

KAHN v. LYNCH COMMUNICATION SYSTEMS, INC.
638 A.2d 1110 (Del. 1994)

Before MOORE, WALSH, and HOLLAND, JJ.

HOLLAND, Justice:

This is an appeal by the plaintiff-appellant, Alan R. Kahn ("Kahn"), from a final judgment of the Court of Chancery which was entered after a trial. The action, instituted by Kahn in 1986, originally sought to enjoin the acquisition of the defendant-appellee, Lynch Communication Systems, Inc. ("Lynch"), by the defendant-appellee, Alcatel U.S.A. Corporation ("Alcatel"), pursuant to a tender offer and cash-out merger. Kahn amended his complaint to seek monetary damages after the Court of Chancery denied his request for a preliminary injunction. The Court of Chancery subsequently certified Kahn's action as a class action on behalf of all Lynch shareholders, other than the named defendants, who tendered their stock in the merger, or whose stock was acquired through the merger.

A three-day trial was held April 13-15, 1993. Kahn alleged that Alcatel was a controlling shareholder of Lynch and breached its fiduciary duties to Lynch and its shareholders. According to Kahn, Alcatel dictated the terms of the merger; made false, misleading, and inadequate disclosures; and paid an unfair price.

The Court of Chancery concluded that Alcatel was, in fact, a controlling shareholder that owed fiduciary duties to Lynch and its shareholders. It also concluded that Alcatel had not breached those fiduciary duties. Accordingly, the Court of Chancery entered judgment in favor of the defendants.

Kahn has raised three contentions in this appeal. Kahn's first contention is that the Court of Chancery erred by finding that "the tender offer and merger were negotiated by an independent committee," and then placing the burden of persuasion on the plaintiff, Kahn. Kahn asserts the uncontradicted testimony in the record demonstrated that the committee could not and did not bargain at arm's length with Alcatel. Kahn's second contention is that Alcatel's Offer to Purchase was false and misleading because it failed to disclose threats made by Alcatel to the effect that if Lynch did not accept its proposed price, Alcatel would institute a hostile tender offer at a lower price. Third, Kahn contends that the merger price was unfair. Alcatel contends that the Court of Chancery was correct in its findings, with the exception of concluding that Alcatel was a controlling shareholder.

This Court has concluded that the record supports the Court of Chancery's finding that Alcatel was a controlling shareholder. However, the record does not support the conclusion that the burden of persuasion shifted to Kahn. Therefore, the burden of proving the entire fairness of the merger transaction remained on Alcatel, the controlling shareholder. Accordingly, the judgment of the Court of Chancery is reversed. The matter is remanded for further proceedings in accordance with this opinion.

Facts

Lynch, a Delaware corporation, designed and manufactured electronic telecommunications equipment, primarily for sale to telephone operating companies. Alcatel, a holding company, is a subsidiary of Alcatel (S.A.), a French company involved in public telecommunications, business communications, electronics, and optronics. Alcatel (S.A.), in turn, is a subsidiary of Compagnie Generale d'Electricite ("CGE"), a French corporation with operations in energy, transportation, telecommunications and business systems.

In 1981, Alcatel acquired 30.6 percent of Lynch's common stock pursuant to a stock purchase agreement. As part of that agreement, Lynch amended its certificate of incorporation to require an 80 percent affirmative vote of its shareholders for approval of any business combination. In addition, Alcatel obtained proportional representation on the Lynch board of directors and the right to purchase 40 percent of any equity securities offered by Lynch to third parties. The agreement also precluded Alcatel from holding more than 45 percent of Lynch's stock prior to October 1, 1986. By the time of the merger which is contested in this action, Alcatel owned 43.3 percent of Lynch's outstanding stock; designated five of the eleven members of Lynch's board of directors; two of three members of the executive committee; and two of four members of the compensation committee.

In the spring of 1986, Lynch determined that in order to remain competitive in the rapidly changing telecommunications field, it would need to obtain fiber optics technology to complement its existing digital electronic capabilities. Lynch's management identified a target company, Telco Systems, Inc. ("Telco"), which possessed both fiber optics and other valuable technological assets. The record reflects that Telco expressed interest in being acquired by Lynch. Because of the supermajority voting provision, which Alcatel had negotiated when it first purchased its shares, in order to proceed with the Telco combination Lynch needed Alcatel's consent. In June 1986, Ellsworth F. Dertinger ("Dertinger"), Lynch's CEO and chairman of its board of directors, contacted Pierre Suard ("Suard"), the chairman of Alcatel's parent company, CGE, regarding the acquisition of Telco by Lynch. Suard expressed Alcatel's opposition to Lynch's acquisition of Telco. Instead, Alcatel proposed a combination of Lynch and Celwave

Systems, Inc. ("Celwave"), an indirect subsidiary of CGE engaged in the manufacture and sale of telephone wire, cable and other related products.

Alcatel's proposed combination with Celwave was presented to the Lynch board at a regular meeting held on August 1, 1986. Although several directors expressed interest in the original combination which had been proposed with Telco, the Alcatel representatives on Lynch's board made it clear that such a combination would not be considered before a Lynch/Celwave combination. According to the minutes of the August 1 meeting, Dertinger expressed his opinion that Celwave would not be of interest to Lynch if Celwave was not owned by Alcatel.

At the conclusion of the meeting, the Lynch board unanimously adopted a resolution establishing an Independent Committee, consisting of Hubert L. Kertz ("Kertz"), Paul B. Wineman ("Wineman"), and Stuart M. Beringer ("Beringer"), to negotiate with Celwave and to make recommendations concerning the appropriate terms and conditions of a combination with Celwave. On October 24, 1986, Alcatel's investment banking firm, Dillon, Read & Co., Inc. ("Dillon Read") made a presentation to the Independent Committee. Dillon Read expressed its views concerning the benefits of a Celwave/Lynch combination and submitted a written proposal of an exchange ratio of 0.95 shares of Celwave per Lynch share in a stock-for-stock merger.

However, the Independent Committee's investment advisors, Thomson McKinnon Securities Inc. ("Thomson McKinnon") and Kidder, Peabody & Co. Inc. ("Kidder Peabody"), reviewed the Dillon Read proposal and concluded that the 0.95 ratio was predicated on Dillon Read's overvaluation of Celwave. Based upon this advice, the Independent Committee determined that the exchange ratio proposed by Dillon Read was unattractive to Lynch. The Independent Committee expressed its unanimous opposition to the Celwave/Lynch merger on October 31, 1986.

Alcatel responded to the Independent Committee's action on November 4, 1986, by withdrawing the Celwave proposal. Alcatel made a simultaneous offer to acquire the entire equity interest in Lynch, constituting the approximately 57 percent of Lynch shares not owned by Alcatel. The offering price was \$14 cash per share.

On November 7, 1986, the Lynch board of directors revised the mandate of the Independent Committee. It authorized Kertz, Wineman, and Beringer to negotiate the cash merger offer with Alcatel. At a meeting held that same day, the Independent Committee determined that the \$14 per share offer was inadequate. The Independent Committee's own legal counsel, Skadden, Arps, Slate, Meagher & Flom ("Skadden Arps"), suggested that the Independent Committee should review alternatives to a cash-out merger with Alcatel, including a "white knight" third party acquiror, a repurchase of Alcatel's shares, or the adoption of a shareholder rights plan.

On November 12, 1986, Beringer, as chairman of the Independent Committee, contacted Michiel C. McCarty ("McCarty") of Dillon Read, Alcatel's representative in the negotiations, with a counteroffer at a price of \$17 per share. McCarty responded on behalf of Alcatel with an offer of \$15 per share. When Beringer informed McCarty of the Independent Committee's view that \$15 was also insufficient, Alcatel raised its offer to \$15.25 per share. The Independent Committee also rejected this offer. Alcatel then made its final offer of \$15.50 per share.

At the November 24, 1986 meeting of the Independent Committee, Beringer advised its other two members that Alcatel was "ready to proceed with an unfriendly tender at a lower price" if the \$15.50 per share price was not recommended by the Independent Committee and approved by the Lynch board of directors. Beringer also told the other members of the Independent Committee that the alternatives to a cash-out merger had been investigated but were impracticable.³ After meeting with its financial and legal advisors, the Independent Committee voted unanimously to recommend that the Lynch board of directors approve Alcatel's \$15.50 cash per share price for a merger with Alcatel. The Lynch board met later that day. With Alcatel's nominees abstaining, it approved the merger.

Alcatel Dominated Lynch Controlling Shareholder Status

This Court has held that "a shareholder owes a fiduciary duty only if it owns a majority interest in *or exercises control over* the business affairs of the corporation." *Ivanhoe Partners v. Newmont Mining Corp.*, Del.Supr., 535 A.2d 1334, 1344 (1987) (emphasis added). With regard to the exercise of control, this Court has stated:

[A] shareholder who owns less than 50% of a corporation's outstanding stocks does not, without more, become a controlling shareholder of that corporation, with a concomitant fiduciary status. For a dominating relationship to exist in the absence of controlling stock ownership, a plaintiff must allege domination by a minority shareholder through actual control of corporation conduct.

Citron v. Fairchild Camera & Instrument Corp., Del.Supr., 569 A.2d 53, 70 (1989) (quotations and citation omitted).

³ The minutes reflect that Beringer told the Committee the "white knight" alternative "appeared impractical with the 80% approval requirement"; the repurchase of Alcatel's shares would produce a "highly leveraged company with a lower book value" and was an alternative "not in the least encouraged by Alcatel"; and a shareholder rights plan was not viable because of the increased debt it would entail.

Alcatel held a 43.3 percent minority share of stock in Lynch. Therefore, the threshold question to be answered by the Court of Chancery was whether, despite its minority ownership, Alcatel exercised control over Lynch's business affairs. Based upon the testimony and the minutes of the August 1, 1986 Lynch board meeting, the Court of Chancery concluded that Alcatel did exercise control over Lynch's business decisions.

The standard of appellate review with regard to the Court of Chancery's factual findings is deferential. Those findings will not be set aside by this Court unless they are clearly erroneous or not the product of a logical and orderly deductive reasoning process. The record supports the Court of Chancery's factual finding that Alcatel dominated Lynch.

At the August 1 meeting, Alcatel opposed the renewal of compensation contracts for Lynch's top five managers. According to Dertinger, Christian Fayard ("Fayard"), an Alcatel director, told the board members, "[y]ou must listen to us. We are 43 percent owner. You have to do what we tell you." The minutes confirm Dertinger's testimony. They recite that Fayard declared, "you are pushing us very much to take control of the company. Our opinion is not taken into consideration."

Although Beringer and Kertz, two of the independent directors, favored renewal of the contracts, according to the minutes, the third independent director, Wineman, admonished the board as follows:

Mr. Wineman pointed out that the vote on the contracts is a "watershed vote" and the motion, due to Alcatel's "strong feelings," might not carry if taken now. Mr. Wineman clarified that

you [management] might win the battle and lose the war.

With Alcatel's opinion so clear, Mr. Wineman questioned

if management wants the contracts renewed under these circumstances

He recommended that management "think twice." Mr. Wineman declared:

I want to keep the management. I can't think of a better management.

Mr. Kertz agreed, again advising consideration of the "critical" period the company is entering.

The minutes reflect that the management directors left the room after this statement. The remaining board members then voted not to renew the contracts.

At the same meeting, Alcatel vetoed Lynch's acquisition of the target company, which, according to the minutes, Beringer considered "an immediate fit" for Lynch. Dertinger agreed with Beringer, stating that the

target company is extremely important as they have the products that Lynch needs now.

Nonetheless, Alcatel prevailed. The minutes reflect that Fayard advised the board:

Alcatel, with its 44% equity position, would not approve such an acquisition as ... it does not wish to be diluted from being the main shareholder in Lynch.

From the foregoing evidence, the Vice Chancellor concluded:

... Alcatel did control the Lynch board, at least with respect to the matters under consideration at its August 1, 1986 board meeting. The interplay between the directors was more than vigorous discussion, as suggested by defendants. The management and independent directors disagreed with Alcatel on several important issues. However, when Alcatel made its position clear, and reminded the other directors of its significant stockholdings, Alcatel prevailed. Dertinger testified that Fayard "scared [the non-Alcatel directors] to death." While this statement undoubtedly is an exaggeration, it does represent a first-hand view of how the board operated. I conclude that the non-Alcatel directors deferred to Alcatel because of its position as a significant stockholder and not because they decided in the exercise of their own business judgment that Alcatel's position was correct [citation omitted].

The record supports the Court of Chancery's underlying factual finding that "the non-Alcatel [independent] directors deferred to Alcatel because of its position as a significant stockholder and not because they decided in the exercise of their own business judgment that Alcatel's position was correct." The record also supports the subsequent factual finding that, notwithstanding its 43.3 percent minority shareholder interest, Alcatel did exercise actual control over Lynch by dominating its corporate affairs. The Court of Chancery's legal conclusion that Alcatel owed the fiduciary duties of a controlling shareholder to the other Lynch shareholders followed syllogistically as the logical result of its cogent analysis of the record.

Entire Fairness Requirement
Dominating Interested Shareholder

A controlling or dominating shareholder standing on both sides of a transaction, as in a parent-subsidary context, bears the burden of proving its entire fairness. *Weinberger v. UOP, Inc.*, Del.Supr., 457 A.2d 701, 710 (1983). The demonstration of fairness that is required was set forth by this Court in *Weinberger*:

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the 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. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, 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. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.

Weinberger v. UOP, Inc., 457 A.2d at 711 (citations omitted).

The logical question raised by this Court's holding in *Weinberger* was what type of evidence would be reliable to demonstrate entire fairness. That question was not only anticipated but also initially addressed in the *Weinberger* opinion. *Id.* at 709-10 n. 7. This Court suggested that the result

could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's length,

because

fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors.

Id. Accordingly, this Court stated,

showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness."

Id. (emphasis added).

In this case, the Vice Chancellor noted that the Court of Chancery has expressed "differing views" regarding the effect that an approval of a cash-out merger by a special committee of disinterested directors has upon the controlling or dominating shareholder's burden of demonstrating entire fairness. One view is that such approval shifts to the plaintiff the burden of proving that the transaction was unfair. The other view is that such an approval renders the business judgment rule the applicable standard of judicial review.

It is often of critical importance whether a particular decision is one to which the business judgment rule applies or the entire fairness rule applies.

Nixon v. Blackwell, Del.Supr., 626 A.2d 1366, 1376 (1993). The definitive answer with regard to the Court of Chancery's "differing views" is found in this Court's opinions in *Weinberger* and *Rosenblatt*. In *Weinberger*, this Court held that because

of the fairness test which has long been applicable to parent-subsiary mergers, the expanded appraisal remedy now available to shareholders, and the broad discretion of the [Court of Chancery] to fashion such relief as the facts of a given case may dictate, we do not believe that any additional meaningful protection is afforded minority shareholders by the business purpose requirement of the trilogy of *Singer v. Magnavox Co.*, Del.Supr., 380 A.2d 969 (1977)], *Tanzer v. International Gen. Indus., Inc.*, Del.Supr., 379 A.2d 1121 (1977)], [*Roland Int'l Corp. v. Najjar* [Del.Supr., 407 A.2d 1032 (1979)], and their progeny. Accordingly, such requirement shall no longer be of any force or effect.

Weinberger v. UOP, Inc., 457 A.2d at 715 (citation and footnotes omitted). Thereafter, this Court recognized that it would be inconsistent with its holding in *Weinberger* to apply the business judgment rule in the context of an interested merger transaction which, by its very nature, did not require a business purpose. See *Rosenblatt v. Getty Oil Co.*, 493 A.2d at 937. Consequently, in *Rosenblatt*, in the context of a subsequent proceeding involving a parent-subsiary merger, this Court held that the "approval of a merger, as here, by an informed vote of a majority of the minority stockholders, while not a legal prerequisite, shifts the burden of proving the unfairness of the merger entirely to the plaintiffs." *Id.*

Entire fairness remains the proper focus of judicial analysis in examining an interested merger, irrespective of whether the burden of proof remains upon or is shifted away from the controlling or dominating shareholder, because the unchanging nature of the underlying "interested" transaction requires careful scrutiny. The policy rationale for the exclusive application of the entire fairness standard to interested merger transactions has been stated as follows:

Parent subsidiary mergers, unlike stock options, are proposed by a party that controls, and will continue to control, the corporation, whether or not the minority stockholders vote to approve or reject the transaction. The controlling stockholder relationship has the potential to influence, however subtly, the vote of [ratifying] minority stockholders in a manner that is not likely to occur in a transaction with a noncontrolling party.

Even where no coercion is intended, shareholders voting on a parent subsidiary merger might perceive that their disapproval could risk retaliation of some kind by the controlling stockholder. For example, the controlling stockholder might decide to stop dividend payments or to effect a subsequent cash out merger at a less favorable price, for which the remedy would be time consuming and costly litigation. At the very least, the potential for that perception, and its possible impact upon a shareholder vote, could never be fully eliminated. Consequently, in a merger between the corporation and its controlling stockholder--even one negotiated by disinterested, independent directors--no court could be certain whether the transaction terms fully approximate what truly independent parties would have achieved in an arm's length negotiation. Given that uncertainty, a court might well conclude that even minority shareholders who have ratified a ... merger need procedural protections beyond those afforded by full disclosure of all material facts. One way to provide such protections would be to adhere to the more stringent entire fairness standard of judicial review.

Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d at 502.

Once again, this Court holds that the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness. The initial burden of establishing entire fairness rests upon the party who stands on both sides of the transaction. *Id.* However, an approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder- plaintiff. Nevertheless, even when an interested cash-out merger transaction receives the informed approval of a majority of minority stockholders or an independent committee of disinterested directors, an entire fairness analysis is the only proper standard of judicial review.

Independent Committees Interested Merger Transactions

It is a now well-established principle of Delaware corporate law that in an interested merger, the controlling or dominating shareholder proponent of the transaction bears the

burden of proving its entire fairness. It is equally well-established in such contexts that any shifting of the burden of proof on the issue of entire fairness must be predicated upon this Court's decisions in *Rosenblatt v. Getty Oil Co.*, Del.Supr., 493 A.2d 929 (1985) and *Weinberger v. UOP, Inc.*, Del.Supr., 457 A.2d 701 (1983). In *Weinberger*, this Court noted that

[p]articularly in a parent-sub subsidiary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness.

457 A.2d at 709-10 n. 7 (emphasis added). Accord *Rosenblatt v. Getty Oil Co.*, 493 A.2d at 937-38 & n. 7. In *Rosenblatt*, this Court pointed out that "[an] independent bargaining structure, while not conclusive, is strong evidence of the fairness" of a merger transaction. *Rosenblatt v. Getty Oil Co.*, 493 A.2d at 938 n. 7.

The same policy rationale which requires judicial review of interested cash-out mergers exclusively for entire fairness also mandates careful judicial scrutiny of a special committee's real bargaining power before shifting the burden of proof on the issue of entire fairness. A recent decision from the Court of Chancery articulated a two-part test for determining whether burden shifting is appropriate in an interested merger transaction. *Rabkin v. Olin Corp.*, Del.Ch., C.A. No. 7547 (Consolidated), Chandler, V.C., 1990 WL 47648, slip op. at 14-15 (Apr. 17, 1990), reprinted in 16 Del.J.Corp.L. 851, 861- 62 (1991), *aff'd*, Del.Supr., 586 A.2d 1202 (1990). In *Olin*, the Court of Chancery stated:

The mere existence of an independent special committee ... does not itself shift the burden. At least two factors are required. First, the majority shareholder must not dictate the terms of the merger. *Rosenblatt v. Getty Oil Co.*, Del.Ch., 493 A.2d 929, 937 (1985). Second, the special committee must have real bargaining power that it can exercise with the majority shareholder on an arms length basis.

Id., slip op. at 14-15, 16 Del.J.Corp.L. at 861-62.⁶ This Court expressed its agreement with that statement by affirming the Court of Chancery decision in *Olin* on appeal.

⁶ In *Olin*, the Court of Chancery concluded that because the special committee had been given "the narrow mandate of determining the monetary fairness of a non-negotiable offer," and because the majority shareholder "dictated the terms" and "there were no arm's-length negotiations," the burden of proof on the issue of entire fairness remained with the defendants. *Id.*, slip op. at 15, 16 Del.J.Corp.L. at 862. In making that determination, the Court of Chancery pointed out that the majority shareholder "could obviously have used its majority stake to effectuate the merger" regardless of the committee's or the board's disapproval, and that the record demonstrated that the directors of both corporations were "acutely aware of this fact." *Id.*, slip op. at 13, 16 Del.J.Corp.L. at 861.

Lynch's Independent Committee

In the case sub judice, the Court of Chancery observed that although

Alcatel did exercise control over Lynch with respect to the decisions made at the August 1, 1986 board meeting, it does not necessarily follow that Alcatel also controlled the terms of the merger and its approval.

This observation is theoretically accurate, as this opinion has already stated. *Weinberger v. UOP, Inc.*, 457 A.2d at 709-10 n. 7. However, the performance of the Independent Committee merits careful judicial scrutiny to determine whether Alcatel's demonstrated pattern of domination was effectively neutralized so that

each of the contending parties had in fact exerted its bargaining power against the other at arm's length.

Id. The fact that the same independent directors had submitted to Alcatel's demands on August 1, 1986 was part of the basis for the Court of Chancery's finding of Alcatel's domination of Lynch. Therefore, the Independent Committee's ability to bargain at arm's length with Alcatel was suspect from the outset.

The Independent Committee's original assignment was to examine the merger with Celwave which had been proposed by Alcatel. The record reflects that the Independent Committee effectively discharged that assignment and, in fact, recommended that the Lynch board reject the merger on Alcatel's terms. Alcatel's response to the Independent Committee's adverse recommendation was not the pursuit of further negotiations regarding its Celwave proposal, but rather its response was an offer to buy Lynch. That offer was consistent with Alcatel's August 1, 1986 expressions of an intention to dominate Lynch, since an acquisition would effectively eliminate once and for all Lynch's remaining vestiges of independence.

The Independent Committee's second assignment was to consider Alcatel's proposal to purchase Lynch. The Independent Committee proceeded on that task with full knowledge of Alcatel's demonstrated pattern of domination. The Independent Committee was also obviously aware of Alcatel's refusal to negotiate with it on the Celwave matter.

Burden of Proof Shifted
Court of Chancery's Finding

The Court of Chancery began its factual analysis by noting that Kahn had "attempted to shatter" the image of the Independent Committee's actions as having "appropriately simulated" an arm's length, third-party transaction. The Court of Chancery found that "to some extent, [Kahn's attempt] was successful." The Court of Chancery gave credence to the testimony of Kertz, one of the members of the Independent Committee, to the effect that he did not believe that \$15.50 was a fair price but that he voted in favor of the merger because he felt there was no alternative.

The Court of Chancery also found that Kertz understood Alcatel's position to be that it was ready to proceed with an unfriendly tender offer at a lower price if Lynch did not accept the \$15.50 offer, and that Kertz perceived this to be a threat by Alcatel. The Court of Chancery concluded that Kertz ultimately decided that,

although \$15.50 was not fair, a tender offer and merger at that price would be better for Lynch's stockholders than an unfriendly tender offer at a significantly lower price.

The Court of Chancery determined that "Kertz failed either to satisfy himself that the offered price was fair or oppose the merger."

In addition to Kertz, the other members of the Independent Committee were Beringer, its chairman, and Wineman. Wineman did not testify at trial.⁷ Beringer was called by Alcatel to testify at trial. Beringer testified that at the time of the Committee's vote to recommend the \$15.50 offer to the Lynch board, he thought "that under the circumstances, a price of \$15.50 was fair and should be accepted" (emphasis added).

Kahn contends that these "circumstances" included those referenced in the minutes for the November 24, 1986 Independent Committee meeting:

Mr. Beringer added that Alcatel is 'ready to proceed with an unfriendly tender at a lower price' if the \$15.50 per share price is not recommended to, and approved by, the Company's Board of Directors.

⁷ Based upon inferences from Kertz's testimony, the Court of Chancery noted that "Wineman apparently agreed" that \$15.50 was a fair price. However, the record also reflects that it was Wineman who urged the other independent directors to yield to Alcatel's demands at the August 1, 1986 meeting.

Wineman's failure to testify also permits both this Court and the Court of Chancery to draw the inference adverse to Alcatel, that Alcatel dictated the outcome of the November 24, 1986 meeting. As we have previously noted, the production of weak evidence when strong is, or should have been, available can lead only to the conclusion that the strong would have been adverse. See *Smith v. Van Gorkom*, Del.Supr., 488 A.2d 858, 878 (1985).

In his testimony at trial, Beringer verified, albeit reluctantly, the accuracy of the foregoing statement in the minutes:

[Alcatel] let us know that they were giving serious consideration to making an unfriendly tender

(emphasis added).

The record reflects that Alcatel was "ready to proceed" with a hostile bid. This was a conclusion reached by Beringer, the Independent Committee's chairman and spokesman, based upon communications to him from Alcatel. Beringer testified that although there was no reference to a particular price for a hostile bid during his discussions with Alcatel, or even specific mention of a "lower" price, "the implication was clear to [him] that it probably would be at a lower price."⁸

According to the Court of Chancery, the Independent Committee rejected three lower offers for Lynch from Alcatel and then accepted the \$15.50 offer "after being advised that [it] was fair and after considering the absence of alternatives." The Vice Chancellor expressly acknowledged the impracticability of Lynch's Independent Committee's alternatives to a merger with Alcatel:

Lynch was not in a position to shop for other acquirors, since Alcatel could block any alternative transaction. Alcatel also made it clear that it was not interested in having its shares repurchased by Lynch. The Independent Committee decided that a stockholder rights plan was not viable because of the increased debt it would entail.

Nevertheless, based upon the record before it, the Court of Chancery found that the Independent Committee had "appropriately simulated a third-party transaction, where negotiations are conducted at arms-length and there is no compulsion to reach an agreement." The Court of Chancery concluded that the Independent Committee's actions "as a whole" were "sufficiently well informed ... and aggressive to simulate an arms-length transaction," so that the burden of proof as to entire fairness shifted from Alcatel to the contending Lynch shareholder, Kahn. The Court of Chancery's reservations about that finding are apparent in its written decision.

⁸ On the other hand, Dertinger, an officer and director of Lynch, testified that he was informed by Alcatel that the price of an unfriendly tender offer would indeed be lower and would in fact be \$12 per share.

The Power to Say No,
The Parties' Contentions,
Arm's Length Bargaining

The Court of Chancery properly noted that limitations on the alternatives to Alcatel's offer did not mean that the Independent Committee should have agreed to a price that was unfair:

The power to say no is a significant power. It is the duty of directors serving on [an independent] committee to approve only a transaction that is in the best interests of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available. It is not sufficient for such directors to achieve the best price that a fiduciary will pay if that price is not a fair price.

(*Quoting In re First Boston, Inc. Shareholders Litig.*, Del.Ch., C.A. 10338 (Consolidated), Allen, C., 1990 WL 78836, slip op. at 15-16 (June 7, 1990)).

The Alcatel defendants argue that the Independent Committee exercised its "power to say no" in rejecting the three initial offers from Alcatel, and that it therefore cannot be said that Alcatel dictated the terms of the merger or precluded the Independent Committee from exercising real bargaining power. Compare *Rabkin v. Olin Corp.*, Del.Ch., C.A. 7547 (Consolidated), Chandler, V.C., 1990 WL 47648, slip op. at 14-15 (Apr. 17, 1990), reprinted in 16 Del.J.Corp.L. 851, 861-62 (1991), *aff'd*, Del.Supr., 586 A.2d 1202 (1990).⁹ The Alcatel defendants contend, alternatively, that

even assuming that such a threat [of a hostile takeover] could have had a coercive effect on the [Independent] Committee,

the willingness of the Independent Committee to reject Alcatel's initial three offers suggests that "the alleged threat was either nonexistent or ineffective." *Braunschweiger v. American Home Shield Corp.*, Del.Ch., C.A. No. 10755, Allen, C., 1991 WL 3920, slip op. at 13 (Jan. 7, 1991), reprinted in 17 Del.J.Corp.L. 206, 219 (1992).

Kahn contends the record reflects that the conduct of Alcatel deprived the Independent Committee of an effective "power to say no." Kahn argues that Alcatel not only threatened the Committee with a hostile tender offer in the event its \$15.50 offer was not recommended and approved, but also directed the affairs of Lynch for Alcatel's benefit in such a way as to make it impossible for Lynch to continue as a public company

⁹ Alcatel also points to the fairness opinions of two investment banking firms employed by the Committee, Kidder Peabody and Thomson McKinnon, and the involvement of independent legal counsel, Skadden Arps, in considering and rejecting alternatives to the Alcatel cash offers.

under Alcatel's control without injury to itself and its minority shareholders. In support of this argument, Kahn relies upon another proceeding wherein the Court of Chancery has been previously presented with factual circumstances comparable to those of the case sub judice, albeit in a different procedural posture. See *American Gen. Corp. v. Texas Air Corp.*, Del.Ch., C.A. Nos. 8390, 8406, 8650 & 8805, Hartnett, V.C., 1987 WL 6337 (Feb. 5, 1987), reprinted in 13 Del.J.Corp.L. 173 (1988).

In *American General*, in the context of an application for injunctive relief, the Court of Chancery found that the members of the Special Committee were "truly independent and ... performed their tasks in a proper manner," but it also found that "at the end of their negotiations with [the majority shareholder] the Committee members were issued an ultimatum and told that they must accept the \$16.50 per share price or [the majority shareholder] would proceed with the transaction without their input." *Id.*, slip op. at 11-12, 13 Del.J.Corp.L. at 181. The Court of Chancery concluded based upon this evidence that the Special Committee had thereby lost "its ability to negotiate in an arms-length manner" and that there was a reasonable probability that the burden of proving entire fairness would remain on the defendants if the litigation proceeded to trial. *Id.*, slip op. at 12, 13 Del.J.Corp.L. at 181.

Alcatel's efforts to distinguish *American General* are unpersuasive. Alcatel's reliance on *Braunschweiger* is also misplaced. In *Braunschweiger*, the Court of Chancery pointed out that

[p]laintiffs do not allege that [the management-affiliated merger partner] ever used the threat of a hostile takeover to influence the special committee.

Braunschweiger v. American Home Shield Corp., slip op. at 13, 17 Del.J.Corp.L. at 219. Unlike *Braunschweiger*, in this case the coercion was extant and directed to a specific price offer which was, in effect, presented in the form of a "take it or leave it" ultimatum by a controlling shareholder with the capability of following through on its threat of a hostile takeover.

Alcatel's Entire Fairness Burden Did Not Shift to Kahn

A condition precedent to finding that the burden of proving entire fairness has shifted in an interested merger transaction is a careful judicial analysis of the factual circumstances of each case. Particular consideration must be given to evidence of whether the special committee was truly independent, fully informed, and had the freedom to negotiate at arm's length. "Although perfection is not possible," unless the controlling or dominating shareholder can demonstrate that it has not only formed an independent committee but also replicated a process

as though each of the contending parties had in fact exerted its bargaining power at arm's length,

the burden of proving entire fairness will not shift. *Weinberger v. UOP, Inc.*, 457 A.2d at 709-10 n. 7. *See also Rosenblatt v. Getty Oil Co.*, Del.Supr., 493 A.2d 929, 937-38 (1985).

Subsequent to *Rosenblatt*, this Court pointed out that

the use of an independent negotiating committee of outside directors may have significant advantages to the majority stockholder in defending suits of this type,

but it does not *ipso facto* establish the procedural fairness of an interested merger transaction. *Rabkin v. Philip A. Hunt Chem. Corp.*, Del.Supr., 498 A.2d 1099, 1106 & n. 7 (1985). In reversing the granting of the defendants' motion to dismiss in *Rabkin*, this Court implied that the burden on entire fairness would not be shifted by the use of an independent committee which concluded its processes with "what could be considered a quick surrender" to the dictated terms of the controlling shareholder.¹⁰ *Id.* at 1106. This Court concluded in *Rabkin* that the majority stockholder's "attitude toward the minority," coupled with the "apparent absence of any meaningful negotiations as to price," did not manifest the exercise of arm's length bargaining by the independent committee. *Id.*

The Court of Chancery's determination that the Independent Committee

appropriately simulated a third-party transaction, where negotiations are conducted at arm's-length and there is no compulsion to reach an agreement,

¹⁰ A "surrender" need not occur at the outset of the negotiation process in order to deny a controlling shareholder the burden-shifting function which might otherwise follow from establishing an independent committee bargaining structure. *See Freedman v. Restaurant Assocs. Indus., Inc.*, Del. Ch., C.A. No. 9212, Allen, C., 1990 WL 135923 (Sept. 19, 1990), *reprinted in* 16 Del.J.Corp.L. 1462 (1991). *See also* Block, Barton & Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* 170-72 (4th ed. 1993). In *Freedman*, finding that there was no "fully functional" independent committee, the Court of Chancery stated:

[F]acts are alleged that would establish that [the] special committee was not given the opportunity to select from among the range of alternatives that an independent, disinterested board would have had available to it; it was, in effect, 'hemmed in' by the management group's actions. Under these circumstances, where, according to the allegations contained in the amended complaint, the management group could (and did) veto any action of the special committee that was not agreeable to the conflicted interests of the management directors it would be formalistically perverse to afford the special committee's action the effect of burden shifting of which that device is capable.

Freedman v. Restaurant Assocs. Indus., Inc., slip op. at 17-18, 16 Del.J.Corp.L. at 1475.

is not supported by the record. Under the circumstances present in the case sub judice, the Court of Chancery erred in shifting the burden of proof with regard to entire fairness to the contesting Lynch shareholder-plaintiff, Kahn. The record reflects that the ability of the Committee effectively to negotiate at arm's length was compromised by Alcatel's threats to proceed with a hostile tender offer if the \$15.50 price was not approved by the Committee and the Lynch board. The fact that the Independent Committee rejected three initial offers, which were well below the Independent Committee's estimated valuation for Lynch and were not combined with an explicit threat that Alcatel was "ready to proceed" with a hostile bid, cannot alter the conclusion that any semblance of arm's length bargaining ended when the Independent Committee surrendered to the ultimatum that accompanied Alcatel's final offer.

Conclusion

Accordingly, the judgment of the Court of Chancery is reversed. This matter is remanded for further proceedings consistent herewith, including a redetermination of the entire fairness of the cash-out merger to Kahn and the other Lynch minority shareholders with the burden of proof remaining on Alcatel, the dominant and interested shareholder.

KAHN V. LYNCH COMMUNICATION SYSTEMS, INC.

669 A.2d 79 (Del. 1995)

Before WALSH, HOLLAND, and HARTNETT, Justices.

WALSH, Justice:

This is the second appeal in this shareholder litigation after a Court of Chancery ruling in favor of the defendants. The underlying dispute arises from a cash-out merger of Lynch Communications System, Inc. ("Lynch") into a subsidiary of Alcatel USA, Inc. ("Alcatel"). In the previous appeal, this Court determined that Alcatel, as a controlling shareholder of Lynch, dominated the merger negotiations despite the fact that Lynch's board of directors has appointed an independent negotiating committee. *Kahn v. Lynch Communication Systems, Inc.*, Del.Supr., 638 A.2d 1110, 1112-13 (1994) ("*Lynch I*"). We concluded, however, that such a determination did not necessarily preclude a finding that the transaction was entirely fair and remanded the matter to the Court of Chancery for a determination of entire fairness, with the burden of proof upon the defendants.

Upon remand, the Court of Chancery reevaluated the record under the appropriate burden of proof and concluded that the transaction was entirely fair to the Lynch minority shareholders. The court also rejected plaintiff's claim that the defendants violated their duty of disclosure in failing to describe specifically the threat of a lower priced tender offer. We affirm in both respects.

I

The facts underlying the derivative claims are set forth extensively in *Lynch I* and we summarize them briefly for present purposes.

Lynch, a Delaware corporation, designed and manufactured electronic telecommunications equipment, primarily for sale to telephone operating companies. Alcatel, a holding company, is a subsidiary of Alcatel (S.A.), a French company involved in public telecommunications, business communications, electronics, and optronics. Alcatel (S.A.), in turn, is a subsidiary of Compagnie Generale d'Electricite ("CGE"), a French corporation with operations in energy, transportation, telecommunications and business systems.

In 1981, Alcatel¹ acquired 30.6% of Lynch's common stock pursuant to a stock purchase agreement. As part of that agreement, Lynch amended its certificate of incorporation to require an 80% affirmative vote to approve any business combination. By the time of the events leading to the contested merger, Alcatel owned 43.3% of Lynch's outstanding stock and designated five of the eleven directors on Lynch's board of directors, two of the three members of the executive committee, and two of the four members of the compensation committee.

¹ "Alcatel" refers to Alcatel and its affiliates.

In the spring of 1986, Lynch determined that it needed to acquire fiber optics technology in order to remain competitive. Lynch management identified a target company, Telco Systems, Inc. ("Telco"), that had the needed technology. Telco was apparently amenable to acquisition by Lynch. Lynch had to obtain Alcatel's consent, however, since the supermajority voting provision gave Alcatel an effective veto over any business combination. Exercising this power, Alcatel vetoed the transaction and instead proposed a combination of Lynch and Celwave Systems, Inc. ("Celwave"), an indirect subsidiary of CGE that possessed fibre optics technology. Ellsworth F. Dertinger ("Dertinger"), chairman of the board and CEO of Lynch, stated that Celwave would not be of interest to Lynch if Celwave were not owned by Alcatel. Nevertheless, the Lynch Board unanimously adopted a resolution that established a committee of independent directors (the "Independent Committee") to negotiate with Celwave and recommend the terms and conditions on which a combination would be based.

On October 24, 1986, Alcatel's investment banking firm, Dillon, Read & Co., Inc. ("Dillon, Read") made a presentation to the Independent Committee in which it explained the benefits of a Lynch/Celwave combination and proposed a stock-for-stock merger. The Independent Committee's investment advisors reviewed the Dillon, Read report and placed a significantly lower value on Celwave than had Dillon, Read. Consequently, the Independent Committee decided that the proposal was unattractive to Lynch and made a recommendation against the Lynch/Celwave combination.

Reacting to the Independent Committee's recommendation, Alcatel withdrew the Celwave proposal and instead offered to acquire the Lynch shares it did not already own at \$14 cash per share. In response, at its November 7th board meeting, the Lynch directors revised the mandate of the Independent Committee and authorized the same directors to negotiate the cash merger offer with Alcatel. Meeting on the same day, the Independent Committee decided that \$14 per share was inadequate.

On November 12, the Independent Committee made a counteroffer of \$17 per share. The parties negotiated for approximately two weeks, during which time Alcatel's highest offer was \$15.50 per share. On November 24, 1986, the Independent Committee met with its financial and legal advisors and were informed by one of the committee members that Alcatel was "ready to proceed with an unfriendly tender at a lower price" if the \$15.50 offer was not accepted. The Independent Committee, after consulting with its financial and legal advisors, voted unanimously to recommend that the Lynch board approve Alcatel's \$15.50 cash per share merger. The Lynch board met later that day and, with Alcatel's nominees abstaining, approved the merger.

Kahn, a Lynch shareholder, brought suit, later certified as a class action, challenging Alcatel's acquisition of Lynch through a tender offer and cash-out merger. Kahn alleged the merger to be unfair in that Alcatel, as a controlling shareholder, breached its fiduciary duties to Lynch's minority shareholders. Specifically, Kahn charged that Alcatel dictated the terms of the merger; made false, misleading, and inadequate disclosures; and paid an unfair price.

In its initial ruling, the Court of Chancery agreed with Kahn in finding that Alcatel exercised control over Lynch, but rejected the claim that Alcatel's disclosures in connection with the merger were insufficient. *Kahn v. Lynch Communication Systems, Inc.*, Del.Ch., C.A. No. 8748, 1993 WL 290193 slip op. at 5, 18, Berger, V.C. (July 9, 1993) (the "1993 decision"). Since Alcatel had negotiated with Lynch through an Independent Committee, however, the court placed the burden of disproving entire fairness on the plaintiff. In its evaluation of the evidence, the court concluded that Kahn had not carried his burden of demonstrating that the price was unfair and thus failed to prove a breach of fiduciary duty on the part of Alcatel. Judgment was accordingly entered for the defendants and Kahn appealed.

On appeal, this Court agreed with the Court of Chancery that Alcatel was a controlling shareholder. Since Alcatel had vetoed Lynch's acquisition of Telco and dominated Lynch's board on other occasions, the Court of Chancery's finding was clearly supported by the record.

This Court then turned to the finding that the transaction was entirely fair. We noted that normally a controlling shareholder, such as Alcatel, bears the burden of proving the entire fairness of a transaction in the context of a parent-subsidiary merger. *Weinberger v. UOP, Inc.*, Del.Supr., 457 A.2d 701, 710 (1983), requires that the party that has the burden of showing entire fairness must address that concept's "two basic aspects: fair dealing and fair price." *Weinberger* also addressed the question of what type of evidence would constitute a showing of entire fairness, and indicated that procedures, such as an independent negotiating committee which approximated an arm's length bargaining process is strong evidence of fairness.

The question remained, however, of the weight to be accorded such evidence, or, more specifically, whether a procedure approximating arm's length bargaining shifts the burden to the plaintiffs to show entire fairness or changes the standard of review so that the transaction will be examined under the business judgment rule. In *Lynch I* we noted that, since *Weinberger*, a business purpose has not been required to justify a merger. Therefore, since no business judgment need be exercised, the business judgment rule is not the proper standard of review. *Id.*

Consequently, in a merger between the corporation and its controlling stockholder--even one negotiated by disinterested, independent directors--no court could be certain whether the transaction terms fully approximate what truly independent parties would have achieved in an arm's length negotiation.

Citron v. E.I. Du Pont de Nemours & Co., Del.Ch., 584 A.2d 490, 502 (1990). Accordingly, the transaction must be examined for its entire fairness

because the unchanging nature of the underlying 'interested' transaction requires careful scrutiny.

[*Lynch I*,] 638 A.2d at 1116.

The next issue addressed by this Court in *Lynch I* was the allocation of the burden of proof. In order to shift the burden of showing entire fairness to the plaintiffs, the Independent Committee's negotiations must have resulted in something approaching arm's length negotiations. When undertaking this evaluation

[p]articular consideration must be given to evidence of whether the special committee was truly independent, fully informed, and had the freedom to negotiate at arm's length.

Lynch I, 638 A.2d at 1120-21. We noted with approval an earlier Court of Chancery ruling to the effect that at least two factors are required for this type of negotiation:

- (1) "the majority shareholder did not dictate the terms of the merger," and
- (2) the committee had real bargaining power so that it could negotiate with the controlling shareholder at arm's length.

Rabkin v. Olin Corp., Del.Ch., C.A. No. 7547 (Consolidated), Chandler, V.C., 1990 WL 47648, slip op. at 14-15 (Apr. 17, 1990), *reprinted in* 16 Del.J.Corp.L. 851, 861-62 (1991), *aff'd*, Del.Supr., 586 A.2d 1202 (1990).

Without explicitly referring to the *Rabkin* test, the Court of Chancery in the 1993 decision found that it had been satisfied to the extent the Independent Committee had appropriately simulated an arm's length transaction. However, in *Lynch I*, this Court found that determination to be unsupported by the record. Alcatel's threat of a hostile bid prevented the negotiations from approximating an arm's length transaction. The Independent Committee had, in effect, surrendered to the ultimatum delivered with Alcatel's last offer. Alcatel's use of its disproportionate bargaining power destroyed any approximation to being at arm's length the negotiations otherwise may have had. We therefore held that the Court of Chancery had improperly allocated the burden of proof to the plaintiff.

Consequently, the case was remanded for a

redetermination of the entire fairness of the cash-out merger to Kahn and the other Lynch minority shareholders with the burden of proof remaining on Alcatel, the dominant and interested shareholder.

Lynch I, 638 A.2d at 1122; *see Cede & Co. v. Technicolor, Inc.*, Del.Supr., 634 A.2d 345, 367 (1993), *on reargument*, 636 A.2d 956 (1994) ("*Cede II*"). Revisiting its decision based solely on the existing record and in light of this Court's instructions, the Court of Chancery preliminarily, and correctly, noted that

the Supreme Court did not intend to foreclose a finding of entire fairness on remand.

Kahn v. Lynch Communication Systems, Inc., Del.Ch., C.A. No. 8748, 1995 WL 301403, slip. op. at 3, Berger, J. (April 17, 1995) (the "1995 decision").

[T]he absence of certain elements of fair dealing does not mandate a decision that the transaction was not entirely fair.

Id. at 3-4; *Accord Cinerama, Inc. v. Technicolor, Inc.*, Del.Supr., 663 A.2d 1156, 1179 (1995).

After examining the transaction for entire fairness, the Court of Chancery once again found for the defendants, holding that they had carried the burden of showing the entire fairness of the transaction. The Court of Chancery rejected the plaintiff's claim that the coercion of the Independent Committee should have been disclosed to the shareholders. In addition, despite this coercion, the defendants were deemed to have met their burden of fair dealing because they had satisfied other relevant factors set forth in *Weinberger*. Specifically, the court examined the transaction's timing, initiation, structure and negotiation.

Next, the Court of Chancery examined the issue of fair price. Finding the evaluation of the plaintiffs' expert flawed, the court concluded that the defendants had also met their burden of establishing the fairness of the price received by the stockholders. Thus, the Court of Chancery held for the defendants after finding that they had established the entire fairness of the transaction.

In this appeal from the 1995 decision of the Court of Chancery, Kahn raises several issues. First, he contends that the finding of fair dealing was inconsistent with our opinion in *Lynch I* and unsupported by the record. Specifically, Kahn asserts that the coercion of the Independent Committee constituted a per se breach of fiduciary duty which strongly compels a finding that the transaction was not entirely fair. In addition, the plaintiff charges that the initiation, timing and negotiation of the merger were unfair and also require a finding of unfair dealing.

Second, the plaintiff contends that Alcatel breached its fiduciary duty to Lynch's stockholders by not fully disclosing its conduct in negotiating the merger. Thus, according to the plaintiff, the Court of Chancery erred by not finding a breach of the duty of disclosure. Such a finding, it is argued, is itself proof of unfair dealing.

The third claim made by Kahn is a challenge to the determination that they received a fair price for their shares. Kahn insists that the evidence submitted by Alcatel did not sustain their burden of showing that the price was fair.

II

Although we address this matter a second time following a partial reversal and remand, the standard of appellate review of the Court of Chancery's second decision is the same. To the extent that the Court of Chancery made supplemental factual findings, we will defer to those findings unless they are clearly erroneous or not arrived at through a logical process. *Cede & Co. v. Technicolor, Inc.*, Del.Supr., 634 A.2d 345, 360 (1993); *Lynch I*, 638 A.2d at 1114. Our review of the formulation and application of legal

principles, however, is plenary and requires no deference. *Gilbert v. El Paso Co.*, Del.Supr., 575 A.2d 1131, 1142 (1990).

A.

At the outset we must confront the disagreement between the parties concerning the extent to which our decision in *Lynch I* limited the scope of the Court of Chancery's re-examination of the record on remand. Kahn argues that this Court's characterization of Alcatel's conduct as "coercive" was not accorded adequate consideration by the trial court in its entire fairness calculation. Alcatel contends to the contrary that this Court's evaluation of the record in *Lynch I* was done in the context of determining which party had the burden of proving entire fairness and that the Court of Chancery, on remand, was restricted procedurally, but not substantively, in its view of the trial evidence.

While we agree that our decision in *Lynch I* limited the range of findings available to the Court of Chancery upon remand, our previous review of the record focused upon the threshold question of burden of proof. Our reversal on burden of proof left open the question whether the transaction was entirely fair. Indeed, Kahn concedes that our ruling on burden shifting did not create per se liability, an obvious concession since we did not address the fair price element in *Lynch I*, except to note that the Independent Committee's ability to negotiate price had been compromised by Alcatel's threat to proceed with a hostile tender offer. The Court of Chancery correctly took as its premise on remand that Alcatel, as the dominant and interested shareholder bore the burden of demonstrating the entire fairness of the merger transaction. Its findings will be tested from that perspective.

As we noted in *Lynch I*,

a controlling or dominating shareholder standing on both sides of a transaction, as in a parent-subsidiary context, bears the burden of proving its entire fairness"

[*Lynch I*, 638 A.2d] at 1115. The standard for demonstrating entire fairness is the oft-repeated one announced in *Weinberger v. UOP, Inc.*, Del.Supr., 457 A.2d 701, 711 (1983): fair dealing and fair price. Fair dealing addresses the timing and structure of negotiations as well as the method of approval of the transaction, while fair price relates to all the factors which affect the value of the stock of the merged company. An important teaching of *Weinberger*, however, is that the test is not bifurcated or compartmentalized but one requiring an examination of all aspects of the transaction to gain a sense of whether the deal in its entirety is fair. In its most recent authoritative analysis of the subject, this Court held:

the board will have to demonstrate entire fairness by presenting evidence of the cumulative manner by which it ... discharged all of its fiduciary duties.

Cinerama, Inc. v. Technicolor, Inc., Del.Supr., 663 A.2d at 1163.

B.

This Court will now review the Court of Chancery's entire fairness analysis upon remand. The record reflects that the Court of Chancery followed this Court's mandate by applying a unified approach to its entire fairness examination. In doing so, the Court of Chancery properly considered

how the board of directors discharged all of its fiduciary duties with regard to each aspect of the non-bifurcated components of entire fairness: fair dealing and fair price.

Cinerama, Inc. v. Technicolor, Inc., Del.Supr., 663 A.2d at 1172.

In addressing the fair dealing component of the transaction, the Court of Chancery determined that the initiation and timing of the transactions were responsive to Lynch's needs. This conclusion was based on the fact that Lynch's marketing strategy was handicapped by the lack of a fiber optic technology. Alcatel proposed the merger with Celwave to remedy this competitive weakness but Lynch management and the non-Alcatel directors did not believe this combination would be beneficial to Lynch. Dertinger, Lynch's CEO, suggested to Alcatel that, under the circumstances, a cash merger with Alcatel will be preferable to a Celwave merger. Thus, the Alcatel offer to acquire the minority interests in Lynch was viewed as an alternative to the disfavored Celwave transaction.

Kahn argues that the Telco acquisition, which Lynch management strongly supported, was vetoed by Alcatel to force Lynch to accept Celwave as a merger partner or agree to a cash out merger with Alcatel. The benefits of the Telco transaction, however, are clearly debatable. Telco was not profitable and had a limited fiber optic capability. There is no assurance that Lynch's shareholders would have benefitted from the acquisition. More to the point, the timing of a merger transaction cannot be viewed solely from the perspective of the acquired entity. A majority shareholder is naturally motivated by economic self-interest in initiating a transaction. Otherwise, there is no reason to do it. Thus, mere initiation by the acquirer is not reprehensible so long as the controlling shareholder does not gain a financial advantage at the expense of the minority.

In support of its claim of coercion, Kahn contends that Alcatel timed its merger offer, with a thinly-veiled threat of using its controlling position to force the result, to take advantage of the opportunity to buy Lynch on the cheap. As will be discussed at greater length in our fair price analysis, *infra*, Lynch was experiencing a difficult and rapidly changing competitive situation. Its current financial results reflected that fact. Although its stock was trading at low levels, this may simply have been a reflection of its competitive problems. Alcatel is not to be faulted for taking advantage of the objective reality of Lynch's financial situation. Thus the mere fact that the transaction was initiated at Alcatel's discretion, does not dictate a finding of unfairness in the absence of a determination that the minority shareholders of Lynch were harmed by the timing. The Court of Chancery rejected such a claim and we agree.

C.

With respect to the negotiations and structure of the transaction, the Court of Chancery, while acknowledging that the Court in *Lynch I* found the negotiations coercive, commented that the negotiations

certainly were no less fair than if there had been no negotiations at all

1995 decision at 4. The court noted that a committee of non-Alcatel directors negotiated an increase in price from \$14 per share to \$15.50. The committee also retained two investment banking firms who were well acquainted with Lynch's prospects based on their work on the Celwave proposal. Moreover, the committee had the benefit of outside legal counsel.

It is true that the committee and the Board agreed to a price which at least one member of the committee later opined was not a fair price. But there is no requirement of unanimity in such matters either at the Independent Committee level or by the Board. A finding of unfair dealing based on lack of unanimity could discourage the use of special committees in majority dominated cash-out mergers. Here Alcatel could have presented a merger offer directly to the Lynch Board, which it controlled, and received a quick approval. Had it done so, of course, it would have borne the burden of demonstrating entire fairness in the event the transaction was later questioned. Where, ultimately, it has been required to assume the same burden, it should fare no worse in a judicial review of the fairness of its negotiations with the Independent Committee.

Kahn asserts that the Court of Chancery did not properly consider our finding of coercion in *Lynch I*. Generally, as in this case, the burden rests on the party that engaged in coercive conduct to demonstrate the equity of their actions. Kahn challenges the Court of Chancery's finding of fair dealing by relying upon the holding in *Ivanhoe Partners v. Newmont Min. Corp.*, Del.Ch., 533 A.2d 585, 605-06 (1987), *aff'd*, Del.Supr., 535 A.2d 1334 (1988), for the proposition that coercion creates liability per se.² *Ivanhoe* makes clear, however, that to be actionable, the coercive conduct directed at selling shareholders must be a "material" influence on the decision to sell.

Where other economic forces are at work and more likely produced the decision to sell, as the Court of Chancery determined here, the specter of coercion may not be deemed material with respect to the transaction as a whole, and will not prevent a finding of entire fairness. In this case, no shareholder was treated differently in the transaction from any other shareholder nor subjected to a two-tiered or squeeze-out treatment. *See, e.g., Unocal Corp. v. Mesa Petroleum Co.*, Del.Supr., 493 A.2d 946, 956 (1985).

² The plaintiffs in *Ivanhoe* were vying for control of Newmont Mining Corp. and challenged a street sweep undertaken by a competitor for control, Consolidated Gold Fields PLC and its subsidiaries. This Court upheld the *Ivanhoe* trial court's determination that the street sweep, which was undertaken in cooperation with the target's management, did not constitute coercion. However, this Court analyzed the street sweep in narrower terms than the Court of Chancery, "view[ing] the street sweep as part of Newmont's own comprehensive defensive strategy," and thus under the guidelines of *Unocal*. *Ivanhoe Partners v. Newmont Min. Corp.*, Del.Supr., 535 A.2d 1334, 1343-44 (1987).

Alcatel offered cash for all the minority shares and paid cash for all shares tendered. Clearly there was no coercion exerted which was material to this aspect of the transaction, and thus no finding of per se liability is required.

D.

As previously noted, in *Lynch I* this Court did not address the fair price aspect of the merger transaction since our remand required a reexamination of fair dealing at the trial level. The parties had presented extensive evidence at the original trial concerning the value of Lynch. Upon remand the Court of Chancery reassessed that evidence with the burden on Alcatel to prove the fairness of the cash-out merger price.

In considering whether Alcatel had discharged its burden with respect to fairness of price, the Court of Chancery placed reliance upon the testimony of Michael McCarty, a senior officer at Dillon Read, who prepared Alcatel's proposal to the Independent Committee. He valued Lynch at \$15.50 to \$16.00 per share--a range determined by using the closing market price of \$11 per share of October 17, 1988 and adding a merger premium of 41 to 46%. Dillon Read's valuation had been prepared in October, 1986 in connection with the Lynch/Celwave combination proposed at a time when Lynch was experiencing a downward trend in earnings and prospects. Subsequent to the October valuation, Lynch management revised its three year forecast downward to reflect disappointing third quarter results.

The Court of Chancery also considered the valuation reports issued by both Kidder Peabody and Thompson McKinnon who were retained by the Independent Committee at the time of the Celwave proposal in October. At that time both bankers valued Lynch at \$16.50 to \$17.50 per share. These valuations, however, were made in response to Alcatel's Celwave proposal and were not, strictly speaking, fairness opinions. When Lynch later revised downward its financial forecasts based on poor third quarter operating results both firms opined that the Alcatel merger price was fair as of the later merger date.

Kahn supported his claim of inadequate price principally through the expert testimony of Fred Shinagle, an independent financial analyst, who opined that the fair value of Lynch on November 24, 1986 was \$18.25 per share. He reached that conclusion by averaging equally the values he derived from market price, book value, earning power and capitalization.

Shinagle used the average market price for Lynch stock during the week of June 23, 1986 since Lynch and Alcatel first began discussion about a Celwave transaction on June 25. That average was \$13.23 per share. He next computed Lynch's book value of \$17.99 per share by applying a multiple of 1.7 to Lynch's accounting book value of \$10.58 per share. The multiple was derived from the average book value multiple of six companies which Shinagle chose for comparison analysis. The information concerning the comparable companies was gathered from Standard & Poor's summary sheets using the Standard Industrial Code (SIC) Classification. Shinagle did not perform a first hand review of the financial statements of the comparable companies but relied solely upon the

Standard & Poor material. Nor did Shinagle perform any independent research on Lynch's production and industry but relied instead on information relayed by Dertinger.

Shinagle's capitalization value for Lynch, \$27.92 per share, was secured by multiplying the book capitalization figure of \$11.17 per share by 2.5. This multiple was not the average but the highest of the six comparable companies. He justified the use of the highest multiple on the ground that Lynch had a lower debt to equity ratio than any of the comparables. He believed that an inverse correlation exists between debt-to-equity and capitalization multipliers.

Finally, Shinagle devised a value for earning power of \$13.37 per share again by calculating average multiples from his comparable companies for revenue, net income and cash flow. These multiples applied against Lynch's forecasted revenue, net income and cash flow yield results which he averaged to reach earning power value.

In addition to the testimony of his valuation expert, Kahn offered the view of Dertinger, Lynch's CEO at the time of the merger, who testified that he thought the fair value of Lynch at the time of the merger was \$20 per share. Dertinger considered "two values of Lynch: Our marketing value--that is in the eyes of our customers--and the value of Lynch on Wall Street as exemplified primarily by the stock price. But I think that is definitely secondary to a company's potential." Board member Hubert Kertz also testified that in his opinion Lynch's value was well above the \$14 merger price. Although conceding that "not being a financial man but being a manager" he thought that "even under almost the worst scenario, it ought to be somewhere in the high teens or \$20 a share."

In its fair price analysis, the Court of Chancery accepted the fairness opinions tendered by Alcatel and found the merger price fair. The court rejected Kahn's attack on the merger price because it found the Shinagle valuation methodology to be flawed for the reason set forth in the trial court's 1993 decision. Those deficiencies included Shinagle's decision to use the highest capitalization ratio instead of the average as he did with his other calculations involving the comparable companies. The court noted that had Shinagle used the average capitalization rate of the comparable companies, consistent with his use of averages for his other valuation approaches, his capitalization value would have been \$13.18 per share instead of the \$27.92 per share produced by applying the highest capitalization ratio. The court rejected Shinagle's assumption that debt/equity ratio correlates to a high capitalization ratio as unjustified.

In resolving issues of valuation the Court of Chancery undertakes a mixed determination of law and fact. When faced with differing methodologies or opinions the court is entitled to draw its own conclusions from the evidence. So long as the court's ultimate determination of value is based on the application of recognized valuation standards, its acceptance of one expert's opinion, to the exclusion of another, will not be disturbed.

The Court of Chancery's finding that Alcatel had successfully born the initial burden of proving the fairness of the merger price is fully supportable by the evidence tendered by the experts retained by Alcatel and by the Independent Committee. Shinagle's opinions

supporting a higher valuation were rejected as flawed and the testimony of Dertinger and Kertz not credited by the trial court because of the lack of analysis or objective support. Although the burden of proving fair price had shifted to Alcatel, once a sufficient showing of fair value of the company was presented, the party attacking the merger was required to come forward with sufficient credible evidence to persuade the finder of fact of the merit of a greater figure proposed. The Court of Chancery was not persuaded that Kahn had presented evidence of sufficient quality to prove the inadequacy of the merger price. We find that ruling to be logically determined and supported by the evidence and accordingly affirm.

III

We next address the remaining question decided by the Court of Chancery in its 1993 decision but not resolved in *Lynch I*--whether Alcatel violated the duty of disclosure in its Offer to Purchase directed to Lynch shareholders. Kahn asserts that in light of this Court's finding that Alcatel used coercion to gain approval of the merger price by the Lynch board, the Offer to Purchase contained material omissions. To the contrary, Alcatel maintains that in both the Offer to Purchase and in its Schedule 13D filed with the Securities and Exchange Commission, Alcatel fully and clearly indicated that its option included a tender offer directly to stockholders if negotiations with the Lynch Board proved unsuccessful.

A controlling shareholder owes a duty of complete candor when standing on both sides of a transaction and must disclose fully all the material facts and circumstances surrounding the transaction. *Arnold v. Society for Sav. Bancorp, Inc.*, Del.Supr., 650 A.2d 1270, 1276 (1994). Information is deemed material if

there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote ...

Rosenblatt v. Getty Oil Co., Del.Supr., 493 A.2d 929, 944 (1985) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 96 S.Ct. 2126, 2132, 48 L.Ed.2d 757 (1976)). The materiality standard is an objective one, determined from the perspective of the reasonable shareholder, not that of the directors or other party who undertakes to distribute information. *Zirn v. VLI Corp.*, Del.Supr., 621 A.2d 773, 779 (1993). In reviewing a ruling pursuant to these legal standards, this Court will review the entire record. *Id.* at 778.

[I]f the findings of the trial judge are sufficiently supported by the record and are the product of an orderly and logical deductive process, ... we accept them, even though independently we might have reached opposite conclusions.

Id. (citations omitted).

We begin our examination of the record below with the allegedly deficient documents. The Offer to Purchase, distributed to Lynch shareholders at the Board's

behest and apparently under Alcatel's direction, described Alcatel's negotiation stance as follows:

Discussions between representatives of Dillon Read on behalf of Alcatel USA and the Independent Committee and its financial advisors continued during the period from November 12 to November 20, 1986. During such discussions representatives of Alcatel USA informed the Independent Committee that, in the event the parties could not reach an agreement for a transaction, Alcatel USA would consider the options that were available to it at that time, including among other things, making an offer directly to the stockholders of the Company.

In its 1993 decision, the Court of Chancery found that the Offer to Purchase and this language in particular

sufficiently describe Alcatel's position. They alert a reasonable investor that Alcatel had a certain amount of bargaining leverage and was using it.

On remand, the Court of Chancery held to the same conclusion, stating:

The Supreme Court's description of the negotiations as coercive does not mandate the use of that term in the proxy materials.

Kahn argues that Alcatel's description of its negotiating options was incomplete and misleading and should have conveyed the additional information that its "making an offer" would have been "far below the merger price of \$15.50 per share." The narrow question thus becomes whether a reasonable shareholder would have considered the additional language "as having significantly altered the total mix of information made available." *Arnold v. Bancorp*, 650 A.2d at 1277.

Although the additional language may have rendered the Offer to Purchase somewhat more informative by "closing the circle" on the full extent of Alcatel's options, we agree with the Court of Chancery that such additional language was not required to describe the extent of Alcatel's bargaining power. There can be little doubt that Alcatel intended to acquire the entire equity interest in Lynch and the description of negotiations contained in the Offer to Purchase described its efforts and the responses of the Lynch Board and the Independent Committee. The Offer to Purchase disclosed the full range of value advanced by the parties during negotiations and notes that the final price of \$15.50 was not within the preliminary range but reflects the change in financial projections based on Lynch's third-quarter results.

Kahn concedes that Alcatel was not required to describe its own conduct as coercive but at the same time argues that the Offer to Purchase should have contained sufficient facts concerning Alcatel's negotiation power to permit the minority shareholders of Lynch to gain the same impression. This contention overstates the effect of our holding in *Lynch I* and misconceives the requirements of materiality. *Weiss v. Rockwell Int'l Corp.*, Del.Ch., C.A. No. 8811, 15 Del.J.Corp.L. 777, 787, 1989 WL 80345, Jacobs, V.C. (July 10, 1989) ("To argue, as plaintiff does, that the proxy statement should have

embellished these disclosures by adding to them a confession of corporate wrongdoing ... is simply not required."), *aff'd*, Del.Supr., 574 A.2d 264 (1990). A reasonable minority shareholder of Lynch was under no illusions concerning the leverage available to Alcatel and its willingness to use it to acquire the minority interest.

Alcatel's consideration of available options including "making an offer directly to the stockholders" is obviously conveying an intent to terminate negotiations with the Board and engage in a hostile tender offer. The materiality of the tendered information is the statement of Alcatel's range of options and that such options were disclosed to the Independent Committee as part of the negotiations that led to the agreement of the Lynch Board to recommend the merger prices. In our view nothing further was required and we find the holding of the Court of Chancery that no disclosure violation occurred here to be clearly supported by the record.

The Court of Chancery's finding of no disclosure violation, which we endorse, though not determinative of entire fairness, is of "persuasive substantive significance." *Cinerama, Inc. v. Technicolor, Inc.*, Del.Supr., 663 A.2d 1156, 1176 (1995). Such a determination precludes the award of damages per se, bears directly upon the manner in which stockholder approval was obtained, and places this case in the category of "nonfraudulent transactions" in which price may be the preponderant consideration. *Id.* (quoting *Weinberger v. UOP, Inc.*, 457 A.2d at 711.)³ Although the merger was not conditioned on a majority of the minority vote, we note that more than 94 percent of the shares were tendered in response to Alcatel's offer.

IV

In summary, after reassessing the trial record under an entire fairness standard, with the burden of proof upon Alcatel, the Court of Chancery determined that, as a result of the manner by which the board discharged its fiduciary duties, the timing and structure of negotiations and the disclosure to shareholders of such event were the product of fair dealing. Similarly, the trial court concluded that the merger price was fair. Thus the non-bifurcated standard of *Weinberger* was satisfied. Under our standard of review, we defer to the trial court's evidentiary findings if supported by the record and logically determined.

In deciding the ultimate question of entire fairness, the Court of Chancery was required to carefully analyze the factual circumstances in the context of how the board discharged all of its fiduciary duties, apply a disciplined balancing approach to its findings, and articulate the basis for its decision. The record reflects that was done. We find no error in the trial court's application of legal standards and accordingly affirm.

³ Our affirmance of the Court of Chancery's disclosure violation determination renders unnecessary any consideration of Kahn's damages claims.