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Jeffrey J. Schick

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TOWARD TRANSACTION-SPECIFIC STANDARDS OF DIRECTORIAL FIDUCIARY DUTY IN THE TRACKING-STOCK CONTEXT

Jeffrey J. Schick

Abstract: In recent years, diversified corporations have increasingly turned to tracking stocks to uncouple high-growth businesses, especially Internet-related operations, from more static business entities. Tracking stock is a unique type of common stock that represents an interest in the financial performance of particular business groups within a diversified parent corporation. However, the tracked business groups are not independent of the parent corporation, and the parent's board of directors still governs the affairs of each business group. This creates unique conflicts for directors who must please multiple groups of stockholders whose interests are not always consistent. Delaware courts have not announced a clear standard for dealing with directorial duties in the tracking-stock context. The three existing legal standards of corporate governance—the traditional fiduciary analysis, a contractual approach, and an entire-fairness evaluation—are individually inadequate when applied to the unique directorial conflicts arising in corporations with tracking stock. This Comment argues that Delaware courts should apply different standards of review to directorial decisions involving tracked business groups depending upon the nature of the transaction. Where the directorial decision involves primarily contractual arrangements, such as the repurchase of stock or the payment of dividends, courts should not grant tracking stockholders fiduciary protections. If the decision involves the allocation of corporate opportunity or resources, courts should apply the fiduciary principles of care and loyalty, ensuring that directors do not have a material self-interest in the transaction. Finally, if the directorial decision involves inter-group dealings, courts should require directors to demonstrate the entire fairness of the transaction regardless of whether the board was interested in the transaction.

After a decade of dormancy, tracking stock[1] has seen a revival in recent years and has recaptured the eye of Wall Street.[2] Companies such as Sprint; Donaldson, Lufkin & Jenrette; Disney; Ziff-Davis; and Circuit City have all recently issued tracking stocks.[3] Over a dozen major corporations, including AT&T, Staples, The New York Times, J.C.

1. Tracking stock, also known as "lettered" or "targeted" stock, is defined as stock tied to the financial performance of a particular segment of a corporation's business. *See* Adam Lashinski, *Will the Boom in Tracking Stocks Derail Investors?*, Fortune, Jan. 10, 2000, at 210–12.

2. Tracking stock is not a new phenomenon. The first tracking stocks were issued in the mid-1980s by General Motors to track its former Electronic Data Systems and Hughes Aircraft subsidiaries. *See* Jeffrey J. Hass, *Directorial Fiduciary Duties in a Tracking Stock Equity Structure: The Need for a Duty of Fairness*, 94 Mich. L. Rev. 2089, 2089 n.2 (1996).

3. *See* Susan Scherreik, *Tread Carefully When You Buy Tracking Stocks*, Bus. Wk., Mar. 6, 2000, at 182.

Penny, Dupont, and Cendant, among others, are in the process of issuing tracking stock.[4]

Because tracking stock creates groups of stockholders within a corporation with potentially competing interests[5] and tasks a single board of directors with governing the interests of these groups,[6] tracking stock can create decision-making nightmares for a board of directors. Delaware courts have not provided guidance to these boards, having twice examined the duties directors owe to tracking stockholders and having twice declined to establish a clear standard.[7]

Although Delaware courts have attempted to apply the traditional fiduciary duties of care[8] and loyalty[9] to directors in corporations issuing tracking stock, they have also suggested that duties owed by directors to tracking stockholders are analogous to the directorial duties owed to preferred stockholders[10] or to minority stockholders[11] in a controlled subsidiary.[12] Directorial duties owed to preferred stockholders are predominantly contractual and defined by the terms of the corporation's articles of incorporation.[13] In the case of minority stockholders in a

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4. *See id.*

5. *See* Hass, *supra* note 2, at 2118.

6. *See, e.g.*, Donaldson, Lufkin & Jenrette, Inc., Prospectus, at 10 (filing date May 26, 1999).

7. *See generally* Solomon v. Armstrong, 747 A.2d 1098 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000); *In re* General Motors Class H Shareholders Litig., 734 A.2d 611 (Del. Ch. 1999).

8. *See infra* notes 90–92 and accompanying text.

9. *See infra* notes 93–96 and accompanying text.

10. *See infra* note 128 and accompanying text.

11. Minority shareholders are shareholders of a corporation who hold too few shares of the corporation's total outstanding stock to control the management of the corporation. *See Black's Law Dictionary* 1012 (7th ed. 1999).

12. *See Solomon*, 747 A.2d at 1123.

13. *See* Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (And Why We Should Care About It)*, 51 Bus. Law. 443, 448 (1996). "Articles of incorporation" and "certificate of incorporation" refer to the basic instrument filed with the secretary of state to establish the existence of the corporation. *Black's Law Dictionary* 107 (7th ed. 1999). The contents of this document are prescribed by statute, and include the corporation's name, purpose, authorized number of shares, classes of stock, and additional conditions of operation. *See id.* This Comment will use "articles of incorporation" when referring to this instrument.

controlled subsidiary, the decisions of directors are subject to an evaluation of the entire fairness[14] of the transaction.[15]

This Comment argues that the traditional fiduciary analysis, the contractual approach applied to preferred stockholders, and the entire-fairness evaluation used in the case of parent-subsidiary dealings are each insufficient legal standards when applied to directorial conflicts in the tracking-stock context. This Comment proposes that courts apply a combination of these three legal standards depending on the transaction entered into by the corporation. Part I of this Comment introduces tracking stock and explains the rationale behind its use. Part II discusses the unique conflicts that directors of corporations with tracking stock face. Part III summarizes three possible legal approaches to these conflicts—a traditional fiduciary analysis, a purely contractual approach, and an entire-fairness evaluation—and examines the Delaware courts' efforts to apply these approaches to the tracking-stock context. Part IV evaluates the effectiveness of these three approaches and argues that each of these legal approaches is individually inadequate when applied to tracking stock. Part V argues that courts should focus on the nature of the transaction within the corporation when determining the rights of tracking stockholders.

I. AN INTRODUCTION TO TRACKING STOCK

A. *The Tracking-Stock Equity Interest*

Tracking stock is a separate class of common stock.[16] Like conventional classes of common stock, tracking stock represents an equity interest in the underlying assets of the corporation as a whole.[17] Unlike conventional classes of common stock, however, which track the financial performance of the corporation as a whole, tracking stock

14. *See infra* notes 97–103 and accompanying text.

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

16. Common stock refers to "an equity security that has voting rights and is entitled to share in the residual assets of the corporation on liquidations after the claims of creditors and other classes of stock are satisfied." R. Franklin Balotti & Jesse A. Finkelstein, *Delaware Law of Corporations & Business Organizations* § 5.4, at 5–7 (Supp. 2000).

17. *See* Hass, *supra* note 2, at 2094–95.

derives its value from the performance of a single "business group"[18] within the diversified[19] parent corporation.[20] A board creates tracking stock by inserting provisions into the company's articles of incorporation that define the components of the business group and the particular rights of each class of tracking stock.[21] The board may then choose to exchange existing common stock for shares of tracking stock in each of the new business groups[22] or may simply redefine the interest of existing common stockholders to exclude a particular line of business and offer tracking stock in the excluded business group to the public.[23]

The performance of a tracked business group is based on the earnings performance and growth potential of the targeted business group.[24] Stockholders invest in tracking stock on the premise that a particular business group is—or has the potential to be—more profitable than the corporation as a whole.[25] A corporation will often issue tracking stock to

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18. "Business groups" are artificial designations limited only by the imagination of the parent corporation. Once a corporation adopts a tracking-stock structure, the entire corporation is divided into groups that may include any combination of subsidiaries, geographic segments, or product lines. *See, e.g.*, Staples, Inc., Proxy Statement, at 3 (filing date Oct. 12, 1999) (creating one class of stock for Staples.com, an Internet business, and separate class for Staples retail stores and delivery services); Donaldson, Lufkin & Jenrette, Inc., *supra* note 6, at 5 (creating DLJdirect to track on-line investment house and DLJ to track conventional investment house); Sprint Corp., Prospectus, at 3–5 (filing date Feb. 5, 1999) (creating PCS business group to track only performance of wireless services and separate FON business group to track performance of all other phone services—long distance service, local service, product distribution and directory publishing activities, and other telecommunications activities).

19. "Diversified" refers to any corporation operating two or more unrelated lines of business. *See* Hass, *supra* note 2, at 2094 n.14.

20. *See, e.g.*, Sprint Corp., *supra* note 18, at 3 (explaining that PCS Stock was intended to reflect separately performance of PCS Group and FON Stock was intended to reflect performance of FON Group).

21. *See* Hass, *supra* note 2, at 2095.

22. *See* J. Roland Shiff, *Virtual Spinoffs: Utilizing Tracking Stock to Decouple Lines of Businesses*, Tax Management Memorandum, Washington, Jan. 18, 1999, at S3–S6 (on file with author).

23. *See, e.g.*, Donaldson, Lufkin & Jenrette, Inc., *supra* note 6, at 3 (redefining DLJ common stock to exclude interest in performance of on-line services of DLJdirect and offering DLJdirect for sale to public).

24. *See* Hass, *supra* note 2, at 2094–95.

25. *See* Lisa Reilly Cullen, *Tracking Stocks: No Free Ride*, Money, Oct. 1999, at 52A.

harness investors' enthusiasm for a particular line of business.[26] For example, Sprint Corp. issued a separate class of stock to track its wireless services division in response to the skyrocketing popularity of wireless communications.[27]

Although tracking-stock investors are entitled to dividends based on the earnings of the targeted business group,[28] investors are usually more interested in the growth potential of the share value of the tracking stock.[29] Because tracking stock generally tracks a "hot" industry or line of business, investors are quick to invest in the tracking stock and share value rises rapidly.[30] However, many of these emerging businesses expend significant resources developing the business or expanding market share[31] and the tracked business groups may not be immediately profitable.[32] Moreover, because many targeted business groups only contemplate long-range profits,[33] dividend or other forms of payment are not immediately available to tracking stockholders.[34]

Tracking stockholders invest in the performance of a business group but do not acquire a direct ownership interest in the underlying assets of the business group.[35] Rather, the assets of the business group are still owned by the corporation as a whole.[36] This potentially limits the tracking stockholders' claims to the assets of their particular business group upon liquidation of that group because the assets must be divided among all classes of common stockholders.[37]

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26. *See* Lashinski, *supra* note 1, at 210–12.

27. *See* Sprint Corp., *supra* note 18, at 2–5.

28. *See, e.g.*, Donaldson, Lufkin & Jenrette, Inc., *supra* note 6, at 22.

29. *See* Hass, *supra* note 2, at 2107 n.58.

30. In the year following Sprint's decision to issue tracking stock, Sprint PCS wireless tracking stock saw a 400% increase in value, while the value of Sprint's FON stock increased 95%. *See* Fred Barbash, *Unease with Tracking Stocks*, Wash. Post, Dec. 5, 1999, at H1.

31. Many tracking stocks, especially those competing in the Internet environment, focus on growth rather than profit. *See* Allan Sloan, *Companies Creating New Coin in Push to Enter the Internet Realm*, Wash. Post, July 20, 1999, at E3.

32. *See* Gregory Dalton, *The e-Business Dilemma*, Info. Wk., Oct. 11, 1999, at 22–24.

33. In this respect, tracking stock does not differ from conventional classes of common stock in a risky or emerging business. *See* Sloan, *supra* note 31, at E3.

34. Such growth-oriented tracking stocks often inform investors that dividends will not be contemplated "in the foreseeable future." Sprint Corp., *supra* note 18, at 12.

35. *See* Hass, *supra* note 2, at 2096.

36. *See id.* at 2097.

37. In addition, these assets may first be subject to the claims of creditors and preferred stockholders. *See id.*

B. *Reasons for Issuing Tracking Stock*

Tracking stock has become an attractive option for corporations for a number of reasons. Corporations that engage in multiple business ventures have looked to tracking stock as a means of unveiling the true value of their businesses by uncoupling high-growth businesses from more static companies. Recently, tracking stock has also gained favor as a new form of currency, both to acquire other businesses and to lure valuable employees from competing businesses.

1. *Tracking Stock as a Mechanism for Unlocking Share Value*

Tracking stock is commonly believed to "unlock" the hidden value of corporations.[38] A diversified parent corporation may believe that investors are simply unable to assess the various holdings of the parent accurately, thereby undervaluing the true potential of the corporation's stock.[39] Investors may not have the information or time necessary to evaluate properly the value of businesses in a corporation's complex financial reports.[40] By issuing stock that tracks a particular business group, corporations are able to highlight their most valuable businesses and better educate the market.[41]

For many companies, the development of Internet commerce has intensified the desire to unlock Internet businesses from the corporation as a whole. Internet companies are scrambling to expand their market share, sustaining heavy losses in the process.[42] Investors in Internet

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38. *See* Lashinski, *supra* note 1, at 210–12.

39. *See* Harry Berkowitz, *The Cutting Edge: Cablevision Systems Plans Tracking Stock*, L.A. Times, Dec. 23, 1999, at C7.

40. *See* Lashinski, *supra* note 1, at 210–12.

41. For corporations that have established reputations in now failing markets, tracking stocks are especially popular. For example, Quantum, known primarily as a disk-drive manufacturer, has struggled in connection with a downswing in the personal-computer and server market. However, Quantum also manufactures tape drives, a thriving market within data storage. One market analyst noted that "the value of Quantum's parts is greater than the whole . . . [a]nd Quantum wants to make investors aware of this." Timothy Kendall, *Show Me the Money*, Forbes ASAP, May 31, 1999, at 22.

42. *See* Dalton, *supra* note 32, at 22–24 (noting that heavy investment in Internet technology, marketing, and employees often generates pre-tax loss even in the most successful Internet companies).

companies not owned by traditional brick-and-mortar businesses anticipate these losses.[43] In contrast, investors in a corporation that owns both Internet businesses and brick-and-mortar operations may be more focused on the bottom line,[44] and the losses from an Internet-focused group may reflect poorly on the share value of the corporation as a whole.[45] By issuing tracking stocks, a diversified corporation is able to create separate financial statements for its Internet endeavors and brick-and-mortar operations, thus clarifying investors' perceptions regarding the respective financial status of each business within the corporation.[46]

2. *Tracking Stock as an Acquisition Tool*

Currently, corporations most commonly employ tracking stock as an additional means of generating capital for the acquisition of other businesses.[47] Corporations may generate cash from the public offering of tracking stock[48] or use the tracking stock itself as consideration in future acquisitions by exchanging tracking stock for stock in the acquired corporation.[49] Because tracking stock may raise the share value of a diversified corporation's common stock by unlocking the value of a particular business group,[50] corporations may make larger acquisitions with less stock.[51]

The development of the Internet has fueled the popularity of tracking stock as a tool of acquisition.[52] The rapid growth of Internet commerce

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43. *See* Sloan, *supra* note 31, at E3 (stating that investment in Internet companies is "about potential, hype and, in many cases, moonbeams. To the extent that numbers matter, they're numbers like revenue or site visits. Profits? What are those?").

44. Dalton, *supra* note 32, at 22–24 ("'Traditional brick-and-mortar investors don't understand losses associated with building an Internet business.'") (quoting Mark McDade, partner at PricewaterhouseCoopers).

45. *See id.* ("'It's hard to run a big dot-com company inside a company that's measured by earnings per share . . . . You have to limit how much you invest because every dollar spent affects earnings.'") (quoting Terry Jones, CEO of Saber Inc.'s Travelocity on-line unit).

46. *See, e.g.*, Staples, Inc., *supra* note 18, at 42.

47. *See* Allan Sloan, *Why AT&T is Feeding Ducks*, Newsweek, Dec. 13, 1999, at 71.

48. *See* Shiff, *supra* note 22, at S3–S6.

49. *See* Sloan, *supra* note 47, at 71.

50. *See supra* Part I.B.1.

51. *See* Sloan, *supra* note 47, at 71 ("Issuing stock is how AT&T can pay more than $100 billion for cable-TV companies and WorldCom can pay $115 billion for Sprint, the big long-distance and wireless company.").

52. *See* Sloan, *supra* note 31.

and the intense competition for market space provide companies little time to develop new markets on their own[53] and increase the importance of expansion through the acquisition of established companies.[54] Yet, the acquisition of Internet companies with brick-and-mortar stock is often impractical because corporations are reluctant to use stock in earnings-based companies to acquire revenue-based[55] Internet companies.[56] Further, Internet companies may be fearful that their growth potential will be swallowed by a diversified corporation.[57] Tracking stock helps resolve this dilemma by allowing a diversified corporation to issue a separate class of stock for its revenue-based businesses and to trade that stock for Internet businesses.[58]

3. *Tracking Stock as Employment Compensation*

The Internet environment has spawned a third use of tracking stock—compensation for employees.[59] The limited pool of top Web designers, programmers, operators, and executives has made it difficult for Internet companies to retain talented employees.[60] Many companies have turned to offering tracking stock as a means of luring and retaining employees with the potential of lucrative stock options, which might be diluted with

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53. *See* Dalton, *supra* note 32, at 22–24.

54. *See id.* ("'Five years ago, we had the time to look at expanding into other markets . . . . Now it's about protecting your vertical focus and then partnering for the rest.'") (quoting Mack Tilling, CEO of Instill Corp., a company working to establish on-line link between food distributors and restaurants).

55. "Revenue-based" businesses are fledgling businesses that generate substantial revenue but have been unable to turn a profit because of the operating expenses that accompany an emerging business. *Cf.* Sloan, *supra* note 31.

56. *See id.* ("'If you use your earnings-based stock to acquire a revenue-based property, . . . they say your earnings are suffering, and they mark your shares down.'") (quoting Tom Staggs, Disney Corp.'s chief financial officer).

57. *See id.*

58. *See id.* ("'We've got to get more wampum. That means we've got to have more 'dot-coms.' Then we can trade our paper for somebody else's paper.'") (quoting General Electric Co. Chairman Jack Welch).

59. *See* Peter Coy, *Tracking Stocks are Accidents Waiting to Happen*, Bus. Wk., Aug. 22, 1999, at 33.

60. *See id.* (noting that Disney Corp. lost top executives to Internet startups).

common stock.[61] While tracking stock has allowed companies to retain top employees, in addition to unlocking the share value of business groups and creating currency for the acquisition of other companies, it has generated new problems for corporate directors.

II. POTENTIAL DIRECTORIAL CONFLICTS IN TRACKING-STOCK CORPORATIONS

Despite its apparent advantages, tracking stock presents directors with unique hurdles that are not prevalent in conventional corporations.[62] In a conventional corporation, all classes of stock share a unified financial interest.[63] All classes of stock derive their share values from the financial performance of the corporation as a whole,[64] which reflects the aggregate of the individual performances of the business groups within the corporation.[65] Thus, if the directors of the corporation make a decision that favors one business group at the expense of the others, but the corporation's value as a whole is increased, each class of stockholders is satisfied.[66]

Like conventional corporations, corporations with tracking stock are governed by a single board of directors.[67] However, in corporations with tracking stock, directors face groups of stockholders with substantially divergent interests.[68] By definition, tracking stock creates classes of stock that derive their value from different parts of the corporation, not from the corporation as a whole.[69] This apportionment places directors in a position of simultaneously maximizing the wealth of multiple business groups within the corporation.[70]

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61. *See* Bruce Orwall, *Disney Agrees to Buy Majority Stake in Infoseek*, Wall St. J., July 13, 1999, at B7 (noting that Disney's inability to offer stock options in Internet company hampered its efforts to recruit top workers).

62. *See* Hass, *supra* note 2, at 2091.

63. *See id.* at 2114.

64. *See id.*

65. *See id.* at 2094–95.

66. *See id.* at 2114.

67. *See, e.g.*, Donaldson, Lufkin & Jenrette, Inc., *supra* note 6, at 10.

68. *See* Hass, *supra* note 2, at 2118.

69. Because tracking stock derives its value only from a particular business group, holders of that stock have little interest in the financial success of other business groups or the corporation as a whole. *See supra* Part I.A.

70. This dilemma has caused some boards to reject tracking stocks. *See* Gregory Dalton, *Companies Seek Easier Money With Net Issues*, Info. Wk., Oct. 4, 1999, at 181; *see also* Hass, *supra*

Tracking stock further complicates the directors' position by creating an opportunity for directors to obtain disparate financial interests in different business groups within the corporation.[71] If a director owns a disproportionate interest, in percentage and value, in certain classes of stock, that director has a personal financial interest that could compromise the decision-making process with respect to competing business groups.[72]

Directorial conflicts predominantly arise in three situations. First, directors face potential conflict whenever they must allocate corporate assets, resources, opportunities, or personnel to one business group at the expense of another. Second, directors encounter conflicted interests among stockholders when repurchasing stock or paying dividends on one class of stock. Third, directors face potential conflict whenever they negotiate contracts between two business groups within the corporation.

A. Conflicts Arising from the Allocation of Corporate Resources, Assets, and Opportunities

Whenever the board of a corporation with tracking stock is required to allocate corporate assets, resources, opportunities, or personnel between business groups, the board potentially favors one group of stockholders at the expense of another.[73] To illustrate this point, suppose Tracking-Stock Corporation (TSC) is composed of Business Group A (Group A) and Business Group B (Group B). Group A stock tracks Internet Company, an on-line electronics store, while Group B stock tracks Brick-and-Mortar Company, an off-line electronics store. TSC directors must allocate limited resources between Group A and Group B. For example,

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note 2, at 2118 (stating that "substantial divergence of financial interest that exists between different classes of tracking stock sets the stage for a potentially explosive sibling rivalry").

71. It is not uncommon for directors to own disproportionate interests in classes of stock. *See, e.g.*, Donaldson, Lufkin & Jenrette, Inc., *supra* note 6, at 11.

72. *See* Hass, *supra* note 2, at 2132–39 (discussing methods of calculating disproportionate equity positions among directors).

73. Although the directors of conventional diversified corporations are faced with the same decisions regarding the allocation of resources, opportunities, and personnel, their only concern is the impact of those decisions on the corporation as a whole—not on particular business groups. *See* Hass, *supra* note 2, at 2121 n.97.

the TSC board of directors must allocate a limited amount of capital and credit. If the supply of capital or credit is exhausted to satisfy the demands of Group A, the projects of Group B will not be undertaken.[74]

Conflict also arises whenever directors redistribute corporate assets among business groups.[75] Suppose the TSC board discovers that computer sales have declined at Brick-and-Mortar Company but are extremely popular on-line. The board might allocate the resources of its computer-manufacturing subsidiary exclusively to Group A to encourage the on-line sales of computers. While this decision may benefit the overall performance of TSC and the performance of Group A stock, it is clearly to the detriment of the owners of Group B stock.[76]

Directors must also make difficult decisions when allocating corporate opportunities among business groups. The most significant conflicts arise when two business groups engage in substantially similar businesses.[77] For example, suppose that a school district approaches TSC with an offer to purchase 2000 computers. TSC's board of directors must then decide which business group accepts the offer. If the corporate opportunity is substantial enough, the loss of that opportunity by one business group may cause its stock value to fall.[78]

Directors may also injure one class of stockholders when seizing corporate opportunities that pose a significant risk for a particular business group.[79] A high-risk business venture may present the possibility of tremendous profit to a particular group. Yet, because the tracked business groups within a corporation share liabilities with one

74. *Cf. id.* at 2121.

75. Recently acquired business groups may be especially at risk if "old-school" management is reluctant to share resources with a new business. Marcia Vickers, *Are Two Stocks Better Than One? Tracking Stocks Mix Blue-Chip Securities with Sky-High Value—But There is a Downside*, Bus. Wk., June 28, 1999, at 98.

76. A similar scenario arises, for example, when TSC's board determines that an executive of one business group would be more valuable running the affairs of another.

77. *See* Hass, *supra* note 2, at 2122. This conflict is increasingly common as corporations issue tracking stock for brick-and-mortar companies and Internet companies engaged in the same business. *See, e.g.*, Donaldson, Lufkin & Jenrette, Inc., *supra* note 6, at 14 ("DLJ and DLJdirect are both engaged in brokerage and related investment service businesses. DLJ is not restricted from competing with DLJdirect and there can be no assurance that DLJ will not expand its operations to compete with DLJdirect.").

78. *See* Hass, *supra* note 2, at 2123.

79. *See, e.g.*, Nikhil Deogun, *Pittson Plans to Sell Coal Business and Scuttle Its Tracking-Stock Effort*, Wall St. J., Dec. 6, 1999, at B16 (noting that coal businesses "cast a shadow" on other two tracked business groups).

another, but not profits, the risk may not be in the best interest of the corporation as a whole.[80]

B. Conflicts Arising from Stock Repurchases or Dividend Payments to One Class of Stockholders

Whenever a board of directors of a corporation with tracking stock decides to repurchase shares of a single class of common stock or authorizes dividend payments on one class of common stock, the board faces groups of stockholders with potentially divergent interests.[81] Because the corporation owns the assets of the business group,[82] directors must use the wealth of the corporation as a whole for stock repurchases and dividend payments.[83] This reduces the pool of corporate funds available to other groups of stockholders and creates financial conflict among classes of stockholders.[84]

C. Conflicts Arising from Transactions Between Competing Business Groups Within a Tracking-Stock Corporation

Directors also face the prospect of dissatisfied stockholders whenever the board negotiates transactions between business groups within a corporation using tracking stock.[85] One business group may look to another group within the corporation for credit, assets, or services. One group's receipt of a "good deal" may be at the financial expense of another class of stockholders.[86] For example, suppose Staples, Inc. used its retail delivery trucks to deliver products purchased from Staples.com, its on-line business. Because the business group for Staples.com does not

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80. *See id.*

81. *See, e.g.*, Donaldson, Lufkin & Jenrette, Inc., *supra* note 6, at 22.

82. *See id.*

83. *See id.* at 70.

84. *See id.*

85. *See* Hass, *supra* note 2, at 2126 n.115 (noting that transactions parallel "common director" transactions—transactions between two corporations that have one or more common directors on their boards—governed by duty of loyalty).

86. *See id.*

include delivery services,[87] stockholders of tracking stock in Staples.com would receive free delivery services while stockholders of tracking stock in Staples' retail stores and delivery services would provide a service without compensation.

In light of these potential conflicts, stockholders need some assurance that directors will not subvert stockholder interests for self-interested reasons. Likewise, directors must be able to navigate the minefield of inter-stockholder conflict with some degree of protection. The Delaware Court of Chancery has twice encountered the unique directorial concerns present in tracking stock corporations and, on both occasions, avoided the application of a single, definitive legal standard.[88] Thus, directors and stockholders in corporations issuing tracking stock continue to ponder the same question: What duties do directors owe to tracking stockholders?

III. POSSIBLE SOLUTIONS TO DIRECTORIAL CONFLICTS IN CORPORATIONS WITH TRACKING STOCK

At least three existing legal standards for corporate governance present possible solutions for defining the scope of directorial duties in corporations issuing tracking stock. First, courts could treat corporations issuing tracking stock identically to conventional corporations, applying the traditional fiduciary duties of care and loyalty to the problems presented by inter-group conflict. Second, courts could choose to treat tracking stockholders similar to preferred stockholders and look primarily to the certificate of incorporation to determine the legal rights of these holders. Third, the court could treat tracked business groups as controlled subsidiaries of a parent corporation, granting holders of tracking stock the same rights and protections as minority stockholders in a controlled subsidiary.

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87. *See* Staples, Inc., *supra* note 18, at 3.

88. *See* Solomon v. Armstrong, 747 A.2d 1098 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000); *In re* General Motors Class H Shareholders Litig., 734 A.2d 611 (Del. Ch. 1999).

A. *Traditional Fiduciary-Duty Analysis and its Application in the Tracking-Stock Context*

1. *Fiduciary Duties of Care and Loyalty*

Corporate directors owe stockholders the fiduciary duties of care and loyalty.[89] The duty of care ensures that corporate directors are adequately informed about the affairs of their corporation by requiring review of pertinent information before making business decisions, as well as proper monitoring of the activities of the corporation.[90] Under the business judgment rule, courts will not disturb a board's decision as long as the directors show that they "'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.'"[91] This rule reflects the view that directors are better equipped than judges to make corporate decisions.[92] The duty of loyalty ensures that the interests of stockholders are not subordinated to the personal interests of a corporation's directorship.[93] Self-interested transactions[94] are not initially subject to the protection of the business judgment rule.[95] If a challenging stockholder demonstrates a material conflict of interest between the corporation and a majority of its directors, the burden shifts to the defendant directors to prove the entire fairness of the transaction.[96]

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89. *See* Balotti & Finkelstein, *supra* note 16, § 4.35, at 4-232.

90. *See id.* § 4.34, at 4-215 to 216

91. Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

92. *See id.*

93. *See* Balotti & Finklestein, *supra* note 16, § 4.35, at 4-233.

94. "Self-interested transactions" refer to those situations in which directors stand on both sides of the transaction. *See id.* Delaware has enacted a statute to govern self-dealing by directors. *See* Del. Code Ann. tit. 8, § 144(a) (2000). Under this statute, no contract or transaction is void solely because an interested director voted on the matter if the contract or transaction was (1) approved by a disinterested quorum of directors, (2) approved in good faith by an informed vote of shareholders, or (3) fair as to the corporation at the time of the transaction. *See* Del. Code Ann. tit. 8, § 144(a).

95. *See* Lewis v. S.L. & E., Inc., 629 F.2d 764, 769 (2d Cir. 1980) ("[T]he business judgment rule presupposes that the directors have no conflict of interest.").

96. *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995); *see also* Weinberg v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) ("When directors . . . are on both sides of a transaction,

The concept of entire fairness has two aspects: fair dealing and fair price.[97] Fair dealing is essentially a procedural inquiry focusing on "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 were obtained."[98] Fair price examines the substance of the 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."[99] Because fair dealing is generally easier to determine than fair price,[100] entire fairness is predominantly an evaluation of the procedure employed by the directors.[101] Although the burden initially rests on the directors to prove the entire fairness of the transaction,[102] self-dealing directors may reclaim the protections of the business judgment rule by a showing that the transaction was ratified by a majority of fully informed stockholders.[103]

2. *Delaware's Application of the Duty-of-Loyalty Test in the Tracking-Stock Context*

In *General Motors Class H Shareholders Litigation*,[104] the Delaware Court of Chancery held that traditional fiduciary duties do apply in the tracking-stock context[105] and dismissed each of the plaintiffs' claims.[106] *General Motors* involved complaining shareholders challenging a series of transactions (the "Hughes Transactions") that restructured the Hughes Electronics business group associated with their tracking stock.[107] In

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they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.").

97. *See* Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993).

98. *Weinberg*, 457 A.2d at 711.

99. *Id.*

100. Even in the case of fungible objects traded in an efficient market, there are no perfect models for identifying fair price. *See* Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 Duke L.J. 425, 473–74 (1993).

101. *See id.*

102. *See* Smith v. Van Gorkom, 488 A.2d 858, 892 (Del. 1985).

103. *See id.*

104. 734 A.2d 611 (Del. Ch. 1999).

105. *See id.* at 619 ("Although the particular features of the classes of stock involved in an individual case may have significance, the general fiduciary principles are the same.").

106. *See id.*

107. *See id.* at 616.

addition to other claims,[108] the shareholders alleged that General Motors directors used an unfair process to establish the terms of the Hughes Transactions and thereby breached their fiduciary duties in apportioning proceeds of the transactions among holders of the Hughes tracking stock and shareholders of other General Motors common stock.[109] The shareholders further claimed that General Motors directors failed to inform themselves about the value of and rights attached to the tracking stock, coerced the tracking-stock shareholders to vote for the Hughes Transaction, and attempted in bad faith to deprive tracking-stock holders of their premium under a provision in the certificate of incorporation.[110]

Although the opinion dealt summarily with the duty-of-care claims,[111] the court offered significant discussion of the duty of loyalty.[112] In determining when the duty of loyalty is triggered, the court rejected the argument that stockholders may establish a material conflict of interest merely by alleging that directors of a corporation with tracking stock treated one business group unfairly or that a director had a disproportionate interest in one class of tracking stock.[113] The court held that the protection of the business judgment rule remains intact unless the director's disproportionate interest in a particular class of stock is material.[114] A disproportionate interest is not material unless the directors' stockholdings "were so substantial as to have rendered it improbable that those directors could discharge their fiduciary obligations in an even-handed manner."[115] Because the plaintiffs failed to plead specific facts demonstrating the materiality of interests of the

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108. *See id.* at 615 (alleging breach of contract and breach of duty of disclosure claims).

109. *See id.* at 616.

110. *See id.*

111. *See id.* (acknowledging possibility of duty of care claims but dismissing such claims without significant discussion because General Motors had exculpatory provision in its certificate of incorporation barring duty-of-care claims against directors).

112. *See id.* at 616–19.

113. *See id.* at 618.

114. *See id.*

115. *Id.* The court may look to the director's financial circumstances to determine the materiality of the holdings. *See id.* at 617.

members of the General Motors board of directors,[116] the court held that the Hughes Transactions were protected by the business judgment rule.[117]

Three days after the decision in *General Motors*, the court in *Solomon v. Armstrong*[118] again rejected duty-of-loyalty claims—this time in the context of a corporation's decision to spin off a tracked business group.[119] In *Solomon*, plaintiff shareholders alleged that General Motors directors had breached the duty of loyalty in connection with the spin-off of Electronic Data Systems (EDS), a business group tracked by General Motors Class E Common Stock.[120] The shareholders alleged that the spin-off amounted to a self-dealing transaction, that the negotiation process did not provide a fair approximation of an arm's-length dealing, and that the directors disseminated materially misleading information about the spin-off and failed to inform the shareholders that consent to the spin-off constituted a waiver of their recapitalization right.[121] The court applied the business judgment rule to the board's decision to spin-off EDS[122] and dismissed the duty-of-loyalty claims.[123] As in *General Motors*, the court found that the complaining shareholders did not allege facts demonstrating that the personal financial interests of the directors were sufficiently material to bias the decision-making process.[124]

In addition to restating the materiality requirement set forth in *General Motors*,[125] the *Solomon* court examined whether directors owe fiduciary duties to each group of shareholders individually or to the corporation itself.[126] The court concluded that the process for allocating value must

116. *See id.* at 617.

117. *See id.* at 616.

118. 747 A.2d 1098 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000).

119. *Id.* at 1106.

120. The spin off provided for a one-to-one exchange of General Motors Class E stock for EDS shares, new information-technology service agreements, and a $500 million lump-sum cash-transfer payment from EDS to General Motors. *See id.*

121. *See id.* at 1106 (explaining shareholders' recapitalization right, which provided that tracking stockholders receive General Motors common stock worth 120% of market value of their tracking stock in event that tracked business group was recapitalized, sold, transferred, or assigned to any entity in which General Motors was not majority owner).

122. *See id.* at 1117.

123. *See id.* at 1117–18.

124. *See id.* at 1118 ("[I]t is well established that when a party challenges a director's action based on a claim of the director's debilitating pecuniary self-interest, that party must allege that the director's interest is material to that director.").

125. *See id.* at 1123–24.

126. *See id.*

be reasonably aimed at providing a fair result to all shareholders taken together and to each and every class of shareholders taken separately.[127] However, this conclusion provides little protection for shareholders when the allocation process, regardless of its impartiality, produces consistently unfair results.

B. *Treatment of Preferred Stockholders and the Application of the Contractual Approach Toward Tracking Stock*

The courts' treatment of preferred stockholders provides another possible standard to determine the directorial duties owed in the tracking-stock context. Preferred stock is stock that derives certain advantages over common stock from a corporation's charter.[128] The advantages often take the form of priority upon liquidation or payment of dividends.[129] Unlike common stockholders, whose dividends depend on capital appreciation or increased profits of the corporation, preferred stockholders usually realize gain from fixed dividends.[130] The payment of these fixed dividends is similar to interest on a loan; in this respect, preferred stock is more analogous to a debt instrument than to common stock.[131]

Courts have viewed preferred rights as essentially contractual.[132] This view is partially based on the theory that preferred stockholders have bargained away their status as common stockholders in exchange for preferences regarding dividends and liquidation.[133] Furthermore, preferred stockholders have freely assumed the risk that their investments would be subordinated to the interests of common

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127. *See id.* (stating that if process is reasonably aimed at providing fair result, business judgment rule remains in effect).

128. *See* Mitchell, *supra* note 13, at 445.

129. *See id.* at 443, 445.

130. *See id.* at 451.

131. *See id.*

132. *See, e.g.*, Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986).

133. *See, e.g.*, Guttmann v. Illinois Cent. R.R. Co., 189 F.2d 927, 930 (2d Cir. 1951) ("Here we are interpreting a contract into which uncoerced men entered . . . . [P]referred stockholders are not . . . . wards of the judiciary.").

stockholders[134] by voluntarily purchasing preferred stock rather than common stock or debt instruments.[135]

Courts have chosen to limit the application of fiduciary duties to preferred stockholders in two significant ways. Courts have applied fiduciary duties only (1) where the right asserted is not a preferential right, and (2) when the duties do not impede the rights of common stockholders.[136] With respect to the first limitation, the crucial question regards which rights are preferences.[137] The Delaware Court of Chancery in *Jedwab v. MGM Grand Hotels, Inc.*[138] stated that matters relating to preferences or limitations that distinguish preferred stock from common are essentially contractual, and that "the scope of the duty is appropriately defined by reference to the specific words evidencing that contract."[139] Further, where the right asserted involves a right shared equally with the common stockholders, fiduciary duties apply.[140] If a court determines that a matter involves a preferred right, the duties of the directors will be defined entirely by the articles of incorporation.[141] If the preference right involves something as straightforward as the payment of dividends, this determination is simple.[142] However, if a corporation has not clearly defined the scope of the right in the articles of incorporation, judges must make a determination as to whether the right at issue is preferred.[143] Courts have generally chosen to define "preferred interests" broadly, avoiding the fiduciary-duty analysis entirely.[144]

The second limitation—that directors owe preferred stockholders no fiduciary duties when the exercise of those duties impedes the rights of common stockholders—finds its rationale in the traditional corporate-law

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134. Courts allow transfers of corporate wealth away from preferred stockholders when the transfers are made for the benefit of common stockholders. *See infra* notes 145–48 and accompanying text.

135. *See* Mitchell, *supra* note 13, at 452.

136. *See, e.g., Jedwab*, 509 A.2d at 594.

137. *See* Mitchell, *supra* note 13, at 448. "Preferences" generally include priority over common shareholders in (1) receiving dividends, and (2) receiving distributions in the event of liquidation. *See id.* at 446.

138. 509 A.2d 584 (Del. Ch. 1986).

139. *Id.* at 594.

140. *See id.*

141. *See id.*

142. *See* Mitchell, *supra* note 13, at 448.

143. *See id.*

144. *See, e.g.,* Rothschild Int'l Corp. v. Liggett Group Inc., 474 A.2d 133, 136 (Del. 1984).

mandate that directors always act in the interests of common stockholders.[145] The net effect of this limitation on fiduciary duties is that preferred stockholders have little protection against the unilateral transfer of corporate wealth from preferred stockholders to common stockholders.[146] As long as the actions of the directors maximize the wealth of common stockholders,[147] preferred stockholders must rely solely on the protections granted in the certificate of incorporation.[148]

Although the Delaware Court of Chancery has not explicitly applied the law regarding preferred stockholders in the tracking-stock context, the court has drawn analogies between preferred and tracking stockholders.[149] In dismissing the duty-of-loyalty claim, the *General Motors* court relied on a series of cases involving preferred stockholders in which a breach-of-charter provision[150] was purely contractual and could not be asserted as a duty-of-loyalty claim.[151] In *Solomon*, the court also emphasized the contractual nature of tracking stock, claiming that the bargaining process at the time of issuance provided the arm's-length dealing necessary to ensure procedural protections for fairness.[152] According to the *Solomon* court, such a bargaining process provides protections for tracking stockholders superior to any of the procedural safeguards (for example, special committees, and burden shifts) created by courts.[153]

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145. *See* Mitchell, *supra* note 13, at 450.

146. *See id.* at 450–51.

147. *See id.* at 450.

148. *See id.* at 451.

149. *See In re* General Motors Class H Shareholders Litig., 734 A.2d 611, 619 (Del. Ch. 1999) (stating that existence of tracking stock "does not distinguish this case from those in which boards had to balance the interests of different classes of common and/or preferred stockholders").

150. A charter provision is any provision found in the corporation's certificate of incorporation. *See, e.g.*, Winston v. Mandor, 710 A.2d 835, 841–42 (Del. Ch. 1997). These provisions may govern such rights as the ability of one class of stockholders to convert their shares to another class of stock. *See id.*

151. *See General Motors*, 734 A.2d at 619.

152. *See* Solomon v. Armstrong, 747 A.2d 1098, 1124 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000). This rationale seems akin to the notion that fiduciary duties should not protect preferred stockholders who have freely bargained for the terms of their relationship with common stockholders. *See supra* notes 132–35 and accompanying text.

153. *See Solomon*, 747 A.2d at 1124.

C. *The Duties of a Parent Corporation to a Controlled Subsidiary and the Application of the* Sinclair *Test to Tracking-Stock Corporations*

Delaware law governing the directors of a controlled subsidiary of a parent corporation offers another possible standard for directorial conduct in tracking-stock corporations. In *Sinclair Oil Corporation v. Levien*,[154] the Supreme Court of Delaware held that parent corporations owe a fiduciary duty to their subsidiaries in the event of parent-subsidiary dealings.[155] The *Sinclair* court concluded that the existence of this fiduciary duty alone does not invoke enhanced scrutiny by the courts.[156] However, if the fiduciary duty is accompanied by self-dealing—that is, when the parent stands on both sides of a transaction with its subsidiary—courts will examine the "intrinsic fairness"[157] of the transaction.[158] Under the *Sinclair* test, "[s]elf-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary."[159]

Under Delaware law, the burden of persuasion regarding the entire fairness of the transaction rests on the defendant directors.[160] The defendants may shift this burden to the plaintiff if a committee of independent directors ratifies the decision.[161] Regardless of where the burden rests, the conduct of the parties will be viewed under the more

154. 280 A.2d 717 (Del. 1971).

155. *Id.* at 720.

156. *Id.*

157. Intrinsic fairness is synonymous with *Weinberg*'s "entire fairness" test. *See* Oberly v. Kirby, 592 A.2d 445, 469 (Del. 1991) ("The standard for intrinsic fairness is the searching test announced in *Weinberg*. The interested directors bear the burden of proving the entire fairness of the transaction in all its aspects, including both the fairness of the price and the fairness of the directors' dealings."). This is also the same test used in Delaware's interested director statute, Del. Code Ann. tit. 8, § 144(a)(3) (2000). *See* Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1371 n.7 (Del. 1995) (stating that section 144(a)(3) codifies entire-fairness test).

158. *See Sinclair*, 280 A.2d at 720.

159. *Id.*

160. *See* Kahn v. Tremont, 694 A.2d 422, 428 (Del. 1997) (citing Weinberg v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983)).

161. *See id.* at 428 (citing Kahn v. Lynch Communication Sys., 638 A.2d 1110, 1117 (Del. 1994)).

exacting standard of entire fairness rather than the more deferential business judgment standard.[162]

Delaware courts have held that the entire-fairness standard remains applicable even after ratification by an independent committee "because the underlying factors which raise the specter of impropriety can never be completely eradicated and still require careful judicial scrutiny."[163] The Delaware Supreme Court reasoned that this policy reflects the reality that in a parent-subsidiary relationship, a risk exists that minority stockholders may be influenced by the prospect of retaliation by a controlling stockholder.[164]

In *Solomon*, the court rejected the argument that tracking-stock corporations—by the nature of their capital structure—automatically trigger the fairness requirements of parent-subsidiary dealings.[165] Holders of Class E stock claimed that they were akin to minority shareholders being frozen out of their continuing interest in the corporation.[166] The court, however, distinguished the case from a traditional freeze-out based on procedural safeguards in General Motors's certificate of incorporation, including voting rights,[167] dividend rights,[168] and a provision setting a mandatory exchange rate in the event of a forced transaction.[169] The court held that these provisions protected the tracking

162. *See id.* (citing Kahn v. Lynch Communication Sys., 638 A.2d 1110, 1116 (Del. 1994)).

163. *Id.* (citing Weinberg v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983)).

164. *See id.* (citing Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490, 502 (Del. Ch. 1990)).

165. Solomon v. Armstrong, 747 A.2d 1098, 1123 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000).

166. *See id.*

167. *See id.* at 1121. General Motors's certificate of incorporation provided that each class vote independently on any amendment that affected that class's rights, powers or privileges. Thus, holders of tracking stock could have effectively vetoed any proposed spin off. *See id.*

168. *See id.* General Motors's certificate of incorporation also limited the board's ability to pay dividends on any one of the three classes of common stock. These limitations protected tracking-stock shareholders from retaliatory dividend policies had the Class E shareholders vetoed the split-off. *See id.*

169. *See id.* Under the Exchange Rate provision in the certificate of incorporation, Class E shareholders would receive an automatic 20% premium above the value of the Class E stock to be paid in the form of one and two-thirds shares of General Motors common stock. This provision would provide additional protection to shareholders if the board were to retaliate by forcing the exchange of Class E stock. *See id.*

stockholders from continuous oppression by the common stockholders.[170] This holding reveals the inherent difficulty in applying a single existing legal standard to directors of corporations with tracking stock: tracking stockholders share some, but not all, of the dangers faced by common stockholders, preferred stockholders, and stockholders in a controlled subsidiary.

IV. EXISTING LEGAL STANDARDS ARE INDIVIDUALLY INADEQUATE WHEN APPLIED TO DIRECTORS OF CORPORATIONS WITH TRACKING STOCK

The traditional fiduciary analysis, the law regarding preferred stockholders, and the courts' treatment of controlled subsidiaries each individually provide inadequate legal standards for governing the behavior of directors in the tracking-stock context. The traditional fiduciary analysis, as adopted in *Solomon* and *General Motors*, is unresponsive to the unique inter-group struggles present in corporations that issue tracking stock. A contractual approach, as used in the preferred-stock context, does not provide enough protection for stockholders who have an equity interest beyond dividend payments. The entire-fairness standard used in connection with parent-subsidiary dealings is too onerous for directors who are expected to make daily decisions regarding the allocation of wealth and opportunity to competing business groups.

A. *The Traditional Fiduciary Analysis Fails to Address the Inter-Group Struggles Inherent in Tracking-Stock Corporations*

The duties of care and loyalty do not address the unique inter-group struggles inherent in corporations that issue tracking stock.[171] When applied to cases involving tracking stock, the fiduciary analysis may provide either too little or too much protection for stockholders. Stockholders receive too much protection when the rights accompanying the transaction at issue are clearly defined in the certificate of incorporation. However, when directors make decisions that significantly

170. *See id.* (stating that "GM board did *not* have the power to unilaterally effectuate a freeze-out merger on its own terms").

171. *See* Hass, *supra* note 2, at 2148, 2156–57.

alter the ownership interest of tracking stockholders, such as a decision to spin-off a business group, stockholders are too vulnerable.

The application of the duty of loyalty to directors of corporations with tracking stock is problematic because of the inevitability of conflicts of interest. Assuming that the directorial duty to maximize stockholder wealth runs to each class of stockholders, any self-interest among directors would jeopardize this duty, thus implicating the duty of loyalty. Considering that any director who owns stock in a particular business group will have a potential conflict of interest, the courts in *General Motors* and *Solomon* correctly framed the issue of loyalty in terms of the materiality of the conflicting interests.[172] Had the duty of loyalty been implicated simply by a showing that a majority of directors owned stock in one business group, as the plaintiffs in both cases suggested,[173] the mere allegation of conflict would have mandated that the directors either prove the entire fairness of the transaction[174] or ratify the transaction by a majority of disinterested stockholders to reclaim the protections of the business judgment rule.[175] Given the inherent competition between groups, stock-holding directors potentially could be required to prove the entire fairness of every corporate transaction, virtually eliminating the courts' deference to the corporate decision-making process.

When framing the application of fiduciary duties, the *Solomon* court appears to have reached a compromise solution between protection of stockholders and deference to directors. Although it stated that the fiduciary duties run to each class of stockholders taken separately,[176] the court's emphasis on a fair decision-making process seems to acknowledge that directors cannot possibly fulfill their duties to each of these groups of stockholders simultaneously. Thus, while it is inevitable that the outcome of board decisions will routinely benefit one class of stock over another,[177] courts will not question the directors' decisions as

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172. *See In re* General Motors Class H Shareholders Litig., 734 A.2d 611, 618 (Del. Ch. 1999); *Solomon*, 747 A.2d at 1117–18.

173. *See General Motors*, 734 A.2d at 618; *Solomon*, 747 A.2d at 1117–18.

174. *See supra* note 96 and accompanying text.

175. *See supra* notes 102–03 and accompanying text.

176. *See Solomon*, 747 A.2d 1098 at 1123–24.

177. *See id.*

long as the process that the board of directors uses to reach those decisions does not disadvantage any one class of stock.[178] However, this compromise does not address situations in which a fiduciary-duty analysis is simply inappropriate.

Even with the materiality requirements of *Solomon*, the application of traditional fiduciary principles to tracking stockholders may be inappropriate depending on the nature of the transaction. In circumstances such as the repurchase of stock or the payment of dividends, where the expectations of the tracking stockholders are predominantly contractual, the fiduciary analysis provides over-protection. If directors have a material conflict of interest based on their ownership of a certain class of tracking stock, and their decision to repurchase stock or issue a dividend to that class of stockholders is not approved by a majority of disinterested stockholders, the directors must defend the entire fairness of that payment.[179] However, stockholder challenges to purely contractual transactions implicate the fairness of the original contract between the stockholders and the corporation, not the judgment of the directors. Thus, if stockholders are entitled to an entire-fairness evaluation even when directors comply with the contractual requirements for stock repurchases and dividend payments, courts will apply fiduciary duties to issues of contract, not corporate governance.

In the case of other transactions, such as inter-group transactions, traditional fiduciary requirements may oppress tracking stockholders. If directors negotiate a contract between business groups, such as an inter-group loan, and the directors do not have any material interests in either business group, traditional fiduciary principles will protect the business judgment of the directors.[180] Yet such a contract does not necessarily involve the business judgment of the directors and, consequently, the board's decision should not receive deference. It is not difficult for directors to determine whether a contract between business groups is fair; the directors must simply look to the marketplace to determine what type of deal the business group could have received had it dealt with an independent third party.[181] Thus, considering the ease with which

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178. *See id.*

179. *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995).

180. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

181. In situations where there is no ascertainable market value for the contract, and directors are asked to make difficult judgments about the fairness of the contract, courts should treat the decision like an allocation decision and apply the traditional fiduciary-duty analysis. *See infra* notes 206–08 and accompanying text.

directors may ascertain the fairness of inter-group contracts, the traditional fiduciary duty analysis is inappropriate when applied to corporate decisions regarding those transactions.

B. *The Contractual Approach Fails to Resolve the Non-Contractual Conflicts Arising in the Tracking-Stock Context*

Similarly, the analogies to preferred stock drawn by *General Motors* and *Solomon* are flawed. Tracking stock creates conflicts between groups that cannot be resolved by contractual protections for two reasons. First, tracking stock represents an equity interest that is more dependent upon the performance of the corporation than preferred stock and thus demands greater protection than preferred stock. Second, daily judgments that directors make regarding the allocation of resources to business groups are inherently difficult to reduce to contractual terms.

Tracking stock is analogous to preferred stock to the extent that certain contractual provisions in the articles of incorporation define certain rights of that class of stock.[182] Tracking stock, however, represents an entirely different type of financial interest than preferred stock and creates more frequent inter-class conflicts.[183] Therefore, the minimal protections afforded preferred stockholders—criticized by some as inadequate even in that context[184]—are insufficient safeguards in the more conflict-laden and less contractual arena of tracking stock.

Unlike preferred stock, the value of tracking stock is not fixed.[185] Because the value of preferred stock is predetermined, it is unlikely that preferred stockholders will benefit from improved financial performance.[186] Therefore, a directorial decision that negatively impacts a business group's ability to profit or appreciate poses a greater threat of financial damage to tracking stockholders than does the same decision to preferred stockholders.

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182. *See supra* notes 21, 128 and accompanying text.

183. *See supra* Part II.

184. *See* Mitchell, *supra* note 13, at 443.

185. *See* Hass, *supra* note 2, at 2094–95.

186. *See supra* notes 130–31 and accompanying text.

Tracking stock is also difficult to reduce entirely to contractual provisions. Whereas preferred stock lends itself to clearly defined contractual terms, such as the timing and amount of dividend payments or liquidation payments, tracking stock raises more complex issues. For example, the decision to allocate corporate opportunity or resources cannot always be reduced to a contractual formula. Rather, it is dependent upon the directors' best judgment at a distinct moment in time. If a contractual term in the certificate of incorporation did attempt to deal with the infinite number of possible corporate opportunities, it is unlikely that the term could provide much more protection than "good faith"[187] on the part of the directors.

Finally, scholars have argued that Delaware's reliance on the contract between preferred and common stockholders to define preferred stockholder rights is flawed even in its application to preferred stock.[188] Because courts have allowed directors to subvert the interests of preferred stockholders at the expense of the common stockholders,[189] preferred stockholders lack any meaningful protection against allocation of wealth away from their interests.[190] In the tracking-stock context, where the allocation of wealth away from one class of stock occurs much more frequently than in preferred stockholder situations, reliance on the contractual terms defining the rights of tracking stockholders is especially deficient.

C. *The* Sinclair *Test Fails to Protect the Discretion of the Board of Directors in Corporations Issuing Tracking Stock*

Even though tracking stockholders are analogous to minority stockholders in a parent-controlled subsidiary, the *Sinclair* test is impractical in the tracking-stock context. Under *Sinclair*, stockholders are entitled to a review of the entire fairness of the transaction whenever one group of controlling stockholders receives a benefit at the expense of another group of stockholders.[191] In the tracking-stock context, where

187. Mitchell, *supra* note 13, at 456 (stating that good-faith doctrine is intended "to prevent a contracting party from opportunistically capitalizing upon the ambiguities of language to defeat the other's legitimate contractual expectations").

188. *See* Rutherford B. Campell, Jr., *Corporate Fiduciary Principles for the Post-Contractarian Era*, 23 Fla. St. U. L. Rev. 561, 577 (1996); Mitchell, *supra* note 13, at 456.

189. *See supra* notes 145–48 and accompanying text.

190. *See* Mitchell, *supra* note 13, at 469–70.

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

business groups are constantly competing, and virtually every day-to-day decision could be subject to an entire-fairness review, importing the *Sinclair* test would frustrate the directors' abilities to govern the corporation.

Despite these differences, the plight of tracking stockholders is more analogous to minority stockholders in a parent-controlled subsidiary than the *Solomon* court was willing to acknowledge.[192] One of the primary rationales for heightened scrutiny in the parent-subsidiary context is the potential for continued oppression by the parent.[193] The same potential for coerced ratification of a board's actions that exists in parent-subsidiary dealings[194] is present in corporations that issue tracking stock.[195] If a class of tracking stockholders refuses to ratify a decision by the board, the board, on behalf of another controlling class of stock, could retaliate by allocating funds to different business groups.[196]

Considering this potential for coercion, "no court could be certain whether the transaction terms fully approximate what truly independent parties would have achieved in an arm's length negotiation."[197] Thus, it seems reasonable that decisions that are subject to a coerced ratification should be evaluated under a standard of entire fairness regardless of whether the decision has been approved by the minority stockholders. Further, under the *Sinclair* test, complaining tracking stockholders would be entitled to a review of the fairness of the transaction if they could demonstrate that a controlling class of stockholders received a benefit to

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192. Solomon v. Armstrong, 747 A.2d 1098, 1121 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000). Because shareholders in *Solomon* had substantial protection from continuous oppression, the court's rejection of the *Sinclair* standard was understandable. *See supra* notes 167–71 and accompanying text.

193. Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) (citing Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490, 502 (Del. Ch. 1990)).

194. *See supra* notes 163–65 and accompanying text.

195. Conceivably, corporations might not provide protections against continuous oppression in their articles of incorporation or might provide inadequate protections.

196. This Comment suggests that the possibility that a board of directors could retaliate against a non-complying business group is not so remote. In the case of inter-group transactions, other classes of shareholders could exert significant pressure on tracking stockholders to approve the terms of an unfair sale.

197. Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490, 502 (Del. Ch. 1990).

their detriment.[198] This would appear to be a fairly easy threshold to meet in a tracking-stock corporation, where business groups are often competing for the same corporate resources and opportunities.[199]

It seems impractical, however, to submit every board decision challenged by a tracking stockholder to an evaluation of entire fairness. The fundamental assumption that directors are best equipped to manage the corporation[200] would be undermined if every decision regarding the allocation of corporate resources or corporate opportunities were subject to an entire-fairness evaluation before the court.[201] Furthermore, with increased disclosure by corporations regarding the internal conflicts that directors may face when allocating resources or opportunities,[202] tracking stockholders should not expect every day-to-day corporate decision to be entirely fair.

V. DELAWARE COURTS SHOULD APPLY A COMBINATION OF EXISTING LEGAL STANDARDS DEPENDING ON THE TRANSACTION IN QUESTION

In dealing with directorial conflicts in tracking-stock corporations, courts should employ a combination of contractual duties, traditional fiduciary duties, and parent-subsidiary duties framed around the nature of the transaction. The nature of the transaction may be determined by examining the degree of directorial discretion involved in the transaction, the expectations of a reasonable tracking-stock investor, the provisions of the articles of incorporation, and the potential for abuse by controlling stockholders. Courts should provide protections to tracking stockholders in proportion to these factors. If a transaction is purely contractual, courts

198. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971). Under current Delaware law, the key issue is control of the subsidiary. *See* Mary Siegel, *The Erosion of the Law of Controlling Shareholders*, 24 Del. J. Corp. L. 27, 38–39 (1999). Hence, entire fairness would not be invoked in situations in which a non-controlling business group received an advantage to the detriment of another non-controlling group.

199. *See* Hass, *supra* note 2, at 2122.

200. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

201. *See supra* notes 97–103 and accompanying text.

202. For example, Donaldson, Lufkin & Jenrette, Inc. left little room for confusion regarding the task of its directors: "The board of directors of Donaldson, Lufkin & Jenrette, Inc., in its sole discretion, will make operational and financial decisions and implement policies that may affect the businesses of DLJ and DLJdirect differently, potentially favoring one business at the expense of the other." Donaldson, Lufkin & Jenrette, Inc., *supra* note 6, at 10. This warning was followed by a detailed list of potential areas of conflict. *See id.* at 11.

should not provide fiduciary protections to tracking stockholders but should instead look directly to the terms of the articles of incorporation. If a transaction involves the allocation of wealth among business groups, the courts should be more protective of tracking stockholders and should apply the fiduciary duties of care and loyalty to the actions of the directors. Finally, if the directorial decision at issue involves an inter-group transaction, or significantly alters the nature of the tracking stock, courts should subject the decision to the heightened scrutiny of an entire-fairness evaluation.

If a transaction between stockholders and the corporation is purely contractual—involving, for instance, dividend rights, voting rights, liquidation rights, or exchange of stock—as defined in the corporation's certificate of incorporation, courts should not provide fiduciary protections. Instead, courts should borrow from preferred-stock cases and enforce the terms of the tracking stockholder's contract with the corporation.[203] Suppose, for example, that a stockholder challenges a board's decision to pay dividends on one class of tracking stock. If, in its articles of incorporation, a corporation has defined the circumstances in which dividends are to be paid, the decision to pay dividends involves little discretion on the part of directors. Because tracking stockholders are reasonably expected to rely on contractual provisions, they should be entitled only to contractual remedies.[204]

In the case of daily directorial decisions involving the allocation of corporate wealth and opportunity among business groups, however, protections based on the certificate of incorporation are insufficient. A board decision to allocate the proceeds from a sale of corporate assets to a particular business group does not involve objective contractual obligations, but rather is subject to the judgment of directors to determine the best allocation of corporate resources. Although tracking-stock investors may expect directors to allocate resources impartially, tracking stockholders cannot expect that every corporate decision will maximize their wealth; corporations are increasingly taking pains to alert potential

203. *See* Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986).

204. Contractual remedies may include performance of the contract, or payment of damages flowing from the corporation's breach of the terms of the articles of incorporation. *See* E. Allan Farnsworth, *Contracts* §§ 12.1–.3, at 755–65 (3d ed. 1999).

investors of the potential conflicts of interests that directors face when allocating corporate wealth and opportunity among competing tracking stockholders.[205] Thus, with regard to allocation decisions, a reasonable and informed investor should be at least minimally familiar with the difficulties facing directors and cannot expect entire fairness.

Therefore, courts should apply the traditional duties of care and loyalty to allocation decisions[206] and only subject the decision to an entire-fairness evaluation if the directors have a material interest in the transaction.[207] The duty of loyalty ensures, at the least, that corporate directors are not subordinating the interests of one class of tracking stockholders to their own personal interests.[208] Under this standard, courts would not scrutinize an allocation decision unless the challenging stockholder could demonstrate that a majority of directors had a personal interest in one class of stock,[209] thus leaving business decisions in the hands of directors. Because decisions regarding allocations often involve judgment calls about the best use of corporate resources, it may be difficult for directors to prove fair dealing with regard to these decisions. The business judgment rule would properly protect these intuitive decisions and allow directors to carry out their day-to-day duties without the constant threat that a decision to move resources within the corporation will be subjected to an entire-fairness inquiry.[210]

In other circumstances, stockholders can expect more than impartiality from directors, and courts should evaluate the entire fairness of the transaction. When a board of directors negotiates a transaction between business groups,[211] a stockholder can reasonably expect that the board will negotiate the transaction as if the business groups were dealing with an independent third party.[212] These transactions do not involve directors'

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205. *See, e.g.*, Donaldson, Lufkin & Jenrette, Inc., *supra* note 6, at 10.

206. Some allocation decisions, for example, major corporate opportunities or resource allocations, may be so significant that they alter the substance of the ownership interest. These transactions should be dealt with under the entire-fairness standard. *See infra* notes 211–13 and accompanying text.

207. *See supra* note 114 and accompanying text.

208. *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995).

209. *See id.*

210. The directors do have the ability to reclaim the protection of the business judgment rule if the decision is ratified by a majority of fully informed shareholders. *See supra* note 103 and accompanying text.

211. *See supra* Part II.C.

212. In fact, some corporations have affirmed this expectation in their corporate filings. *See, e.g.*, Sprint Corp., *supra* note 18, at 31–32.

value judgments about the most effective allocation of resources or opportunities; rather, the fairness of the transaction can be clearly measured against the terms of the transaction that would have been available if the board had bargained with a third party. For example, if a board of directors negotiates a contract for the sale of goods between two business groups, the fairness of that transaction would be apparent if the price of the goods reflected fair market value. Thus, transactions between business groups should not afford directors the same protections as allocation decisions.

Likewise, when a corporate decision significantly alters the ownership interest of tracking stockholders, such as a spin-off of a business group or the sale of all or substantially all of the assets of a group, those stockholders can expect more than impartiality. Regardless of what statements are made in corporate filings qualifying the rights of tracking stockholders, investors have a reasonable expectation that the business they are investing in will remain substantially the same.[213] Thus, if a board decides to redefine the nature of a business group, sell all or substantially all of the assets of the business group, or spin-off that business group, the investors in that stock can reasonably expect that such a decision would be entirely fair. Therefore, courts should apply the entire-fairness determination of *Sinclair*[214] to inter-group transactions and to those transactions which significantly alter the ownership interest of a tracking stock.

VI. CONCLUSION

As tracking stock becomes more prevalent, it is likely that courts will confront claims by disgruntled tracking stockholders. Courts should not try to force the unique equity structure of tracking stock into one of the three existing legal standards. The traditional fiduciary-duty analysis is unresponsive to the unique inter-group struggles in the tracking-stock context and as a result provides either over- or underprotection to stockholders. The contractual approach used in the preferred-stock

213. The ability to be specific about one's investment choice is one of the prime advantages of tracking stock. *See* Hass, *supra* note 2, at 2090.

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

context is also inadequate because tracking stocks are more dependent on corporate performance and cannot be reduced to purely contractual provisions. Finally, the entire-fairness standard used in connection with parent-subsidiary dealings is too onerous for directors who are expected to make daily decisions regarding the allocation of wealth and opportunity to competing business groups.

The applicable legal standard should depend on the nature of the transaction at issue. This inquiry would turn on the degree of directorial discretion involved in the transaction, the expectations of the investing stockholder, the provisions of the articles of incorporation, and the potential for abuse by controlling stockholders. If the transaction is purely contractual, courts should provide tracking stockholders with only the rights granted to those stockholders in the company's articles of incorporation. If the transaction involves the allocation of corporate resources among business groups, courts should be moderately protective of tracking stockholders. To balance stockholder expectations of impartiality and deference to a board's business judgment, courts should apply the duties of care and loyalty to allocation decisions, granting the protections of the business judgment rule unless the directors have a material financial interest in a business group. Finally, if the directorial decision involves an inter-group transaction, courts should be especially protective of tracking stockholders. Inter-group transactions involve little discretion on the part of directors, but the potential for abuse is relatively high. Therefore, courts should evaluate the entire fairness of inter-group dealings in the tracking-stock context regardless of whether the directors have a material financial interest in any of the business groups involved in the transaction.