SEIZING THE FIRST-MOVER ADVANTAGE: RESOLVING THE TENSION IN DELAWARE LAW BETWEEN BOARDS OF DIRECTORS AND CONTROLLING SHAREHOLDERS

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In 2018, the Delaware courts confronted an extraordinary crisis of corporate governance: an open conflict between a corporation's board of directors and its controlling shareholder. The board of CBS Corporation, a large media firm, voted to issue a dividend that would have diluted the shares of its controlling shareholder, National Amusements, Inc. (NAI). The dividend would have severed NAI's control, leaving the board in sole command of CBS's future. NAI challenged the CBS board's authority to issue the dividend, and litigation ensued. In CBS v. National Amusements, Inc.*, the Delaware Court of Chancery issued a brief ruling denying CBS's motion for a temporary restraining order. The opinion described the broader issue in the case as the problem of first-mover advantage. The problem derives from two lines of Delaware cases that place inconsistent demands on boards of directors and controlling shareholders. It can be formulated as follows: When a board of directors reasonably believes that a controlling shareholder threatens to exploit a corporation or its minority shareholders, can it adopt measures to preempt such exploitation by the controller, or can the controller take action to preserve its control by preempting the board's efforts? But before the court could address this question on the merits, the parties settled. The central corporate governance issue in the case remains unresolved.*

This Note proposes that courts respond to contemporary developments in corporate law, chief among them the rise of dual-class stock structures in American corporations, by resolving the first-mover advantage problem raised in CBS v. National Amusements, Inc. *The Delaware courts should settle the problem by assigning first-mover advantage to controlling shareholders in corporations with one-share-one-vote regimes and by assigning first-mover advantage to boards of directors in corporations that have dual-class stock structures. By distinguishing among corporations on the basis of their stock structures in assigning first-mover advantage, courts can help restore the balance of power between boards and controllers, alleviate the increased agency costs of corporations with dual-class stock structures, and make progress toward regularizing what remains an unsettled area of corporate law.*

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* J.D. Candidate 2020, Columbia Law School. The author would like to thank Jeffrey N. Gordon for his invaluable guidance in connection with this Note. The author would also like to thank Assaf Hamdani, Theodore N. Mirvis, and Charlotte A. Walkovik for their helpful feedback and comments. Finally, the author would like to thank the staff of the *Columbia Law Review* for their superb editorial support.

INTRODUCTION

At the beginning of 2018, CBS Corporation was one of the world's largest, most successful media companies.[1] But within a few short months, and despite the record financial strength of the underlying company, a crisis of corporate governance nearly tore the corporation asunder. A dispute broke out between the Board of Directors of CBS and the company's controlling shareholder, National Amusements, Inc. (NAI).[2] Rumors emerged that NAI planned to merge CBS with NAI's troubled subsidiary, Viacom, and that it was willing to replace the board if necessary to do so.[3] The CBS board vehemently disagreed with the proposed merger, and in an unprecedented move, it resolved to take action against the corporation's own controlling shareholder.[4]

In an extraordinary act of defiance, the board decided to vote on whether to issue a stock dividend to dilute NAI's controlling position.[5] If left unchallenged, the dilutive dividend would have released CBS from NAI's control, allowing the board to determine the corporation's future, free from the interference of the controlling shareholder.[6] The board sued for a temporary restraining order in the Delaware Court of Chancery,[7] but before the board could vote on the dividend, NAI struck

1. See CBS Corp., Annual Report (Form 10-K) II-4 (Feb. 16, 2018), http://www.annualreports.com/HostedData/AnnualReportArchive/c/NYSE_CBS_2017.pdf [https://perma.cc/3CR8-ELBS] ("For 2017, revenues grew 4% to an *all-time high* of $13.69 billion . . . ." (emphasis added)).

2. See Keach Hagey & Joe Flint, Shari Redstone Wants New CBS Directors, Renews Push for Merger with Viacom, Wall St. J. (Jan. 17, 2018), https://www.wsj.com/articles/shari-redstone-wants-new-cbs-directors-renews-push-to-merge-cbs-and-viacom-1516217045 (on file with the *Columbia Law Review*).

3. See id. ("Shari Redstone is advocating for new blood on the board of CBS Corp. as she renews her push to merge the company with Viacom Inc . . . . Ms. Redstone is already gathering names of possible candidates . . . . Ms. Redstone reached out . . . to jump-start talks about merging CBS and Viacom Inc. . . . .").

4. Jessica Toonkel & Tom Hals, CBS Sues Controlling Redstone Family in Bid for Independence, Reuters (May 14, 2018), https://www.reuters.com/article/us-viacom-cbs/cbs-sues-controlling-redstone-family-in-bid-for-independence-idUSKCN1IF1TO [https://perma.cc/7APW-2M4M] ("CBS Corp filed a lawsuit on Monday to reduce the voting power of controlling shareholder National Amusements Inc, the movie theater company owned by Sumner and Shari Redstone, in an act of defiance aimed at thwarting the Redstones' plan to merge CBS with Viacom Inc.").

5. See Keach Hagey & Joe Flint, Shari Redstone Moves to Defend Family's Voting Power over CBS, Wall St. J. (May 16, 2018), https://www.wsj.com/articles/redstones-call-cbs-maneuver-unprecedented-usurpation-of-voting-power-1526490887 (on file with the *Columbia Law Review*) ("CBS's special committee of independent board members . . . is seeking to block National Amusements from replacing board members or modifying the company's governance documents before CBS convenes a special meeting on Thursday to vote on diluting the Redstones' control.").

6. See CBS Corp. v. Nat'l Amusements, Inc., No. 2018-0342-AGB, 2018 WL 2263385, at *2 (Del. Ch. May 17, 2018).

7. Verified Complaint at 35, *CBS*, No. 2018-0342-AGB, 2018 WL 2194011.

first—it amended the bylaws of the company to effectively preclude the CBS board from issuing the dividend.[8] The board refused to concede the amendments' validity and voted to issue the dilutive dividend. The board amended its complaint, seeking a declaration of the legality of the dilutive dividend and the invalidity of the bylaw amendments.[9] Yet after receiving only a brief ruling from the Court of Chancery denying CBS's request for a temporary restraining order against NAI,[10] the parties settled.[11] The central corporate governance issue raised by the case remains unresolved.

The court in *CBS Corp. v. National Amusements, Inc.* described the broader issue in the case as the problem of first-mover advantage.[12] The problem can be formulated as follows: When a board of directors reasonably believes that a controlling shareholder threatens to exploit a corporation or its minority shareholders, can it adopt measures to preempt such exploitation by the controller, or can the controller take action to preserve its control by preempting the board's efforts?[13] The origin of the problem stems from two lines of Delaware cases that place inconsistent demands on boards of directors and controlling shareholders. While one line of Delaware cases appears to empower boards of directors to take action against their controlling shareholders, a parallel line of Delaware cases appears to endorse the reverse—that a controlling shareholder has the right to intervene against an uncooperative board.

This Note argues that Delaware courts should resolve the first-mover advantage problem raised by the tension between the *Adlerstein v. Wertheimer*[14] and *Mendel v. Carroll*[15] lines of cases by assigning first-mover advantage to controlling shareholders in corporations with one-share-one-vote regimes

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8. *CBS*, 2018 WL 2263385, at *2 ("NAI . . . delivered consents to amend CBS's bylaws to . . . require approval by 90% of the directors . . . . Given that CBS's Board currently consists of fourteen members, three of which are NAI-designees, the 90% Bylaw (if valid) would allow NAI to block enactment of the Dividend Proposal.").

9. See Amended Verified Complaint at 7–8, 64–65, *CBS*, No. 2018-0342-AGB, 2018 WL 2397715.

10. *CBS*, 2018 WL 2263385, at *6.

11. Edmund Lee, CBS Board Tries to Move past Moonves Crisis with New Directors, N.Y. Times (Sept. 10, 2018), https://www.nytimes.com/2018/09/10/business/media/cbs-board-les-moonves-shari-redstone.html (on file with the *Columbia Law Review*) (explaining that, under the terms of the settlement between CBS and NAI, CBS agreed to withdraw its lawsuit).

12. *CBS*, 2018 WL 2263385, at *3.

13. The problem of first-mover advantage arises when a disagreement between a board of directors and a controlling shareholder escalates into open conflict between the two entities. This scenario implicates an "apparent tension in [Delaware] law between a controlling stockholder's right to protect its control position and the right of independent directors . . . to respond to a threat posed by a controller . . . ." *CBS*, 2018 WL 2263385, at *5.

14. No. CIV.A. 19101, 2002 WL 205684 (Del. Ch. Jan. 25, 2002).

15. 651 A.2d 297 (Del. Ch. 1994).

and by assigning first-mover advantage to boards of directors in corporations that have dual-class stock structures.[16] Part I surveys the five major cases in which the Delaware courts have addressed open conflicts between controlling shareholders and boards of directors. Part II assesses the implications of a legal rule that would assign first-mover advantage to boards of directors, outlines the consequences of a legal rule that would assign first-mover advantage to controlling shareholders, and explains why Delaware's existing legal regime fails to vindicate the legitimate concerns raised by the arguments supporting either legal rule. Finally, Part III argues that the tension in the case law described in Part I and the concerns outlined in Part II would best be resolved by a legal rule that assigns first-mover advantage to controlling shareholders in one-share-one-vote companies and to boards of directors in companies with dual-class stock regimes. Part III then concludes by describing the methods by which Delaware courts can assign first-mover advantage in each of these two contexts.

I. A Survey of Conflicts Between Boards of Directors and Controlling Shareholders

This Part traces the history of conflicts between boards of directors and controlling shareholders in Delaware courts. Its analysis focuses on the *Adlerstein* and *Mendel* lines of cases, which together give rise to the "tension" described by the court in *CBS Corp. v. National Amusements, Inc.* Section I.A outlines the line of cases in which Delaware courts have suggested that boards can move preemptively against a controlling shareholder in the event of a conflict between the two entities. Section I.B outlines the line of cases in which Delaware courts have suggested that the opposite is

16. This Note refers to "one-share-one-vote" regimes (which are also known as "single-class" stock regimes) and "dual-class stock" regimes, but these terms are intended to encompass more than those two structures alone. The term "one-share-one-vote" is used to refer to firms in which there is no wedge between the cash-flow rights and the voting rights of the corporation's stock. See Glossary of Stock Market Terms, Nasdaq, https://www.nasdaq.com/investing/glossary/o/one-share-one-vote-rule [https://perma.cc/ZM5B-B2M9] (last visited Oct. 12, 2019) (defining the one-share-one-vote rule as "[t]he principle that all shareholders should have equal voting rights in public companies and each shareholder should have one vote"). "Dual-class stock," on the other hand, is used to refer to firms in which there is a wedge between the cash-flow rights and the voting rights of the corporation's stock. This wedge can arise from a dual-class stock structure, but it can also arise from other arrangements, such as a pyramidal voting structure. See Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1031–33 (Del. Ch. 2004), aff'd, 872 A.2d 559 (Del. 2005) (describing how the controlling shareholder exercised his control over a corporation through a pyramidal ownership structure consisting of a series of intermediate holding corporations); Lucian Arye Bebchuk, Reinier Kraakman & George G. Triantis, 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, 298–99 (Randall K. Morck ed., 2000) (explaining how pyramidal structures can be utilized to achieve separation between voting rights and cash-flow rights in the absence of a dual-class stock regime and detailing the incidence of pyramidal structures across jurisdictions). For convenience, this Note uses "dual-class" stock as shorthand for all equity arrangements that create wedges between a corporation's cash-flow rights and voting rights.

true—that controllers have the right to move preemptively against their firms' boards. Section I.C compares these two lines of cases and demonstrates that they place inconsistent demands on boards of directors and controlling shareholders. Finally, Section I.D canvases *CBS*, an inconclusive case that belongs to neither line of cases but represents the Delaware courts' most recent engagement with this issue.

A. *The Pro-Board Cases:* Mendel v. Carroll *and* Hollinger International, Inc. v. Black

1. Mendel v. Carroll. — In *Mendel v. Carroll*, the Delaware Court of Chancery endorsed, in dicta, the idea that a board of directors can take preemptive action against a controlling shareholder that abuses its power and exploits minority shareholders.[17] The plaintiff in *Mendel* sought to acquire the defendant's company.[18] The defendant, however, controlled 50.6% of the company's voting power and refused to allow the sale of the firm.[19] The plaintiff then sued, seeking an injunction "requiring the board of directors . . . to grant an option to buy 20% of its stock to a third party for the primary purpose of diluting the voting power of an existing control block of stock."[20] The plaintiff's primary arguments were "that the controlling shareholders are exploiting the vulnerability of the minority shares," that "the foregoing protective principle grounded in fiduciary obligation would apply to this situation, and that the board is, as a result, under a current obligation to take the radical step of intentionally diluting the control of the controlling block of stock."[21]

Chancellor William T. Allen of the Delaware Court of Chancery found the proposed dilution of the defendant controlling shareholder's shares to be an "unprecedented remedy" and proceeded to explore the legality of such a move.[22] The court began by first reasserting the principle enunciated in *Condec Corp. v. Lukenheimer Co.*[23] and *Canada Southern Oils, Ltd. v. Manabi Exploration Co.*[24] that a board cannot dilute a controlling

17. 651 A.2d at 304.

18. Id. at 298.

19. Id.

20. Id.

21. Id. at 304.

22. Id. at 298.

23. 230 A.2d 769 (Del. Ch. 1967). *Condec* involved a corporation with a one-share-one-vote regime. An individual shareholder assembled a large enough block that it controlled over 50% of the shares, so the preexisting board tried to dilute the newly created controlling shareholder by issuing authorized but yet-unissued shares. Id. at 772–73. The court invalidated the dilutive issuance on the ground that it "unjustifiably strikes at the very heart of corporate representation." Id. at 777. Central to the court's reasoning was its finding that the case involved no breach of any fiduciary duties by the controlling shareholder. Id. at 776 (finding no justification for the board's belief that the controller's "aspirations represented a reasonable threat to the continued existence" of the company).

24. 96 A.2d 810 (Del. Ch. 1953). A later case, *Phillips v. Insituform of North America, Inc.*, noted that *Canada Southern* might alternatively be read for the broad proposition that boards

shareholder's position without breaching its duty of loyalty "if the principal motivation for such dilution is simply to maintain corporate control ('entrenchment') . . . ."[25] Importantly, however, the Chancellor then qualified this principle, reasoning that "[w]here . . . 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, . . . *the board might permissibly take such an action*."[26] Although the court ultimately found that the facts of the case before it simply did not "justify discrimination against a controlling block of stock,"[27] the case nonetheless left open the question of just what set of facts would.[28]

The reasoning of *Mendel* supports the proposition that there are circumstances in which a board of directors can take measures to dilute a controlling shareholder's stock—namely, when it reasonably believes that the controller is exploiting or threatens to exploit the company's minority shareholders.[29] On the whole, *Mendel* increases the powers of boards vis-à-vis controllers in disputes between the two by explicitly recognizing that there are circumstances in which the former may be justified in taking extreme measures, such as outright dilution of a control block, to curtail the power of the latter.[30]

2. Hollinger International, Inc. v. Black. — *Hollinger International, Inc. v. Black* was the second major case in which the Delaware courts affirmed a board's right to take preemptive action against the company's controlling shareholder.[31] In that case, the controller (Conrad Black) exercised his control over the company (Hollinger International, Inc.) indirectly through

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cannot—under any circumstances—issue shares to dilute a large shareholder's voting power. See No. 9173, 1987 WL 16285, at *8 (Del. Ch. Aug. 27, 1987). But the *Mendel* court appeared to endorse *Insituform*'s narrower reading of *Canada Southern* (which the *Insituform* court found to be more consistent with Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985)), under which *Canada Southern* merely requires that a board present a "compelling corporate purpose" before it issues shares to dilute a large shareholder's voting power. *Insituform*, 1987 WL 16285, at *8.

25. *Mendel*, 651 A.2d at 304.

26. Id. (emphasis added).

27. Id. The court found in favor of the defendant controlling shareholder because it did not find the requisite exploitation of the firm's minority shareholders. Id. at 306 ("[N]othing . . . suggests . . . that the . . . price the Carroll Group proposed to pay for the . . . shares was an inadequate or unfair price for the non-controlling stock. . . . [T]he fact that [another buyer] was willing to pay more for . . . the shares does not . . . support an inference that the Carroll proposal . . . was not fair.").

28. Id.

29. Id. Additionally, *Mendel* provides an example of a set of facts in which a controller's actions do *not* constitute "exploitation . . . towards a vulnerable minority that might . . . justify discrimination against a controlling block of stock." Id. at 304. *Mendel* thus provides a concrete lower bound of when dilution of a controller by a board is inappropriate and a vaguely defined upper bound of when such action might be acceptable.

30. See supra notes 25–26 and accompanying text.

31. 844 A.2d 1022 (Del. Ch. 2004), aff'd, 872 A.2d 559 (Del. 2005).

a series of intermediate holding companies.[32] Under pressure from an investigation into a series of self-dealing transactions,[33] Black signed an agreement with the company, under which, among other concessions, he would resign as CEO and consent to "a newly reconstituted board including a solid majority of independent directors."[34] Yet "[a]lmost immediately after the . . . [a]greement was announced, Black violated it . . . by diverting to himself a valuable opportunity that had been presented to International—the possible sale of one of its flagship businesses."[35]

At that point, the board began considering whether to adopt a "poison pill" with the intention of blocking Black's proposed transaction.[36] In response, Black threatened to remove the International board if it adopted the poison pill.[37] Black then repudiated his earlier agreement with the company and attempted to sell his controlling stake in the intermediary company (which itself controlled International) to outside investors.[38] The board then responded by forming a special committee authorized to implement a shareholder rights plan.[39] Black retaliated by causing Hollinger, Inc. (the intermediary company that controlled International) to issue written consent decrees amending International's bylaws, which "fundamentally altered

32. Id. at 1030–32. Hollinger International operated several well-known newspapers through its subsidiaries, including the *Chicago Sun–Times*, the *Daily Telegraph*, and the *Jerusalem Post*. Id. Hollinger, Inc. owned 30.3% of Hollinger International, Inc. (note the two distinct but similarly named firms). Id. But as a result of the company's dual-class stock structure, it controlled 72.8% of the company's voting power. Id. In turn, Ravelston Corporation Limited owned 78% of Hollinger, Inc.'s common stock. Id. at 1032. Finally, through a personal holding company, Lord Conrad Black owned 65% of Ravelston's common stock. The court thus found him to be the ultimate controlling shareholder of Hollinger International, Inc. Id. at 1028.

Scholars have described these pyramidal ownership structures as "controlled-minority structures" (also referred to as "CMS" firms), whereby a shareholder is able "to control a firm while holding only a fraction of its equity." Bebchuk et al., supra note 16, at 295, 298 ("A [controlling-minority structure] firm can be established with a single class of stock by pyramiding corporate structures. . . . In a three-tier pyramid, the primary holding company controls a second-tier holding company that in turn controls the operating company."). Professors Bebchuk, Kraakman, and Triantis contrast this more complex arrangement with straightforward "controlled structure[s] . . . in which a large blockholder owns a majority or large plurality of a company's shares." Id. at 295.

33. *Hollinger Int'l*, 844 A.2d at 1033–35. Black also served as Hollinger International, Inc.'s (hereinafter "International") CEO and Chairman of the Board. Id. at 1033. The dispute between Black and his fellow directors of International began when one of International's largest shareholders requested that the company's board initiate an investigation into several large payments made by the company to Black and other members of the firm's management team. Id. at 1034.

34. Id. at 1043.

35. *Hollinger Int'l*, 872 A.2d at 562. Further, Black "consciously chose to conceal" the possible transaction, which the Delaware Court of Chancery found to constitute a breach of his fiduciary duties owed to International. *Hollinger Int'l*, 844 A.2d at 1072.

36. *Hollinger Int'l*, 844 A.2d at 1050.

37. Id.

38. Id. at 1053.

39. Id. at 1053–54.

the power that the International independent directors possessed."[40] Finally, the board, believing Black's amendments to be invalid, elected to adopt the long-discussed shareholder rights plan in spite of them.[41]

At the behest of its board's special committee, International filed suit against Black in the Delaware Court of Chancery, challenging the validity of the Bylaw Amendments.[42] After determining that Black's actions constituted a breach of the duty of loyalty that he owed to International, the court invalidated the Bylaw Amendments.[43] Turning to the validity of the shareholder rights plan, the court conceded that, in the general case, Black's argument that it would be "perverse" for a subsidiary corporation to use a rights plan to prevent its parent corporation from selling itself would stand.[44] But the court then cited *Mendel v. Carroll* for the proposition that "extraordinary scenarios" may justify resistance by a board of directors of a controlled corporation against its controller when the latter threatens to commit "serious acts of wrongdoing towards the corporation."[45] Under the authority of that case, the court upheld the board's "proportionate" adoption of the shareholder rights plan.[46]

The ruling in *Hollinger International* empowers boards to take preemptive action in disputes with controllers in two respects. First, the court placed a limit on a controller's right to take action against a board

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40. Id. at 1055. The amendments would have had the effect of empowering Black to prevent the execution of any shareholder rights plan. Id. ("After the Bylaw Amendments, Black could unilaterally block any material sale of assets, disable the board from adopting a shareholder rights plan, and prevent the signing of a merger agreement.").

41. Id. at 1056 ("The independent directors were not cowed by the Bylaw Amendments. They believed them to be invalid. The [special committee] therefore continued to meet. On January 25, 2004, the [special committee] adopted the 'Rights Plan.'").

42. Id. at 1059. Concurrently, Black and Hollinger, Inc. filed counterclaims seeking a declaration of the invalidity of the shareholder rights plan. Id.

43. The court invalidated the Bylaw Amendments because they were "clearly adopted for an inequitable purpose and have an inequitable effect." Id. at 1080. Recognizing that the invalidation of a controlling shareholder's bylaw amendments represented an extraordinary step, the court submitted that "action is required here because [the] amendments *complete a course of contractual and fiduciary improprieties*. [Hollinger,] Inc.'s written consent was the culmination of Black's efforts on his (and [Hollinger,] Inc.'s) behalf to end-run the [agreement] he had agreed to lead and support." Id. at 1081 (emphasis added). The court balanced concerns of fairness, reasoning that invalidating the bylaws would still allow the controller to maintain its majority of International's voting power, while upholding the validity of the bylaws would inequitably disable the board from exercising its statutorily conferred powers under title 8, section 141 of the Delaware Code. Id. at 1082 (citing Del. Code tit. 8, § 141 (2004)).

44. Id. at 1087.

45. Id. at 1087–88 (citing Mendel v. Carroll, 651 A.2d 297, 306 (Del. Ch. 1994)).

46. Id. In doing so, the court reasoned that the dilution of a controller's position that the court in *Mendel* considered authorizing was far more extreme than the mere restraint on alienation of the controller's shares imposed by the International board's rights plan. Id. ("[I]f actual action to dilute the majority might be justified, the less extreme act of interposing a rights plan should not be ruled out . . . as a . . . response to a controll[er's] . . . serious acts of wrongdoing towards the corporation. . . . [It] merely acts as an inhibition on alienation . . . .").

of directors. While the controller reserves the right to amend the company's bylaws, it can only do so to the extent that the amendments do not cause the board to be "inequitably disable[d] . . . from taking effective action . . . that is within the authority granted to [it] by § 141 and other provisions of the [Delaware General Corporation Law]."[47] Second, the court endorsed the right of a board of directors to adopt a shareholder rights plan limiting a controller's ability to alienate its shares, but only if the plan is used "to stop the bleeding" when the controller is committing "serious acts of wrongdoing towards the corporation."[48] On the whole, *Hollinger International* limits the powers of controlling shareholders and expands the powers of boards of directors to take preemptive action against them. It thus assigns first-mover advantage to boards of directors.

B. *The Pro-Controller Cases:* Frantz Manufacturing Co. v. EAC Industries *and* Adlerstein v. Wertheimer

1. Frantz Manufacturing Co. v. EAC Industries. — A second line of Delaware cases that includes *Frantz Manufacturing Co. v. EAC Industries*[49] and *Adlerstein v. Wertheimer*[50] appears to support the inverse of the pro-board proposition enunciated in *Mendel* and applied in *Hollinger International*. In *Frantz*, EAC Industries acquired a controlling stake in Frantz Manufacturing Company.[51] Immediately after acquiring control, EAC issued consent decrees[52] to amend Frantz's bylaws so that its board could not act without the express approval of EAC's president.[53] In defiance of the newly amended bylaws, Frantz's board voted to dilute EAC's control block.[54] EAC filed suit against Frantz in the Delaware Court

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47. Id. at 1082.

48. Id. at 1088.

49. 501 A.2d 401 (Del. 1985).

50. No. CIV.A. 19101, 2002 WL 205684 (Del. Ch. Jan. 25, 2002).

51. *Frantz*, 501 A.2d at 405 ("EAC . . . purchased a block of shares . . . to accumulate approximately 51% of Frantz' outstanding shares."); id. at 405 n.4 ("EAC purchased five blocks of stock on April 17, 1985, to reach majority control.").

52. The consent decrees were issued pursuant to title 8, section 228 of the Delaware Code:

> [A]ny action which may be taken at any annual or special meeting of such stockholders, may be taken without a meeting, without prior notice and without a vote, if a consent or consents in writing, setting forth the action so taken, shall be signed by the holders of outstanding stock having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all shares entitled to vote thereon were present and voted . . . .

Id. at 405–06 & n.7 (citing Del. Code tit. 8, § 228 (1985)).

53. Id. at 405 ("The . . . changes . . . required: (a) all directors to be present for a quorum; (b) unanimous vote of directors for any board action; [and] (c) unanimous approval for ratification of all committee action . . . . [I]f the consents were effective, further action by the Frantz board would be invalid without [EAC's president's] approval.").

54. Id. at 402 (describing how Frantz's board tried to dilute EAC's newly acquired control by transferring 125,000 treasury shares to an Employee Stock Ownership Plan

of Chancery, seeking a preliminary injunction "to nullify the actions taken by the Frantz board to regain control of the corporation."[55] In addition, EAC sought a declaration that its bylaw amendments were valid and that the Frantz board's dilutive measures were invalid.[56] Frantz counter-claimed, seeking a declaration of the bylaw amendments' invalidity and the validity of the board's dilutive actions.[57] Affirming the Court of Chancery, the Delaware Supreme Court upheld the validity of the controller's preemptive bylaw amendments.[58] The court then held that the board's dilutive measures were invalid, since the controller's bylaw amendments preempted them.[59] In so holding, the court distinguished *Unocal Corp. v. Mesa Petroleum Co.*[60] as a case that dealt with possible or pending corporate takeovers, rather than "an accomplished takeover."[61]

Frantz is thus a case in which a controlling shareholder preempted (by amending the corporation's bylaws so as to foreclose any possibility of resistance by the board) an effort by the board to dismantle its control. The Delaware Supreme Court endorsed the controller's move and effectively recognized that a controlling shareholder has the right to protect its control by preemptively disabling a board's capacity to defy it. *Frantz*, the earliest of the five principal decisions surveyed in this Part, thus decisively assigns first-mover advantage to controlling shareholders.

2. Adlerstein v. Wertheimer. — *Adlerstein v. Wertheimer* authorizes controlling shareholders to take preemptive measures against boards of directors that surreptitiously seek to undermine their control.[62] The facts

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(ESOP) four days after EAC amended Frantz's bylaws and placed EAC's president on Frantz's board of directors). For an exhilarating account of how a family-owned corporation once used an ESOP in an attempt to fend off a hostile takeover in the 1980s, see Mark Stevens, King Icahn: The Biography of a Renegade Capitalist 131–32 (1993) (describing how Dan River, Inc. deployed an ESOP plan in a failed bid to stave off a hostile takeover by Carl Icahn).

55. *Frantz*, 501 A.2d at 402.

56. Id. at 403.

57. Id.

58. Id. at 407 ("[T]he EAC bylaw amendments were a permissible part of EAC's attempt to avoid its disenfranchisement as a majority shareholder and . . . the bylaw amendments should be given effect as of the date of the consents.").

59. Id. at 409 ("We find that funding an ESOP in response to a shift in ownership of a corporation is not valid because the directors' action was not taken under the provision of the then valid bylaws.").

60. 493 A.2d 946 (Del. 1985).

61. *Frantz*, 501 A.2d at 408 ("*Unocal* . . . did not address the issue of whether a board of directors could take retrospective defensive measures against a majority stockholder . . . . *Unocal* dealt with . . . a possible or a pending takeover of a corporation, not an accomplished takeover."); id. ("Although . . . directors . . . act under . . . the business judgment rule . . . in . . . seeking to ward off a threatened hostile takeover, corporate action which seeks to undo a takeover bid *after* control has already passed to another group is not protected by the business judgment rule. Therefore, the measures here . . . constituted inequitable conduct.").

62. No. CIV.A. 19101, 2002 WL 205684, at *9 (Del. Ch. Jan. 25, 2002) (concluding that the controlling shareholder had a right to advance notice of a plan to dilute his voting control, so that he could remove the board's directors if he so desired).

of *Adlerstein* are as follows. The directors of SpectruMedix Corporation determined that the company's controlling shareholder (who controlled 73.27% of the company's voting power)[63] posed a threat to its business operations.[64] To combat this perceived threat, the directors negotiated a merger with an outside investor without telling the controller, who served as Chairman of the Board and CEO.[65] The effect of the merger would be to dilute the controller's control block through the issuance of new shares.[66] The plan was sprung on the controller at a board meeting, and the board voted to approve the deal over the silence of the controller.[67] Several months later, the controller, refusing to concede the legitimacy of the board's dilutive merger, voted his controlling block to remove his fellow directors and filed suit challenging the validity of the actions taken at the board meeting.[68] The Delaware Court of Chancery determined post hoc that the measures taken at the meeting were invalid.[69] The controller "possessed the contractual power" to prevent the dilutive merger, he "was entitled to know ahead of time of the plan to . . . destroy[] his voting control over the Company," and "the machinations of those individuals who deprived him of this opportunity were unfair."[70]

Adlerstein endorsed the proposition that controllers have (at a minimum) the right to advance knowledge of whether their boards of directors intend to deprive them of their control.[71] At the close of its opinion, the court addressed and distinguished *Mendel v. Carroll*, reasoning that "neither [*Mendel*] nor any other authority suggests that directors could [dilute a controlling shareholder] *through trickery or deceit*."[72]

The Delaware Court of Chancery's decision in *Adlerstein* thus represents a marked departure from the positions taken in *Mendel* and *Hollinger International*. While those two cases empowered boards at the expense of

63. Id. at *2.

64. Id. at *4 ("[A consultant] . . . concluded that [the controller] was 'the central problem' at the Company, because 'he is totally lacking in managerial and business competence . . . . For [the company] to have any chance, [the controller] must be removed from any operating influence within the company.'" (footnote omitted)).

65. Id. at *4–5.

66. Id. at *7.

67. Id. at *6–7.

68. Id. at *7. The threshold issue before the court was whether the surprise meeting of the directors was a legitimate board meeting in the first instance. The court concluded that it was, and it then passed upon the validity of the actions taken at the board meeting. Id. at *8.

69. Id. at *9.

70. Id.

71. Id. It reached this result despite the fact that a management consultant hired by the board determined that the controller was a serious risk to the company's continued existence. Id. at *4. Further, the court refused to concede that the "dire financial circumstances and actual or impeding insolvency" of the company might justify the directors' drastic actions. Id. at *11. In fact, the court found the opposite to be true, concluding that "it is in such times of dire consequence that the well-established rules of good board conduct *are most impor[t]ant*." Id. (emphasis added).

72. Id. at *11 (emphasis added).

controllers, *Adlerstein* grants significant power back to controllers in their conflicts with boards. But the *extent* of that grant is unclear because *Adlerstein* appears to lend support for either of two distinct propositions.[73] On the one hand, the case can be read as establishing that a controlling shareholder has a *procedural right* to advance notice of a board's plan to deprive it of its control, and that such deprivation cannot be accomplished through "trickery or deceit."[74] On the other hand, the case can be read as establishing that a controlling shareholder has a *substantive right* to "an adequate opportunity to protect [its] interests" (in essence, to move preemptively against the firm's board to protect its control).[75]

On either reading, it is clear that *Adlerstein* expands the legal rights of controlling shareholders vis-à-vis their companies' boards. Yet depending on how broadly the case is read, this expansion can take two forms. The narrow reading of *Adlerstein* gives controlling shareholders a procedural right in their dealings with boards of directors: the right to advance notice of a board's proposal to dilute the controlling shareholder's control block. This reading will therefore be referred to as the "procedural" reading of *Adlerstein*. The broad reading of *Adlerstein* gives controlling shareholders a substantive right against boards of directors: the right to protect their control block by taking preemptive action against the board. This reading will therefore be termed the "substantive" reading of *Adlerstein*.

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73. From the briefs of *CBS Corp. v. National Amusements, Inc.*, it is clear that *Adlerstein v. Wertheimer* can be read in two distinct ways. Read narrowly, *Adlerstein* stands for the proposition that boards cannot resort to "trickery or deceit" to dilute a controlling shareholder's control position. Id. And to pass muster under this "trickery or deceit" standard, boards should serve the controller with notice that the board intends to take measures to deprive it of its control. Id. This "procedural" reading of *Adlerstein*, although not labeled as such, appears to have been the view of CBS Corporation in *CBS*. See Plaintiffs' Reply in Support of Motion for Temporary Restraining Order at 6, CBS Corp. v. Nat'l Amusements, Inc., No. 2018-0342-AGB (Del. Ch. May 17, 2018) ("The issue in *Adlerstein* was . . . whether directors, through 'trickery or deceit,' could keep a controller uninformed about the purpose of a meeting at which they disenfranchised him. . . . *Adlerstein* . . . recognized that a board might dilute a controlling stockholder who was threatening . . . the corporation if it did so openly and transparently." (citation omitted)).

By contrast, when read broadly, *Adlerstein* stands for the proposition that a controller has the right to protect its control from a board's attempt to weaken it. On this reading, "trickery or deceit" is unacceptable not only because of its means but also because of its ends (the deprivation of the controller's control), suggesting that controlling shareholders have a substantive legal right to protect their voting position. This "substantive" reading appears to have been the view of NAI in *CBS*. See Defendants' Brief in Opposition to Plaintiffs' Motion for a Temporary Restraining Order at 18, *CBS*, No. 2018-0342-AGB, 2018 WL 2303390 ("[T]he proposed dilutive stock dividend would be invalid under *Adlerstein* . . . . There, the Court recognized that where a controlling stockholder *has the power* to forestall board action by preemptively removing directors, the board *cannot* take steps to neutralize the controlling stockholder's voting power in order to effectuate the board action." (emphasis added) (footnote omitted)).

74. *Adlerstein*, 2002 WL 205684, at *11.

75. Id. at *10.

C. *The Inconsistencies of Delaware's Two Lines of Cases*

Far from answering the question of whether a board has the right to move preemptively against a controller that threatens the company, or whether a controller has the right to move preemptively against a board that threatens to undermine its control, Delaware's decisions in the *Mendel* and *Adlerstein* lines of cases leave the law unsettled. While the *Mendel* line supports the proposition that boards can take action to protect a corporation and its minority shareholders from a controller,[76] the *Adlerstein* line—on either the procedural or substantive reading of the case—forbids boards from doing so, at least covertly.[77]

First, it should be noted that the *Mendel v. Carroll* rule seems irreconcilable with that of *Frantz Manufacturing Co. v. EAC Industries*.[78] The court in *Hollinger International*, however, did address *Frantz* and attempted to distinguish its facts.[79] The *Hollinger International* court determined that the court in *Frantz* "found the very restrictive bylaws at issue proper because the majority stockholder—which had committed no acts of wrongdoing—was acting to protect itself from being diluted."[80] The court then distinguished the relative innocence of the controlling shareholder in *Frantz* from the extraordinary actions taken by Conrad Black, the controlling shareholder of the company at issue in the case before it.[81] While the *Hollinger International* court may have succeeded in distinguishing *Frantz*, the *Mendel* court failed to even try, and it remains unclear how courts are to reconcile these conflicting lines of cases.

Thus, a board seeking to comply with both the *Mendel* and *Adlerstein* lines of cases in protecting against a controlling shareholder that it believes to pose a threat to the corporation and its minority shareholders would find itself in an untenable position. If *Adlerstein* is read for its substantive proposition, then a board might be outright barred from taking action to dilute a controlling shareholder.[82] But if *Adlerstein* is read for its procedural proposition, then the case may be reconciled with *Mendel*,

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76. Mendel v. Carroll, 651 A.2d 297, 304 (Del. Ch. 1994).

77. See *Adlerstein*, 2002 WL 205684, at *9–11.

78. Interestingly, *Mendel v. Carroll* (decided nearly a decade later in 1994) fails to even cite *Frantz Manufacturing Co. v. EAC Industries* (decided in 1985). See *Mendel*, 651 A.2d 297.

79. Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1079 (Del. Ch. 2004), aff'd, 872 A.2d 559 (Del. 2005).

80. Id. at 1080.

81. Id. at 1080–81.

82. The substantive reading of *Adlerstein* cannot be reconciled with *Mendel*. More accurately, the former directly contradicts the proposition raised in the latter. *Mendel* suggested that a situation might arise in which a board, consistent with its fiduciary duties, could dilute a controller. See *Mendel*, 651 A.2d at 304. The substantive reading of *Adlerstein* forecloses this possibility because it recognizes that a controller is "entitled to the opportunity" to protect its control by preempting any action by the board. *Adlerstein*, 2002 WL 205684, at *9. The substantive reading of *Adlerstein* thus imposes a sweeping prohibition on efforts by boards of directors to dismantle their shareholders' control blocks.

albeit with some difficulty. A board of directors that seeks to dilute a controlling shareholder can do so under *Mendel*. But paired with the procedural reading of *Adlerstein*, the board must first notify the controller of its intention to do so before the board's next meeting. If the controller passes its time idly until the next board meeting, then the board will be able to destroy the control block if it can gather the requisite number of votes.

Yet practically speaking, this sequence of events would never occur.[83] Upon receiving notice, the controlling shareholder would immediately move to preempt the board by replacing the directors or amending the bylaws. To contend with this, boards would be forced to concurrently give notice to the controller and petition the Court of Chancery to issue a temporary restraining order (TRO) to restrain the controller from preempting the board's vote. At that point, the court would have the *option* of giving the controlling shareholder the right to take preemptive action against the board (by refusing to issue the TRO), and it would also have the option of giving the board of directors the right to take preemptive action against the controlling shareholder (by issuing the TRO). Thus, under the procedural reading of *Adlerstein*, the resolution of the problem of assigning first-mover advantage would lie squarely in the Court of Chancery's hands. Balancing the equities, the court could assign first-mover advantage to either controlling shareholders or boards of directors at its discretion. This is precisely what occurred in *CBS Corp. v. National Amusements, Inc.*, and it exposed the legal uncertainties raised by Delaware's inconsistent jurisprudence.

D. CBS Corp. v. National Amusements, Inc.

1. *Overview. — CBS Corp. v. National Amusements, Inc.* is the most recent case involving open conflict between a board of directors and a controlling shareholder.[84] National Amusements, Inc.[85] is a holding company that

83. Control itself has value, since "[a] controlling stockholder reaps a number of benefits from its position, including the ability to determine the outcome of director elections, to control the business operations of the corporation, and to seek a premium for its control block of shares." IRA Trust FBO Bobbie Ahmed v. Crane, No. 12742–CB, 2017 WL 7053964, at *7 n.54 (Del. Ch. 2017). Given these advantages, it would be unrealistic to expect a controller faced with the prospect of losing voting control to simply acquiesce in the face of the board's plans to dilute it.

84. No. 2018-0342-AGB, 2018 WL 2263385 (Del. Ch. May 17, 2018).

85. In addition to serving as a holding company, NAI is one of the world's largest motion picture exhibitors, operating over 950 movie screens around the world. About National Amusements, Nat'l Amusements, https://www.nationalamusements.com/ [https://perma.cc/YJM4-4W8F] (last visited Oct. 8, 2019). NAI is a closely held company. Id. As such, in contrast to CBS and Viacom, its shares are not traded on the public markets. Further, NAI is itself a controlled company. *CBS*, 2018 WL 2263385, at *1. Its controlling shareholder is a trust controlled by NAI's founder, Sumner Redstone. See Keach Hagey, Court to Appoint Guardian for Sumner Redstone, Wall St. J. (Dec. 17, 2018), https://www.wsj.com/articles/court-to-appoint-guardian-for-sumner-redstone-11545084893 (on file with the *Columbia Law Review*) ("[Sumner] Redstone's trust . . . holds 80% of the shares of National Amusements

functions as the controlling shareholder of both CBS Corporation and Viacom.[86] Both CBS[87] and Viacom[88] have dual-class stock regimes in place,[89] which allow NAI to maintain voting control despite owning only a small fraction of each company's overall equity.[90]

In September 2016, NAI resolved to use its voting control over the two companies to reunite them into a single media conglomerate.[91] Yet despite NAI's undisputed control, trouble ensued. The Board of Directors of CBS aligned itself with CBS's management, which opposed NAI's plans for a merger and disagreed with its strategic vision for the company.[92] The board then discovered that NAI intended to replace the board with directors who would vote in favor of a merger with Viacom.[93] The board then determined that NAI's actions constituted a breach of its fiduciary duties,

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Inc. . . . . The trust remains under Mr. Redstone's sole control until he dies or is deemed incapacitated, at which point it will be overseen by seven trustees, including his daughter, Shari Redstone . . . ."). However, although NAI's controlling shareholder, the trust, remains nominally in Sumner Redstone's control, his daughter, Shari Redstone (hereinafter simply "Redstone"), now "effectively controls" it, as a result of Sumner Redstone's "deteriorating health." Id. This Note refers to NAI alone as the controlling shareholder of CBS and Viacom due to the ongoing controversy regarding the mental capacity of Sumner Redstone and the uncertain allocation of power among the members of the Redstone family. See id.

86. *CBS*, 2018 WL 2263385, at *1; see also Press Release, Nat'l Amusements, Inc., National Amusements, Inc. Amends CBS' Bylaws (May 16, 2018), https://www.nationalamusements.com/wp-content/uploads/2018/05/NAI-Press-Release-05-16-18.pdf [https://perma.cc/9FSF-78JM] (stating that, at the time of the bylaw amendment at issue in the litigation, NAI controlled 79.8% of Viacom's voting rights, while owning 10% of its equity, and that NAI controlled 79.6% of CBS's voting rights, while owning 9.5% of its equity). CBS and Viacom were once a unified company, before CBS was spun off from Viacom as a standalone public company in 2005. Verified Complaint at 4, *CBS*, No. 2018-0342-AGB, 2018 WL 2194011.

87. CBS Corporation is a large, publicly traded media company whose assets include film, TV, and publishing enterprises. About CBS Corporation, CBS Corp., https://www.cbscorporation.com/about-cbs/ [https://perma.cc/4XMR-Q2KZ] (last visited Oct. 8, 2019).

88. Viacom is a media and entertainment company whose assets include Paramount Pictures, Paramount Television, Nickelodeon, Comedy Central, MTV, BET Networks, Telefe, and Channel 5. About, Viacom, http://www.viacom.com/about (on file with the *Columbia Law Review*) (last visited Jan. 11, 2019).

89. See Verified Complaint at 4, *CBS*, No. 2018-0342-AGB, 2018 WL 2194011.

90. See supra note 86.

91. Press Release, Nat'l Amusements, Inc., National Amusements, Inc. Proposes Combination of CBS and Viacom (Sept. 29, 2016), https://www.nationalamusements.com/wp-content/uploads/2016/09/National-Amusements-Inc.-Proposes-Combination-of-CBS-and-Viacom.pdf [https://perma.cc/48YC-V2CX] ("[NAI] believe[s] that a combination of CBS and Viacom might offer . . . synergies that would allow the combined company to respond even more aggressively and effectively to the challenges of the changing . . . media landscape. . . . [W]e would like both companies' boards to consider a potential combination of the companies.").

92. Verified Complaint at 29, *CBS*, No. 2018-0342-AGB, 2018 WL 2194011. Specifically, the board formed a special committee of its independent directors, and it was this special committee that determined that the contemplated merger would not serve the interests of CBS and its minority shareholders. Id.

93. *CBS*, 2018 WL 2263385, at *3–4.

and that NAI posed a threat to CBS and its minority shareholders.[94] A special committee of the board composed of five independent directors was formed, and it resolved that the board's fiduciary duties required it to take action against NAI.[95]

The CBS board proceeded to schedule a special board meeting.[96] At that meeting, the board intended to vote on a stock dividend that would effectively dilute NAI's voting stake from approximately 80% to 17% without affecting NAI's overall economic stake in the company.[97] CBS then filed suit in the Delaware Court of Chancery seeking a TRO to prevent NAI from preempting the Board's vote.[98] Yet just an hour before the court was scheduled to hear oral arguments on the motion for the TRO, NAI resolved to preempt the CBS board by issuing written consents to amend CBS's bylaws so as to make the vote on the proposed dilutive dividend impossible.[99]

Chancellor Andre G. Bouchard of the Delaware Court of Chancery issued a short opinion denying CBS's request for a TRO in advance of the board's vote.[100] In dicta, the Chancellor briefly discussed the possible validity of the dilutive dividend.[101] Addressing the central issue raised by the case, Chancellor Bouchard noted that "[t]he real issue underlying defendants' argument is who—a controller or a board of directors—should have 'first-mover' advantage to take action and define the contours of a fight between them."[102] Further, the Chancellor reasoned that the issue "implicates an apparent tension" in the Delaware law between a controlling shareholder's "right to protect its control" and the right of a board of directors "to respond to a threat posed by a controller . . . ."[103] The court located the heart of the tension in two conflicting lines of cases, that of *Adlerstein v. Wertheimer*

94. Verified Complaint at 36–37, *CBS*, No. 2018-0342-AGB, 2018 WL 2194011.

95. See id. at 5 ("The five members of CBS's Special Committee, all independent directors of the Company, unanimously believe that the CBS Board has a fiduciary duty to act now to protect all stockholders and prevent Ms. Redstone from continuing to misuse her power as a controller, in breach of her fiduciary duties.").

96. Press Release, CBS Corp., CBS and the CBS Special Committee File Lawsuit to Protect and Give Voting Power to Stockholders (May 14, 2018), https://investors.cbscorporation.com/news-releases/news-release-details/cbs-and-cbs-special-committee-file-lawsuit-protect-and-give [https://perma.cc/KZ5K-5JY4].

97. See supra note 6 and accompanying text.

98. See supra note 7 and accompanying text.

99. See supra note 8 and accompanying text.

100. See *CBS*, 2018 WL 2263385, at *6.

101. Id. at *2. The Chancellor remarked that "the Dividend Proposal is an *extraordinary measure*, presumably reflective of the depth of concern the independent members of the Special Committee have about Ms. Redstone's intentions." Id. (emphasis added).

102. Id. at *3.

103. Id. at *5.

and that of *Mendel v. Carroll*.[104] It then concluded that *Adlerstein* weighed in favor of NAI, and it declined to issue CBS's requested TRO.[105]

2. *Implications.* — Undeterred by the Court of Chancery's denial of its request for a TRO, the CBS board voted to dilute NAI's voting control despite NAI's earlier bylaw amendment,[106] which ostensibly prohibited it from doing so.[107] CBS then amended its complaint, seeking a declaration of both the invalidity of the bylaw amendments and the validity of the dilutive dividend.[108] NAI, in turn, amended its own complaint and sought a declaration of the validity of the bylaw amendments and the invalidity of the dilutive dividend.[109] Thus, each party attempted to seize the initiative and preempt its adversary by passing measures designed to undermine its position. Yet before the Court of Chancery could decide which party had the right to the first-mover advantage referenced in Chancellor Bouchard's ruling on the temporary restraining order, the parties settled.[110] The central question in the case remains unanswered.

II. WHO SHOULD HAVE FIRST-MOVER ADVANTAGE WHEN BOARDS OF DIRECTORS AND CONTROLLING SHAREHOLDERS COLLIDE?

This Part analyzes the first-mover advantage problem in Delaware corporate law that the Court of Chancery described in *CBS*: When a board of directors reasonably believes that a controller threatens to exploit the corporation or its minority shareholders, can it take action to preempt such exploitation by the controller, or can the controller act to preserve its control by preempting the board's measures?

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104. See id. at *5–6.

105. Id. at *6 ("*Adlerstein*, which expressly endorsed a controller's right to make the first move preemptively to protect its control interest, is the clearest precedent and weighs heavily in [NAI's] favor.").

106. Interestingly, the board took the unique step of declaring that the dilutive dividend would be issued on a conditional basis, pending a declaration of its legality by the Delaware courts. See Press Release, CBS Corp., CBS Board of Directors Declares Dividend to Protect and Give Voting Power to Stockholders (May 17, 2018), https://investors.cbscorporation.com/news-releases/news-release-details/cbs-board-directors-declares-dividend-protect-and-give-voting [https://perma.cc/FBD2-C3JK] ("The payment of the dividend is conditioned on a final determination by the Delaware courts, including a final decision on or the exhaustion of time for any appeals, that the dividend is permissible.").

107. See Amended Verified Complaint at 7–8, *CBS*, No. 2018-0342-AGB, 2018 WL 2397715.

108. See supra note 9 and accompanying text. Among other arguments, counsel for CBS attempted to distinguish the facts of *CBS* from earlier cases implicating conflicts between boards of directors and controlling shareholders by taking the position that CBS's Certificate of Incorporation expressly authorized its board of directors to issue a dilutive dividend. Amended Verified Complaint at 51–52, *CBS*, No. 2018-0342-AGB, 2018 WL 2397715 ("[T]he plain language of the Certificate authorizes the Board to issue either "identical" stock dividends to both classes of stockholders or different securities . . . to the different classes. . . . Plaintiffs are entitled to a declaration that the Certificate permits the Stock Dividend.").

109. Amended Verified Complaint at 64–65, *CBS*, No. 2018-0342-AGB, 2018 WL 2397715.

110. See supra note 11 and accompanying text.

Section II.A argues that it is imperative for any legal rule assigning first-mover advantage to empower boards of directors to manage the added agency costs that accrue in controlled firms. Section II.B demonstrates that it is equally important, in the mine run of corporate conflicts, for a legal rule to affirm the rights of controlling shareholders to maintain their control. Having established the validity of these competing ideals, section II.C then shows that Delaware's existing framework governing these issues, as it can be gleaned from the relevant cases, falls short of realizing the legitimate aims identified in section II.A and in section II.B.

A. *The Implications of Assigning First-Mover Advantage to Boards of Directors*

A legal rule assigning first-mover advantage to boards of directors would appear to benefit firms and their minority shareholders by empowering boards of directors to protect against their exploitation by the controlling shareholder. It was precisely this risk of minority shareholder exploitation at the hands of the controller that motivated the court in *Mendel v. Carroll* to consider assigning first-mover advantage to the board.[111] If it were assigned first-mover advantage, a board of directors would, in theory, be empowered to protect minority shareholders against such exploitation. For reasons described below in section II.A.2, however, this theory would be unlikely to hold in practice.

1. *Advantages.* — The theoretical underpinnings of minority shareholder exploitation should be explored before any discussion of the nature of this exploitation can begin. A leading theory of why controlling shareholders seek to acquire and maintain corporate control is the so-called "rent-protection" theory of corporate ownership.[112] Under this theory, controllers value and seek to defend and perpetuate their control because it enables them to extract "private benefits"[113] from the corporation at the expense of minority shareholders.[114] A comparison of dispersed and controlled companies is helpful for understanding the nature of these private benefits of control. In dispersed companies, shareholders, as the owners of the firm and the residual claimants on its cash flows, operate as principals in the principal–agent relationship between

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111. See supra note 26 and accompanying text.

112. Lucian A. Bebchuk, A Rent-Protection Theory of Corporate Ownership and Control 1 (Nat'l Bureau of Econ. Research, Working Paper No. 7203, 1999), https://www.nber.org/papers/w7203.pdf [https://perma.cc/H539-TGJE].

113. Private benefits are benefits that accrue to the controlling shareholder but do not accrue to minority shareholders. See Ronald J. Gilson & Jeffrey N. Gordon, Controlling Controlling Shareholders, 152 U. Pa. L. Rev. 785, 785 (2003).

114. Bebchuk, supra note 112 ("When private benefits of control are large, and when control is thus valuable enough, leaving control up for grabs would attract attempts to grab control by rivals seeking to capture these private benefits . . . . [T]o preclude a control grab, founders of companies . . . will . . . maintain a lock on control.").

shareholders and the board of directors.[115] The shareholders own the firm, while the board oversees its affairs on their behalf. But in controlled companies, there is an additional dimension to the standard principal–agent arrangement. Minority (i.e., non-controlling) shareholders find themselves engaged in a second principal–agent relationship vis-à-vis the controlling shareholder, in which the latter, although more capable of overseeing the firm's management, is well positioned to extract private benefits from the corporation,[116] and the minority shareholders struggle to restrain it.[117]

Private benefits of control can accrue in several different ways. In their 2003 article, *Controlling Controlling Shareholders*, Professors Ronald Gilson and Jeffrey Gordon identified three channels through which controllers can extract private benefits: by operating the company, by selling control at a premium price, and by freezing out minority shareholders.[118] Controlling shareholders can extract private benefits in the course of the company's operation. Scholars have divided these benefits into two categories. The first "concerns the business and strategic decisions of the corporation" and includes dividend policies, investment decisions, and the like.[119] The

115. See Frank H. Easterbrook & Daniel R. Fischel, Corporate Control Transactions, 91 Yale L.J. 698, 700 (1982) ("An agency relationship is an agreement in which one or more persons (the principal) delegates authority to another person (the agent) to perform some service on the principal's behalf. The entire corporate structure is a web of agency relationships. Investors delegate authority to directors, who subdelegate to upper managers . . . .").

116. See Gilson & Gordon, supra note 113, at 785 ("[T]he presence of a large shareholder may better police management than the standard panoply of market-oriented techniques. . . . The presence of a controlling shareholder reduces the managerial agency problem, but at the cost of the private benefits agency problem."); id. at 785–86 ("Non-controlling shareholders will prefer the presence of a controlling shareholder so long as the benefits from reduction in managerial agency costs are greater than the costs of private benefits of control.").

117. Id. at 785 ("The second is the agency problem that arises between controlling and non-controlling shareholders, which produces the potential for private benefits of control—benefits to the controlling shareholder not provided to the non-controlling shareholders."); see also Lucian A. Bebchuk & Assaf Hamdani, Independent Directors and Controlling Shareholders, 165 U. Pa. L. Rev. 1271, 1279 (2017) ("At widely held companies, the fundamental governance problem arises from the divergence of interests between managers and investors, and so corporate law and governance arrangements aim to address managerial agency costs. By contrast, the fundamental governance problem in controlled companies concerns the agency problems between controllers and public investors.").

118. See Gilson & Gordon, supra note 113, at 787 (providing an in-depth description of the three methods that controlling shareholders use to extract private benefits from controlled firms).

119. See id. at 790. The authors cite Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971), as an example of this first category of private benefits (those that accrue through the operation of the business). In *Sinclair*, the controlled company paid out a disproportionately large share of its profits in the form of dividend distributions, foregoing other oil-related investment opportunities in order to maintain their issuance. See id. at 720–21. The minority shareholders alleged that the dividend policy unfairly favored the controlling shareholder. See id. For the controller, a large oil corporation, the dividends represented a tax-efficient form of income, while for the minority shareholders, the dividends were less

second category involves actions that raise concerns of blatant self-dealing.[120] Beyond these private benefits derived from the operation of the company, controllers can extract benefits by selling their control at a premium price not shared with minority shareholders.[121] Finally, controllers can "freeze out" minority shareholders through either a tender offer or a merger.[122]

Faced with these various methods of private-benefit extraction by the controller, a board of directors empowered with first-mover advantage by the courts can sever or diminish the control of the controlling shareholder. Of course, given that the controlling shareholder often appoints the directors in the first instance, only in extreme circumstances would a board go through with such an extraordinary action.[123] But if the extraction of private benefits rises to a level that the board views as threatening the business operations of the company or verging on exploitation of its minority shareholders,[124] action by the board to either wholly eliminate the controller's voting control[125] or to limit its ability to exercise its control[126] is

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favorably taxed. See Levien v. Sinclair Oil Corp., 261 A.2d 911, 927 (Del. Ch. 1969), aff'd in part, rev'd in part, 280 A.2d 717.

120. See Gilson & Gordon, supra note 113, at 790 ("Here we are in the realm of true self-dealing—unfair transfer pricing, the transfer of assets from the controlled corporation to the controlling shareholder, and the use of the controlled corporation's assets as collateral for a controlling shareholder's debt."). The literature also refers to this latter mode of private benefits extraction as "tunneling." See id. at 787 ("[T]he controlling shareholder can benefit through 'tunneling'—that is, through contractual dealings with the company, like transfer pricing, that favor the controlling shareholder."). Professor Vladimir Atanasov presents a fuller account of the "tunneling" method of private benefits extraction. See Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello, Law and Tunneling, 37 J. Corp. L. 1, 3 (2011) ("We consider three . . . types of tunneling: cash flow tunneling, in which insiders extract some of the firm's current cash flows; asset tunneling, in which insiders buy (sell) assets from (to) the firm at below (above) market prices; and equity tunneling, in which insiders acquire equity at below market price . . . .").

121. See Gilson & Gordon, supra note 113, at 794 ("Whether one looks to Delaware case law or to the American Law Institute's (ALI) *Principles of Corporate Governance,* the rule is clear: in general, a controlling shareholder can sell control at a premium that is not shared with non-controlling shareholders." (footnotes omitted)).

122. See id. at 796 ("The third method by which a controlling shareholder can extract private benefits of control is through freezing out minority shareholders at a market price that reflects a discount equivalent to the private benefits of control available from operating the controlled corporation.").

123. See Bebchuk & Hamdani, supra note 117, at 1274 ("Because [arrangements for electing directors] provide controllers with decisive power to appoint independent directors and decide whether to retain them, independent directors have significant incentives to side with the controller and insufficient countervailing incentives to protect public investors in conflicted decisions.").

124. See supra notes 116–117 and accompanying text.

125. See, e.g., CBS Corp. v. Nat'l Amusements, Inc., No. 2018-0342-AGB, 2018 WL 2263385, at *2 (Del. Ch. May 17, 2018); Adlerstein v. Wertheimer, No. CIV.A. 19101, 2002 WL 205684, at *1 (Del. Ch. Jan. 25, 2002); Mendel v. Carroll, 651 A.2d 297, 298 (Del. Ch. 1994).

126. See, e.g., Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1088 (Del. Ch. 2004) (recognizing that, in certain circumstances, a board of directors has the right to adopt a

not unforeseeable. Assigning first-mover advantage to the board would thus give the board an alternative method of recourse to prevent private-benefit extraction beyond the available judicial remedies.

Two hypothetical scenarios can illustrate this point. First, consider a regime in which first-mover advantage is assigned to the controlling shareholder, rather than the board. If the board determined that the company's dividend policy (promoted by the controlling shareholder) operated to deny valuable corporate opportunities that would disproportionately benefit the company's minority shareholders, the board could alter the company's dividend scheme. The reaction by the controller would be swift, and the end result would likely be the replacement of the disobedient directors with nominees who are prepared to more faithfully carry out the controller's directives.

By contrast, assume that this same board were given first-mover advantage before the events described above transpired. The board would be much more likely to exercise its independent business judgement in evaluating the comparative viability of the dividend plan relative to other investment opportunities. Faced with an empowered board, the controller could cede some of its authority over the company's operations to the board, or it could risk the possibility that the board might exercise its independent right to preempt any efforts by the controller to replace the board or amend the corporation's bylaws. The end result in this alternative scenario could range from the board imposing limits on the controller's ability to interfere with its dividend policies to the board effecting the complete dilution of the controller's control block.

In short, assigning first-mover advantage to a company's board of directors would seem to empower the board to mitigate the controller's private benefits of control for the purpose of advancing the interests of stockholders generally—from retail investors who hold only a single share of stock to the company's parent and controlling corporation. This boardroom-centered mitigation can take place in parallel to judicial remedies or as their substitute. In circumstances in which the controlling shareholder's private benefits do not rise to the level of judicial cognizance, the board can take cognizance on its own accord and give relief to minority shareholders when a court would not otherwise be disposed to do so.

2. *Disadvantages.* — A legal rule assigning first-mover advantage to controlling shareholders would (of course) benefit controlling shareholders. Yet such a legal rule would—paradoxically—likely benefit minority shareholders far more than a legal rule that assigns first-mover advantage to a board of directors. This section explores this paradox by demonstrating that the composition of a board of directors is endogenous to the legal rule that governs its rights vis-à-vis a controlling shareholder.

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shareholder rights plan to restrict a controlling shareholder's ability to alienate its shares in the corporation), judgment entered, No. 183-N, 2004 WL 5322715 (Del. Ch. 2004), and aff'd, 872 A.2d 559 (Del. 2005).

Consider a hypothetical scenario in which a firm's controlling shareholder threatens to exploit its minority shareholders, and the governing legal rule assigns first-mover advantage to the board of directors. If it disagrees with the controller's actions, the board can exercise its legal right to protect minority shareholders by preempting (e.g., through a dilutive dividend) any efforts on the part of the controller to replace the insubordinate board. The readily foreseeable effect of this sequence of events would be that the board would be able to halt the controller's exploitation of the firm's minority shareholders. On its face, a legal rule that gives a board of directors an unrestricted first-mover right would seem to safeguard the interests of minority shareholders from an overreaching controller.

The hypothetical outlined above is constructive, but it is flawed in one key respect: Its time framing is too narrow; it fails to accurately depict the dynamic, long-term relationship between a firm's board of directors and its controlling shareholder. A more accurate analysis of this relationship requires a second hypothetical employing an expanded timeline. Ex ante to the outbreak of any conflict between the board and the controller, the latter, aware that the governing legal rule empowers an insubordinate board to take action against it, will use its voting control to ensure that a maximally subservient board is appointed in the first instance.[127]

If first-mover advantage is assigned to the board, controlling shareholders will be incentivized to appoint as few independent directors as they possibly can. Already, the major U.S. stock exchanges do not require the boards of controlled companies to reserve a minimum number of their seats for independent directors.[128] Thus, if the controlling shareholder intends to derive private benefits through channels other than self-dealing transactions (and assuming a purely self-interested controlling shareholder), the optimal number of independent directors, from the controller's perspective, is *zero*. If the controlling shareholder does intend to extract private benefits through self-dealing transactions, however, then Delaware law incentivizes, although it does not require, the controlling

127. See Bebchuk & Hamdani, supra note 117, at 1276 ("[C]ontrolling shareholders normally play a decisive role in the appointment and retention of independent directors. . . . [I]ndependent directors . . . are inherently dependent on the controller for their election and retention . . . . This regime incentivizes independent directors to favor the controller, and it fails to provide them countervailing incentives to protect public investors.").

128. See Nasdaq, Inc., The Nasdaq Stock Market Rules § 5615(c)(2) (2019), http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_1_1&manual=/nasdaq/main/nasdaq-equityrules/ (on file with the *Columbia Law Review*) (exempting controlled companies from the Nasdaq's corporate governance standards that pertain to independent director minimum requirements); NYSE, Inc., Listed Company Manual § 303A.00 (2019), https://nyseguide.srorules.com/listed-company-manual/document?treeNodeId=csh-da-filter!WKUS-TAL-DOCS-PHC-%7B0588BF4A-D3B5-4B91-94EA-BE9F17057DF0%7D--WKUS_TAL_5667%23teid-68 [https://perma.cc/9K2J-ASLK] (exempting controlled companies from the NYSE's corporate governance standards that require boards to be composed of a majority of independent directors).

shareholder to appoint a sufficient number of disinterested directors to the board in order to form a special committee with the power to approve or deny any self-dealing transactions.[129] In either scenario, the controlling shareholder, in the interest of protecting its control against the possibility (however remote) that the board will one day exercise its first-mover-advantage right to sever or diminish its control, will seek to minimize the number of independent directors on the board.

Thus, in practice, the most significant effect of a legal rule that ostensibly empowers boards of directors on behalf of minority shareholders may ultimately be its effect on board *composition*. Such a rule can be expected to incentivize a controlling shareholder to appoint as large of a majority of supine directors as it can, limited only by its need to have enough independent directors on hand to form a special committee to vote on self-dealing transactions.[130] This loss of director independence would undermine corporate governance standards for controlled firms as a class.[131] Delaware law charges boards of directors with managing the

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129. See In re MFW S'holders Litig., 67 A.3d 496, 535 (Del. Ch. 2013) (holding that a controlling shareholder can qualify for business judgment review of a self-dealing transaction if the transaction is both ratified by a majority-of-the-minority shareholder vote and approved by a special committee of independent directors), aff'd sub nom. Kahn v. M & F Worldwide Corp., 88 A.3d 635 (Del. 2014). If no independent directors serve on the board, then the controlling shareholder will not be able to have its self-dealing transaction reviewed under the deferential business judgment standard. Id. Instead, one form or another of entire fairness review will apply. Id. The Delaware courts' use of varying levels of judicial scrutiny to incentivize controlling shareholders to appoint independent directors is a worthwhile effort because different standards of review impose vastly different burdens on the controlling shareholder. Bebchuk & Hamdani, supra note 117, at 1282 ("Delaware courts . . . have used the entire fairness standard to review . . . self-dealing transactions involving controlling shareholders. Whereas the business judgment rule substantially insulates a transaction from judicial scrutiny, . . . entire fairness . . . requires the defendants to prove that the transaction was fair . . . by showing a fair process and a fair price.").

For example, assume that the board in question has eight directors. The controlling shareholder might prefer to have no independent directors on the board. If, however, the controller anticipates that it may execute a self-dealing transaction at some future time, the controller will appoint the minimum number of independent directors (three) that is necessary to form a special committee on an eight-person board. The controller can thus be expected to appoint anywhere from zero to three independent directors on an eight-person board, the remaining five being selected in part on the basis of loyalty to the controller.

130. See supra note 123 and accompanying text.

131. See Bebchuk & Hamdani, supra note 117, at 1284 ("Empowering independent directors to review . . . conflicted decisions might offer public investors at controlled companies some degree of protection. For example, the incentives of directors to go along with the preferences of the controller might be less powerful when they have no ties to the controller . . . ."); id. ("[A]cademic studies on reforms in Korea, Taiwan, India, China, and other countries provide evidence suggesting that the appointment of independent directors at controlled firms can enhance share value."). Minority shareholders in controlled firms would lose the "degree of protection" that Professor Bebchuk and Professor Hamdani describe if their controlling shareholders minimized (or eliminated) the presence of independent directors on their firms' boards.

business and affairs of the corporations that they oversee.[132] To accomplish this, they must manage the agency costs that exist both between a firm's minority shareholders and its controlling shareholder and between a firm's shareholders as a general class and its management.[133] The paradox described above illustrates how a legal rule that assigns first-mover advantage to a board undermines its ability to manage the first of these two agency costs. A legal rule with this effect will also reduce the ability of boards to manage the second of these two agency costs as well. From the perspective of a minority shareholder, directors will ideally be selected for their expertise, competence, and ability to oversee the firm's management. Under a legal rule assigning first-mover advantage to a board, however, controllers will select their directors on the basis of an additional, entirely different criterion: loyalty to the controlling shareholder. If directorial appointments are motivated in part by the controller's fear that the appointees will one day bite the hand that feeds them, the interests of minority shareholders will suffer. The end result is that servile directors will fill seats on boards that would otherwise be allocated on the basis of managerial merit.

B. *The Implications of Assigning First-Mover Advantage to Controlling Shareholders*

Contrast the effects that a legal rule assigning first-mover advantage to a controlling shareholder would have on board composition. Under this regime, a controlling shareholder would have nothing to fear from even the most fiercely independent board. Loyalty to the controller would cease to be a significant factor in directorial appointments because controllers would retain the right to preempt any efforts by an unruly board to dilute or otherwise dismantle their control. Relative to a rule assigning first-mover advantage to a board of directors, this rule would promote the appointment of independent-in-fact directors to the boards of controlled firms. While these boards would be defanged vis-à-vis controllers, in the sense that they would effectively lose the power to deprive a controller of its control, they would be strengthened relative to the firm's management because loyalty to the controlling shareholder would be substituted for other factors (such as general competence, industry expertise, and

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132. The statute in question reads:

> The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

Del. Code tit. 8, § 141(a) (2020).

133. See supra notes 115–117 and accompanying text.

business acumen) that more transparently relate to the directors' ability to oversee management.

In conclusion, board composition is endogenous to the legal rule allocating rights between a board of directors and a controlling shareholder. Under a legal rule that assigns first-mover advantage to a board of directors, corporate governance standards for controlled firms as a class would suffer.[134] Paradoxically, boards would be less able to manage the agency costs inherent in the principal–agent relationship that exists between a firm's controlling shareholder and its minority shareholders.[135] Additionally, the ability of the board to manage the agency costs of the principal–agent relationship between shareholders generally and the firm's management would be reduced.[136]

Under a legal rule that assigns first-mover advantage to a controlling shareholder, however, corporate governance standards for controlled firms as a class would improve. As expected, boards would remain unable to manage the agency costs that inhere in controlled firms. But such a rule would encourage the appointment of directors on the basis of a more meritocratic set of criteria, as loyalty to the controller would cease to be a dispositive factor in the calculus of directorial appointments.

C. *The Inadequacy of Delaware's Current Legal Doctrine and the Need for a New Prospective Legal Rule*

The optimal legal rule governing the assignment of first-mover advantage would protect the interests of minority shareholders by empowering boards to curb private-benefit extractions on the part of controlling shareholders while carefully weighing any adverse effects on board composition. Delaware's current legal doctrine struggles to accomplish either objective. Because controlling shareholders have the power to appoint directors to their board seats,[137] conflicts between boards and controlling shareholders are rare, and courts have only had the chance to opine on issues that resemble the first-mover advantage problem in a small set of cases.[138] *CBS Corp. v. National Amusements, Inc.*, the most recent of these cases, suggests that the current doctrine consists of little more than an ad hoc inquiry under which the controller is slightly favored, on account of *Adlerstein's* notice requirement.[139] But while Chancellor Bouchard in *CBS* noted the "tension" between the rights of controllers and boards under Delaware law,[140] the parties settled before the court could reach the merits

134. See supra note 131 and accompanying text.
135. See supra note 131 and accompanying text.
136. See supra note 117 and accompanying text.
137. See supra note 123 and accompanying text.
138. See supra Part I.
139. See supra notes 100–105 and accompanying text.
140. See supra notes 103–104 and accompanying text.

of the case.[141] Furthermore, the narrow procedural posture of Chancellor Bouchard's decision makes it difficult to extract a clear, prospective legal rule, since the ruling merely decided whether a TRO should be issued.[142] In short, other than the competing doctrines of *Mendel v. Carroll* and *Hollinger v. Black* on the one hand, and those of *Frantz Manufacturing Co. v. EAC Industries* and *Adlerstein v. Wertheimer* on the other hand, Delaware law has no clear rule about whether boards of directors or controlling shareholders should be assigned first-mover advantage.

A prospective legal rule that simultaneously vindicates the concerns addressed in section II.A and those addressed in section II.B is needed. The conclusions that can be drawn from these concerns are as follows: First, a legal rule assigning first-mover advantage must leave a limited amount of discretion to the board of directors to exercise a first-mover right in situations where the extraction of private benefits on the part of the controller is sufficiently egregious.[143] Second, a legal rule assigning first-mover advantage must incentivize controlling shareholders to select directors on the basis of merit, rather than allegiance to the controller, so as not to compromise corporate governance standards at controlled firms.[144] Finally, the consequences of a legal rule assigning first-mover advantage must be clear to all parties involved (be they directors, controlling shareholders, minority shareholders, courts, or financial markets), so that controlled firms are not destabilized by prolonged corporate governance litigation.[145]

III. RESOLVING THE TENSION: DUAL STANDARDS FOR DUAL-CLASS STOCK

This Part argues that the Delaware courts should distinguish between controlled corporations with one-share-one-vote structures and those with dual-class stock regimes in determining whether to assign first-mover advantage to boards of directors or to controlling shareholders. Section III.A explores the justifications for distinguishing between corporations on the basis of their share class structures. Section III.B argues that the Delaware courts should assign first-mover advantage to controlling

141. See supra note 11 and accompanying text.

142. See supra notes 98–105 and accompanying text.

143. See supra section II.A.1.

144. See supra sections II.A.2, II.B.

145. The Delaware Court of Chancery in *NACEPF v. Gheewalla* embraced the principle that firms most need effective corporate governance when they confront adverse, uncertain conditions. N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, No. Civ.A. 1456-N, 2006 WL 2588971, at *13 (Del. Ch. Sept. 1, 2006) (concluding that a firm passing through the narrow straits of the "zone of insolvency" was arguably "one in most need of effective and proactive leadership"), aff'd, 930 A.2d 92 (Del. 2007). The issue that the firm in that case confronted was its own near-insolvency, id. at *1, but the principle applies just as well to firms that face significant corporate events of other kinds, including mergers and acquisitions, spin-offs, and changes of control. The five cases outlined in Part I provide illustrative case studies of how firms operating under Delaware's conflicting first-mover advantage doctrines can suffer from destabilizing crises of leadership at critical junctures in their corporate lives.

shareholders in firms that have single-class stock structures. Finally, section III.C argues that the Delaware courts should assign first-mover advantage to boards of directors in firms that have dual-class stock structures, but it proposes a series of procedural safeguards designed to limit the circumstances in which a court can confer this extraordinary power on a board of directors.

A. *Justifications for Differentiating Between Companies with One-Share-One-Vote Regimes and Companies with Dual-Class Stock: Alignment and Divergence of Shareholder Interests*

Courts should distinguish between corporations with one-share-one-vote regimes and corporations with dual-class stock regimes in assigning first-mover advantage. This section argues that courts should so distinguish because the principal–agent problem that exists between a controlling shareholder and minority shareholders is greatly lessened in a one-share-one-vote corporation, since the controlling shareholder typically has greater "skin in the game" in these companies than it would in a corporation with dual-class stock.

A legal rule assigning first-mover advantage should empower boards relative to controllers in situations in which the controller's interests are misaligned with those of minority shareholders. In a one-share-one-vote corporation, a controlling shareholder's control derives from its ownership of a sufficiently large block of the corporation's stock. Thus, if one shareholder owns 70% of a corporation's stock, and the remaining 30% of the shares are owned by other shareholders, the former will be designated as the "controlling shareholder" by virtue of its outsized claim on both the corporation's cash flows (70%) and its voting rights (70%). The controlling shareholder is only entitled to the largest voting block because the controller has the most to gain (or lose) from the board's successful (or unsuccessful) management of the corporate enterprise. In other words, the controlling shareholder has the most "skin in the game" of any shareholder, and its domination of the voting franchise flows from this fundamental economic fact.

By contrast, in a corporation with a dual-class stock regime, the controlling shareholder may or may not have proportional cash-flow and voting rights. For example, the controlling shareholder might have 80% of the voting rights, but its claim on the cash-flow rights might total to little more than 5%. It is this wedge between voting rights and cash-flow rights that increases the agency costs that accrue to the minority shareholders of the firm.[146] Although the controlling shareholder might have only a relatively minor pecuniary interest in the firm, it might nonetheless be master of the

146. Bebchuk et al., supra note 16, at 296 ("[T]he agency costs imposed by controlling shareholders who have a small minority of the cash-flow rights in their companies can be an order of magnitude larger than those imposed by controlling shareholders who hold a majority of the cash-flow rights.").

voting franchise.[147] This discrepancy leads to a divergence between the interests of the corporation's controlling and minority shareholders.[148] The minority, although stripped of effective voting control, remains incentivized to maximize the value of the firm. The controller, however, may perceive that it stands to gain more by using its control to further its own interests in a distorted manner that actually reduces the value of the firm, rather than by maximizing the value of the firm's overall equity.[149] Given this tendency toward misalignment of shareholder interests in controlled firms with dual-class stock structures, a legal rule assigning first-mover advantage should give the boards of these firms a wider range of options in their dealings with controllers.

B. *Assigning First-Mover Advantage to Controlling Shareholders in Companies with One-Share-One-Vote Regimes*

Courts should presumptively assign first-mover advantage to controlling shareholders in one-share-one-vote companies. This section proposes that courts do so by adopting the restrictive standard of *Mendel v. Carroll*: Boards should only have the power to dilute a controlling shareholder when the controller is threatening a serious breach of fiduciary duty.[150] The dilution

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147. For example, in *CBS Corp. v. National Amusements, Inc.*, NAI was the controlling shareholder of CBS; although NAI had held only 10.3% of the cash-flow rights, it controlled 79.6% of the voting rights. Verified Complaint at 4, CBS Corp. v. Nat'l Amusements, Inc., No. 2018-0342-AGB (Del. Ch. May 17, 2018), 2018 WL 2194011.

148. The structure of a widely held company usually helps to ensure that the interests of a controlling shareholder are aligned with those of the minority. See Lucian A. Bebchuk & Kobi Kastiel, The Perils of Small-Minority Controllers, 107 Geo. L.J. 1453, 1459 (2019) ("In companies that are widely held, the market for corporate control and the threat of replacement incentivize corporate insiders to serve the interests of public investors."). Similarly, the structure of a corporation that has a majority owner but retains a one-share-one-vote regime binds the interests of the majority and minority shareholders together. See id. ("In companies with a majority owner, the disciplinary force of the control market does not operate. However, the controller's ownership stake forces her to bear the majority of the economic effect of her choices . . . , providing strong ownership incentives that align the controller's interests with those of public investors."). But in a firm with a controlling *minority* shareholder, neither of these two forces operates effectively to align the interests of the controlling and noncontrolling shareholders, creating the conditions for a divergence between the interests of the two groups. See id. ("By contrast, a company with a small-minority controller lacks both the discipline of the control market and the incentives generated by having to bear the majority of any effect on total market capitalization.").

149. See id. at 1460 ("[S]mall-minority controllers can be expected to distort corporate decisionmaking, including decisions regarding the allocation of opportunities and talents, strategy and company scale, related-party transactions, [and] responses to acquisition offers . . . . In these contexts, small-minority controllers can be expected to make *value-reducing choices*." (emphasis added)).

150. See 651 A.2d 297, 304 (Del. Ch. 1994) ("Where . . . 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, . . . the board might permissibly take such an action." (footnote omitted)). A plainly improper breach might include an outright self-dealing transaction, for example.

would be accomplished as follows. First, the board would resolve that the controlling shareholder is threatening the aforementioned breach and that it must take dilutive action. Second, to comply with *Adlerstein*'s "trickery or deceit" standard, the board would have to give notice to the controller of its intent to dilute the controller's control.[151] Concurrent with the delivery of notice and to avoid being preempted by the controller, the board would have to file a motion for a temporary restraining order (TRO) in the Court of Chancery to restrain the controlling shareholder from interfering with the board's voting process by immediately replacing the directors.

From the perspective of the board, the application for a temporary restraining order can be understood as the board's petition for first-mover advantage. From the perspective of the controller, the TRO stage will afford the controlling shareholder its first opportunity for judicial review.[152] If the court does not perceive a sufficient fiduciary breach by the controller, it can deny the petition for a TRO, effectively conceding first-mover advantage to the controlling shareholder. The controlling shareholder can then immediately move to replace the board and end the insurrection. If the court perceives that the board's claims may have merit, it can issue the TRO and allow the dilution of the controller's economic stake to proceed to a board vote.

If the board votes for the dilutive measure, then the controlling shareholder's economic interest—its property right—can be weakened. However, given the severity of such an action, the board's decision to dilute should be subjected to heightened scrutiny at a second stage of judicial review. Here, the controlling shareholder can challenge the board's decision to dilute its economic interest under the *Unocal* standard.[153] First,

151. Even on the narrowest reading of *Adlerstein v. Wertheimer*, the case suggests that a board must at least give notice to the controller of its intent to reduce the controller's voting power. See supra note 74 and accompanying text.

152. The Delaware courts use a three-part test to review TRO petitions. *CBS*, 2018 WL 2263385, at *3. The party moving for a TRO must show that it "[1] has a colorable claim," "[2] faces a likelihood of imminent, irreparable harm if relief is not granted," and "[3] will suffer greater hardships if the TRO is not granted than the defendants would if the relief were granted." Id. (internal quotation marks omitted) (quoting Arkema Inc. v. Dow Chem. Co., No. 5479–VCP, 2010 WL 2334386 (Del Ch. Nov. 7, 2008)). Further, "[t]he 'colorable claim' requirement means that a plaintiff must state 'essentially a non-frivolous cause of action.'" Id. (quoting Reserves Dev. Corp. v. Wilmington Tr. Co., No. 4144-CC, 2008 WL 4951057 (Del Ch. Nov. 7, 2008)).

153. Admittedly, *Unocal* is not a perfect fit in board-controller conflicts, since *Unocal* was decided in the takeover defense context, in which the "omnipresent specter" of board entrenchment exists. Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 408 (Del. 1985) ("*Unocal* dealt with the duty of care owned by directors in addressing a possible or a pending takeover of a corporation, not an accomplished takeover."). However, although board-controller conflict cases deal instead with "accomplished takeovers," the underlying structure of the *Unocal* test remains very much relevant. *Unocal* reviews board evaluations of and responses to corporate "threats." Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) ("[Directors'] duty of care extends to protecting the corporation and its owners from perceived

the controller can formally challenge under *Unocal* whether its actions constituted a sufficient threat to the corporate enterprise.[154] Under the second prong of the *Unocal* test, the controlling shareholder can challenge the proportionality of the board's response to the perceived threat.[155] This heightened standard, applied at a later stage in the litigation than the TRO motion, would afford a controlling shareholder a fuller opportunity to demonstrate that the alleged fiduciary breach is insufficiently definite and serious to justify the deprivation of its control rights. Thus, at two separate stages, the board's severe measures would be presented for judicial review. And at the latter stage, the court would be able to test the board's actions through the more rigorous lens of *Unocal*.

In sum, in a one-share-one-vote company, first-mover advantage presumptively belongs to the controller except in the case of an

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harm whether a threat originates from third parties *or other shareholders*." (emphasis added)). In *Unocal* itself, the threat came from Mesa Petroleum, a minority shareholder. Id. at 958 ("[I]n the face of the destructive threat Mesa's tender offer was perceived to pose, the board had a supervening duty to protect the corporate enterprise."). In *CBS Corp. v. National Amusements, Inc.*, the threat came from NAI, a controlling shareholder. Verified Complaint at 36–37, *CBS*, No. 2018-0342-AGB, 2018 WL 2194011. Despite the differing origins of the threat, the nature of *Unocal*'s threat-response analysis remains the same, and it should be extended to the board-controller context.

154. In conjunction with the alleged fiduciary breaches, this "threat" should turn in part on the size of the wedge between the controlling shareholder's voting and cash-flow rights because of the nonlinear relationship between the increase in the size of the wedge and the increase in the size of the agency costs accrued. See Bebchuk et al., supra note 16, at 296 ("[A]s the size of cash-flow rights held [by the controlling shareholder] decreases, the size of agency costs increases, not linearly, but rather at a sharply increasing rate."). Professors Lucian Bebchuk and Kobi Kastiel note that not all dual-class structures are created equal. See Bebchuk & Kastiel, supra note 148, at 1457–58 ("The use of dual-class structures is the subject of heated debate. . . . [B]oth proponents and opponents have tended, until recently, to lump all dual-class structures into one category. By contrast . . . we sought to reorient the debate by stressing certain key differences among dual-class structures."). Instead, they propose dividing controlling-minority shareholders who use dual-class structures into three subsets. Id. First, there are "small minority" stakes, in which the controller holds below 15% of total equity capital. Id. at 1459. Second, there are "very-small minority" stakes, in which the controller holds below 10% of total equity capital. Id. Finally, there are "tiny-minority" stakes, in which the controller holds less than 5% of total equity capital. Id. As the controlling shareholder's equity stake sinks beneath each of these successive thresholds, courts should recognize an inversely large "threat," for purposes of *Unocal* analysis, to account for this nonlinear increase in the corporation's agency costs. See Bebchuk et al., supra note 16, at 296. In other words, board action that would be held "disproportionate" under *Unocal* at one level of controller equity ownership might be held "proportionate" at a lower level.

155. See *Unocal*, 493 A.2d at 955. Proportionality analysis in the case of a board's dilution of a controller's economic stake might consist of judicial review of the extent of the dilution. A proportionate response might include a board's decision to reduce a controller's narrow majority stake to 49%, for example. If a board resolved to outright destroy a narrow majority interest by reducing it to say, 15%, a court might deem this to be an invalid, disproportionate response. Finally, there may be situations in which a controller's economic interest is so high (e.g., at 85% of the overall equity) that only the most egregious breaches of the controller's fiduciary duties would justify a dilution to a minority stake (e.g., a reduction to 49% of the overall equity).

extraordinary breach of its fiduciary duties. In such a case, a board can petition the court for first-mover advantage through the mechanism of a TRO. If issued, the controller will have one final opportunity to defend its control rights with the full force of the *Unocal* standard at its backing. On the whole, this solution is relatively favorable to the controller, as is appropriate, due to the reduced agency costs inherent in this class of firms.[156]

C. *Assigning First-Mover Advantage to Boards of Directors in Companies with Dual-Class Stock Structures*

Courts should assign first-mover advantage to boards of directors in companies with dual-class stock arrangements. For this class of companies, courts should recognize that a board has the right to act preemptively against a controller when it makes a reasoned decision that a dilution of the control block would be in the best interests of the wider shareholder base and the company. As Professors Bebchuk, Kraakman, and Triantis note, "[w]hether agency costs do in fact increase at a sharply increasing rate thus depends on whether there are additional constraints on the decisions of [controlled-minority structure] controllers besides the tug of ownership structure and private benefits of control."[157] Bringing a board's decision to dilute the controlling shareholder of a firm that has a dual-class stock structure within the boundaries of the business judgment rule would provide a sufficient "additional constraint[]."[158]

A board can accomplish this dilution through the following process. As with a one-share-one-vote company, *Adlerstein* requires the board to first

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156. See supra note 146 and accompanying text.

157. Bebchuk et al., supra note 16, at 301.

158. Id. Professors Bebchuk, Kraakman, and Triantis identify two sources of constraints on a controlling shareholder that can reduce agency costs in controlled-minority structure firms. See id. at 305. First, reputational concerns can serve to restrain a controlling shareholder. See id. at 305–06 (noting that in family-controlled firms, "one might expect family controllers to limit their appropriation of private benefits in order to assure continued growth for the benefit of their offspring"). Second, legal rules that protect minority shareholders against a controller can reduce agency costs. See id. at 306. This Note places into the latter category the "additional constraint[]" provided by assigning first-mover advantage to a board of directors in a controlled-minority structure firm.

The business judgment rule is a highly deferential standard of review. See Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("The business judgment rule is . . . a presumption that in making a business decision the [corporation's] directors . . . acted on an informed basis . . . . Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption." (citations omitted)), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000). The standard requires a board to satisfy the duty of care, and this duty is satisfied if the board does not commit gross negligence in reaching its decision. See Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985) ("[A] director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty . . . . [T]he concept of gross negligence is . . . the proper standard for determining whether a business judgment reached by a board of directors was an informed one."), overruled on other grounds by Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

give the controller notice of its intent to vote to dilute its voting control.[159] Once this notice is served, the board will effectively be forced to seek a TRO from the Court of Chancery. At this stage, the process would be largely the same as that in a one-share-one-vote company, but the scope of the court's review would differ. In a one-share-one-vote company, the court would be reviewing for outright fiduciary breaches by the controller. In a firm with a dual-class stock regime, the court would be reviewing whether the board acted with due care in determining that dilution of the controller is in the best interests of the corporation. Thus, while the procedural posture would be similar in these two classes of firms, the scope of review at the TRO stage would be more favorable to the board of directors when firms with dual-class stock structures are the subject of judicial review.

In ruling on the TRO, the court can choose to assign first-mover advantage to the controller by declining to issue the order. If a court decides to issue the TRO, however, it would effectively grant the board first-mover advantage. Here, the solution proposed for corporations with dual-class stock structures varies significantly from that submitted for corporations with one-share-one-vote arrangements. After the issuance of a TRO, courts should only review the board's decision to dilute under the deferential business judgment rule rather than the more exacting *Unocal* standard that should be used in the context of one-share-one-vote arrangements. Under the business judgment rule, the board's decision to dilute the controller would have a much higher likelihood of being upheld.[160] This is justified because of the increased agency costs that can accrue in corporations with dual-class stock structures.[161]

This approach empowers boards of corporations with dual-class stock structures to have first-mover advantage against their controlling shareholders. Although they must still seek a TRO in order to claim this first-mover advantage, the scope of review at this stage is limited, since a court must only ask whether the board acted with due care in resolving to dilute the controller's voting rights. Moreover, if the controller later challenges the board's decision to dilute its voting control on the merits, courts will review this decision under the highly deferential business judgment rule.

CONCLUSION

Financial markets may prize stability, regularity, and predictability, but corporate law is an inherently unstable field. Its major task consists of managing a tense balancing act among boards of directors, shareholders, and, in controlled firms, controlling shareholders. The rise of dual-class structures in recent decades and the attendant separation of cash-flow rights and voting rights in many controlled firms has upset this delicate

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159. See supra notes 74–75 and accompanying text.
160. See supra note 158 and accompanying text.
161. See supra note 146–147 and accompanying text.

balance,[162] ceding new power to controlling shareholders at the expense of minority shareholders and boards of directors. Yet in this new world of dual-class stock, the legal rule demarcating the rights of boards of directors from those of controlling shareholders remains uncertain,[163] and with it the expectations of the investing public, regulators, minority shareholders, and the very boards and controllers that are the primary actors in these conflicts.

This Note proposes that courts respond to contemporary developments in the corporate law, chief among them the rise of dual-class stock structures in American corporations, by resolving the first-mover advantage problem raised in *CBS v. National Amusements, Inc.* By distinguishing between corporations with one-share-one-vote regimes and those with dual-class stock structures in the assignment of first-mover advantage, courts can help restore the balance of power between boards and controllers, alleviate the increased agency costs of corporations with dual-class stock structures, and make progress toward regularizing what remains an unsettled area of the corporate law.

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162. See Bebchuk & Kastiel, supra note 148, at 1463 ("Since Google went public with dual-class stock in 2004, IPOs have increasingly featured dual-class stock: 19% of the companies listed on U.S. exchanges in 2017 used a dual-class structure, compared to just 1% in 2005.").

163. See supra section II.C.