INSIGHTS

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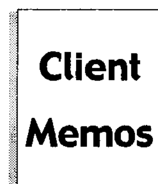

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Diluting the Significant Stockholder to Satisfy *Revlon*

A board's decision to grant a dilutive option to an acquiror in order to consummate a transaction that is opposed by a significant stockholder raises significant fiduciary concerns and highlights the tension between a board's duty to maximize value for minority stockholders and its fiduciary duty to all stockholders, including controlling stockholders. Recent publicly announced transactions confirm that acquirors continue to demand dilutive options as a condition of proceeding with a transaction. Is a board's decision to grant a dilutive option to an acquiror a permissible exercise of fiduciary power or an impermissible breach of fiduciary duty?

By Tariq Mundiya

A recurrent question faced by boards of directors of companies overseeing a sale or other corporate control transaction is whether the board is permitted to dilute a controlling stockholder in order to enable the company to accept a superior proposal from a third party over the controlling stockholder's objection. Recent publicly announced transactions confirm that acquirors continue to demand that target boards grant dilutive options to overcome the voting blocks of controlling stockholders even though such action may, in some circumstances, expose a board to a claim for breach of fiduciary duty by the controlling stockholder. In addition, the recent increase in the number of going private transactions[1] also highlights the importance of striking a balance between a board's fiduciary duty to maximize stockholder value to the minority on the one hand, and its duty to controlling stockholders on the other.

Once a company has put itself up for sale, or where a sale or change of control is inevitable, a board of directors is under a duty to maximize stockholder value.[2] There is no single blueprint for discharging *Revlon* duties, and courts have given boards significant latitude in determining the manner in which they satisfy the *Revlon* standard. A board of directors can, for instance, tilt the playing field in an auction if it reasonably believes that by doing so it can maximize value for shareholders.[3] Although a board has significant latitude under *Revlon* to create competitive tension, there are limits to the means by which *Revlon* obligations may be discharged.

At the same time, a stockholder that owns a large or controlling block of shares has the power to vote its shares in its own economic interest, including in a change of control context.[4] Chancellor Strine of the Delaware Chancery Court recently confirmed that Delaware law does not "impose on controlling stockholders a duty to engage in self-sacrifice for the benefit of minority shareholders," finding that a controlling stockholder could not be compelled to vote in favor of a transaction where his personal interests did not favor such a transaction, even if it would benefit the minority stockholders.[5] To do so, Chancellor Strine concluded, "would turn on its head the basic tenet that controllers have a right to vote their shares in their own interest."[6]

When a company is involved in a contest for corporate control, a board of directors (or a

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special committee of the board) may find itself balancing these two competing principles. That tension becomes even more acute when the controlling stockholder is competing with a third-party bidder for the company. The question posed here is when, if ever, is a board of directors (or a special committee appointed by a board) permitted to dilute a controlling stockholder where it believes that doing so will maximize shareholder value for the minority stockholders.

Although there is dicta suggesting that dilution might be permissible where a board is *Revlon* mode, no reported decision has upheld such conduct by a board. Absent an actual or threatened breach of fiduciary duty by a controlling stockholder, the grant of a dilutive option to a third-party bidder in order to increase the likelihood of a value-maximizing transaction for other stockholders is fraught with peril. Unless there is a clear and unambiguous right to do so, boards and special committees should consider carefully the litigation and transaction consequences of a dilutive share issuance designed to facilitate a third-party bid opposed by a controlling stockholder.

When, if ever, is a board of directors permitted to dilute a controlling stockholder where it believes that doing so will maximize shareholder value for the minority stockholders?

Dilution of significant, but non-controlling, stockholders rests on even more tenuous grounds because non-controlling stockholders (a) do not owe fiduciary duties and, therefore, cannot breach them, and (b) pose even less of a threat to a third-party bid given their inability to control the outcome of such a bid. Thus, the grant of a dilutive option is even less justifiable in those circumstances.[7]

Notwithstanding the questions surrounding the legality of a dilutive option adopted to satisfy *Revlon*, acquirors faced with large or controlling shareholders that present impediments to their bids have not been shy about demanding that boards issue dilutive options as a condition to proceeding with value maximizing transactions. Minority shareholders seeking value-maximizing transactions also can be vocal in exhorting the directors to grant a dilutive option to a potential acquiror Usually the proponents of such options seek the issuance of up to 20 percent of a company's outstanding stock because any issuance above that percentage threshold would, in many circumstances, require stockholder approval under governing NASDAQ or NYSE rules.[8]

While many cases have addressed the circumstances in which a board' s dilution of stockholders is wrongful,[9] the narrower question of whether *Revlon* empowers a board to dilute a controlling stockholder has been pointedly addressed in three Delaware Chancery Court cases beginning in 1987 with *Freedman v. Restaurant Associates Industries, Inc.*, and later in *Mendel v. Carroll,* and *In re Frederick's of Hollywood, Inc., Shareholders Litigation* in 1994 and 1998, respectively.

Freedman v. Restaurant Associates Industries, Inc.

In *Freedman v. Restaurant Associates Industries, Inc.*,[10] shareholders sought to enjoin a management-led buyout, claiming that the board of directors had acted wrongfully in rejecting the recommendation of a special committee to dilute the management's 48 percent voting block. The board, with 11 directors in total, had been faced with a competing bidder that insisted that the board issue a dilutive option as a condition to commencing due diligence in support of a bid that was 11 percent higher than the management bid. The option, if exercised, would have diluted the management group's voting power to approximately 40 percent "at which level a hostile tender offer [by the competing bidder] was thought

more feasible."[11] A three-member special committee initially had recommended that a dilutive option be granted allowing the purchase, at the bid price, of one million authorized but unissued shares of the same class owned by the management group. The option, for which the bidder would also make a $2 million non-refundable payment, would remain open for 10 days to allow the competing bidder to engage in diligence. The full board rejected grant of the option. The special committee then informed the bidder that he should conduct due diligence *before* the company would agree to a dilutive option. The bidder walked away, and a class of shareholders sued to enjoin the management-led buyout, seeking mandatory injunctive relief requiring the company to enter into the option agreement approved by the special committee but rejected by the board.

> ***A board contemplating a dilutive issuance must first perceive a threat by the controlling stockholder.***

Chancellor Allen denied the injunction. He first confirmed the established principle that it is an abuse of power for a board "to issue stock, not for the principal purpose of raising necessary or desirable capital, but for the sole or primary purpose of diluting the voting power of an existing block of stock."[12] Nevertheless, Chancellor Allen also noted that diluting a stockholder might "in extraordinary circumstances, be valid if the purpose of the issuance is to further an independent corporate purpose rather than to entrench an existing board (even though it may collaterally have such an effect)."[13] He thus posed the question of whether the need to satisfy a *Revlon* duty could supply the extraordinary circumstances required for a dilutive issuance:

> [T]he question arises whether a board, in order to attempt to achieve the highest available price for the shareholders (in a setting where it appears that the public shareholders are to be eliminated by one technique or another), might be justified in issuing an option that would have the effect of diluting the voting power of an existing block. I believe the Supreme Court's opinion in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (1985) suggests that the answer to that question is in the affirmative.[14]

Although Chancellor Allen did not elaborate on the type of conduct in which a controlling shareholder would have to engage before it could be diluted, the Court's citation to the Delaware Supreme Court's decision in *Unocal* suggests that a board contemplating a dilutive issuance must first perceive a threat by the controlling stockholder, and that any dilutive response would have to be reasonable and proportionate to the threat posed.[15]

Chancellor Allen ended his analysis with the following important caveat: "[s]ome of the matters touched upon are weighty and I express my views reluctantly, not having had time to consider them very deeply."[16]

Mendel v. Carroll

Seven years after *Restaurant Associates,* Chancellor Allen had an opportunity to revisit, in greater detail, the issue of whether a board could dilute a significant stockholder in order to satisfy *Revlon*. In *Mendel*,[17] the board of directors of Katy Industries, Inc., acting upon the recommendation of an independent special committee, agreed to a merger in which the public shareholders would receive $25.75 in cash per share from members of the Carroll family that collectively owned a 52.6 percent stake in Katy Industries. The Carroll family made clear that it was not interested in selling its shares should a topping bid for the company be made. After a proxy statement was mailed to stockholders, a competing bidder group led by Steinhardt Partners emerged with a cash $27.80 per share bid for all outstanding shares of the company.

Although its stake had decreased temporarily to 47.9 percent the Carroll family interest thereafter increased to above 50 percent through open market purchases. In response to the higher bid, the Carroll family declared that it was no longer interested in a going private transaction and terminated the merger agreement.

Steinhardt continued to pursue Katy Industries after the Carroll transaction was terminated, and presented a merger agreement that was conditioned on execution of a stock option agreement to purchase approximately 20 percent of Katy Industries' unissued but authorized common stock at the bid price. The stock option agreement also provided that the bidder could put the newly issued shares back to the company if stockholders failed to approve the Steinhardt merger agreement. Issuance of the shares under the option agreement would have diluted the Carroll family's interests to below 50 percent and put significant pressure on the Carroll family once Steinhardt-controlled shares constituted a majority of the Company's voting power.

A controlling stockholder would have to be engaged in abusive conduct and exploitation of the minority before a dilutive option could be issued.

The Carroll family made clear that if the dilutive option was issued, it would sue. Understandably concerned about the legality of issuing an option that would dilute the family's controlling interest to below 50 percent, the special committee sought an opinion on the legality of the dilutive option. Because the opinion was inconclusive, the special committee terminated discussions with Steinhardt.

Katy Industries stockholders then sued, asserting that the board was under a *Revlon* duty to maximize stockholder value, which required it to grant a dilutive option to Steinhardt so that the public stockholders could take advantage of Steinhardt's $27.80 per share bid.

Chancellor Allen, as he did in *Restaurant Associates*, denied the injunction. After confirming that such dilution would violate the norm of loyalty if "the principal motivation for such dilution is simply to maintain corporate control," Chancellor Allen provided further explanation as to when it might be permissible to dilute a controlling stockholder:

> Where, however, a board of directors acts in good faith and on the reasonable belief that a controlling shareholder is abusing its power and is exploiting or threatening to exploit the vulnerability of minority shareholders, I suppose, for reasons touched upon in the cases cited in the margin, that the board might permissibly take such an action. *See Unocal Corp. v. Mesa Petroleum Co.*, Del. Supr., 493 A.2d 946 (1985).[18]

Unlike *Restaurant Associates*, where the Court simply cited *Unocal*, in *Mendel* Chancellor Allen made clear that a controlling stockholder would have to be engaged in abusive conduct and exploitation of the minority before a dilutive option could be issued in furtherance of the board's *Revlon* obligations. The stockholders asserted the Carroll family was "exploiting" the minority stockholder because it had tried to buy the minority interest at the unfairly low price of $25.75, but had refused to sell or buy at Steinhardt's offer price of $27.80. Chancellor Allen rejected this argument, finding that the Carroll family, whose ownership interest ranged from 48–52 percent over the relevant time period, was not seeking to buy control because the family already had it. Thus, there was no incongruity or unfairness in the Carroll family seeking to buy out the minority position at $25.75, without paying a control premium, but refusing to sell at $27.80, which could very well be inadequate given that Steinhardt was

seeking to acquire control of the entire company and, therefore, would be obligated to pay a control premium for it.

Chancellor Allen also noted that the members of the Carroll family had made it clear that they were "completely uninterested in being sellers in any transaction" and, consistent with the Delaware Supreme Court's decision in *Bershad v. Curtiss-Wright*, that "no part of their fiduciary duty as controlling shareholders requires them to sell their interest." As to the board's duty in the face of a controlling stockholder who refused to sell into a premium third party bid, Chancellor Allen noted (with emphasis added):

> The board's fiduciary obligation to the corporation and its shareholders, in this setting, requires it to be a protective guardian of the rightful interest of the public shareholders. But while that obligation may authorize the board to take extraordinary steps to protect the minority from plain overreaching, it does not authorize the board to deploy corporate power against the majority stockholders, in the *absence of a threatened serious breach of fiduciary duty by the controlling stock.*[19]

Chancellor Allen reiterated that a board owes a fiduciary duty to *all* stockholders, and that the existence of *Revlon* duties, without more, could not serve as the basis for a grant of a dilutive option:

> Thus, while I continue to hold open the possibility that a situation might arise in which a board could, consistently with its fiduciary duties, issue a dilutive option in order to protect the corporation or its minority shareholders from exploitation by a controlling shareholder who was in the process or threatening to violate his fiduciary duties to the corporation, such a situation does not at all appear to have been faced by the Katy board of directors.
>
> In my opinion, far from "Revlon duties" requiring such action, the Katy board could not, consistent with its fiduciary obligations to all of the stockholders of Katy Industries, have issued the dilutive option for the purpose sought in this instance.[20]

Frederick's of Hollywood

In *In re Frederick's of Hollywood, Inc., Shareholders Litigation,*[21] Frederick's executed a merger agreement pursuant to which an acquiror, Knightsbridge Capital, would buy all of Frederick's shares for $6.14 in cash per share. A competing bidder, The Veritas Capital Fund, bid $7.75 per share conditioned upon Frederick's grant to Veritas of an option to purchase newly issued shares of Frederick's in an amount sufficient to dilute Knightsbridge's significant stock interest. Shareholders representing 43 percent and 53 percent of Frederick's Class A and B shares sold their shares to Knightsbridge, who made it clear that the newly-acquired shares would be used to vote in favor of the Knightsbridge-Frederick's merger. Knightsbridge also made it clear that it "would not vote in favor of the bid submitted by Veritas or any other bid to acquire the Company." Knightsbridge also matched the Veritas offer of $7.75 per share, and purchased additional shares on the open market, resulting in the ownership of an absolute majority of both classes of Frederick's stock.

Veritas responded with an unsolicited offer of $9.00 per share, to which the Frederick's board did not respond. The board's reasons for failing to respond to the higher offer were threefold: (1) the merger agreement did not contain a "fiduciary out;" (2) Knightsbridge had acquired a majority of each class of Frederick's stock and had declared that it would refuse to vote those shares except in support of its own bid; and (3) Veritas had requested a dilutive option, whose legal validity had been questioned by the board.[22] The board thereupon approved the merger with Knightsbridge at $7.75 per share.

Frederick's stockholders sued Frederick's directors for breaching their fiduciary duties because the board had failed to take measures to maximize stockholder value, such as granting a dilutive option that would have made a merger with Veritas at $9.00 per share more likely, rather than executing a merger agreement with Knightsbridge at $7.75 per share. As to that argument, Vice Chancellor Jacobs succinctly stated: "That, however, would appear to be contrary to Delaware law. *See Mendel v. Carroll*, Del. Ch. 651 A.2d 297 (1994)."[23] Plaintiff stockholders also claimed that Knightsbridge, the acquiror, intentionally and wrongfully interfered with their expectancy of obtaining a higher price for their stock, namely, $9.00 per share from Veritas. Vice Chancellor Jacobs concluded that plaintiffs had failed to show they had any valid business expectancy (with emphasis added):

> Although the plaintiffs argue that Frederick's board had the power to issue a dilutive option, they do not allege that the board had a fiduciary or other duty to exercise that power. Moreover, the limited case law on this subject indicates that except where the majority stockholder is acting to maintain corporate control or is threatening to exploit the vulnerability of the minority stockholders, the issuance of a "dilutive option" would constitute a breach of fiduciary duty in violation of Delaware law. In short, the plaintiffs have not pled that a valid business expectancy existed, because the *complaint reveals no lawful way that Frederick's could have circumvented Knightsbridge's power (and, as the majority shareholder, its right) to vote down any transaction it did not favor.*[24]

Vice Chancellor Jacobs, like Chancellor Allen in *Mendel v. Carroll*, reiterated the principle established in *Bershad v. Curtiss-Wright* that Knightsbridge, as a majority stockholder, could vote its shares however it chose: "[u]nder Delaware Law, a majority stockholder is not obligated to vote its shares in favor of a transaction that it opposes."[25]

What Is a Serious Breach of Fiduciary Duty Justifying Dilution?

What conduct by a controlling stockholder justifies a board's resort to a dilutive option? While not directly involving a dilutive option, *Hollinger International v. Black*[26] involved a stockholder affirmatively threatening to interfere with a company's strategic process for the sale of its assets. There, the Delaware Chancery Court approved the adoption of a poison pill against a controlling stockholder, conduct which is less draconian than the issuance of a dilutive option.[27]

In *Hollinger*, Conrad Black who, through Hollinger Inc., controlled 72.8 percent of the voting power of Hollinger International, had agreed not to engage in any transactions that would negatively impact the strategic process upon which Hollinger International's independent directors had embarked. According to the Chancery Court, however, during the strategic process, Black (1) attempted to sell his interest to a third party, the Barclay Brothers, which would have transferred control of Hollinger Inc. before the bidding had even begun; (2) misled the other directors about his conduct; (3) improperly used confidential information belonging to Hollinger International without authorization from his fellow directors; and (4) urged the Barclay Brothers to provide improper inducements to Hollinger International's investment bank in order to secure board assent to Black's transaction with the Barclay Brothers. Vice Chancellor Strine summed up the controlling stockholder's conduct:

> Black intentionally subverted [Hollinger's] Strategic Process he had pledged to support through a course of conduct involving misleading and deceptive conduct toward his fellow directors, all designed with the goal of presenting them with a "fait accompli." . . . It is difficult to conceive of a meaningful definition of the duty of loyalty that tolerates conduct of this kind.[28]

Vice Chancellor Strine held that adoption of a pill by the independent directors of Hollinger International for a limited duration was a proportionate and reasonable response to the threat posed by Black's sale of his interest in Hollinger International. Importantly, Vice Chancellor Strine underscored that his ruling was less draconian than the dilution of a controlling stockholder as envisaged in the limited circumstance identified in *Mendel*:

> By parity of reasoning, if actual action to dilute the majority stockholder might be justified, the less extreme act of interposing a rights plan should not be ruled out entirely as a permissible response to a controlling stockholder's serious acts of wrongdoing towards the corporation. . . . By operation of its terms, the Rights Plan merely acts as an inhibition on alienation or additional purchases and does not work an immediate dilution.[29]

The Delaware Supreme Court affirmed, noting, however, that a subsidiary's adoption of a rights plan against a parent "should be understood as limited to the specific, rather extreme, circumstances of this case."[30]

Conclusion

The trilogy of *Restaurant Associates*, *Mendel*, and *In re Frederick's of Hollywood* makes clear that a board's duty to maximize value under *Revlon*, in and of itself, may not justify the grant of a dilutive option. Only if a controlling stockholder engages in a serious breach of fiduciary duty may a board consider granting a dilutive option. Even then, the board may have to justify its conduct under the high "compelling justification" standard established in *Blasius*, as Chancellor Allen indicated in *Mendel v. Carroll*. If a stockholder does not owe a fiduciary duty because it does not "own a majority interest or exercise[] control over the business affairs of the corporation,"[31] then it cannot breach such a duty, making a dilutive option even less likely to meet the *Mendel v. Carroll* standard.

While the circumstances in which a controlling stockholder may breach its fiduciary duties are numerous and varied, the mere fact that a controlling stockholder has elected not to vote in favor of a transaction for its own economic reasons cannot form the basis of a fiduciary duty claim. If a controlling stockholder makes open market purchases in the face of a third-party bid, as in *In re Frederick's of Hollywood*, and secures absolute majority ownership as a result, that cannot constitute a breach of fiduciary duty. Furthermore, a controlling stockholder's participation in a bidder group that competes against a third-party bid should not, without more, constitute a breach of fiduciary duty that would permit a board to issue a dilutive option. Indeed, in both *Mendel* and *Frederick's of Hollywood,* the controlling stockholder was competing against a third-party bidder to buy out the minority stockholders.

Nothwithstanding the Delaware case law on this issue, controlling stockholders of Delaware corporations should remain wary that dilutive options are a theoretical tool in the arsenal of a board that is engaging in a sales effort if a credible case can be made that such a stockholder is breaching its fiduciary duties towards the minority stockholders.

> ***Knowing participation in a breach of fiduciary duty is actionable.***

Boards of directors, and special committees acting at their request, should likewise remain wary that, under the existing case law, dilutive options sought by acquirors, in the absence of fiduciary breaches by a controlling stockholder, may be subject to legal challenge even if the board is under a *Revlon* duty to maximize

shareholder value. Litigation against a board of directors for adopting a dilutive option may be expensive and disruptive, particularly if there are multiple bids for a company, which could also result in prolonged uncertainty and long term harm to stockholder interests.[32] In order to minimize such litigation risk, it is theoretically possible that a special committee could demand an express contractual right to issue a dilutive option in the special committee's charter, although it is difficult to see how or why a controlling stockholder would consent to providing a board of directors (or a special committee) the contractual right to issue a dilutive option given the existing Delaware case law on the subject. For the same reasons, a special committee's failure to secure such an express right would be unlikely to constitute a breach of fiduciary duty to the minority stockholders.

Acquirors, too, should think carefully before demanding a provision whose very adoption could constitute a breach of fiduciary duty and provide the target board with an excuse not to engage in further negotiations. For example, the board in *In re Frederick's of Hollywood* used a competing bidder's demand for a dilutive option of questionable legal validity as one reason to justify its failure to negotiate, even though the competing bidder had offered a higher headline price than the preferred merger partner.[33] Furthermore, while an acquiror ordinarily does not owe fiduciary duties to a target's stockholders, knowing participation in a breach of fiduciary duty is actionable. Although succeeding on such a claim is quite difficult, the transaction costs of bargaining for, and receiving, a provision that is ultimately found to constitute a breach of fiduciary duty, can be high.[34]

Notes

1. *See, e.g.*, Jaehoon Kim, *Time-Series Analysis of Going-Private Transactions: Before and After the Sarbanes-Oxley Act*, *in* 27 RESEARCH IN FINANCE 1, 1 (John W. Kensinger ed., 2011) ("Recent corporate scandals have led to legislative and regulatory responses that significantly increase the monitoring costs and other burdens of becoming or remaining a public corporation. As a result, there has been a substantial increase in going-private transactions . . . .").

2. *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

3. *In re J.P. Stevens & Co. S'holders Litig.*, 542 A.2d 770, 782 (Del. Ch. 1988).

4. *See, e.g., Bershad v. Curtiss-Wright*, 535 A.2d 840 (Del. 1987).

5. *In re Synthes S'holder Litig.*, 50 A.3d 1022, 1040 (Del. Ch. 2012) (*citing Getty Oil v. Skelly Oil Co.*, 267 A.2d 883, 888 ("[T]he duty [of a parent to its subsidiary] does not require self-sacrifice from the parent."); *Odyssey P'rs, L.P. v. Fleming Cos., Inc.*, 735 A.2d 386, 411 (controlling stockholder was under no fiduciary obligation to agree to a proposal that would have "required significant and disproportionate self-sacrifice"); *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 598 (Del. Ch. 1986) ("While the law requires that corporate fiduciaries observe high standards of fidelity and, when self-dealing is involved, places upon them the burden of demonstrating the intrinsic fairness of transactions they authorize, *the law does not require more than fairness.* Specifically, it does not, absent a showing of culpability, require that directors or controlling shareholders sacrifice their own financial interest in the enterprise for the sake of the corporation or its minority shareholders.") (emphasis added)).

6. *In re Synthes S'holder Litig.*, 50 A.3d 1022, 1041; *see also Bershad*, 535 A.2d 840, 845 ("Stockholders in Delaware corporations have a right to control and vote their shares in their own interest."); *Tanzer v. Int'l Gen. Indus., Inc.*, 379 A.2d 1121, 1123 (Del. 1977) ("[W]e are well aware that a majority stockholder has its rights, too. And among these is exercising a fundamental right of a stockholder in a Delaware corporation; namely, the right to vote its shares."), *overruled on other grounds by Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *see also Williams v. Geier*, 671 A.2d 1368, 1380–81 (Del. 1996) ("Stockholders (even a controlling stockholder bloc) may properly vote in their own economic interest[.]").

7. Under Delaware law, a controlling stockholder is somebody who owns a "majority interest in or *exercises control* over the business affairs of the corporation." *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1113 (Del. 1994) (*citing Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1334 (Del. 1987)). Only controlling stockholders owe fiduciary duties to other stockholders. *Id.*

8. *See* NASDAQ Listing Rule 5635(d); NYSE Rule 312.03.

9. *Condec Corp. v, Lunkenheimer*, 230 A.2d 769 (Del. Ch. 1967) (issuance of stock by majority stockholder for primary purpose of freezing out minority interest and maintaining control was improper); *Frantz Mfg. Co. v. EAC Indus., Inc.*, 501 A.2d 401 (Del. 1985) (corporate funding of ESOP and issuance of shares to ESOP that caused majority

stockholder to lose control was not protected by the business judgment rule); *Can. S. Oils v. Manabi Exploration Co.*, 96 A.2d 810, 814 (Del. Ch. 1953) (issuance of shares whose primary purpose was to deprive shareholder of majority voting control was improper, noting that "majority voting control is a right which a court of equity will protect under these circumstances.").

10. 1987 Del. Ch. LEXIS 498 (1987).

11. *Freedman v. Rest. Assocs. Indus., Inc.*, 1987 Del. Ch. LEXIS 498, at *11 (1987).

12. *Id.* at *26.

13. *Id.* at *27.

14. *Id.* at *27–28.

15. *Unocal Corp. v. Mesa Petroluem Co.*, 493 A.2d 946, 955 (Del. 1985) (board may take a defensive measure if it reasonably believes there is a "threat" to corporate policy and effectiveness, and any response must be "reasonable" and proportionate to the threat posed.). The Court ultimately found that the board's decision was protected by the business judgment rule because a majority of the directors was disinterested.

16. *Freedman,* 1987 Del. Ch. LEXIS 498 at *30.

17. *Mendel v. Carroll*, 651 A.2d 297 (Del. Ch. 1994).

18. 651 A.2d 297, 304. The cases cited by Chancellor Allen "in the margin" were *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988); *Freedman v. Rest. Assocs.*; and *Phillips v. Insituform of N. Am.*, 1987 Del. Ch. LEXIS 474 (1987).

19. *Mendel*, 651 A.2d 297, 306.

20. *Id.* (citation omitted). Importantly, Chancellor Allen noted that a board would, in such a situation, be governed by the high *Blasius* standard of review, observing that "[i]n such an instance the board would bear a heavy burden to establish the justification for any steps purposely taken to affect the outcome of shareholder action. *See Blasius Indus., Inc. v. Atlas Corp.* Del. Ch., 564 A.2d 651 (1988)." *Id.* at n.20. In *Blasius*, decided between *Restaurant Associates* and *Mendel*, Chancellor Allen held that conduct whose primary purpose was to interfere with the exercise of the shareholder franchise could not be justified absent a "compelling justification." *Blasius*, 564 A.2d 651, 661.

21. 1998 Del. Ch. LEXIS 111 (1998). In a later decision on a motion to dismiss an amended complaint, the Chancery Court affirmed its earlier ruling dismissing the complaint. *See In re Frederick's of Hollywood, Inc. S'holders Litig.*, 2000 Del. Ch. LEXIS 19, *26–27 (2000), *aff'd sub nom. Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001).

22. *Id.* at *4–8; *In re Frederick's*, 2000 Del. Ch. LEXIS at *11–12, *aff'd sub nom. Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001).

23. *Id.* at *11 n.9.

24. *Id.* at *20 (citations omitted).

25. *Id.* (citing *Emerson Radio Corp. v. Int'l Jensen Inc.*, 1996 Del. Ch. LEXIS 100 (1996); *Thorpe v. Cerbco, Inc.*, 676 A.2d 436, 444 (Del. 1996); *Bershad*, 535 A.2d 840, 845).

26. 844 A.2d 1022 (Del. Ch. 2004), *aff'd*, 872 A.2d 559 (Del. 2005).

27. *Id. See also* Judith R. Thoyer, *Controlling Shareholders and Poison Pills*, 10 THE M&A LAWYER 13 at *8 n.18 (2005) (noting that a poison pill falls far short of some more draconian measures attempted by aggressive boards to dilute controlling stockholders to maximize value, observing that "[e]ven pills recognize the limitations on dilution of a majority shareholder's control position. . . . [P]ills generally provide that the board may not effect such exchange at any time after any person becomes the beneficial owner of 50 percent or more of the voting power of the common shares.").

28. *Hollinger*, 844 A.2d at 1062.

29. *Id.* at 1088.

30. *Black v. Hollinger Int'l*, 872 A.2d 559, 567 n.16 (Del. 2004).

31. *Kahn v. Lynch*, 638 A.2d at 1113.

32. There are limits to the power of a board to dilute a stockholder, even when it believes that a controlling stockholder is breaching its fiduciary duties. *See, e.g., Adlerstein v. Werthheimer*, 2002 Del. Ch. LEXIS 13, at *14, *36 (2002) (observing that Mendel does not "suggest[] that directors could accomplish such action through trickery or deceit.").

33. *In re Frederick's*, 2000 Del. Ch. LEXIS at *26–27.

34. *Paramount Commc'ns, Inc. v. QVC Network Inc.*, 637 A.2d 34, 51 (Del. 1994) (observing that "[acquiror] cannot be now heard to argue that it obtained vested contract rights by negotiating and obtaining contractual provisions from a board acting in violation of its fiduciary duties.") (acquirer had no vested contract right in option that constituted a breach of fiduciary duty); *Ace Ltd. v. Capital Re Corp.*, 747 A.2d 95, 105 (Del. Ch. 1999) ("a suitor cannot importune a target board into entering into a deal that effectively prevents the emergence of a more valuable transaction or that disables the target board from exercising its fiduciary responsibilities.") (court strikes down no-talk provision finding that acquiror had no contract or other right to a provision that caused a director to breach its fiduciary duties to stockholders).