics of how the Plan would work in practice had the effect of strengthening the Family Group's control."); see also id. at 1382 (noting that in the case "entire fairness is not an issue").

[78] Id. at 1386.

[79] See id. ("The proposed Plan significantly alters shareholder voting rights to the detriment of those minority shareholders who have no interest in preserving the family ownership, or whose investment objectives may have a different time frame from the Family Group.").

[80] See eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1 (Del. Ch. 2010).

regime[81] that was designed to give eBay, a minority shareholder, the ability to appoint one out of the three members of the board.[82] The majority shareholders, however, subsequently amended the charter to provide for a classified board, which created three classes of directors, with only one director facing an election each year.[83] The classified board amendment rendered the cumulative voting regime impractical, in that it eliminated the possibility for eBay "to cumulate votes and direct those votes towards a single director candidate," and thereby allowed the controllers to ensure that only their candidates would be elected to the board.[84] eBay contended that entire fairness should apply because the classified board amendment benefited the controlling shareholders and harmed them, the minority shareholder.[85] While the court in *eBay* recognized the conflict underlying the charter amendment,[86] it refused to review the amendment under the entire fairness standard. Instead, the court held that the amendment's disparate impact did not amount to self-dealing, and that *eBay* was not deprived of any right awarded to it under Delaware law.[87]

[81] For a discussion of cumulative voting regimes, see Jeffrey N. Gordon, Institutions as Relational Investors: A New Look at Cumulative Voting, 94 Colum. L. Rev. 124, 127 n.8 (1994) (describing the typical cumulative voting regime in corporate settings). Classified boards work against cumulative voting by requiring increased voting power to elect a director. Consider for instance a board of 9 individuals elected using a cumulative voting regime and a minority shareholder M who owns 40 shares, corresponding to 40% of the voting power. If the 9 board members are elected annually, then M only needs to allocate 11% of her voting power to elect a director. Edmund A. Stephan, Cumulative Voting and Classified Boards: Some Reflections on *Wolfson v. Avery*, 31 Notre Dame Law. 351, 354 n.5 (1956). However, if the board is classified, with only 3 directors up for election every year, then M will need to use 26% of her voting power elect a director. Id.

[82] *eBay Domestic Holdings, Inc.*, 16 A.3d at 13 (explaining that though eBay did not have a "contractual right" to fill the third board seat, "the laws of mathematics under a cumulative voting system with a non-staggered board" ensured it would be able to elect one of the three directors).

[83] Id. at 22.

[84] Id. at 23.

[85] See id. at 37 (noting that "eBay contends that the Staggered Board Amendments must pass muster under the entire fairness standard," in part because, "Jim and Craig, as controlling stockholders and directors, were personally interested in the Staggered Board Amendments because implementing a staggered board redounded to their benefit but harmed eBay as the minority stockholder").

[86] See id. at 23 ("Practically speaking, however, the cumulative voting provisions are not meaningful if only one director position is up for election in any given year.").

[87] Id. at 38. The chancery court offered several reasons. First, it noted that "[the controllers] did not realize a financial benefit by approving the Staggered Board Amendments so there was no self-dealing on the basis of financial considerations." Id. Second, it explained that eBay was importantly not "deprived" of an entitlement because it was not "entitled" to craigslist's cumulative voting regime. Id. ("If a corporation implements a staggered board, and this renders the corporation's cumulative voting system ineffective, minority stockholders have not been deprived of anything they are entitled to under the common law or the DGCL, because minority stockholders are not entitled to a cumulative voting system in the first instance."). Lastly, the court admitted that the amendment had "disparate" impact on eBay, but concluded that it was "not the sort of disparate treatment, however, that can be classified as self-dealing because the law expressly allows majority stockholders to elect the entire board.…" Id.

2. Entire Fairness Review

The decisions discussed above applied the business judgment rule to midstream reallocations of control rights. More recent Delaware decisions, however, seem to have implied that entire fairness is the standard of review for midstream recapitalizations. The discussion below provides a chronological overview of recent cases in order to provide insight into Delaware's treatment of such recapitalizations.

Google. As we explained above,[88] the plaintiffs in Google argued that Google's move from a dual-class to a triple-class structure reallocated control rights from Class A to Class B shares.[89] Thus, the Class A shareholders alleged that the recapitalization constituted a form of self-dealing, subject to Delaware's exacting entire fairness scrutiny.[90] In response, the Google defendants claimed the recapitalization was aimed at long-term value-maximization rather than entrenchment and, critically, that the recapitalization decision was approved by an independent and disinterested board of directors, entitling the decision to Delaware's highly deferential business judgment rule review.[91] Ultimately, the parties settled, and Google was able to follow through with the recapitalization after agreeing to several concessions to the Class A plaintiffs.[92]

Though the case ended in settlement, the corporate community was not left wholly in the dark regarding the court's intuition. During the settlement hearing, the then-Chancellor,[93] Strine, suggested that the proposed recapitalization may have run afoul of *expectations* on the part of Class A shareholders that they might *eventually*, given enough time and dilution of Class B voting

[88] See supra note 2 and accompanying text.

[89] Plaintiffs' Opening Pre-trial Brief at 32, In re Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 2728583 (Del. Ch. Jun. 10, 2013).

[90] Id. ("[D]efendants with a conflicting self-interest must demonstrate that the deal was entirely fair to other stockholders. The proposed Recapitalization unquestionably provides personal benefits to Page and Brin, triggering the entire fairness review.").

[91] Opening Pre-trial Brief for Google Inc. and Independent Director Defendants at 25—31, In re Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 2728591 (Del. Ch. June 10, 2013) ("[T]he Recapitalization was approved by Google's disinterested and independent Board for the purpose of providing the Company with the flexibility it needs to do stock-based acquisitions and issue stock-based compensation, while at the same time maintaining Google's incredibly successful governance structure.").

[92] Order and Final Judgment, In re Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 5949928 (Del. Ch. Nov. 6, 2013); Jamie Santo, Google Settles Stock-Split Suit on Eve of Trial, Law 360 (Jun. 17,2013), https://www.law360.com/articles/450580/google-settles-stock-split-suit-on-eve-of-trial; Settlement Hearing and Rulings of the Court, In re Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 6735045, at *30 (Del. Ch. Oct. 28, 2013) ("We settled on the eve of trial, literally on the eve of trial.").

[93] Now the Chief Justice of Delaware Supreme Court.

power, obtain a majority stake in Google.[94] Moreover, he referenced "tensions" in Delaware law as to the treatment of a conflicted vote by controlling shareholders, suggesting that *Williams v. Geier* might not squarely dictate business judgment review in the case of midstream recapitalizations.[95] Still, given the settlement context, Strine cautioned that "it would be hazardous for anyone to predict how [the trial] would have come out."[96] Indeed, the notion that a recapitalization like the one proposed by Google might be subject to entire fairness was surprising, as such *expectations* of minority shareholders were never legally recognized. Moreover, the reallocation effect on minority shareholders of switching from dual-class to triple-class shares is less pronounced than the effect of switching from a one-share-one-vote to a dual-class structure or to a tenure voting regime, the latter of which received the business judgment rule protection.[97] In short, the Google case became the first in a series of recent cases which have cast doubt on the standard of review that applies to midstream recapitalizations.

Facebook and IAC. Following Google's settlement, Facebook and IAC each proposed amending their respective charters to authorize the issuance of a new class of nonvoting stock, citing as their motivation the flexibility to raise and deploy significant capital without diluting the ownership stakes of the founders—–Mark Zuckerberg of Facebook and Barry Diller of IAC.[98] Stockholders of both Facebook and IAC sued to challenge the respective recapitalizations.[99]

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[94] See Settlement Hearing and Rulings of the Court, In re Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 6735045, at * *27 ("[R]ight now I have a certain percentage contractual expectancy if Google pays out dividends, and then I have a certain kind of noncontractual market-based assumption about how people look at the equity of the company . . . You've now taken my same interest and just divided it in half."). Strine also noted that "it's never been the case that interested voting power gets a pass simply because it has voting power." Id. at *38.

[95] Id.

[96] Id. at *38. Strine also noted that the recapitalization approval by Google's independent directors and the fact that investors knew all along that Google's founders had no intention to relinquish control were the defendants' strongest arguments. Id. ("[T]he stronger argument on behalf of the defendants is that they were well-motivated independent directors who they would have presented at trial who believed that this was the right thing for Google's public stockholders and that from the beginning, everyone has been clear with the people who lined up in hoards … to buy Google stock, with the understanding that these founders were going public but with no intention to relinquish voting control over the company that they founded and loved, and that when you invested in Google, that was sort of your understanding.")

[97] Perhaps with this in mind, some have agreed with Strine's assessment that it was far from guaranteed that entire fairness would have been the correct standard to apply to the Google recapitalization purely as a doctrinal matter. See Settlement Deletes Trial over Google Stock Split, 27 Westlaw J. Del. Corp., June 24, 2013, at 3 (noting that Professor Lawrence A. Hamermesh observed that the Google "plaintiffs' characterization of the stock split was puzzling" and stated "[i]f you have corporate control, there shouldn't be anything suspect about approving an action that keeps control exactly where it's been since the company's inception").

[98] *See* note 14, *supra.*

[99] Dan Levine, Facebook Hit with Lawsuit Over Plan to Issue New Stock, Reuters (Apr. 29, 2016), http://www.reuters.com/article/us-facebook-stocks-lawsuit-idUSKCN0XQ2LM (noting the Facebook lawsuit); Josh

Unlike Google, however, these lawsuits did not end in a settlement. Rather, both Facebook and IAC withdrew their recapitalization plans and avoided facing the costs and uncertainty of litigation.[100]

Crane. In the case of *Crane*, NRG Energy, Inc. (NRG) proposed a dual-class to triple-class recapitalization of NRG Yield, Inc. (Yield), a portfolio company in which NRG held a controlling stake.[101] However, unlike the Google, Facebook, or IAC cases, NRG conditioned the recapitalization from the *outset* on the approval of both (1) a majority of Yield shares not affiliated with NRG, and (2) a fully-empowered, independent special committee.[102] In so doing, NRG attempted to shepherd the transaction through the voluntary *MFW* conditions in order to lower the standard of review from entire fairness to business judgment.[103] *Crane* is noteworthy for two reasons: First, the transaction structure revealed that NRG considered the risk of entire fairness review sufficiently likely to warrant the time and expense of implementing the voluntary *MFW* conditions. Second, and just as importantly, the Chancery court did in fact choose to apply entire fairness review as a threshold matter, but then reduced the level of scrutiny to business judgment deference per *MFW*.[104] As the Court explained, entire fairness applied because the recapitalization afforded NRG "something uniquely valuable to the controller," namely, "a means…to ensure it would be able to retain voting control of Yield well into the future without abandoning a key aspect of its original business model."[105] In other words, the court found that in a reallocation of control

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Beckerman, CalPERS Sues Barry Diller Over IAC/InterActive Stock Plan, Wall St. J. (Dec. 12, 2016), https://www.wsj.com/articles/calpers-sues-barry-diller-over-iac-interactive-stock-plan-1481585007.

[100] See Facebook, Current Report (Form 8-K) (September 21, 2017), https://www.sec.gov/Archives/edgar/data/1326801/000132680117000042/form8k_92217.htm. In approving the settlement, the court allowed the plaintiff to recover $68 million due to the "success" of blocking Facebook's recapitalization. See also IAC, Current Report (Form 8-K) (Jun. 21, 2017), https://www.sec.gov/Archives/edgar/data/891103/000110465917041328/a17-15693_18k.htm ("IAC's Board of Directors has determined not to pursue the Company's previously announced plan to create a new class of non-voting stock."). In announcing its intent to abandon its recapitalization plans, IAC specifically noted the pending litigation as a motivating factor: "[R]ecent developments in the stockholder litigation that made it unlikely that the litigation would be finally resolved until late 2018 or 2019, the burden and distraction that the litigation was likely to impose on IAC and its management, including the considerable legal and related expenses of the litigation, and other relevant information, the Board determined not to proceed with the Class C Recapitalization." Id.

[101] IRA Tr. FBO Bobbie Ahmed v. Crane, No. CV 12742-CB, 2017 WL 7053964, at *4 (Del. Ch. Dec. 11, 2017).

[102] Id.

[103] See Kahn v. M & F Worldwide, Corp. 88 A.3d 635 (Del. 2014).

[104] *Crane*, 2017 WL 7053964, at *9.

[105] Id. (quoting GAMCO Asset Mgmt. Inc. v. iHeartMedia Inc., 2016 WL 6892802, at *16 (Del. Ch. Nov. 23, 2016)).

rights, notwithstanding the pro-rata legal effect, the controller receives something "to the exclusion of, and detriment to, the minority."[106]

CBS. On May 17, 2018, CBS, a dual-class corporation controlled by National Amusements Inc. (NAI),[107] decided to distribute a pro-rata *voting-shares* stock-dividend to all of its shareholders, including shareholders who previously held non-voting shares. Given the company's dual-class structure, this move would have resulted in diluting the voting power of the controlling shareholder "from approximately 79% to 20%."[108] As motives for this action, CBS cited, among other things, the ability to "unlock shareholder value" and "more fully evaluate strategic alternatives."[109] For the purposes of this Article, CBS' corporate action matters because the distribution would have reallocated control rights from the controlling shareholder to the minority. By distributing voting shares to the current owners of its non-voting stock, CBS would effectively accomplish the opposite of what Google, Facebook, and IAC wanted and eliminate the majority voting power of its controlling shareholder, NAI.[110] Unsurprisingly, NAI challenged the distribution in court.[111] However, on September 9, 2018, the parties announced they had settled the dispute.[112]

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[106] Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721--22 (Del. 1971).

[107] See CBS Corp., Quarterly Report (Form 10-Q) (June 30, 2018), https://www.sec.gov/Archives/edgar/data/813828/000081382818000036/cbs_10q-063018.htm. In its most recent quarterly filing, CBS reported that as its controlling shareholder NAI owned approximately 79.7% of the company's Class A voting stock. Id. The Sumner M. Redstone National Amusements Trust in turn owns approximately 80% of NAI's voting interest and is itself controlled by the Redstone family. Id.

[108] See Press Release, CBS, CBS Board of Directors Declares Dividend to Protect and Give Voting Power to Stockholders (May 17, 2018), investors.cbscorporation.com/news-releases/news-release-details/cbs-board-directors-declares-dividend-protect-and-give-voting; see also CBS, Current Report (Form 8-K) (May 17, 2018), https://www.sec.gov/Archives/edgar/data/813828/000089882218000033/8-k.htm.

[109] Press Release, CBS, CBS Board of Directors Declares Dividend to Protect and Give Voting Power to Stockholders (May 17, 2018), investors.cbscorporation.com/news-releases/news-release-details/cbs-board-directors-declares-dividend-protect-and-give-voting.

[110] See generally Matt Levine, Opinion, CBS Wants to Get Rid of a Shareholder, Bloomberg (May 15, 2018), https://www.bloomberg.com/view/articles/2018-05-15/cbs-wants-to-get-rid-of-a-shareholder (explaining the effect of CBS's proposed dividend distribution). Importantly, the pro rata distribution will succeed in diluting NAI's voting power primarily because NAI only owns around 10.4% of CBS's non-voting interest. See CBS Corp., Quarterly Report (Form 10-Q) (June 30, 2018), https://www.sec.gov/Archives/edgar/data/813828/000081382818000036/cbs_10q-063018.htm.

[111] See CBS Corp. v. National Amusements, Inc., No. 2018–0342–AGB, 2018 WL 2263385, at *2 (Del. Ch. May 17, 2018). The path to Delaware's involvement in the case was a bit more complicated than in the prior recapitalizations, since it was CBS that filed the complaint asking for a temporary restraining order to prevent NAI from interfering with the proposal by changing the composition of the board. Id. at *1; see also Plaintiff's Motion for a Temporary Restraining Order at 4--6, *CBS*, 2018 WL 2263385 (No. 2018–0342–AGB).

[112] See Press Release, CBS, CBS Corporation and National Amusements Announce Resolution of Governance Disputes and Transition to New Leadership (Sept. 9, 2018), http://investors.cbscorporation.com/news-releases/news-release-details/cbs-corporation-and-national-amusements-announce-resolution; see also CBS Corp., Current Report (Form 8-K), Settlement and Release Agreement (Ex. 10(a)) (Sept. 9, 2018), https://www.sec.gov/Archives/edgar/data/813828/000119312518269601/d622048dex10a.htm.

The above doctrinal review illustrates that while Delaware courts quite consistently apply the entire fairness review and voluntary *MFW* conditions to conflicts over cash-flow rights, they have been unable to achieve a similarly coherent approach in the context of control rights conflicts. This asymmetry prompts the question: Why? As the next Part explains, conflicts over control rights have unique features that prevent the application of the tools that have worked well in cash-flow conflicts.

II. THE COMPLEXITY OF ALLOCATING CONTROL RIGHTS

Part I of this Article introduced the distinction between cash-flow rights and control rights and demonstrated that the Delaware courts have struggled to fashion a consistent approach to address conflicts over the reallocation of control rights. This Part argues that conflicts over the reallocation of control rights have two unique qualities that prevent their regulation like cash-flow rights conflicts. First, section II.A explains that the reallocation of control rights entails bargaining under conditions of a bilateral monopoly over an inevitably dichotomous choice between giving controllers a right to unilaterally reallocate control rights and giving minority shareholders a right to veto such reallocation. Second, section II.B shows that there are no acceptable methods, *nor will there ever be*, for valuing reallocation of control rights, as the value of control rights is both firm-specific and individual-specific. These realities make courts inherently incapable of adjudicating conflicts over the reallocation of control rights.

A. The Dichotomous Choice over Reallocation of Control Rights

To understand the dichotomous choice over the reallocations of control rights, one must first ask: Why do entrepreneurs and investors care about the allocation of control rights?

Entrepreneurs value corporate control because it allows them to pursue their idiosyncratic vision—the strategy that they genuinely believe would produce abnormal returns for the company, thereby benefiting all shareholders.[113] Importantly, an entrepreneur's idiosyncratic vision reflects the parts of the entrepreneur's business idea that outsiders may be unable to

[113] See Goshen & Hamdani, Idiosyncratic Vision, supra note 29, at 566.

observe or verify.[114] Given that business ideas take time to implement and require numerous decisions, ranging from day-to-day management issues to major strategic choices, investors might disagree with entrepreneurs about the company's future direction—due to asymmetric information or differences of opinion—and prevent them from implementing their vision.[115] Thus, control over corporate decisions enables entrepreneurs to pursue their vision even against investors' objections. In other words, control matters for entrepreneurs mostly when investors might disagree with the entrepreneurs' decisions about the company's direction. Investors, by contrast, value control over corporate decisions because it offers protection against agency costs, like mismanagement and self-dealing.[116]

In controlled companies, the parties allocate control rights and cash-flow rights, with the aim of balancing the controller's need to pursue idiosyncratic vision and minority shareholders' need for protection against agency costs. Allocating more control rights to the controller gives her more freedom to pursue her idiosyncratic vision (if she is loyal and competent) and increases the risk of agency costs (if she is disloyal and incompetent); allocating more control rights to the minority has the opposite effect.

At the initial contracting stage, such as the Initial Public Offering (IPO), the parties negotiate under competitive conditions: The investors can choose to invest elsewhere and the company may be considering multiple offers.[117] Through the negotiation, the parties are able to reach an acceptable balance between idiosyncratic vision and agency cost that fits their preferences and the nature of the business activity. If future developments prompt a need to shift the balance the parties achieved in their initial allocation of control rights, the parties may reallocate control

[114] See Goshen & Hamdani, Idiosyncratic Vision, supra note 29, at 579 ("The entrepreneur's idiosyncratic vision will often include elements that outsiders, including the firm's minority shareholders, cannot observe or verify. This could be because sharing the information with outsiders would destroy its value (e.g., competitors could copy the idea) or simply because the entrepreneur can present outsiders with nothing more than her strong conviction concerning the value of her idea.").

[115] See also Eric Van den Steen, Disagreement and the Allocation of Control, 26 J.L. ECON. & ORG. 385 (2010).

[116] Id. at 581--82 ("Controllers can engage in *mismanagement*, including reduced commitment, shirking, pursuit of acquisitions just to increase firm size or achieve diversification without creating shareholder value, and investment of resources in entrenchment. Controllers can also engage in *takings*, directly diverting pecuniary private benefits to themselves by, for example, consuming excessive pay and perks or conducting favorable related-party transactions.").

[117] See generally Lucian Arye Bebchuk, Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments, 102 Harv. L. Rev. 1820, 1825 (1989) (discussing differences in the contracting process at the IPO stage and the midstream stage).

rights midstream. Any reallocation of control rights midstream will again raise the same tradeoff between idiosyncratic vision and agency costs that the parties faced initially. Importantly, however, while in the initial stage the parties negotiate the allocation of control rights under competitive conditions, midstream changes take place when the parties are locked in a *bilateral monopoly*.[118] The parties, therefore, can only agree on who will have the right to decide the new balance of idiosyncratic vision and agency cost. Either controllers will receive the right to unilaterally reallocate control rights, or minority shareholders will have a veto right over such decisions. Subsections II.A.1 and II.A.2 explore this tradeoff below and discuss the consequences of giving either party control rights.

1. Controllers

To understand the effect of granting either controllers or minority shareholders the right to determine midstream reallocations of control rights, consider the Google recapitalizations from dual to triple class whereby it will issue non-voting stock for the express purpose of allowing the company to raise additional capital without (a) forcing the controllers to tie up more of their wealth in the company by holding stock, or (b) diluting the controllers' voting power.[119] Google justified this reallocation of control rights on the basis that it would allow the controllers to continue to pursue their idiosyncratic vision while the company expands and issues equity.[120] Over time, Google explained, circumstances or business strategy changed to an extent that requires an adjustment to the original allocation of control rights. Indeed, Google's very success and fast growth may be the kinds of changing circumstances that demand a reallocation of control rights. Should the company's proposal thus be accepted?

The reallocation of control rights is desirable only if the expected benefit—the future increase in company value—from preserving the controllers' ability to pursue its idiosyncratic vision exceeds the likely increase in agency costs that could arise from allowing the controllers to preserve control with a lower fraction of the company's equity.[121] In other words, if the parties

[118] See infra note 126 and accompanying text.

[119] See supra notes 88--100 and accompanying text.

[120] See infra section II.B.1.

[121] For helpful background on this view, see Lucian Arye Bebchuk et al, Stock Pyramids, Cross-Ownership, and Dual-class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights, *in* Concentrated Corporate Ownership 295, 301-05 (Randall K. Morck ed., 2000). See also In re Ezcorp Inc.

choose to provide the controllers with the power to unilaterally reallocate control rights, the minority shareholders might benefit from the controllers' ability to keep pursuing idiosyncratic vision, but that benefit comes at the cost of exposing minority shareholders to the high risk of agency costs. Clearly, it only makes sense to give the controllers the power to unilaterally reallocate control rights if the benefit, as judged by the parties ex ante, exceeds the cost.

Similarly, the agency costs that arise when the controller has the power to unilaterally reallocate control rights are no different from any other case of self-dealing:[122] Even if a reallocation would not be in the best interest of the company, the controller might pursue the recapitalization anyway and reallocate control rights from the minority shareholders to herself. In other words, the controller might be motivated by a desire to entrench herself while getting more liquidity rather than by a genuine concern about her ability to pursue idiosyncratic vision. This is the essence of the agency costs risk.

2. Minority Shareholders

Consider the alternative scenario: what if the minority shareholders are given the power to decide about the reallocation of control rights? Recall that the reallocation is desirable if, and only if, the expected benefit from allowing the controller to pursue its idiosyncratic vision exceeds the likely increase in agency costs. Given this objective, empowering minority shareholders to veto a proposed recapitalization raises several issues.

First, there is a clear tension between the fundamental justification for giving controllers more control and the requirement that minority shareholders approve such reallocation of control rights. Leaving control with the company's founder is valuable solely because it allows her to execute her idiosyncratic vision about the company's future direction in the face of disagreement from other investors. Further, because by its nature, idiosyncratic vision is subjective and prone to differences of opinion between the controller and the minority shareholders, persuading minority shareholders about the value of the founders' idiosyncratic vision is challenging. Thus, "[t]he risk

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Consulting Agreement Derivative Litigation, 2016 WL 301245 (Del. Ch.) at * 3 ("As control rights diverge from equity ownership, the controller has heightened incentives to engage in related-party transactions and cause the corporation to make other forms of non-pro rata transfers.").

[122] See generally Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, 3 J. Fin. Econ. 305 (1976) (broadly analyzing agency costs within a firm).

of investors disrupting the entrepreneur's pursuit of her idiosyncratic vision exists even when the firm is publicly traded and investors are using stock prices as a proxy for the firm's performance."[123]

As a result, requiring minority shareholders' approval can be inconsistent with the controller's justification for reallocating control rights. The controller offers no "payment" for the reallocation, but instead offers a non-enforceable, non-quantifiable promise that leaving control in her hands would lead to better firm performance in the future.[124] Minority shareholders must decide whether they believe that the founder's idiosyncratic vision is indeed so valuable as to justify the increased risk of agency costs. The fact that the value of the controller's idiosyncratic vision, by its very definition, may not be fully appreciated by the minority shareholders means that value-increasing reallocations of control rights may be blocked.[125]

Second, as already mentioned, this bargaining would take place under conditions of a *bilateral monopoly*.[126] That is, there is no readily available replacement to the controlling shareholder who is seeking extra power in order to influence the direction of the company; the minority shareholders cannot force out the controller and replace her with another. The inherently subjective nature of idiosyncratic vision combined with the dynamic of a bilateral monopoly increases the risk of a negotiation breakdown.

[123] See Goshen & Hamdani, Idiosyncratic Vision, supra note 29, at 580.

[124] Id. at 579 ("The entrepreneur's idiosyncratic vision will often include elements that outsiders, including the firm's minority shareholders, cannot observe or verify. This could be because sharing the information with outsiders would destroy its value (e.g., competitors could copy the idea) or simply because the entrepreneur can present outsiders with nothing more than her strong conviction concerning the value of her idea.").

[125] The fact that the company is already public—that investors had the opportunity to evaluate the founder's performance—does not mean that investors surely know whether the founder's idiosyncratic vision is sufficiently valuable. See infra section II.B.2. Another reason why value-enhancing reallocations may be blocked is that they affect not only the value of the company, but also the allocation of such value between the controller and the minority shareholders. That is, during the bargaining process, both controllers and minority shareholders will be thinking not only about how to maximize the company's value, but also about the division of value between the parties. Where the minority shareholders have veto power, it is therefore important for them to accurately assess the value of control rights for the founder, or else they will not be able to extract a distributional benefit in the bargaining process. However, unlike in the merger context, where the synergies of a combination can be easily derived, in reallocation of control rights, the controller's reservation price—the highest price she is willing to pay to retain control—is less likely to be known to minority shareholders. The value of control may even be so great to the controller that she refrains from value-enhancing transactions that put her control at risk.

[126] The term "bilateral monopoly" as used here refers to a situation "in which two parties must deal with each other." John Cirace, A Synthesis of Law and Economics, 44 Sw. L.J. 1139, 1149 (1990); Herbert Hovenkamp, Rationality in Law & Economics, 60 Geo. Wash. L. Rev. 293, 298 (1992) ("the relationship between a husband and a wife, or between the two parties to an already executed contract, is a bilateral monopoly.").

To make concrete why the dynamic might lead to a negotiation breakdown, consider again the case of Google, but now assume that the proposed recapitalization requires the support of the Class A shareholders. When negotiating with the controlling shareholder, the Class A shareholders will consider the expected benefit (the impact on the company in terms of the controller's idiosyncratic vision) and the expected costs (agency costs associated with the controller's potential for abuse and the loss stemming from the decreased probability of Class A shareholders gaining control over the company). Although it is hard to predict the result of the vote, ultimately a shareholder vote will aggregate the differing views of the Class A shareholders into a "yes" or a "no" answer to the proposed reallocation. Assume that the Class A shareholders voted "no" and that the controlling shareholders do genuinely believe that their idiosyncratic vision could substantially increase the value of the company. What can the controllers do? They have limited options in such a scenario: They can either give up on the idiosyncratic vision by stopping the company from raising capital for expanding, allow the company to expand and risk losing their ability to implement their vision or, if they can raise the resources, resort to alternative transactions such as a freezeout.[127]

Taken together, the concerns raised by giving minority shareholders a veto on the reallocation of control rights suggest that while empowering minority shareholders will protect them from the risk of agency costs, it will also increase the risk of frustrating the controller's pursuit of idiosyncratic vision.[128] Therefore, the parties must choose between two imperfect regimes: Allow the controller to unilaterally reallocate control rights, thereby protecting the pursuit of idiosyncratic vision while risking high exposure to agency costs; or provide minority shareholders with a veto right, thereby protecting against agency costs, but potentially sacrificing idiosyncratic vision. This tradeoff is inherent in the allocation of control rights, and it requires the parties to estimate which risk is more costly—exposure to agency costs or loss of idiosyncratic

[127] This predicament *ex post* explains why controllers may be unwilling, *ex ante*, to give minority shareholders veto power over the reallocation of control rights.

[128] The claim here is not that minority shareholders will *always* reject the controller's proposal to reallocate control right. *See* for example Anita Anand, Governance in Dual-class Share Firms, *supra* note 65, at 22-24 (describing a case in Canada where minority shareholders voted to allow the controller of Fairfax, a dual-class company, to get more control rights subject to certain limitations). Rather, we argue that there is no assurance that such a vote would lead to value-enhancing reallocations.

vision.[129] Given that the answer to this question is firm-specific and individual-specific, the parties will have to make their choice *ex ante* based on their relative bargaining position and accept whatever *ex post* consequences result from that choice.

B. The Impossibility of Valuing Control Rights

Section II.A has shown that the parties face an inevitable tension between agency costs and idiosyncratic vision. This analysis raises the question: Can a third-party mechanism, such as judicial review, assist the parties in reaching a better midstream allocation of control rights? This Article argues that due to the impossibility of developing methods for valuing control rights, judicial review will be ineffective. Section II.B.1 demonstrates that there is no acceptable economic method for valuing control rights, and that economists are unlikely to develop such a method because these rights are both *firm-specific* and *individual-specific.* Section II.B.2 explains the difference between valuation and *valuation models*, and in so doing, shows why average market premiums or the market's reaction to a proposed reallocation of control rights cannot serve as substitutes for valuation models.

1. Lack of Methodology to Value Control Rights

Financial economics does not provide a methodology for valuing different allocations of control rights over a corporation. We are aware of no method—least of all one commonly accepted within the financial community—for determining the objective value of granting control over corporation A to individual B (as opposed to individual C).[130] The lack of acceptable methods for valuing different allocations of control rights is not a matter of sheer coincidence. Rather, this Article contends that financial economists cannot devise a workable methodology for valuing allocations of control rights because the value of such allocations depends on *firm-specific and individual-specific* attributes.

[129] Moreover, entrepreneurs and investors might attach different values to these risks. *See* Goshen & Hamdani, Idiosyncratic Vision, supra note 29, at 586 ("[A]gency costs and idiosyncratic vision are not necessarily valued symmetrically. Thus, the entrepreneur might proportionally value control rights much more than the increase in price that the investors will demand due to their increased exposure to agency costs.").

[130] See supra note 27.

A key feature of common methodologies for valuing cash flow rights is their ability to value assets independently of the individuals that control these assets. The methods for valuing companies, for example, abstract away from the person or entity that controls or manages these companies. A firm's future cash-flows are capable of derivation from readily available objective values,[131] *e.g.*, a firm's exposure to systematic risk, debt-to-equity ratios, expected revenue, and other financial metrics which are not inherently tied to particular officers of the firm. This abstraction from individual-specific and firm-specific factors is critical for turning these methodologies into objective measures of value that can be generalized and applied across different companies.[132]

However, the abstraction that is so critical for modeling cash-flow rights' valuation cannot work in the context of control rights. The goal of valuing the reallocation of control rights is to determine the value of a *specific* company under the control of a *specific* individual. In other words, the decision at issue in conflicts over reallocation of control rights is not between controlled ownership and dispersed ownership, but rather between giving more, or less, control rights to Controller A, as opposed to Controller B. Thus, any methodology for valuing allocations of control rights would have to determine the value of a specific entrepreneur's idiosyncratic vision for a specific company, and the potential loss from agency costs associated with granting more control to that individual, who might abuse her control.

To demonstrate the central point here, consider the valuation challenges associated with the Google and Facebook recapitalizations. Recall that these recapitalizations reallocated control rights by making it easier for the founders to preserve their voting majority while the companies continued to raise equity capital. In both cases, the companies' principal justification for the recapitalization focused not on the price that the founders paid for the reallocation of control rights, but on the benefit that the new control structure allegedly would produce for the company and its investors. Google argued that the recapitalization would allow its founders to continue steering the

[131] See, e.g., Jay W. Eisenhofer & John L. Reed, Valuation Litigation, 22 Del. J. Corp. L. 37, 113 (1997) (describing DCF methodology and its use in calculating cash flows); Tom Copeland et al., McKinsey & Company, Inc., Valuation: Measuring and Managing the Value of Companies 424 (3d ed. 2000).

[132] To be sure, some methodologies require several firm-specific inputs: The DCF method for valuing companies, for example, often relies on management projections about the company's future revenues, and these projections might reflect the past performance of those in control of the corporation. Yet, these methodologies do not purport to measure the likely *contribution* of specific individuals to company value.

company without "becoming vulnerable to short-term pressures,"[133] and Facebook emphasized the vision of the company's founder and the need to maintain a "long-term" focus.[134] Operating in the background for these companies was an additional concern that the risk of losing control would discourage their controllers from funding growth by raising capital or making acquisitions. Taken together, both companies claimed that the recapitalizations would increase their value.[135]

Given these justifications, the valuation would have to determine the recapitalizations' effect on the corporation—that is, the effect that facilitating the founders' control over Facebook and Google would have on company value. As explained above, incontestable control allows founders to pursue their idiosyncratic vision for the company's future even against investors' objections.[136] At the same time, incontestable control increases the risk of agency costs—the risk that controllers will use their dominant position to advance their own interests at the expense of the company or its minority shareholders. Thus, any method for valuing control rights will have to objectively evaluate individual-specific traits that are difficult to observe—the controller's idiosyncratic vision, her competence to execute it, and her loyalty—within a firm-specific context.

The valuation of an idiosyncratic vision is on its own particularly difficult, as idiosyncratic vision is, by its very nature, a subjective view for improvement of the firm that may run *counter* to market consensus. This inquiry is forward-looking and inherently individual-specific. For instance, the goal of the inquiry would be to determine the value of having *Mark Zuckerberg's* idiosyncratic vision, and not that of any other entrepreneur, implemented at *a specific company*,

[133] Opening Pre-trial Brief of Defendants Larry Page and Sergey Brin at 4--10, In re Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 2728591 (Del. Ch. June 10, 2013) ("By holding their shares longer than other pre-IPO holders, the Founders now have the ability, if they vote together, to elect directors who support Google's long-term focus and unique mission."); see also Letter from Larry Page & Sergey Brin, Google founders, to shareholders (Apr., 2012), https://abc.xyz/investor/founders-letters/2012/ ("We have always tried to concentrate on the long term, and to place bets on technology we believe will have a significant impact over time. It's hard to imagine now, but when we started Google most people thought search was a solved problem and that there was no money to be made apart from some banner advertising. We felt the exact opposite . . .").

[134] Facebook Apr. 2016 Proxy Statement, https://www.sec.gov/Archives/edgar/data/1326801/000132680116000053/facebook2016prelimproxysta.htm ("The Special Committee and our board of directors believe that a significant portion of the success realized by us has been attributable to Mr. Zuckerberg's leadership, creative vision, and management abilities. The Special Committee and our board of directors also believe that Mr. Zuckerberg's continued leadership role in our company will provide substantial benefits to us and to our stockholders.").

[135] Note that in Facebook's case, the company also claimed that Zuckerberg agreed to new restrictions on his control shares. This Article does not address that point.

[136] Goshen & Hamdani, Idiosyncratic Vision, supra note 29, at 590.

Facebook (and not any other company). Any model would therefore need to grapple with a particular individual's contribution to a particular firm.

The valuation of agency costs also poses challenges. The methodology would have to assign a value to the effect that *increased* control has on *Zuckerberg's* agency costs—his likelihood of abusing control to expropriate investors—and the likely impact of these agency costs on *Facebook's* value.[137] And there is yet another type of agency cost to evaluate: Recall that one of the concerns underlying the recapitalizations is that, unless companies make it easier for founders to preserve their control, the companies might not raise more equity capital, thereby missing out on opportunities for growth. A valuation would therefore have to assess both the value of these growth opportunities and whether the recapitalization is necessary for the company to pursue them. The extent to which a controller will abuse her control, with or without the recapitalization, will depend on a myriad of specific characteristics, including the controller's identity and personality, her liquidity position, the company's industry, and so on.

Further, and even more difficult for accurate valuation, the model would need to make forward-looking predictions. After all, Zuckerberg may well be able to successfully execute his idiosyncratic vision *today*. However, a reallocation of control rights will have implications for Facebook down the line, so any valuation model will have to consider Zuckerberg's loyalty and competence *then* as well as now. It is hard enough to evaluate human behavior and determine an individual's values and incentives on the basis of *today's* knowledge; it is even harder to predict human behavior in the future.

Valuation techniques are simply not equipped to consider all of these individual-specific and firm-specific factors that are crucial for valuing control rights and yet very difficult to observe. Once one abstracts away from the firm-specific and individual-specific features, there is no meaningful metric left. In other words, the goal of valuing the reallocation of control rights is to assign value to the *expected* idiosyncratic vision and *expected* agency costs of a *specific* individual in the context of a *specific* company. Abstracting away from individual-specific and firm-specific

[137] The Google plaintiffs' pre-trial brief seems to have recognized the difficulties of this valuation, framing this valuation difficulty as a reason for courts to prevent any dual-to-triple class recapitalizations. *See* Plaintiffs' Opening Pre-trial Brief, In re Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 2728583 (Del. Ch. Jun. 10, 2013) ("[A controller] cannot take advantage of a run of success, even a long run of success, to change a company's corporate governance to give him permanent voting control. If this was permissible, then every controlled company would be claim "success" and institute such changes. This Court would then be stuck with the invidious task of deciding how much "success" was enough to justify entrenching management.")

features—the basic aspect that typically enables economists to perform valuation of cash flow rights—would contradict the *precise* goal of the valuation and render it meaningless in the context of reallocation of control rights. Thus, there is no, nor can there ever be, an economic methodology for determining firm value under different allocations of control rights.

2. Valuations and Valuation-Models

Section II.B.1 has argued that it is inherently impossible to create valuation models for the reallocation of control rights. This claim, however, does not imply that control rights do not have value or that investors or other market actors do not value them. Indeed, investors routinely engage in valuing control rights, because these rights affect idiosyncratic vision and agency costs, and hence firm value. But the fact that investors value control rights does not mean that there is an objective valuation method that a competent court could use while adjudicating a conflict over the reallocation of control rights. To see why, the below focuses on two methods by which control might be valued. The first subsection discusses empirical studies that measure the average premium paid for control across *other* firms. The second subsection discusses the market's reaction to a *specific* company's reallocation of control.

Empirical Average Values of Control. Empirical studies of control *measure*, using different methods, the value that the market has assigned to control rights.[138] In particular, studies have calculated the *average premium* paid in complete acquisitions of a firm in different industries,[139] the *average premium* paid for a control block in different countries,[140] and the *average premium* for the superior shares of dual-class firms in different countries.[141]

[138] *See, e.g.,* Avner Kalay, OgˇUzhan Karakas, & Shagun Pant, The Market Value Of Corporate Votes: Theory And Evidence From Option Prices, 69 J. Fin., 1235 (2014) (using option prices to estimate the market value of the shareholder voting rights associated with a stock).

[139] Gregg A. Jarrell, James A. Brickley and Jeffry M. Netter, The Market For Corporate Control: The Empirical Evidence Since 1980, 2 J. Econ. Persp. 49 (1988).

[140] Michael J. Barclay & Clifford G. Holderness, 1989, Private Benefits From Control Of Public Corporations, 25 J. Fin. Econ. 371 (1989); Alexander Dyck & Luigi Zingales, Private Benefits Of Control: An International Comparison, 59 J. Fin. 537 (2004).

[141] Rydqvist, Kristian, Takeover Bids And The Relative Prices Of Shares That Differ In Their Voting Rights, 20 J. Banking and Fin., 1407 (1996); Luigi Zingales, What Determines The Value Of Corporate Votes? 110 Quar. J. Econ. 1047 (1995).

As an illustration, assume that a firm is auctioned for sale.[142] To determine what purchase price to offer, each potential bidder will estimate the improvements that can be made to the firm (such as reducing the cost of capital, cutting operational costs, or improving sales), the synergies that can be attained with the bidder's own business (such as costs savings due to economies of scale or scope), and any idiosyncratic vision the bidder might have. While it is possible to objectively estimate the potential improvements[143] and synergies,[144] it is impossible to estimate the bidder's idiosyncratic vision, for the reasons discussed above. Nevertheless, each bidder assesses the value of her idiosyncratic vision and reflects any such value in its bid for the company. If there is more than one bid, the average control premium offered for the firm can be calculated. Similarly, with a sample of several acquisitions, one can calculate the average control premium in an industry.[145]

Likewise, the average premium paid for control blocks reflects the fact that when a controlling shareholder is selling its control block, potential bidders will offer a premium for the same reasons as above, but may additionally do so for one other reason: Some bidders might include the private benefits of control they intend to gain from expropriating the minority in their offered bid price.[146] Again, if there is more than one bidder, an average premium can be calculated, and given different transactions in control blocks, an average premium in a specific country can be calculated.[147]

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[142] We assume that incumbent management would leave the business. Thus, whatever idiosyncratic vision they have is no longer relevant.

[143] See generally Aswath Damodaran, The Value of Control: Implications for Control Premiums, Minority Discounts and Voting Share Differentials, 8 N.Y.U. J. L. & Bus. 487 (2012) [hereinafter Damodaran, The Value of Control] (proposing a methodology to measure such premiums).

[144] Aswath Damodaran, The Value of Synergy (2005), Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=841486 (considering the various sources of synergy and categorizing them into operating and financial synergies).

[145] See, for example, George Alexandridis et. al., Deal Size, Acquisition Premia and Shareholder Gains, 20 J. Corp. Fin. 1 (2013) (a study of control premiums in a sample consisting of acquisitions of 3,691 U.S. firms).

[146] U.S. law allows controllers to sell their shares for a premium. See John C. Coffee, Jr., Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?, 21 Del. J. Corp. L. 359, 360 (1996); Ronald J. Gilson & Jeffrey N. Gordon, Controlling Controlling Shareholders, 152 U. Pa. L. Rev. 785 (2003).

[147] Alexander Dyck & Louigi Zingales, Private Benefits of Control: An International Comparison, 59 J. Fin. 537, 590 (2004); see also Michael J. Barclay & Clifford G. Holderness, Private Benefits from Control of Public Corporations, 25 J. Fin. Econ. 371 (1989) (arguing that premiums on block trades reflect the value of control).

Lastly, empirical studies also calculate the premium at which the superior-voting-class shares trade when a corporation has tradeable dual-class shares.[148] This premium reflects investors' estimates of the potential control premium they might receive or the potential cost they might suffer due to agency costs.

Despite the existence of empirical studies measuring the value of premiums paid in each of the above cases, to date, no empirical study has offered an objective method to evaluate control by a specific individual of a specific company. The fact that investors value control and buyers of control are willing to pay a control premium does not imply that there is an acceptable method for valuing different allocations of control rights over a specific company.

More specifically, the fact that empirical studies can calculate the average value of control in some markets cannot serve as a substitute for a methodology that measures the effect of providing a specific individual with more control over a specific company. In a midstream reallocation of control rights, the value of the firm will increase if a competent and loyal controller will succeed in attaining idiosyncratic vision. But the value might decrease if an incompetent and disloyal controller simply pursues agency costs, or a loyal and competent controller is simply wrong about the value of idiosyncratic vision or about her ability to attain it.

Relying upon a calculation of the average premium paid for control provides no help in this situation, because by its very definition, the average value of control in a given market will reflect every breed of controller—the competent and loyal, the successful and unsuccessful, as well as the incompetent and disloyal. However, in a midstream reallocation of control rights the specific controller is arguing that *she* is loyal and that implementing *her* idiosyncratic vision would produce above-market returns, that is, she is arguing she is above the average. Thus, an average, as such, cannot help a court when adjudicating such claims.[149]

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[148] Stephen R. Cox & Diane M. Roden, The Source of Value of Voting Rights and Related Dividend Promises, 8 J. of Corp. Fin. 337 (2002) (analyzing the relationship between different classes of stock and their corresponding prices); Renée Adams & Daniel Ferreira, One Share, One Vote: The Empirical Evidence, 12 Rev. Fin. 51, 77-79 (2008) (reviewing the empirical studies on differences in market value between high-vote and low-vote shares); Tatiana Nenova, The Value of Corporate Voting Rights and Control: A Cross-Country Analysis, 68 J. Fin. Econ. 325, 344-45 (2003) (studying the difference in price between high-vote and low-vote shares in 18 countries).

[149] The average could be useful in other contexts in which the idiosyncratic vision of the manager is not at play. For instance, when claiming a negligent sale process of a firm (Revlon breach), the average premium that could be attained in the industry could serve a useful measure for damages.

Market Reaction to Reallocations of Control Rights. In a publicly traded company, any reallocation—or expected reallocation—of control rights will be priced by the market. Indeed, when Google announced its recapitalization, the market price of its publicly traded Class A shares dropped, suggesting that the market viewed the specific decision to reallocate control rights to Brin and Page as unfavorable to Class A shares.[150] In the face of that market reaction, it is tempting to argue that changes in companies' stock prices should serve as an objective measure of the value of the reallocated control rights. While the controller's claim that they do have idiosyncratic vision can be challenged on the grounds of bias, the market reaction is arguably unbiased (after all, investors were willing to accept a lower price for their shares and exited).

However, the market reaction to the announcement about expected reallocation of control rights cannot serve as an "objective" valuation methodology.[151] This follows from the fact that underlying the concept of idiosyncratic vision is a fundamental disagreement with the market. This disagreement is not necessarily about *conflict* (whether the controller is disloyal and thus lying about the need to get more control rights to pursue idiosyncratic vision), but can also be about *competence* (whether the controller is right about the value of her idiosyncratic vision and her ability to attain it). Despite the market's disagreement a (loyal) controller seeks to retain control in order to execute her idiosyncratic vision, because the controller believes her idiosyncratic vision will increase the value of the company. But by its very nature, the idiosyncratic vision may not be accurately priced by the market. Indeed, as we explained earlier,[152] this concern is an important reason for controllers' unwillingness to provide the market—minority shareholders—with the power to veto reallocation of control rights. To subject the reallocation of control rights to a valuation based on the market's reaction to a proposed recapitalization would be to restate the fact that the shareholders and the controller do not share the same opinion of the controller's vision. Using market prices as the methodology for valuing reallocations of control rights would therefore be inconsistent with the fundamental justification for allocating control rights to founders. Indeed, using the market reaction would be tantamount to courts routinely accepting the valuation claim of one side to the litigation.

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[150] *See infra* note 153.

[151] Others have explained, in other contexts, why market prices should not be used for valuation purposes. See, for example, Albert H. Choi & Eric Talley, Appraising the "Merger Price" Appraisal Rule, 34 J. L. Econ. & Org. 543 (2018).

[152] *See* Section II.A.2., *supra*.

Moreover, according to the controller, shareholders that sold their shares did so based on an improper understanding of her idiosyncratic vision. To illustrate this point, first note that from the announcement of the recapitalization on April 12, 2012 to April 13, 2012 the Google share price dropped roughly 4.1% while the Nasdaq composite dropped only about 1.4%, suggesting a "damage" of 2.7% to the value of Google.[153] However, fast-forwarding five years, the shareholders who held, or bought, the shares seem to have won out: While the Nasdaq composite rose 119.24%, Google shares rose 213.97%, beating the index by 94.73%.[154] These facts are malleable and can be used by both parties in litigation regarding a midstream reallocation of control rights. While the controllers will argue that without the recapitalization Google would not have beaten the market, the opposing minority shareholders will argue that Google would have outperformed the market by an even greater percentage of 97.43% (94.73% + 2.7%), had they not reallocated control rights.[155] Thus, although the selling shareholders choose to exit, their view about the value of the reallocation of control rights cannot be determinative because they might be wrong. The possibility of error seems especially troubling in litigation that takes place immediately following the announcement of a recapitalization, before the effect of the recapitalization has been seen. Thus, while controllers may not always be right about the value of their idiosyncratic vision, the market reaction to reallocation of control rights might also be wrong, and in any case, it is far from objective.

Finally, using the market's reaction to measure the value of control is problematic because market reaction reflects investors' assessment of the likely impact of the new allocation of control not only on company value, but also on minority investors' expectation of gaining a portion of the control premium. To illustrate these two components of market reaction, consider again the case of Google. When the recapitalization was announced, Google's share price dropped, reflecting at least some investors' *valuation* that reallocation of control rights to Brin and Page would not

[153] Alphabet Inc. (GOOG): Chart, YAHOO! FINANCE, https://finance.yahoo.com/quote/GOOG/chart?p=GOOG (start: Apr. 12, 2012; end: Apr. 13, 2012); NASDAQ Composite (^IXIC): Chart, YAHOO! FINANCE, https://finance.yahoo.com/quote/%5EIXIC/chart?p=%5EIXIC (start: Apr. 12, 2012; end: Apr. 13, 2012)..

[154] Alphabet Inc. (GOOG): Chart, YAHOO! FINANCE, https://finance.yahoo.com/quote/GOOG/chart?p=GOOG (start: Apr. 12, 2012; end: Apr. 12, 2017); NASDAQ Composite (^IXIC): Chart, YAHOO! FINANCE, https://finance.yahoo.com/quote/%5EIXIC/chart?p=%5EIXIC (start: Apr. 12, 2012; end: Apr. 12, 2017).

[155] Practically, it is hard to believe that the selling shareholders estimated that Google would beat the market by 97.43%, and thus sold because 2.7% would be deducted from their expected return after the recapitalization. Where could they realistically invest their money instead and beat the market by more than 94%?!

maximize value for Google's class A shareholders. However, it is not at all clear why the price dropped. Some shareholders did not trade, while some sold and others bought. Were the shareholders who sold for a lower price willing to do so because they feared higher agency costs or did the price drop to reflect the lower likelihood that the market could eventually gain control and with that the accompanying premium? For a method that will measure the effect of different allocations of control rights on the value of Google, a price drop due to fears of increased agency costs is relevant, but a drop reflecting the loss of control expectations is not. After all, corporate law recognizes the controllers' entitlement to avoid actions that will lead to their loss of control.[156]

Ultimately, as is explained in more detail below, the lack of an acceptable methodology for valuing control rights means that judicial review cannot assist controllers and minority shareholders in making better decisions, *ex post*, about the reallocation of control rights. Thus, the parties remain with the dichotomous choice between giving the controller or the minority shareholders the power to decide on midstream reallocations of control rights.

III. Resolving Control Conflicts

The unique features of the reallocation of control rights—a dichotomous choice made in a setting where a bilateral monopoly is present and the absence of acceptable methods for valuation—has implications for how Delaware should resolve disputes over the allocation of these rights.[157] This Part argues that the only appropriate response by the Delaware courts when addressing reallocations of control rights in controlled companies is to treat the issue as a question of charter interpretation as to who has the decision-making power, rather than as a question of self-dealing.[158]

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[156] See Goshen and Hamdani, supra note 29, at 602 ("As courts in Delaware have long recognized, controllers cannot be forced to sell their control blocks even when doing so would clearly benefit the corporation or its minority shareholders.").

[157] This observation does not at all detract from the expertise and operational acumen of the Delaware forum. The Delaware courts have historically demonstrated an ability to provide swift and expert analysis of complex corporate litigation. See, e.g., John C. Coffee, Jr., Foreword: The Delaware Court of Chancery: Change, Continuity, and Competition, 2012 Colum. Bus. L. Rev. 387, 387–88 (2012) ("Academics and practitioners alike have been impressed by both the depth and thoughtfulness of the court of chancery's decisions and the hardworking style of its vice chancellors . . . who regularly seem able to turn out lengthy decisions in days that would take many federal circuit courts months and even years to complete.").

[158] The approach of this Article might require courts to focus more closely on the default rule for mid-stream reallocations of control. "Default rule," here refers to a "rule[] that parties can contract around by prior agreement," in this case, the agreement being the corporate charter. Robert Gertner & Ian Ayres, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 Yale L.J. 87 (1989).

This Part begins by considering the application of Delaware's entire fairness standard—the regime that applies to self-dealing—to reallocations of control rights. Section III.A uses the example of the dual-to-triple-class recapitalization of the kind proposed by Google and Facebook to show that the entire fairness standard, in any form, should not apply to conflicts over reallocation of control rights. The section then argues that any intermediate form of judicial review is also unlikely to be desirable. Section III.B explains that Delaware courts should regulate reallocations of control rights by deferring to the arrangement settled upon in the charter. Where the charter does not offer an answer, Delaware courts should apply the business judgment rule to midstream reallocations of control rights.

A. The Limits of Judicial Review

This section argues that Delaware courts' approach for adjudicating conflicts between controlling and minority shareholders is dependent on the financial community to develop valuation methodologies. Since no methodologies exist for valuing reallocation of control rights, Delaware's existing approaches—the entire fairness review (III.A.1), voluntary *MFW* conditions (III.A.2), and intermediate scrutiny (III.A.3)—should not apply to the reallocation of control rights.

1. Entire Fairness Review

As we explained above,[159] Delaware's regime governing self-dealing—entire fairness review—critically relies on courts' competence to value cash-flow rights and determine their "fair price."[160] Under the entire fairness standard, controlling shareholders can engage in self-dealing transactions without securing the approval of independent directors or minority shareholders, as long as the transaction is subject to a judicial determination of its fairness.[161] Judicial review of a transaction's fairness has worked well in the context cash-flow rights conflicts, as economic theory has long developed methodologies—on which Delaware courts rely—for valuing companies and other assets.

[159] See supra section I.A.1.

[160] Weinberger v. UOP, 457 A.2d 701, 711 (Del. 1983) ("The concept of fairness has two basic aspects: fair dealing and fair price.").

[161] Id.; see also supra section I.A.1.

Subjecting midstream reallocations of control rights to entire fairness review would require the court to assess the fairness of the new allocation of control rights. However, as section II.B explained, there are no acceptable methods on which courts can rely for valuing control rights. Moreover, attempting to develop such methods is an inherently futile task because of the subjective nature of control rights. Without valuation models to guide courts, entire fairness review would be quite speculative: Courts will have no reliable methodology for identifying value-enhancing reallocations of control rights, and the outcome of judicial review will be unpredictable.[162]

Parties will not wish to rely on speculative and unpredictable judicial review as it might fail to protect investors from agency costs and deter controllers with idiosyncratic vision from attempting to reallocate control rights.[163] Under the entire fairness standard, even controllers with extremely valuable idiosyncratic visions would be subject to costly litigation.[164] Moreover, the

[162] Cf. Geeyoung Min, Geeyoung, Governance by Dividends (September 13, 2018). Available at SSRN: https://ssrn.com/abstract=3237752 or http://dx.doi.org/10.2139/ssrn.3237752 (arguing that dividend distributions that reallocate control rights should be subject either to enhanced scrutiny or to entire fairness review).

[163] To see why, assume there are 100 controlled firms in the market, each with a controller who owns 15% of the equity. Of these 100, assume that 25 will wish to reallocate control rights, and assume further that while in five of these firms the controllers have idiosyncratic vision, in twenty of them controllers would merely exploit the private benefits of control. If one of the 20 firms reallocates control rights, the controller will inflict damage due to agency costs, ranging from $2 and $30 in consumption of private benefits of control, with an average of $20. If one of the 5 firms with the truly exceptional controllers reallocates control rights it will add $100 in firm value, out of which $15 dollars will accrue to the controller because of her equity. To understand the deterrent effect of unpredictable valuations, assume a controller needs to first go through with an irreversible reallocation of control rights and thereafter, using an unpredictable valuation method, the court submits the bill, which requires the controller to pay damages if the allocation is found to be unfair. Given that 20 out of 25 firms will have agency costs, in each litigation, there is an 80% probability that the court will find the allocation to have been unfair. Thus, in 20% of the cases the court will believe that the controller has idiosyncratic vision and the bill will be zero, while in 80% of the cases the bill will be positive, and will randomly range from $2 to $30, though still maintaining an average of, $20, over many cases. How would that affect the behavior of controllers? The worst controllers, those who inflict $30 in damage, will go through with the reallocation. The "worst" that can happen to them is that the court submits the correct bill of $30 and they break even. Any lower bill will represent a windfall and this windfall will arrive with a high probability (20% probability to keep the $30 and 80% probability to pay back $30 or less). Controllers with idiosyncratic vision will be deterred, even if they are not risk averse. If the court recognizes their idiosyncratic vision (20% probability), the bill will be zero and they can increase value and collect their share of the gain, $15. If the court is mistaken (80% probability), then they might receive a bill with an average value of $20. For the controller with idiosyncratic vision the expected value of the reallocation is negative (20% x $15 – 80% x $20 = -$13). Once all the 5 firms are deterred, and all the controllers within the 20 firms that might consume less than $20 in private benefits are also deterred, the court will adjust the average upward until even the worst controllers are deterred. This "equilibrium" of entire fairness valuations will practically evolve into a flat prohibition of reallocation of control rights. This result will damage diversified shareholders and the market. The prohibition blocks 20 firms from inflicting a total damage of $400 at the price of losing $500 increase in value of the 5 firms with idiosyncratic vision.

The situation is not going to improve if, as it might be the case in reality, controllers can reverse course and cancel the reallocation after the court declines to find idiosyncratic vision and issues an injunction. See infra note 195.

[164] See In re MFW Shareholders Litig., 67 A.3d 496, 534 (Del. Ch. 2013), aff'd sub nom. Kahn v. M & F Worldwide Corp., 88 A.3d 635 (Del. 2014) ("[A]bsent the ability of defendants to bring an effective motion to dismiss, every case has settlement value, not for merits reasons, but because the cost of paying an attorneys' fee to settle

deterrence effect on the controllers with idiosyncratic vision might be particularly acute given the likelihood that courts will tend to underestimate the value of their idiosyncratic vision. As courts know, all controllers have an incentive to claim that they have an extremely valuable idiosyncratic vision, but many of them will be objectively wrong about the value of their idiosyncratic vision and their ability to attain it, and some of them will simply be lying when they make the initial claim. These realities might bias courts against finding idiosyncratic vision.

Moreover, loyal controllers with a genuine belief in the value of their idiosyncratic vision may expect to benefit from a reallocation mostly through their pro-rata share of any positive effect such reallocation will have on firm value. Courts, however, might insist on having the controller—and not the company—bear the cost if the reallocation is found to be unfair.[165] Thus, entire fairness litigation might place the competent and loyal controller at an inherent disadvantage.[166]

Ultimately, the possibility that courts will be unsympathetic to a controlling shareholder's claim of idiosyncratic vision will have a deterrent effect which will transform the entire fairness standard into a de facto requirement to receive majority-of-minority support to avoid the uncertainty of the valuation. With the odds stacked against them in this way, a controlling shareholder is left with no real other choice than to seek *MFW* protection. In other words, although the controller is formally allowed to unilaterally reallocate control rights, practically, due to the lack of objective valuation methods, minority shareholders will always be given a veto right because a sensible controlling shareholder will make a reallocation of control contingent on their approval.

Indeed, the parties cannot rely on judicial review to ameliorate the inherent tension they face, and must therefore themselves choose between the risk of high agency costs and that of losing idiosyncratic vision. An inherently speculative and unpredictable judicial valuation is unlikely to reduce either the risk of agency costs or that of losing idiosyncratic vision. To the contrary, it will add litigation costs and an additional risk of judicial mistakes. Thus, courts' inability to value

litigation and obtain a release … exceeds the cost in terms of dollars and time consumed of going through the discovery process under a standard of review in which a substantive review of financial fairness is supposedly inescapable.")

[165] During the Google settlement hearing, the court has repeatedly criticized the failure to have the founders personally share the settlement costs. For example, see Settlement Hearing and Rulings of the Court, In re Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 6735045, at *27 ("So what you're telling me here in terms of the settlement is that the founders who wish to retain voting control but not by continuing to purchase shares with an economic interest and preserving that voting control that way, they're not taking any haircut in this.")

[166] Limiting courts to issuing only injunctions might mitigate the deterrence effect on controlling shareholders. But, as explained in note 163, *supra*, such a regime might still produce undesirable outcomes.

control rights means that they should not assess the fairness of reallocations of control rights. In the absence of economic models for valuing different allocations of control rights, there is no reason to expect judicial review to produce an optimal allocation of these rights.

2. Voluntary MFW *Conditions*

The analysis thus far has assumed that subjecting midstream reallocations of control rights to judicial review would require courts to value the new allocation of control rights. One may argue, however, that this assumption overlooks the current state of Delaware's entire fairness regime. After all, Delaware courts often forego entire fairness review (and judicial valuation) by encouraging controlling shareholders to voluntarily condition the execution of a self-dealing transaction upon receiving the support of a majority of the minority shareholders and the approval of an independent special committee. With these conditions—the *MFW* conditions[167]—in place, courts will grant the deal review under the deferential business judgment standard and thus abstain from assessing the fairness of the transaction.[168] At first blush, this regime ostensibly sidesteps the problems inherent in judicial valuation of control rights: The majority-of-minority requirement relies on the minority shareholders' competence to value the proposed transaction, and courts only supervise the approval process to ensure that it was uncoerced, informed, and that a majority of disinterested shareholders approved the deal.[169] This section explains why the *MFW* conditions of the Delaware regime, by themselves, cannot overcome the need for a reliable model to guide courts in valuing control rights.

Majority-of-Minority Support Condition. Delaware doctrine does not *require* controllers to subject a self-dealing transaction to a vote by minority shareholders. Rather, it provides the controller with an *option*: The controller can either subject the transaction to a vote by minority shareholders *or* have the court review the transaction for its fairness. The controller will therefore compare the possible outcome of negotiating with minority shareholders—including the risk of a negotiation failure—against the outcome that is likely to be produced by judicial valuation. If the controlling shareholder anticipates that minority shareholders will behave strategically and hold-

[167] See supra section I.A.2.
[168] *In re MFW Shareholders Litig*., 67 A.3d at 502.
[169] Id. at 525.

out for an unreasonable price or fail to approve a value-enhancing transaction for any other reason, the controller can avoid the negotiations altogether, force the transaction upon the minority, and simply opt to show in court that the price is fair under the entire fairness review.[170]

Moreover, minority shareholders' willingness to approve the proposed transaction will also be affected by the controller's option to 'walk away' from negotiations and go forward with the transaction without the minority's approval. In other words, under Delaware's voluntary MFW conditions, *both* parties, the controller and the minority shareholders, negotiate "in the shadow" of Delaware's fair-price requirement. This judicial benchmark affects the parties' bargaining strategies, as each side will base its demands on its estimate of the valuation result a court would reach if it were asked to determine the "fair price."[171] The judicial backstop, resting on both parties' ability to predict how the court will evaluate the deal, incentivizes both the controlling and minority shareholders to reach an agreement. The looming presence of judicial valuation also prevents a negotiation breakdown, as the controller cannot offer too little and the minority cannot demand too much compared to the predictable outcome of "entire fairness" review.[172] The dynamic changes, however, when courts cannot objectively value control rights. When both parties lack confidence in courts' ability to objectively value control rights, the shadow of credible judicial valuation evaporates and the incentive to remain at the bargaining table is dramatically curtailed. Neither party can predict what the "fair price" will be, which renders the focal point of the negotiation elusive.

Thus, this analysis shows that Delaware's partial reliance on some type of veto right for minority shareholders to regulate self-dealing is in fact more dependent on accurate valuation than may be immediately apparent. Due to this fact, Delaware's most recent approach to the reallocation of control rights is problematic. In *Crane*, the court held that entire fairness applied, and used the

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[170] For a discussion of the link between controllers' need to test the market and the requirement that the controller adopt the majority-of-minority condition at the outset of negotiations, see https://corpgov.law.harvard.edu/2018/11/08/synutra-a-practical-application-of-mfw-or-a-free-look-for-controlling-stockholders/

[171] Indeed, an empirical study has found that the premium paid under the *MFW* procedure is similar to the premium determined by courts under the entire fairness process. See, Fernan Restrepo, Judicial Deference, Procedural Protections, and Deal Outcomes in Freezeout Transactions: Evidence from the Effect of MFW (January 19, 2018). Available at SSRN: https://ssrn.com/abstract=3105169 or http://dx.doi.org/10.2139/ssrn.3105169.

[172] In other words, the ability to turn to the Delaware courts for an objective valuation makes the parties more likely to reach an agreement in which the minority "sells" litigation insurance to the controlling shareholder in exchange for a larger percentage of the surplus value generated by the deal. Zohar Goshen, The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality, 91 Cal. L Rev. 393 (2003).

MFW conditions to reduce the level of review to business judgment.[173] Given NRG's successful implementation of the conditions required under *MFW* to receive business judgment deference, the court was not required to assess the recapitalization's fairness. However, if NRG had failed to condition the recapitalization on a vote by minority shareholders, the court would be left in the position of reviewing the reallocation of control rights under entire fairness.[174] But without a valuation model, how could the court determine whether the reallocation was indeed fair?

Moreover, *Crane* was an exceptional case, where the controller was likely going to be able to secure the majority-of-minority vote without the difficulties identified above.[175] The company in *Crane* was an entity that owned income-producing energy assets. It had no management of its own and instead relied on its controlling shareholder, through a "Management Services Agreement," to manage its day-to-day affairs, including placing new energy assets, which are routinely and easily evaluated, into the company. Thus, in *Crane* the need for the operator to preserve control as the company continued to acquire assets was an *operational* issue rather than a question of idiosyncratic vision. That is, the controller was not making appeals to the company's vision as Page and Brin were, but rather to the need to ensure that *Crane*'s regular operations were run successfully. In this way, *Crane* was an exceptional case in which it was easy to explain to the minority shareholders that reallocation of control rights was needed to prevent the fairly immediate negative consequences that could result if the controller-operator lost control. In other cases, however, where the controller's idiosyncratic vision is at issue, it will not be as easy for a controller to persuade minority shareholders to vote for the reallocation of control rights.[176]

To summarize, the *MFW* majority-of-minority conditions take on a different meaning when courts cannot evaluate the fairness of the underlying transaction. As explained above, the parties must choose between allowing the controller to unilaterally reallocate control rights and subjecting the reallocation to a veto right by minority shareholders. If courts require the majority of minority support to avoid valuation of reallocation of control rights, then in cases where the parties gave the controller the right to unilaterally reallocate control rights, the judicial requirement practically overrules the parties' choice by mandating a veto right to the minority shareholders.

[173] See supra section I.B.2; see also supra notes 101--106 and accompanying text.

[174] The same result would follow if Delaware chose to afford the recapitalization business judgment deference and the company had failed to meet one of the required conditions for such review. See infra section III.B.

[175] See supra section II.A.2.

[176] See supra section II.A.2.

Special Independent Committee. In addition to voluntarily asking for majority-of-minority support as explained above, under *MFW*, controllers that wish to avoid entire fairness review must empower a special committee of independent directors to negotiate the transaction and approve its terms.[177] Indeed, the requirement that independent directors approve decisions that raise conflicts of interest issues is common in corporate law.[178] However, in the context of reallocation of control rights, even this requirement is problematic.

Ideally, a special committee of independent directors should verify that the controller indeed has the idiosyncratic vision to justify the higher risk of agency costs that come with a reallocation of control rights. Thus, the usefulness of a special independent committee depends on its ability to ascertain the real value of idiosyncratic vision, which requires that such vision be verifiable. But, because of the subjective nature of idiosyncratic vision it is inherently non-verifiable.[179] Indeed, if idiosyncratic vision were verifiable, then there would be few differences of opinion between controllers and minority shareholders. Moreover, for the reasons explained in section II.B, directors—like courts—would be unable to rely on valuation experts to offer an objective assessment of the value of the company under the new allocation of control rights. If it were possible to generate such an objective valuation courts would also be able to do so.

As a result, the role of a special committee of independent directors would ultimately boil down to deciding whether to put their faith in the controller's claims based on their knowledge of the controller's competence and integrity. While the directors' access to non-public information may allow them to observe the controller's behavior in variety of occasions, there is nothing to suggest that independent directors enjoy any advantage over Delaware's judges in decoding the

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[177] In re MFW Shareholders Litig., 67 A.3d 496, 499 (Del. Ch. 2013), aff'd sub nom. Kahn v. M & F Worldwide Corp., 88 A.3d 635 (Del. 2014); see also supra note 168.

[178] In both *Crane* and the Google settlement, courts have emphasized the significance of having the recapitalization negotiated and approved by a special committee of independent directors. IRA Tr. FBO Bobbie Ahmed v. Crane, No. CV 12742-CB, 2017 WL 7053964, at *8 (Del. Ch. Dec. 11, 2017) (suggesting that the presence of well-motivated and truly independent directors might play an important role in determining the scope of judicial review); Settlement Hearing and Rulings of the Court, In re Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 6735045, at *38 (Del. Ch. Oct. 28, 2013) ("[I] think the stronger argument on behalf of the defendants is that they were well-motivated independent directors who … trial who believed that this was the right thing for Google's public stockholders").

[179] See Goshen & Hamdani, Idiosyncratic Vision, supra note 29, at 601 ("Asymmetric information and differences of opinion could prevent the controller-entrepreneur from credibly communicating her idiosyncratic vision not only to investors, but also to skeptical independent board members."). Another concern is independent directors' dependence on the controller for continued service at the company. See Bebchuk & Hamdani, Independent Directors and Controlling Shareholders, supra note 48.

human traits relevant here: competence (vision) and integrity (agency costs). As such, the inherent tension between idiosyncratic vision and agency costs will render the special independent committee impractical, as their mere trust in the controller cannot translate to validation of the existence of idiosyncratic vision.

Lastly, Delaware's tendency to focus on the approval *process* of the independent special committee might transform the process into a "cosmetic" negotiation solely aimed at meeting the judicial desire to see give-and-take between the controllers and the independent directors.[180] To clarify, although the true consideration for the reallocation of control rights is the promise of increased firm value, in the Facebook and Google recapitalizations the independent directors negotiated for "concessions" from the controller in the form of additional contractual restrictions on its control rights.[181] Yet, when these concessions are seriously considered, it becomes evident that they were merely put in place to satisfy the court's desire to see some compromise between the parties.

In sum, the lack of valuation methods for reallocation of control rights limits judicial application of the voluntary *MFW* conditions, as the tools of entire fairness used to resolve cash-flow rights conflicts will not work in the context of control rights conflicts. The next subsection explores whether an intermediate standard of review will work.

3. The Intermediate Approach

After reading the above subsections, one might wonder if this Article goes too far in eliminating judicial review. Even if entire fairness cannot be applied in the absence of objective valuation methodologies, the arguments goes, perhaps courts could still play a useful role in adjudicating disputes over the reallocation of control rights. Under this view, courts could adopt an intermediate standard of review—one in between entire fairness and business judgment—that does *not* require valuation, to prevent controllers from overreaching. Consequently, this view reasons, intermediate review by Delaware's equity court would avoid the complexities of entire

[180] When the board is asked to approve some corporate action that amounts to doing the controller a favor—such as waiving transfer of control conditions or providing assistance in due diligence—to facilitate the sale of the controller's shares, courts required that the board negotiate receiving something in return. See In re Digex Inc. S'holders Litig., 789 A.2d 1176, 1207 (Del. Ch. 2000). In our context of reallocation of control rights, however, the controller is not asking for a favor, but rather for a corporate action she believes would benefit the company.

[181] See supra note 90 and accompanying text.

fairness valuations while arguably preventing at least some egregious cases where midstream reallocations are driven purely by agency costs.

This approach is familiar to corporate law scholars. Delaware courts have implemented intermediate standards of review in other contexts where business judgment review seems too deferential and the entire fairness standard seems too strict. For example, in assessing a board of directors' defensive measures in response to a hostile takeover, Delaware requires the board to show a good faith determination that there was a threat and that the defense was proportional (the *Unocal* test).[182] In assessing a board action that interferes with shareholders' voting rights, Delaware courts require that the board show a compelling justification (the *Blasius* test).[183] The main role of these intermediate tests is to provide pre-transaction litigation, in which courts typically either block the deal or let it go through because of some *legal* standard rather than because of an objective *valuation*.

At least at first glance, the intermediate standard seems to avoid judicial valuation issues and achieve an improved balance between the risks that parties aim to minimize: high agency costs and the loss of idiosyncratic vision. A closer look at the Delaware courts' application of these intermediate standards, however, highlights their inherent shortcomings. Consider, for instance, the *Blasius* standard for boards' interference with the shareholder vote, which requires that a corporate board have a compelling justification when the primary purpose of a corporate action is to interfere with the shareholders' vote.[184] Indeed, it was already clear from the facts of *Blasius* itself that even a good faith attempt to protect the firm from a financial disaster would not satisfy the compelling justification test.[185] As courts have acknowledged the practical impossibility of providing a goal that would satisfy *Blasius'* requirements, the court's focus has shifted from the board's *goal* to the *means* that it used to accomplish the challenged interference with a shareholder

[182] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

[183] Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988) (explaining that where a unilateral board action is "done for the primary purpose of impeding the exercise of stockholder voting power" past cases have articulated that "the board bears the heavy burden of demonstrating a compelling justification for such action"). Delaware courts use a similar approach to evaluate board decisions to sell control of a company (the *Revlon* test). See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 175 (Del. 1986).

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

[185] *Blasius Indus.*, 564 A.2d at 659 (finding that the board acted "in a good faith effort to protect its incumbency, not selfishly, but in order to thwart implementation of the recapitalization that it feared, reasonably, would cause great injury to the Company.")

vote.[186] The test has evolved into a list of permitted and restricted actions, allowing the board to *regulate* but not *dictate* the shareholder vote.[187] Scholars and judges seem to agree that, in the already very limited circumstances when the *Blasius* standard applies, cases in which the court has found the compelling justification burden met are exceedingly rare, if not entirely nonexistent.[188] Thus, in the *Blasius* context, the intermediate standard of review simply means a judicially imposed prohibition on board interference with the shareholder vote.

The other form of intermediate scrutiny, the *Unocal* test, focuses on the *motives* of the boards that use defensive measures.[189] Since a well-advised board can prepare an adequate paper trail showing the right motives, the *Unocal* standard has essentially evolved into business judgment review for companies that hire sophisticated counsel.[190] Thus, in the *Unocal* context, the intermediate standard of review simply means a judicially imposed default rule according to which the use of defensive measures is allowed.

The failings of existing intermediate standards to produce meaningful judicial review should be instructive. Any prospect that subjecting midstream allocation of control rights to an intermediate standard of review would provide a silver bullet seems to fly in the face of Delaware's actual practice. Assume, like in *Unocal,* that the intermediate test used to regulate control rights

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[186] David C. McBride & Danielle Gibbs, Interference with Voting Rights: The Metaphysics of *Blasius Industries v. Atlas Corp.*, 26 Del. J. Corp. L. 927, 942 (2001) ("The court never has found a justification sufficiently compelling to permit a board to thwart the shareholder franchise.").

[187] Compare Pell v. Kill, 135 A.3d 764, 789 (Del. Ch. 2016) ("Pell has established a reasonable probability of showing successfully that the Board Reduction Plan is preclusive. Pell has therefore established a reasonable likelihood of success on the merits on a claim for breach of fiduciary duty under the enhanced scrutiny standard."), *with* Mercier v. Inter-Tel (Delaware), Inc., 929 A.2d 786, 788 (Del. Ch. 2007) ("I also find that directors fearing that stockholders are about to make an unwise decision that poses the threat that the stockholders will irrevocably lose a unique opportunity to receive a premium for their shares have a compelling justification—the protection of their stockholders' financial best interests—for a short postponement in the merger voting process to allow more time for deliberation.").

[188] McBride & Gibbs, supra note 186, at 942 ("The court never has found a justification sufficiently compelling to permit a board to thwart the shareholder franchise.").

[189] Some defensive measures such as a poison pill indirectly affects shareholders voting rights (preventing some shareholders from increasing their ownership of voting shares), and reallocation of control rights could also be viewed in such a way (preventing control from shifting to the market).

[190] Mary Siegel, *The Illusion of Enhanced Review of Board Actions*, 5 U. Pa. J. Bus. L. 599, 617 (2013) ("Underneath this veneer of judicial review, however, is convincing evidence that Delaware courts, in reality, heavily defer to the decision of the target directors."); In re Dollar Thrifty S'holder Litig., 14 A.3d 573, 598 (Del. Ch. 2010) ("[S]ome of the prior Unocal case law gave reason to fear that that standard, and the related Revlon standard, were being denuded into simply another name for business judgment rule review.").

focuses on both the motives of the controllers, as well as the process used to make the decision.[191] A well-advised controller can always prepare the "right" paper trail to show a good motive for maintaining control: the pursuit of idiosyncratic vision. And, as explained above, by its very nature the objective value of idiosyncratic vision or even its existence cannot be verified by courts.[192] Thus, it is only the poorly-advised or naive controllers that will be captured by the test. The same fate awaits any process-related inquiry. Indeed, in this regard, the story of Facebook is illuminating. There, the plaintiffs alleged, after discovery, that the special committee procedure had been compromised, in part because one of the members of the committee had sent Mark Zuckerberg text messages updating him on the status of the special committee's meetings.[193] Even if the litigation had continued and Delaware had found that indeed the special committee was compromised, the next well-advised company proposing a recapitalization would learn the lesson and quickly avoid Facebook's mistake.

The same outcome can be expected if the intermediate test takes the approach of *Blasius* and focuses on the goal of reallocating control rights. Indeed, one might think that reallocations of control rights could be viewed through the *Blasius* framework as an incident of interference with shareholder voting rights. Again, well-advised controllers will state and demonstrate the pursuit of idiosyncratic vision as their goal. As the court in *Blasius* rejected the board's good faith goal of avoiding financial disaster as a qualified compelling justification, there is no reason to think that the goal of pursuing idiosyncratic vision would be treated differently. However, in cases of reallocation of control rights the court will not be able to come up with a list of permitted and restricted actions as all reallocations have the same effect of shifting control from one group of shareholders to another. And the court cannot prohibit *all* reallocations of control rights, as such a ruling will run counter to the parties' agreement to allow the controller to unilaterally reallocate

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[191] See, for example, Air Products v. Airgas, Inc., 16 A.3d 48, 103 (Del. Ch. 2011) (noting that the first prong of *Unocal* requires directors-defendants to show that after "reasonable investigation" they determined in "good faith" that the bidder's offer presented a threat).

[192] One might argue that the success of the company could indicate the value of the entrepreneur's vision. Yet, business failures (temporary or not) do not necessarily imply that the entrepreneur lack vision. In fact, control matters for the pursuit of idiosyncratic vision precisely when investors or markets believe that the controller's vision is wrong.

[193] See Deepa Seetharaman & Sarah E. Needleman, Facebook Abandons Plans to Change Share Structure, Avoiding Lawsuit, Wall St. J. (Sept. 22, 2017), https://www.wsj.com/articles/facebook-abandons-plans-to-change-share-structure-avoiding-lawsuit-1506114877 ("In one instance, Mr. Andreessen texted Mr. Zuckerberg during a March meeting of the special committee with progress reports. 'NOW WE'RE COOKING WITH GAS,' Mr. Andreessen wrote.").

control rights in genuine cases of pursuit of idiosyncratic vision. Thus, practically, an intermediate test will gradually transform into business judgment review.

One might argue that the risk of intermediate litigation, on its own, might deter some disloyal controllers from ever trying to go through with opportunistic reallocation of control rights. After all, lawyers cannot justify *every* action, and the need to persuade professional courts, with the costs involved in the process, might indeed deter some expropriation from taking place. However, this speculative benefit should be weighed against the potential costs arising out of possible judicial mistakes. In the absence of a methodologically sound tool for distinguishing between "good" and "bad" reallocations of control rights, the likelihood of mistakes is very high. Thus, the prospect of costly litigation under an intermediate standard of review will deter even legitimate, value-maximizing reallocations by controllers with idiosyncratic vision.[194] Indeed, given the high probability of mistakes, even if all controllers litigate midstream reallocations and courts merely engage in judicial screening—granting injunctions or allowing the action to go through—an intermediate standard of review might harm the market by allowing some "bad" reallocations to go through and stopping some "good" ones.[195]

[194] It must be recognized that in theory, the justification for applying an intermediate standard of review to controllers' right to unilaterally reallocate control rights equally applies to minority shareholders' veto right (if they exist). As it can be expected that controlling shareholders would challenge minority refusals to approve reallocations of control rights as badly motivated illegitimate hold-outs. Similarly, here as well, courts will have no ability to review hold-outs and ascertain their legitimacy, in the face of minority shareholders' claims that they see no idiosyncratic vision but rather just high risk of agency costs.

[195] To see why, assume again that there are 100 controlled firms in the market traded at 100 dollars each; see also supra note 163. As stipulated, only 25 of the 100 will wish to reallocate control rights, and of those 25, only five have controllers with idiosyncratic vision. If one of these 5 firms reallocates control rights it will add $100 in firm value. However, in the other 20 firms, any reallocation of control rights will result in the controller inflicting an average of $20 damage due to agency costs. Courts are aware that only 5 out of 25 firms will have idiosyncratic vision. Thus, there is 20% probability that courts will believe that a controller has idiosyncratic vision and would allow a reallocation to go through, while in 80% of the cases the court will issue an injunction against the reallocation of control rights. To underscore the dangers of an erroneous determination, notice the outcome of applying the statistical probabilities assumed above within each group. If 80% of the 20 firms that yield high agency costs and 80% of the 5 firms that yield gains from idiosyncratic vision come before the court, the following is the result: Courts will block 16 of the firms that have no idiosyncratic vision (avoiding $320 in damage), but they will also block 4 of the firms with idiosyncratic vision (losing $400 in value). At the same time, taking 20% from each of the groups, courts will allow 4 firms (20% of 20) with agency costs to go through (allowing $80 in damage) and 1 firm (20% of 5) with idiosyncratic vision to go through (keeping $100 value). This will damage the market as courts will avoid $340 in damages (preventing $320 in agency costs and preserving $20 in value) at the cost of losing $400 in idiosyncratic vision. Since all mistakes reduce value (blocking idiosyncratic vision or allowing agency costs), this result is damaging even to shareholders holding a diversified portfolio.

B. Implications for Corporate Law

Section III.A has argued that Delaware courts should not review reallocations of control rights for their fairness or institute a new intermediate standard of review. This section claims that this leaves courts with the task of determining whether the controller has the power to unilaterally reallocate control rights. If the court finds that the controller has the power to make midstream reallocation of control rights without the need for a vote by minority shareholders, then it should apply the business judgment rule.[196] Otherwise, the court should enforce the right of the minority shareholders to veto the reallocation.

1. Deferring to the Parties' Choice

Controllers and minority shareholders face an inherent tradeoff between two opposing concerns. On the one hand, allowing the controller to unilaterally reallocate control rights might lead to opportunistic control allocations that would benefit the controller without increasing company value. On the other hand, a requirement that minority shareholders approve reallocations of control rights might lead to a bargaining failure and prevent the controller from realizing her idiosyncratic vision. As explained above, judicial review cannot ameliorate this tension. Instead, the parties must themselves choose between imperfect alternatives by agreeing ex ante on the rule that will govern midstream reallocations of control rights. They can either agree that the controller will hold the power to unilaterally reallocate control rights or that the minority's approval is required, for example, by including a charter provision to that effect. In the first case they protect idiosyncratic vision, by strengthening the controller's freedom to pursue her idiosyncratic vision for the company regardless of investors' views, and risk agency costs, by increasing the controller's ability to expropriate control. In the second case, they minimize the risk of agency costs, but risk losing idiosyncratic vision.

The principal task of courts is therefore to determine whether the controller can reallocate control rights without receiving the approval of the minority shareholders. In some cases, the

[196] One could argue that the parties may incorporate the prospect of judicial review into their initial allocation of the power to reallocate control rights. For example, minority shareholders might leave the power with the controller under the assumption that its use of the power will be constrained by judicial review. As we explained above, however, it is highly unlikely that the parties would like to subject midstream reallocation of control right to judicial review based on unreliable method for assessing fairness.

parties may expressly address the question in the company's charter or other foundational document.[197] For instance, the charter may require that minority shareholders approve any reallocation of control rights by providing that certain charter amendments receive a supermajority vote or, in the case of a dual-class company, a so-called class vote.[198] Alternatively, the charter may expressly authorize the controller to make future changes without a vote by the majority-of-the-minority.[199] If controllers and investors agree ex ante on an allocation of control in the corporate charter that empowers the controller to recapitalize the firm, subsequent judicial rewriting of this allocation runs directly counter to the ex ante motivation for entering into this type of arrangement.

This Article takes no position on the optimal allocation of the power to reallocate control rights, as it is inherently firm-specific and individual-specific. Thus, the best approach for corporate law is to (i) allow the parties ex ante to determine who should have the power to reallocate control rights; and (ii) judicially settle ex post disputes about whether the controller has the power to reallocate these rights without a vote by minority shareholders. However, courts should not determine the fairness of such reallocations or review the motives of the controller. The only role for courts faced with disputes over the reallocation of control rights is to enforce the parties' arrangement for who has the power to reallocate control rights.[200]

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[197] Throughout this section, the term "charter" is used because that seems to be the most likely place that an allocation of authority in midstream changes is likely to occur. However, it is possible for it to be contained in a different document. The idea is merely that there are cases in which the parties have explicitly indicated who will have the authority to decide on midstream reallocations of control.

[198] For example, see In re Delphi Fin. Grp. S'holder Litig., No. CIV.A. 7144-VCG, 2012 WL 729232, at *1 (Del. Ch. Mar. 6, 2012) (case in which the "deal was conditioned on a majority of the publicly held Class A shares being voted in favor, and a successful vote to amend the [company] Charter to allow [the controller] to receive the differential").

[199] Andrew William Winden, Sunrise, Sunset: An Empirical and Theoretical Assessment of Dual-Class Stock Structures, __Colum. Bus. L. Rev. at 40 n.119 (forthcoming 2018) (noting that Blue Apron, Inc. "authorize[es] the issuance of non-voting shares in the future, if necessary, in the IPO charter").

[200] It is possible that, by limiting their role to identifying the parties' arrangement, courts might be pushed to confront the task of recognizing new "default rules" that limit controllers' power. Alternatively, courts could presumably apply the doctrines that they have developed for adjudicating disputes about charter interpretation. As the optimal allocation of the power to relocate control rights is company specific, courts may be asked by minority shareholders to read implied limitations on the controller's power into specific charter provisions at specific companies Thus, instead of engaging in the impossible task of reviewing discretion, courts will be invited to create new broad default rules—for certain types of companies or specific reallocation of control rights—under which the controller cannot relocate control rights without minority shareholders' consent.

Consider, for example, companies that go public with a dual-class structure. Founders of these companies presumably attach substantial value to their ability to pursue their idiosyncratic vision, and investors in these companies have faith in and deference to the idiosyncratic vision of the entrepreneur. The investors realize that the controller will have the ability to purse her idiosyncratic vision even if she owns only a small fraction of the company's

When the controller has the right to unilaterally reallocate control rights, the business judgment rule should apply to its decision to reallocate these rights. In other words, the controller's conflict-of-interest notwithstanding, courts should not treat the reallocation as self-dealing. As explained in Part II, the lack of acceptable valuation methodologies prevents courts from distinguishing between value-enhancing and value-reducing allocations of control rights.

The Delaware case that best reflects the approach outlined in this section is *eBay*. In *eBay* the Delaware Chancery Court declined to review a corporate governance decision that clearly benefited the controllers—the implementation of a staggered board that effectively denied board representation to the minority shareholder—under the entire fairness standard.[201] This case fits an approach focused on charter interpretation not only because it applied the business judgment rule to a midstream reallocation of control rights, but also because the court emphasized that applying the entire fairness standard would contradict the parties' initial decision to provide the controllers with the right to unilaterally implement this change:

> The right to amend the Craigslist charter, however, without eBay's consent if eBay chose to compete with craigslist *was* a benefit Jim and Craig negotiated for *and* secured in the Shareholders' Agreement. Section 8.3 [of the Shareholder Agreement] plainly articulates that benefit. Thus, the Staggered Board Amendments cannot be inequitable because they were exactly the sort of consequence eBay accepted would occur if eBay decided to compete with Craigslist.[202]

As such, the court plainly stated that the plaintiffs were "seek[ing] to obtain a benefit [they were] not able to obtain" in negotiations for the "Shareholders' Agreement."[203]

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cash flow rights. That is, the investors accept the high risk of agency costs rising out of the wedge between the controller small holding of cash flow rights and the power granted to her. In this case, in which the parties already agreed to the separation between cash flows and control rights, Delaware might adopt a default rule allowing the controller to unilaterally reallocate control rights.

In contrast, in controlled companies without different classes of shares, the assumption is that the ability to pursue idiosyncratic vision is tied to cash flow rights. In other words, the controller has the uncontestable ability to pursue idiosyncratic vision only as long as she owns a majority of the company's cash flow rights.[200] Cite Delphi. In such a case, of one-share-one-vote, Delaware might adopt a default rule requiring a vote by minority shareholders in case of a recapitalization that breaks the link between cash flow and control rights.

[201] eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 37 (Del. Ch. 2010) ("I am not persuaded that entire fairness review applies to the Staggered Board Amendments . . . The cases eBay relies on do not support a rule of law that would invoke entire fairness review any time a corporate action affects directors or controlling stockholders differently than minority stockholders."); see also supra section I.B.1.

[202] *eBay*, 16 A.3d at 39.

[203] Id.

Moreover, the approach laid out here is also consistent with *Williams v. Geier*, where the Delaware Supreme Court granted business judgment review to a controlled public company that adopted a charter amendment creating "tenure shares" resulting in an effect similar to that achieved through a dual-class structure.[204] The *Williams* plaintiffs argued that, "the action of the Board in recommending the Amendment and Recapitalization to the stockholders constituted either a breach of fiduciary duty or an impermissible effort at entrenchment, both of which are claimed to rebut the business judgment presumption and implicate entire fairness review."[205] The court squarely rejected this contention, even while acknowledging the possibility that the majority shareholders would benefit more from the recapitalization than the minority shareholders.[206] As explained above, similar rulings were given in the other cases detailed in section I.B.1. Yet, all of these cases reach results similar to the approach recommended in this Article——deferring to the allocation of control rights outlined in the corporate charter—without explicitly adopting its reasoning.[207] Expressly explaining that this outcome is the result of the controller's right to reallocate control rights will importantly provide the market with better guidance.

Lastly, the analysis here also applies to the *CBS* dispute. This Article contends that if the dispute had not settled, the court should have focused on the parties' *ex ante* arrangements about the allocation of power concerning midstream reallocation of control rights. As the default rule in controlled companies is that the controller's control is protected by a property rule,[208] the only way

[204] Williams v. Geier, 671 A.2d 1368, 1370, 1377 (Del. 1996) ("The essence of the Recapitalization is to provide for a form of 'tenure voting' whereby holders of common stock on the record date would receive ten votes per share. Upon sale or other transfer, however, each share would revert to one-vote-per-share status until that share is held by its owner for three years."); see also supra section I.B.1.

[205] *Williams*, 671 A.2d at 1378.

[206] Id. at 1385 ("The Board's action in recommending the Recapitalization to the stockholders was the result of an independent business decision of the Board, protected by the presumption of the business judgment rule which was not rebutted. The fully informed stockholder vote approving the Amendment validly effected the Recapitalization. The fact that the Family Group voted in favor of the Amendment does not invalidate the vote, even if they benefited more than the minority.").

[207] Note, however, that although these cases reached a conclusion that conforms with our recommendation, these cases continue to subject the outcome to judicial discretion by relying on the business judgment rule to achieve their results. This is problematic because the business judgment rule, like the conditional property rule in the *MFW* framework—which was accepted by the court in *Crane*—reverts to entire fairness if one of the conditions for its application is failed. Thus, granting companies business judgment review in reallocations of control rights only works if the companies "get it right"; if they fail, like Facebook might have, then the court will again be forced to evaluate the recapitalization under the fairness standard, which section III.A has shown is impossible. The approach proposed in this Article calls on Delaware to address the question as one of *charter interpretation* rather than one of *judicial review*.

[208] Goshen & Hamdani, Idiosyncratic Vision, supra note 29, at 601.

to justify the board's discretion to take control rights from the controller is to find that the controller had agreed *ex ante* to grant the board such a power. The extent to which this was the case was disputed in the CBS litigation. But, if the controller had indeed so agreed, the business judgment rule should apply to the board's decision to dilute the controller, without any further review of the board's discretion.

The proposal to defer to the parties' choice is driven by the need to respect the rights of sophisticated parties to adopt the corporate arrangement that is most tailored to their needs. In the control rights context, this need is reinforced by the recognition that no arrangement is generally superior. Rather, the parties must choose between two imperfect alternatives.[209] Moreover, a clear statement from courts indicating that they will defer to the parties' initial choice—rather than attempt to assess ex post the fairness of the reallocation of control rights—will signal to parties the need to choose at the outset the arrangements that will govern midstream reallocation of control rights. In the case of public companies with a dual-class structure, for example, investors could insist on expanding the scope of class voting rights.

In the past, corporate law scholars were skeptical about the claim that governance arrangements adopted at the IPO stage are optimal.[210] In recent decades, however, there has been a dramatic rise in the power of institutional investors which now own most of the shares of publicly traded corporations in the United States.[211] These sophisticated investors are able to negotiate governance terms and prices with any firm wishing to go public.[212] Moreover, at least for companies with a dual-class share structure, the IPO market for governance terms seems to be quite an active one. To begin, although many founders would clearly like to go public with a dual-class structure, only a minority of firms succeed.[213] Additionally, dual-class companies that go public exhibit a considerable variety of governance arrangements in their charter, providing different provisions regarding the allocation of power between controllers and minority

[209] The parties' *ex ante* agreement can reflect their mutual preference to risk agency costs in order to secure the controller's ability to pursue its idiosyncratic vision. It can also reflect the outcome of competitive bargaining at the IPO stage.

[210] See, e.g., Robert Daines & Michael Klausner, Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs, 17 J. L. Econ. & Org. 83 (2001).

[211] See Zohar Goshen & Sharon Hannes, The Death of Corporate Law, N.Y.U. L. Rev. (forthcoming 2019) (manuscript at 36--39), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3171023.

[212] See id.

[213] See Council of Institutional Investors, *Dual-Class IPO Snapshot: 2017-2018 Statistics* (in 2017, only 19% of IPOs had dual class structures).

shareholders.[214] This variety suggests that founders cannot simply dictate governance terms and that some form of bargaining between founders and investors does take place at the IPO stage. Thus, whatever charter arrangements the parties have made as to midstream reallocation of control rights should be respected.

2. A Default Rule

The approach explained in section III.B.1 would require Delaware courts to identify the parties' choice concerning the power to reallocate control rights. Delaware courts often address disputes over charter interpretation,[215] and the rules that guide courts when they interpret corporate charters will not be revisited here. However, how should courts decide cases in which the process of charter interpretation provides no answer on the parties' agreement on the issue of control rights? And what should be the default rule?

There is substantial literature about what types of default rules are optimal;[216] this literature will not be reviewed here. Instead, this section will focus on the inherent tradeoff implicating the choice of a default rule for midstream reallocations of control rights. As explained above, the two possible rules are imperfect. The rule allowing the controller to unilaterally reallocate control rights will increase both the expected benefit from idiosyncratic vision and the expected loss from agency costs. The rule providing the minority with a veto right will decrease both the expected benefit from idiosyncratic vision and the expected loss from agency costs. The expected value of

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[214] Andrew William Winden, Sunrise, Sunset: An Empirical and Theoretical Assessment of Dual-Class Stock Structures, __Colum. Bus. L. Rev. (forthcoming 2018) (conducting an empirical study of the charter provisions dual-class companies used to achieve a balance between idiosyncratic vision and agency costs).

[215] For example, see In re Delphi Fin. Grp. S'holder Litig., No. CIV.A. 7144-VCG, 2012 WL 729232 (Del. Ch. Mar. 6, 2012) (holding that the controller lacked the power to propose a charter amendment that would entitle it to a control premium).

[216] For literature on default rules in contracts, see for example David Charny, Hypothetical Bargains: The Normative Structure of Contract Interpretation, 89 Mich. L. Rev. 1815 (1991)(explaining that a majoritarian default rule aims to replicate the rule that is most likely to be the one that most parties would have wanted had they contracted on the issue); Symposium on Default Rules and Contractual Consent, 3 S. Cal. Interdisciplinary L. J. 1 (1993); Eric Posner, There Are No Penalty Default Rules in Contract Law, 33 Fla. St. U. L. Rev. 563, 585 (2006) (conducting an empirical investigation of penalty default rules and noting that "courts almost always think of themselves as choosing the rule that a majority would want," such that "if some default rules are not majoritarian, the most likely explanation—putting aside the consumer protection defaults...—is that courts or the drafters of the U.C.C. simply made a mistake about what the majority prefers"). For default rules in corporate law, see for example Ian Ayres, Making a Difference: The Contractual Contributions of Easterbrook and Fischel, 59 U. Chi. L. Rev. 1391, 1397-400 (1992) (discussing how to design corporate law defaults in light of information-forcing considerations); Michael Klausner, Corporations, Corporate Law, and Networks of Contracts, 81 Va. L. Rev. 757, 826-834 (1995) (examining how to design corporate defaults in light of network externalities).

each rule is the sum of both effects. Thus, if the expected benefits from idiosyncratic vision are higher than the expected loss from agency costs the default rule should allow the controller to unilaterally reallocate control rights, and vice versa.[217]

For many years Delaware law had a single uniform default:[218] Shareholders holding a majority of the votes can unilaterally amend the corporate charter.[219] Indeed, in a long line of cases, described in section I.B.1 and illustrated most prominently by *Williams v. Geier*,[220] Delaware concluded that the controller has the authority to unilaterally reallocate control rights and accordingly applied the business judgment rule. Unfortunately, this simple default lost its certainty

[217] The analysis in the text discusses in the abstract the benefit from idiosyncratic vision and the loss from agency costs. A fuller account would also consider the likelihood that, given the difficulties that were identified above, minority shareholders would fail to approve value-enhancing reallocation of control rights.

[218] It is important to note that the optimal default does not necessarily have to be identical across all types of control rights and all governance structures. Consider, for example, the difference between dual-class share structure companies and other controlled companies. Founders of companies that go public with a dual-class structure clearly attach substantial value to their ability to pursue their idiosyncratic vision. Investors in these companies have faith in the idiosyncratic vision of the controller or at least realize that the controller adopted this governance structure because she has no intention of relinquishing her control, even if she owns only a small fraction of the company's cash flow rights. This view might be reinforced by Leo Strine's comments at the Google settlement. See Settlement Hearing and Rulings of the Court, In re Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 6735045, at * *38 ("from the beginning, everyone has been clear with the people who lined up in hoards … to buy Google stock, with the understanding that these founders were going public but with no intention to relinquish voting control over the company that they founded and loved, and that when you invested in Google, that was sort of your understanding."). In contrast, in controlled companies with a single-class of shares, the controller's ability to pursue idiosyncratic vision is tied to cash flow rights: The controller has the uncontestable ability to pursue idiosyncratic vision only as long as she owns a majority of the company's cash flow rights.

Thus, one could argue that different default norms should govern certain midstream allocation of control rights. Under this view, in companies with a single-class of shares, for example, controllers wishing to break the link between cash flow and control rights (by creating dual-class shares or tenure shares) could do so only subject to a vote by minority shareholders. Needless to say, this default rules stands in sharp contrast to the Delaware case law that was discussed in section II.B.1 *supra*. In dual-class companies, by contrast, the default rule might be different. For similar reasons, one could imagine a different default rule for different types of control rights or different subsets of dual-class companies. Indeed, similar logic is reflected in the stock exchange rules that prohibit midstream changes from single to dual-class of shares but allow issuing dual-class shares at the IPO stage. See Bebchuk & Kastiel, The Untenable Case of Perpetual Dual-Class Stock, supra note 3, at 596, 596 n.35 (on the "constraints of introducing a dual-class structure midstream" in the US); see also id. at 599--601 (describing the foreign stock exchange rules).

[219] In dual-class companies, this default rule is supplemented by the Delaware default arrangement on the conditions under which a charter amendment requires a specific shareholder class vote. See Del. Code Ann. tit. 8, § 242(b)(2) (2018). Under Delaware law, in companies with more than one class of shares, a charter amendment would have to be approved by a class of shares if it would change "the powers, preferences, or special rights of the shares of such class so as to affect them adversely." Id. For an analysis of the differences between the Delaware approach and that of the Model Business Corporations Law, see Michael P. Dooley & Michael D. Goldman, Some Comparisons Between the Model Business Corporation Act and the Delaware General Corporation Law, 56 Bus. Law. 737, 750--752 (2001).

[220] See supra notes 75--76 and accompanying text.

during Google's 2012 settlement hearing[221] and culminated in the application of the entire fairness test in *Crane*. This variation might have altered Delaware's *de-facto* default rule. While the application of the business judgment rule in earlier cases granted the controller the power to unilaterally reallocate control rights, the application of the entire fairness in the recent cases has practically granted the minority shareholders a veto right over reallocation of control rights.[222]

The earlier Delaware cases applying the business judgment rule preferred the protection of idiosyncratic vision over the risk of agency costs. We believe there is no evidence to justify changing this preference, especially for companies with a dual class share structure. While the risk of agency costs is omnipresent, so is the promise of idiosyncratic vision. For instance, a 2018 study found that only a handful of the publicly traded firms are responsible for most of the return in the stock market. Specifically, "the best-performing 4% of listed companies explain the net gain for the entire US stock market since 1926, as other stocks collectively matched Treasury bills."[223] Given the wide variety of industries,[224] and the large 90-year window used, this study attests to the potential value of idiosyncratic vision. Even if only some of the firms in that 4 percent group had managers with idiosyncratic vision, the market-wide costs from losing that vision would be substantial, thereby supporting a default rule that allows controllers to unilaterally reallocate control rights.

Moreover, especially for dual-class companies, changing market realities provide another reason to question the change in the default rule suggested by the recent Delaware cases. In the past, institutional investors were less powerful, more shares were held by retail investors, and few activist attacks or hostile takeovers took place. Thus, powerful CEOs *practically* enjoyed uncontestable control that allowed them to pursue their idiosyncratic vision without fear of removal by investors. Consequently, the unilateral power to reallocate control rights was less crucial to preserve idiosyncratic vision. Today, with the increasing dominance of institutional

[221] This view might be reinforced by Leo Strine's comments at the Google settlement that "it's never been the case that interested voting power gets a pass simply because it has voting power." See Settlement Hearing and Rulings of the Court, In re Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 6735045, at * *38.

[222] As was explained in detail above, subjecting midstream reallocation of control rights to entire fairness review might deter controllers from reallocating control rights without a vote by minority shareholders.

[223] Hendrik Bessembinder, Do Stocks Outperform Treasury Bills? (May 28, 2018). Journal of Financial Economics (JFE), Forthcoming. Available at SSRN: https://ssrn.com/abstract=2900447 or http://dx.doi.org/10.2139/ssrn.2900447

[224] See id. at 51--52 for a summary of the 50 firms with the greatest creation of wealth to its shareholders.

investors' ownership and the rise of hedge fund activism, managers need *formal* control to pursue their idiosyncratic vision even when investors think that they are wrong,[225] and the most effective tool to accomplish that end is a dual-class structure. Indeed, in the recent decade the demand by entrepreneurs for, and the use of, dual-class structures has increased, suggesting that, in today's market environment, having legal incontestable control is increasingly perceived as essential for managers wishing to attain idiosyncratic vision.[226] Consequently, the recent Delaware cases

[225] See also Goshen & Hannes, The Death of Corporate Law, supra note 211.

[226] Bradford D. Jordan, Soohyung Kim & Mark H. Liu, Growth Opportunities, Short-Term Market Pressure, and Dual-Class Share Structure, 41 J. Corp. Fin. 304 (2016) (finding that "dual-class shares can help managers focus on the implementation of long-term projects while avoiding short-term market pressure.")

Unfortunately, the inevitable tension between agency costs and idiosyncratic vision cannot be resolved by existing empirical studies on dual-class firms. Since these companies provide controllers with incontestable control, their relative performance or market valuation could indicate whether the benefits of securing founders' ability to pursue their idiosyncratic vision exceed the loss from agency costs. However, empirical studies on the relative performance of dual-class firms have reached conflicting results. See Renée Adams & Daniel Ferreira, One Share-One Vote: The Empirical Evidence, 12 Rev. Fin. 51, 84 (2008) (surveying the empirical literature on dual-class structures and concluding that "the findings . . . on ownership disproportionality often disagree" and that "simple conclusions may not be possible [because] [o]wnership disproportionality may destroy the value of outside equity in some contexts, but not in others."). More recent empirical studies focus on the life cycle of dual dual-class firms. One study, for example, found that when they go public dual-class firms enjoy a premium over single-class firms, but after seven to nine years they do worse. K. J. Martijn Cremers, Beni Lauterbach, and Anete Pajuste, The Life-Cycle of Dual-class Firm Valuation (December 19, 2018). Available at SSRN: https://ssrn.com/abstract=3062895. Another study found that "young" dual-class firms trade at a premium, but as they mature, these companies lose their valuation advantage and tend to become less efficient than similar single-class companies. Hyunseob Kim & Roni Michaely, Sticking around Too Long? Dynamics of the Benefits of Dual-Class Voting (January 2, 2019). Available at SSRN: https://ssrn.com/abstract=3145209. See also Bebchuk & Kastiel, supra note 3. As midstream reallocations of control are more likely to take place at mature companies, one could take these studies to suggest that the costs of allowing controllers to unilaterally reallocate control rights would outweigh the benefits. This conclusion, however, is questionable. First, to the extent they are based on comparing matching samples of dual-class and single-class companies, these studies raise obvious methodological concerns. Briefly, the concern is that the differences between the two types of companies are not caused by their governance differences, but by other factors not captured by the study. Second, these studies cover long periods whereas the costs and benefits of the dual-class structure might have changed. Indeed, one of these studies found that the life-cycle effect is much weaker for firms that went public in the 21st century. K. J. Martijn Cremers, Beni Lauterbach, and Anete Pajuste, The Life-Cycle of Dual-class Firm Valuation (December 19, 2018). Available at SSRN: https://ssrn.com/abstract=3062895. Third, these studies are "too new" to be trusted. It usually takes time for other scholars to challenge the methodology, specification and findings of other studies. Indeed, the first studies that tested the relative performance of dual-class firms found that dual-class firms underperform single-class firms, and only later other studies have challenged this finding and shown that dual-class firms outperform single-class firms. Fourth, the findings of these studies are puzzling from an economic standpoint. After all, if dual-class firms are consistently likely to underperform in seven years, why would rational investors pay a premium to buy their shares in the IPO or immediately thereafter? Who will buy these shares from them down the road and pay the premium?!

Moreover, a recent study found that controllers of dual-class companies do not take full advantage of their ability to maintain control while holding only a small fraction of the company's cash flow rights. Lucian A. Bebchuk & Kobi Kastiel, The Perils of Small-Minority Controllers, 38 (December 27, 2018). Forthcoming, Georgetown Law Journal. Available at SSRN: https://ssrn.com/abstract=3128375 (finding that 91.8% of controllers could control the firm while holding only 15% of its cash flow right, but only 18.9% of controllers take advantage of this opportunity). This finding casts doubt on the agency cost view of dual-class structure. If controllers were motivated by agency costs, why would they hold more shares than required to preserve control rather than diversify their holdings?

proposing a change of the default rule go against the market reality in which it is more crucial to protect idiosyncratic vision by keeping the old default allowing unilateral reallocation of control rights.

The optimal default rule regarding reallocation of control rights depends on the relative expected benefits of idiosyncratic vision compared to the expected losses from agency costs. Indeed, past Delaware cases adopted a default rule that favored idiosyncratic vision over agency costs. Given the current market realities, we see no reason to change that default.

CONCLUSION

This point cannot be overstated: Without an objective valuation, entire fairness review collapses, as there is no way to determine the appropriate payment to impose upon a controlling shareholder for engaging in the proposed action. In the context of cash-flow disputes, objective valuation has proven to be a fairly surmountable challenge. Cash flows are, intrinsically, readily capable of being assigned an objective fair value. Relying on techniques developed by financial economists——most commonly a DCF analysis[227]——Delaware judges faced with cash-flow disputes engage in fairly complex valuation analyses to determine the fair value of a challenged transaction. Indeed, this practice has been codified into Delaware's corporate code.[228] In so doing, the Delaware courts have become renowned for their acumen in deploying the entire fairness standard bolstered by competent valuations.

However, similar valuation techniques cannot be devised for control rights. These rights are simply too firm-specific and individual-specific to permit of a reliable, objective valuation. Thus, in assessing the reallocation of control rights, courts are unable to use the legal tools that they have successfully employed to resolve cash-flow conflicts. The entire fairness and Delaware's voluntary *MFW* conditions both necessitate valuation models to operate. Similarly, if history is a guide, intermediate standards of review will also fail to provide any meaningful regulation and ultimately will devolve into business judgment review. As a result, Delaware is left with only one choice: to enforce the allocation of control rights for which parties have bargained in the charter and to establish a default rule for cases in which the charter is silent on the issue of reallocation.

[227] Jay W. Eisenhofer & John L. Reed, Valuation Litigation, 22 Del. J. Corp. L. 37, 112 (1997).

[228] Under Delaware law, "[i]n determining such fair value, the Court shall take into account all relevant factors." 8 Del. C. §262(h). Although § 262 as written governs appraisal rights, the Court has held that this principle likewise governs cash-out mergers. Weinberger v. UOP, 457 A.2d 701, 715 (Del. 1983).

This approach not only provides a sensible resolution to control rights conflicts, but also comports with a long line of Delaware jurisprudence.