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Directorial Fiduciary Duties in a Tracking Stock Equity Structure: The Need for a Duty of Fairness

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DIRECTORIAL FIDUCIARY DUTIES IN A TRACKING STOCK EQUITY STRUCTURE: THE NEED FOR A DUTY OF FAIRNESS

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INTRODUCTION

> If some of Wall Street's financial engineers have their way, an exotic corporate financing tool known as [track]ing stock will be coming to a company near you.
>
> When it does, some experts advise, run for the hills.[1]

Trouble is brewing in the seemingly sedate realm of corporate directorial fiduciary duties. A number of prominent U.S. companies — including, among others, U S West, Inc., General Motors Corp., USX Corp., and Tele-Communications, Inc.[2] — have been operating their

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1. Stephanie Strom, *It's Called Targeted Stock: Shun It, Some Experts Say*, N.Y. TIMES, July 12, 1994, at D1.

2. *See* GENERAL MOTORS CORP., PROXY STATEMENT/PROSPECTUS (Sept. 21, 1984) [hereinafter GM-EDS PROXY STATEMENT] (used in connection with GM's acquisition of Electronic Data Systems Corp., which GM recently split-off (*see infra* note 41)); GENERAL MOTORS CORP., SOLICITATION STATEMENT (Nov. 13, 1985) [hereinafter GM-HUGHES SOLICITATION STATEMENT] (used in connection with GM's acquisition of Hughes Aircraft Co.); TELE-COMMUNICATIONS, INC., PROXY STATEMENT AND PROSPECTUS (June 29, 1995) [hereinafter TCI PROXY STATEMENT]; U S WEST, INC., PROXY STATEMENT AND PROSPECTUS (Sept. 5, 1995) [hereinafter U S WEST PROXY STATEMENT]; USX CORP., PROXY STATEMENT AND PROSPECTUS (Apr. 10, 1991) [hereinafter USX-MARATHON PROXY STATEMENT]; USX CORP., PROXY STATEMENT (Apr. 13, 1992) [hereinafter USX-DELHI PROXY STATEMENT]; *see also* GENZYME CORP., PROSPECTUS AND JOINT PROXY STATEMENT (Nov. 10, 1994) [hereinafter GENZYME PROXY STATEMENT]; SEAGULL ENERGY CORP., PROXY STATEMENT (May 2, 1994) [hereinafter SEAGULL PROXY STATEMENT].

In addition to those companies discussed above, Ralston Purina Co. also adopted a tracking stock equity structure. *See* RALSTON PURINA CO., PROXY STATEMENT AND PROSPECTUS (June 9, 1993) [hereinafter RALSTON PROXY STATEMENT]. However, Ralston Purina unwound its tracking stock equity structure in May 1995 by exchanging outstanding shares of Ralston-Continental Baking Group Common Stock for shares of Ralston-Ralston Purina Group Common Stock in anticipation of the sale of its Contibusinesses using an evolutionary corporate equity structure that employs "tracking" stocks.[3] Like conventional common stocks, these hybrid forms of common stock legally represent an equity stake in a diversified parent corporation. Unlike their conventional counterparts, however, tracking stocks possess carefully tailored attributes that are designed to provide investors with the economic equivalent of an equity stake in a particular business segment or "group"[4] operated by a diversified parent corporation, rather than in the whole corporation.[5]

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nental Baking subsidiary to Interstate Bakeries Corp. in July 1995. *See* Carl Quintanilla, *Interstate Bakeries Set to Buy Ralston's in $560 Million Agreement,* WALL ST. J., Jan. 9, 1995, at B6.

Two other prominent U.S. companies attempted to implement a tracking stock equity structure and failed. Kmart Corp.'s proposed structure — detailed in its annual report and proxy statement dated April 28, 1994 (*see* KMART CORP., PROXY STATEMENT AND 1993 ANNUAL REPORT (Apr. 28, 1994) [hereinafter KMART PROXY STATEMENT]) — was rejected by its stockholders on June 3, 1994. *See* Christina Hoff, *K-Mart Weighs Its Options After Defeat by Shareholders at Stock-Sale Proposal,* WALL ST. J., June 6, 1994, at A2. RJR Nabisco Holdings Corp.'s proposed structure — detailed in its proxy statement dated June 4, 1993 (*see* RJR NABISCO HOLDING CORP., PROXY STATEMENT (June 4 1993) [hereinafter RJR PROXY STATEMENT]) — was rejected by its stockholders on June 23, 1993.

At least one foreign corporation — Fletcher Challenge Ltd., a New Zealand corporation — has adopted a tracking stock equity structure. *See* FLETCHER CHALLENGE LTD., SOLICITATION STATEMENT AND PROSPECTUS (Oct. 21, 1993) [hereinafter FLETCHER SOLICITATION STATEMENT]. Fletcher Challenge, which recently split one of its two tracking stocks into three separate tracking stocks, now has four classes of tracking stock. *See* Karen Chan, *Fletcher Challenge's New Shares Draw Mixed Views From Analysts,* ASIAN WALL ST. J., Mar. 15, 1996, at 15.

3. Tracking stocks also are referred to as *alphabet* stocks, *lettered* stocks, or *targeted* stocks. The terms *alphabet* and *lettered* stock arose originally when General Motors Corp. issued two classes of common stock known as GM class "E" common stock (representing an economic interest in GM's former Electronic Data Systems subsidiary) and GM class "H" common stock (representing an economic interest in GM's current Hughes Aircraft subsidiary). The term *targeted* stock was coined by Lehman Brothers in the early 1990s in an attempt to create a proprietary distinction in services it was rendering to corporations interested in implementing a tracking stock equity structure. *See generally Targeted Stock Picking Up As Restructuring Choice,* TREASURY MANAGER'S REP., Aug. 2, 1996, at 4, 4 [hereinafter *Restructuring Choice*] (noting that "targeted stock" was created by Lehman Brothers in 1991 for Pittsburgh-based USX Corp.).

4. The Securities and Exchange Commission (the "SEC") typically requires corporations adopting tracking stock equity structures to use the term *group* to identify the distinct business segments of the corporation to which a particular class of tracking stock will be linked economically. For example, in 1991 USX Corp. artificially bifurcated itself into the Steel Group and the Marathon Group and, in 1992, further subdivided the Marathon Group into the Marathon Group and the Delhi Group. USX's three tracking stocks are named accordingly "USX-U.S. Steel Group Common Stock," "USX-Marathon Group Common Stock," and "USX-Delhi Group Common Stock."

5. *See infra* section I.B.2.

The advent of such a novel equity structure, in turn, presents unique and formidable challenges to directors that are not faced by directors of corporations with conventional equity structures. These challenges primarily stem from the extensive intergroup conflicts and directorial loyalty concerns inherent in tracking stock equity structures. These conflicts and concerns arise when a parent corporation implementing a tracking stock equity structure artificially divides itself into two or more distinct business groups. Although that corporation strives to present its business groups to the financial community as separate and distinct stand-alone corporations,[6] it remains intact and governed by a single board of directors and executive management team. Not surprisingly, the traditional corporate fiduciary duties of care and loyalty,[7]

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6. The SEC requires that corporations with tracking stock equity structures distribute two sets of financial statements to holders of shares of each class of tracking stock. The first set contains details of the financial performance of the business group to which shares of such class are linked economically. The second set contains details of the financial performance of the entire tracking stock corporation on a consolidated basis. Tracking stock corporations typically send the two sets of financial statements to stockholders in one disclosure document. *See, e.g.*, U.S. STEEL GROUP, 1995 ANNUAL REPORT (Feb. 13, 1996) (detailing the financial performance of both USX Corp.'s U.S. Steel Group and USX Corp. as a whole during 1995).

7. *See* Anadarko Petroleum Corp. v. Panhandle E. Corp., 545 A.2d 1171, 1174 (Del. 1988) ("It is a basic principle of Delaware General Corporation Law that directors are subject to the fundamental fiduciary duties of loyalty and disinterestedness."); Sternberg v. O'Neil, 550 A.2d 1105, 1124 (Del. 1988) ("It is a basic principle of Delaware corporate law that directors of Delaware corporations are subject to fiduciary duties."); Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985) (holding that corporate directors are fiduciaries and as such owe the corporation a duty of care to inform themselves properly before making a business decision); LEWIS SOLOMON & ALAN R. PALMITER, CORPORATIONS: EXAMPLES AND EXPLANATIONS 314 (2d ed. 1994).

As Solomon and Palmiter have explained:

> According to the traditional fiduciary analysis, corporate managers owe two duties to the corporation: care and loyalty. The duty of care imposes minimal standards of attentiveness and prudence; it specifies standards for judging the adequacy of corporate decisions when the fiduciary is charged with laziness, although not with a conflict of interest. The duty of loyalty arises when a fiduciary undertakes a transaction that may conflict with the corporation's interests. It imposes stringent standards of fairness in cases of diversion and self-dealing.

Id.; see infra sections IV.A.1 and IV.B.1 (providing an overview of the duties of care and loyalty under Delaware law).

Because many of the most prominent tracking stock corporations in existence today are Delaware corporations (for example, Tele-Communications, Inc., General Motors Corp., and USX Corp.), Delaware law will be used throughout this article exclusively as the backdrop in evaluating traditional corporate fiduciary duties. In fact, as part of its implementation of a tracking stock equity structure, U S West, Inc., a Colorado corporation at the time, reincorporated in the State of Delaware. *See* U S WEST PROXY STATEMENT, *supra* note 2, at 1, 41-42, 61-68. Another important reason to focus on Delaware law is the fact that the large variety of permitted corporate transactions under Delaware law has created an ample number of fiduciary duty questions for which were designed to promote due care in directorial decisionmaking and prevent improper self-dealing by directors,[8] fail to address the unique fairness issues raised by these intergroup conflicts and loyalty concerns. The ambiguities caused by this failure are a disservice to both the millions of stockholders holding shares of tracking stock[9] and the directors serving on tracking stock corporate boards.

On the one hand, directors of tracking stock corporations deserve the legal guidance necessary to make corporate decisions and formulate corporate policies giving rise to intergroup conflicts free from unwarranted stockholder litigation. On the other hand, stockholders of tracking stock corporations need legal assurance that these directors, when making business decisions and formulating corporate policies, are considering fully and fairly the needs of the business group to which their shares are linked economically. In addition, these stockholders deserve legal assurance that the individuals serving as directors are "disinterested"[10] from a financial point of view. The need for legal guidance in this area is all the more acute today because several additional corporations have adopted recently, or have proposed adopting, tracking stock equity structures.[11]

Corporate fiduciary law, therefore, needs to evolve to accommodate this novel capital structure development. This author argues that directors of tracking stock corporations should comply with a newly created "duty of fairness" when making decisions and formulating policies that could have disparate impacts on the business groups operated by those corporations. This new duty addresses head-on the intergroup conflicts and directorial loyalty concerns that arise in a tracking stock equity structure. The creation of this new duty is more appropriate than

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the Delaware courts to resolve. *See* Leo Herzel & Laura D. Richman, *Foreword: Delaware's Preeminence by Design, in* 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS F-1, F-3 (2d ed. Supp. 1991); U S WEST PROXY STATEMENT, *supra* note 2, at 41-42 (summarizing the benefits of incorporating in Delaware). *Importantly, this article neither has attempted to, nor does it, analyze the issues raised herein under the substantive laws of any jurisdiction other than the laws of the State of Delaware.*

8. *See infra* sections IV.A.1 (discussing the duty of care and the business judgment rule) and IV.B.1 (discussing the duty of loyalty).

9. General Motors Corp. alone had over 1.1 million record holders of its lettered stocks on December 31, 1995: 625,652 record holders of GM's $1⅔ par value Common Stock, 272,096 record holders of GM's Class E Common Stock, and 267,052 holders of GM's Class H Common Stock. *See* GENERAL MOTORS CORP., 1995 FORM 10-K, at II-45 n.6.

10. "Disinterested" in a tracking stock context has a unique meaning because of the substantial divergence of financial interest that exists among different classes of tracking stock. *See infra* section II.C.

11. *See infra* note 51 and accompanying text.

simply creating a judicial gloss on the traditional fiduciary duties of care and loyalty because those duties as currently interpreted can play the same vital role in the corporate governance of tracking stock corporations as they do in the corporate governance of conventional corporations.

Part I of this article briefly describes the key distinctions between a tracking stock corporation and a conventional corporation. It then touches on the reasons why corporations have adopted tracking stock equity structures. Part II articulates the unique legal challenges presented by a tracking stock equity structure. Part III discusses the disclosure that tracking stock corporations have made with respect to these challenges. Part IV briefly summarizes the fiduciary duties of care and loyalty and explores why these duties are ill-equipped to address these challenges. Part V presents the duty of fairness and discusses the duty's elements in detail. In addition, Part V sets forth practical advice as to what tracking stock boards can do today to help minimize their exposure to litigation that may be commenced by disgruntled tracking stock stockholders in the future.

I. Tracking Stock Equity Structure — A Primer

A. *Key Distinctions Between a Conventional Corporation and a Tracking Stock Corporation*

A tracking stock corporation and a conventional corporation differ in several material respects. These differences all arise from a tracking stock corporation's attempt to link the performance of each class of its common stock[12] to a particular business group operated by that corporation. The distinctions between a conventional corporation and a tracking stock corporation are revealed by comparing the different classes of common stock issued by a conventional corporation and a tracking stock corporation, the respective voting, dividend and liquidation rights of those classes of common stock, and the corporate governance structure of those corporations.[13]

12. A class of common stock of a corporation with a tracking stock equity structure commonly is referred to as "tracking stock" in the financial marketplace and throughout this article.

13. For a general overview of the attributes of tracking stock corporations, see Erica H. Steinberger & Jeffrey J. Hass, *Introduction to Tracking Stocks*, *in* Acquisitions, Mergers, Spin-Offs, and Other Restructurings 523 (PLI Corporate Law & Practice Course Handbook Series No. B-825, 1993).

1. *Classes of Common Stock*

An examination of the classes of common stock issued by a conventional corporation and a tracking stock corporation reveals the most pronounced difference between them. The equity structure of a conventional corporation — even one with diversified operations[14] — typically consists of a single class of common stock.[15] The holders of the outstanding shares of that class collectively own the entire equity or ownership interest in the corporation.[16] To the extent the corporation as a whole performs well, shares of that class should likewise perform well regardless of how any particular division or subsidiary of that corporation performs.

By contrast, a corporation with a tracking stock equity structure must have shares of at least two separate and distinct classes of common stock outstanding.[17] Holders of the outstanding shares of those

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14. "Diversified" in this context means a corporation with two or more substantially unrelated business pursuits or lines of business. For example, a corporation that solely manufactures shoes is specialized rather than diversified, whereas a corporation that both manufactures shoes and operates a chain of restaurants is diversified rather than specialized. A corporation often strives for diversification in order to soften the effects of a downturn in the business cycle associated with its primary line of business or to guard against the obsolescence of that business. Diversification is also thought to provide synergies. *See* Dennis C. Carey & Ralph S. Saul, *Have Spinoffs Spun Out of Control?*, N.Y. TIMES, July 14, 1996, § 3, at 11.

15. As discussed later in this article, *see infra* note 67, some corporations, of course, do have more than one class of common stock. While the economic rights of those classes mirror each other, the legal rights of those classes differ, especially with respect to exchange and voting rights. A tracking stock corporation, by contrast, has multiple classes of common stock, each of which has unique economic and legal rights. Preferred stock of a conventional corporation is not discussed in this article mainly because the holders of such stock "usually realize their gain from fixed dividends, not from capital appreciation or increased [corporate] profits, and so are analogous to debtholders who receive their return from interest. . . . In short, preferred stockholders, like debtholders, receive little benefit from improved corporate performance." Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (and Why We Should Care About It)*, 51 BUS. LAW. 443, 451 (1996). This work also contains an excellent discussion and analysis of corporate fiduciary duties in a preferred stock context.

16. *See* BALOTTI & FINKELSTEIN, *supra* note 7, § 5.1, at 5-4 (Supp. 1996). The term *common stock* generally refers to an "equity security that has voting rights and is entitled to share in the residual assets of the corporation on liquidation after the claims of creditors and other classes of stock are satisfied." *Id.* § 5.2, at 5-10. Importantly, common stock also has a "maximization right — that is, the right to require that management run the corporation in a way intended to maximize benefits accruing to [common stock]holders." Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEXAS L. REV. 1273, 1288 (1991).

17. General Motors Corp., U S West, Inc., and Genzyme Corp. have, and Ralston Purina Co. had at one time, two classes of tracking stock. USX Corp. has three classes of tracking stock. Fletcher Challenge Ltd., a New Zealand corporation that initially had

classes own, in the aggregate, the entire equity interest in the tracking stock corporation. Yet, unlike a class of common stock of a conventional corporation, each class of common stock of a tracking stock corporation "tracks" or "targets" the financial performance of a distinct business segment or "group"[18] operated by that corporation. Such tracking is achieved by inserting specific provisions into a corporation's certificate or articles of incorporation that define the particular rights of each class of tracking stock. In addition, the board of directors adopts certain managerial and accounting policies that foster tracking.[19]

As discussed below,[20] the goal in implementing a tracking stock equity structure is, in essence, to create a fiction in the investment community. This fiction maintains that a particular class of tracking stock is really common stock of a stand-alone corporation that operates the

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two classes of tracking stock, recently split one class into three separate classes; consequently, Fletcher Challenge now has four classes of tracking stock. *See supra* note 2. Kmart Corp., had it successfully adopted its Specialty Retail Stock Proposal in 1994, would have had the ability to issue up to five classes of tracking stock. *See supra* note 2.

Tele-Communications, Inc. ("TCI") has, perhaps, the most confusing equity structure of any tracking stock corporation. Immediately prior to adopting its tracking stock proposal, TCI had two classes of common stock (Class A and Class B). Upon adopting its proposal, TCI redesignated its two existing classes of common stock into two series of tracking stock: Series A TCI Group Common Stock and Series B TCI Group Common Stock. Shares of these two series are designed to track TCI's newly created TCI business group. Simultaneously with the redesignation of its existing classes of common stock, TCI distributed shares of two new series of tracking stock designated as Series A Liberty Media Group Common Stock and Series B Liberty Media Group Common Stock. Shares of these two new series are designed to track TCI's newly created Liberty Media business group. *See generally* TCI PROXY STATEMENT, *supra* note 2 (detailing, in a 479-page fine-print document, TCI's tracking stock proposal and financial information for its two business groups).

With regard to the complexity of TCI's tracking stock equity structure, Robert Wood commented that:

> [T]he biggest current flap over target stock involves [TCI]. TCI has achieved significant publicity for its four-pronged approach to tracking stock. Reduced to simplicity (if anything can be simple here), the TCI plan calls for four issuances based on TCI components. . . . [I]t is understandable that investors may be circumspect [of TCI's plan] upon receiving the 600 page preliminary proxy materials plopped on their desks.

Robert W. Wood, *Current Trends and Transactions, in* 8 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS AND RESTRUCTURINGS 1995, at 585, 624 (PLI Tax Law & Practice Course Handbook Series No. J-378, 1995).

18. *See supra* note 4.

19. *See, e.g.*, RALSTON PROXY STATEMENT, *supra* note 2, at 30-32; SEAGULL PROXY STATEMENT, *supra* note 2, at 45-47; TCI PROXY STATEMENT, *supra* note 2, at 49-53; U S WEST PROXY STATEMENT, *supra* note 2, at 42-45; USX-DELHI PROXY STATEMENT, *supra* note 2, at 18.

20. *See infra* section I.B.2.

same type of business as the tracked business group. Tracking stock corporations bolster this fiction by publishing and distributing to the financial community separate audited financial statements of their various business groups.[21] Tracking stock corporations hope that shares of each class will trade in the financial marketplace based directly on how the tracked business group performs and only indirectly (if at all) on the performance of the corporation as a whole. Tracking stocks, however, do not provide stockholders with an outright equity interest in the tracked business group.[22]

2. *Dividend, Voting, and Liquidation Rights*

Holders of common stock of a conventional corporation ordinarily receive one vote for each share on all matters upon which common stockholders are entitled to vote. This right usually is set forth explicitly in the certificate or articles of incorporation of the corporation or, in the absence of such a provision, is granted by the corporate law of the state in which the corporation was organized.[23] Dividends on shares of common stock are payable at the discretion of the corporation's board of directors and then solely out of the funds of the corporation legally available for the payment of dividends, as determined by state corporate law.[24] Upon the liquidation or winding-up of the corporation, holders of common stock share ratably, based on the number of shares held, in any assets of the corporation remaining once creditors and preferred stockholders have received all amounts owed to them.[25]

The voting and liquidation rights of holders of tracking stock differ significantly from those of holders of conventional common stock. With respect to voting rights, the holders of shares of different classes of tracking stock of the same corporation often have an unequal number of

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21. *See supra* note 6.

22. *See, e.g.*, RALSTON PROXY STATEMENT, *supra* note 2, at 21; SEAGULL PROXY STATEMENT, *supra* note 2, at 38; TCI PROXY STATEMENT, *supra* note 2, at 30; U S WEST PROXY STATEMENT, *supra* note 2, at 29.

23. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 151(g), 212, 215(a)-(b) (1991).

24. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 141(a), 170(a) (1991).

25. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 280, 281 (1991 & Supp. 1994); Garrett v. Edge Moor Iron Co., 194 A. 15 (Del. Ch. 1937), *affd. sub nom.* Pennsylvania Co. for Ins. on Lives & Granting Annuities v. Cox, 199 A. 671 (Del. 1938) (noting that in corporate dissolution, unpaid cumulative dividends on preferred stock must be paid out of funds in receiver's hands before anything is paid on common stock); Gaskill v. Gladys Belle Oil Co., 146 A. 337, 339 (Del. Ch. 1929) (holding that in distribution of corporate assets, all outstanding stock is entitled to share ratably unless the statute or charter provides otherwise).

votes per share.[26] Typically, the number of votes per share for one class is fixed at one while the number of votes per share of the other class or classes is adjusted periodically based on either the relative per share values or relative market capitalizations of the various classes of tracking stock and fixed until the next periodic adjustment.[27] Similarly, the liquidation rights of the various classes of tracking stock typically are based on the relative market capitalizations of the various classes of tracking stock at the time of liquidation.[28] Most importantly, holders of a particular class of tracking stock have no direct claim against the assets of the business group to which their class is linked economically.[29] Instead, based on their respective liquidation rights, such holders share

26. State corporate law generally provides that the right to vote shares of a particular class or series within that class may be denied outright or may be limited to specific matters only. In addition, more than or less than one vote per share may be granted to the shares of any class or series, and the separate vote of a class or series may be required before specific corporate actions may be taken. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 102(a)(4), 102(b)(1), 102(b)(4), 151(a), 212(a) (1991 & Supp. 1994). As a general rule, however, the voting rights of the shares of stock of a particular class or a particular series within a class cannot be varied. *See* Providence & Worcester Co. v. Baker, 378 A.2d 121 (Del. 1977).

27. If, for example, voting rights are determined based on per share values, then the voting rights of Group A common stock will be fixed at one vote per share, while those of Group B common stock will be adjusted periodically to equal the quotient of the weighted average trading price of one share of Group B common stock divided by the weighted average trading price of one share of Group A common stock. *See, e.g.*, U S WEST PROXY STATEMENT, *supra* note 2, at 56-58 (voting rights of each outstanding share of Communications Stock fixed at one vote; voting rights of each outstanding share of Media Stock adjusted before each shareholder vote to equal the quotient of the weighted average market value of one share of Media Stock (based on values available on trading days prior to the record date) divided by the weighted average market value of one share of Communications Stock). Thus, at any given time each share of Group B common stock may have more than, less than, or exactly one vote per share. TCI and GM, however, break from this mold by fixing the voting rights of shares of each class of their tracking stocks. *See* TCI PROXY STATEMENT, *supra* note 2, at 54-55 (voting rights of each outstanding share of Series A TCI Group Common Stock and Series A Liberty Media Group Common Stock fixed at one vote; voting rights of each outstanding share of Series B TCI Group Common Stock and Series B Liberty Media Group Common Stock fixed at ten votes); GM-HUGHES SOLICITATION STATEMENT, *supra* note 2, at 36-37 (voting rights of each outstanding share of GM-$1⅔ Stock, GM-E Stock, and GM-H Stock fixed at one vote, one-quarter of one vote, and one-half of one vote, respectively).

28. *See, e.g.*, KMART PROXY STATEMENT, *supra* note 2, at 7; RALSTON PROXY STATEMENT, *supra* note 2, at 41; SEAGULL PROXY STATEMENT, *supra* note 2, at 59; TCI PROXY STATEMENT, *supra* note 2, at 71; USX-DELHI PROXY STATEMENT, *supra* note 2, at 14. U S West breaks from this mold by providing for fixed liquidation rights for its classes of tracking stock. *See* U S WEST PROXY STATEMENT, *supra* note 2, at 58-59.

29. *See, e.g.*, GENZYME PROXY STATEMENT, *supra* note 2, at 46; SEAGULL PROXY STATEMENT, *supra* note 2, at 38; TCI PROXY STATEMENT, *supra* note 2, at 30; U S WEST PROXY STATEMENT, *supra* note 2, at 29.

in any assets of the entire corporation remaining once creditors and preferred stockholders have received all amounts owed to them.

As with conventional corporate dividends, dividends paid on shares of tracking stock are paid at the discretion of the board of directors and then only out of funds legally available for the payment of dividends, as determined by state corporate law.[30] A tracking stock corporation's certificate or articles of incorporation, however, also will provide that dividends on one or more of its classes of tracking stock will be limited further to an "available dividend amount." This amount typically equals the maximum amount that would be legally available for the payment of dividends if the business group to which such class is linked were a stand-alone corporation.[31] In addition, a tracking stock board usually adopts a policy initially establishing the expected dividend rates of the various classes of tracking stock at the time a tracking stock equity structure is implemented.[32]

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30. *See, e.g.*, SEAGULL PROXY STATEMENT, *supra* note 2, at 48-50; TCI PROXY STATEMENT, *supra* note 2, at 55; U S WEST PROXY STATEMENT, *supra* note 2, at 47; USX-DELHI PROXY STATEMENT, *supra* note 2, at 15.

31. For example, in addition to being restricted to legally available funds of Tele-Communications, Inc. as determined in accordance with Delaware law, dividends on TCI Group Common Stock (which consists of both Series A and Series B TCI Group Common Stock) are limited further to an amount not in excess of the "TCI Group Available Dividend Amount." This amount is intended to equate substantially to the amount that would be legally available for the payment of dividends on the TCI Group Common Stock under Delaware law if the TCI Group were a separate, stand-alone Delaware corporation. *See* TCI PROXY STATEMENT, *supra* note 2, at 55-57.

See also GENZYME PROXY STATEMENT, *supra* note 2, at 43-44; RALSTON PROXY STATEMENT, *supra* note 2, at 33-35; SEAGULL PROXY STATEMENT, *supra* note 2, at 48-50; U S WEST PROXY STATEMENT, *supra* note 2, at 47-48; USX-DELHI PROXY STATEMENT, *supra* note 2, at 15-16; USX-MARATHON PROXY STATEMENT, *supra* note 2, at 23-24.

32. *See, e.g.*, RALSTON PROXY STATEMENT, *supra* note 2, at 29-30; U S WEST PROXY STATEMENT, *supra* note 2, at 45-46. The establishment and announcement of a dividend policy help to ensure that the shares of the different classes of tracking stock eventually come to rest in the hands of investors with investment objectives (growth, income, and so on) that correspond to the attributes of each such class. For example, U S West disclosed its intention to establish a dividend policy applicable to its Communications Stock that was comparable to the dividend policy applicable to its conventional common stock. Thus, U S West anticipated that it would pay quarterly dividends on its Communications Stock of $0.535 per share (the amount paid on its conventional common stock). *See* U S WEST PROXY STATEMENT, *supra* note 2, at 45. By contrast, U S West noted that it anticipated paying no quarterly dividend on its Media Stock once its proposed tracking stock equity structure was implemented. *Id.* U S West's anticipated dividend policy thus supported its attempt to market its Communications Stock as an "income-oriented" stock and its Media Stock as a "growth-oriented" stock. *See id.* at 40; *see also infra* note 58.

3. *Governance by a Single Board of Directors*

A conventional corporation is governed by a single board of directors. This board is responsible for formulating corporate policies and making major corporate decisions.[33] A tracking stock corporation similarly has a single board of directors. Ultimately, the board of either a conventional corporation or a tracking stock corporation is accountable to the owners of the corporation, namely the stockholders.

A tracking stock corporation has at any given time at least two groups of stockholders with economic interests linked to the performance of different business groups operated by that corporation. Because of this, the board of directors of a tracking stock corporation must look out for the interests of multiple groups of stockholders that often have competing financial interests.[34] In other words, the board must answer to at least two and perhaps even more masters, depending on how many classes of tracking stock the corporation has. Each distinct group of stockholders, therefore, is disadvantaged by having no "truly independent agency"[35] looking out for its interests and those of the business group to which its shares are linked.

B. *Reasons for Implementing a Tracking Stock Equity Structure*

Corporations have implemented a tracking stock equity structure primarily for one of two reasons. The first is to provide a unique type of consideration that can be used in connection with corporate acquisitions. The second is as a means to enhance — or attempt to enhance — stockholder value. Each of these uses for tracking stock is explored briefly below.

1. *Use of Tracking Stocks as Acquisition Consideration*

Stockholders who are considering a sale of their shares in a corporation as part of the acquisition of that corporation by another corporation have a common fear. They fear that the agreed upon acquisition price for the corporation does not reflect the true value of that corporation. Indeed, those stockholders are loath to give away the "upside" po-

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33. *See* EDWARD BRODSKY & M. PATRICIA ADAMSKI, LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES AND LIABILITIES § 2:02 (1984).

34. *See infra* text accompanying notes 79-90.

35. *In re* FLS Holdings, Inc. Shareholders Litig., No. CIV.A.12623, 1993 WL 104562, at *1, *5 (Del. Ch. Apr. 2, 1993) (noting that in determining whether the allocation of merger consideration between preferred and common stockholders was fair, no "truly independent agency" existed on behalf of the preferred stockholders, because all the directors were elected by the common stockholders).

tential of their corporation at a bargain price. A corporation seeking to acquire another corporation, however, typically desires to purchase 100% of the equity interest in that corporation in order to eliminate the problems that arise when a minority equity interest in an acquired corporation remains outstanding.

Using shares of the acquiring corporation's common stock for all or part of the consideration paid to the selling stockholders often can solve this dilemma. Selling stockholders who receive those shares are able to continue their participation in the growth and success of the acquired corporation through a rise in value of the acquiring corporation's stock. This, in turn, increases the likelihood that the acquiring corporation successfully will purchase the entire equity interest in the acquired corporation. Thus, the use of stock consideration[36] helps quell selling stockholders' fears about price while simultaneously allowing the acquiring corporation to operate its newly acquired business as it sees fit.

A problem arises, however, when the acquiring corporation is such a large conglomerate that the performance of the acquired corporation will become "lost" within the performance of the conglomerate. In this case, selling stockholders naturally are concerned that the value of the common stock of the acquiring corporation that they receive will be affected only marginally if at all by the performance of the acquired corporation. As a result, their fear of giving away the "upside" potential of their corporation is not assuaged.

One solution to this dilemma would be for the acquiring corporation to create a separate class of tracking stock designed to track the economic performance of the acquired corporation.[37] In this way, selling stockholders can continue to participate in the future success — and failure — of the acquired corporation more directly than if they owned conventional common stock of the acquiring corporation.[38] The acquir-

36. Frequently the consideration received by selling stockholders consists of both cash and stock of an acquiring corporation. The use of cash, of course, placates to a certain degree those selling stockholders who desire to have no interest in the acquiring corporation going forward.

37. The acquiring corporation's outstanding common stock would be modified simultaneously to track all of that corporation's businesses with the exception of the newly acquired business. *See, e.g.*, GENZYME PROXY STATEMENT, *supra* note 2, at 38; GM-EDS PROXY STATEMENT, *supra* note 2, at 19-21.

38. *See, e.g.*, GM-EDS PROXY STATEMENT, *supra* note 2, at 10 (stating that shares of GM-E Stock allow the former shareholders of Electronic Data Systems Corp. to participate indirectly in growth opportunities of EDS after the acquisition of EDS by General Motors).

ing corporation, meanwhile, would meet its goal of purchasing the entire equity interest in the acquired corporation.[39]

Certain acquisitions made by General Motors Corp. ("GM") and Genzyme Corp. ("Genzyme") provide vivid examples of the use of tracking stock as acquisition consideration. In 1984, GM acquired all the outstanding common stock of Electronic Data Systems Corporation ("EDS"). Part of the consideration paid by GM to EDS's stockholders (the most famous of whom was Ross Perot) consisted of newly created GM class "E" common stock ("GM-E Stock").[40] GM-E Stock was de-

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39. Most tracking stock corporations have noted that one of the reasons for adopting a tracking stock equity structure is to provide them with a choice of stock consideration for use in connection with acquisitions. *See, e.g.*, RALSTON PROXY STATEMENT, *supra* note 2, at 29; TCI PROXY STATEMENT, *supra* note 2, at 49; U S WEST PROXY STATEMENT, *supra* note 2, at 40. However, the utility of tracking stocks as acquisition consideration in practice remains questionable due to the negative response of selling stockholders towards it. This response arises for three reasons. First, most selling stockholders of an acquired corporation simply do not understand what tracking stock is and the purposes it serves. A good deal of educating, therefore, must be accomplished by the acquiring corporation before selling stockholders of an acquired corporation will embrace the concept of tracking stock. Second, because selling stockholders retain no direct voting rights with respect to the acquired corporation, they no longer are entitled to elect directors to the board of the acquired corporation after its sale. Thus, they lose all control over the acquired corporation, which is subsumed within a new or existing business group of a tracking stock corporation. Finally, use of tracking stocks as acquisition consideration also may pose problems from an accounting and tax perspective. *See* U S WEST PROXY STATEMENT, *supra* note 2, at 41 (noting that tracking stocks could limit the ability of a company to use the "pooling" method of accounting in structuring an acquisition).

Nevertheless, tracking stock is used from time to time as acquisition consideration. For example, U S West, Inc. recently announced that its Media Group would acquire Continental Cablevision Inc. for $5.3 billion in cash and stock, plus the assumption of $5.5 billion in debt. The stock to be issued was reported to consist of $2.8 to $3.3 billion in Media Group common stock and $1.0 billion in U S West preferred stock convertible into shares of Media Group common stock. *See* Leslie Cauley & Mark Robichaux, *U S West Media To Pay $5.3 Billion To Buy Continental Cablevision,* WALL ST. J., Feb. 28, 1996, at A3. By using Media Group common stock as acquisition consideration, U S West will avoid issuing shares of stock with a hefty dividend attached. As Jim Anderson, the Chief Financial Officer of U S West, has stated, "We did not want to use our combined stock to make large acquisitions like Continental because issuing all those shares with the dividend attached would be very expensive." Gautam Naik, *PacTel To Reduce Dividend 42 Percent,* MORNING NEWS TRIB. (Tacoma, Wash.) Apr. 4, 1996, at C9 (internal quotation marks omitted).

40. GM allowed each EDS selling shareholder the option of selecting one of two consideration packages, or a combination of both packages. Option I consisted of receiving $44 in cash for each EDS share — that is to say, an all-cash deal with no interest in EDS's future performance. Option II consisted of a combination of cash ($35.20 for each EDS share), two-tenths of a share of GM-E Stock for each EDS share, and a contingent value note. Shareholders who did not indicate which option they desired received Option I only. *See* GM-EDS PROXY STATEMENT, *supra* note 2, at 7-8. Shareholders who objected to the sale of EDS were entitled to dissenters' rights under Texas law.

signed through its carefully tailored attributes to track the performance of EDS upon the acquisition of EDS by GM. GM's existing common stock ("GM-$1⅔ Stock") continued to track the performance of the old GM.[41]

Their ownership of GM-E Stock allowed Mr. Perot and the other selling stockholders of EDS to participate in the upside potential of EDS after its sale to GM. More importantly to Mr. Perot, however, was the fact that EDS's management team, which continued to include Mr. Perot even after the sale of EDS, would be motivated to perform after the acquisition through the use of stock options tied to GM-E Stock rather than GM-$1⅔ Stock.[42] GM, in turn, was able to ensure that it alone would control EDS.[43]

Genzyme similarly used tracking stock to effect its acquisition of BioSurface Technology, Inc. ("BioSurface") in 1994.[44] As part of the transaction, Genzyme stockholders approved the creation of a new class of Genzyme common stock called Tissue Repair Division Common Stock ("TR Stock") and the simultaneous redesignation of Genzyme's

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See id. at 44-45. Ross Perot and certain other significant shareholders of EDS had negotiated in advance for, and agreed to accept, Option II consideration as part of the overall transaction. *See id.* at 8-9.

41. GM announced in August 1995 that it was "splitting-off" EDS by exchanging shares representing an actual equity interest in EDS itself for outstanding shares of GM-E Stock. GM received a favorable tax ruling on December 28, 1995, which would allow the split-off to occur tax free to both the holders of GM-E Stock and to GM itself. *See* Allen R. Myerson, *Government to Permit Tax-Free Split of G.M. and E.D.S.*, N.Y. TIMES, Dec. 30, 1995, at 43. GM effected the split-off on June 7, 1996. *See Dow Jones Equity Market Index*, WALL ST. J., June 10, 1996, at C7. Details of the split-off can be found in the joint Solicitation of Written Consent of General Motors Corporation Common Stockholders and Prospectus of Electronic Data Systems Holding Corporation, GENERAL MOTORS CORP., SOLICITATION STATEMENT/PROSPECTUS (Apr. 23, 1996) [hereinafter GM SOLICITATION STATEMENT/PROSPECTUS].

42. *See* Jennifer Reingold, *Heartburn (Targeted Stock)*, FIN. WORLD, Sept. 26, 1995, at 32.

43. While GM was able to control EDS, upon completion of the transaction Mr. Perot became GM's largest stockholder, joined GM's board of directors, and continued on as EDS's chairman. Soon thereafter, he also became GM's biggest gadfly, as he increasingly became openly critical of GM's operations, business, and management. *See generally* Grobow v. Perot, 539 A.2d 180 (Del. 1988).

GM used lettered stock again in 1985 in connection with its acquisition of Hughes Aircraft Co. ("Hughes") from Howard Hughes Medical Institute. In connection with this acquisition, GM created GM class "H" common stock ("GM-H Stock"). In addition to certain other cash and noncash consideration, GM issued 50 million shares of GM-H Stock to the Institute in payment for Hughes. GM-H Stock was designed to track the performance of Hughes upon its acquisition by GM. *See generally* GM-HUGHES SOLICITATION STATEMENT, *supra* note 2 (detailing GM's acquisition of Hughes through its use of lettered stock).

44. *See generally* GENZYME PROXY STATEMENT, *supra* note 2 (detailing Genzyme's acquisition of BioSurface through its use of tracking stock).

existing common stock as General Division Common Stock ("General Stock"). TR Stock was designed to relect the performance of a newly established division within Genzyme called the Tissue Repair Division, while General Stock was designed to reflect the performance of the rest of Genzyme's businesses. The Tissue Repair Division was created by combining certain Genzyme programs and licenses relating to tissue repair with the newly acquired business of BioSurface.[45] Upon consummation of the acquisition, Genzyme issued five million shares of TR Stock (representing 50% of the initial equity interest in the Tissue Repair Division) to BioSurface stockholders and shortly thereafter distributed 3.3 million shares of TR Stock (representing 33% of the initial equity interest in the Tissue Repair Division) to Genzyme's existing stockholders.

Corporations that implement tracking stock equity structures in connection with an acquisition have an additional hurdle to overcome that is not confronted by those seeking to employ those structures for value enhancement purposes. That hurdle is an arm's-length negotiation with the management of the acquired corporation.[46] This negotiation not only addresses such traditional matters as the number of shares of tracking stock to be received by the acquired corporation's stockholders, but also covers the specific terms of, and management policies to be adopted with respect to, that tracking stock. In addition, the management for the acquired corporation can negotiate for specific prophylactic measures designed to ensure that the acquiring corporation's board respects the integrity of the business group to which that tracking stock relates.[47]

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45. Genzyme's use of tracking stock was unique in that it was linked to a newly formed division whose products were in development and that had never generated operating income or paid dividends. Consequently, the valuation of the tracking stock issued to BioSurface's stockholders proved difficult. *See id.* at 31.

46. *See id.* at 39.

47. For example, BioSurface bargained for a number of provisions that restrict the flexibility of Genzyme's board to manage Genzyme's Tissue Repair Division. These provisions included the following:

1. The number of "TR Designated Shares" was fixed and cannot be increased unless at least one of several circumstances occurs, including possibly a class vote of the holders of TR Stock. "TR Designated Shares" are shares of TR Stock that Genzyme could issue without allocating any of the proceeds to the Tissue Repair Division.
2. Significant restrictions were placed on the board's ability to transfer assets — especially "key" assets — from the Tissue Repair Division to Genzyme's General Division. Such restrictions cannot be modified or repealed by the board without a class vote of the holders of TR Stock.
3. Genzyme was prohibited from making a de facto redemption of TR Stock through open market purchases without paying the requisite 30% exchange pre-

2. *Use of Tracking Stocks in an Attempt To Enhance Stockholder Value*

Tracking stocks are used today chiefly in an attempt to unlock stockholder value. Operating on the assumption that the financial marketplace was not completely efficient in valuing their businesses, certain diversified corporations have adopted tracking stock equity structures in an attempt to unlock the hidden, or unrecognized, value in those businesses. For example, U S West, Inc. ("U S West"), USX Corp. ("USX"), Ralston Purina Co. ("Ralston"), and Tele-Communications, Inc. ("TCI") all have implemented tracking stock equity structures during the 1990s for this purpose, among others.[48] Two other prominent U.S. companies — Kmart Corp. ("Kmart") and RJR Nabisco Holding Corp. ("RJR") — attempted to implement such structures for this purpose, but failed.[49] MCI Communications Corp. entertained the idea of

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mium to holders of TR Stock. (This 30% exchange premium is one of the highest exchange premiums found in any tracking stock corporate charter.)

4. Genzyme was prohibited from developing products outside the Tissue Repair Division that compete or would compete in the market with products being developed or sold by the Tissue Repair Division.

5. Holders of TR Stock were given the power to veto a merger or business combination of Genzyme if, as a result thereof, the holders of all classes of Genzyme common stock (a) no longer owned, directly or indirectly, at least 50% of the voting power of the surviving corporation and (b) did not receive the same form of consideration, distributed among such holders in proportion to the Market Capitalization (as defined) of each class of Genzyme common stock as of the date of the first public announcement of such merger or business combination.

See id. at 40-43, 45-46.

48. *See* RALSTON PROXY STATEMENT, *supra* note 2, at 28-29; TCI PROXY STATEMENT, *supra* note 2, at 49; U S WEST PROXY STATEMENT, *supra* note 2, at 40; USX-DELHI PROXY STATEMENT, *supra* note 2, at 11; *see also Unlocking Stock Value,* INVESTOR REL., June 1, 1995; *cf.* FLETCHER SOLICITATION STATEMENT, *supra* note 2, at 23 (example of foreign corporation adopting tracking stock equity structure to enhance stockholder value).

49. *See* KMART PROXY STATEMENT, *supra* note 2; RJR PROXY STATEMENT, *supra* note 2. Kmart's proposal was defeated soundly by its shareholders on June 3, 1994, and a few months later Kmart sold 51% of each of its Officemax, Sports Authority, and Borders-Walden Books subsidiaries. Each of the three companies has an independent executive management team and a separate board of directors. *See* HOOVER'S HANDBOOK DATABASE, KMART CORPORATION 1 (1995). According to one commentator, Kmart shareholders defeated the tracking stock proposal because they viewed it "as a Band-Aid when major surgery was required." Reingold, *supra* note 42, at 32. Many believe that the concept of tracking stock "took a beating" due to the Kmart debacle. *See U S West To Begin Promotional Tour for Stock Plan,* STAR-TRIB. (Minneapolis-St. Paul) Oct. 10, 1995, at 3D [hereinafter *Promotional Tour*]; *Restructuring Choice, supra* note 3, at 5. RJR's unsuccessful attempt to implement a tracking stock equity structure did not further the cause of tracking stock either, with at least one commentator labeling it a "notorious targeted-stock-issue flop." Lyn Perlmuth, *Wriggling Out of Preferred,* INSTITUTIONAL INVESTOR, Nov. 1995, at 35, 36.

tracking stock, but ultimately decided against it in favor of providing investors and stock analysts with more detailed financial information about its various businesses.[50] Other prominent companies are believed to be considering currently the implementation of tracking stock equity structures primarily for value-enhancement purposes.[51]

Use of tracking stocks in an attempt to unlock stockholder value is thought to be particularly expedient with respect to a diversified parent corporation that is operating simultaneously one or more growth businesses and one or more declining, out-of-favor, or even stable yet financially uninspiring businesses.[52] The belief of such a corporation —

50. *See Promotional Tour, supra* note 49, at 3D.

51. *See* COMCAST CORP., PROXY STATEMENT AND 1995 FORM 10-K, at 28-30 (May 17, 1996) (pursuant to which Comcast shareholders approved a charter amendment providing for, among other things, the future issuance of tracking stock); *Westinghouse Says It Weighs Separate Broadcasting Stock,* N.Y. TIMES, Apr. 20, 1996, at 34 (discussing Westinghouse Electric Corp.); Laura Landro, *Sony May Sell Stake in U.S. Operations,* WALL ST. J., Oct. 30, 1995, at A3 (discussing Sony Corp. of America); *Public Service Enterprise May Spin Off Exploration Unit,* DOW JONES INTL. NEWS SERV., Dec. 7, 1995, *available in* WL, DJNS Database (discussing Public Service Enterprise Group Inc.); Jill Goldsmith, *Time Warner's 4Q Buoyed by Film Unit; No News on U S West,* DOW JONES INTL. NEWS SERV., Feb. 6, 1996, *available in* WL, DJNS Database (discussing Time Warner, Inc.); *see also Restructuring Choice, supra* note 3, at 4 (reporting that a source at Lehman Brothers stated that several companies are in advanced discussions with Lehman Brothers regarding the issuance of targeted stock, and that interest in targeted stock is clearly growing). On the international front, the utility industry in the United Kingdom is considering the use of tracking stocks in an effort to avoid additional governmental regulation being considered in connection with the current merger activity within the industry. *See The Lex Column: Utilities on Track,* FIN. TIMES (London), Jan. 15, 1996, at 20; *U.K. Utility Mergers May Cause Tighter Rules: Conference,* DOW JONES INTL. NEWS SERV., Jan. 24, 1996, *available in* WL, DJNS Database.

52. John Oslund of the *Star-Tribune* cleverly described U S West's businesses as consisting of "two basic types of vessels: a powerful but slow battleship (the telephone company) and a squadron of flashy speed boats, represented by the cable TV, wireless and entertainment ventures." He added that, before tracking stock, investors "wonder[ed] whether they [were] buying battleships or speed boats when they acquire[d] U S West shares." John J. Oslund, *U S West Twosome — Chairman and CEO of Baby Bell Tries To Sell Shareholders on 'Targeted' Plan,* STAR-TRIB. (Minneapolis-St. Paul), Oct. 16, 1995, at 1D. Stephen Keating of the *Denver Post* commented, with respect to U S West, that "[t]he cooks in the U S West Communications kitchen are making a racket splitting up the POTS and PANS." Stephen Keating, *U S West Makes Pitch for New Class of Stock Reflecting Media Potential,* SEATTLE TIMES, Oct. 17, 1995, at E3.

USX Corp., Ralston Purina Co., U S West, Inc., and Tele-Communications, Inc., all of which have implemented tracking stock equity structures at one time, impliedly categorized their respective businesses as follows:

Name of Corporation	*Growth Business(es)*	*Declining or Out-of-Favor Business(es)*
USX	oil and gas (based on original 1991 proposal)	steel

often sparked, fueled, and fanned by its investment bankers[53] — is that the marketplace simply is failing to understand and fully appreciate, and thus value, all the businesses operated by that diversified corporation.[54] In other words, the corporation believes that the financial community, when determining the trading value of that corporation's conventional common stock, is placing too much weight on its declining businesses and not enough on its growth businesses.[55] The net effect of the finan-

Name of Corporation	*Growth Business(es)*	*Declining or Out-of-Favor Business(es)*
Ralston	food business	baking
U S West	nonregulated cable TV, multimedia and wireless businesses	regulated local telephone business
TCI	media products and electronic retailing	cable and telephone businesses

Of course, what is considered a growth business and what is considered a declining or out-of-favor business changes over time. For example, when USX adopted its initial tracking stock equity structure in 1991, it created two classes of tracking stock: one linked to its steel business — both a declining and out-of-favor business at that time — and the other linked to its oil and gas business. In 1992, USX redesignated its tracking stock linked to the oil and gas business into two new tracking stocks, one of which was linked to the oil business and the other of which was linked to the gas pipeline business. USX then sold shares linked to the gas pipeline business to the public in an effort to raise money for its stalled oil business. *See* Dana Milbank, *USX Weighs Plan to Offer Shares of Delhi Gas Pipe,* WALL ST. J., Apr. 14, 1992, at C15. More recently, USX's steel business once again has become a viable business.

53. At least one commentator has taken an extremely cynical view in this regard. Jennifer Reingold of *Financial World* has stated that "[i]n the end, targeted stock just complicates everyone's life a bit and adds a couple of million dollars per transaction to the coffers of the investment bankers." Reingold, *supra* note 42, at 33.

54. *See, e.g.,* RALSTON PROXY STATEMENT, *supra* note 2, at 28-29; TCI PROXY STATEMENT, *supra* note 2, at 48-49; U S WEST PROXY STATEMENT, *supra* note 2, at 39-40. Some support for this theory does exist, as a recent study indicated Wall Street's preference for "pure plays" — one-business companies — rather than companies engaging in multiple businesses. *See* Judith H. Dobrzynski, *Why the Market Likes Johnny-One-Notes . . . and Is Skeptical of One-Man Bands,* N.Y. TIMES, Oct. 8, 1995, at F4; Strom, *supra* note 1, at D5.

Spin-offs — the traditional alternative to tracking stock equity structures — are thought to enhance stockholder value for this same reason. *See infra* section I.B.3. "Spinoffs merely make it easier for Wall Street to recognize value," according to Roger Lowenstein of the *Wall Street Journal.* He adds that "[p]ortfolio managers, even those with working calculators, dislike having to add the values of multiple businesses; one-trick ponies make a better 'story.' " Roger Lowenstein, *Intrinsic Value — Confessions of a Corporate-Spinoff Junkie,* WALL ST. J., Mar. 28, 1996, at C1.

55. In financial terms, the conventional common stock of the particular corporation was trading at a price-earnings ratio ("P/E ratio") more associated with the P/E ratio of a stand-alone corporation primarily operating in the declining businesses, rather than at a P/E ratio of a stand-alone corporation primarily operating in the growth busi-

cial community's naiveté is its undervaluation of the corporation as a whole.

Tracking stocks are thought to help unlock stockholder value by, in essence, "uncoupling" the growth businesses from the other businesses operated by a diversified parent corporation.[56] The belief and hope of a corporation implementing a tracking stock equity structure is that the financial marketplace, through more increased and focused equity research, will value shares of each class of tracking stock as if they were shares of a stand-alone corporation primarily engaging in the business of the particular business group to which they are linked.[57] Once these stocks begin trading like stocks of separate, stand-alone corporations, it is anticipated that the combined trading value of the two tracking stocks will be greater than that of the former conventional common stock.[58] Or so the theory goes.[59]

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nesses. The price-earnings ratio is calculated by dividing the price per share of stock by the corporation's earnings per share. *See* THE PORTABLE MBA IN INVESTMENT 196 (Peter L. Bernstein ed., 1995). A stock with a high P/E ratio indicates that the financial marketplace views that stock's growth prospects more favorably than those of a stock with a lower P/E ratio. *See* THE PORTABLE MBA IN FINANCE AND ACCOUNTING 26 (John Leslie Livingstone ed., 1992) [hereinafter MBA IN FINANCE].

56. Because the businesses of a diversified parent corporation are artificially "uncoupled" when a tracking stock equity structure is implemented, a tracking stock proposal is sometimes referred to as an "internal spin-off."

57. *See, e.g.*, GENZYME PROXY STATEMENT, *supra* note 2, at 40; KMART PROXY STATEMENT, *supra* note 2, cover letter of former Chairman Joseph E. Antonini; RALSTON PROXY STATEMENT, *supra* note 2, at 28-29; RJR PROXY STATEMENT, *supra* note 2, at 27; SEAGULL PROXY STATEMENT, *supra* note 2, at 62; TCI PROXY STATEMENT, *supra* note 2, at 48. U S West's tracking stock proposal has been labeled "an acknowledgment that U S West's investors, among others, are confused by the Colorado-based company's diversification strategy and as a result aren't accurately valuing the company's stock." Oslund, *supra* note 52, at 1D. In order to facilitate increased equity research, U S West appointed a director of investor relations for each of its two business groups. *See Split Positions*, INVESTOR REL., Oct. 1, 1995.

58. Having two different classes of tracking stock also can be appealing to distinct types of investors. Using U S West as an example, more conservative investors, such as pension funds, should tend to favor U S West's Communications Stock, a conservative stock linked to the company's traditional local telephone business paying a quarterly dividend. More risk-taking investors should favor U S West's Media Stock, a more risky stock reflecting the performance of the company's growth businesses initially paying no dividend. *See* Keating, *supra* note 52, at E3; *Restructuring Choice, supra* note 3, at 4. By appealing to distinct types of investors, tracking stocks are thought to lure new investors into holding a tracking stock corporation's stock. Richard McCormick, Chairman of U S West, stated his belief that the creation of a U S West "growth" stock — U S West's Media Stock — would attract "100 new institutional investors." *Stock Split Gets Resounding OK — Communications, Media Shares To Trade Separately Today*, DENVER POST, Nov. 1, 1995, at C1 (quoting Richard McCormick) (internal quotation marks omitted).

59. Although not the focus of this article, scholars need to answer the question of whether tracking stocks actually increase stockholder value. If they do, then the logical

follow-up question is how. If, in fact, value is created, where does it come from? Does a tracking stock equity structure, for example, reduce information asymmetry through the publication of additional financial information about a corporation that was previously available only to management? If so, and if this is the reason for any increased stockholder value, then should not corporations follow the lead of MCI Communications Corp., which merely publishes more detailed financial information about its various businesses, rather than USX Corp. and the other tracking stock converts?

It should be noted that many commentators have criticized whether the implementation of a tracking stock equity structure alone can enhance stockholder value. For example, Edmund Andrews of the *New York Times* likened such implementation to the application of "cheap makeup on the same old face." Edmund L. Andrews, *U S West To Stake Out Some New Turf,* N.Y. TIMES, Oct. 9, 1995, at D1, D4; *see also* Reingold, *supra* note 42, at 33 (quoting Professor Bruce Greenwald of the Columbia Business School who labeled a tracking stock equity structure "a sleight-of-hand transaction" designed to solve management's fundamental problem, "which is their nonperformance").

With respect to corporate restructurings in general and U S West's tracking stock proposal in particular, Roger Lowenstein of the *Wall Street Journal* has stated that "[r]earranging the financial furniture merely to look attractive to Wall Street . . ." is a bad idea. He added that " 'getting the stock up' is probably the worst motivation there is" for a company, and that "[w]hen a company pays attention to business, the stock will take care of itself." Roger Lowenstein, *Intrinsic Value — When Are Corporate Overhauls Worthwhile?,* WALL ST. J., Sept. 28, 1995, at C1.

Not surprisingly, corporations implementing a tracking stock equity structure set forth explicit disclaimers in their disclosure documents noting that such implementation may or may not serve its intended purpose of enhancing stockholder value. *See, e.g.,* KMART PROXY STATEMENT, *supra* note 2, at 14; TCI PROXY STATEMENT, *supra* note 2, at 36; RALSTON PROXY STATEMENT, *supra* note 2, at 23; U S WEST PROXY STATEMENT, *supra* note 2, at 35-36.

BioSurface Technology, Inc. retained PaineWebber Inc. to render a fairness opinion to it with respect to the consideration to be received by BioSurface's stockholders from its acquiror — Genzyme Corp. That consideration consisted of shares of a newly created class of Genzyme tracking stock (TR Stock). The *Prospectus and Joint Proxy Statement* of Genzyme and BioSurface (Annex XI of which sets forth PaineWebber's fairness opinion) had this to say about PaineWebber's findings with respect to tracking stock:

> Additionally, PaineWebber noted that "tracking stocks" generally trade at a multiple of earnings per share that is not discounted when compared to the multiples at which stock of other companies in the same industry trades, indicating that investors are valuing the business of the tracking stock in the same way that they value stocks of other companies in the same industry. PaineWebber compared the ratio (the "P/E Multiple") of the stock price to 1993 actual earnings per share and 1994 and 1995 projected earnings per share of the eight widely recognized tracking stocks to the P/E Multiple of selected companies considered by PaineWebber to be comparable. In each case, PaineWebber examined the average premium or discount for the three annual periods of the P/E Multiple for the tracking stocks to the average P/E Multiple of the stocks of the selected comparable companies. Of the eight stocks that PaineWebber considered, *six traded on average at a premium to the selected comparable companies and two at a discount to the selected comparable companies.*

GENZYME PROXY STATEMENT, *supra* note 2, at 59-60 (emphasis added).

3. *Comparison with Spin-Off Strategy*

Any corporation willing to consider the implementation of a tracking stock equity structure usually has considered a more traditional corporate strategy — the "spin-off" — for enhancing stockholder value. A corporate spin-off entails an actual distribution (or "spin-off") by a corporation to its stockholders of actual shares of one of its subsidiaries. Each stockholder of the corporation immediately prior to the spin-off thus winds up holding two types of common stock as a result of the spin-off: one representing a direct equity interest in the parent corporation minus the spun-off subsidiary; and the other representing a direct equity interest in the spun-off subsidiary. Each type of common stock then will trade separately in the marketplace and presumably reflect the value inherent in the corporation to which it relates. A tracking stock equity structure also places shares of different classes of stock into the hands of stockholders, but those shares all represent equity interests in the parent corporation itself, and not in the business groups to which they are linked economically. Thus, a tracking stock equity structure is sometimes referred to as an "internal spin-off."

A tracking stock equity structure has several advantages over a traditional corporate spin-off strategy. First, by remaining one large diversified corporation, all businesses operated by a tracking stock corporation potentially benefit from the lower cost of capital available to a large, diversified parent corporation.[60] This benefit stems from the availability of all the tracking stock corporation's assets to service the debt of that corporation.[61] A spun-off subsidiary, by contrast, must secure its own financing, and the cost of this financing likely will reflect its new status as a smaller, and more risky, stand-alone corporation.

Second, tracking stock corporations can spread corporate overhead costs, such as payroll, employee benefits, legal, and accounting, over a larger corporate entity. A spun-off subsidiary needs to implement these functions for itself, as well as to fund its own corporate management structure.[62] Third, if properly structured, a tracking stock proposal can

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60. *See* GENZYME PROXY STATEMENT, *supra* note 2, at 40.

61. *See DCR Adds U S West, Inc. and U S West Capital Funding to Rating Watch — Down; U S West Communication, Inc.'s Ratings Reaffirmed,* PR Newswire, Feb. 27, 1996, *available in* WL, PRNEWS Database; *DCR Rates U S West, Inc. $130 Million Exchangeable Issue 'A+,'* PR Newswire, Dec. 11, 1995, *available in* WL, PRNEWS Database, at *2 (stating that, with respect to U S West, that "[c]reditors of parent and parent-related debt continue to have legal claims on the assets of the consolidated enterprise").

62. RJR Nabisco Holdings Corp. speculated that the costs of operating two separate entities would be 30% to 50% higher than operating RJR Nabisco Holdings Corp. alone. *See* RJR PROXY STATEMENT, *supra* note 2, at 26.

be effected on a tax-free basis to both the stockholders of the corporation and the corporation itself.[63] A tax free spin-off ruling from the Internal Revenue Service (a 355 Ruling, which, in the view of corpora-

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63. In October 1987, the Internal Revenue Service ("IRS") added tracking stock to the list of areas under extensive study with respect to which it would not rule until the issue was resolved. *See* Rev. Proc. 87-59, 1987-2 C.B. 764. Recently, the IRS decided that tracking stock involved an area of tax law upon which the IRS would not issue any rulings or determination letters. *See* Rev. Proc. 95-3, 1995-1 C.B. 385.

The important tax issue relating to tracking stock has to do with determining whether tracking stock is stock of the issuing company or of an actual or constructive subsidiary owning the tracked business group. All tracking stock corporations have taken the position that tracking stock is stock of the issuing company — the parent corporation. If this position proves to be the correct one, then the following tax consequences will follow:

1. A distribution of tracking stock to stockholders of the parent corporation will qualify as a nontaxable stock dividend under § 305(a) of the Internal Revenue Code of 1986, as amended (the "Code").
2. Such a distribution also will be tax-free to the parent corporation itself under § 311 of the Code.
3. A public offering of tracking stock by the parent corporation will be nontaxable under § 1032 of the Code.
4. The conversion of tracking stock into conventional common stock by the parent corporation under either § 1036 or § 368(a)(1)(E) of the Code will result in the recognition of no gain or loss.
5. The tracked assets will remain part of a consolidated tax group.

If, however, the IRS determines that tracking stock is really the stock of an actual or constructive subsidiary of the parent corporation, then the following negative tax consequences may follow:

1. Assuming that a tracking stock transaction does not qualify as a § 355 spin-off, tracking stock distributed to the parent corporation's stockholders would be taxable as dividends under § 301 of the Code.
2. Also assuming that a tracking stock transaction does not qualify as a § 355 spin-off, the difference between the fair market value and the basis of the tracking stock distributed would be recognized as gain to the parent corporation under § 311 of the Code.
3. A public offering of tracking stock would not qualify under § 1032 of the Code and the parent corporation would recognize gain.
4. The conversion of tracking stock into conventional common stock by the parent corporation would not qualify under either § 1036 or § 368(a)(1)(E) of the Code and could be taxable, unless such conversion qualified under § 368(a)(1)(B) of the Code.
5. If the tracking stock distributed constituted more than 20% of the equity of the subsidiary in question, then deconsolidation would result for federal tax purposes.

See Harold R. Handler & Dickson G. Brown, *Tracking Stock, in* 6 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES AND OTHER STRATEGIC ALLIANCES, FINANCINGS, REORGANIZATIONS AND RESTRUCTURINGS 1993, at 369 (PLI Tax Law & Estate Planning Course No. J-346, 1993). This uncertainty relating to the proper tax treatment of tracking stock "has had a chilling effect on the use of tracking stock, particularly with respect to closely held corporations, since practitioners cannot give complete assurance that the form of the transaction will be respected." James C. Diana, *Recent Transactions Involving Tracking Stock,* 37 Tax Mgmt. Mem. (BNA) No. 6, at S-44, S-44 (Mar. 18, 1996).

tions considering a spin-off, is normally a *sine qua non* to its implementation[64]) is not always obtainable due to the stringent requirements that a corporation must satisfy in order to obtain that ruling.[65]

Finally, by remaining part of a larger corporate entity, the businesses operated by a tracking stock corporation receive additional protection from unsolicited takeover bids. A spun-off subsidiary, by contrast, must defend itself.[66] This defense is difficult to accomplish given the smaller size of the spun-off subsidiary. In addition, that subsidiary must incur the additional costs and expenses associated with installing its own takeover defenses.

II. Special Concerns Arising in a Tracking Stock Equity Structure

The special concerns that arise in a tracking stock equity structure and confound the traditional corporate fiduciary duties of care and loyalty stem from the achievement of the major goal of that structure: the creation of a substantial divergence of financial interest between different classes of tracking stock. That goal is achieved by artificially dividing a conventional corporation into two or more distinct business groups and then economically linking each particular class of tracking stock to the performance of one of those business groups. By contrast, as discussed below, the holders of different classes of conventional

64. Dunn & Bradstreet, for example, has proposed splitting itself into three publicly traded companies. The spin-off plan, even if approved by the stockholders of D&B, remains "contingent on a ruling from the Internal Revenue Service that [D&B] can proceed on a tax-free basis." Kenneth N. Gilpin, *Dunn & Bradstreet To Split Into 3 Companies*, N.Y. Times, Jan. 10, 1996, at D1. GM, which recently split-off EDS, also made the receipt of a tax-free ruling from the IRS a precondition of consummating that transaction. *See supra* note 41.

65. *See generally* Jeffrey Bagner & Warren de Wied, *Spin-Off Transactions: Corporate Considerations, in* Acquisitions, Mergers, Spin-Offs, and Other Restructurings, *supra* note 13, at 481, 517-20 (discussing the "myriad of requirements" under § 355 of the Code that must be met to obtain a 355 ruling).

66. *See, e.g.*, Kmart Proxy Statement, *supra* note 2, at 14; Ralston Proxy Statement, *supra* note 2, at 21; RJR Proxy Statement, *supra* note 2, at 7, 25; TCI Proxy Statement, *supra* note 2, at 40, 135; U S West Proxy Statement, *supra* note 2, at 76-77; *see also* Reingold, *supra* note 42, at 33 ("But the big drawback to targeted stock, from the shareholders' point of view, is that it can actually impede a takeover."); Carey & Saul, *supra* note 14, § 3, at 11 (citing a study by J. Randall Woolridge and James A. Miles, professors at Penn State University, and Patrick Cusatis of Lehman Brothers, that found that spin-offs were about five times more likely to be taken over than were other companies). Prior to the split-off of EDS from GM, EDS's board of directors approved the adoption of a "poison pill" shareholder rights plan. *See* Neil Templin & Rebecca Blumenstein, *Pathway Clears for GM Spinoff of EDS Unit*, Wall St. J., Mar. 14, 1996, at A4.

common stock of a corporation have a substantial unity of financial interest.

To illustrate this crucial point, the juxtaposition of C Corp. and TS Corp. will be used from time to time in the remainder of this article. C Corp. is a diversified conventional corporation that operates two businesses (Business 1 and Business 2). It also has two classes of common stock (Class A and Class B).[67] TS Corp., by contrast, is a tracking stock corporation with two designated business groups (Group X and Group Y) and two classes of tracking stock (Group X Common Stock and Group Y Common Stock). The economic performance of Group X Common Stock and Group Y Common Stock is linked to Group X and Group Y, respectively.

A. *Relationship Between Different Classes of Common Stock*

The overall relationship between different classes of common stock of a corporation, whether conventional or tracking stock in nature, can be broken down into two distinct sub-relationships. The first of these is the legal relationship between the different classes. This relationship is set forth generally in the specific provisions of the certificate or articles of incorporation of the corporation in question.[68] These provisions contain the distinct dividend, voting, liquidation, and other rights of each

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67. As previously stated, conventional corporations typically have only one class of common stock that represents the entire equity interest in the corporation. *See supra* text accompanying notes 14-16. On occasion, some corporations do issue more than one class of common stock. Corporations that issue shares of a second class of common stock typically have a large percentage of shares of their first class of common stock in the hands of a single stockholder or a group of stockholders (often a family). The issuance of shares of a second class of common stock allows these corporations to raise equity financing while ensuring that the controlling stockholder or group of stockholders retains control. This often is accomplished by altering the voting rights of the second class of common stock and providing for its convertibility into shares of the first class of common stock. *See, e.g.*, EVERGREEN MEDIA CORP., PROSPECTUS 1, 32 (July 20, 1995) (stating that economic rights of Class A and Class B Common Stock are identical, that no dividend may be paid on shares of Class A Common Stock unless simultaneously the same dividend is paid on Class B Common Stock (and vice versa), and that the only differences between Class A and Class B Common Stock relate to voting and conversion rights); *see also* BALOTTI & FINKELSTEIN, *supra* note 7, § 6.59 (Supp. 1996) (discussing use of multiple classes of conventional common stock); E.S. Browning, *As Hot New Issues Increase So Does Supervoting Stock*, WALL ST. J., Apr. 24, 1996, at C1.

68. *See, e.g.*, Lawson v. Household Fin. Corp., 147 A. 312, 315-16 (Del. Ch. 1929), *affd.*, 152 A. 723 (Del. 1930). The certificate or articles of incorporation are viewed, in fact, as a "contract" between the corporation and its security holders that delineates the relationship between them. *See* Wolfensohn v. Madison Fund, Inc., 253 A.2d 72, 75 (Del. 1969). The corporate law of the state in which a corporation was incorporated also contains specific provisions governing the legal relationship between different classes or series of stock. Provisions exist, for example, that specify when a

class of common stock.[69] By comparing these provisions, one can ascertain the rights of the holders of one class of common stock vis-à-vis those of the holders of another class.

The second sub-relationship is the economic or financial relationship that exists between the different classes of common stock. The correlation between the trading values of various classes of common stock as they fluctuate in response to both external factors, such as interest rate changes and the release of economic data, and internal factors, such as corporate earnings and new product developments, determines this relationship. While a corporation has no control over external factors, the strategic business decisions and policies of its board of directors directly influence internal factors.

1. *Relationship Between Different Classes of Common Stock of a Conventional Corporation*

Different classes of common stock of a conventional corporation differ with respect to the legal rights that define those classes.[70] For example, each share of one class of common stock may have one vote while a share of another class may have more than or less than one vote, or even no votes.[71] Shares of one class of common stock also may be convertible into shares of another class of common stock while shares of that other class may not be convertible at all.[72] The certificate or articles of incorporation of the corporation that issued the particular classes of common stock in question describe these legal rights in detail.

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separate vote of one class of stockholders is required at the exclusion of other classes of stockholders. *See, e.g.*, DEL. CODE ANN. tit. 8, § 242(b)(2) (1991).

69. In situations where the certificate or articles of incorporation are silent as to a particular legal right (for example, voting rights), state corporate law fills in the gap. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 212, 215 (a)-(b) (1991); BALOTTI & FINKELSTEIN, *supra* note 7, § 5.4 (Supp. 1996).

70. This, of course, must be the case. If a corporation desired to issue additional shares of common stock with the exact same legal rights as those of another class, then the corporation simply would issue additional shares of that existing class, rather than create a new class. *See supra* note 67.

71. *See supra* note 67.

72. *See* DEL. CODE ANN. tit. 8, § 151(e) (1991). Under Delaware law, such convertibility may be at the option of either the stockholders, the corporation, or both. The specific provisions detailing the convertibility features of a class of stock must be set forth in the corporation's certificate of incorporation. *See* DEL. CODE ANN. tit. 8, §§ 102(a)(4), 151(a), (e) (1991); *see also supra* note 67 (providing an example of a company that allows shares of one of its two classes of common stock to be converted into shares of its other class of common stock).

With respect to the economic or financial relationship between two classes of conventional common stock, each such class shares a substantial unity of financial interest with the other class. This substantial unity exists because the trading value of shares of each class is linked to the financial performance of the corporation *as a whole.* Since the performance of the corporation as a whole already reflects the individual performances of distinct businesses or divisions operated by that corporation, business decisions or policies of the board of directors that have disparate impacts on such businesses or divisions will not affect the trading value of shares of the various classes in a materially different way. Hence, there is no "sibling rivalry" between different classes of conventional common stock from an economic or financial point of view, as holders of shares of all classes of conventional common stock desire the corporation *as a whole* to perform well.[73]

This notion of a substantial unity of financial interest can be illustrated using the example above. Suppose that, on the one hand, a given board decision of C Corp. — for example, to allocate $100 million of capital to Business 1 rather than Business 2 — has a positive impact on Business 1 and no impact on Business 2. In this event, and assuming that all other external and internal variables are held constant, the trading value of both Class A Common Stock and Class B Common Stock should rise because the overall effect on C Corp. as a whole will be favorable. If, on the other hand, this same decision ultimately has no impact on Business 1 and a negative impact on Business 2, then the trading value of both Class A Common Stock and Class B Common Stock should decline because the overall effect on C Corp. as a whole will be unfavorable. Thus, even though different business decisions or policies of the board may have disparate impacts on the businesses or divisions operated by a diversified conventional corporation, the trading values of the different classes of common stock should react substantially in unison due to their link to the financial performance of the corporation as a whole.

73. Shares of different classes of common stock, of course, do not trade in perfect unison. The trading value of shares of a particular class reflects not only the overall performance of the corporation but also the value of any additional legal rights — such as enhanced voting rights — associated with that class. In addition, other factors, such as the "float" or liquidity of the secondary trading market for the shares of a particular class and the board's dividend policy with respect to such class, can influence the trading value of those shares.

2. *Relationship Between Different Classes of Tracking Stock of a Tracking Stock Corporation*

Like different classes of conventional common stock, different classes of tracking stock also differ with respect to their legal rights. Dividend, voting, exchange, and liquidation rights frequently vary between different classes of tracking stock of the same corporation,[74] and such rights also vary as between classes of tracking stock of different tracking stock corporations.[75] For example, each share of U S West's Communications Group Common Stock has one vote while each share of its Media Group Common Stock initially has eight-tenths of one vote, subject to certain subsequent adjustments.[76] With respect to exchange or redemption rights, only shares of one of Genzyme's two classes of tracking stock are subject to exchange or redemption under certain circumstances,[77] while shares of all three classes of USX's tracking stock are subject to exchange or redemption under certain circumstances.[78]

Unlike classes of conventional common stock, however, different classes of tracking stock as a general matter have a substantial divergence of financial interest.[79] This divergence stems from the fact that each class is linked economically to the financial performance of one business group operated by a diversified parent corporation. As a result, the trading value of shares of one class of tracking stock can rise and fall substantially independently of the trading value of shares of the other class or classes. Of course, establishing this divergence of financial interest is the primary goal of corporations implementing a tracking stock equity structure today, as they attempt to create the fiction that a class of tracking stock is really a class of common stock of a standalone corporation.[80]

This notion of a substantial divergence of financial interest can be illustrated using the example above. Suppose that, on the one hand, a given board decision of TS Corp. — for example, to allocate $100 million of capital to Group X rather than Group Y — has a positive impact on Group X and no impact on Group Y. In that event, and assuming

74. *See supra* section I.A.2.

75. *See id.*

76. *See* U S West Proxy Statement, *supra* note 2, at 56-58.

77. *See* Genzyme Proxy Statement, *supra* note 2, at 44.

78. *See* USX-Delhi Proxy Statement, *supra* note 2, at II-1 to II-6.

79. *See* Genzyme Proxy Statement, *supra* note 2, at 31 (referring to classes of tracking stock as "multiple classes of common stock with divergent interests"); Kmart Proxy Statement, *supra* note 2, at 10 (same).

80. *See supra* text accompanying notes 56-59.

that all other external and internal variables are held constant, the trading value of Group X Common Stock should rise while the trading value of Group Y Common Stock should remain largely unchanged. If, on the other hand, that decision has a positive impact on Group X and a negative impact on Group Y, for example, because Group Y is now unable to fund fully its own capital expansion plan, then the trading value of Group X Common Stock should rise while the trading value of Group Y Common Stock should decline. Thus, to the extent that business decisions and policies of the board of a tracking stock corporation affect the business groups operated by that corporation differently, the trading values of shares of the various classes of tracking stock should react differently.

While the trading values of shares of different classes of tracking stock can diverge, this divergence nonetheless does not reflect a complete separation. Indeed, shares of each class of tracking stock are, for better or for worse, still legally an equity investment in the diversified parent corporation and not a given business group. Rather, these shares are only economically linked to distinct business groups operated by that corporation. These business groups, in turn, are the corporate equivalent of "Siamese Twins" — distinct businesses attached at the hip through their common ownership and control by the same parent corporation. Because of this, shares of each class of tracking stock remain subject to the risks associated with all the businesses, assets, and liabilities of that parent corporation, and not solely to those of the business group to which they are linked.[81] Unfortunately, this fundamental

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81. *See, e.g.*, TCI PROXY STATEMENT, *supra* note 2, at 30. A vivid example of this link is found by looking at Genzyme Corp.'s recent announcement of its proposed purchase of Deknatel Snowden Pencer Inc. ("DSP") for $250 million in cash. Both the business of DSP and the cost to acquire it would be attributed to Genzyme's General Division. Reflecting the concerns of analysts that Genzyme was overpaying for DSP, Genzyme's General Division Stock dropped approximately 4.5% after the announcement. Genzyme's TR Stock, which is linked to its Tissue Repair Division, also fell approximately 2% even though the Tissue Repair Division was not directly involved in the proposed acquisition of DSP and no other negative information concerning the Tissue Repair Division was given. *See* William M. Bulkeley, *Genzyme Will Buy Deknatel Snowden for $250 Million*, WALL ST. J., May 29, 1996, at B8.

RJR Nabisco's tracking stock proposal was apparently defeated by its shareholders because of the link that the shares of its different classes of tracking stock would continue to have with RJR Nabisco Holdings Corp. as a whole. RJR Nabisco had attempted to uncouple its food businesses from its tobacco business through the use of tracking stocks. As explained by Jennifer Reingold, shareholders quickly realized that this attempted "uncoupling" was not enough to pacify shareholder concerns with respect to the liabilities — or potential liabilities — of RJR Nabisco's tobacco business:

> Another potential pitfall [to tracking stock] is corporate liability, which the new entity continues to share with other parts of the parent company. That seems

point is likely to be overlooked by the unsophisticated investor.[82]

This indirect link to the financial health of the entire corporation tends to decrease the variance in the trading values of shares of different classes of tracking stock. In fact, corporations adopting tracking stock equity structures are quick to point out in their disclosure documents that financial effects arising from any particular business group that affect the corporation's overall operations or financial condition could, if significant, affect the results of operations or financial condition of the other business group or the trading value of shares of the class of tracking stock linked to that group.[83] Thus, the financial performance of, or financial outlook for, a particular business group could enhance, diminish, or have no effect on the trading value of shares of a class of tracking stock economically linked to another business group. Due to this indirect link to the corporation as a whole, tracking stocks theoretically should never trade completely like stocks of stand-alone corporations.[84]

> to be why RJR Nabisco's shareholders rejected the idea of a target stock separating the food and tobacco businesses. If tobacco companies were ever found liable in any of the big class-action cigarette suits and didn't have enough cash to cover the damages, the food stockholders could end up holding the ashes. Shareholders felt RJR was trying to create the illusion of legal separation without actually doing so. RJR ended up doing a partial IPO of 19% of its food business [subsidiary] in January [1995].

Reingold, *supra* note 42, at 33.

82. Despite the earnest attempts of tracking stock corporations to explain the complicated nature of a tracking stock equity structure, many stockholders never fully understand it. As one U S West spokesperson stated, "You'd be surprised how may people think it's a stock split or a spinoff, rather than what it is." Bill Menezes, *U S West Puts a Spin on 2 Classes of Stock: Investors Will Have Choice of Core Phone Business or Ventures into New Technology*, ROCKY MTN. NEWS, Oct. 10, 1995, at 37A (quoting Lois Leach) (internal quotation marks omitted); *see also* Hu, *supra* note 16, at 1296 (noting that the popular Value Line Investment Survey analyzes GM as if it were three different corporations, with separate one-page analyses of GM-$1⅔ Stock, GM-E Stock, and GM-H Stock). Investors' misconceptions are perfectly understandable given the exceedingly thick disclosure documents typically distributed to stockholders by companies seeking to implement tracking stock equity structures. The hyper-complexity of the *TCI Proxy Statement* has already been noted. *See supra* note 17. TCI, however, is in good company in this regard.

83. *See, e.g.*, GENZYME PROXY STATEMENT, *supra* note 2, at 31; KMART PROXY STATEMENT, *supra* note 2, at 10; RALSTON PROXY STATEMENT, *supra* note 2, at 21; RJR PROXY STATEMENT, *supra* note 2, at 23; SEAGULL PROXY STATEMENT, *supra* note 2, at 38; TCI PROXY STATEMENT, *supra* note 2, at 30; U S WEST PROXY STATEMENT, *supra* note 2, at 29.

84. Evidence of this can be found by looking at the price of GM-E Stock after GM announced that it intended to split-off EDS officially from GM. *See supra* note 41. Despite the fact that GM-E Stock had appreciated sevenfold since its issuance in 1984, it jumped 6% on the news of the split-off. *See* Reingold, *supra* note 42, at 32. As part of the split-off, GM, in fact, required EDS to pay GM a special dividend of $500 mil-

The substantial divergence of financial interest that exists between different classes of tracking stock sets the stage for a potentially explosive sibling rivalry. This rivalry creates an unprecedented dilemma from both the perspective of the holders of different classes of tracking stock of a tracking stock corporation and that corporation's directors. Holders of each class of tracking stock, unlike common stockholders of a stand-alone corporation, do not have an independent executive management team and a separate board of directors looking out for and promoting their interests alone.[85] Rather, the interests of those holders are at the mercy of a single executive management team and a single board of directors that also must consider the interests and needs of the holders of shares of one or more other classes of tracking stock. Adding fuel to the fire is the fact that the holders of shares of at least one class of tracking stock of any particular tracking stock corporation are arguably minority stockholders of that corporation.[86] Thus, it is more appropriate to view the sibling rivalry created by a tracking stock equity structure as a struggle between a big sister and a little sister rather than as a struggle between identical twins.[87]

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lion, which amount was intended to reflect the increased value of EDS as a stand-alone business. *See* GM SOLICITATION STATEMENT/PROSPECTUS, *supra* note 41, at 3; Templin & Blumenstein, *supra* note 66. An additional reason why tracking stocks trade only near, but not at, multiples of stocks of stand-alone corporations is their lack of "takeout" premium — the additional premium necessary to gain control of a corporation. *See* Reingold, *supra* note 42, at 33.

85. *See supra* text accompanying notes 34-35. It should be noted, however, that tracking stock corporations frequently create holding company structures as a matter of convenience in maintaining accounting records. Thus, a parent corporation with tracking stocks will place the assets and operations of each of its business groups in a separate, wholly owned subsidiary. Because each such subsidiary is a separate corporation, it will have its own board of directors. Under Delaware law, however, that board solely is accountable to the parent corporation and its stockholders. *See* Sternberg v. O'Neil, 550 A.2d 1105, 1123 (Del. 1988) (quoting Anadarko Petroleum Corp. v. Panhandle E. Corp., 545 A.2d 1171, 1174 (Del. 1988)).

86. Ralston Purina actually sets forth its discussion of this point under a risk factor heading entitled "Minority Voting Power." *See* RALSTON PROXY STATEMENT, *supra* note 2, at 23; *see also* U S WEST PROXY STATEMENT, *supra* note 2, at 57 ("The Company anticipates that the Communications Stock would initially represent a majority of the voting power of all classes and series entitled to vote in the election of directors."); Susan Pulliam & Steven Lipin, *Target Stock Is Under Fire from Investors*, WALL ST. J., Apr. 11, 1995, at C1 (quoting Leon Cooperman of Omega Advisors, who stated, with respect to targeted stock, "I don't like buying something that amounts to a minority interest").

87. Genzyme Corp. provides an extreme example of this proposition. Upon Genzyme's implementation of a tracking stock equity structure, the holders of its General Stock and holders of its TR Stock had approximately 91% and 9%, respectively, of the total voting power of Genzyme. As a result of this imbalance, according to Genzyme, "on matters which are submitted to a vote of the holders of all classes of common stock, the preferences of the holders of the General Stock are likely to dominate and determine the outcome of such vote unless and until the relative number of

Directors of a tracking stock corporation have to satisfy two or more different groups of stockholders with substantially divergent financial interests.[88] Each such group of stockholders, together with its team of litigators, potentially can second-guess any board decision that does not favor, or that neglects or does a disservice to, the business group to which its stock is linked economically.[89] Complicating this problem is the fact that many tracking stock directors apparently have made corporate decisions while owning disproportionate equity positions in their corporations.[90] Such disproportionate equity positions give rise, at a minimum, to an appearance of impropriety that could bolster a stockholder claim of blatant favoritism or purposeful or benign neglect.

B. *Intergroup Conflicts Arising in a Tracking Stock Context*

Corporations adopting tracking stock equity structures today are not coy about the "slew of potential conflicts of interest"[91] that can arise between different stockholder groups. Early on, however, corporations were not so frank. GM, for example, failed to mention the possibility that intergroup conflicts could arise among the holders of its three classes of lettered stock.[92] By contrast, one of the most recent tracking

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shares outstanding and/or the market value of the General Stock and TR Stock materially changes." GENZYME PROXY STATEMENT, *supra* note 2, at 32.

88. Directors are faced with a host of difficult issues in this regard. What, for example, does the financial mantra of "maximizing stockholder wealth" mean in the context of an equity structure with two or more competing groups of common stockholders? Should "stockholder wealth" be viewed on a multiple class basis? Or should it be viewed on an individual class basis? If the former, does not this mean that directors should promote the business group with the best growth prospects even if this proves detrimental to the declining business group? If the latter, can the maximization of stockholder wealth for one class of stockholders be achieved simultaneously with the maximization of stockholder wealth for the other class or classes of stockholders? *See generally* Hu, *supra* note 16, at 1294-97 (discussing multiple maximization problems in the context of GM).

89. *See* Reingold, *supra* note 42. As Jennifer Reingold has stated:

> This is not as easy as it looks, however. Keeping two sets of shareholders happy means that every internal decision, whether it's which products the sales force should focus on or whether one unit should borrow money at a rate that might affect the parent's debt rating, needs to be done in a way that will keep the other shareholders' lawyers from getting involved.

Id. at 33.

90. *See infra* section II.C.

91. Keating, *supra* note 52, at E3.

92. *See* GM-EDS PROXY STATEMENT, *supra* note 2; GM-HUGHES SOLICITATION STATEMENT, *supra* note 2. A participant in GM's issuance of GM-E Stock, however, indicated to the author that GM was well aware of potential intergroup conflicts but decided not to disclose them in an effort to bolster its tax position that its lettered stocks were stocks of GM and not separate companies. Indeed, as Henry T.C. Hu has pointed out, "[t]he fiduciary complications [in GM's structure] are immense even when com-

stock converts — U S West[93] — prominently featured the following statement in its public disclosure documentation:

> The Board could, in its sole discretion, from time to time, make operational and financial decisions or implement policies that affect *disproportionately* the businesses of the Communications Group and the Media Group . . . . *Any such decision may favor one Group at the expense of the other.* For example, the decision to obtain funds for one Group may adversely affect the ability of the other Group to obtain funds sufficient to implement its growth strategies.[94]

This type of disclosure, however, does not do justice to the realities of the intergroup "sibling rivalry" inherent in every tracking stock corporation. Indeed, intergroup conflicts underlie virtually every substantive business decision and policy made by a tracking stock board of directors.[95] Yet the holders of stock linked to each business group are neither entitled to vote on those decisions and policies as a separate class nor entitled to elect their own representative to the board of directors.

Although the specific business decisions or policies of tracking stock boards that can give rise to intergroup conflicts vary, the majority fall into one or more of the following categories:

> (1) decisions involving the allocation of scarce corporate resources, corporate opportunities, corporate expenses, or merger or acquisition consideration;
> (2) decisions on whether to promote or discourage particular public policies or laws;
> (3) dividend policies relating to the various classes of tracking stock;
> (4) decisions or policies involving intergroup transactions and dealings;

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pletely ignoring fiduciary duties owed to holders of GM's preferred stock." Hu, *supra* note 16, at 1296.

93. Stockholders of U S West approved a tracking stock equity structure on October 31, 1995.

94. U S WEST PROXY STATEMENT, *supra* note 2, at 33 (emphasis added). *See also* KMART PROXY STATEMENT, *supra* note 2, at 10 (referring to the board making "operational and financial decisions with respect to one Group that could be considered to be detrimental to another Group").

95. Although discussing the tension between common and preferred stockholders, Lawrence E. Mitchell has labeled conflicts between two classes of participants in a corporate capital structure "horizontal" in nature, because they center on the competing legitimate interests of those participants in the corporate pie. By contrast, Professor Mitchell has labeled conflicts arising between corporate directors and officers and the corporation itself and other corporate constituent groups "vertical" in nature. *See* Mitchell, *supra* note 15, at 449-50, 463-70. The conflicts arising among competing groups of tracking stock stockholders are quintessential "horizontal" conflicts, although they can take on "vertical" overtones whenever tracking stock directors hold disproportionate equity positions in their corporations. *See infra* section II.C.

(5) decisions to exchange outstanding shares of one class of tracking stock for shares of another class of tracking stock; and
(6) decisions relating to capital-raising activities and the use of proceeds stemming therefrom.

What follows is a brief discussion of the manner in which each of these categories of business decisions or policies foments sibling rivalry between the holders of different classes of tracking stock.

1. *Allocable Decisions*

Intergroup conflicts arise each time directors make corporate decisions involving allocations between or among business groups. Allocable decisions may involve, among other things, the distribution or allocation between or among business groups of corporate resources, opportunities, and expenses. In addition, if the tracking stock corporation as a whole is merged with or acquired by a third party, the board must allocate merger or acquisition consideration among the various classes of stockholders.[96] Because of the substantial divergence of financial interest existing among different classes of tracking stock, allocable decisions that have disparate impacts on the business groups likewise will have disparate impacts on the trading value of shares linked to those groups. This, in turn, could give rise to dissatisfied stockholder groups and eventually lead to litigation.[97]

Corporate resources, whether financial or human in nature, are limited. The board of directors is charged with the duty of allocating these resources among the different business groups. For example, a tracking stock board must allocate its corporation's limited supply of capital among the various capital projects of the different business groups. If the amount of capital is insufficient to fund all of these capital projects, then some projects simply will not be undertaken due to capital ration-

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96. For one of the more thoughtful discussions concerning allocable decisions and their potentially disparate impacts on different business groups, see the TCI PROXY STATEMENT, *supra* note 2, at 33.

97. Many of the allocable decisions discussed in this section also confront directors of diversified conventional corporations. For example, if a corporation has $50 million of capital available, how should it allocate it? Using the example from above, C Corp. could allocate it all to Business 1, all to Business 2, or could allocate some to Business 1 and the rest to Business 2. Of course, how this allocation ultimately is made is of no particular consequence to holders of Class A Common Stock and Class B Common Stock because they share a substantial unity of financial interest in the corporation as a whole. If the allocation decided upon proves to be beneficial to the corporation as a whole, the trading values of those stocks should react favorably. If, however, such allocation proves to be detrimental to the corporation as a whole, the trading values of those stocks should decline accordingly.

ing.[98] Similarly, tracking stock corporations typically have one or more credit facilities with financial institutions in place at the parent corporation level.[99] The board of directors must somehow allocate the credit available under those facilities among the various business groups. Human resources, too, must be allocated among the groups.[100] While each business group will likely have its own operational management team that runs the day-to-day affairs of the group, each member of the parent corporation's executive management team must determine how much of her time to devote to each business group.

The board of directors must also make decisions allocating corporate opportunities among the business groups. While the various business groups of most tracking stock corporations conduct vastly different operations,[101] others do not. Occasionally, a business opportunity may arise that could be undertaken by two or more business groups because their businesses overlap to some extent.[102] This exact situation exists, for example, between U S West's Communications Group and its Media Group.[103] If a viable new communications-related corporate opportunity arose and was available to U S West, its board would have to allocate it

98. According to the *TCI Proxy Statement:*

> The Board of Directors could from time to time allocate resources and financial support to . . . one Group instead of the other Group. The decision to allocate resources and financial support to one Group may adversely affect the ability of the other Group to obtain funds sufficient to implement its business strategies.

TCI PROXY STATEMENT, *supra* note 2, at 33.

99. The lower costs obtained through the ability to continue to borrow funds at the parent corporation level is one of the major benefits that a tracking stock equity structure has over other stockholder value enhancement strategies, such as a spin-off. *See supra* text accompanying notes 60-61.

100. *See generally* TCI PROXY STATEMENT, *supra* note 2, at 34 ("The Board of Directors could from time to time make operational and financial decisions that affect the Groups disproportionately, such as . . . the allocation of resources and personnel that may be suitable for more than one Group.").

101. For example, USX's U.S. Steel Group conducts a steel and domestic iron ore business; USX's Marathon Group conducts an oil exploration and production business; and USX's Delhi Group conducts a natural gas gathering, processing, and pipeline business.

102. According to the *TCI Proxy Statement:*

> Because both the Liberty Media Group and the TCI Group . . . have significant interests in entities which provide programming services to markets outside the United States, and also have business strategies which anticipate expansion into international markets, it is likely that the Board of Directors of the Company will be presented with opportunities which could be pursued through either the TCI Group . . . or the Liberty Group, or jointly through both Groups.

TCI PROXY STATEMENT, *supra* note 2, at 33.

103. *See* U S WEST PROXY STATEMENT, *supra* note 2, at 15-16.

to one business group or the other.[104] The board's ultimate decision could send out a not-so-subtle message to the financial community about both the business group that received the opportunity and the business group that lost out on it. The potentially adverse impact on the trading value of shares of the tracking stock class linked to the losing business group is self-evident and could lead holders of those shares to cry foul.[105]

Tracking stock directors also must decide how to allocate corporate overhead costs and expenses among the various business groups. These costs and expenses include, among others, the salaries of the directors, the executive management team, and the other unassigned employees,[106] as well as the expenses associated with running the corporate headquarters. Because all of the business groups of a tracking stock corporation theoretically benefit by having a board of directors, an executive management team, and a corporate headquarters, the associated expenses must be allocated on some consistent, rational basis to the various business groups.[107]

104. *See id.* at 33 ("The Board could . . . make operational and financial decisions . . . such as . . . the allocation of business opportunities . . . that may be suitable for both Groups. Any such decision may favor one Group at the expense of the other."); *cf.* GENZYME PROXY STATEMENT, *supra* note 2, at 43 (discussing noncompete provision between Genzyme's two business divisions). U S West has indicated that, in allocating any such corporate opportunity, the board would consider a number of factors, including "whether the business opportunity is principally within the scope of a Group's business, whether the business opportunity is principally within the geographic area served by a Group and whether a Group, because of its managerial or operational expertise, would be better positioned to undertake the business opportunity." U S WEST PROXY STATEMENT, *supra* note 2, at 43. Presumably, overlapping business groups could, in theory at least, "joint venture" any business opportunity suitable to both business groups in an attempt to allay stockholder concerns.

105. On this exact point, Tim Horan, a securities analyst at Smith Barney, stated that the " 'target stock structure that [U S West is] putting forward creates a lot of inefficiencies . . . . There will be conflicts of interest between the two companies.' They could end up competing against one another in wireless markets." Oslund, *supra* note 52, at 1D, (quoting Tim Horan). Apparently, the existence of conflicts between EDS and the rest of GM is a primary reason GM decided to split-off EDS. *See* GM SOLICITATION STATEMENT/PROSPECTUS, *supra* note 41, at 27-30. In fact, one notable conflict stemmed from the reluctance of certain competitors of GM to do business with EDS because of its affiliation with GM. *See id.* at 28-29.

106. USX Corp., for example, stated that 276 of its active USX Headquarters employees in 1995 had not been assigned to any specific USX business group. *See* USX CORP., 1995 FORM 10-K, at 3.

107. *See* GENZYME PROXY STATEMENT, *supra* note 2, at 41 (stating management policy to allocate corporate and general and administrative expenses to each Genzyme division "in a reasonable and consistent manner based on utilization by [each] [d]ivision of the services to which such costs relate").

Also involving allocations are board decisions concerning the distribution of consideration to be received by holders of shares of different classes of tracking stock in the event the corporation as a whole is merged with, or acquired by, a third party in a negotiated transaction.[108] The board of directors of each tracking stock corporation is charged with the responsibility of determining the percentage of the consideration to be allocated to holders of different classes of tracking stock.[109] Because various methods of allocation are available, a particular group of disgruntled stockholders could argue that the allocation method chosen by the board was unfair.[110]

2. *Promotion or Discouragement of Particular Public Policies or Laws*

A tracking stock board of directors must determine which public policies or laws its corporation will promote or discourage through lobbying efforts, corporate contributions, and related political activities. To the extent that the various business groups have conflicting business purposes, the board may find itself in the unenviable position of deciding whether or not to promote a particular governmental policy or law that would facilitate the operations of one business group but hurt those of another business group.[111] If, on the one hand, the board decides to

108. Such decisions are not implicated in a hostile acquisition context, in that the bidder alone will determine what consideration it is willing to give in return for shares of each class of tracking stock of the target corporation. If, however, a hostile bidder ultimately convinces management of a target corporation to participate in a negotiated acquisition, then the board of the target corporation must, as part of the negotiation process, decide how the merger or acquisition consideration will be allocated among stockholders of the various classes of tracking stock.

109. *See* TCI PROXY STATEMENT, *supra* note 2, at 33; *cf.* SEAGULL PROXY STATEMENT, *supra* note 2, at 14 (discussing pre-established board policy of distributing merger or consolidation consideration to holders of Seagull's two classes of tracking stock based on relative Market Capitalizations (as defined) of those classes). *But see* GENZYME PROXY STATEMENT, *supra* note 2, at 46 (placing restrictions on board's ability to effect certain mergers and business combinations that would disadvantage holders of Genzyme's TR Stock without first obtaining the affirmative vote of such holders).

110. *See* U S WEST PROXY STATEMENT, *supra* note 2, at 31-32; *cf. In re* FLS Holdings, Inc. Shareholders Litig., No. CIV.A.12623, 1993 WL 104562 (Del. Ch. Apr. 2, 1993); Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 596-97 (Del. Ch. 1986) (evaluating the allocation of merger consideration between common stockholders and preferred stockholders, where court required the allocations to be fair but not necessarily equal).

111. U S West provided the following example of this conflict: "[T]he Communications Group's interests may be advanced by regulation requiring all common carriers, including new entrants, to comply with the same tariff filing and approval requirements, while the Media Group's interests may be advanced by regulation permitting nondominant, new entrants to comply with a relaxed set of requirements." U S WEST

promote that policy, the board opens itself up to the legitimate complaints of the holders of shares linked to the injured business group. If, on the other hand, the board decides not to promote that policy, complaints from the stockholders of the business group that would have benefited likely will follow.

3. *Decisions and Policies in Respect of Dividends*

The payment of any cash dividend on any particular class of tracking stock involves an outflow of corporate funds. As a result, any such payment reduces the pool of funds legally available to pay dividends on all classes of tracking stock.[112] Therefore, a decision by a tracking stock board of directors to declare and pay a dividend on shares of one class of tracking stock is susceptible to charges of unfairness by holders of shares of other classes of tracking stock. This is particularly true when the board makes a decision to pay a dividend on shares of a class of tracking stock linked to a business group that is not generating any income at that time. In such a case, the board must also decide how to fund that dividend.[113] This additional decision, in turn, also can be subject to claims of unfairness if, for example, funds from another business group are borrowed to pay that dividend.

4. *Intergroup Transactions and Dealings*

Transactions and other dealings between or among business groups of a tracking stock corporation offer fertile ground for claims of unfairness brought by different groups of tracking stock stockholders. Examples of these types of transactions and dealings include the extension of credit from one business group to another; the sale of assets of one business group to another; and the furnishing of goods, services, or techni-

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PROXY STATEMENT, *supra* note 2, at 33. U S West added that the "increasing overlap between the business of the two Groups resulting from regulatory changes and technological advancements may increase such conflicts." *Id.*

112. *See, e.g., id.* at 31; TCI PROXY STATEMENT, *supra* note 2, at 33-34. Dividend payments, of course, are not the only events that can reduce "legally available funds." As TCI states:

> Any net losses of the Company (without regard to whether such losses arose from any specific Group), and any dividends or distributions on, or repurchases of, the TCI Group Common Stock or the Liberty Media Group Common Stock, and dividends on, and certain repurchases of, preferred stock, will reduce the funds of the Company legally available for payment of dividends on both the TCI Group Common Stock and the Liberty Media Group Common Stock.

Id.

113. Presumably, the necessary funds could be borrowed from a profitable business group or from an outside lender. In either case, the net effect on a profitable business group could be adverse.

cal know-how by one business group to another.[114] To the extent one business group receives a better bargain — or is perceived to receive a better bargain — than another business group, holders of shares linked to the disadvantaged business group could challenge the validity of the transaction. A stockholder claim in this regard could focus on the board's decision to effect a transaction in the first place, the actual terms of any such transaction, and/or the actions taken by a board to enforce those terms.[115]

In order to forestall these claims, many tracking stock corporations have established a board policy that requires intergroup transactions to be conducted only on an "arm's-length" basis.[116] Intergroup loans, for example, will be made only if the borrowing business group pays inter-

114. *See, e.g.*, TCI PROXY STATEMENT, *supra* note 2, at 35; U S WEST PROXY STATEMENT, *supra* note 2, at 34, 42-43.

A potential intergroup conflict never disclosed by any tracking stock corporation relates to the allocation of synergies between an acquired corporation and an acquiring tracking stock corporation. Assuming that the acquiring tracking stock corporation issues a new class of tracking stock in connection with such acquisition, the acquired corporation would be deemed a new business group of that tracking stock corporation. The shares of the new class of tracking stock would be linked economically to that new business group. The intergroup conflict arises with respect to the allocation of synergies that exist between the new business group and the existing business groups. For example, should the new business group be forced to share proprietary technology with the existing business groups? If so, at what cost, if any? *See* GENZYME PROXY STATEMENT, *supra* note 2, at 41-42 (stating policy of giving each Genzyme division "free access" to all the technology and know-how of the other Genzyme division, except with respect to research specifically conducted by one division at the request of the other division). Because technology is a valuable asset, forcing the new business group to share its technology with existing business groups without compensation would result in substantial benefits flowing to the stockholders of those existing business groups at the expense of the stockholders of the new business group. This concern does not exist in a conventional corporate context. Indeed, a conventional corporation typically makes strategic acquisitions only if they can provide synergistic benefits to the entire corporation and its stockholders. There are no allocation issues as long as the acquiring corporation acquires the entire equity interest in the acquired corporation.

115. An interesting aspect of these intergroup transactions and dealings is how closely they parallel "common director" transactions addressed by the duty of loyalty. In such a common director transaction, a conventional corporation enters into a transaction with another corporation, and both corporations have one or more common directors on their boards of directors. In an intergroup transaction, by contrast, two business groups of a tracking stock corporation enter into a transaction approved by the single board of directors of that corporation. Conceptually, all the tracking stock directors are on both sides of the intergroup transaction since they make the decisions for both business groups.

116. *See, e.g.*, RALSTON PROXY STATEMENT, *supra* note 2, at 32; U S WEST PROXY STATEMENT, *supra* note 2, at 42; USX-DELHI PROXY STATEMENT, *supra* note 2, at 18; *cf.* GENZYME PROXY STATEMENT, *supra* note 2, at 41-42 (prohibiting transfer of Key TR Programs (as defined) from Genzyme's Tissue Repair Division to its General Division without a class vote of holders of TR Stock unless certain conditions are met).

est on that loan to the lending business group at a rate representative of the actual borrowing rate of the corporation as a whole.[117] While this policy seems fair on its face, it suffers in two significant respects.

First, an "arm's-length" policy does not address the issue of whether a particular business group, if viewed as a stand-alone corporation, would elect to enter into the transaction in the first place. With respect to an intergroup loan, for example, would the lending business group choose to be in the "lending business" at all if it were a stand-alone corporation with a wholly independent board of directors? Similarly, if the lending business group chose to lend money, is the borrowing business group the type of borrower to which the lending business group would lend — that is to say, is the borrowing business group a good credit risk? Unlike a stand-alone corporation with a wholly independent board, a particular business group of a tracking stock corporation lacks an independent decisionmaker with the all-important power to say "no" either to entering into certain types of transactions or to dealing with particular parties.[118]

To understand the second problem with an "arm's-length" policy, assume that a particular business group, when viewed as a stand-alone corporation, would choose to enter into an intergroup transaction with another business group. In such a case, an "arm's-length" policy could result in one of the business groups accepting unfavorable transactional terms if such a policy focuses on what would be acceptable to the parent corporation rather than the business group. Again, using an intergroup loan as an example, the rate charged to a borrowing business group could be viewed as either too low or too high, if it is based on the rate paid by the entire corporation on its debt rather than on the rate that the borrowing business group would pay as a stand-alone corporation. Because of this, stockholders interested in the lending business group or the borrowing business group could allege, depending on the

117. *See, e.g.*, GENZYME PROXY STATEMENT, *supra* note 2, at 41 (interdivision borrowing bears interest at Genzyme's short-term borrowing rate); U S WEST PROXY STATEMENT, *supra* note 2, at 42-43 (referring to short-term ordinary course advances of funds between business groups to be made at market rates associated with U S West's centralized cash management).

118. This stems from the fact that the same board of directors is, in essence, on both sides of an intergroup transaction. As Warren Buffet has stated in a different context: "Negotiating with one's self seldom produces a barroom brawl." Warren E. Buffett, *Lessons for Corporate Lawyers*, 19 CARDOZO L. REV. 25 (Lawrence A. Cunningham ed., forthcoming 1997).

particular facts, that the other business group was gaining a benefit at their group's expense.[119]

A related issue arising in the intergroup transaction context concerns the action, if any, a board would take if one business group breached the terms of an agreement with another business group. Using the intergroup loan example once more, would the board take any action against a defaulting business group?[120] Conceivably, the board could liquidate assets of the borrowing business group to ensure that a default does not occur; however, the board also could restructure the terms of the loan unilaterally to allow the borrowing business group more time to meet its obligations. The board's action, if any, in this situation likely will be scrutinized closely by the holders of shares linked to the lending business group.

5. *Optional Exchange of Shares of One Class of Tracking Stock for Shares of Another Class of Tracking Stock*

The certificates or articles of incorporation of most tracking stock corporations provide for an optional exchange or conversion of outstanding shares of one class of tracking stock for, or into, shares of another class of tracking stock.[121] This optional exchange feature provides a tracking stock corporation with the ability to "unwind" its tracking stock equity structure by collapsing one business group into another and

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119. In the *RJR Proxy Statement,* a different type of problem is highlighted. That proxy statement points out that RJR Nabisco Holdings Corp. ("Holdings") would have managed most financial activities on a centralized, consolidated basis had Holdings' tracking stock proposal been approved by its stockholders. In such event, each business group would have been allocated a portion of Holdings' debt (pooled debt), and interest expense would have been charged to each business group based on the weighted average rate of the interest expense applicable to such pooled debt. The proxy statement then points out that:

> [i]n addition, in obtaining its financing through increases of its allocated pooled debt balance, a Group will receive a "benefit" or "detriment" to the extent such weighted average rate is lower or higher, respectively, than the market rate for a hypothetical borrowing by such Group if such Group were a stand-alone corporation.

RJR PROXY STATEMENT, *supra* note 2, at 25.

120. *Cf.* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 723 (Del. 1971) (holding that where majority owned subsidiary entered into contract with wholly owned subsidiary of common parent corporation and such wholly owned subsidiary thereafter breached such contract, under intrinsic fairness standard parent corporation must prove that its failure to cause majority owned subsidiary to enforce the contract was intrinsically fair to minority shareholders of majority owned subsidiary).

121. *See, e.g.,* RALSTON PROXY STATEMENT, *supra* note 2, at 35-38; RJR PROXY STATEMENT, *supra* note 2, at 33; TCI PROXY STATEMENT, *supra* note 2, at 59-61; U S WEST PROXY STATEMENT, *supra* note 2, at 51; USX-DELHI PROXY STATEMENT, *supra* note 2, at 17.

thus returning to the status quo ante.[122] The ability of a tracking stock board to effect such an exchange is particularly susceptible to charges of unfairness by the holders of outstanding shares linked to the collapsed business group who must forfeit their shares in exchange for shares linked to another business group.[123] Indeed, this stems from the board's unilateral ability to decide whether and, if so, when to effect an exchange.[124]

Often, but not always, optional exchange provisions provide for a fixed "premium" to compensate the exchanging stockholders for giving up their shares.[125] This premium is, in essence, an acknowledgment that those stockholders are being forced to give up their interest in the "upside" potential of the collapsed business group.[126]

A question arises, however, as to whether the fixed premium is the correct premium to be paying. The premium logically should be determined at or near the time the exchange is announced and should be based on the circumstances existing at that time, including elements of the collapsed business group's future value known or susceptible of

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122. *See, e.g.*, Genzyme Proxy Statement, *supra* note 2, at 40, 44; Ralston Proxy Statement, *supra* note 2, at 35; RJR Proxy Statement, *supra* note 2, at 33.

123. An optional exchange occurs when one business group is collapsed into another. It results in the receipt by the collapsed business group's stockholders of shares linked to the other business group, in exchange for their old shares linked to the collapsed business group. The effects of such an exchange can be likened to those of a stock merger transaction between two unrelated conventional corporations. In such a merger, the acquiring corporation issues shares of its common stock in exchange for the outstanding shares of the target corporation. The target corporation then is merged typically with a wholly owned subsidiary of the acquiring corporation. Yet, because a tracking stock board can force an exchange at a predetermined exchange rate by virtue of provisions in its certificate or articles of incorporation, a tracking stock corporation does not need to conduct a valuation of the disappearing business group. By contrast, before a board of a conventional corporation can accept an offer to merge, its board of directors must make an assessment of the corporation's value, either through internal means, such as by a valuation by its chief financial officer, or external means, such as by obtaining a fairness opinion from an investment banking firm. *See* Smith v. Van Gorkom, 488 A.2d 858, 876 (Del. 1985).

124. *See, e.g.*, Genzyme Proxy Statement, *supra* note 2, at 44; RJR Proxy Statement, *supra* note 2, at 33; TCI Proxy Statement, *supra* note 2, at 32; U S West Proxy Statement, *supra* note 2, at 32; USX-Delhi Proxy Statement, *supra* note 2, at 14.

125. *See, e.g.*, Genzyme Proxy Statement, *supra* note 2, at 44; Ralston Proxy Statement, *supra* note 2, at 35-36; RJR Proxy Statement, *supra* note 2, at 33; USX-Delhi Proxy Statement, *supra* note 2, at 17.

126. In discussing its provision allowing for an optional exchange of outstanding shares of TR Stock for shares of General Stock, Genzyme Corp. stated "[a]ny such optional exchange . . . would preclude holders of TR Stock from retaining their investment in a security that is intended to reflect separately the performance of the Tissue Repair Division." Genzyme Proxy Statement, *supra* note 2, at 33; *see also* Ralston Proxy Statement, *supra* note 2, at 22.

proof.[127] Instead, most tracking stock corporations fix their premiums in stone at the time they implement a tracking stock equity structure. If the fixed premium is, for example, 10% and the premium that otherwise would be payable based on factors existing at the time the exchange is announced is 16%, then the group of stockholders forced to give up their shares could argue that it is being shortchanged, while the other group of stockholders arguably is receiving a benefit. Similarly, if the premium that otherwise would be payable based on factors existing at the time the exchange is announced is only 5%, then the group of stockholders giving up their shares arguably is being given a benefit at the expense of the other group of stockholders.[128]

6. *Capital Formation and Use of Proceeds*

Various stockholder groups could view an additional issuance of shares of a class of tracking stock, depending on the particular facts surrounding that issuance, as unfair from either a voting-power or use-of-proceeds perspective. This potential unfairness stems from the fact that, as a general matter, a tracking stock board of directors has the power to authorize an additional issuance unilaterally.[129] In such a case, unless otherwise required by applicable state corporate law or stock exchange rules, no authorizing vote of either the existing stockholders of the class of tracking stock being issued, voting as a separate class, or the stock-

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127. *Cf.* Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983) (holding that Delaware appraisal statute requires that dissenter not only be paid the current value of her shares but also that such value be determined by considering elements of the corporation's future value "known or susceptible of proof as of the date of the merger").

128. In discussing the fixed 30% premium to be received by holders of its TR Stock upon an optional or mandatory exchange of TR Stock for General Stock, Genzyme noted the following:

> [H]olders of the TR Stock may receive a greater or lesser premium for their shares than any premium paid by a third party buyer of all or substantially all the assets of the Tissue Repair Division. In addition, any such exchange for shares of General Stock could be made at a time when the General Stock may be considered to be overvalued or undervalued and would dilute the interests of the holders of General Stock.

GENZYME PROXY STATEMENT, *supra* note 2, at 33.

129. This assumes that the tracking stock corporation has authorized but unissued shares of a class of tracking stock available for issuance. To ensure that shares are available for issuance in the future, at the time a conventional corporation adopts a tracking stock equity structure its stockholders typically approve a charter amendment that increases the number of shares of common stock available for issuance. Thus, most tracking stock corporations have a significant number of authorized but unissued shares of their various classes of tracking stock available for future use in connection with acquisitions or capital raising.

holders of all classes of tracking stock, voting together as a single voting group, is required.

Any additional issuance of shares of one class of tracking stock potentially can increase the voting power of the holders of that class of tracking stock vis-à-vis the holders of the other class or classes of tracking stock. Thus, from a voting power perspective, a stock issuance could alter the voting balance between the holders of various classes of tracking stock.[130] In turn, the board's decision on how to allocate the proceeds garnered from such an issuance could exacerbate this alteration.

With respect to the proceeds raised from a stock issuance, tracking stock boards usually adopt a general policy that requires those proceeds to be attributed to the business group to which the issued stock is linked.[131] As logical as this arrangement is, some notable exceptions exist. Indeed, some tracking stock corporations have provided in their charters that one of their business groups — usually the larger or more dominant or established one — will have a "retained interest" in another of their business groups.[132] If so, this can lead to the attribution of proceeds from a stock offering to a business group other than the business group to which the newly issued shares are linked.

To illustrate this "retained interest" concept, the example of TS Corp. from above will be used. Assume that at the time TS Corp. adopted its tracking stock equity structure, the authorized number of shares of Group Y Common Stock was set at 1.5 million. Further assume that TS Corp.'s board made a determination at that time that a 100% equity interest in Group Y equaled only 1 million shares of Group Y Common Stock. If TS Corp. issues or distributes a number of shares less than 1 million (for example, 600,000 shares) in connection

130. *See, e.g.*, U S West Proxy Statement, *supra* note 2, at 30 (noting that share issuances and repurchases, among other things, could impact the relative voting power of shares of Communications Stock and Media Stock).

131. *See, e.g.*, Genzyme Proxy Statement, *supra* note 2, at 42; Ralston Proxy Statement, *supra* note 2, at 31-32; USX-Delhi Proxy Statement, *supra* note 2, at 18; USX-Marathon Proxy Statement, *supra* note 2, at 28.

132. *See, e.g.*, U S West Proxy Statement, *supra* note 2, at 59-60 (Communications Group having retained interest in Media Group); Ralston Proxy Statement, *supra* note 2, at 10, annex II (RPG Group having retained interest in CBG Group); Seagull Proxy Statement, *supra* note 2, at 59-61, II-1 to II-8 (possibility of Seagull Energy having retained interest in ENSTAR Alaska Group in event less than 100% of equity attributable to ENSTAR Alaska Group was sold to public as part of ENSTAR Alaska Stock Offering); TCI Proxy Statement, *supra* note 2, at 72-74 (no immediate retained interest, but TCI Group could have retained interest in Liberty Media Group in future upon occurrence of certain events); USX-Delhi Proxy Statement, *supra* note 2, at 12-13, annex IV (Marathon Group having retained interest in Delhi Group).

with its implementation of a tracking stock equity structure, then the ownership of the number of shares not issued (400,000 shares in the example) is attributed to Group X. Thus, the net effect is that Group X is deemed to have the tracking stock equivalent of an equity interest in Group Y (in this case, a 40% interest).[133]

By implementing this "retained interest" concept, TS Corp.'s board gains the flexibility of being able to issue shares of Group Y Common Stock in the future from one of two sources.[134] The first source is from the authorized but unissued shares of Group Y Common Stock (500,000 in this example). Proceeds raised from the sale of these shares would be attributed to Group Y. The second source is from Group X's retained interest in Group Y. Proceeds raised from the sale of these shares would be attributed not to Group Y, but to Group X. While any such issuance would reduce Group X's retained interest in Group Y, the holders of existing Group Y Common Stock nevertheless would be diluted while the proceeds were attributed to Group X.[135] Thus, an issuance of tracking stock in general may raise many questions of fairness depending on the circumstances surrounding that issuance.

C. *Directorial Loyalty Concerns*

The intergroup conflicts discussed above become even more worrisome when viewed in light of the unique loyalty concerns inherent within a tracking stock equity structure. These concerns arise whenever a tracking stock director makes decisions at a time when her share ownership ratio of her corporation's different classes of tracking stock, measured on a fully diluted basis, is out of line with the outstanding share ratio of those different classes.[136] This method of comparison is called the Ratio Method.

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133. A retained interest is not represented by actual shares linked to a business group of the tracking stock corporation, and thus the business group deemed to own a retained interest in another business group has no voting rights with respect to that retained interest. Nonetheless, the business group holding the retained interest is entitled to its proportional share of dividends paid by that other business group. *See, e.g.*, RALSTON PROXY STATEMENT, *supra* note 2, at 41-42; SEAGULL PROXY STATEMENT, *supra* note 2, at 59-60; TCI PROXY STATEMENT, *supra* note 2, at 72-74; USX-DEHLI PROXY STATEMENT, *supra* note 2, at annex V.

134. This assumes that no shares of Group Y Common Stock are held in treasury.

135. *See* RALSTON PROXY STATEMENT, *supra* note 2, at 22 ("If the Company issues shares of CBG Stock for the account of the RPG Group [rather than the CBG Group], the voting power of holders of shares of CBG Stock immediately prior to such issuance would be diluted even though any consideration received for such shares would not be attributed to the CBG Group.").

136. Similar concerns arise whenever a director who owns a significant amount of common stock makes a distributional decision favoring common stockholders over pre-

An example will clarify how the Ratio Method of comparison works. Suppose that TS Corp. has 3 million outstanding shares of Group X Common Stock and 1 million outstanding shares of Group Y Common Stock. The ratio of outstanding shares of each class of tracking stock would therefore be 3 to 1 (always using the class of tracking stock with the fewest shares outstanding as the common denominator). If Director A beneficially owns 50,000 shares of Group X Common Stock and 1000 shares of Group Y Common Stock, Director A's ownership ratio would be 50 to 1.

Because Director A's ownership ratio of 50 to 1 is out of line with the ratio of outstanding shares, which is 3 to 1, Director A would be considered to have a "Disproportionate Equity Position" or "DEP" in Group X. By favoring the business group in which she has the Disproportionate Equity Position — in this case, Group X — Director A can benefit financially through an increase in the value of her shares of Group X Common Stock. Similarly, Director A would have little personal financial motivation to bestow favors on Group Y, because such favoritism would not benefit her significantly through an increase in the value of her shares of Group Y Common Stock. Instead, favoring Group Y actually could backfire if such favoritism negatively affects Group X, and thus the value of her Group X Common Stock.[137]

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ferred stockholders. *See* Eisenberg v. Chicago Milwaukee Corp., 537 A.2d 1051, 1056-57 (Del. Ch. 1987); Mitchell, *supra* note 15, at 464.

137. Of course, other ways of viewing disproportionate equity positions could be adopted. For example, the number of shares of each class of tracking stock owned by a director could be the measuring stick — the "Number of Shares Method." Thus; if a director held more shares of Group X Common Stock than shares of Group Y Common Stock, she would be deemed to have a disproportionate equity position in Group X. Similarly, the aggregate dollar amount of the shares of each class of tracking stock owned by a director could be used — the "Aggregate Dollar Method." Thus, if a director held shares of Group X Common Stock that were worth more than her shares of Group Y Common Stock, she would be deemed to have a disproportionate equity position in Group X.

This article, however, rejects these other methods of determining disproportionate ownership. Instead, it embraces the Ratio Method for four primary reasons.

First, the Ratio Method recognizes how directors generally come to own shares of various classes of tracking stock in the first place. For instance, each of TCI, USX, and Ralston distributed shares of a new class of tracking stock to the current owners of its conventional common stock — and simultaneously redesignated its conventional common stock as another class of tracking stock — based on a predetermined distribution ratio. (U S West accomplished the same result through a "conversion" of each outstanding share of its conventional common stock into one share of Communications Stock and one share of Media Stock.) For example, when Ralston Purina originally adopted a tracking stock equity structure in 1993, it distributed to its stockholders one share of CBG Stock for every five shares of conventional common stock held by its stockholders at that time. *See* Ralston Proxy Statement, *supra* note 2, at 1. As a result, immediately after the distribution the ratio of outstanding shares of RPG Stock (the

Whether a director winds up holding a Disproportionate Equity Position intentionally or by happenstance is not the issue. The issue is simply that a director who finds herself with a DEP has an inherent loyalty concern that must be addressed.[138] Even if that director is not improperly influenced by her DEP, its mere existence gives the appearance of impropriety to the financial marketplace.[139]

Any decision by a director holding a Disproportionate Equity Position that favors the business group in which she has the DEP over

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redesignated conventional common stock of Ralston Purina) to shares of CBG Stock (the newly distributed stock of Ralston Purina) was 5 to 1. Accordingly, a Ralston Purina director who held 500 shares of conventional common stock before the distribution wound up holding 500 shares of RPG Stock and 100 shares of CBG Stock after the distribution. In theory, assuming no additional shares of either RPG Stock or CBG Stock are issued and no outstanding shares of either RPG Stock or CBG Stock are repurchased by Ralston Purina, any stockholder, including a director, who maintains this 5 to 1 ownership ratio holds an equity position that reflects the status quo ante. Thus, requiring that a director maintain her ownership ratio in line with the ratio of outstanding shares of each class of tracking stock, as such outstanding share ratio changes from time to time, ensures that board decisions will impact that director's tracking stock portfolio in the same manner as they would have impacted her conventional stock portfolio had a tracking stock equity structure never been implemented in the first place.

Second, the Ratio Method is easy to administer. Since this method is based on directors' fully diluted stock ownership, their exercise of stock options and related derivatives will not affect their ownership ratio. In addition, any changes to the outstanding share ratio, such as through an additional stock issuance or through a repurchase, exchange, or redemption of stock, will have to be approved by the directors themselves. Because of this, the directors control when the outstanding share ratio will change and thus are in a position to modify their portfolios accordingly.

Third, the Number of Shares Method fails to consider the value of those shares. Thus, 1000 shares of Group X Common Stock, at any given time, could be more than, less than, or exactly equal to the value of 1000 shares of Group Y Common Stock. If, for example, 1000 shares of Group X Common Stock was worth \$100,000 and 1000 shares of Group Y Common Stock was worth only \$1000, then a director still would feel pressure to favor Group X because her financial interest in Group X is significantly greater than her financial interest in Group Y. While the Ratio Method also suffers from this problem, as indicated above it reflects the status quo ante, while the Number of Shares Method does not.

Finally, the Aggregate Dollar Method would prove unworkable. Directors continually would have to measure the value of their portfolios and make correcting trades on a frequent, if not daily, basis. Making corrective trades, however, would be impossible at those times when directors are prohibited from buying and selling shares by applicable securities laws and regulations.

138. *See* TCI Proxy Statement, *supra* note 2, at 34-35 (stating that disproportionate ownership interests by board members could create or appear to create potential conflicts of interest when directors are faced with decisions that could impact different series of tracking stock differently).

139. As one federal court stated: "For this country's economic system to work in the area of corporate investment, the investor must be assured that the corporation's officers and directors will put the interests of the corporation first and that their decisions will not be clouded in any way by competing personal interests." Enstar Group, Inc. v. Grassgreen, 812 F. Supp. 1562, 1570 (M.D. Ala. 1993).

another business group could give rise to a claim that her judgment has been clouded by her own pecuniary interests. This stems from the fact that the decision likely will affect the stock prices of shares linked to the various business groups differently, due to the substantial divergence of financial interest that exists among different classes of tracking stock. Of course, whether a particular director actually will be swayed by her DEP will depend on many factors, including her moral fiber, the magnitude of her disproportionate ownership, and the amount of her potential financial gain.[140]

The election of an executive officer of a tracking stock corporation to that corporation's board heightens loyalty concerns of this order.[141] Unlike an outside director who may meet only periodically to discuss company matters, an inside director, through her role as an executive officer of the corporation, is in a position to influence directly how the corporation implements particular board policies and decisions. An inside director, therefore, could make decisions daily that favor, or diminish the impact on, the business group in which she has a Disproportionate Equity Position.

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140. The purpose of this disproportionate ownership point is not in any way to impugn the character or reputation of any current or former director or officer of any tracking stock corporation. Indeed, the author has no direct or indirect information suggesting that any such director or officer has in any way failed to perform his or her duties in a loyal and faithful manner. However, it would be naive to ignore the fact that at some point in time there may be tracking stock directors who might be influenced in their directorial decisionmaking because of their disproportionate ownership, especially when the magnitude of the disparity is significant. Indeed, one of the reasons the law is suspicious of self-dealing transactions in general is that "[h]uman nature tells us the director will advance her own interests in the transaction, to the detriment of the corporation." SOLOMON & PALMITER, *supra* note 7, at 343; *cf.* Eisenberg v. Chicago Milwaukee Corp., 537 A.2d 1051, 1061 (Del. Ch. 1987) (holding that potential conflict of interest necessitates disclosure even when there is no evidence that directors were influenced by conflict).

The mere existence of a director with a DEP creates an appearance of impropriety that tracking stock corporations should acknowledge and address to the satisfaction of their stockholders. As tracking stock equity structures increasingly become embraced by companies less august than the General Motors of the world, this problem only will become more acute.

141. It is common for the chief executive officer of a corporation, whether conventional or tracking stock in nature, to be a member, and often the chairperson, of the corporation's board of directors. For example, Louis Gerstner is the Chief Executive Officer and Chairman of the Board of International Business Machines Corp., a conventional corporation. Thomas J. Usher is the Chief Executive Officer and Chairman of the Board of USX Corp., a tracking stock corporation. Many corporations have more than one executive officer on their boards. USX Corp., for example, has four executive officers on its board of directors. *See generally* USX CORP., PROXY STATEMENT (Mar. 8, 1996) [hereinafter 1996 USX PROXY STATEMENT].

Particularly troubling is the situation where an executive officer who has responsibilities running primarily to one business group rather than to the tracking stock corporation as a whole is elected to the board.[142] Not only will that officer be faced with the conflicts noted in the preceding paragraph, but because her compensation package likely will be aligned closely to the performance of the business group that she runs, she will have a strong personal financial interest in that group's performance irrespective of any Disproportionate Equity Position she may have in that group. In such a case, the board likely will find itself with a vocal advocate of the interests of that group.

Particular examples highlight that many directors of tracking stock corporations, indeed, have held Disproportionate Equity Positions in their corporations, although in many cases the magnitude of those DEPs rendered them inconsequential. In USX's *1996 Proxy Statement*,[143] USX disclosed that on March 1, 1996 there were outstanding approximately 287.4 million shares of Marathon Stock, 83.2 million shares of Steel Stock, and 9.4 million shares of Delhi Stock. Using Delhi Stock as the common denominator, this yields approximately a 30 to 9 to 1 ratio.[144] None of USX's fifteen directors, however, had an ownership ratio of the three classes of tracking stock that came remotely close to matching that 30 to 9 to 1 ratio.[145] All of USX's ten outside directors[146] had ratios

142. For example, while Victor G. Beghini and Paul J. Wilhelm were both members of USX Corp.'s board of directors, Mr. Beghini was also Vice Chairman of USX's Marathon Group while Mr. Wilhelm was President of USX's U.S. Steel Group. *See id.* at 9-10. Curiously, no executive officer of USX's Delhi Group (USX's only other business group) was on USX's board to balance things off.

143. *See id.*

144. *See id.* at 4. Outstanding stock options and related derivatives of USX were excluded from the calculation of the outstanding share ratio. Of course, as such options and derivatives are exercised or converted, as the case may be, from time to time in the future, the outstanding share ratio would be modified correspondingly. Because the stock options and related derivatives held by each USX director can provide significant financial incentives to those directors, the ownership ratio of each such director was calculated on a fully diluted basis to reflect his or her ownership of such options and derivatives.

145. *See id.* at 12. USX provided ownership figures for directors as of January 31, 1996. Beneficial ownership figures of the directors used in calculating their ownership ratios included shares deemed to be owned beneficially by them through the USX Saving Fund Plan, the Marathon Thrift Plan, the Delhi Thrift Plan, the USX Dividend Reinvestment Plans, the 1990 Stock Plan, and through stock options. *See id.* at 12 nn.1-2 to tbl. entitled "Security Ownership of Directors and Executive Officers."

146. An "outside director" of a corporation is a director who is not also an officer or other employee of, or a consultant to, that corporation. Because of Charles A. Corry's former role as USX's Chairman of the Board and Chief Executive Officer, Mr. Corry is considered an "inside director" of USX for purposes of this discussion.

at or close to a 1 to 1 to 1 ratio.[147] At first glance this would indicate that each such outside director's personal portfolio was underweighted in both Marathon Stock and Steel Stock. As a result, each outside director would be benefited financially the most by taking steps to ensure the successful performance of the Delhi Group. However, in this particular case this is highly unlikely because each outside director owned only a token number of shares of each class of USX tracking stock.[148]

The same cannot be said with respect to the five inside directors[149] of USX. While each inside director had ownership of a significant number of shares of each class of USX tracking stock,[150] none had an ownership ratio even close to the 30 to 9 to 1 ratio.[151] One of the five inside directors was overweighted substantially in Marathon Stock, while another was overweighted substantially in Steel Stock. Of the three remaining inside directors, one was overweighted substantially in Dehli Stock, a second was overweighted in Marathon Stock and substantially underweighted in Steel Stock, and the third was overweighted substantially in Steel Stock and underweighted in Marathon Stock. Particularly troubling was the fact that two of the inside directors were officers whose duties ran primarily to only one of the three business groups operated by USX.[152] Not surprisingly, each such director's portfolio was overweighted, one quite substantially, with shares linked to the business group to which his duties ran.[153]

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147. Five of the ten outside directors had approximately 1 to 1 to 1 ratios. The ratios of the five remaining outside directors were approximately: 1.6 to .3 to 1; 1.5 to .3 to 1; 2 to .4 to 1; 1.7 to .3 to 1; and 2 to 1.2 to 1. *See* 1996 USX PROXY STATEMENT, *supra* note 141, at 12.

148. No outside director owned more than 2,000 shares of any class of USX tracking stock. *See id.*

149. An "inside director" of a corporation is a director who is also an officer or other employee of, or a consultant to, that corporation. Because of Charles A. Corry's former role as USX's Chairman of the Board and Chief Executive Officer, Mr. Corry is considered an inside director of USX for purposes of this discussion.

150. The sole exception to this is Paul J. Wilhelm. Mr. Wilhelm owned 32,769 shares and 75,508 shares of Marathon Stock and Steel Stock, respectively, but only 1000 shares of Delhi Stock. *See* 1996 USX PROXY STATEMENT, *supra* note 141, at 12.

151. The ownership ratios of these five inside directors were approximately: 61.3 to 7.3 to 1; 11.7 to 2.3 to 1; 38 to 4 to 1; 24.1 to 19.9 to 1; and 32.8 to 75.5 to 1. *See id.* at 12.

152. Perhaps these directors should be labeled more appropriately as "one-sided directors" rather than "inside directors."

153. The two directors were Victor G. Beghini, the Vice Chairman of USX's Marathon Group, and Paul J. Wilhelm, the President of USX's U.S. Steel Group. Mr. Beghini's ownership ratio was approximately 38 to 4 to 1, while Mr. Wilhelm's ownership ratio was approximately 32.8 to 75.5 to 1. *See* 1996 USX PROXY STATEMENT, *supra* note 141, at 12.

GM's *1996 Proxy Statement*[154] discloses similar results for GM directors. On March 25, 1996 there were outstanding approximately 756.1 million shares of GM-$1⅔ Stock (the car company stock), 485.7 million shares of GM-E Stock, and 97.9 million shares of GM-H Stock. Using GM-H Stock as the common denominator, this yields approximately an 8 to 5 to 1 ratio.[155] None of GM's fourteen directors, however, had ownership ratios of the three classes of common stock that mirrored that 8 to 5 to 1 ratio.[156] Of GM's eleven outside directors,[157] three owned shares of GM-$1⅔ Stock but no shares of either GM-E or GM-H Stock. GM's eight other outside directors had ownership ratios ranging from as high as approximately 29 to 12 to 1 to as low as approximately 1 to 1 to 1.[158] Unlike the case of USX's outside directors, each of whom only owned a token number of shares of USX common stock, four of GM's eleven outside directors individually owned, either directly or through deferred stock units, the equivalent of over 20,000 shares of GM common stock.[159]

154. GENERAL MOTORS CORP., PROXY STATEMENT (Apr. 9, 1996) [hereinafter 1996 GM PROXY STATEMENT]. The discussion of the stock holdings of GM's directors is based on facts existing prior to GM's split-off of EDS, and thus reflects the ownership by certain of those directors of shares of GM-E Stock. *See supra* note 41.

155. *See* 1996 GM PROXY STATEMENT, *supra* note 154, at 2. Once again, stock options and related derivatives of GM were excluded from the calculation of the outstanding share ratio, but those held by a particular GM director were included when calculating that director's ownership ratio. *See supra* note 144.

156. *See id.* at 7-10. GM provided ownership figures for directors as of February 29, 1996. Beneficial ownership figures of the directors used in calculating their ownership ratios included shares deemed to be owned beneficially by them through the General Motors Deferred Compensation Plan for Non-Employee Directors, the Hughes Electronics Deferred Compensation Plan for Non-Employee Directors, the General Motors Savings-Stock Purchase Program, the General Motors Benefit Equalization Plan-Savings, and through certain stock options. *See id.* at 9-10 nn.a, b, d, f to tbl. entitled "Security Ownership of Directors, Named Executive Officers and Certain Others." For purposes of this discussion, Eckhard Pfeiffer, a director-nominee at that time, is treated as an actual director of GM since he was running unopposed. Share ownership figures for Paul H. O'Neill, the GM director replaced by Mr. Pfeiffer, were not broken out separately in the *1996 GM Proxy Statement* and thus have been ignored.

157. For purposes of this discussion, John Smale is considered an inside director of GM because of his position as Chairman of the Board of GM from November 2, 1992 through December 31, 1995.

158. The ownership ratios of these eight outside directors were approximately: 9.2 to 2.4 to 1; 5.5 to 3.6 to 1; 9.9 to 1 to 1; 9.1 to .4 to 1; 1.5 to 1.3 to 1; 15 to .9 to 1; 29.4 to 12 to 1; and 5.7 to .9 to 1. *See* 1996 GM PROXY STATEMENT, *supra* note 154, at 7-10.

159. The aggregate number of shares of GM common stock beneficially owned and deferred stock units held by Edmund T. Pratt, Jr., Charles T. Fisher, III, Dennis Weatherstone, and Anne L. Armstrong were 42,589, 25,827, 24,044, and 20,571, respectively. *See id.*

Similar to the inside directors of USX, the inside directors of GM had significant Disproportionate Equity Positions. The ownership ratios of GM's three inside directors were approximately 103 to 1 to 1, 20 to 1 to 1, and 2 to 1 to 1.[160] The first two ratios reflect an extraordinary overweighting of shares of GM-$1⅔ Stock, while the third ratio reflects a substantial underweighting of both GM-$1⅔ Stock and GM-E Stock. Unlike the two inside directors of USX noted above, however, all of GM's inside directors were officers with company-wide responsibilities, rather than responsibilities running primarily to one of GM's three business groups.

III. Disclosure by Tracking Stock Corporations

The greatest challenges presented to traditional corporate fiduciary duties by a tracking stock equity structure are the ever-present intergroup conflicts and the disturbingly real directorial loyalty concerns arising from the existence of Disproportionate Equity Positions. Delaware corporations that have adopted tracking stock equity structures generally have presented discussions of potential intergroup conflicts in their disclosure documents discussing such structures. Only one of those corporations, however, has made any mention of the directorial loyalty concerns that arise from Disproportionate Equity Positions.[161] What those Delaware corporations have said provides an interesting insight into the inability of the duties of care and loyalty, as currently interpreted under Delaware law, to address the concerns raised by tracking stock equity structures.

A. *Intergroup Conflict Discussions in Disclosure Documents*

With respect to intergroup conflicts, the Delaware tracking stock corporations discussed in this article have taken a particularly troubling "don't worry, be happy" position. One can observe this position by closely examining what has become a fairly standard pattern of disclosure on this issue. An indicative example is the following statement from U S West:

> Although the Company is not aware of any legal precedent involving the fiduciary duties of directors of corporations having two classes of common stock, or separate classes or series of capital stock, the rights of which are defined by reference to specified operations of the corporation, principles of Delaware law established in cases involving differing treatment of two classes of capital stock or two groups of holders of the same

160. *See supra* note 157.
161. *See infra* section III.B.

> class of capital stock provide that a board of directors owes an equal duty to all stockholders regardless of class or series. Under these principles of Delaware law and the related principles known as the "business judgment rule," absent abuse of discretion, a good faith business decision made by a disinterested and adequately informed Board, or a committee thereof, with respect to any matter having disparate impacts upon holders of Communications Stock and holders of Media Stock *would be a defense* to any challenge to such determination made by or on behalf of holders of either class of Common Stock. *Nevertheless, a Delaware court hearing a case involving such a challenge may decide to apply principles of Delaware law other than those discussed above, or may develop new principles of Delaware law, in order to decide such a case, which would be a case of first impression.*[162]

With respect to the quote above, several important points need to be made. First, Delaware tracking stock corporations are falling all over themselves to stress the current state of the law as it applies in a con-

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162. U S WEST PROXY STATEMENT, *supra* note 2, at 33-34 (emphasis added); *see also* RJR PROXY STATEMENT, *supra* note 2, at 23 (making essentially the same statement as U S West, but providing no disclosure similar to the last sentence of the U S West quote); TCI PROXY STATEMENT, *supra* note 2, at 34 (making essentially the same statement); USX-DELHI PROXY STATEMENT, *supra* note 2, at 14-15 (making essentially the same statement as U S West, but providing no disclosure similar to the last sentence of the U S West quote); *cf.* GENZYME PROXY STATEMENT, *supra* note 2, at 31-32 (similar statement made with respect to Massachusetts law); KMART PROXY STATEMENT, *supra* note 2, at 10 (similar statement made with respect to Michigan law); RALSTON PROXY STATEMENT, *supra* note 2, at 22 (similar statement made with respect to Missouri law); SEAGULL PROXY STATEMENT, *supra* note 2, at 39 (similar statement made with respect to Texas law).

Although its statements relate to Massachusetts rather than Delaware law, Genzyme Corp. actually implied at one point in time that its board of directors may be *legally required* to act against the interests of the holders of its "minority" tracking stock (TR Stock):

> [Under Massachusetts law, the Board has a] fiduciary duty to act in good faith and in a manner it reasonably believes to be in the best interests of the corporation. So long as the Tissue Repair Division continues to represent a disproportionately smaller portion of Genzyme's business, there is a likelihood that decisions of the Board made in conformity with the foregoing duty when the interests of the holders of the General Stock and the TR Stock diverge will favor the holders of the General Stock to the disadvantage of the holders of the TR Stock.

GENZYME PROXY STATEMENT, *supra* note 2, at 32. Importantly, however, Genzyme conspicuously left this statement out of its two prospectuses relating to secondary offerings of its General Stock and TR Stock. *See* GENZYME CORP., PROSPECTUS 6 (Oct. 12, 1995) (covering the sale of 2,500,000 shares of Genzyme General Division Common Stock); GENZYME CORP., PROSPECTUS 5 (Sept. 22, 1995) (covering the sale of 3,000,000 shares of Genzyme Tissue Repair Division Common Stock). Given the unlikelihood that Palmer & Dodge, counsel for Genzyme, would have allowed such an important legal statement to be omitted accidentally from two prospectuses of Genzyme, it is logical to conclude that the omissions were intentional and, thus, that Genzyme and its counsel no longer believed that the above-quoted statement was accurate.

ventional corporate context. They point out that the legal principles that make up the current state of the law "would be a defense" to challenges based on intergroup conflicts.[163] Clearly, in order to protect themselves from disgruntled stockholders and their lawyers, these corporations are taking the offensive by stating that their defense to intergroup challenges would be based on conventional corporate law principles — in particular, the business judgment rule. Of course, these principles, as discussed below, provide boards with tremendous leeway in making corporate decisions.[164]

Second, in order to fulfill their duty to make full and fair disclosure to stockholders, these corporations must expose their Achilles' heel. They do so first by stating that they are not aware of any legal precedent under Delaware law involving the fiduciary duties of directors of tracking stock corporations. This is entirely accurate, as there is no guidance from the Delaware courts directly on point.[165] Next, their duty requires them to undermine the implication that conventional principles of Delaware law would apply in a tracking stock context by explaining that a Delaware court hearing a challenge based on intergroup conflicts could choose to apply existing Delaware law principles other than those presented, or may fashion totally new principles of Delaware law, in order to decide such a challenge. Indeed, as these corporations themselves clearly state, a case involving such a challenge "would be a case of first impression."[166]

In a bold move, U S West decided to take this disclosure a bit further, but did so in an unhelpful way. In an attempt to ease stockholder fears about intergroup conflicts in a tracking stock context and thus

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163. Interestingly, this disclosure actually *backtracks* from a similar disclosure made by USX Corp. which stated that "established rules of Delaware law would apply" to the resolution of intergroup conflicts, in addition to merely being "a defense" to challenges based on intergroup conflicts. USX-DELHI PROXY STATEMENT, *supra* note 2, at 15; *see also* USX-MARATHON PROXY STATEMENT, *supra* note 2, at 22 (discussion of fiduciary duties of the board omits any discussion of Delaware law and its applicability to intergroup conflicts).

164. *See infra* section IV.A.1.

165. *See* Bagner & de Wied, *supra* note 65, at 517 (stating that "[t]argeted stock may raise complex questions under state law," and that "[i]t is unclear how the courts will apply principles of fiduciary duty in [a targeted stock] context"). It should be noted, however, that three lawsuits (two of which have been consolidated) brought against GM by certain former holders of GM-E Stock currently are pending in the Delaware Chancery Court. The complaints all essentially allege that GM's directors breached their fiduciary duties by approving a plan to split-off EDS from GM that unfairly benefitted GM at the expense of EDS. *See* GM SOLICITATION STATEMENT/PROSPECTUS, *supra* note 41, at 69.

166. *See* TCI PROXY STATEMENT, *supra* note 2, at 34; U S WEST PROXY STATEMENT, *supra* note 2, at 34.

chill potential lawsuits, U S West reassuringly pointed out that these conflicts were also present in its conventional equity structure days: "Many of the . . . [intergroup] conflicts exist today with respect to decisions that affect disproportionately U S West Communications and the rest of [U S West's] businesses."[167] This clearly is a true statement, as board decisions and policies do have disparate impacts on the different businesses operated by a diversified conventional parent corporation;[168] however, it is also a misleading statement. The existence of these conflicts is irrelevant to a corporation with a conventional equity structure due to the substantial unity of financial interest shared by all common stockholders of that corporation. These conflicts matter a great deal, however, in the context of a tracking stock corporation due to the substantial divergence of financial interest that exists among holders of shares of different classes of tracking stock. U S West conveniently left this latter point out of its fiduciary duty discussion.

B. *Discussion of Directorial Loyalty Concerns in Disclosure Documents*

Only one of the Delaware tracking stock corporations discussed in this article made any mention in its disclosure document of the loyalty concerns that arise from disproportionate share ownership by directors.[169] That corporation — TCI — took a remarkably cavalier approach in this regard. TCI first underscored its awareness of the loyalty concerns relating to disproportionate share ownership by directors:

> Disproportionate ownership interests of members of the Board of Directors in the TCI Group Common Stock and the Liberty Media Group Common Stock or disparate values of the TCI Group Common Stock and the Liberty Media Group Common Stock could create or appear to create potential conflicts of interests when directors are faced with decisions that could have different implications for different series [of tracking stock].[170]

After such a serious statement, one would have expected TCI to discuss its elaborate plans to deal with these very real concerns in order to calm investors' fears. TCI, however, did nothing of the sort.

In perhaps the most perplexing disclosure of any Delaware tracking stock corporation, TCI instead followed its statement about disproportionate share ownership by directors with a conclusory statement:

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167. U S WEST PROXY STATEMENT, *supra* note 2, at 33.

168. *See supra* note 97.

169. *See* TCI PROXY STATEMENT, *supra* note 2, at 34-35. The disclosure documents of GM, U S West, USX, and RJR Nabisco made no mention of these loyalty concerns.

170. TCI PROXY STATEMENT, *supra* note 2, at 34-35.

"Nevertheless, [TCI] believes that a director would be able to discharge his or her fiduciary responsibilities even if his or her interests in shares of the TCI Group Common Stock and Liberty Media Group Common Stock were disproportionate or had disparate values."[171] TCI, however, offered absolutely nothing in support of its "belief" other than, perhaps, the implicit message of "trust us."[172]

It is not clear why the other Delaware tracking stock corporations discussed in this article did not make any disclosure in this regard. U S West, the most recent tracking stock convert, certainly had access to TCI's disclosure document. Perhaps U S West noticed the problems with TCI's disclosure, was baffled as to how to improve upon it and simply chose to ignore the issue altogether. This, however, is pure speculation. The more important point is that the disproportionate share ownership concerns that arise in a tracking stock equity structure are at best given lip service. Moreover, no tracking stock corporation discussed in this article — TCI included — has pointed out the heightened loyalty concerns that arise when an officer of a tracking stock corporation (particularly an officer whose duties run primarily to a single business group) serves on its board.[173]

IV. The Duties of Care and Loyalty and the Need for a Duty of Fairness

This Part provides an overview of the traditional fiduciary duties of care and loyalty as they have been interpreted by the Delaware courts.[174] It also discusses whether those duties properly address the

171. *Id.* at 35; *cf.* GENZYME PROXY STATEMENT, *supra* note 2, at 32 (similar statement from Massachusetts corporation); RALSTON PROXY STATEMENT, *supra* note 2, at 22 (similar statement from Missouri corporation); SEAGULL PROXY STATEMENT, *supra* note 2, at 39 (similar statement from Texas corporation).

172. Although never explicitly stated by any tracking stock corporation, the disclosure made in this regard as to the possibility of opportunistic conduct by directors appears designed to ward off stockholder lawsuits through the advanced conditioning of stockholder expectations. Fiduciary obligations, however, should not be disavowed so easily. *See* Mitchell, *supra* note 15, at 465 & n.113.

173. *See supra* text accompanying notes 141-42.

174. As stated earlier, this article addresses the issues raised herein solely under Delaware law. *See supra* note 7. In this regard, only an overview of corporate fiduciary duties under Delaware law is provided due to the extensive commentary that already exists on the subject. For a more detailed discussion of corporate fiduciary duties under Delaware law, the cases on point and the contexts in which these duties have been discussed, see, for example, BALOTTI & FINKELSTEIN, *supra* note 7; DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS (4th ed. 1993); BRODSKY & ADAMSKI, *supra* note 33; HARVEY GELB, PERSONAL CORPORATE LIABILITY — A GUIDE FOR PLANNERS, LITIGATORS, AND CREDITORS' COUNSEL (1991); SOLOMON & PALMITER, *supra* note 7.

unique concerns arising in a tracking stock equity structure. As shown below, those duties were neither designed to nor do they address these concerns. Nevertheless, they can continue to play an important role in the corporate governance of tracking stock corporations. This conclusion stems from the simple fact that, despite the artificial bifurcation of a tracking stock corporation into two or more distinct business groups, that corporation remains governed by a single board of directors. Like the board of a conventional corporation, a tracking stock board must deal with the exact same pressures that originally gave rise to the need for the duties of care and loyalty in a conventional corporate context.

A. *The Duty of Care and the Business Judgment Rule*

1. *Current Interpretation Under Delaware Law*

The duty of care deals with the responsibility of corporate directors to oversee the affairs of their corporations by, among other things, attending directors' meetings, reviewing adequate information before making corporate decisions, and monitoring the activities of corporate officers to whom responsibilities have been delegated properly.[175] Under Delaware law, in performing their duties corporate directors are required to exercise the same degree of skill, diligence, and care in managing the affairs of a corporation that a reasonably prudent business person would exercise in similar circumstances.[176] Case law in Delaware clearly has established that this standard is predicated on "concepts of gross negligence,"[177] rather than ordinary negligence.

Cases holding directors liable for a breach of a duty of care, uncomplicated by self-dealing or conflict of interest, are exceedingly rare.[178] The paucity of such cases is directly attributable to the important

175. *See* BRODSKY & ADAMSKI, *supra* note 33, §§ 2:01, :02.

176. Unlike most states, Delaware does not have a statutory provision setting forth its duty of care. However, in dictum in the 1963 case of Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963), the Delaware Supreme Court stated that "directors . . . in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances." 188 A.2d at 130; *see also* Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985).

177. Aronson v. Lewis, 473 A.2d 805, 812 & n.6 (Del. 1984).

178. *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1147 (Del. Ch. 1994) (noting that a leading authority had identified only ten modern cases finding actionable director negligence without a concurrent breach of loyalty or conflict of interest); *In re* Beatrice Cos. Litig., No. CIV. 86-8248, 1986 WL 4749, at *5 (Del. Ch. Apr. 16, 1986), *affd.*, 522 A.2d 865 (Del. 1987) ("[H]istory has shown it to be a vary rare case in which the judgment of disinterested directors who follow a deliberate process in reaching a business decision will be found to have breached that duty."); BLOCK ET AL., *supra* note 174, at 72-75. Of course, it is not clear how many challenges to corporate action

policy consideration of limiting the ability of the courts to second-guess the business decisions and policies of corporate directors.[179] The law embodies the belief that directors, rather than judges, are the best decisionmakers in the corporate arena.[180]

This deferential policy towards directorial decisionmaking is effected through a tool of judicial review known as the business judgment rule.[181] This rule acts as both a procedural guide for stockholder litigants as well as a substantive rule of law.[182] From a procedural standpoint, it creates "a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[183] From a substantive standpoint, unless a challenger rebuts this presumption the business judgment rule attaches to protect the directors themselves and their decisions.[184]

Under Delaware law, overcoming the presumption of the business judgment rule is "a heavy burden for a plaintiff to meet."[185] Neverthe-

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based on alleged breaches of the duty of care were filed with the courts but settled before decisions were rendered.

179. *See* DEL. CODE ANN. tit. 8, § 141(a) (1991).

180. *See* Atwood Grain & Supply Co. v. Growmark, Inc., 712 F. Supp. 1360, 1366 (N.D. Ill. 1989) (discussing Delaware law); BRODSKY & ADAMSKI, *supra* note 33, § 2:02.

181. *See* Spegiel v. Buntrock, 571 A.2d 767, 774 (Del. 1990); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989); Smith v. Van Gorkom, 488 A.2d 858, 871 (Del. 1985); Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984); Aronson v. Lewis, 473 A.2d 802, 812 (Del. 1984); Moran v. Household Intl., Inc., 490 A.2d 1059, 1076 (Del. Ch.), *affd.*, 500 A.2d 1346 (Del. 1985); BALOTTI & FINKELSTEIN, *supra* note 7, § 4.7 (Supp. 1996).

The business judgment rule reflects corporate law's attempt to strike a careful balance between the need to have a sufficiently independent board of directors manage the affairs of a corporation while ensuring that the interests of the stockholders of the corporation are effected. *See Atwood Grain*, 712 F. Supp. at 1367 n.5. Indeed, the business judgment rule plays a major role in the judiciary's attempt to benefit stockholders through the promotion of wealth creation through calculated corporate risk taking activities. *See* Steiner v. Meyerson, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,857, at 93,146 (Del. Ch. July 18, 1995).

182. *See Citron*, 569 A.2d at 64; Garza v. TV Answer, Inc., No. CIV.A.12784, 1993 WL 77186, at *6 (Del. Ch. Mar. 15, 1993).

183. *Aronson*, 473 A.2d at 812; *see Citron*, 569 A.2d at 64; *Smith*, 488 A.2d at 872; Grobow v. Perot, 539 A.2d 180, 187 (Del. 1988); Emerald Partners v. Berlin, No. CIV.A.9700, 1993 WL 545409 (Del. Ch. Dec. 23, 1993). In the context of an alleged breach of a corporate fiduciary duty, determining which party has the burden of proof is often outcome-determinative. *See infra* note 223.

184. *See Citron*, 569 A.2d at 64; *Garza*, 1993 WL 77186, at *6; *In re* J.P. Stevens & Co. Shareholders Litig., 542 A.2d 770, 780 (Del. Ch. 1988); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986).

185. BALOTTI & FINKELSTEIN, *supra* note 7, § 4.6, at 4-51 (Supp. 1996); *see also* BRODSKY & ADAMSKI, *supra* note 33, § 2:01 (noting that the business judgment rule pro-

less, a plaintiff can overcome it by pleading "particular facts"[186] that, if taken as true, establish "director self-interest, if not self-dealing, or that the directors either lacked good faith or failed to exercise due care."[187] Thus, plaintiff allegations in this regard can be broken down into two general categories.[188] The first category, which is discussed in further detail below,[189] includes allegations of direct or indirect director disloyalty as evidenced by bad faith, self-interest, self-dealing, or misconduct.[190] The second category contains allegations of a lack of due care in directorial decisionmaking.

When mounting a challenge based on a lack of due care, a challenger must allege particular facts that, "taken as true, support a reasonable doubt that a challenged transaction was [in fact] the product of a valid business judgment."[191] A judicial due care examination focuses on both procedural due care (a board's decisionmaking process) and sub-

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vides directors with a wide range of discretion within which to act without fear of liability). An important exception exists with respect to the adoption of defensive measures in the corporate takeover context. In this regard, the initial burden is on the directors to show that "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed" and that any defensive action taken by them was "reasonable in relation to the threat posed." Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955, 958 (Del. 1985); *see* Moran v. Household Intl., Inc., 500 A.2d 1346, 1356 (Del. 1985).

186. *See* Stepak v. Addison, 20 F.3d 398, 403 (11th Cir. 1994). Rebutting the presumption created by the business judgment rule requires much more than mere assertions or accusations. *See Grobow*, 539 A.2d at 187. In *Grobow*, the Delaware Supreme Court expanded on this point:

> [O]nly well-pleaded allegations of fact must be accepted as true; conclusionary allegations of fact or law not supported by allegations of specific fact may not be taken as true. A trial court need not blindly accept as true all allegations, nor must it draw all inferences from them in plaintiff's favor unless they are reasonable inferences.

539 A.2d at 187 (footnote omitted).

187. *Citron*, 569 A.2d at 64; *see Stepak*, 20 F.3d at 403; *Grobow*, 539 A.2d at 183.

188. *See generally* BALOTTI & FINKELSTEIN, *supra* note 7, § 4.6 (Supp. 1996). (As Balotti and Finkelstein point out:

> In analyzing claims, the courts generally considered allegations of breaches of loyalty (i.e., whether the directors were motivated by other than an honest desire to benefit the corporation and its stockholders in approving the transaction) or lack of due care (i.e., whether the directors failed to make a reasonable effort to ascertain and consider all relevant information).

Id. at 4-51.

189. *See infra* section IV.B.1.

190. Allegations of "bad faith" or "fraud" imply that directors have been motivated by other than an honest desire to benefit the corporation and the stockholders, and thus have loyalty implications.

191. *Grobow*, 539 A.2d at 187 (quoting Aronson v. Lewis, 473 A.2d 802, 815 (Del. 1984)) (alteration in original).

stantive due care (the decision itself).[192] Under Delaware law, the courts use different standards of review when conducting a procedural due care review and a substantive due care review.[193]

In order to invoke the business judgment rule's protections, directors have "a duty to inform themselves of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties."[194] Accordingly, in a procedural due care challenge a plaintiff must present evidence that the board did not act in a deliberate and informed manner when making its decision.[195] Establishing a prima facie case in this regard is extremely difficult because the Delaware courts apply concepts of gross negligence in assessing whether directors exercised due care in their decisionmaking process.[196]

If, however, a plaintiff establishes a prima facie case that directors were grossly negligent in their decisionmaking, then the presumption that directors were exercising proper business judgment is overcome.[197] As a result, the directors then take on the burden of establishing that the decision or transaction in question was "entirely fair" to the stockholders or the corporation.[198] If they fail to demonstrate the entire fairness of

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192. *See Grobow*, 539 A.2d at 189.

193. *See* BALOTTI & FINKELSTEIN, *supra* note 7, § 4.6, at 4-44 to 4-45 (Supp. 1996).

194. *Aronson*, 473 A.2d at 812; *see* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Kumar v. Racing Corp. of Am., [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,896, at 99,422 (Del. Ch. Apr. 26, 1991).

Delaware, of course, recognizes that much of the information reviewed by boards comes from management or third-party sources. Directors explicitly are entitled to rely on such information as long as such reliance is both reasonable and in good faith. *See* DEL. CODE ANN. tit. 8, § 141(e) (1991).

195. *See Grobow*, 539 A.2d at 189-92; *Smith*, 488 A.2d at 873.

196. Stepak v. Addison, 20 F.3d 398, 404-05 (11th Cir. 1994); *Aronson*, 473 A.2d at 812; Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1148 (Del. Ch. 1994); *Kumar*, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 99,423.

To be held grossly negligent, corporate directors must demonstrate "reckless indifference to or a deliberate disregard of the stockholders" or take actions that are "without the bounds of reason." Rabkin v. Philip A. Hunt Chem. Corp., 547 A.2d 963, 970 (Del. Ch. 1985). A court's inquiry in this regard will be "directed to the material or advice the board had available to it and whether it had sufficient opportunity to acquire knowledge concerning the problem before acting." Moran v. Household Intl., Inc., 490 A.2d 1059, 1075 (Del. Ch. 1977) (citing Kaplan v. Goldsamt, 380 A.2d 556, 568 (Del. Ch. 1977); Puma v. Marriot, 283 A.2d 693, 695 (Del. Ch. 1971)).

197. *See Smith*, 488 A.2d at 872-73.

198. *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995) (quoting Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 371 (Del. 1993)); *see also Smith*, 488 A.2d at 893 (after determining that defendant directors failed to make an informed decision in accepting a per share merger price for their corporation of $55, the Delaware Supreme Court remanded the case to Delaware Court of Chancery to conduct

a decision or transaction, they can incur personal liability unless their corporation has adopted a charter provision limiting their liability for grossly negligent acts.[199] In addition, a court may enjoin an unconsummated transaction.[200]

During a substantive due care review, a court will look to see if the business decision in question had any "rational business purpose."[201] In order for a decision to receive the business judgment rule's protection under this rationality standard, it must not be so patently frivolous or capricious as to amount to an "abuse of discretion."[202] This standard is so high, however, that to meet it a business decision would have to be "so bizarre that no reasonable person would countenance it."[203] The mere fact that the decision was "ill-advised, stupid or questionable" simply would not be enough.[204]

2. *Failure To Address Tracking Stock Concerns*

The overview presented above reveals that the duty of care and the business judgment rule, as they currently are interpreted under Delaware law, do not address the concerns uniquely arising in a tracking stock context. Indeed, the duty of care and, more importantly, the business judgment rule were designed to ensure that directors comply only with "minimal standards of attentiveness and prudence."[205] While concerns about attentiveness and prudence continue to exist with respect to boards of tracking stock corporations, they are not the concerns caused by the intergroup conflicts that pervade a tracking stock equity structure. Rather, those concerns relate to unfairness, favoritism, unreasonableness and neglect. Accordingly, the duty of care and the business judgment rule are simply the wrong tools to deal with these concerns, and their blanket application to stockholder fairness challenges, as advocated by the Delaware tracking stock corporations discussed in this article, will prevent these concerns from being addressed.

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evidentiary hearing to determine fair value of plaintiffs' shares and, to the extent such fair value was greater than $55 per share, to award damages to plaintiffs).

199. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1994) (adopted by the Delaware legislature in response to the ruling of *Smith*).

200. *See* Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986); *see also* Gimbel v. Signal Cos., 316 A.2d 599 (Del. Ch.), *affd. per curiam*, 316 A.2d 619 (Del. 1974).

201. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

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

203. BALOTTI & FINKELSTEIN, *supra* note 7, § 4.6, at 4-61 (Supp. 1996).

204. *Id.*

205. SOLOMON & PALMITER, *supra* note 7, at 314.

This conclusion rests squarely on the formidable presumptions of the business judgment rule. A tracking stock stockholder interested in challenging a particular board decision or transaction likely would base her challenge on fairness grounds. Specifically, that stockholder would allege that the business group to which her shares are economically linked was treated unfairly or unreasonably or was neglected by the board as a result of that decision or transaction. Yet, as seen above, under the duty of care the fairness of a decision or transaction only receives judicial attention once a challenger overcomes the heavy presumptive burden of the business judgment rule.

Assuming for the moment that a tracking stock stockholder was successful in overcoming that burden, the concept of "fairness" in a tracking stock context would have to be given meaning by the courts. As currently interpreted in a conventional corporate context, "fairness" means "fairness to the corporation and its stockholders." Would "fairness" be reinterpreted in a tracking stock context to mean fairness to just one business group and its stockholders? Because each tracking stock corporation remains a single corporate entity despite its artificial bifurcation into two or more distinct business groups, it would be unlikely that a court would embrace this expanded meaning of fairness.[206]

It would be even more unlikely, however, for a court ever to reach the issue of fairness in the first place. The juxtaposition of two fact patterns — one involving a conventional corporation and the other involving a tracking stock corporation — clarifies this point. Using the basic facts from above,[207] assume that the board of C Corp. (the conventional corporation) is deciding how to allocate $100 million of available capital to the proposed capital projects of Business 1 and Business 2. Assume for this example that Business 1 is a growth business and that Business 2 is a declining business.[208] After reviewing materials in advance that describe the various capital projects, the board discovers that,

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206. As discussed in Part V, this author argues that the courts should not reinterpret the duty of care or the business judgment rule to address intergroup conflicts arising in a tracking stock equity structure. The reason for this is that a tracking stock corporation remains intact as a single corporate entity and, therefore, its board continues to confront the same fiduciary concerns affecting boards of conventional corporations. Accordingly, the duty of care and the business judgment rule can play the same role in a tracking stock corporate context as they do in a conventional corporate context. Indeed, tracking stock corporations enter into contracts, acquire assets, enter into financing arrangements, and hire employees at the parent company level as well as at the business group level.

207. *See supra* text accompanying note 67.

208. *See supra* text accompanying notes 52-59.

not surprisingly, the expected internal rate of return[209] on each of the capital projects of Business 1 exceeds the expected internal rate of return on each of the capital projects of Business 2. This higher return is one of the reasons why Business 1 is considered a "growth" business in the first place. However, the internal rates of return on all the capital projects of both Business 1 and Business 2 exceed C Corp.'s cost of capital.[210] Still, because C Corp. only has a limited supply of capital available to it, the board cannot undertake every capital project even though they all would be profitable from a cost of capital perspective. After due deliberations, the board decides to fund several of the proposed capital projects of Business 1 but none of the proposed capital projects of Business 2.

Under current Delaware interpretations of the business judgment rule, a stockholder challenge — assuming there even was a challenge[211] — to the decision of the C Corp. board should fail. The board displayed the requisite procedural due care by reviewing materials prepared in advance of its meeting and by deliberating at the meeting in a careful and meaningful way. The board's decision also is clearly rational from a substantive due care point of view, since the board decided to fund capital projects with internal rates of return higher than C Corp.'s cost of capital. Assuming, then, that the challenger has not alleged bad faith or self-dealing on the part of the directors, a court's inquiry into the matter should quickly come to an end.

Now assume substantially similar facts for TS Corp. (the tracking stock corporation). Thus, the board of TS Corp. is deciding how to allocate $100 million of available capital to the proposed capital projects of

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209. The internal rate of return ("IRR") of a given project is equal to that rate of discount at which the sum of the present values of a series of expected future cash flows is equal to the amount — the capital investment — required to produce them. *See* MBA IN FINANCE, *supra* note 55, at 275-77. Generally, finance theory supports the undertaking of all capital projects with IRRs that exceed a corporation's cost of capital, assuming the corporation has the available capital to undertake all such capital projects. If the corporation is subject to capital rationing because it has only a limited supply of capital, then those capital projects with the highest IRRs should be undertaken in declining order until the supply of capital is exhausted.

210. *See supra* note 209.

211. A stockholder challenge in this regard would be unusual because each stockholder of C Corp. shares a substantial unity of financial interest with the other stockholders. Of course, a stockholder challenge might be brought if the board's funding decision proved to be ill-advised in hindsight. In that case, all stockholders likely would have suffered a decline in their share price. Importantly, however, a stockholder would not bring a challenge claiming that it was unfair to fund projects of Business 1 but none of Business 2. The allocation made was irrelevant since the economic interests of all stockholders are linked to the performance of the entire corporation, and not a particular business operated by C Corp. *See supra* text accompanying note 73.

Group X and Group Y. Assume for this example that Group X is a growth business and that Group Y is a declining business. After reviewing materials in advance that describe the various capital projects, the board discovers that the expected internal rate of return on each of the capital projects of Group X exceeds the expected internal rate of return on each of the capital projects of Group Y. All the internal rates of return on the capital projects of both Group X and Group Y exceed TS Corp.'s cost of capital. After due deliberations, the board decides to fund several of the proposed capital projects of Group X but none of the proposed capital projects of Group Y.

A challenge to the board's decision by a tracking stock stockholder whose shares are economically linked to Group Y should fail assuming the court simply measures the board's decision against the business judgment rule. After all, like the board of C Corp., the board of TS Corp. also displayed the requisite procedural due care by reviewing materials prepared in advance of its meeting and by deliberating at that meeting in a careful and meaningful way. The board's decision also is clearly rational from a substantive due care point of view for the same reason that the decision of C Corp.'s board was rational. A court, therefore, should end its inquiry at that point and never reach the issue of whether the decision was fair to Group Y and its stockholders.[212]

As stated earlier, a judicial determination of whether, if at all, and if so, how, the business judgment rule and its presumptions would apply to stockholder challenges based on tracking stock board decisions involving intergroup conflicts has not yet occurred.[213] When the first of these challenges is brought, however, the courts should cast aside their business judgment blinders and refuse to allow tracking stock corporations to use a judicial rule designed to encourage business risk-taking as a shield to protect unfair treatment. In this regard, the courts should recognize two important distinctions between tracking stock corporations and conventional corporations. First, in a tracking stock context, a single board of directors and executive management team must look out for the needs of at least two competing stockholder groups. Thus, a tracking stock stockholder, unlike a stockholder of a conventional corporation, does not have the benefit of an independent agency promoting the interests of the business group to which her shares are linked. Sec-

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212. This outcome is, without question, the outcome hoped for by the tracking stock corporations discussed in this article. Boards of tracking stock corporations will be granted the most leeway in making decisions involving intergroup conflicts if the courts decide that those decisions will be afforded the protections of the business judgment rule. *See supra* text accompanying notes 162-64.

213. *See supra* note 165 and accompanying text.

ond, because a substantial divergence of financial interest exists between different classes of tracking stock, board decisions can have disparate impacts on the trading values of shares of those classes.

These distinctions demonstrate that a tracking stock stockholder suffers from a type of vulnerability to which stockholders of conventional corporations are immune. That vulnerability stems from the ability of directors to subjugate — purposefully or unintentionally — the needs of a particular business group to those of another business group while claiming the protections of the business judgment rule.[214] At its extreme, this ability could even extend to running a particular business group "into the ground" through, among other means, a sustained pattern of purposeful or benign neglect. While this conduct is perfectly acceptable in a conventional corporate context where stockholder interests are linked to the performance of the entire corporation, it should not be tolerated in a tracking stock context where a specific group of stockholders will suffer while another group will not.[215]

In the example above, the board of TS Corp. could perpetually decide to forgo funding Group Y's capital projects and thus stunt its industrial development.[216] If this were to occur, holders of Group Y Common Stock would have little, if any, recourse against the board under current Delaware interpretations of the duty of care and the business judgment rule. The board's course of action would help make winners out of the holders of Group X Common Stock and losers out of the holders of Group Y Common Stock. Thus, tracking stock stockholders generally are at the complete mercy of a board and an executive management team that have divided loyalties. With the incredible latitude afforded by the business judgment rule, a tracking stock board and executive management team can act virtually unchecked.

By contrast, a decision by the board of C Corp. to run Business 2 "into the ground" is, as it should be, completely the board's preroga-

214. Those needs can include, for example, the need for financial and human capital. *See supra* section II.B.1.

215. Indeed, one can argue that conventional corporations forfeit their ability to run businesses into the ground when they adopt tracking stock equity structures. If the board of a tracking stock corporation desires to ignore the industrial development of a particular business group, then it should either (a) sell that business group and distribute the proceeds to the holders of shares linked to that group or (b) first unwind the tracking stock equity structure and then ignore the industrial development of that former business group.

216. *Cf.* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (where minority stockholders of subsidiary challenged policy of parent company-majority stockholder of forcing subsidiary to pay large amounts of dividends, and thus inhibiting subsidiary's industrial development, court rejected challenge on, among other grounds, that minority stockholders received their proportionate share of dividends).

tive. If the board makes an informed decision to do so, that decision will prove either to be a "winner" for all involved or a "loser" for all involved. If that decision turns out to be ill-advised, a stockholder challenge could be brought that alleges, most likely unsuccessfully, that the directors breached their duty of care by making an uninformed or unintelligent decision. Such a challenge, however, would not be based on the unfairness of running Business 2 into the ground, because no shares of C Corp. are specifically linked to Business 2; rather, they are linked to the performance of the entire corporation.

B. *The Duty of Loyalty*

1. *Current Interpretation Under Delaware Law*

While the duty of care ensures that directors meet minimal standards of attentiveness and prudence, the duty of loyalty ensures that corporate fiduciaries demonstrate an "undivided and unqualified loyalty to the corporation which they serve."[217] Under Delaware law, these fiduciaries may not misuse their "power over corporate property or processes"[218] in order to serve their own interests at the expense of the corporation.[219] Delaware courts use the duty of loyalty to evaluate, based on stringent fairness grounds,[220] diversionary or self-serving activities by corporate fiduciaries. These activities, of course, come in many shapes and forms.[221] A stockholder challenging such an activity

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217. BRODSKY & ADAMSKI, *supra* note 33, § 3:01, at 1.

218. *See* Steiner v. Meyerson, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,857, at 93,146 (Del. Ch. July 18, 1995).

219. *See* Enstar Group, Inc. v. Grassgreen, 812 F. Supp. 1562, 1570 (M.D. Ala. 1993) ("One risk which the investor should not assume, however, is that the officers and directors who have accepted the responsibility of using that investor's money might put their personal interests ahead of that of the corporation."). When a director's interest as a stockholder conflicts with the interests of the corporation, the director must ignore her personal interests as a stockholder and attend to the corporation's interests. *See* Freedman v. Restaurant Assocs. Indus., Inc., [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,617, at 97,888 (Del. Ch. Sept. 21, 1990).

220. *See* SOLOMON & PALMITER, *supra* note 7, at 314.

221. The following is a list of categories into which diversionary or self-serving activities generally fall:

a. Flagrant diversions of corporate assets;
b. Self-dealing transactions;
c. Excessive executive compensation;
d. Usurpation of corporate opportunities;
e. Trading on inside information;
f. Accepting bribes in return for corporate favors; and
g. Using corporate assets and governance mechanisms for entrenchment purposes.

See id. at 315-16.

must allege facts that, if true, would constitute a material conflict of interest between the corporation and one or more of its directors. If those facts are not alleged, then the business judgment rule attaches to the actions of the directors and a challenger has the heavy burden of overcoming that rule's presumptions.[222]

If a challenger alleges those facts, however, two things occur. First, the implicated directors are precluded from invoking the business judgment rule to protect their actions.[223] Second, the burden of proof shifts to them. As a result, they will have to meet the "rigorous standards"[224] associated with proving the "entire fairness" of the transaction.[225] This

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222. *See supra* section IV.A.1; Dennis J. Block & Jonathan M. Hoff, *Corporate Governance and Institutional Activism,* N.Y. L.J., Jan. 18, 1996, at 5.

223. *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995). One of the most important decisions a court can make in this context is whether to apply the business judgment rule or the entire fairness test. In fact, the Delaware Supreme Court has stated that "[b]ecause the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of derivative litigation." Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1989) (quoting AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) (internal quotation marks omitted)).

224. Kumar v. Racing Corp. of Am., [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,896, at 99,422 (Del. Ch. Apr. 26, 1991).

225. *See* Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1115-16 (Del. 1994); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); Steiner v. Meyerson, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,857, at 93,146 (Del. Ch. July 19, 1995); *Kumar,* [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 99,422.

Under Delaware law, the concept of "fairness" in a loyalty context has two basic components — fair dealing and fair price. *See* Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993); *Weinberger,* 457 A.2d at 711; *Kumar,* [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 99,422-23; Pinson v. Campbell Taggart, Inc., No. CIV.A.7499, 1989 WL 17438, at *5 (Del. Ch. Feb. 28, 1989). These components encompass both procedural burdens and substantive duties. *See Pinson,* 1989 WL 17438, at *5. Fair dealing, on the one hand, has a procedural focus that looks at "when a transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders [if applicable] were obtained." *Weinberger,* 457 A.2d at 711. Fair price, on the other hand, has a substantive focus that looks into the economic and financial considerations of the proposed transaction, including "all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." 457 A.2d at 711. Depending on the factual context of a particular duty of loyalty challenge, only "fair dealing" may be implicated because the action or transaction at issue did not involve a pricing component. *See Nixon,* 626 A.2d at 1376 (in challenge alleging breach of fiduciary duty as a result of allegedly discriminatory policy that unfairly favored Class A employee stockholders over Class B nonemployee stockholders, Delaware Supreme Court stated that "[t]he case before us involves only the issue of fair dealing").

As the Delaware Supreme Court noted in *Kahn,* however, if the self-dealing transaction has been approved by either an informed and truly independent committee of directors or an informed majority of minority stockholders, then the burden of proof on the issue of fairness shifts to the challenging stockholder. *See Kahn,* 638 A.2d at 1117.

burden shifting acts as a compensating procedural safeguard in situations where the interests of stockholders are not being protected due to director self-interest.[226]

The directorial loyalty concerns arising in a tracking stock context mirror most closely self-dealing transactions currently addressed by the duty of loyalty. In a traditional self-dealing transaction, a director's loyalty is tested because she winds up on both sides of a transaction with her corporation.[227] This occurs when a director either approves or authorizes a corporate transaction in which she has a direct or indirect personal or financial interest.[228]

Most states have adopted statutory provisions that seek to promote fairness in self-dealing transactions,[229] and Delaware is no exception.[230] Commonly referred to as interested director statutes ("IDS"), these statutes will uphold an interested director transaction if some neutral decisionmaking body — a committee of independent directors, the stockholders, or a court — has ratified it, or if the transaction is otherwise fair to the corporation.[231] Fairness — either substantive, procedural, or both — lies at the heart of all those statutes. Delaware's IDS, for example, provides that a contract or transaction[232] "shall not be voida-

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However, the court noted that if such approval is given by a special committee of directors, a court must give "careful judicial scrutiny of a special committee's real bargaining power before shifting the burden of proof on the issue of entire fairness." 638 A.2d at 1117.

226. *See Pinson,* 1989 WL 17438, at *5. If the directors meet their burden of proving the entire fairness of a transaction, then that transaction is protected from a stockholder challenge. *See* Oberly v. Kirby, 592 A.2d 445, 466 (Del. 1991). If, however, the directors fail to meet this burden and the transaction is found to be unfair to the corporation, two remedies may flow. First, stockholders may demand rescission of the transaction itself. Second, if rescission proves impractical, stockholders may demand the payment of rescissory damages. *See Weinberger,* 457 A.2d at 714.

227. *See* Anadarko Petroleum Corp. v. Panhandle E. Corp., 545 A.2d 1171, 1174 (Del. 1988) ("It is a basic principle of Delaware General Corporation Law that . . . directors cannot stand on both sides of the transaction nor derive any personal benefit through self-dealing."); *Weinberger,* 457 A.2d at 710 ("When directors . . . are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.").

228. *See* SOLOMON & PALMITER, *supra* note 7, at 343.

229. *See* BRODSKY & ADAMSKI, *supra* note 33, § 3:02, at 3. Forty-seven out of fifty states have statutes controlling conflict of interest transactions. *See id.* § 3:02, at 18 n.1 (providing citations to the statute of each of the forty-seven states).

230. *See* DEL. CODE ANN. tit. 8, § 144(a) (1991).

231. *See* Oberly v. Kirby, 592 A.2d 445, 467 (Del. 1991); Lawrence E. Mitchell, *Fairness and Trust in Corporate Law,* 43 DUKE L.J. 425, 439-40 & n.47 (1993).

232. Although it is unclear if the existence of a transaction or a contract is a *sine qua non* to the application of the statute, precedent exists for its application when directors interested in one proposed transaction refuse to approve another competing proposed transaction in which they have no interest, as such refusal implicates the same

ble" solely for the reason that a director has a direct or indirect interest therein if (1) the material facts of her interest are disclosed and a majority of disinterested directors authorizes the transaction in good faith, (2) the material facts of her interest are disclosed and the stockholders of the corporation vote in good faith to approve the transaction, or (3) a court determines that the contract or transaction is fair to the corporation.[233]

2. *Failure To Address Tracking Stock Concerns*

The duty of loyalty, as currently interpreted under Delaware law, and Delaware's IDS both fail to address the unique loyalty concerns arising in a tracking stock context. Once again, these concerns stem from the ability of tracking stock directors with Disproportionate Equity

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self-serving concerns as when directors approve interested transactions. *See* Freedman v. Restaurant Assocs. Indus., Inc., [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,617 at 97,888 (Del. Ch. Sept. 21, 1990).

In *Freedman,* stockholders challenged a decision of the corporation's board to reject the sale of a stock option to a third party in connection with that third party's offer to acquire the corporation. At the time of the rejection, the board was dominated by inside directors who had made a competing management buyout offer. Although the board's rejection did not involve a transaction between the interested directors and the corporation, the rejection paved the way for the board to accept management's competing buyout offer. Noting this, the Delaware Chancery Court stated that "only a wooden understanding of the law of self-dealing would deny that the concerns underlying that law are present here." [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 97,888. The court then went on to analyze the interested directors' rejection of the stock option under Section 144(a) of the Delaware General Corporation Law. While making such an analysis, the court noted that the stock option was not rejected "by the disinterested directors or by the shareholders. Thus, the board's decision will be upheld only if it was fair. Further, the defendants bear the burden of proving fairness." [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 97,888 (citations omitted).

233. *See* DEL. CODE ANN. tit. 8, § 144(a) (1991). The enactment of this statute limited stockholders' power under the common law in two ways. First, the statute allows for a committee of disinterested directors to approve a transaction and bring it within the scope of the business judgment rule. Second, if an independent committee is not available, stockholders may either ratify the transaction or challenge its fairness in court, but they no longer have the power to automatically nullify it. *See Oberly,* 592 A.2d at 466.

The first two prongs of Delaware's IDS are procedural in nature because they focus on what was disclosed about a particular transaction and who authorized it. The third prong, by contrast, is substantive in nature, as it calls for a court determination that the transaction itself is "fair" to the corporation. While Delaware's statutory provision appears to be disjunctive in nature, it has not been interpreted that way. The Delaware Supreme Court has held that the approval of a conflict of interest transaction by disinterested directors or stockholders does not displace the court's role to assure the fairness of the transaction. *See* Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976) (applying a two-tiered analysis: application of Section 144 coupled with an intrinsic fairness test); Marciano v. Nakash, 535 A.2d 400, 404 (Del. 1987) (citing *Fliegler* favorably).

Positions in their corporations — such directors hereinafter are referred to as "TS Interested Directors" — to manipulate corporate decisions and policies in such a way as to favor one business group over another business group thereby securing personal financial gain. In other words, these directors will play favorites in their decisionmaking based on their own personal financial interests.

In the context of a tracking stock equity structure, the duty of loyalty and Delaware's IDS are problematic in two respects. First, they simply do not address a number of situations that raise loyalty concerns solely in a tracking stock context. Second, questions of interpretation arise with respect to how they will treat, in a tracking stock context, certain traditional situations that raise loyalty concerns in both conventional and tracking stock equity structures. These two problems are explored below.

a. Loyalty Concerns Where None Existed Before. Certain unique situations arise in a tracking stock context that create loyalty concerns that are not addressed by the duty of loyalty or Delaware's IDS. As seen in the examples that follow, these situations all involve TS Interested Directors who profit through the promotion of the business group in which they have a Disproportionate Equity Position.[234] Thus, these directors can profit by ensuring that that business group is successful, and they have the means at their disposal to make this happen.

The duty of loyalty and Delaware's IDS do not address these situations because of their holistic approach toward the corporation. The duty of loyalty, on the one hand, speaks to directors placing their interests ahead of those of the corporation, rather than before those of particular businesses operated by a corporation. Delaware's IDS, on the other hand, focuses on transactions and contracts involving both the corporation and a particular director or an entity in which that director has a direct or indirect interest.[235] Thus, the statute focuses on dealings in which the corporation itself is an active participant.[236]

This holistic approach is entirely appropriate from the "all for one, one for all" perspective of a conventional corporation. Indeed, due to

234. Favoritism of this kind also can occur through the neglect of one business group in an effort to promote the interests of another business group.

235. That interest may be directly or indirectly financial in nature or result from the fact that the director is also a director of that other corporation and thus would be referred to as a "common director."

236. Examples of these types of transactions include sales of property or other assets to or by the corporation, loans to or by the corporation, and, in cases involving outside directors, the furnishing of services (such as legal or accounting services) to the corporation by such directors. *See generally* BALOTTI & FINKELSTEIN, *supra* note 7, § 4.9 (Supp. 1996).

the substantial unity of financial interest that exists between different classes of common stock of a conventional corporation,[237] the interests of the corporation itself are generally synonymous with those of its stockholders. Hence, there is no "loyalty" pull to favor one of the businesses or divisions operated by a conventional corporation over another.[238] The focus, rather, is on how well the corporation as a whole performs. The duty of loyalty and Delaware's IDS simply reinforce this.

This holistic approach, however, simply does not address the unique tracking stock vice of profiting through favoritism. Indeed, in order for this vice to be possible, a corporation first must be subdivided into two or more business groups and have securities linked to the performances of those business groups. Once this is done, TS Interested Directors have the ability to enhance their own financial interests through the promotion of one business group over another.

Particularly troubling in this regard is the ability of TS Interested Directors to point out that their self-serving efforts benefit other stockholders as well as themselves. When a particular business group is favored over another through directorial decisionmaking, not only is that business group benefited but the holders of shares linked to that group also are benefited. At the same time, of course, the TS Interested Directors reap financial rewards. Such favoritism, therefore, is particularly insidious because a particular group of stockholders in addition to the TS Interested Directors also benefit from acts of favoritism.

An example will highlight the problems that the holistic approach towards the corporation has in addressing tracking stock loyalty concerns. Assume that a majority of the directors of TS Corp. have Disproportionate Equity Positions in Group Y, and thus are TS Interested Directors. Also assume that, when making capital allocations (a common intergroup conflict situation), the board decides to fund all of Group Y's capital projects but few of Group X's. Further assume that the TS Interested Directors voted this way in an effort to increase the value of their shares of Group Y Common Stock.

In this example, the duty of loyalty, as currently interpreted under Delaware law, is of no use in policing this act of favoritism designed for personal profit. Since that duty focuses on the corporation as a

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237. *See supra* text accompanying note 73.

238. This is true even when some directors of a conventional corporation own stock in that corporation while others do not. In such a case, none of the directors has any financial incentive to favor one business operated by the corporation over the other, because no director will benefit thereby. Those directors with an equity interest, however, certainly have an interest in not making ill-advised corporate decisions in general because the value of their shares will decline if poor decisions are made.

whole, attention currently is not paid to how resources are divided between business groups. Nor does Delaware's IDS address this situation. This shortcoming stems from the fact that a TS Interested Director is not even considered "interested" by that statute. To be "interested" under that statute, the director herself must be a party to a transaction with the corporation or have a direct or indirect financial interest in an entity that is. Instead, directors are considered "interested" in a tracking stock context if they have Disproportionate Equity Positions — an impossibility with a conventional corporation.[239]

A related problem with the duty of loyalty and Delaware's IDS is their failure to address situations in which TS Interested Directors can profit through transactions with third parties in which no such director has any interest whatsoever. An example will highlight this point. Assume again that a majority of the directors of TS Corp. have a Disproportionate Equity Position in Group Y. Also assume that either Group X or Group Y is equally capable of consummating the transaction in question with a third party corporation in which no TS Corp. director has any interest. The TS Interested Directors, however, decide to have Group Y enter into the transaction in an effort to enhance the value of their Group Y Common Stock.

Once again, the duty of loyalty, as currently interpreted under Delaware law, falls short in addressing this act of favoritism. Indeed, dealings between a corporation and a third party in which no director is interested implicate not the duty of loyalty but rather the duty of care. Accordingly, the board's decision almost always will receive the protections of the business judgment rule.[240] In this instance, the fact that a director qua stockholder benefits as the corporation benefits is irrelevant, because the duty of loyalty has been interpreted only in terms of a conventional corporation. In a conventional corporate context, "[d]irectors who are also shareholders usually have interests as shareholders that coincide with the best interests of the company."[241]

Delaware's IDS fares no better in this regard. It too suffers because it applies solely to transactions between the corporation and a third-party entity in which a director has a direct or indirect interest. In the example above, TS Corp. is dealing with a third party corporation in

239. Directors of a conventional corporation with multiple classes of common stock could also own a disparate number of shares of each such class; however, no economic loyalty concerns should arise because the performance of the shares of each such class of stock is linked to the corporation as a whole.

240. *See supra* section IV.A.1.

241. Freedman v. Restaurant Assocs. Indus., Inc., [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,617, at 97,888 (Del. Ch. Sept. 21, 1990).

which no TS Corp. director has an interest. The statute, therefore, is not applicable, as the TS Interested Directors are not considered "interested" thereunder.

The unusual nature of intergroup transactions that arise in a tracking stock context also throw a curveball to the duty of loyalty and Delaware's IDS.[242] Unlike the typical interested director transaction where the corporation is one of at least two parties to the transaction, an intergroup transaction occurs solely between business groups of a tracking stock corporation. The corporation is, in essence, on both sides of the transaction. Because of this, it is hard to say that the well-being of the corporation as a whole has been injured when a lopsided intergroup transaction occurs, even though one business group could be viewed as a winner and the other a loser. But a TS Interested Director clearly could promote her own financial well-being by ensuring that the winner is the business group in which she has a DEP.

b. Interpretational Problems. Because a tracking stock corporation legally is a single corporate entity, it remains just as susceptible as a conventional corporation to the perpetration of traditional diversionary or self-serving activities[243] by its directors. As discussed earlier, in a conventional corporate context interested directors must show the entire fairness of dealings between themselves and their corporation unless, in accordance with an interested director statute, those dealings have been approved or ratified by an informed majority of disinterested directors or stockholders. Directors of tracking stock corporations who have dealings with their corporations should also be required to show the entire fairness of those dealings unless those dealings have been so approved or ratified.

Questions of interpretation, however, arise in situations in which the actions of tracking stock directors would cause them to be considered "interested" within the meaning of the duty of loyalty and Delaware's IDS. With respect to an interested director transaction covered by Delaware's IDS, assume that it is not possible to secure the approval of a majority of disinterested directors.[244] In order to protect that transaction under the statute, therefore, the transaction is put to a vote of the stockholders.[245] The question arises, however, as to which

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242. For a discussion of intergroup transactions and dealings among the business groups of a tracking stock corporation, see *supra* section II.B.4.

243. *See supra* note 221.

244. This could happen if either there were no disinterested directors to approve the transaction or the transaction were put to a vote of stockholders after a previous decision was reached by the directors to adopt a neutral stance towards the transaction.

245. *See* DEL. CODE ANN. tit. 8, § 144(a)(2) (1991).

"stockholders" should be entitled to approve the interested transaction. Should all tracking stock stockholders, regardless of class, vote on the matter? Or should only those stockholders whose shares are linked economically to the business group implicated in the transaction control the outcome?[246]

Similarly, assuming no disinterested body has approved the interested director transaction in question, the burden of proof shifts to the directors to prove the entire fairness of the transaction "to the corporation."[247] But as discussed earlier in the context of the duty of care,[248] in a tracking stock context does fairness to the corporation mean fairness to the corporation as a whole or fairness to a particular business group? This issue also plagues the duty of loyalty because "fairness to the corporation" is paramount to that duty as well. Interpretive questions like those discussed above ultimately must await judicial resolution.

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246. Certificates or articles of incorporation of tracking stock corporations generally provide that, unless state law otherwise requires, all tracking stock stockholders vote together as one class on all issues coming before common stockholders. State law generally requires a separate class vote on matters that could adversely affect the rights of holders of a particular class of stock and on any other matter specifically set forth in a corporation's certificate or articles of incorporation. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 102(b)(4), 242(b)(2) (1991). Therefore, the likely outcome of this issue is that all tracking stock stockholders would vote together as one class.

While this is not troubling from a fiduciary duty point of view, it has significant drawbacks from a stockholder perspective. Using the above example, assume that the matter upon which the stockholders of TS Corp. will vote is a sale of assets of Group X to a corporation in which all the directors of TS Corp. have a financial interest. Assume also that each share of Group X Common Stock has one vote and that holders of Group X Common Stock have 40% of the corporation's voting power. One share of Group Y Common Stock also has one vote and holders of Group Y Common Stock have the remaining 60% of the corporation's voting power. Assuming TS Corp. is a Delaware corporation and that its charter does not provide for lower quorum and approval percentages, a majority of shares entitled to vote must be represented at the stockholders' meeting in person or by proxy to constitute a quorum. *See* DEL. CODE ANN. tit. 8, § 216(1) (1991). Assuming a quorum is present, the sale of assets can only be approved by the affirmative vote of a majority of the shares so represented. *See* DEL. CODE ANN. tit. 8, § 216(2) (1991).

Two problems thus arise. First, assuming all of the shares of Group X Common Stock are represented at the stockholders' meeting, at least approximately 17% of the shares of Group Y Common Stock must also be represented before a quorum can even be achieved. Since the issue at hand is a sale of assets of Group X, however, the quorum requirements could be defeated through sheer apathy on the part of holders of Group Y Common Stock. Second, assuming for whatever reason holders of Group Y Common Stock disliked the proposed sale, those holders if they exercise their superior voting power could effectively veto it even if all the holders of Group X Common Stock were in favor of it.

247. *See supra* text accompanying notes 223-26.

248. *See supra* text accompanying note 206.

V. The Duty of Fairness

This author does not advocate altering or reinterpreting traditional corporate fiduciary duties to enable them to address the unique concerns arising in a tracking stock equity structure. The reason for this is simple: these duties continue to perform the same important functions in the corporate governance of a tracking stock corporation as they do in the corporate governance of a conventional corporation. A tracking stock corporation, despite its artificial bifurcation into distinct business groups, remains legally intact as a single corporate entity. As such, it is governed by only one board of directors that, like the board of a conventional corporation, must guard against the conventional vices of directorial negligence and disloyalty. Accordingly, the traditional fiduciary duties of care and loyalty should be used by the courts to address these vices regardless of whether they occur in a conventional corporate context or a tracking stock context.

The fact that a tracking stock corporation has only one board of directors while having holders of shares of multiple classes of stock with substantially divergent financial interests, however, gives rise to new challenges involving issues of fairness and favoritism. As seen in Part IV, the traditional fiduciary duties of care and loyalty fail to address these issues. The duty of care, on the one hand, promotes the undertaking of risky business activities within a framework of minimal directorial prudence, and issues of fairness are never reached unless the formidable presumptions of the business judgment rule are overcome. The duty of loyalty, on the other hand, suffers from its focus on the corporation as a whole rather than on distinct business groups operated by that corporation. The notion of profiting by favoring one part of a corporation over another is simply alien to duty of loyalty jurisprudence.

A. *Why Tracking Stock Concerns Need To Be Addressed*

In light of the foregoing, a logical question arises: Should the law concern itself with the unique concerns arising in a tracking stock equity structure at all? Perhaps stockholders of tracking stock corporations should simply close their eyes to these concerns and cross their fingers? This appears to be what the tracking stock corporations discussed in this article are hoping for, as they assert that their stockholders have no additional rights as a result of their implementation of tracking stock equity structures.[249] In addition, these corporations can ease stockholder

249. *See* Ralston Proxy Statement, *supra* note 2, at 21; RJR Proxy Statement, *supra* note 2, at 23; Seagull Proxy Statement, *supra* note 2, at 38; TCI Proxy

concerns by pointing out that they are among an elite group of America's finest corporations and that their directors are all prominent members of the business, academic, and/or political communities.

But what if, in the future, as tracking stock equity structures become more widespread, control of a tracking stock corporation falls into less able hands? Will directors of less stature and scruples be able to handle the reins of corporate law's equivalent of a bucking bronco? Indeed, it is already troubling that, as shown earlier,[250] certain members of the boards of at least two tracking stock corporations have held Disproportionate Equity Positions in the past. While these directors may not have chosen to use their DEPs to their personal financial advantage, others in the future may not exercise such self-restraint.

Perhaps the most worrisome prospect of all, however, arises from an intergroup conflict standpoint. The tracking stock corporations in existence today are all profitable ventures. Clearly this will not always be the case. One day a tracking stock corporation will move from the profitable end of the success/failure continuum towards the end where financial disaster lurks. One day a tracking stock corporation will file for bankruptcy.

Because financial developments of each business group of a tracking stock corporation could affect the performance of the corporation as a whole,[251] a corporate disaster could result from a financial decline of only one business group. Indeed, if one business group begins to act more like an anchor than a sail, the voyage of the entire corporation could be imperiled. Under these circumstances, and given the extensive intergroup conflicts that naturally arise in a tracking stock context, significant stockholder litigation would appear inevitable. As the corporate pie gets smaller, the friction between different stockholder groups will grow. Embracing the "don't worry, be happy" position of tracking stock corporations, therefore, seems ill-advised.

In this regard, one can only shudder over what would have happened to Kmart Corporation had it successfully issued *five classes of tracking stock* back in 1994.[252] In late 1995 and early 1996, Kmart's flagship discount store business suffered from a number of serious fi-

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STATEMENT, *supra* note 2, at 30; U S WEST PROXY STATEMENT, *supra* note 2, at 29. Formulating this assertion in another way, Genzyme Corp. stated that a "Massachusetts court would hold that a board of directors . . . does not have separate or additional duties to any group of stockholders." GENZYME PROXY STATEMENT, *supra* note 2, at 31-32.

250. *See supra* text accompanying notes 143-60.

251. *See supra* text accompanying notes 81-84.

252. *See supra* notes 2, 49.

nancial woes.[253] As a result, Kmart's common stock price plunged from a 52-week high closing price of $16¼ to a closing price of $7 on February 22, 1996. Assuming Kmart had issued five classes of tracking stock in 1994, how, for example, would the four groups of stockholders interested in Kmart business groups other than its flagship discount store business group have responded when Kmart announced that its top management priority was the turnaround of that ailing business group rather than the development of the other four business groups?[254] In addition, given management's proposed multi-billion dollar make-over of that ailing business group, would enough capital be available to further the industrial development of the other four business groups? If not, would the four groups of stockholders left out in the cold sit idly by on the sidelines and watch this happen? This author submits that the resulting stockholder infighting would have rivaled the famed feuds between the Hatfields and McCoys.

B. *The Duty of Fairness*

The special concerns arising in a tracking stock equity structure require an evolutionary development in corporate law in order to protect tracking stock stockholders and guide tracking stock directors. By moving to a new level of principle and policy, corporate law can promote corporate decisionmaking based on fairness and reasonableness rather than favoritism and apathy in a tracking stock context. A new standard is needed with which to evaluate directorial decisions that have disparate impacts on the different business groups and the holders of shares linked to them. This standard, however, must carefully balance the needs of the directors to manage the corporation with those of competing stockholder groups for fair and reasonable treatment. Importantly, it also must avoid mandating simplistic solutions to intergroup conflicts, such as requiring exactly "equal" treatment of each business group or "splitting the baby" when scarce resources are allocated among business groups. These solutions would likely guarantee the achievement of corporate mediocrity.

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253. *See* Robert Berner, *Kmart, in Letter, Seeks To Calm Vendors on Profits,* WALL ST. J., Feb. 16, 1996, at A3; Jennifer Steinhauer, *Can Kmart Put Together a Comeback,* N.Y. TIMES, Nov. 17, 1995, at D1; *Can Kmart Pull Out of Its Spin? New Chief Cuts Jobs, Closes Stores to Boost Financials,* INVESTOR'S BUS. DAILY, Oct. 18, 1995, at A4 [hereinafter *Can Kmart Comeback?*].

254. According to Robert Buchanan, an analyst at NatWest Securities, Inc., Kmart "needs about $4 to $5 billion to rejuvenate its stores, many of which are old and need remodeling." Robert Buchanan, *quoted in Can Kmart Comeback?, supra* note 253, at A4 (internal quotation marks omitted).

This author argues for the statutory or judicial enactment of a duty of fairness that can address the special concerns arising in a tracking stock equity structure. The goal of the duty of fairness would be to ensure that tracking stock boards do not exercise, while hiding behind the business judgment rule, their broad discretionary powers in a way that is unfair to, or fails to properly consider the needs of, a particular business group and the holders of shares linked to it. Fairness is the proper standard because the intergroup conflicts that arise in a tracking stock context raise fairness issues.[255] A fairness standard would require tracking stock boards to affirmatively consider and address the industrial development of all business groups, especially the declining or out-of-favor business groups, when making decisions and policies that could have disparate impacts. Neither blatant favoritism toward, nor benign or purposeful neglect of, any particular business group would be tolerated under such a standard.

As seen below, the duty of fairness is not designed to bring the directorial decisionmaking process to a grinding halt. In fact, it creates a presumption in favor of tracking stock directors that any decision made by them that has disparate impacts was both fair and reasonable to all involved. Stockholders challenging a decision would have to plead particular facts to rebut this presumption. Those facts would have to demonstrate that one or more of the three operative provisions of Section (a) of the duty were not met. If the presumption is overcome, then the directors would have the burden of demonstrating that they satisfied all of those provisions when they made the challenged decision, unless one of the two remedial provisions of Section (b) of the duty were met. Failure on the part of directors to do so would result in the granting of either equitable relief, such as enjoining or unwinding the decision itself, or, if such relief were not feasible, compensatory damages paid by either the favored business group or the directors themselves, depending on the facts.

The duty of fairness provides:

(a) With respect to any corporation having outstanding shares of two or more classes of capital stock, or series of capital stock, the rights of which are defined by reference to specified Business Groups, any Approved Action that has materially disparate impacts on the Business Groups of such corporation and/or the trading value of shares of the clas-

255. Judicial precedent for requiring fairness in similar contexts already exists. *See In re* FLS Holdings, Inc. Shareholders Litig., No. CIV.A.12623, 1993 WL 104562 (Del. Ch. Apr. 2, 1993) (holding that division of merger consideration between preferred stockholders and common stockholders must be "fair" though not necessarily equal); Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 596-97 (Del. Ch. 1986) (same).

ses or series of capital stock linked to such Business Groups will be presumed to be fair and reasonable to such Business Groups and the holders of such shares unless, at the time approval was granted, one or more of the following provisions were not satisfied:

1. The Approved Action was approved by a majority of Disinterested Directors of the board of directors or a committee of such board;
2. Prior to granting its approval, the board or such committee shall have received and considered such Information as is necessary to make an informed business judgment with respect to the Approved Action; and
3. At the time it granted its approval, the board or such committee reasonably believed, based upon such Information, that the Approved Action was fair and reasonable to each Business Group and the holders of shares of the class or series of capital stock linked thereto.

(b) In the event that Section (a) shall not be satisfied, an Approved Action covered thereby shall nevertheless be deemed fair and reasonable if either of the following provisions is satisfied:

1. The holders of a majority of shares of each class or series of capital stock, voting as a separate class or series, shall have ratified in good faith the Approved Action after having received such Information as is necessary to make an informed decision with respect to such Approved Action; or
2. At the time it was approved, the Approved Action was fair and reasonable to each Business Group and the holders of shares of the class or series of capital stock linked thereto. Directors of the corporation shall bear the burden of proving the fairness and reasonableness of such Approved Action under this Section (b)2.

(c) For purposes of the foregoing:

"*Action*" shall mean any action, activity, decision, policy, transaction, contract, negotiation, or dealing of any kind whatsoever.

"*Approved Action*" shall mean any Action affirmatively approved by the board or such committee. For purposes of this definition, an Approved Action shall include, without limitation, an affirmative decision by the board or such committee to cease or terminate a current on-going Approved Action. In addition, in the event alternative Actions are under consideration by the board or such committee, the approval of one such Action shall be deemed the simultaneous disapproval of all other Actions that the board or such committee believed to be viable alternatives to the Approved Action.

"*Beneficial Effects*" shall mean all material beneficial consequences of an Action that are reasonably foreseeable at the time such Action is considered by the board or such committee.

"*Business Group*" shall mean any business group, division, subsidiary, assets, or set of operations of the corporation with respect to which the rights of a particular class or series of capital stock are defined.

"*Detrimental Effects*" shall mean all material adverse consequences of an Action that are reasonably foreseeable at the time such Action is considered by the board or such committee. For purposes of this definition, "Detrimental Effects" shall include, without limitation, all material opportunity costs associated with a disapproved Action.

"*Disinterested Director*" shall mean, at the time the board or such committee approves any Action, either (A) any Outside Director or (B) any Inside Director whose responsibilities run to all Business Groups, in each case who beneficially owns, on a fully diluted basis, either (1) shares of all classes or series of capital stock with an aggregate trading value of less than $100,000 or (2) a number of shares of each class or series of capital stock that, in proportional terms, reasonably reflects the same proportion that outstanding shares of all classes or series of capital stock have to each other.

"*Information*" shall mean, with respect to any Approved Action, all materially relevant information relating to such Action. For purposes of this definition, "materially relevant information" shall include, without limitation: (A) all Beneficial Effects and Detrimental Effects of (1) the Approved Action, (2) any disapproved Action that the board or such committee reasonably believed to be a viable alternative to the Approved Action, and (3) all previously approved and disapproved Actions that are materially relevant to the Approved Action; (B) with respect to any Approved Action effected solely between or among two or more Business Groups, the board's or such committee's reasonable judgment as to how a wholly independent board or committee of a stand-alone corporation with characteristics substantially similar to each Business Group affected thereby would assess such Action; and (C) for purposes of Section (b)1, the nature and extent of the interest of any Interested Director.

"*Inside Director*" shall mean a director of the corporation who is also either an officer or other employee of or a consultant to the corporation.

"*Interested Director*" shall mean any director of the corporation who is not a Disinterested Director.

"*Outside Director*" shall mean a director of the corporation who is neither an officer or other employee of nor a consultant to the corporation.

C. *Elements of the Duty of Fairness Explained*

As seen from above, the duty of fairness has three sections. Section (a) contains the central provisions of the duty. Section (b) sets forth two remedial provisions that are available to directors in the event Section (a) is not satisfied. Section (c) contains a set of ten defined terms. The way in which each of these three sections helps to address the concerns raised by a tracking stock equity structure is described below. Because the set of defined terms is used throughout the duty's first two sections, it is not independently discussed.

1. *Central Nature of Section (a)*

Section (a) is the heart of the duty of fairness. Through its provisions, this section restricts the applicability of the duty of fairness, sets forth a presumption in favor of tracking stock directors, addresses directorial loyalty concerns, and provides for a subjective measure of fairness. Moreover, it provides valuable guidance to tracking stock directors as to the process they should be following when making decisions that could have materially disparate impacts on a corporation's business groups and related stockholders.

The purpose of the introductory paragraph is to limit the applicability of the duty of fairness solely to situations in which the tracking stock concerns discussed in this article arise. The first clause of this paragraph limits the duty's applicability solely to tracking stock corporations. Use of the broadly defined term "Business Group," however, is designed to help capture all forms of tracking stock corporations regardless of whether their capital stock is linked to the traditional business group or some other aspect of the corporation. The introductory paragraph further limits the scope of the duty by requiring an "Approved Action" that has had materially disparate impacts on the Business Groups of the corporation, the trading values of shares of the capital stock linked to such Groups, or both. Most importantly, the introductory paragraph establishes the presumption that an Approved Action is fair and reasonable to all involved unless one or more of the three operative provisions of Section (a) have not been satisfied.

The defined terms "Action" and "Approved Action" are particularly important to Section (a). "Action," which plays a role in several defined terms including "Approved Action," is broadly defined so as to avoid the arguably narrow focus of interested director statutes on only transactions and contracts. An Action, therefore, includes any and all actions in which a corporation may engage. "Approved Action" includes not only any Action approved by the board or a committee, but also a board or committee decision to cease a previously approved, ongoing Action, such as the termination of a project or the cessation of negotiations. Finally, the concept of materiality is not specifically mentioned with respect to either an Action or an Approved Action, because boards and committees rarely spend time considering matters that are not material to the corporation. Accordingly, the scope of the duty of fairness is further limited to Actions considered by the board or a committee. As a result, ordinary day-to-day operational decisions made by the management team would not be subject to judicial scrutiny.

Section (a) of the duty of fairness also contains three operative provisions that must be satisfied by the board or a committee with respect to any Approved Action. The first provision tackles head-on the directorial loyalty concerns that arise when tracking stock directors hold Disproportionate Equity Positions in their corporations. An Approved Action must have received approval by a majority of "Disinterested Directors" of the board or a committee. This requirement, while mirroring one of the approval provisions available under Delaware's interested director statute,[256] covers only the loyalty concerns arising in a tracking stock context.

The first provision targets tracking stock loyalty concerns through its use of the carefully formulated definition of "Disinterested Director." The key to that definition is its focus on disproportionate stock ownership rather than on the corporation as a whole. Because of this focus, the particular parties involved in any Approved Action are not relevant to the analysis. Thus, this loyalty provision would have to be met even when an Approved Action involved either an intergroup transaction or a transaction between a Business Group and a third-party entity in which no director had any interest. To the extent an Approved Action also implicated the traditional duty of loyalty — because, for example, a director who is a direct participant in a transaction with her corporation also happens to have a Disproportionate Equity Position at the time — compliance with both the duty of fairness and any applicable interested director statute would be required. This would ensure that any such Approved Action was fair to both the corporation as a whole and the various Business Groups of that corporation.

Under the duty of fairness, whether a particular director is "disinterested" is measured at the time the board or a committee approved the Action in question. Leaving aside the stock ownership requirements for the moment, either an Outside Director (defined in the usual sense of the term) or an Inside Director (also defined in the usual sense of the

256. *See supra* text accompanying notes 232-33.

term) can be "disinterested." However, an Inside Director's duties must run to all Business Groups or she will be disqualified regardless of her stock holdings.[257] With respect to the stock ownership requirements, a de minimis threshold of $100,000[258] ensures that, except as just indicated, those directors who own shares worth less than $100,000 in the aggregate will always be deemed "disinterested." If, however, a director owns shares worth $100,000 or more in the aggregate, then that director's proportional ownership must "reasonably reflect"[259] the same proportion that outstanding shares of all classes of tracking stock have to each other. A director's stock ownership is calculated on a fully diluted basis so that her stock options and related derivatives are always considered when determining whether she is disinterested.[260]

The second operative provision of Section (a) requires tracking stock directors to exercise a heightened degree of procedural due care when deciding whether to approve a particular Action. Before granting its approval, the board or a committee must have both received and considered such "Information" as is necessary to make an informed business judgment. Importantly, this is an objective test that allows a court to make an independent and impartial determination of whether the board or a committee took action prematurely based on inadequate information. Information considered by a board or a committee after an Action has been approved will not cure an uninformed business judgment.[261]

The amount of information that a tracking stock board or committee must receive and consider is designed to be materially greater than the amount of information normally received and considered by the board of a conventional corporation. This reflects the fact that, as a re-

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257. Thus, an Inside Director whose duties run only to one Business Group because, for example, she is an officer of that Business Group rather than an executive officer of the entire corporation will always be deemed interested regardless of her stock holdings.

258. The $100,000 figure, while arbitrary, is designed to ensure that those directors with limited stock ownership interests in the corporation are always assured a "Disinterested Director" designation. *Cf.* Gaimmalvo v. Sunshine Mining, No. CIV.A.12842, 1994 WL 30547 (Del. Ch. Jan. 31, 1994) (holding that mere ownership by directors of common stock did not create conflict that gave rise to fiduciary concerns in context of a transaction that had potential to benefit common stockholders at expense of preferred stockholders, at least in absence of allegation that directors' common stock ownership was substantial in relation to number of outstanding shares).

259. The term *reasonably reflect* is used to provide necessary wiggle room. It is designed to be a lower standard than *reasonably approximate*.

260. *See supra* note 144.

261. *Cf.* Smith v. Van Gorkom, 488 A.2d 858, 888 (Del. 1985) (ruling that consideration by board of pertinent information after a decision had been made did not convert an uninformed judgment into an informed one).

sult of any given decision, certain stockholder groups may come out as winners while others may come out as losers. This potential for divergent consequences underscores the need for tracking stock boards and committees to pay very close attention to the prospective impact that any Action will have on all interested parties.

"Information" is defined to mean all "materially relevant information" relating to any Approved Action. The definition of "Information," therefore, is purposely general in order to ensure flexibility in its application. However, the phrase "materially relevant information" is itself set forth in more specific terms. This was done so that a board or committee is forced to weigh at least the three significant pieces of information specified in clause (A) when considering any Action.

The first of these three pieces of information consists of all Beneficial and Detrimental Effects of the Approved Action. "Beneficial Effects," on the one hand, are the material positive consequences, or "pros," flowing from the approval of a given Action. "Detrimental Effects," on the other hand, are the material negative consequences, or "cons," flowing from the approval of a given Action. In either case, a board or committee must only consider those Effects that are reasonably foreseeable from an objective standpoint.

The second piece of information is all Beneficial and Detrimental Effects of any disapproved Action that the board or a committee reasonably believed to be a viable alternative to the Approved Action. Thus, the board or committee must affirmatively consider what it is giving up when it approves a given Action rather than any other viable alternative Action. Indeed, the definition of "Detrimental Effect" specifically includes all material opportunity costs associated with a disapproved Action, and, under the definition of "Approved Action," any viable alternative Action not approved by the board or committee is deemed to be disapproved. Importantly, only the effects of alternative Actions viewed as "viable" in the eyes of the board or committee at the time an Action is approved must be considered. This limitation purposely cuts off judicial second-guessing as to why a board or committee failed to consider an alternative Action revealed to be "viable" only with the benefit of hindsight.

The third piece of information is all Beneficial and Detrimental Effects of all previously approved and disapproved Actions that are materially relevant to the Approved Action. The goal behind requiring board or committee consideration of this information is to ensure that past Actions, whether approved or disapproved, are considered when deciding whether or not to approve an Action currently under consideration. By considering their past Actions, boards and committees will have the opportunity to discern patterns of favoritism and neglect and to take any appropriate corrective measures. Importantly, this is an objective test that allows the courts to address patterns of favoritism and neglect if a board or committee fails to do so. Courts, however, would review only previously approved and disapproved Actions that had a "material relevance" to the Approved Action at issue.[262]

One final point on "Information" must be made. Clause (B) of "materially relevant information" specifically requires the board or a committee to consider one highly relevant piece of information when deciding whether to approve an intergroup transaction. That piece of information is, with respect to each Business Group involved in such transaction, the board's or committee's reasonable judgment as to how a wholly independent board or committee of a stand-alone corporation with characteristics substantially similar to such Business Group would assess the transaction. In other words, the board or committee must "stand in the shoes" of a theoretical, wholly independent board or committee and make a reasonable judgment as to how that board or committee would assess the transaction under consideration.[263] If, standing in those shoes, the board or committee decides that the theoretical board or committee would vote against the transaction, then the actual board or committee must have a compelling reason to go ahead with it. Otherwise, the transaction would be highly suspect on fairness grounds.[264]

The purpose of the third operative provision of Section (a) is to provide a substantive review of the board's or committee's Approved Action. Unlike in a substantive due care review, mere "rationality" is not the standard against which a court will evaluate that Action.[265] Rather, concepts of fairness and reasonableness form the backdrop for this type of substantive review.[266] When evaluating a particular decision,

262. It is assumed that the relevance of any particular approved or disapproved Action diminishes as time passes.

263. *Cf.* Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994) ("[F]airness . . . can be equated to conduct by a theoretical, wholly independent, board of directors."(quoting Weinberger v. UOP, Inc., 457 A.2d 701, 709-10 n.7)).

264. *See Kahn,* 638 A.2d at 1115.

265. *See supra* text accompanying notes 201-04.

266. As Lawrence E. Mitchell wrote in his analysis of the "horizontal" conflicts arising between competing participants in a corporate capital structure, "fairness, properly applied, is supremely well-suited to a situation in which there exist competing claimants to the same property." Mitchell, *supra* note 15, at 475. Professor Mitchell has added that "[f]airness, as defined by and as used throughout our legal system, is a concept of balance, of proportionality among the parties to a transaction or proceeding." Mitchell, *supra* note 231, at 426. For a listing of the academic literature on fairness as used in the corporate context, see *id.* at 428 n.13.

however, a court will use a subjective test. That is, it will judge the fairness and reasonableness of the Approved Action through the eyes of the board or committee. If, after receiving and considering the requisite amount of Information in advance, a board or committee of Disinterested Directors "reasonably believed" the Approved Action was fair and reasonable to all involved, a court's inquiry will end. However, the reasonableness of the board's or committee's belief is inextricably tied to the Information considered by it. Therefore, if a court finds, based on such Information, that the board's or committee's belief is unreasonable, a plaintiff's challenge should prevail, unless one of the remedial provisions of Section (b) of the duty of fairness is satisfied.[267]

The third operative provision thus requires boards and committees to follow a balanced approach to decisionmaking that weighs both the benefits and detriments of Approved Actions, viable alternative Actions and previously approved or disapproved related Actions. Decisions made by a disinterested board or committee based on such a balanced approach will be deemed to be fair and reasonable, even if hindsight ultimately indicates otherwise. Importantly, "fair and reasonable" does not necessarily mean absolutely "equal,"[268] as "equality" is just one shade of fairness and reasonableness.[269] As stated earlier, requiring exactly equal treatment of the various Business Groups is a simplistic, im-

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267. An interesting parallel in this regard can be found by looking at how the courts evaluate challenges brought against corporations that have adopted defensive measures in a corporate takeover context. In this regard, the initial burden is on the directors to show that "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed" and that any defensive action taken by them was "reasonable in relation to the threat posed." Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955, 958 (Del. 1985); *see also* Moran v. Household Intl. Inc., 500 A.2d 1346, 1356 (Del. 1985); BALOTTI & FINKELSTEIN, *supra* note 7, § 4.6 (Supp. 1996).

268. Delaware law, in fact, has long recognized that different groups of stockholders need not always be treated equally for all purposes. *See* Nixon v. Blackwell, 626 A.2d 1366, 1376-77 (Del. 1993) (holding that establishment of employee stock ownership plan and key man life insurance programs that provided liquidity to employee stockholders but not nonemployee stockholders was valid); *Unocal,* 493 A.2d at 957 (holding discriminatory exchange offer was valid); Cheff v. Mathes, 199 A.2d 548, 554-56 (Del. 1964) (holding stock buyback of leading holder's shares at above-market price to be valid).

269. As Frank Easterbrook and Daniel Fischel have written:

> Many scholars, though few courts, conclude that one aspect of fiduciary duty is the equal treatment of investors. Their argument takes the following form: fiduciary principles require fair conduct; hence, fiduciary principles require equal treatment. The conclusion does not follow. The argument depends on an equivalence between *equal* and *fair* treatment.

FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 110 (1991).

practical solution that would likely lead all Business Groups down the path of mediocrity.

2. *Remedial Nature of Section (b)*

Section (b) of the duty of fairness contains fall back provisions to Section (a). In other words, it allows an Approved Action that has failed to meet the requirements of Section (a) nevertheless to be deemed fair and reasonable to all parties. Under Section (b), an imperiled Approved Action can be remediated, and thus directors can avoid liability, in one of two ways.

First, an imperiled Approved Action can be remediated through its subsequent ratification by the holders of a majority of shares of each class or series of capital stock, voting as a separate class or series. Thus, if an Approved Action fails to meet the requirements of Section (a) because, for example, directors did not consider the requisite amount of Information, subsequent stockholder ratification of the Approved Action will save it. For ratification to be effective, however, two things must occur. First, the holders of each class or series of capital stock, voting as a separate class or series, must ratify it. This means, among other things, that the group of stockholders most disadvantaged by the Approved Action must affirmatively ratify it. Second, the corporation must have provided its stockholders with such "Information" as is necessary for them to make an informed decision. In addition to the kinds of information previously discussed, clause (C) of "materially relevant information" requires that the corporation inform its stockholders of the nature and extent of the interest of any Interested Director.

Second, an imperiled Approved Action can be remediated through a judicial determination that it is fair and reasonable to all involved. This ensures the rightful remediation of an Approved Action that is otherwise fair and reasonable but which did not meet the requirements of Section (a) because, for example, a majority of Disinterested Directors failed to approve it. Unlike Section (a), which looks at fairness subjectively through the eyes of directors, Section (b) looks at fairness objectively through the eyes of a court. Thus, Section (b) provides a tougher standard of fairness than Section (a). This enhancement, coupled with the fact that the burden of proof is on directors, is designed to encourage directors to comply fully with the provisions of Section (a) when making decisions that can have materially disparate impacts on the various Business Groups and their stockholders.

D. *Practical Advice for Boards of Tracking Stock Corporations*

Tracking stock directors are not to be envied. As seen above, the corporate decisions and policies they make can have disparate impacts on the various business groups of their corporations and the trading value of the shares of stock linked to those groups. Sooner or later, the plaintiff securities bar will wake up to this fact and start bringing challenges that focus on those disparate impacts. When this happens, the courts will have to decide whether, as advocated in this article, tracking stock directors owe additional fairness-based duties to the stockholders of their corporations or whether the business judgement rule will prevail. Accordingly, it is naive — and risky — for tracking stock directors to make decisions and policies under the belief that the status quo will rule the day.

What, therefore, should a tracking stock corporation and its directors be doing to ensure victory in the coming showdown with the plaintiff securities bar? Several things come to mind. First and foremost, the corporation's board and committees should voluntarily satisfy the provisions of Section (a) of the duty of fairness described above. This means that board decisions must be made by "disinterested directors" as such term is defined by the duty of fairness. Tracking stock directors holding Disproportionate Equity Positions should modify their holdings so that their ownership ratios reasonably reflect the outstanding share ratio of the corporation. In addition, if any officer of that corporation is a member of the board, that officer should have duties running to the entire corporation. If she does not, then she should resign from the board immediately.

With respect to its decisionmaking process, a tracking stock board must take a proactive, balanced approach to evaluating alternative courses of action that can have disparate impacts. This means that a board should not only consider the pros and cons of all viable alternative courses of action, but that it should also view those alternatives in light of historical courses of action it previously considered and either took or rejected. Based on this information, the board should make decisions that it considers fair and reasonable to all involved.

In order to ensure that each stockholder group is adequately represented in the boardroom, a tracking stock corporation should consider allowing each group to nominate and elect at least one director at each annual meeting.[270] For example, if a given tracking stock corporation

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270. Ample precedent for this type of arrangement exists with respect to both common and preferred stockholders. *See* Lehrman v. Cohen, 222 A.2d 800 (Del. 1966); BALOTTI & FINKELSTEIN, *supra* note 7, § 4.4 (Supp. 1996). *See generally* FRANKLIN A.

has a board consisting of ten directors and the holders of its two classes of tracking stock hold 70% and 30% of the voting power, respectively, then a charter provision could be adopted that allows the 70% group to elect seven directors and the 30% group to elect the remaining three directors.[271] Just as most tracking stock corporations alter the voting power of their various stockholder groups at predetermined intervals based on changes in the relative market values of their different classes of tracking stock, so too could the number of directors that the various stockholder groups are entitled to elect be altered. In this way, every stockholder group will have elected at least one director to the board who will voice that group's concerns.

Clearly, this article contemplates that tracking stock directors will spend a greater amount of time and energy in overseeing tracking stock corporations than their counterparts will spend overseeing conventional corporations.[272] For this added burden no apology is forthcoming. Indeed, given the substantial concerns that arise in a tracking stock context, a lesser effort by tracking stock directors would be a true disservice to the stockholders who have placed their trust in them. Tracking stock directors are the proper parties to be charged with ensuring that the novel equity structures of their corporations work for all of their stockholders regardless of the business group to which their shares are linked.

Conclusion

This article has described a novel equity structure that employs tracking or targeted stocks. Through this structure shares of different classes of common stock are economically linked to the performance of distinct business groups operated by a tracking stock corporation. While the goal of implementing this equity structure is the enhancement of

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Gevurtz, Business Planning 424-25 (2d ed. 1995) (discussing the issuance of two or more classes of stock with differing voting rights). Indeed, Delaware law specifically provides for this: "The certificate of incorporation may confer upon holders of any class or series of stock the right to elect 1 or more directors who shall serve for such term, and have such voting powers as shall be stated in the certificate of incorporation." Del. Code Ann. tit. 8, § 141(d) (1991).

271. The best time to implement this type of charter provision is, of course, at the time a corporation implements a tracking stock equity structure.

272. At a minimum, tracking stock directors will have to become much more familiar with the financial statements of the various business groups of their corporations in order to make informed decisions that impact those groups. In addition, they must expect additional pressure from various stockholder groups whenever their corporations experience serious financial difficulties of the type that Kmart Corp. previously faced and most likely is still facing today. *See supra* text accompanying notes 252-54.

stockholder value, this structure carries with it the heavy baggage of intergroup conflicts. These conflicts raise substantial issues involving fairness and favoritism in directorial decisionmaking. In addition, new directorial loyalty concerns arise when directors hold Disproportionate Equity Positions.

The traditional fiduciary duties of care and loyalty were not designed to, nor do they, address these concerns. The duty of care and the business judgment rule only require directors to adhere to a minimal standard of care and prudence. The duty of loyalty, with its focus on the corporation as a whole, is ill-equipped to handle the disproportionate ownership problems of a tracking stock corporation that play out in unorthodox ways. While the traditional duties of care and loyalty can and should continue to play a role in the corporate governance of tracking stock corporations, a new duty is needed to ensure that directorial decisions and policies are made in a way that promotes fairness and reasonableness rather than favoritism and neglect.

This author advocates that a duty of fairness be adopted either statutorily or judicially. Until it is, tracking stock corporations should voluntarily comply with this duty. Compliance would be required whenever a tracking stock corporate board makes a decision or formulates a policy that will have a materially disparate impact on that corporation's business groups and related stockholders. Decisions and policies of this nature must be approved by directors who are "disinterested" in a tracking stock context. They should be based on a balanced approach to decisionmaking that requires a careful evaluation of the benefits and drawbacks of alternative courses of action. They should be made in the context of historical courses of action previously considered and either taken or rejected by the board in order to prevent patterns of favoritism and neglect from developing. Finally, they should be fair and reasonable to all parties in light of all the information before the board.