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SUBSTANCE AND PROCESS IN CORPORATE LAW

JAMES AN*

The central purpose of corporate law is to facilitate the relationship between the shareholders who provide the corporation's equity capital and the managers who make the bulk of corporate decisions. Although select aspects of corporate law considers the economic merits of those decisions ("substance"), the bulk of corporate law regulates the procedures by which a corporation's managers reached those decisions ("process"). Moreover, recent judicial decisions have tended to push corporate law even further toward process-centered considerations. Courts have defended such tendencies on the basis that the courts charged with reviewing disputed corporate decisions are often better at evaluating process than engaging in financial analysis, an argument with which this Article largely agrees.

That said, the courts have often overlooked the difficulties with analyzing process and the complex relationship between process and substance, which are sometimes inseparable as a practical matter. This has led to doctrines and rules that have failed to deliver on promises of a more straightforward judicial review, unintentionally redirected courts back into substantive analyses of business decisions, burdened defendants with unexpected costs, and left plaintiffs without a meaningful remedy despite plain misconduct. As this Article contends, there is significant room for improvement in our understanding of the interactions between substance and process and thus throughout corporate law's various legal standards.

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Introduction

Corporate law's constraints on the decisions of a corporation's management may be divided into two broad categories: procedural propriety and substantive propriety. That is to say, corporate law considers two facets of a transaction: (1) whether the corporation's management used processes that are fair to stockholders to reach its decision and (2) whether the economic results of that decision were substantively fair to stockholders. When reviewing a decision in the course of litigation, courts need not always examine both, and indeed, they often do not. This dichotomy not only is facially present in numerous corporate law standards, most obviously in the "entire fairness" test,

which explicitly requires "fair dealing" and "fair price,"[1] but also perpetually lurks in the background.

Yet tensions arise due to the difficulty of determining substantive economic value. After all, *tantum bona valent, quantum vendi possunt*[2] (things are worth only what they can sell for). For a court to step in and decide the proper price of a transaction is for the court to substitute its own judgment of value for that of the market, which entails serious complications given the common assumption that a properly functioning market's determination of price is conclusive as to value.[3] And after all, the notion that courts should not be second guessing the economic wisdom of business decisions made by duly selected corporate executives is fundamental to the deferential business judgment standard that applies to most management decisions. To resolve this tension between the courts' role as the final overseers of the shareholder-management relationship and the courts' comparative and absolute disadvantage at evaluating the economic substance of business decisions, corporate law has often given primacy to process-based concerns.

In recent decades, the courts of Delaware, the world's leading corporate law jurisdiction,[4] have pushed corporate law's emphasis on process even further. In so doing, the courts have focused on challenged decisions' qualitative procedural attributes—such as whether there was stockholder ratification—and discouraged trial judges from engaging in extensive quantitative examination of the economic substance of a decision, regardless of whether the deferential business judgment rule or some "heightened" standard of scrutiny applies.

Although previous commentary has identified the Delaware courts' orientation toward process in individual areas,[5] this Article argues that the push toward process is evident in

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1. Weinberger v. UOP, Inc., 457 A.2d 701, 714 (Del. 1983).

2. EDWARD COKE, THE THIRD PART OF THE INSTITUTES OF THE LAWS OF ENGLAND 105 (1644).

3. *See* Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Grp., Ltd., 847 A.2d 340, 357 (Del. Ch. 2004).

4. *See* Ido Baum & Dov Solomon, *The Least Uncomfortable Choice: Why Delaware and England Win the Global Corporate Law Race*, 73 S.C. L. REV. 387, 395 (2021).

5. *See, e.g.*, William W. Bratton, *Fair Value As Process: A Retrospective Reconsideration of Delaware Appraisal*, 47 DEL. J. CORP. L. 497, 572 (2023); Amir N. Licht, *Farewell to Fairness: Towards Retiring Delaware's Entire Fairness Review*, 44 DEL. J. CORP. L. 1, 2 (2020); Charles R. Korsmo, *Delaware's Retreat from Judicial Scrutiny of Mergers*, 10 U.C. IRVINE L. REV. 55, 101 (2019); Marcel Kahan, Paramount *or*

nearly every aspect of Delaware corporate law. Furthermore, this Article argues that this push is not, as some commentators have argued,[6] a wholesale retreat from judicial oversight of management. Instead, it is a recalibration of the means by which corporate law should police management. This Article largely agrees with courts' explicit statements and implicit reasoning that, as a matter of judicial policy, it is generally wise for courts to shy away from financial analysis, particularly in public or otherwise liquid markets.

However, the distinction between substance and process often blurs at the edges, leading to serious doctrinal and practical issues when courts instead treat the two as a Manichean duality or otherwise gloss over the complex interactions between the two aspects of corporate decision-making. For example, in merger cases to which the *Revlon* doctrine applies, courts have held that certain deal-protection clauses inappropriately impaired the sales process to the detriment of shareholders.[7] But as theory and data indicate, these clauses are integral to the substantive economic terms of merger agreements,[8] which courts say should be left to the market. Nevertheless, courts have not paused and explained why it is appropriate for them to rule upon what is effectively the economic substance of deal-protection clauses. Similarly, in poison pill cases, the courts have held that defensive devices that directly impair voting rights are impermissible, but those that operate via economic mechanisms are allowed. But from at least one view, the substantive effect of both types of defensive devices is the same: delay the ability of a majority of shareholders to sell their shares to a would-be acquirer.

Issues also arise when courts attempt to center their inquiry on procedural questions that turn out to be less procedural than envisioned. For example, *Corwin* attempted to shift courts' focus away from more complex mixed issues of a deal's substance and process by instead first asking courts to examine whether stockholders properly approved those deals. But as subsequent litigation has shown, analyses of stockholder votes under *Corwin* often devolve back into the substantive economic

Paradox: The Delaware Supreme Court's Takeover Jurisprudence, 19 J. Corp. L. 583, 596, 588, 605–06 (1994).

6. *See, e.g.*, Korsmo, *supra* note 5, at 82–105.

7. *See infra* Part I.D.

8. *Infra* note 127 and accompanying text.

considerations surrounding the deal as courts must evaluate whether the underlying fiduciary breaches were so significant as to render the vote unreliable.[9] Similarly, this Article argues that the *Caremark* doctrine, which requires boards to monitor corporate risks and react to red flags indicating imminent danger, is not the simple process-only question that the courts claim. As shown by recent cases, courts applying *Caremark* do and perhaps must consider the economic substance of those risks. Likewise, to the extent that *Caremark* examines risk monitoring processes and responses to red flags, there is still reason to wonder when these processes and responses are but manifestations of substantive business decisions.

Finally, this Article contends that there are instances where the courts have chosen the wrong procedural guardrail. For instance, although process-centered rules are not inherently strict or forgiving, it certainly would seem that several recent cases have nevertheless approved of what were arguably flawed deal processes.[10] And while this Article argues that the proper response is to call for more stringent judicial review of the procedural aspects of a transaction, these cases certainly make it difficult to outright dismiss critics' claims that current process-centered rules are inadequately protective of stockholders. That said, as illustrated by the infamous *Van Gorkom* case, courts can also impose too harsh of a procedural standard, and there are concerns that *Caremark* may be headed down a similar path. As such, a judicial migration from focusing on substance to focusing on process may not be as simple or effective as imagined.

As these examples illustrate, the issues that arise out of the complex interplay between substance and process manifest themselves in many different ways. Although there is an intimate connection between how judicial standards examine substance and process and the results of judicial review, that connection cannot be reduced to a simple formula. It cannot be said simply that mishandling the substance-process divide leads to law that is too shareholder-friendly, too management-friendly, too complicated, too simple, or any other singular descriptor. Rather, the myriad issues that arise are the mixed results of complex interactions between legal theory and business practice,

9. *See infra* Part I.E.
10. *See* Parts I.C and IV.A.ii.

the latter of which of course changes over time. Ultimately, creating an optimized legal framework requires that courts squarely confront a host of issues and interactions, allowing them to synthesize judicial standards that are both more effective and more straightforward.

This Article explores the foregoing in four parts. Parts I and II illustrate corporate law's substance-process divide—and the issues related to that divide—via discussions of specific corporate doctrines organized into change-of-control deals (viz. mergers) and management of going concerns, respectively. Part III synthesizes the lessons offered by the courts' handling of the substance-process divide. Part IV offers specific critiques of some select doctrines and proposals for going forward.

I.
Mergers

Conflicts between shareholders and the board of directors often come to a head in the mergers and acquisitions context, with shareholder-board disputes particularly likely for the target (selling) entity. This is an unremarkable fact, given that a sale is one of the two most significant single events a business can experience, with the other being bankruptcy. Though shareholders have more say in the sale of a corporation than in nearly any other corporate decision,[11] shareholders generally have only the power to give an up-or-down vote to the final merger agreement negotiated by the board (or, in the case of tender offers, to either accept or reject the offer) and have no direct ability to negotiate any of the terms of a sale, not the least being the price.

Thus, when it comes to mergers, the great deference that corporate law generally affords to a board's decisions often gives way to more stringent standards of review. Delaware has created a comprehensive scheme to police merger deals for fairness, particularly for the selling corporation's shareholders.

First, if a board decides to sell the corporation, corporate law imposes a heighted standard of review of the process by which the board conducts the sale process to ensure that shareholders receive the best price possible. Shareholders making such so-called *Revlon* claims supplement charges of inadequate

11. *Compare* Del. Code Ann. tit. 8, § 141(a) (2021) *with* Del. Code Ann. tit. 8, § 251(c) (2021).

price with allegations that the board failed to follow a prudent sales process that would sufficiently ensure a fair price. However, a board may immunize itself against such claims by receiving the approval by a majority of disinterested and fully informed shareholders (i.e., *Corwin* cleansing).

Second, after the sale of a company and regardless of any flaws in the sale process, a shareholder may obtain an appraisal for the fair value of their shares.

Third, corporate law also imposes a heightened standard of review upon boards acting to *avoid* a merger, for example, by adopting a poison pill. The *Unocal* framework seeks to ensure that defensive actions undertaken to avoid takeovers do not merely serve to protect the jobs and other interests of the corporation's executives.

Finally, in mergers where a controlling shareholder or a majority of the board seeks to buy out the other shareholders, corporate law applies its strictest standard of review, entire fairness. The entire fairness standard recognizes the inherent conflicts of interest in such cases and requires defendants to prove the fairness of both the course of dealing and the final economic terms of the deal, i.e., fair dealing and fair price.

This Part examines each of the aforementioned schemes within the process-substance framework, illustrates how the courts have shifted doctrines toward more process-centered analyses, and explains how these shifts have often been accompanied by unforeseen complications. That said, because of the obvious correspondence between the two prongs of entire fairness and the substance-process divide, this Article starts with entire fairness as its first case study.

A. *Entire Fairness and the Difficulty of the Fair Price Determination*

Entire fairness is a paradigmatic example of the divide between substance and process in corporate law—and of several of the issues related to that divide. Where a transaction (including but not limited to mergers) involves self-dealing by a corporation's board or its controlling stockholder (to the extent that one exists), a court will generally apply the entire fairness standard of review to that transaction.[12] Under entire fairness,

12. *Weinberger*, 457 A.2d at 711.

a court examines two qualities of a challenged transaction: fair dealing and fair price. "[Fair dealing] 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. [Fair price] relates to the economic and financial considerations 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 [the transaction]."[13] The correspondence between the two aspects of entire fairness and the substance-process dichotomy is obvious.

Unlike numerous other corporate law standards, entire fairness unambiguously requires the court to evaluate the economic substance of a deal. Indeed, notwithstanding the courts' characterization of entire fairness as an unbifurcated whole,[14] fair price is often the linchpin of an entire fairness inquiry.[15] And in several cases, discussed immediately below, courts have awarded minimal damages despite finding unfair dealing due to the supposed fairness of the price.

As it were, entire fairness cases in which courts found unfair dealing but awarded no damages provide an excellent view of the challenges that courts face in evaluating the substantive economic merits of a transaction.[16] First, a court may

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13. *Id.*

14. *Id.*; Kahn v. Tremont Corp., 694 A.2d 422, 432 (Del. 1997) (citing *Weinberger*, 457 A.2d at 711); Kahn v. Lynch Commc'n Sys., 669 A.2d 79, 84 (Del. 1995); *see also* Bomarko, Inc. v. Int'l Telecharge, 794 A.2d 1161, 1182–83 (Del. Ch. 1999) (describing the entire fairness test as "structurally bifurcated" but nevertheless "conceptually singular"). There is no clear explanation of how this "unbifurcated" approach actually differs from various other multi-prong tests in the law. *See* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. Pa. L. Rev. 785, 798 & n.41 (2003) (describing *Weinberger*'s description of entire fairness as "unhelpful" and its reasoning as "unclear"). It should also not be missed that, as of this writing, Delaware courts have yet to find an instance of fair dealing but unfair price. Notwithstanding the courts' characterization of entire fairness, it is perhaps better described as a framework under which the fair dealing inquiry determines liability and the fair price inquiry determines damages.

15. *Tremont*, 694 A.2d at 432; *see also* Licht, *supra* note 5, at 9–10.

16. *E.g.*, *In re* Straight Path Commc'ns. Inc. Consol. S'holder Litig., C.A. No. 2017-0486-SG, 2023 WL 6399095 (Del. Ch. Oct. 3, 2023); William Penn P'ship v. Saliba, 13 A.3d 749 (Del. 2011); *In re* PLX Tech. Inc. S'holders Litig., C.A. No. 9880-VCL, 2018 WL 5018535, at *50 (Del. Ch. Oct. 16, 2018) [hereinafter *PLX Trial*], *aff'd*, 211 A.3d 137 (Del. 2019); ACP Master, Ltd. v. Sprint Corp., C.A. No. 8508-VCL, 2017 WL 3421142, at *19 (Del. Ch. July 21, 2017); Ross Holding & Mgmt. Co. v. Advance Realty Grp. L.L.C., C.A. No. 4113-VCN, 2014 WL 4374261, at *34 (Del. Ch. Sept. 4, 2014); Oliver v. Bos. Univ., C.A.

misinterpret the complex evidence before it—this was the problem in *Trados*[17] and *Nine Systems.*[18] Second, the evidence itself may be deficient—*Nine Systems* suffered from this issue as well.

Trados is probably the most well-known case in which a court found unfair dealing but did not award damages. In *Trados*, the preferred stockholders, who controlled the corporation, sought an exit because the business had failed to satisfy their growth targets.[19] The preferred stockholders' liquidation preferences meant that the first $57.9 million from any merger would be paid to preferred stockholders before common stockholders received anything.[20] Trados' board also gave management an incentive plan such that management's "return profile and incentives closely resembled those of the preferred."[21] Ultimately, management negotiated a sale in which preferred stockholders received $52.2 million, management received $7.8 million, and common stockholders received nothing.

In its post-trial decision, the Court of Chancery found that the process for selling the corporation was not entirely fair to common stockholders.[22] Yet, the court awarded no damages because it determined, after conducting an extensive financial valuation, that the expected value, and consequently the fair value, of Trados' common stock was zero.[23]

The problem with *Trados* is that the Court of Chancery misunderstood how to calculate the expected value of common stock. Contrary to *Trados*'s approach, the expected value of the common stock is different from the expected value of the firm less preferences. As Adam Katz has pointed out, subtracting a firm's fixed claims against the expected enterprise value to produce equity value will invariably fail to account for the option value inherent in the equity of a limited liability entity.[24] Just as underwater options trade at positive prices, equity also must

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No. 16570-NC, 2006 WL 1064169, at *30 (Del. Ch. Apr. 14, 2006); *see also* Gilson & Gordon, *supra* note 14, at 798 n.41 ("Suppose the price is entirely fair, but the process is faulty. To what else are shareholders entitled beyond a fair price?").

17. *In re* Trados Inc. S'holder Litig., 73 A.3d 17 (Del. Ch. 2013).

18. *In re* Nine Sys. Co. S'holders Litig., C.A. No. 3940-VCN, 2014 WL 4383127 (Del. Ch. Sept. 4, 2014).

19. *Trados,* 73 A.3d at 56.

20. *Id.* at 33.

21. *Id.* at 62.

22. *Id.* at 72.

23. *Id.* at 20, 78.

24. *See generally* Adam M. Katz, *Addressing the Harm to Common Stockholders in* Trados *and* Nine Systems, 118 Colum. L. Rev. Online 234 (2018).

trade at a positive price.[25] Indeed, *Trados* itself cites a numerical example of how the expected value of equity is greater than the expected enterprise value less fixed claims.[26] For another numerical example, here based on the facts of *Trados*, consider a firm with a payout and financing structure per the below:

Probability	**Firm value**	**Preferences**	**Common stock value**
75%	$50 m	$58 m	$0 m
25%	$76 m	$58 m	$18 m

The expected value of the above firm is $56.5 million, and less $58 million in preferences, the "value" of the common stock so calculated would be zero. But the expected value of the common stock is in fact much higher than $0, and a risk-neutral investor would pay $4.5 million for the firm's common stock. Therefore, $4.5 million should be considered the "fair value" of the firm's common stock. Perhaps such logic convinced the defendants to settle before appeal for a substantial fraction of the plaintiff's original demand.[27]

In *Nine Systems*, the court not only made a similar miscalculation to *Trados* but also relied on questionable evidence to conclude that no economic harm had resulted. *Nine Systems* involved the dilutive recapitalization of a company in the then-nascent field of streaming media.[28] Despite finding unfair dealing,[29] the court concluded that the corporation's equity value was zero when the recapitalization occurred, deemed

25. *Id.* at 247–51.

26. *Trados*, 73 A.3d at 50 n.25.

27. The settlement amounted to about 19 cents per share before fees. *See In re* Trados Inc. S'holder Litig., C.A. No. 1512-VCL, 2016 WL 502898, at *1 (Del. Ch. Feb. 8, 2016). At trial, the plaintiff sought $13,357,573 for himself and the class in compensatory damages, or about 55 cents per share. *See* Opening Post-Trial Brief of Marc Christen and the Class, at 71–72, *In re* Trados Inc. S'holder Litig., C.A. No. 1512-VCL (Del. Ch. Apr. 12, 2013). The 55 cents per share figure excludes the cost of the management incentive from the value of the common shares. The plaintiff also proposed an alternative calculation that included part of the management incentive for a result of 38 cents per share. *Id.* If the management incentive were to be entirely deducted from the plaintiff's damages figure, the class would have been entitled to about 24 cents per share.

28. *Nine Systems*, 2014 WL 4383127, at *10. The recapitalization involved two large investors of Nine Systems investing additional money in exchange for an allegedly excessive amount of convertible preferred stock.

29. *Id.* at *51–52.

the transaction to be economically fair, and awarded no economic damages.[30] The court reached this conclusion after having relied primarily on expert valuations based on comparable company revenue multiples for the trailing twelve months and subtracting the corporation's debt load.[31] As described above, taking enterprise value and subtracting debt will systematically underestimate a firm's equity value, particularly as the debt-to-equity ratio increases. But even setting aside that methodological error, there were numerous problems with much of the valuation evidence,[32] making it difficult to trust *Nine Systems'* final estimate of fair value.

Finally, insofar as "[t]he economic inquiry called for by the fair price aspect is the same as the fair value standard under the appraisal statute,"[33] fair price analyses also suffer from all the issues associated with appraisal methodologies, discussed in Part I.C, *infra*. Even given flawless advocacy and impeccable judicial reasoning, corporate finance valuation methods have numerous shortcomings in determining whether any particular price is fair or not, especially in the context of conflicted transactions where, often, no market-based test is practically available.[34] These problems, reasons, and more have prompted the Delaware courts try to rejigger entire fairness away

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30. *Id.* at *42–45.

31. *Id.* at *42–45.

32. The court's opinion identified many of the problems with the plaintiffs' valuation evidence. *Nine Systems*, 2014 WL 4383127, at *38–45. However, the defendants' valuation approach—which the *Nine Systems* court endorsed—was also deeply flawed as it was based on the revenue multiples of comparable companies. But just four years after the recapitalization, Nine Systems was sold for a figure that the defendants' expert agreed had no reasonable connection to Nine Systems' free cash flow or revenue. Testimony of Defendant's Expert Witness, Jerry Hausman, 2864:19–2867:1, *In re* Nine Sys. S'holders Litig., No. 3940-VCN, 2013 WL 7121317 (Del. Ch. Dec. 13, 2013). Moreover, given that Nine Systems was only founded in fall 1999, Delaware Department of State, Division of Corporations, File No. 3078338, the revenue-multiple method was basically based on the revenue from a technology startup's second year of operation. It is well-understood that startups may take years to begin generating meaningful revenues with significant variance from company to company. Finally, it is undeniable that 2002 was a nadir for technology startup market valuations. *See* Hausman Testimony, *supra*, at 2777:20–2779:1.

33. ACP Master, Ltd. v. Sprint Corp., C.A. No. 8508-VCL, 2017 WL 3421142, at *18 (Del. Ch. July 21, 2017). *See also PLX Trial*, 2018 WL 5018535, at *50.

34. *See* Lawrence A. Hamermesh et al., *Optimizing the World's Leading Corporate Law: A Twenty-Year Retrospective and Look Ahead*, 77 BUS. LAW. 321, 342 n.99 (2022).

from examining the substantive economics of a conflicted transaction.[35]

B. *Fairness and the Process-Centered Protections of* MFW

In 2013, the Court of Chancery issued the landmark *MFW* decision,[36] which promised to reduce the burden of judicial review on transactions involving controlled entities that would otherwise be subject to entire fairness review,[37] not the least being the burden of determining fair price.

MFW sought to achieve its goal by encouraging defendants to use processes that were theoretically more protective of minority shareholders. Absent *MFW*, the burden of proof in entire fairness review lies with the defendant by default. But the defendant may shift the burden of proof onto the plaintiff by obtaining approval of the transaction from either an special independent board committee or an informed, uncoerced vote of disinterested stockholders.[38] However, the burden-shifting rules left a controller unlikely to use both protective processes because the second protective process resulted in no additional benefit.[39] To incentivize controllers to use both protections, *MFW* held that the business judgment standard, which generally results in judicial approval, would apply to conflicted mergers that used both protection devices.[40]

As *MFW* saw it, use of both protections would likely result in a substantively fair outcome. First, "independent directors are presumed to be motivated to do their duty with fidelity, like most other people, and [] directors have a [] self-protective interest in retaining their reputations as faithful, diligent fiduciaries."[41] Second, "a majority-of-the-minority condition gives minority investors a free and voluntary opportunity to decide what is fair for themselves."[42] Third, the combination of the two devices would cause the independent committee to "procure a

35. *See generally* Licht, *supra* note 5, at 34–35.
36. *In re* MFW S'holders Litig., 67 A.3d 496 (Del. Ch. 2013), *aff'd*, 88 A.3d 635 (Del. 2014).
37. Hamermesh et al., *supra* note 34, at 336.
38. Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985); *Lynch*, 638 A.2d at 1117.
39. *MFW*, 67 A.3d at 500–01.
40. *Id.* at 536.
41. *Id.* at 528–29.
42. *Id.* at 534.

deal that their minority stockholders think is a favorable one," not the least so that the directors of such a committee do not "suffer the reputational embarrassment of repudiation at the ballot box."[43] *MFW* also noted that "it has long been thought beneficial to investors for courts, which are not experts in business, to defer to the disinterested decisions of directors, who are expert, and stockholders, whose money is at stake."[44] Finally, *MFW* concluded that the two devices "replicate[d] the arm's-length merger steps of the DGCL by requir[ing] two independent approvals."[45]

By offering an incentive for controllers to voluntarily adopt process-centered shareholder protections, *MFW* reduced the burden on courts and improved outcomes for the parties, at least in theory. The complex entire fairness inquiry could be simplified to determining that the minority vote and the independent committee complied with *MFW*. Controllers would no longer need to bear the costs of litigation (and any possible damages award). And minority shareholders would be ensured a fair price, as they received not only the guarantee that their approval was needed for any deal to go through, but also that an independent committee would negotiate the terms of the deal on their behalf.

But even on its own terms, *MFW* was not a magic bullet. Litigation, instead of disappearing entirely, often simply shifted focus from whether the challenged transaction passed muster under entire fairness to whether the controller adequately implemented *MFW*'s protections. For example, *Flood v. Synutra*[46] and *Olenik v. Lodzinski*[47] needed to determine whether *MFW*'s dual protections were implemented early enough to satisfy its requirements. The factual analysis at both the trial and the appellate level was substantial and undoubtedly required much work from both the courts and the parties.

Flood and *Olenik* do not by themselves necessarily give sufficient reason to doubt the overall salutary effects of *MFW*. After all, a doctrine as significant as *MFW* will inevitably require some refining around the edges. That relatively more complex litigation occasionally arises does not necessarily mean that *MFW*

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43. *Id.* at 529.
44. *Id.* at 526.
45. *Id.* at 528.
46. Flood v. Synutra Int'l, Inc., 195 A.3d 754 (Del. 2018).
47. Olenik v. Lodzinski, 208 A.3d 704 (Del. 2019).

has not achieved its ends. Still, *Flood* and *Olenik* suggest that process-centered analyses are not inherently immune to the problems—such as the expense and difficulty of litigating and judging close or complex cases[48]—that prompt Delaware courts to avoid analyzing economic substance,[49] an issue that will recur in this Article.[50]

The more significant problem is that *MFW* may be built upon a flawed foundation. For one, although *MFW* is premised on the idea that it replicates an arm's-length negotiation process, there are still serious differences between an *MFW*-compliant deal and a genuine arm's-length deal process involving a widely held corporation. An important protection for the selling shareholders of a widely held corporation is the possibility of a bidding war among multiple potential buyers, but no bidding war is possible to protect the minority in a squeeze-out because there is only one potential buyer. Likewise, even under *MFW*, the controller still has the power to remove the independent committee negotiating on behalf of the minority,[51] whereas in widely held corporations, the board serves at the pleasure of shareholders whom they represent.

Furthermore, as some commentators have pointed out,[52] *MFW* allows controllers to self-commit in what is effectively a

48. For example, given that the Delaware Supreme Court ultimately held that the deal protections in *Olenik* did not satisfy *MFW*, necessitating traditional entire fairness analysis, *MFW* may have increased the total costs and burdens of litigation in that case.

49. Furthermore, assuming that *MFW* does not require all future deals to be submitted to a minority vote, *MFW* does not address how a court should evaluate a controller who, having been rebuffed by the minority in an *MFW*-compliant vote, attempts to force through a similar, but not identical, squeeze-out. As an illustration, suppose that after a failed *MFW* minority vote, a controller sells a portion of the at-issue corporation's assets to a disinterested third party and then attempts a traditional, non-*MFW* squeeze-out. At what level of deal dissimilarity should a court return to traditional entire fairness analysis rather than enjoining the squeeze-out as a runaround of *MFW*'s dual protections? And what if the parties disagree on the significance of the third-party sale (e.g., even if the parties agree on the price of the third-party sale, they might well disagree on the value of the assets remaining after the sale, which obviously impacts the relative significance of the third-party sale)?

50. *See, e.g.*, *infra* Parts I.C, I.D, and I.E.

51. *See In re* EZCORP, Inc. Consulting Agreement Derivative Litig., C.A. No. 9962-VCL, 2016 WL 301245, at *41–42 (Del. Ch. Jan. 25, 2016).

52. *See* Ryan Bubb et al., *Shareholder Rights and the Bargaining Structure in Control Transactions* 21–23 (Oct. 27, 2022) (unpublished manuscript) (on file at the European Corporate Governance Institute).

game of chicken (also known as the hawk-dove game)[53]: In a game of chicken, two cars speed toward one another, with whomever swerves being the loser. A winning strategy against a rational opponent would therefore be to remove one's own steering wheel, forcing a rational opponent to swerve (and lose). Transferred to the squeeze-out context, the controller is speeding in one direction, claiming that the price cannot possibly be raised, while the minority is speeding in the opposite direction, claiming that the price must be raised or that they will sue or otherwise attempt to blow up the deal. The power to credibly make a take-it-or-leave-it offer would be akin to the power to remove one's own steering wheel, but a controller normally lacks this power because the controller, by definition, can cause the corporation to enter into a deal without minority approval (though subject to entire fairness review). So absent *MFW*, minority shareholders need not accept any deal that is worse than one that a court would consider entirely fair. However, *MFW* essentially allows a controller to remove their own steering wheel by unilaterally committing to the results of any minority vote, forcing a rational minority to accept deals that steer the bulk of benefits to the controller so long as a small crumb is left to the minority. In other words, *MFW* might in fact make minorities *worse* off. *MFW* thus illustrates that choosing effective process-based protections is far from a straightforward exercise.

C. *Appraisals and Fair Value as a Matter of Process*

This Article now turns to appraisal, which is a statutory remedy to give shareholders of a selling corporation a judicially determined[54] price for their shares, rather than the contractually specified merger price. By statute, the price is based on "the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger,"[55] which is generally understood to mean that appraisal values

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53. Anatol Rapoport & Albert M. Chammah, *The Game of Chicken*, 10 Am. Behavioral Sci. 10, 10 (1966).

54. There is technically no burden of proof in an appraisal case, though this should not generally matter. Americas Mining Corp. v. Theriault, 51 A.3d 1213, 1242–43 (Del. 2012); *see also* Kahn v. Tremont Corp., 694 A.2d 422, 434 (Del. 1997).

55. Del. Code Ann. tit. 8, § 262(h) (2021).

should exclude merger synergies and control premia.[56] Thus, unique to corporate law, appraisal is solely focused on the economic substance of a deal, or so the statutory text would suggest. However, in recent years, the Delaware Supreme Court has remade appraisal proceedings into inquiries that begin—and often end—with the dealmaking process, effectively turning the question of fair value into a process-based analysis.

Historically, courts used the "Delaware block" method for determining fair value.[57] Under the Delaware block method, a court would take a judicially weighted average of a firm's book value, market value (e.g., trading price), and discounted future earnings to arrive at the firm's fair value.[58] In the 1983 *Weinberger* case, the Delaware Supreme Court held that the Delaware block method would no longer be the exclusive method for valuation, but rather that "any techniques or methods which are generally considered acceptable in the financial community" would be admissible.[59] Still, *Weinberger* did not completely disavow the Delaware block method, and the Court of Chancery continued to use modified versions of the method after *Weinberger*, frequently giving heavy weight to discounted cash flow ("DCF") valuations.[60]

A court conducting an appraisal under either the Delaware block method or post-*Weinberger* DCF methods necessarily engaged in intensive financial factfinding and analysis, particularly given the sensitivity of DCF results to input variables that cannot be readily measured with certainty (such as beta and discount rates) and predictions about the future that are

56. *In re* Appraisal of Jarden Corp., C.A. No. 12456-VCS, 2019 WL 3244085, at *3 (Del. Ch. July 19, 2019); Berger v. Pubco Corp., C.A. No. 3414-CC, 2010 WL 2025483, at *1 (Del. Ch. May 10, 2010). *But see In re* Books-A-Million S'holders Litig., C.A. No. 11343-VCL, 2016 WL 5874974, at *17 (Del. Ch. Oct. 10, 2016).

57. *Weinberger*, 457 A.2d at 712. Although named for Delaware, the Delaware block method is also used across the country. *See, e.g.*, Chokel v. First Nat'l Supermarkets, Inc., 660 N.E.2d 644, 649 (Mass. 1996); Richardson v. Palmer Broad. Co., 353 N.W.2d 374 (Iowa 1984); Utah Res. Int'l, Inc. v. Mark Techs. Corp., 342 P.3d 761, 771 (Utah 2014).

58. *See* Paskill Corp. v. Alcoma Corp., 747 A.2d 549, 555 (Del. 2000).

59. *Weinberger*, 457 A.2d at 712–13.

60. *See, e.g.*, Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 472 & n.21 (Del. Ch. 2011); *In re* Radiology Assocs., Inc., 611 A.2d 485, 498 (Del. Ch. 1991). DCF is a valuation methodology that essentially uses finance theory to estimate the value of all future profits of a business and add the present values of those profits together.

obviously subject to error (such as forward cash flows).[61] Other traditional methods, such as comparable companies methods, suffer from similar shortcomings (e.g., what constitutes a comparable company?). These problems are compounded by the adversarial nature of litigation,[62] but even absent the fog of litigation, calculated valuations are inherently noisy and error-prone.[63]

Given the problems with traditional methods of estimating fair value, Delaware courts began looking elsewhere. In particular, the Delaware courts have looked in recent years to the deal price itself. This trend began with the 2003 appraisal case, *Union Illinois*,[64] which was decided by then-Vice Chancellor Strine. In *Union Illinois*, a troubled bank with a large but not controlling group of family shareholders sold itself in an open auction to a third-party buyer.[65] The family sought an appraisal of their shares, arguing that DCF valuations indicated a higher fair value. The Court of Chancery rejected the DCF valuations, noting that in numerous other contexts, Delaware courts have stated that market prices were strong indicia of fair prices.[66] Reasoning that because the deal price resulted from an open auction process, the best evidence of market value—and thus of fair value—was the deal price.[67]

Union Illinois was not appealed, and it was seven years before the Delaware Supreme first waded into the issues around using deal price as fair value in appraisal proceedings in *Golden Telecom*.[68] The *Golden Telecom* trial decision, which was

61. *See, e.g.*, Kruse v. Synapse Wireless, Inc., C.A. No. 12392-VCS, 2020 WL 3969386, at *12–19 (Del. Ch. July 14, 2020).eee

62. Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd., 177 A.3d 1, 20 (Del. 2017) [hereinafter *Dell Appeal*] (practical result of appraisal litigation is that "petitioners contend fair value far exceeds the deal price, and the company argues that fair value is the deal price or lower.").

63. *See DCF Analysis Pros & Cons*, CORP. FIN. INST. (last visited May 9, 2023), https://corporatefinanceinstitute.com/resources/valuation/dcf-pros-and-cons/.

64. Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Grp., Ltd., 847 A.2d 340 (Del. Ch. 2003). That said, *Union Illinois* was not the first Delaware decision to use deal price as fair value. *Id.* at 357; *In re* Appraisal of Columbia Pipeline Grp., Inc., C.A. No. 12736-VCL, 2019 WL 3778370, at *47 n.45 (Del. Ch. Aug. 12, 2019).

65. *Union Ill.*, 847 A.2d at 342–50.

66. *Id.* at 357.

67. *Id.* at 357–58.

68. Golden Telecom, Inc. v. Glob. GT LP, 11 A.3d 214 (Del. 2010) [hereinafter *Golden Telecom Appeal*].

also authored by then-Vice Chancellor Strine, began with the proposition that an "arms-length merger price resulting from an effective market check is entitled to great weight in an appraisal."[69] However, the Court of Chancery found that the actual merger price in the case did not result from an effective market check, and in fact did not result from any market check.[70] This was because the buyer was largely owned by the seller's two largest shareholders, who preempted the possibility of a market check via their influence.[71] *Golden Telecom* then evaluated the parties' DCF models at length and arrived at a final value that was about 20% higher than the deal price.[72] The Delaware Supreme Court affirmed the Chancery decision in a relatively short opinion. Notably, the affirmance stated that the Delaware courts could not "defer—conclusively or presumptively—to the merger price, even in the face of a pristine, unchallenged transactional process," as doing so "would contravene the unambiguous language of the statute."[73]

Between the affirmance of *Golden Telecom* and the end of 2016, the Court of Chancery used the deal price as fair value in six cases and a combination of metrics in five other cases.[74] Where the Court of Chancery had used something other than or in addition to deal price, it generally pointed to issues with the sale process that undermined confidence in the deal price.[75] The respondents (i.e., the buyers) in two of the appraisal cases decided in 2016 that did not rely exclusively upon deal price appealed, and the Delaware Supreme Court reversed both in decisions that upended appraisal doctrine.

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69. Glob. GT LP v. Golden Telecom Inc., 993 A.2d 497, 507–08 (Del. Ch. 2010) [hereinafter *Golden Telecom Trial*].

70. *Id.* at 508.

71. *Id.*

72. *Id.* at 509–24.

73. *Golden Telecom Appeal*, 11 A.3d at 218.

74. *See* Merion Cap. L.P. v. Lender Processing Servs., Inc., C.A. No. 9320-VCL, 2016 WL 7324170, at *1, 30–31 (Del. Ch. Dec. 16, 2016) (noting that 5 cases after *Golden Telecom* used deal price as fair value and 5 did not; *Merion* itself used deal price).

75. *See, e.g.*, *In re* Orchard Enters., Inc., C.A. No. 5713-CS, 2012 WL 2923305, at *4–5 (Del. Ch. July 18, 2012); Dunmire v. Farmers & Merchs. Bancorp of W. Pa., Inc., C.A. No. 10589-CB, 2016 WL 6651411, at *7 (Del. Ch. Nov. 10, 2016).

The first case, *DFC*,[76] involved determining the fair value of a payday lender that was acquired amidst substantial regulatory uncertainty, with authorities in numerous jurisdictions looking into cracking down on payday lending practices.[77] The Court of Chancery determined the firm's fair value after trial by taking an equally weighted average of the DCF valuation, a comparable-firms analysis, and the deal price.[78] The Court of Chancery's method had obvious similarities to the traditional Delaware block method, and the court defended its method as being the most reliable method where all single-technique methods were "imperfect" in one way or another.[79]

However, this did not satisfy the Delaware Supreme Court, which reversed the trial decision. On appeal, the Delaware Supreme Court claimed that it was not creating a judicial "presumption" that the deal price is the best evidence of fair value after a proper sales process, reasoning that doing so would undermine the statutory text's command that the Court of Chancery "take into account all relevant factors."[80] Nevertheless, the *DFC* appeal decision stated that it is "economic reality that the sale value resulting from a robust market check will often be the most reliable evidence of fair value, and that second-guessing the value arrived upon by the collective views of many sophisticated parties with a real stake in the matter is hazardous."[81]

DFC then went through the Court of Chancery's fair value determination with a fine-tooth comb. It first took issue with the Court of Chancery's discounting of the deal price. The Court of

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76. *In re* Appraisal of DFC Glob. Corp., C.A. No. 10107-CB, 2016 WL 3753123 (Del. Ch. July 8, 2016) [hereinafter *DFC Trial*], *rev'd sub nom.* DFC Glob. Corp. v. Muirfield Value Partners, L.P., 172 A.3d 346 (Del. 2017) [hereinafter *DFC Appeal*].

77. *DFC Trial*, 2016 WL 3753123, at *2–4.

78. *Id.* at *21–23.

79. *Id.* at *23.

80. *DFC Appeal*, 172 A.3d at 366.

81. *Id.* Admittedly, it is not entirely clear what the difference is between (1) creating a presumption that deal price is the best evidence of fair value after a proper sales process and (2) recognizing an economic reality that the deal price will often be the most reliable evidence of fair value. *Cf.* Rivest v. Hauppauge Digit., Inc., C.A. No. 2019-0848-PWG, 2022 WL 3973101, at *23 (Del. Ch. Sept. 1, 2022) (arguing that accepting a widely held justification as sufficient to support an outcome is not materially different from creating a judicial presumption in favor of that outcome), *aff'd*, No. 442, 2022, 2023 WL 4440279 (Del. July 10, 2023).

Chancery had expressed concern that the unstable regulatory environment had depressed the trading price, which led to a lower deal price. The appellate decision instead reasoned that any depression in pre-deal trading price from regulatory risk was, absent contrary evidence, a proper market pricing of that risk, which presumably should figure into fair value.[82] Similarly, the Delaware Supreme Court did not think that the absence of any other bidders after an apparently fair market check or that lenders would not provide additional debt financing indicated any issues with the deal price.[83] *DFC* also gave a litany of reasons why the Court of Chancery's DCF model used an incorrect perpetuity growth rate.[84]

The Delaware Supreme Court doubled down in *Dell*, which arose out of the management buyout engineered by Dell founder and CEO Michael Dell and his private equity backer Silver Lake. In the decision below, Vice Chancellor Laster had given the sale price no weight in his final fair value determination,[85] pointing to numerous factors that undermined the deal price as a determinant of fair value, including but not limited to:

- the buyers' use of leveraged buyout pricing models that returned lower valuations than going-concern valuation models that relied on the same assumptions;[86]
- "investor myopia"[87]

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82. *DFC Appeal*, 172 A.3d at 372–75. Professors Charles Korsmo and Minor Myers have criticized this reasoning on the basis that the deal price in *DFC* was depressed because a financial buyer could not diversify away firm-specific risk and that the Delaware Supreme Court ignored this. Charles Korsmo & Minor Myers, *The Flawed Corporate Finance of* Dell *and* DFC Global, 68 EMORY L.J. 221, 254–55 (2018), However, *DFC*'s comment regarding the depression in price was probably primarily directed toward the publicly traded price, to which Professors Korsmo and Myers agree "firm-specific risk is not relevant." *Id.* at 254. Furthermore, although public stockholders would not demand a risk premium for idiosyncratic risk (which is what Professors Korsmo and Myers seem to be saying), that does not mean that public stockholders do not reduce their expectations of firm value in accordance with the idiosyncratic risk of a firm.

83. *DFC Appeal*, 172 A.3d at 374–76.

84. *Id.* at 376–86.

85. *In re* Appraisal of Dell Inc., C.A. No. 9322-VCL, 2016 WL 3186538, at *29 (Del. Ch. May 31, 2016) [hereinafter *Dell Trial*].

86. *Id.* at *29–31.

87. *Id.* at *32–34.

- that deal markets, which involve the purchase and sale of entire firms all at once, are less liquid and less efficient than the stock market for individual shares.[88]
- that deal prices are made by "[t]ime-bound mortals," who, even if acting loyally and in good faith, may not have arrived at fair value in agreeing to a deal price;[89]
- that the at-issue transaction was a management buy-out where Michael Dell was (at least viewed as) a key component of the deal value;[90]
- the lack of pre-signing competition;[91]
- the buyers' match right, albeit a limited one, during the go-shop period;[92]
- the difficulty of properly valuing a company as large as Dell by a would-be buyer.[93]

Ultimately, Vice Chancellor Laster concluded that "it is impossible to quantify the exact degree of the sale process mispricing."[94] Instead, to reach fair value, he waded through the parties' experts' DCF assumptions and averaged two DCF valuations based on projections that the company had submitted to the deal creditors and projections that Boston Consulting Group had provided to the board committee negotiating the deal.[95]

The Delaware Supreme Court, however, slammed the Court of Chancery's reasoning, in particular the Court of Chancery's determination that Dell shares were mispriced on stock exchanges despite Dell's prominence and its stock's liquidity.[96]

88. *Id.* at *24.

89. *Id.* at *25–27; *see also* 31 (noting that the negotiating committee "did not seek to determine a pre-merger going concern value for the Common Stock to determine the fairness of the merger consideration to the Company's unaffiliated stockholders").

90. *Id.* at *28, 43–44. For further discussion of the economics of Michael Dell's involvement, see Guhan Subramanian, *Deal Process Design in Management Buyouts*, 130 Harv. L. Rev. 590, 626–27 (2016).

91. *Dell Trial*, 2016 WL 3186538 at *37.

92. *Id.* at *41; *see also* Guhan Subramanian & Annie Zhao, *Go-Shops Revisited*, 133 Harv. L. Rev. 1215, 1233–38 (2020).

93. *Dell Trial*, 2016 WL 3186538 at *42.

94. *Id.* at *51.

95. *Id.* at *45–51.

96. Dell, Inc. v. Magnetar Glob. Event Driven Master Fund, 177 A.3d 1, 25–27 (Del. 2017) [hereinafter *Dell Appeal*].

Among other things, the fact that there was no strategic buyer for Dell did not indicate that there was anything amiss with the deal price:

> Fair value entails at minimum a price some buyer is willing to pay—not a price at which no class of buyers in the market would pay. If a company is one that no strategic buyer is interested in buying, it does not suggest a higher value, but a lower one.[97]

Likewise, *Dell* disputed the Court of Chancery's arguments that there were other fundamental issues with management buyouts that undermined the probative value of the deal price.[98]

Lastly, *Dell* discounted the DCF analysis undertaken by the Court of Chancery. *Dell* argued that if no buyer would come forth at the price produced by the DCF analysis, "that is not a sign that the asset is stronger than believed—it is a sign that it is weaker."[99] *Dell* also noted that DCF analyses depend on numerous inputs, and small differences in those inputs (particularly discount and growth rates) can produce large differences in outputs.[100] Accordingly, *Dell* reversed the decision below, whereupon the parties settled for the deal price plus statutory interest.[101]

Aruba[102] was a coda to the *Dell/DFC* saga. In *Aruba*, which concerned the acquisition of network hardware supplier Aruba by Hewlett-Packard, the Delaware Supreme Court confronted the problem of synergies that might be generated from a strategic merger as opposed to a purchase made by a financial buyer. Although it was long recognized that appraisal valuations should exclude synergies to account for § 262's command to exclude "any element of value arising from the accomplishment or expectation of the merger or consolidation,"[103] the matter

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97. *Id.* at 29.
98. *Id.* at 31–34.
99. *Id.* at 37.
100. *Id.* at 37–38.
101. *In re* Appraisal of Dell Inc., No. 9322-VCL, 2018 WL 2939448, at *1 (Del. Ch. June 11, 2018).
102. Verition Partners Master Fund, Ltd. v. Aruba Networks, Inc., 210 A.3d 128 (Del. 2019) [hereinafter *Aruba Appeal*].
103. Merion Cap. LP v. BMC Software, Inc., C.A. No. 8900-VCG, 2015 WL 6164771, at *16 (Del. Ch. Oct. 21, 2015).

was not squarely at issue in *Dell* and *DFC*,[104] which suggested that courts should be wary when conducting or assessing financial analyses, a necessary part of determining synergy value. The *Aruba* trial decision identified a tension in the *Dell/DFC* framework: use of the deal price as a starting point for fair value may also require the court to subtract synergies, which in turn may require the use of analyses that *Dell* and *DFC* had denounced as subject to error. Instead, the Court of Chancery used the pre-announcement trading price as the basis for fair value.

The Delaware Supreme Court reversed, primarily criticizing the Court of Chancery's decision for its supposedly excessive concern over "reduced agency costs" that might arise from the merger.[105] The appellate *Aruba* decision also criticized the decision below for ignoring Aruba's stock price increase after the announcement of earnings, though the Court of Chancery had reasoned that it did so because the day before the earnings announcement, news of the merger had been leaked to the public.[106] Finally, *Aruba* instructed the Court of Chancery to award the deal price minus synergies on remand, glossing over any inaccuracies that might arise from calculating those synergies.[107]

DFC, *Dell*, and *Aruba* set the tenor for the cases that came after, which illustrate the primacy of deal process in contemporary appraisal litigation. The first significant case after *Aruba* was *PLX*, which applied quasi-appraisal methods in an entire fairness proceeding. The *PLX* plaintiffs had alleged that (1) an activist shareholder, Potomac, improperly pushed the PLX board to sell the company and (2) the board withheld material information[108] in the proxy statement recommending the sale.

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104. DFC Glob. Corp. v. Muirfield Value Partners, L.P., 172 A.3d 346, 367 (Del. 2017) ("synergy gains . . . are not contested" here); *see Dell Appeal*, 177 A.3d at 29 (noting lack of strategic/synergistic buyers).

105. *Aruba Appeal*, 210 A.3d at 133; Verition Partners Master Fund, Ltd. v. Aruba Networks, Inc., C.A. No. 11448-VCL, 2018 WL 922139, at *54 (Feb. 15, 2018) [hereinafter *Aruba Trial*].

106. *Aruba Appeal*, 210 A.3d at 140; *see Aruba Trial*, 2018 WL 922139, at *33–34. *Cf. In re* Tesla Motors, Inc. S'holder Litig., 298 A.3d 667, 732 (Del. 2023) ("Our discussion in *Aruba* should have cautioned against reliance on a stock price that did not account for material, nonpublic information"). Of course, the issue in *Aruba* was that the Court of Chancery did not wish to rely on a stock price that had included material public information that was irrelevant to the question of going-concern value.

107. *Aruba Appeal*, 210 A.3d at 130, 142.

108. Namely, that the buyer was willing to pay more than the deal price.

However, despite finding Potomac liable, the Court of Chancery held that "the sale process was sufficiently reliable" that the deal price was the best estimate of fair value and that the plaintiffs were not entitled to damages.[109]

Similarly, in *Stillwater*,[110] Court of Chancery adopted the deal price, noting that while "[t]he sale process was not perfect," it compared favorably to other deal processes in previous cases that had endorsed the deal price as the measure of fair value.[111] *Stillwater* rejected the parties' DCF analyses, finding that the parties' disagreements on DCF inputs resulted from "legitimate debates," but that "the large swings in value they create undercut the reliability of the DCF model as a valuation indicator."[112]

Amid these cases that adopted deal price as the proper measure of fair value, there was one notable case, *Jarden*,[113] in which the Court of Chancery rejected the deal price. Instead, the Court of Chancery used the pre-announcement trading price on the basis that the deal price was reached after a deficient deal process and would have required the court to subtract synergies, even though reliable evidence regarding synergies was sparse.[114] The *Jarden* affirmance noted that, unlike in *Aruba*, there was likely no material non-public information that would have supported a higher trading price but for the public's ignorance,[115] and furthermore that the shareholders had attacked the deal price as unreliable at trial and it was accordingly within the Court of Chancery's discretion to not treat the deal price as a floor. While *Jarden* was the only case that used trading price as the proper measure of fair value, some commentators have argued that every case from *DFC* to *Stillwater* has signaled the primacy of trading price in the Delaware courts.[116] But if anything, these cases suggest the importance of *deal* price, with

109. *PLX Trial*, 2018 WL 5018535, at *54.

110. *In re* Stillwater Mining Co., C.A. No. 2017-0385-JTL, 2019 WL 3943851, at *59 (Del. Ch. Aug. 21, 2019).

111. *Id.* at *44.

112. *Id.* at *61.

113. *In re* Appraisal of Jarden Corp., C.A. No. 12456-VCS, 2019 WL 3244085 (Del. Ch. July 19, 2019) [hereinafter *Jarden Trial*], *aff'd sub nom.* Fir Tree Value Master Fund, LP v. Jarden Corp., 236 A.3d 313 (Del. 2020) [hereinafter *Jarden Appeal*].

114. *Jarden Trial*, 2019 WL 3244085, at *3.

115. *Jarden Appeal*, 236 A.3d at 321–22.

116. Charles Korsmo & Minor Myers, *What Do Stockholders Own? The Rise of the Trading Price Paradigm in Corporate Law*, 47 J. Corp. L. 389, 421 (2022) (arguing that *Stillwater* "cemented" the views expressed in *Jarden*).

Jarden sitting as an outlier that employed trading price. Still, even such an interpretation would fail to adequately capture the gestalt of these appraisal cases.

Rather, the best way to reconcile these cases with one another is that, intending to give appraisals greater certainty in outcome and reduce the impact of uncertain expert witness testimony,[117] the Delaware Supreme Court elevated deal process as the primary question in appraisal cases.[118] In theory, such a mode of analysis allows courts to establish and enforce clear process-centered standards to protect shareholders. In turn, such clarity allows future buyers and sellers to structure deals in a way that conforms to those standards. Finally, conforming deals, having been subject to a protective process, are accordingly less likely to be subject to the expense of appraisal litigation, as would-be plaintiffs recognize that their recourse lies only at the ballot box.

Do the Delaware Supreme Court's theories of appraisal jurisprudence truly ensure that shareholders receive fair value? That question prompts yet more fundamental questions: what does "fair value" even mean, and how does it relate to the deal price and deal process? And given the real world of transactional costs, imperfect information, and limited resources, what does it mean for a deal process to "pristine"? And at what level of deviation from the ideal deal process can the deal price no longer be trusted, requiring the court to make its own estimate of fair value? Certainly, given that the Court of Chancery took great exception with the deal process in *DFC* and *Dell* while the Delaware Supreme Court blessed both, reasonable minds may well differ on the answers to these questions.

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117. Bratton, *supra* note 5, at 569.

118. Accordingly, the notion that there is some logical inconsistency or doctrinal conflict between the *Dell/DFC* framework and *Airgas*, which credited a board's evaluation of the corporation's market price as undervaluing the company, is misplaced. Korsmo & Myers, *supra* note 116, at 428–29 ("The appraisal cases suggest that *Airgas* is now bad law."). *Dell/DFC* and *Airgas* are, at bottom, not really about what the value of a corporation is. Rather, the cases stand for the proposition that a court should generally not be determining the value of a corporation at all, and to the extent that a court must determine the value of a corporation because of a case brought before the court, it should, when possible, defer to the judgment of loyal directors acting dutifully.

D. *The Two Sides of* Revlon *Review*

The *Revlon* doctrine, which polices the conduct of a board when sale of the corporation is inevitable, is often misconceived as a mandate for a board seeking to sell a corporation to obtain the highest price possible. This misconception is understandable given *Revlon*'s stated holding that once the board determines that sale of the corporation is inevitable, the "directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[119] And it logically follows from the idea that *Revlon* charges directors with getting the highest price possible that *Revlon* charges a court with conducting an inquiry into a deal's economic substance.

But such thinking would be incorrect, as *Revlon* is a standard of review of *process*, not *price*.[120] The focus of *Revlon* review not on whether the board in fact obtained a price commensurate to the firm's underlying value, but rather whether the board has "undertak[en] a logically sound *process* to get the best deal that is realistically attainable."[121] When a court applies *Revlon*, it is not actually determining whether the directors got the "best price" (except perhaps to the extent that the price is probative of whether the board in fact had "reasonable grounds to believe they acted in good faith.")[122]

Moreover, *Revlon* does not prescribe specific sale process protections, and it does not proscribe any conduct *per se* in the deal process. *Revlon* does not impose a duty to conduct an auction, a duty to preserve a right to take a better offer, or a special duty to maximize sale price beyond what the duty of loyalty already imposes.[123] Instead, the *Revlon* inquiry is a holistic "judicial examination of the reasonableness of the board's decision-making process."[124]

Nevertheless, the supposed process bent of *Revlon* sometimes seems to go beyond just the board's decision-making

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119. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

120. J. Travis Laster, Revlon *is a Standard of Review: Why It's True and What It Means*, 19 FORDHAM J. CORP. & FIN. L. 5 (2013).

121. *In re* Netsmart Techs., Inc. S'holders Litig., 924 A.2d 171, 192 (Del. Ch. 2007) (emphasis added).

122. Laster, *supra* note 120, at 31.

123. *Id.* at 19–33.

124. *Netsmart*, 924 A.2d at 192 (emphasis added).

process. Rather, *Revlon* review touches on the economics of the actual decision itself. This is exemplified by how deal protection measures, such as termination fees and no-shop provisions, are treated under *Revlon*. Although some decisions have stated that such protection measures are permissible so long as they are negotiated in good faith, many *Revlon* analyses have stated that such measures must also be substantively reasonable, and several decisions have found deal protection measures impermissible because they effectively preclude competing bids and prevent shareholders from receiving the highest possible price.[125]

Insofar as some these decisions might be distinguished based on, among other things, the precise amount of the termination fee negotiated, it is hard to say what makes courts particularly well-qualified to decide, as a matter of business economics,

125. *Compare Stillwater*, 2019 WL 3943851, at *61 (collecting cases where the Court of Chancery approved of certain deal protection measures under *Revlon*); *In re* Zale S'holders Litig., C.A. No. 9388-VCP, 2015 WL 5853693, at *16 (Del. Ch. Oct. 1, 2015) (approving of no-shop provision and 2.75% termination fee); Dent v. Ramtron Int'l Corp., C.A. No. 7950-VCP, 2014 WL 2931180, at *8–9 (Del. Ch. June 30, 2014) (approving of no-shop provision and 4.5% termination fee); *In re* BioClinica, Inc. S'holder Litig., C.A. No. 8272-VCG, 2013 WL 5631233, *2-3, *12 (Del. Ch. Oct. 16, 2013) (approving of no-shop and 5.3% termination fee); *In re* BJ's Wholesale Club, Inc. S'holders Litig., C.A. No. 6623, 2013 WL 396202, at *13 (Del. Ch. Jan. 31, 2013) (approving of no-shop provision and 3.1% termination fee); *In re* CNX Gas Corp. S'holders Litig., 4 A.3d 397 (Del. Ch. 2010) (approving of no-shop provision and 3% termination fee); *In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 996–97, 1014–22 (Del. Ch. 2005) (approving of no-shop provision and 3.75% termination fee); Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34 (Del. Ch. 1993) (approving of 3% termination fee and no-shop provision) *with* FrontFour Cap. Grp. LLC v. Taube, C.A. No. 2019-0100-KSJM, 2019 WL 1313408, at *27–28 & n.303 (Del. Ch. Mar. 11, 2019) (disapproving of no-shop provision and 2.79% termination fee in controller transaction); *In re* Comverge, Inc. S'holders Litig., C.A. No. 7368-VCP, 2014 WL 6686570, at *14–15 (Del. Ch. Nov. 25, 2014) (disapproving of no-shop provision and termination fee between 5.5% and 13.1%); Phelps Dodge Corp. v. Cyprus Amax Mins. Co., C.A. No. 17383, 1999 WL 1054255, at *2 (Del. Ch. Sept. 27, 1999) (stating in dicta that a 6.3% termination fee is excessive). *See In re* Topps Co. S'holders Litig., 926 A.2d 58, 86 (Del. Ch. 2007) (calling a 4.3% termination fee "a bit high in percentage terms"); *In re* Answers Corp. S'holders Litig., C.A. No. 6170-VCN, 2011 WL 1366780, at *4 & n.52 (Del. Ch. Apr. 11, 2011) (calling a 4.4% termination fee "near the upper end of a 'conventionally accepted' range"). *See also* La. Mun. Police Emps.' Ret. Sys. v. Crawford, 918 A.2d 1172, 1181 & n.10 (Del. Ch. 2007) ("Though a '3% rule' for termination fees might be convenient for transaction planners, it is simply too blunt an instrument, too subject to abuse, for this Court to bless as a blanket rule").

why a 3% or 4% termination fee would not deter rival bidders, but a 6% or higher termination fee would. This notably contrasts with *Unocal* review, under which courts are loathe to determine that poison pills may effect a certain amount of dilution but not more.[126]

Furthermore, although terms such as the length of go-shop periods or the presence of no-shop clauses would seem to relate to process concerns, they also inescapably relate to the economic substance of deals: buyers benefit economically from greater deal certainty, and some of these benefits are shared with sellers. Restrictions on deal protection devices that effectively demand that buyers bear a greater risk that a merger agreement is signed but the merger does not ultimately close, will, in expectation, reduce the price that buyers are willing to bid for a target and may also reduce the overall volume of mergers as an empirical matter.[127] In other words, even when evaluating questions of deal process, courts reach into economic substance of those deals and risk giving the wrong answer, given that the net economic effect of some of these process questions can only be empirically determined after the fact.

Now, this is not to say that courts should not be evaluating go-shops, no-shops, and termination fees under *Revlon*. Indeed, totally avoiding a decision is philosophically impossible—ignoring these provisions and permitting them all is still a decision. Rather, the point is that *Revlon* does not simply consider process alone. Process inevitably affects price, and additionally, these evaluations of process require drawing the kind of fine lines that have historically troubled courts about judicial evaluations of economic substance.

E. *The Illusory Promise of* Corwin

Corwin arguably represents the apex of the Delaware courts' approach toward process and the distillation of its belief that the vagaries of having courts evaluate substance can be excised by adding additional layers of process. *Corwin*, which followed on the heels of *MFW*, held that "when a transaction not subject

126. *Infra* Part I.F.

127. Micah S. Officer, *Termination Fees in Mergers and Acquisitions*, 69 J. FIN. ECON. 431 (2003); Fernán Restrepo & Guhan Subramanian, *The Effect of Prohibiting Deal Protection in Mergers and Acquisitions: Evidence from the United Kingdom*, 60 J.L. & ECON. 75 (2017).

to the entire fairness standard is approved by a fully informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies."[128] Practically speaking, *Corwin* held that a stockholder approval "cleansed" a transaction and relieved the corporation's management of fiduciary liability. On its face, *Corwin* swept away enormous amounts of judicial scrutiny of dealmaking. So long as there was proper stockholder approval, *Revlon* was gone, *Unocal* was gone, and in principle, even recoveries for breaches of duty of loyalty—so long as they were disclosed—were gone.[129]

In theory, *Corwin* provides a powerful tool for defendants in merger litigation to seek early dismissal of claims and for reducing courts' analytical burdens. So long as there was a valid stockholder approval, a court could avoid trekking into thorny issues of substance discussed above, such as whether a termination fee was preclusive or how much damages plaintiffs suffered.[130] But as things turned out, plaintiffs have instead often pleaded around (or at least tried to plead around) *Corwin* cleansing by alleging that the shareholder vote was not fully informed or uncoerced. A key focus of legal analysis in post-*Corwin* cases is whether the vote met *Corwin*'s requirements that it was "fully informed" and "uncoerced."

Most plaintiffs trying to avoid *Corwin* cleansing have focused on whether the vote was "fully informed," as even "[o]ne sufficiently alleged disclosure deficiency will defeat a motion to dismiss under *Corwin*."[131] The standard for adequate disclosure is cribbed from federal securities law on materiality and asks "if there is substantial likelihood that a reasonable shareholder would consider [an omission] important in deciding how to vote."[132] As securities lawyers know well, the materiality standard

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128. Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 309 (Del. 2015), *aff'g In re* KKR Fin. Holdings LLC S'holder Litig., 101 A.3d 980, 1001 (Del. Ch. 2014).

129. *In re* USG Corp. S'holder Litig., C.A. No. 2018-0602-SG, 2020 WL 5126671, at *2 (Del. Ch. Aug. 31, 2020); Goldstein v. Denner, C.A. No. 2020-1061-JTL, 2022 WL 1671006, at *19 (Del. Ch. May 26, 2022).

130. Matteo Gatti, *Did Delaware Really Kill Corporate Law? Shareholder Protection in a Post-*Corwin *World*, 16 N.Y.U. J.L. & Bus. 345, 383 (2020).

131. *In re* Mindbody, Inc. S'holder Litig., C.A. No. 2019-0442-KSJM, 2020 WL 5870084, at *26 (Del. Ch. Oct. 2, 2020); *see also* van der Fluit v. Yates, C.A. No. 12553-VCMR, 2017 WL 5953514, at *8 n.115 (Del. Ch. Nov. 30, 2017); *see also* Franklin A. Gevurtz, *The Shareholder Approval Conundrum*, 60 B.C. L. Rev. 1831, 1848 (2019).

132. Morrison v. Berry, 191 A.3d 268, 282 (Del. 2018).

under securities law is far from self-explanatory and has engendered significant confusion and apparent inconsistency in its application.[133]

Even aside from the vagueness of the materiality standard, the question of whether shareholders received adequate disclosure is often tied up in the economic significance of the omitted information.[134] In cases where the omission related to management misconduct, this analysis devolves into whether the misconduct was serious enough so as to lead to liability under substantive standards of conduct.[135] Thus, despite *Corwin*, a court often must analyze the purportedly cleansed claim, with plausible claims ineligible for cleansing due to inadequate disclosure, and implausible claims making cleansing unnecessary.

Although less frequently litigated, *Corwin*'s non-coercion requirement also often results in legal analyses that are no simpler than what would have been necessary absent *Corwin*. As the Delaware courts have acknowledged, "[t]he term [coercion] itself 'is not very meaningful,'"[136] and courts have added additional gloss to the term to make it analytically tractable. As Vice Chancellor Laster described the noncoercion requirement, "the court must have confidence that the vote reflects an endorsement of the merits of the transaction, not just a

133. Kurt S. Schulzke & Gerlinde Berger-Walliser, *Toward a Unified Theory of Materiality in Securities Law*, 56 COLUM. J. TRANSNAT'L L. 6, 9 (2017) (describing the Supreme Court's definition of materiality as "so vague that it invites arbitrary decision-making"); James J. Park, *Assessing the Materiality of Financial Misstatements*, 34 J. CORP. L. 513, 515 (2009) (describing the current approach to the materiality standard to be "qualitative" and "nebulous"); Dale A. Oesterle, *The Overused and Under-defined Notion of "Material" in Securities Law*, 14 U. PA. J. BUS. L. 167, 168 (2011) (describing the application of the materiality standards by federal courts in the absence of a clear definition as "maddeningly imprecise and often fickle"); *see also* Escott v. BarChris Constr. Corp., 283 F. Supp. 2d 643, 682 (S.D.N.Y. 1968) ("Since no one knows what moves or does not move the mythical 'average prudent investor,' it comes down to a question of judgment, to be exercised by the trier of the fact as best he can in light of all circumstances.").

134. *See, e.g.*, Finnerty v. Stiefel Lab'ys, Inc., 756 F.3d 1310, 1321 (11th Cir. 2014); *In re* Insys Therapeutics, Inc. Sec. Litig., No. 17-cv-1954, 2018 WL 2943746, at *5 (S.D.N.Y. June 12, 2018).

135. *In re* Mindbody, C.A. No. 2019-0442-KSJM, 2020 WL 5870084, at *26 (Del. Ch. Oct. 2, 2020) ("Generally, where facts alleged make the paradigmatic *Revlon* claim reasonably conceivable, it will be difficult to show on a motion to dismiss that the stockholder vote was fully informed.").

136. Sciabacucchi v. Liberty Broadband Corp., C.A. No. 11418-VCG, 2017 WL 2352152, at *20 (Del. Ch. May 31, 2017) (quoting Katz v. Oak Indus. Inc., 508 A.2d 873, 880 (Del. Ch. 1986)).

preference for a marginally better alternative over an already bad situation."[137]

For *Corwin* purposes, there are at least two types of coercion: structural and situational. Structural coercion is illustrated by *Sciabacucchi v. Liberty Broadband*.[138] In *Sciabacucchi*, the Court of Chancery held that structural coercion was plausible where the plaintiff had alleged that the deal proposed to shareholders essentially required them to approve or reject both 1) two mergers that were undisputedly beneficial to the corporation's shareholders, and 2) a purportedly unfair financing transaction involving the corporation's largest shareholder that were express conditions of the merger transaction.[139] The plaintiffs alleged that, by conditioning the lucrative merger transactions on the financing transaction, shareholders were coerced into approving something that they otherwise would have rejected.[140] Situational coercion, on the other hand, is illustrated by *Saba Software*. In *Saba*, the court held that stockholders were subject to situational coercion where the board pushed for a sale of the company at a depressed price after having grossly mismanaged the company's response to a fraud perpetuated by two of its former executives.[141] As *Saba* stated, "inequitable coercion flowed from the situation in which the Board placed its stockholders as a consequence of its allegedly wrongful action and inaction."[142] In other words, either type of coercion returns a court to an examination of the board's conduct, the same examination that *Corwin* cleansing was supposed to allow courts to avoid.

Moreover, in several cases where *Corwin* was found to apply and the complaint dismissed, the courts' opinions explicitly indicated that other reasons would have prompted dismissal anyway.[143] Thus, if the impact of *Corwin* has been less than what

137. *In re* Dell Techs. Inc. Class V S'holders Litig., C.A. No. 2018-0816-JTL, 2020 WL 3096748, at *27 (Del. Ch. June 11, 2020).
138. *Sciabacucchi*, 2017 WL 2352152 (Del. Ch. May 31, 2017).
139. *Id.* at *1.
140. *Id.* at *2–4.
141. *In re* Saba Software, Inc. S'holder Litig., C.A. No. 10697-VCS, 2017 WL 1201108, at *16 (Del. Ch. Mar. 31, 2017).
142. *Id.* at *16.
143. *See, e.g.*, Ryan v. Buckeye Partners, L.P., C.A. No. 2021-0432-JRS, 2022 WL 389827, at *9 (Del. Ch. Feb. 9, 2022); *In re* Cyan, Inc. S'holders Litig., C.A. No. 11027-CB, 2017 WL 1956955, at *7–11 (Del. Ch. May 11, 2017).

was expected, it may be because *Corwin* made but empty promises of empowering shareholders and simplifying litigation.

F. *Poison Pills and Shareholder Empowerment*

Unlike most of the other doctrines discussed in this Part that aim to regulate the power of controllers and managers to engineer unfair mergers, the rules around poison pills aim to contain a legal device that allows managers to avoid mergers. Invented in the 1980s to ward off so-called hostile takeovers, the original poison pills were essentially instruments that diluted the holdings of would-be hostile bidders to make takeovers economically impossible without the consent of target boards.[144] Since then, poison pills have evolved to also protect boards from activist shareholders who pursue only minority stakes in a corporation.[145] The problem for corporate law is that poison pills also limit the powers and rights of shareholders to make decisions and undertake transactions that those shareholders would otherwise be entitled to make and take.[146] What could justify such an intrusion? Delaware courts have struggled with the answer, and recent case law suggests that such intrusions may often be inappropriate.

Nominally, Delaware's *Unocal* standard required courts to consider whether the board had articulated a legitimate threat justifying its action and whether the board's actions were proportionate to that threat. Specifically, a board defending the adoption of a poison pill must show "(1) that it had reasonable grounds for believing a danger to corporate policy and effectiveness existed (i.e., the board must articulate a legally cognizable threat) and (2) that any board action taken in response to that threat is reasonable in relation to the threat posed."[147] While less deferential than the business judgment standard used in many other states,[148] *Unocal* is by no means as tough as entire

144. Marcel Kahan & Edward Rock, *Anti-Activist Poison Pills*, 99 B.U. L. Rev. 915, 921 (2019).
145. *Id.* at 918–20, 923–25.
146. *See, e.g.*, Julian Velasco, *The Enduring Illegitimacy of the Poison Pill*, 27 J. Corp. L. 381, 403–11 (2002).
147. Air Prod. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 92 (Del. Ch. 2011) (quoting Unitrin v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995) (citing Unocal v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985))).
148. Michal Barzuza, *The State of State Antitakeover Law*, 95 Va. L. Rev. 1973, 1998–2002, 2042–46 (2009).

fairness, and Delaware courts have often approved poison pills, especially in *Unocal*'s earlier years.[149]

Unocal's first prong is primarily an investigation of decision-making process.[150] Under that prong, a board must demonstrate that it had "reasonable grounds for believing a danger to corporate policy and effectiveness existed," which it does by showing that it conducted a reasonable investigation. Although *Unocal*'s first prong technically requires that the threat be "legally cognizable," giving the inquiry a sheen of judicial inquiry into substance, under the *Unocal* standard, boards may implement a poison pill on the mere basis that a takeover offer supposedly underprices the corporation and shareholders may confusedly and erroneously accept such an offer, a notion known as "substantive coercion."[151] Before Delaware courts deprecated the theory, the availability of substantive coercion as a legitimate threat effectively eliminated consequential inquiry into the legitimacy of the threat.[152]

The meaning of *Unocal*'s second prong, known as the proportionality test, is more contested. Under the proportionality test, courts consider the nature of the threat and the nature of management's response to that threat.[153] In the years after *Unocal*, Professors Ronald Gilson and Reiner Kraakman influentially argued that courts must evaluate the economic value of the hostile offer and the value of management's proposed alternative in cases where a board claims substantive coercion.[154] As Gilson and Kraakman acknowledge, a "real challenge" of the proportionality test arises when courts must determine values of the competing alternatives.[155] For instance, if a court finds structural coercion in the threat, and a board proposes a preclusive restructuring

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149. *See, e.g.,* Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985); Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1154 (Del. 1989); *Airgas*, 16 A.3d at 49. *See generally* Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 268 (1989).

150. *Airgas*, 16 A.3d at 92 ("The first hurdle under *Unocal* is essentially a process-based review").

151. *Unitrin*, 651 A.2d at 1384; *Paramount*, 571 A.2d at 1154.

152. A notable exception is Chesapeake Corp. v. Shore, 771 A.2d 293, 329 (Del Ch. 2000), in which the court excoriated the board for the lackadaisical manner by which the board considered the pill in question.

153. *See* Versata Enters., Inc. v. Selectica, Inc., 5 A.3d 586, 606 (Del. 2010); *Chesapeake*, 771 A.2d at 329.

154. Gilson & Kraakman, *supra* note 149, at 266–71.

155. *Id.* at 270.

to thwart the threat, Gilson and Kraakman argue that a court should require a "demonstration of a benefit to shareholder interests."[156] In other words, Gilson and Kraakman would seemingly have courts examine the economic merits of the competing alternatives. However, as discussed previously, the Delaware courts are often leery of conducting substantive economic analysis, and the courts have often resorted to other process-centered analytics to avoid making such quantitative comparisons.

The *Airgas* case is illustrative of Delaware courts' avoidance of examining quantitative proportionality. In *Airgas*, Air Products made a "structurally non-coercive, all-cash, fully financed tender offer" to Airgas's stockholders.[157] In response, the Airgas board instituted a poison pill with flip-over and back-end rights.[158] There was no question that the sole legally cognizable basis of Airgas's poison pill was that the Airgas board felt that Air Products' offer should have been higher. But why should the board usurp stockholders' right to accept or reject the tender offer for themselves? *Airgas* replied simply that a board could not delegate its duty to decide what is best for the corporation (and presumably, for stockholders) to stockholders themselves.[159] The court then found that the pill fell within the range of reasonableness because it "d[id] not *forever* preclude Air Products, or any bidder, from acquiring Airgas."[160] Indeed, this is the Delaware courts' usual approach when faced with poison pills that operate via what might be termed financial or economic mechanisms—e.g., diluting a would-be acquirer or paying out large cash dividends in the event of a sale.[161]

By contrast, the Delaware courts have rejected defensive measures under *Unocal* when the measure directly impaired the decision-making powers of shareholders or of boards, labeling such measures "draconian" or "preclusive." For example, in *Quickturn*, the Delaware Supreme Court considered a "dead-hand" pill, which prevented any newly elected boards from redeeming the pill for six months.[162] *Quickturn* affirmed

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156. *Id.*
157. *Airgas*, 16 A.3d at 54.
158. Airgas, Inc., Current Report (Form 8-K) (May 10, 2007).
159. *Airgas*, 16 A.3d at 124.
160. *Id.* at 124 (emphasis in original).
161. *See, e.g.*, Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1388 (Del. 1995).
162. Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1288 (Del.), *aff'g* Mentor Graphics Corp. v. Quickturn Design Sys., Inc., 728 A.2d 25, 49–52 (Del. Ch. 1998).

the Court of Chancery's invalidation of the pill, reasoning that dead-hand pills violate Delaware law by limiting the power of a board to manage the corporation.[163] As *Quickturn* held, D.G.C.L. § 141(a) requires that corporate decisions be made by the current board, and a board cannot delegate the powers of a future board to itself.[164]

Likewise, in *Liquid Audio*,[165] the Delaware Supreme Court determined that a board expansion violated *Unocal* because the expansion was specifically meant to frustrate a stockholder vote that would have likely replaced two incumbent directors with directors nominated by a would-be acquirer, who had previously made an offer that the board rejected as inadequate.[166] The Delaware Supreme Court ruled that such actions violated the rule articulated in *Blasius v. Atlas* that where a board "act[s] for the primary purpose of interfering with or impeding the effective exercise of a shareholder vote," it "bears the heavy burden of demonstrating a compelling justification for such action."[167] In such cases, "the board must first demonstrate a compelling justification for such action as a condition precedent to any judicial consideration of reasonableness and proportiona[lit]y."[168] Without any meaningful factual analysis, *Liquid Audio* held that the board had not demonstrated a compelling justification for its actions and reversed the trial court's decision.[169]

As shown by these cases, the operative inquiry under *Unocal* seems to concern the nature of the poison pill—its purpose and mechanism of operation—as much as the process by which the board adopted the pill. At first blush, that may seem to be a question of business substance. Still, the rubric by which a pill is examined focuses on whether that pill infringes on the procedural rights of shareholders and boards to control the fate of the corporation; courts leave in place those measures that make it more economically difficult for a would-be acquirer to

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163. *Id.* at 1290–92.

164. *Id.*

165. MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118 (Del. 2003).

166. *Id.* at 1125–27, 1135.

167. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659–61 (Del. Ch. 1988) (quoted in *Liquid Audio*, 813 A.2d at 1129).

168. *Liquid Audio*, 813 A.2d at 1132.

169. *See id.* at 1125–26, 1131–32. *Cf.* Coster v. UIP Cos., 300 A.3d 656, 663 (Del. 2023) (affirming the trial court's approval of a stock sale that diluted a 50% stockholder, ended a deadlock, and mooted a custodial action).

take over a corporation but do not directly infringe upon shareholder or board rights.

That said, are pills that operate via economic mechanisms all that different from pills that more directly impact decision-making processes? Returning to *Airgas*, which involved a solely "economic" pill that did not directly limit shareholder or board powers, the court gave three reasons why the board's defensive measures were within the range of reasonableness.[170] First, it found that the board was "not 'cramming down' a management-sponsored alternative" but instead "simply maintaining the status quo."[171] Second, the board's actions "do not *forever* preclude" a change-of-control.[172] Third, it found that appraisal, an alternative protection suggested by stockholders, may not adequately recognize Airgas's value, in part due to appraisal's exclusion of synergies from fair value.[173] But do not all three reasons apply also the measures in *Quickturn* and *Liquid Audio*? After all, the *Quickturn* dead-hand pill was not "forever" either, but lasted only six months, and the impact of the board expansion in *Liquid Audio* could have been neutralized by subsequent shareholder votes.[174] It is far from clear that the two groups of defensive measures can be genuinely distinguished under process-centered principles, and it may be the case that the two types of defensive measures are more similar—and should be treated more similarly—than might initially appear.

Recently, the use of poison pills has gone beyond attempting to limit takeovers to limiting even minority shareholder activism. The precise terms of pills, particularly the terms of triggers, are far more important in activism contexts than in takeovers because activists economically benefit in proportion only to their shareholdings, whereas takeover buyers often obtain only a small toehold position anyway before launching a tender offer for the remaining shares.[175] Thus, in a lucid

170. *Airgas*, 16 A.3d at 124–25. *Airgas* also noted in its section on the range of reasonableness that the board was responding to a legitimately articulated threat. *Id.* at 122–23. This seems to fall under the first prong of *Unocal*, however.

171. *Id.* at 124.

172. *Id.* at 124–25 (emphasis in original).

173. *Id.* at 125–26.

174. *Quickturn*, 721 A.2d at 1287–88, 1291-92; *Liquid Audio*, 813 A.2d at 1125.

175. Kahan & Rock, *supra* note 144, at 922–924.

exposition of anti-activist pills, Professors Marcel Kahan and Ed Rock have argued that "[t]he analysis of whether a pill is reasonable requires greater scrutiny in the context of an anti-activist pill than in the context of an anti-takeover pill."[176] Professors Kahan and Rock conclude that pills should be allowed only to the extent that they "serve to maintain a balanced election process, without significantly impeding an activist."[177] In their view, provisions that include derivative exposure in calculating ownership and "wolf-pack" provisions that trigger a pill when investors act in parallel without any actual agreement should be invalidated because they do not plausibly protect, much less enhance, the benefits of shareholder democracy.[178]

The 2021 *Williams*[179] case relied heavily on Professors Kahan and Rock's analysis to invalidate an anti-activist pill with a 5% ownership trigger. The pill's trigger also included an expansive beneficial ownership definition that encompassed economic exposure via derivatives, a wolf-pack provision, and a more limited definition of "passive" investor than what the federal securities laws provides.[180]

In its *Unocal* analysis, the Court of Chancery first rejected stockholder activism and then short-termism (which appeared to be essentially another way of describing "substantive coercion") as legitimate corporate threats against which a board may adopt a poison pill at all.[181]

Williams then considered the legitimacy of the board's third justification: filling in a supposed "gap" in the rules implementing Section 13(d) of the Securities Exchange Act that allows parties to surreptitiously acquire significant portions of a corporation's stock in the days before disclosure is required of a stockholder who newly becomes a holder of 5% or more of a company's stock. (The current rule requires disclosure within 10 days; the Securities and Exchange Commission has formally proposed shortening the period to five days, but no final rule

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176. *Id.* at 946.
177. *Id.* at 970.
178. *Id.* at 951–53, 962–66.
179. Williams Cos. S'holder Litig., C.A. No. 2020-0707-KSJM, 2021 WL 754593, at *38–40 (Del. Ch. Feb. 26, 2021) [hereinafter *Williams Trial*], *aff'd sub nom.* Williams Cos. v. Wolosky, 264 A.3d 641 (Table), 2021 WL 5112495 (Del. 2021).
180. *Williams Trial*, 2021 WL 754593, at *10–13 (comparing the pill's definitions to those under 17 C.F.R. § 240.13d-1).
181. *Id.* at *9.

has been promulgated as of the date of this writing.) The court noted that "if gap filling were a legitimate corporate objective that justified the adoption of a poison pill, then all Delaware corporations subject to the federal disclosure regime would have a ready-made basis for adopting a pill,"[182] which bears obvious similarities to criticisms of substantive coercion claiming that it would be universally available. The court then assumed without deciding that filling gaps in federal disclosure requirements was a permissible purpose.[183]

Nevertheless, the court invalidated the pill as disproportional because it went beyond the gap-fillers previously suggested by commentators. The pill's passive investor provision excluded investors who engaged in "routine activities such as attending investor conferences and advocating for the same corporate action" and, combined with the pill's acting-in-concert provision, was "likely to chill a wide range of anodyne stockholder communications."[184] Notably, conduct that might trigger the wolf-pack provision included "exchanging information, attending meetings, conducting discussions, or making or soliciting invitations to act in concert or in parallel,"[185] which nearly exactly mirrored the provisions that Kahan and Rock had criticized.[186]

We can thus see *Williams* as an *a fortiori* application of *Quickturn* and *Liquid Audio*: Given that the defensive measures in *Quickturn* and *Liquid Audio* were impermissible because they threatened to dilute the practical impact of shareholder votes, a measure that threatens the pre-vote campaigns and activities that give votes credibility as genuine reflections of shareholder preferences and sentiment must be even more impermissible.[187] But as noted above, the *Quickturn* and *Liquid Audio* measures were, in some ways, no more restrictive upon shareholder choices than traditional poison pills.[188] Likewise, if, under *Williams*, pills may not dilute the power of shareholder

182. *Id.* at *34.
183. *Id.*
184. *Id.* at *37.
185. *Id.* at *11.
186. *Id.* at *38 (citing Kahan & Rock, *supra* note 144, at 962–66).
187. Compare this to the requirements in *Corwin* and *MFW* that cleansing votes be "fully informed." Corwin v. KKR Fin. Holdings, LLC, 125 A.3d 304 (Del. 2015); *In re* MFW S'holders Litig., 67 A.3d 496 (Del. Ch. 2013), *aff'd*, 88 A.3d 635 (Del. 2014).
188. *See supra* notes 170–73.

votes as a means to express shareholder sentiment, then why may pills block tender offers as a means to express shareholder sentiment?

II.
Management of Going Concerns

The complications raised by the interactions between substance and process also extend to the ordinary day-to-day management of corporations. In the day-to-day context, the business judgment rule looms large and generally shields unconflicted management decisions from investor attack via judicial processes. However, the Delaware courts have considered two contexts in which even unconflicted, non-merger management decisions might be subject to fiduciary liability. One of these contexts, *Van Gorkom*, is widely viewed as wrongly decided, but the other, *Caremark*, has recently been invigorated by several decisions that have expanded its scope.

In theory, both *Van Gorkom* and *Caremark* are process-centered schemes, which, also in theory, should be a point of strength for courts. But as just mentioned, *Van Gorkom* has been widely derided.[189] And although *Caremark* has been received more positively, it often shifts its focus away from process, as this Article will illustrate. Rather, *Caremark* regularly requires courts to second-guess directors' business judgment. These lines of decisions also show how a focus on process does not guarantee good decisions, and moreover, may even lull the unsuspecting into falling for a mirage.

A. Van Gorkom, Disney, *and the Death of the Duty of Care*

It is a carefully guarded principle of Delaware corporate law that the board of directors manages the affairs of the corporation,[190] and the business judgment rule is perhaps the most significant realization of that principle. Under the business judgment rule, courts "presume[] that in making a business decision the directors of a corporation acted on an informed

189. *See, e.g.*, Leo Herzel & Leo Katz, Smith v. Van Gorkom: *The Business of Judging Business Judgment*, 41 Bus. Law. 1187 (1986); Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 Bus. Law. 1 (1985).

190. Del. Code Ann. tit. 8, § 141(a) (2023).

basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[191] Unless that presumption is rebutted, "a court will not interfere with the judgment of a board of directors."[192]

The business judgment rule is highly deferential and protects the great bulk of corporate actions from judicial review. A board may adopt a terrible business plan; it may hire an incompetent CEO; it may award the same CEO tens of millions in severance. Absent self-dealing, none of these decisions will be subject to successful stockholder attack. That is, until *Smith v. Van Gorkom*[193] threatened to eviscerate the protection offered by the business judgement rule. (Although *Van Gorkom* was a merger case, the perceived impact also extended to review of ordinary business decisions, hence its discussion in this Part.)

In *Van Gorkom,* Trans Union (the same company as the credit reporting agency, but then also engaged in railcar leasing) held millions of nonrefundable tax credits, an issue that the board had discussed repeatedly.[194] To realize the value of those tax credits, Trans Union's CEO, Jerome Van Gorkom, decided to sell the company to an entity controlled by businessman Jay Pritzker, then-patriarch of the wealthy Pritzker family.[195] After negotiating for a few days, Van Gorkom reached a deal in principle with Pritzker at $55 per share.[196] Van Gorkom then called a Saturday meeting of the Trans Union board, and after a two-hour meeting, the board resolved to approve the deal.[197] The merger agreement was executed without any director having read the final copy, and later amendments were also executed without the directors having read them.[198]

The Delaware Supreme Court held that the board breached its duty of care by approving the merger without having sufficiently analyzed the deal and by not disclosing the board's ignorance to stockholders in the proxy statement soliciting stockholder approval of the deal. Two of the five justices dissented. In his dissent, Justice McNeilly noted that by the

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191. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
192. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (citations omitted).
193. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).
194. *Id.* at 864–65, 895 (McNeilly, J., dissenting).
195. *Id.* at 866.
196. *Id.* at 866–67.
197. *Id.* at 867–69.
198. *Id.* at 869–70, 882–83.

time of the merger, the Trans Union board had repeatedly discussed Trans Union's tax problems and had recently reviewed forecasts and analyses of Trans Union's business.[199] Justice McNeilly's dissent also criticized the majority's emphasis on the speed with which the deal was approved, noting that the "the corporate world . . . operates on what is so aptly referred to as 'the fast track'" and that Trans Union's outsider directors were each CEOs of large corporations or prominent business professors.[200]

Even under *Van Gorkom*, the focus of the duty of care analysis remains on the process by which the directors arrived at their decision and not the result. Contrary to suggestions in other bodies of law, under Delaware law,

> compliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests. To employ a different rule—one that permitted an "objective" evaluation of the decision—would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all good faith board decisions.[201]

199. *Id.* at 895 (McNeilly, J., dissenting).

200. *Id.* at 894–95 (McNeilly, J., dissenting); *see* Jonathan R. Macey & Geoffrey P. Miller, Trans Union *Reconsidered*, 98 YALE L.J. 127, 129 (1988) ("While the majority opinion claimed to have articulated a 'gross negligence' standard as governing the case, the facts did not support a finding of negligence, much less gross negligence.").

201. *Caremark*, 698 A.2d at 967-68 (footnotes omitted) (contrasting the Delaware position with that espoused by the American Law Institute, which stated that for a decision to qualify for judicial deference under the business judgment rule, a director must have "rationally believe[d] that the business

Nevertheless, *Van Gorkom* sent the business world into a tizzy.[202] The following year, the Delaware General Assembly responded with Section 102(b)(7),[203] which allowed corporations to indemnify directors for breaches of the duty of care, overruling *Van Gorkom* in all but name. Following enactment of § 102(b)(7), the threat of liability for breach of the duty of care largely disappeared. It would prove nearly impossible to assert actionable damages claims against directors: demand futility required that plaintiffs plead that the directors face a meaningful risk of personal financial liability, which § 102(b)(7) eliminated for duty of care claims.

Later retrospectives on *Van Gorkom* have rehabilitated it somewhat into an early heightened-scrutiny case for mergers, i.e., a *Revlon* before *Revlon*.[204] I am sympathetic to these views, but there is good reason to believe that even under the legal standard articulated by the majority, *Van Gorkom* was simply an incorrect application of law to fact, as expressed by Justice McNeilly's dissent and others.[205] Even if *Van Gorkom* represented a court's skepticism of a board's deliberative process and not of the substance of the final decision, that skepticism still seems unjustified. And thus, one of the worst business court decisions of the last 40 years, requiring almost immediate rectification by the legislature, was in a field—process—where courts were supposed to excel.

Disney[206] was the coup de grâce for the duty of care. In *Disney*, the Delaware Supreme Court held that, among other things, Disney's board did not breach its fiduciary duties by approving a contract to hire Michael Ovitz as president that eventually cost Disney $140 million for just over one year of (poor) service. Although *Disney* technically did not overrule *Van Gorkom*,

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judgment is in the best interests of the corporation." AM. L. INST., PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c) (1994)).

202. *See* Hamermesh et al., *supra* note 34, at 351 & n.136.

203. DEL. CODE ANN. tit. 8, § 102(b)(7) (2023).

204. Laster, *supra* note 120, at 24 n.94; Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1051 n.4 (Del. Ch. 1996); *see* Cinerama, Inc. v. Technicolor, Inc., C.A. No. 8358, 1991 WL 111134, at *16 (Del. Ch. June 24, 1991) ("the due care theory and the *Revlon* theory do not present two separate legal theories justifying shareholder recovery").

205. *Supra* note 200.

206. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006) [hereinafter *Disney Appeal*].

the effect was the same. Both the Delaware Supreme Court and the Court of Chancery took many pains to distinguish the facts from those of *Van Gorkom*,[207] but it is hard to see light between the angle taken by the *Disney* opinions and Justice McNeilly's dissent in *Van Gorkom*: the board "f[e]ll short of best practices,"[208] "underperformed,"[209] and did not "reflect . . . ideal corporate governance,"[210] but nevertheless knew enough and tried hard enough to satisfy their duty of care.

B. Caremark, Marchand, *and the Mirage of Process*

Section 102(b)(7) and *Disney* seemingly restored the status quo ante to duty of care rules: absent self-dealing or a similar conflict of interest, directors could do as they pleased. In the years afterward, cases such as *Revlon* raised the bar for director conduct in the merger context, but there was little judicial oversight of directors' management of day-to-day business. Still, there was one case that lurked in the shadows: *Caremark*,[211] a 1996 Court of Chancery case that had stated that a board was obligated to (1) set up a reasonable system of monitoring,[212] and (2) act in the face of known issues, or "red flags."[213]

Nominally, *Caremark* is an inquiry into process, not results. It examines whether a board had systems and procedures for making good decisions and not whether those decisions were

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207. *Id.* at 55–60; *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 760–72 (Del. Ch. 2005) [hereinafter *Disney Trial*].

208. *Disney Appeal*, 906 A.2d at 56.

209. *Disney Trial*, 907 A.2d at 772.

210. *Id.*

211. Before *Caremark*, the leading Delaware case on directors' duty of oversight was *Graham v. Allis–Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963), in which the Delaware Supreme Court absolved a large corporation's directors from failing to address antitrust violations on account of the firm's large size and the directors' ignorance of indications that the firm was in fact engaged in illegal activity. *Caremark* did not and could not technically overrule *Graham* because *Caremark* was a Court of Chancery decision, and moreover, was a settlement approval in which its most remembered statements were technically dicta. Still, it is *Caremark* and not *Graham* that forms the basis for today's law on the duty to monitor. *See* Jennifer Arlen, *The Story of* Allis-Chalmers, Caremark, *and* Stone: *Directors' Evolving Duty to Monitor*, in CORPORATE LAW STORIES 323, 331, 339 (J. Mark Ramseyer ed., 2009).

212. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996); *In re* GoPro, Inc., C.A. No. 2018-0784-JRS, 2020 WL 2036602, at *10 (Del. Ch. Apr. 28, 2020).

213. *Id.* at 971.

actually any good. The monitoring system required under *Caremark*'s first monitoring prong "is a question of business judgment," and *Caremark* itself acknowledged that "no rationally designed information and reporting system" will eliminate the possibility of regulatory and risk-management violations.[214] Likewise, directors are entitled to rely upon management reports to assure themselves that there are no issues requiring their attention.[215] By its own terms, *Caremark* is not a particularly strict standard. As *Caremark* remarked, "[t]he theory here advanced is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[216] In the decade after *Caremark* was decided, it does not appear that the Court of Chancery denied a single motion to dismiss a *Caremark* claim for failure to state a claim.[217]

Despite the weakness of *Caremark* by its own terms, *Stone v. Ritter*,[218] decided just five months after *Disney* and by the same court, further called into question whether *Caremark* had any real force. In *Stone*, a bank facilitated a Ponzi scheme and failed to make proper disclosures required by federal laws designed to

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214. *Id.* at 970.

215. *Id.* at 971; *see also* Wood v. Baum, 953 A.2d 136, 143 (Del. 2008).

216. *Caremark*, 698 A.2d at 967.

217. In rare cases, non-Delaware courts did allow *Caremark* claims to proceed past the dismissal stage during this period. *See, e.g.*, *In re* Abbott Lab'ys Derivative S'holders Litig., 325 F.3d 795 (7th Cir. 2003) (applying Delaware law and reversing dismissal). After the financial crisis, the Delaware courts also allowed a few *Caremark* claims to proceed past dismissal. These cases were (1) *In re* Am. Int'l Grp., Inc., Consol. Derivative Litig., 965 A.2d 763, 774, 777 (Del. Ch. 2009), in which the Court of Chancery found that the complaint raised a plausible inference that the individual defendants knew that AIG's internal controls were faulty and did nothing about it; (2) *In re* Puda Coal, Inc. S'holders Litig., C.A. No. 6476-CS, 2013 WL 769400 (Del. Ch. Feb. 6, 2013) (bench ruling), in which independent directors failed to discover for two years that the corporation's chairman fraudulently transferred the corporation's primary asset, and upon the fraud coming to their attention, quit instead of taking any remedial action; (3) *In re* China Agritech, Inc. S'holder Derivative Litig., C.A. No. 7163-VCL, 2013 WL 2181514, *19, *20, *24 (Del. Ch. May 21, 2013), in which the court found that the complaint raised a plausible inference that, *inter alia*, the members of the audit committee knowingly disregarded their duties by never meeting or doing any actual work, even as they were also aware of ongoing oversight problems; and (4) Rich *ex rel.* Fuqi Int'l, Inc. v. Chong, 66 A.3d 963 (Del. Ch. 2013), in which the court found that the complaint raised a plausible inference that, *inter alia*, the board had no "meaningful" controls in place and ignored red flags.

218. Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006).

police such crimes.[219] Federal regulators found that the bank's compliance program "lacked adequate board and management oversight," and that "reporting to management for the purposes of monitoring and oversight of compliance activities was materially deficient."[220] Despite all this, the Court of Chancery found that the complaint had failed to state a claim, and the Delaware Supreme Court affirmed. In its affirmance, the Delaware Supreme Court found that the board had implemented a sufficient oversight system by adopting written compliance policies and procedures, establishing numerous departments to handle compliance matters, receiving annual compliance reports, and having an audit committee that "oversaw [the company's] compliance program on a quarterly basis."[221] However, seemingly in part to avoid § 102(b)(7) exculpation, *Stone* also held that *Caremark* claims—which relate to a board's oversight duties—relate to the duty of loyalty rather than the duty of care.[222] If time had stopped there, Delaware's critics would have a fair basis to argue the duty to monitor is all hat, no cattle.[223]

Marchand v. Barnhill,[224] decided in 2019, heralded the arrival of a more vigorous *Caremark* standard. The headline holding of *Marchand* was a refinement of *Caremark*'s first monitoring prong to require that "a board make a good faith effort to put in place a reasonable system of monitoring and reporting about the corporation's central compliance risks."[225] But more significant than that rule statement was how *Marchand* applied it to the factual allegations at hand: the inferences drawn in *Marchand*

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219. *Id.* at 365–66.
220. *Id.* at 366.
221. *Id.* at 371–73.
222. *See id.* at 369–70 (distinguishing *Caremark* claims from the duty of care claims found to be exculpated in *Disney*). Arguably, *Stone*'s verbal gymnastics are unnecessary, as § 102(b)(7) does not allow exculpation of "acts or omissions not in good faith," an exclusion separate from the exclusion for breaches of the duty of loyalty. DEL. CODE ANN. tit. 8, § 102(b)(7)(i)-(ii) (2021).
223. *See, e.g.*, Cheryl L. Wade, *Corporate Governance Failures and the Managerial Duty of Care*, 76 ST. JOHN'S L. REV. 767, 769 (2002). *See also* Robert T. Miller, *Wrongful Omissions by Corporate Directors:* Stone v. Ritter *and Adapting the Process Model of the Delaware Business Judgment Rule*, 10 U. PA. J. BUS. & EMP. L. 911, 941 (2008) (arguing that *Caremark* and *Stone* lack a meaningful inquiry into what information a monitoring system must provide and proposing that boards pass a resolution to determine what information is necessary on penalty of an *ad hoc* judicial determination of necessary information).
224. Marchand v. Barnhill, 212 A.3d 805 (Del. 2019).
225. *Id.* at 824.

go far beyond what Delaware courts had previously been willing to infer from complaints asserting *Caremark* claims. Although the Delaware Supreme Court framed its decision in terms of a total failure to monitor food safety,[226] the complaint does not actually seem to suggest that the company completely lacked a system of oversight. In *Marchand*, which concerned the Blue Bell ice cream company, management undisputedly provided regular reports from food safety regulators and third-party food safety auditors to the board chairman individually as well as to the entire board,[227] which arguably should suffice under the business judgment standard that *Caremark* would apply to oversight systems.[228] Even so, *Marchand* concluded that it was plausible that "no board-level system of monitoring or reporting on food safety existed."[229] Similarly, *Marchand* inferred that the directors' response that "management regularly reported to them on 'operational issues'" indicated only reporting of "general operations" in a manner insufficient to satisfy *Caremark*.[230]

In *Marchand*'s wake, plaintiffs have filed several successful *Caremark* complaints, resulting in decisions that have rapidly expanded *Caremark*'s scope and have placed into question former assumptions about limitations on *Caremark* liability. To illustrate, although some post-*Marchand* analyses suggested that risks must be "mission-critical" to warrant *Caremark* scrutiny,[231] a subsequent Chancery case explained that *Caremark* applies not only to "mission critical risks," but in fact to all "central compliance risks," an inherently broader standard.[232] Moreover, as that decision held, a risk need not be a central compliance risk or a mission-critical risk to warrant action in the face of

226. The Court of Chancery also rejected a "red-flag" *Caremark* claim. Although management received several "red flags," none of these flags appeared to have been passed on to the board. The Supreme Court's decision noted some of these red flags, but it did not appear to have reversed on that holding.

227. *Marchand*, 212 A.3d at 817.

228. *Caremark*, 698 A.2d at 970.

229. *Marchand*, 212 A.3d at 824.

230. *Id.* at 823–24.

231. *See, e.g.*, H. Justin Pace & Lawrence J. Trautman, *Mission Critical:* Caremark, Blue Bell, *and Director Responsibility for Cybersecurity Governance,* 2022 Wis. L. Rev. 887, 891 (2022) (stating that the most plausible interpretation of *Caremark* is that it "will be limited to 'mission critical' operations").

232. *In re* McDonald's Corp. S'holder Derivative Litig., 291 A.3d 652, 678 (Del. Ch. 2023).

a red flag.[233] Rather, the significance of a risk merely makes it "easier to draw an inference that a failure to respond meaningfully resulted from bad faith."[234]

Likewise, recent Chancery guidance places in serious doubt previous attempts to limit *Caremark* to monitoring failures "in connection with the corporation's violation of positive law."[235] These recent cases suggest that even nonlegal risks may be subject to *Caremark* duties so long as they carry sufficient economic significance.[236] Given, however that nearly all modern economic business risks overlap with legal and compliance risks,[237] it is not clear what it would mean to limit *Caremark* to violations of positive law.

The line between economic and legal risk is particularly blurred for public companies, which must disclose potential risks and financially account for those risks in regulatory filings. The regulatory requirements that apply to public companies mean that economic problems can often be rolled over into violations of securities and accounting law. Consider that in *Hughes v. Hu*, the underlying misconduct was improper self-dealing by corporate executives, but the instant claim against the board was that the board failed to implement adequate accounting controls to prevent self-dealing, resulting in inaccurate regulatory filings that prompted accounting restatements and securities fraud lawsuits.[238] In other words, even if *Caremark* monitoring duties only covered those risks that arise from unlawful conduct, the wide ambit of securities and accounting

233. *Id.* at 680.

234. *Id.*

235. Constr. Indus. Laborers Pension Fund v. Bingle, C.A. No. 2021-0940-SG, 2022 WL 4102492, at *1 (Del. Ch. Sept. 6, 2022), *aff'd*, No. 411, 2022, 2023 WL 3513271 (Del. May 17, 2023) (rejecting such a characterization). *Cf.*, Elizabeth Pollman, *Corporate Oversight and Disobedience*, 72 Vand. L. Rev. 2013, 2031–32 (2019); Lisa M. Fairfax, *Managing Expectations: Does the Directors' Duty to Monitor Promise More than It Can Deliver?*, 10 U. St. Thomas L.J. 416, 427–28 (2012).

236. *Bingle*, 2022 WL 4102492, at *1.

237. For example, *McDonald's* cited both employee walkouts and regulatory investigations as reasons why sexual harassment constituted a risk subject to *Caremark* monitoring. *In re* McDonald's Corp. S'holder Derivative Litig., 289 A.3d 343, 353 (Del. Ch. 2023). *See also* Roy Shapira, *Max Oversight Duties: How* Boeing *Signifies a Shift in Corporate Law*, 48 J. Corp. L. 119, 130 (2022).

238. Hughes v. Hu, C.A. No. 2019-0112-JTL, 2020 WL 1987029, at *13–16 (Del. Ch. Apr. 27, 2020).

laws may act to sweep many seemingly non-legal business risks within *Caremark* anyway.[239]

Other post-*Marchand* cases such as *Pettry v. Smith*[240] also undermine the view that the core of *Caremark* concerns legal compliance. *Pettry* concerned illegal shipments of cigarettes delivered by FedEx. In 2006, FedEx agreed to cease future shipments and pay $1,000 for each violation thereafter in a settlement that expressly bound its directors.[241] However, FedEx continued to make illegal shipments of cigarettes, and for six years, the board seemed to take no steps to improve compliance.[242] Nevertheless, *Pettry* concluded that it was implausible that the board knew that FedEx was violating the law, given that "illegal cigarette shipments at issue here, and the resulting fines, constitute an infinitesimal fraction of the overall business FedEx does."[243] As *Pettry* suggests, even legal risks need not trigger *Caremark* monitoring duties if the reviewing court determines that those legal risks are but minor business risks.

Furthermore, it is hard to see how determining what constitutes "central compliance" and "mission-critical" risks is not something that otherwise should be entrusted to the sound business judgment of the board.[244] At high enough levels of generality, almost any significant corporate trauma can be linked to a corporation's core functions, and an artfully pleaded complaint could seemingly charge that any impactful activity worthy of derivative litigation was by definition a critical activity. For example, in *Boeing*, the absence of a specific board committee to oversee safety (a mission-critical matter, according to the

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239. *Cf. Bingle*, 2022 WL 4102492, at *1 (cybersecurity risks, even if untethered to violations of positive law, nevertheless may constitute mission-critical risks falling within *Caremark*).

240. Pettry *ex rel.* FedEx Corp. v. Smith, C.A. No. 2019-0795-JRS, 2021 WL 2644475, at *12 (Del. Ch. June 28, 2021), *aff'd*, 273 A.3d 750 (Del. 2022).

241. Assurance of Compliance ¶ 23, 31, *In re* Federal Express Corp., and FedEx Ground Package Sys., Inc., N.Y. Att'y Gen. Health Care Bureau (Feb. 3, 2006), https://web.archive.org/web/20150911225103/https://ag.ny.gov/sites/default/files/press-releases/archived/FedEx%20-%20Executed%20AOC.pdf.

242. Notwithstanding being legally bound to a settlement that required it to cease illegal shipments, the board even may have been unaware of FedEx's illegal conduct until so notified by counsel in 2012. *Pettry*, 2021 WL 2644475, at *12.

243. *Id.* at *7, *12 n.125.

244. *See, e.g.*, *In re* Boeing Co. Derivative Litig., C.A. No. 2019-0907-MTZ, 2021 WL 4059934, at *26 (Del. Ch. Sept. 7, 2021).

court) purportedly indicated a plausible *Caremark* violation.[245] Now, it may be that there was no board committee on safety, but neither was there a board committee that specifically oversaw macro risk management (i.e., managing risk from events such as terrorist attacks or global pandemics that might negatively affect airplane sales), or even sales and marketing.[246] Risks in each of these areas, if realized, might have impacts as large or greater on Boeing than the 737 MAX disasters, and yet the absence of committees overseeing these matters did not seem to suggest to the court that it was reaching deeply into questions of business judgment and discretion.

Post-*Marchand Caremark* is thus often defined by judicial estimation of business substance. *Marchand* requires courts to second guess the judgement of boards as to what constitutes a "central compliance risk" or a "mission-critical risk," which is determined in part with reference to the economic significance of the risk. Likewise, despite the characterization of the necessary monitoring processes as a matter of business judgment not subject to a court's second guessing in the original *Caremark* decision, *Marchand* suggests that courts may legitimately find some monitoring mechanisms to be plainly deficient. In the wake of *Marchand*'s characterization of a board's monitoring duties, we might fairly ask what truly divides substance and process in corporate law?

III.
Lessons from Looking Back

The Delaware courts have good reason to be wary of engaging in judicial second-guessing of business decisions. Among other things, it is tremendously difficult for even the most invested and talented businesspeople, much less courts of law, to make consistently accurate business forecasts. It is largely undisputed that the valuation methodologies used to evaluate economic substance often suffer from great uncertainty and imprecision. For example, DCF outputs can swing wildly depending on the discount and growth rates chosen, and comparable firms analyses depend heavily on which firms are deemed comparable. Likewise, when faced with competing

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245. *Id.* at *5. Notably, the comparator companies cited to have had safety board committees were each airlines and not manufacturers. *Id.* at *5 n.18.
246. *Id.* at *5 (identifying the board's standing committees).

sets of assumptions, it is often challenging for a court to decide which set of assumptions is the more justified one. Consider a restaurant chain that aims to establish Welsh food as the next big thing in the United States. Suppose that, during an appraisal proceeding, management argues that the best growth rate that can be expected from a business that celebrates cawl and Welsh rarebit is a few basis points over inflation, while a plaintiff-shareholder argues that properly promoted stew and cheesy toast are likely to rival hamburgers and hot dogs in popularity. Who is right, and how is a court supposed to decide? Many smart, educated, and well-meaning businesspeople have lost their shirts by incorrectly answering these sorts of questions.

Thus, corporate law usually anchors itself around evaluating the processes by which corporate fiduciaries reached a decision rather than the economics of those decisions. Any reforms to corporate law in the foreseeable future will likely concern modifying the rules around board decision-making processes rather than having courts reevaluate the economic substance of challenged transactions.

Along these lines, commentators proposing that courts dive headfirst into the economic substance of challenged transactions, despite claiming to offer concrete "suggestions for policy reform,"[247] rarely explain how judges should actually adjudicate these matters. How can courts effectively distinguish *ex ante* between the economic merits of Time's poison pill, which by one estimate cost stockholders $6.26 billion,[248] and those of Airgas's poison pill, which resulted in a subsequent acquisition price just a few years later that was more than double the contested offer?[249] Such matters are still "left as an exercise for the reader."[250]

By contrast, process-based analyses require seemingly less prescience. There is little doubt as to whether courts can accurately decide whether a director was conflicted, whether such a director was involved with deliberations, or whether a director

247. Reza Dibadj, *Delayering Corporate Law*, 34 HOFSTRA L. REV. 469, 504 (2005).

248. Park McGinty, *The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 EMORY L.J. 163, 298–99 (1997).

249. *See* Leslie Picker, *Why Airgas Was Finally Sold, for $10 Billion Instead of $5 Billion*, N.Y. TIMES (Sept. 5, 2016).

250. Dibadj, *supra* note 247, at 504.

was kept out of the loop and then railroaded into approving a particular transaction.

As such, when the Delaware courts state that corporate law should not be interpreted to require courts to compare the relative economic merits of alternative business decisions,[251] there is no reason to believe that the Delaware judiciary is being disingenuous. The Delaware Court of Chancery, which is properly held in high regard for its business-law acumen, is nevertheless not an investment bank or business strategy hub. As of this writing, there are six vice chancellors and one chancellor, aided by fourteen judicial clerks who are often recent law school graduates. That is not sufficient to review the substance of business decisions made after thousands of hours of collective analysis.

Judicial review of the economic substance of transactions would likely also impose additional costs on businesses and shareholders. For instance, the possibility of litigation injects additional risk into any business decision, and management would likely respond accordingly by choosing decisions that reduce the amount of litigation risk and minimizing the combination of litigation and business risk.[252] Even worse, management may make *ex ante* risky and/or unprofitable decisions simply because such decisions reduce litigation risk, as exemplified by the business maxim "nobody ever got fired for buying IBM." Business leaders may well know ahead of time that a particular business decision is suboptimal but still make that decision because they believe that pleading the suboptimality of the decision and proving it at trial will be difficult. Relatedly, business leaders may systematically choose suboptimal decisions where the suboptimality is less than the costs of litigation for would-be plaintiffs. Although similar problems may arise with increased process requirements (e.g., a board may decide to have a formal meeting and keep minutes to lower litigation risk when absent such risk, the board would have conducted the same business over informal emails or text messages), the magnitude of the downsides are arguably lower, and with any

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251. *See, e.g.*, Paramount Commc'ns., Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1989).

252. For a discussion of that issue, see Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 110–17 (2004).

luck, perhaps the increased process may lead to substantively better business decisions.[253]

And critics should not overlook the promise of process-based protections. In a series of decisions since 2019, Delaware courts have significantly broadened shareholder rights[254] under Section 220 of the D.G.C.L., which gives shareholders who suspect misconduct the right to obtain corporate books and records to further investigate that wrongdoing. As Professor Roy Shapira has convincingly argued, judicial review in recent years has been invigorated by the resurgence of Section 220,[255] notwithstanding criticism that the underlying standards of review have been diminished. Thus, by guarding shareholders' procedural rights to examine the documents underlying a transaction, Delaware courts have improved the protection afforded by corporate law's substantive fiduciary standards.

Of course, this Article does not suggest that it is easy or simple for courts to evaluate process. Certainly, a central point of this Article is that courts have underestimated the difficulties of adopting good process-based rules. Both the choice of the proper rule and the application of any given rule to the facts at hand present challenges for courts, challenges that compound themselves when the law unduly favors process and discounts process's weaknesses.

A. *The Real Problem with* Van Gorkom

Indeed, just as courts can err when determining the fair price of a transaction, courts can also err when determining

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253. *See* Roy Shapira, *Corporate Law, Retooled: How Books and Records Revamped Judicial Oversight*, 42 CARDOZO L. REV. 1949, 1973–92 (2021); *see* KT4 Partners v. Palantir Techs., 203 A.3d 738, 758 (Del. 2019).

254. *See* AmerisourceBergen Corp. v. Lebanon Cnty. Emps.' Ret. Fund, 243 A.3d 417 (Del. 2020) (holding that stockholder need not identify the particular course of action for a proper Section 220 inspection demand); Tiger v. Boast Apparel, Inc., 214 A.3d 933 (Del. 2019) (holding that Section 220 inspections are not subject to a presumption of confidentiality and any confidentiality order requires weighing the stockholder's legitimate interests in communication against the corporation's interests in confidentiality); *KT4*, 203 A.3d at 748–65; Rivest v. Hauppauge Digit., Inc., C.A. No. 2019-0848-PWG, 2022 WL 3973101, at *1 (Del. Ch. Sept. 1, 2022), *aff'd*, 300 A.3d 1270 (Del. 2023).

255. Shapira, *supra* note 253; Roy Shapira, *A New* Caremark *Era: Causes and Consequences*, 98 WASH. U.L. REV. 1857, 1872–80 (2021).

whether fair dealing occurred or when defining what ought to constitute legally permissible deal process.

Notwithstanding the passage of § 102(b)(7), *Van Gorkom* can still illuminate the fundamental tensions in judicial review of deal process. In an article written shortly after *Van Gorkom* was decided, Professor Dan Fischel argued that because *Van Gorkom* involved no allegations of conflicted interests, the Delaware Supreme Court should have applied the business judgment rule and affirmed the dismissal of the suit.[256] In Professor Fischel's view, the factual disagreements between the *Van Gorkom* majority and the dissenters regarding the board's adequacy of understanding were of no moment.[257]

But the facts do matter, and as a matter of principle and positive law, it was proper for the *Van Gorkom* court to craft rules for deal-making processes, investigate the process at hand, and apply those rules to the facts of the case. Conceptual lines such as that between the duty of care and the duty of loyalty, as Professor Fischel would draw, can provide indicia of the deference due to fiduciaries' decisions but cannot alone suffice for that task, not the least because the duty of care and the duty of loyalty represent somewhat arbitrary divisions on a continuous spectrum of agency costs.[258] Accordingly, the problem with *Van Gorkom* is not that Delaware courts should not consider how boards reached a decision, that the deal-making process in particular is a matter where the courts should defer to boards' judgment,[259] or that the case should have been dealt with as essentially a breach of the board's *Revlon* duties.[260] Courts—especially specialized courts such as the Delaware Court of Chancery—can and must somehow decide whether the defendant fiduciaries did their job, and if courts are loathe to look at

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256. Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 Bus. Law. 1437, 1445–50 (1985).

257. *Id.* at 1438–39.

258. Although the duty of care is sometimes conceptualized without an inherent conflict of interest unlike the duty of loyalty, the duty of care too involves a conflict of interest—namely, the fiduciary's interest in doing less work for the beneficiary in opposition to the beneficiary's interest in having the fiduciary do more work.

259. Fischel, *supra* note 256, at 1447.

260. *See generally* Robert T. Miller, Smith v. Van Gorkom *and the Kobayashi Maru: The Place of the Trans Union Case in the Development of Delaware Corporate Law*, 9 Wm. & Mary Bus. L. Rev. 65 (2017).

the economic substance of the decision, then they must look at the process by which the decision was made.

Rather, the problem with the *Van Gorkom* majority opinion is well characterized by Justice McNeilly's dissent: the Trans Union board's process for approving the sale was in fact adequate. As Justice McNeilly (and Professor Fischel) correctly pointed out, the board had received multiple briefings regarding Trans Union's finances, the directors were well-versed in business, and the speed with which they approved the deal was reasonable in the age of computers and telecommunications.[261]

B. *The Challenges of Process-Centered Review*

As shown by *Van Gorkom*, evaluating process-based protections is not necessarily simple or straightforward, and courts may well make mistakes in deeming a process to be permissible or impermissible. There are numerous such sources of risk of judicial error or oversight.

As an initial matter, it may be easier to err significantly when adjudicating questions of process than when conducting economic valuations because a binary scale applies to the former while a continuous scale applies to the latter. That is to say, when a court has concerns about a party's numerical evidence of economic value, the court may discount dubious calculations in proportion to its concerns and find a middle ground. But when a court faces troubling conduct combined with mitigating factors, courts cannot deem the conduct somewhat unacceptable and place the conduct within a gray area of liability. Courts must decide where to draw the line between sufficient process and insufficient process. For instance, a court cannot enjoin a 10% breakup fee, allow a 3% breakup fee, and "partially enjoin" a 6% breakup fee. Rather, process decisions are often an all-or-nothing deal.

Relatedly, it may be difficult to ascertain the optimal level of protective benefits. For example, determining when a breakup fee is permissible or impermissible requires courts to evaluate matters that are inextricable from the economic terms of a transaction, which courts have acknowledged to be a difficult matter to judge. Market conditions and practices can also

261. Fischel, *supra* note 256, at 1445–48; *supra* notes 199–200 and accompanying text.

change rapidly, making precedent less reliable as a touchstone of wisdom: go-shops were non-existent before 2004; now they are relatively common, particularly in private equity deals.[262]

Likewise, questions of economic theory that bear on the proper rule may be difficult to assess. For instance, a few Court of Chancery cases over the years suggested that in controller-conflicted transactions other than squeeze-outs, a single cleansing device (i.e., an independent negotiating committee or a majority-of-the-minority approval) could change the standard of review from the stringent entire fairness standard to the much more forgiving business judgment standard.[263] Most other cases, however, held that a single cleansing device could shift the burden of proof, but that the entire fairness standard would still apply.[264] Underlying the differing outcomes in these cases was a disagreement on whether controller-conflicted transactions were invariably tainted due to the controller's influence.[265] In the recent *Match* decision, the Delaware Supreme Court found that the inherent coercive power wielded by a controller does taint all controller-conflicted transactions, regardless of the precise nature of that transaction.[266] *Match* thus held that a single cleansing device could not change the standard of review, but only shift the burden of proof.[267] However, *Match*'s understanding of inherent coercion and its legal holding were far from preordained, given not only the case law conflict but also that multiple former members of the Delaware judiciary—including former Chief Justice Strine—publicly doubted the salience of inherent coercion as well as the proper legal significance of a single cleansing device.[268] *Match* thus could have been decided quite differently had it been judged on another day by another set of jurists.

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262. Subramanian & Zhao, *supra* note 92, at 1216, 1223.
263. *See e.g., In re* Tyson Foods, Inc., 919 A.2d 563 (Del. Ch. 2007); Friedman v. Dolan, 2015 WL 4040806 (Del. Ch. June 30, 2015).
264. *See, e.g., In re* EZCORP Inc. Consulting Agreement Deriv. Litig., 2016 WL 301245, at *30 (Del. Ch. Jan. 25, 2016).
265. *See* Hamermesh et al., *supra* note 34, at 332–44.
266. *In re* Match Grp., Inc. Deriv. Litig., No. 368, 2022, 2024 WL 1449815, at *14 (Del. Apr. 4, 2024). I co-authored an amicus brief in support of the ultimate holding of the court. Amicus Curiae Br. of Academics in Support of Appellants, *In re* Match Grp., Inc. Derivative Litig., No. 368, 2022 (Del. Sept. 7, 2023).
267. *Match*, 2024 WL 1449815, at *16.
268. Hamermesh et al., *supra* note 34, at 336.

Moreover, insofar as the spirit of the law—including that of corporate law—concerns normative questions of distributive fairness, even a supposedly "efficient" economic outcome may fail to serve other normative ends of the law. For instance, distributional concerns arise in controller conflicts that take the form of an ultimatum game, or a "take-it-or-leave-it" offer.[269] In such situations, one participant proposes how to divide up a benefit (say, $10), and the other participant can either accept or reject the proposal. If the latter participant rejects the proposal, neither participant receives anything. However, because the first participant has sole control over the terms of the proposal, he can propose lopsided deals ("I get $9 and you get $1") that a rational second participant would nevertheless accept.[270] While any outcome where the second participant accepts the proposed deal is economically efficient, a lopsided deal is generally considered unfair. The analogy to minority approval in controller transactions readily presents itself: A rational minority may vote to accept an unfair deal that reserves the bulk of benefits to the controller simply because the controller's offer is better than nothing. Consequently, the minority vote may have little to no value as an indicator of fairness. As a matter of political economy, Americans have trillions of dollars invested in the great corporations of America, including over $3 trillion in just publicly traded controlled companies,[271] but the vast majority of Americans are not sitting on the other side as controllers, board members, or executives. Accordingly, when corporate law decides whether majority-of-the-minority votes may be indicia of entire fairness, it is inherently also deciding normative questions of political economy.

Finally, even having determined the nominal rule to apply, courts may err in applying that rule to fact, whether because they incorrectly determined those facts or because they incorrectly evaluated the legal significance of the facts. This latter issue is the underlying problem with *Van Gorkom*—even if *Van Gorkom* were but an early, *sub silentio* attempt to apply *Revlon*,

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269. *See generally* John C. Harsanyi, *On the Rationality Postulates Underlying the Theory of Cooperative Games*, 5 J. CONFLICT RESOL. 179 (1961).

270. *Id.* at 180.

271. Author's calculations. *See* Steven Rosenthal & Lydia Austin, *The Dwindling Taxable Share of U.S. Corporate Stock*, Tax Notes 923, 928 (2016), available at https://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000790-The-Dwindling-Taxable-Share-of-U.S.-Corporate-Stock.pdf.

Van Gorkom still reached the wrong ultimate conclusion because it incorrectly assessed the practical sufficiency of the deal process. Conversely, in cases such as *Dell*, even accepting the nominal rule that deal price should be heavily weighted when there is a robust deal process, a conflicted management buyout in which the CEO of the company stood to profit from a lower deal price does not seem like a robust deal process.[272]

While each of these problems are significant, they are not insurmountable. However, what is necessary is awareness and concerted effort to confront these problems. Process is not simply substance's smarter, better-looking, and more successful sibling. Instead, process is both entangled with substance and laden with its own issues. A court therefore must constantly guard against doctrinal and case-specific missteps, regardless of whether it is examining substance or process.

IV.
Applying Lessons to Laws

This Article finally turns to four particular areas in which the inherent natures of substance and process have created ongoing issues and in which a reevaluation of doctrine may produce better results going forward.

A. *Fair Value via Fair Process*

DFC and *Dell* attempted to circumvent the issues with previous methods of determining the fair value of a corporation by directing trial courts to examine the deal process first: If the deal process is fair, then the deal price suffices as fair value. After all, if the purpose of an appraisal is to award shareholders "what would fairly be given to them in an arm's-length transaction,"[273] and there was an arm's length transaction, then how could the deal price be anything but the authoritative standard for an appraisal award? However, despite *DFC*'s framing of its answer as a common-sense, practical solution, there are still several issues and questions that arise. Relatedly, to the extent that *DFC* and *Dell* have reduced the volume of appraisal suits, it is not clear that they have done so by actually awarding fair

272. *See supra* notes 86-93 and accompanying text.
273. DFC Global Corp. v. Muirfield Value Partners, 172 A.3d 346, 370–71 (Del. 2017).

compensation after fair deal processes rather than by gutting appraisal as a meaningful remedy.

1. *What is Fair Value?*

As the Roman philosopher Seneca once wrote, no wind will help those who do not know the port to which they sail.[274] So it is with appraisal. There are multiple conceptions of fair value, and attempts to rationalize appraisal doctrine cannot succeed without analyzing these conceptions, and ultimately, selecting the most appropriate conception. A significant difficulty with contemporary appraisal law under *Dell* and *DFC* is that they in fact contain different and contradictory visions of fair value. One conception of fair value, third-party sale value, is described in the quote from *DFC* above: what shareholders would receive in an arm's-length transaction.[275] Its primary competitor, going-concern value, instead represents "the net present value of the firm's future free cash flows."[276] *DFC* also endorses this approach, which it terms "stand-alone value."[277]

These two conceptions of fair value entail not only different objectives but also different methodologies.[278] The debate over which approach is superior is longstanding with fair arguments on both sides.[279] Notably, however, the leading arguments for both sides begin with supposed substantive economic principles and legal entitlements. Proponents of third-party sale value argue that using third-party sale value increases minority economic returns and promotes efficiency, while proponents of going-concern value argue that their choice promotes value-creating mergers and allocates surplus to those who create it: the buyers of an enterprise.[280]

I would suggest that this debate also be examined from a process viewpoint, which recommends third-party sale value for

274. LUCIUS ANNAEUS SENECA, MORAL LETTERS TO LUCILIUS LXXI ("ignoranti quem portum petat nullus suus ventus est.").

275. *See* Bratton, *supra* note 5, at 509–12.

276. Lawrence A. Hamermesh & Michael L. Wachter, *The Short and Puzzling Life of the "Implicit Minority Discount" in Delaware Appraisal Law*, 156 U. PA. L. REV. 1, 4 (2007).

277. *DFC*, 172 A.3d at 368 (citing Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1144 (Del. 1989)). There are yet other possible conceptualizations of value, such as liquidation value, that modern courts generally do not use for appraisal purposes.

278. *See* Bratton, *supra* note 5, at 516–22.

279. *Id.* at 513–16.

280. *Id.*

a few reasons. First, going-concern value requires extensive use of DCF and like methods,[281] while third-party sale value does not necessarily need to do so, at least where there was a fair sale process. And to the extent that the statutory exclusion of "value arising from the accomplishment or expectation of the merger" may require courts to deduct synergies or control premia estimated via DCF and like methods, that exclusion should be removed for the same reason.[282]

Second, among the rights that appraisal aims to protect is shareholders' right to have fiduciaries undertake a fair deal process. In other words, "what has been taken from the shareholder" in a merger is not merely "his proportionate interest in a going concern,"[283] but also the shareholder's ability to receive the price obtained after a fair deal process.[284] Some have argued that shareholders have no rational expectation of receiving a control premium[285] (and thus do not deserve to receive one in appraisal). But if shareholders had no rational expectations of receiving control premia, then trading prices should not

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281. *See* Hamermesh & Wachter, *supra* note 275, at 47. To the extent that courts might instead solely use pre-announcement trading prices as fair value or estimate fair value as the merger price less synergies and control premia, that simply eliminates the viability of appraisal as a remedy, as such methods contain no possibility that the judicial determination of fair value exceeds deal price.

282. Notably, *Weinberger* applauded the synergy exclusion because when financial estimation methods are used as the primary valuation method, inclusion of synergy value may require the use of "*pro forma* data and projections of a speculative variety." Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983). That policy concern, of course, is essentially flipped when courts begin with deal price, which, by their nature, incorporate a portion of synergy value. *See also* Steven J. Cleveland, *Appraisal Rights and "Fair Value,"* 43 CARDOZO L. REV. 921, 960–66 (2022) (suggesting yet other reasons for removing the synergy exclusion).

283. Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1144 (Del. 1989).

284. *See DFC*, 172 A.3d at 370-71 (purpose of appraisal is to "make sure that [shareholders] receive fair compensation for their shares in the sense that it reflects what they deserve to receive based on what would fairly be given to them in an arm's-length transaction"); Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 125–26 (Del. Ch. 2011) (criticizing appraisal as insufficiently protective of shareholders due in part to the synergies exclusion); *see also* Bomarko, Inc. v. Int'l Telecharge, Inc., 794 A.2d 1161, 1183 (Del. Ch. 1999). The contrary view is expressed in a series of articles by Professors Lawrence Hamermesh and Michael Wachter. *See, e.g.*, Lawrence A. Hamermesh & Michael L. Wachter, *Finding the Right Balance in Appraisal Litigation: Deal Price, Deal Process, and Synergies*, 73 BUS. LAW. 961 (2018).

285. William J. Carney & Mark Heimendinger, *Appraising the Nonexistent: The Delaware Courts' Struggle with Control Premiums*, 152 U. PA. L. REV. 845, 870 (2003).

increase after announcements of merger agreements, whereby a control premium is included in the announced merger price. However, trading prices do increase after merger announcements because shareholders now expect to receive those control premia. Before such an announcement, share prices also incorporate expectations of control premia, though those amounts are discounted by the likelihood that a change-of-control transaction will take place. Additionally, if we are to anchor notions of fair value in market considerations, then it seems strange to exclude the market for corporate control from the list of relevant markets that affect fair value.[286] So far as a fair deal process is considered an important protection for shareholders, it is hard to see why the concept of fair value would, much less should, discount it by ignoring what shareholders would obtain after a fair deal process.

2. *What is Fair Process?*

Still, even if we define fair prices in terms of fair processes, that raises the questions of what constitutes a fair deal process, and perhaps more importantly, how much a real transaction process can deviate from the Platonic ideal of a fair process and still produce a deal price that is determinative of fair value.

Answers to those questions should be informed by the substantive purpose of appraisal: minority protection.[287] Unlike other events that may involve shareholder disagreements (such as contested board elections), a merger extinguishes the possibility of future debates over the future of the business, particularly

286. Professors Hamermesh and Wachter have argued that going-concern value is appropriate because "value belongs to the party that creates it." Hamermesh & Wachter, *supra* note 275, at 32–33. However, the notion of who creates value is subjective and often indeterminate. Consider a widget manufacturer who produces a widget at a cost of $1 and a widget consumer who can use the widget in his factory to produce knickknacks that then sell for $10. What is the value of the widget, and who has created it? It seems unlikely that Professors Hamermesh and Wachter would insist that the consumer is legally entitled to pay only $1 for each widget because any additional value from the widget is in fact created by the consumer.

287. *Dell Appeal*, 177 A.3d at 19; Cede & Co. v. Technicolor, 542 A.2d 1182, 1186 (Del. 1988); *see* Barry M. Wertheimer, *The Purpose of the Shareholders' Appraisal Remedy*, 65 TENN. L. REV. 661, 679 (1998) (arguing basically that all defensible purposes of appraisal "can be seen as animated by a goal of minority shareholder protection, primarily against the risk that majority shareholders and insiders could act to appropriate corporate value to the detriment of minority shareholders").

when cash is the merger consideration. After the merger is approved by shareholders, the courts provide the sole option for redress. And even with the availability of fiduciary duty claims, appraisal provides a valuable protective function: as studies have shown, stronger appraisal rights lead to higher deal prices.[288]

Protecting minorities does not necessarily mean tilting the fair-value scale in their favor,[289] but it does mean that courts should not reflexively avoid shouldering the burden of determining whether and to what degree minority stockholders were injured. By contrast, if a court is bent on using deal price and avoiding substantive review of a deal's economic merits, then it must also generally lower the bar it applies to the deal's process. That is to say, the problem is not that courts defer to deal prices upon satisfaction of certain minimum conditions, but rather that those conditions, are sometimes, in the words of two commentators, "minimal."[290] Indeed, in *Dell* and *DFC*, the Court of Chancery found that the deals' process problems rendered the deal price unreliable, and the Delaware Supreme Court's reversals rehabilitated those process problems into irrelevancy in order to hold that the deal price sufficed.[291] But laxity is not inherent to process-centered standards. Courts can and should demand high-quality deal processes before deferring to deal prices as measures of fair value.

Academics have also suggested other process-centered mechanisms that aim to strengthen *Dell/DFC* without undermining the concerns that prompted those decisions. Professor Guhan Subramanian has proposed a framework whereby a deal price is presumptively entitled to deference if and only if it was reached after a reasonably thorough market check that was not

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288. Audra Boone et al., *Merger Negotiations in the Shadow of Judicial Appraisal*, 62 J.L. & Econ. 281, 314 (2019); *see* Matthew Schoenfeld, *The High Cost of Fewer Appraisal Claims in 2017: Premia Down, Agency Costs Up*, 8 Harv. Bus. L. Rev. Online 7, 8–9 (2017).

289. Professors Alex Peña and Brian Quinn have suggested that Delaware courts have given weight to deal price partially "to reduce the option value of appraisal." *See* Alex Peña & Brian JM Quinn, *Appraisal Confusion: The Intended and Unintended Consequences of Delaware's Nascent Pristine Deal Process Standard*, 103 Marq. L. Rev. 457, 480, 504 (2019). However, the option value of appraisal is limited by the fact that fair value determinations can fall below the deal price (i.e., appraisal is not an option). Furthermore, even if some option value remains, that should not be considered *per se* problematic, or else all litigation would be suspect as creating option value for plaintiffs.

290. Korsmo & Myers, *supra* note 116, at 427.

291. *Supra* Part I.C.

impeded by unduly inhibitive match rights or other deal protection devices.[292] With the greater certainty of outcome that accompanies a clear framework providing presumptive deference (as opposed to the reading-between-the-lines kind of deference that *Dell/DFC* holdings provide), buyers and sellers would have accordingly greater incentive to use deal mechanisms that are protective of stockholders.

That said, when reforming *Dell/DFC*, courts should take care to remember the special problems that arise during management buyouts (*Dell*) and controller squeeze-outs (*Weinberger*). In both cases, shareholders are at a particular disadvantage because those with power have a particular interest in channeling corporate value to themselves. In the case of controller squeeze-outs, no meaningful market market check is possible, and the effect of board and minority approval is significantly diminished.[293] In such cases, courts should consider heightening the process requirements for deal price deference, such as granting any deference to deal price only if two-thirds or three-quarters of disinterested stockholders approve the deal.

All said, if process review is to have genuine meaning, it must be that some deal processes fail that review. And if a court determines that the deal process did not represent a fair arm's length transaction, how is a court supposed to determine what a shareholder should fairly receive? The next subpart turns to that issue.

3. *Fairer Prices and Plaintiffs' Attorneys*

Professors Gilson and Gordon once asked how damages should be calculated if there was unfair dealing, but the deal price fell within the range of fairness.[294] Although the question posed originally related to entire fairness, it can also be transplanted to appraisal as well, given the use of quasi-appraisal in entire fairness proceedings.

In *Dole Food*, the Court of Chancery answered the professors' question by holding that a transaction that fails the entire

292. Subramanian, *supra* note 90, at 647–49, 654–57.

293. *See generally* Amicus Br. of Academics, *supra* note 266; *In re* Orchard Enters., Inc. S'holder Litig., 88 A.3d 1, 36 (Del. Ch. 2014); *see In re* Dell Techs. Inc. Class V S'holders Litig., C.A. No. 2018-0816, 2020 WL 3096748, at *80 (Del. Ch. June 11, 2020).

294. Gilson & Gordon, *supra* note 14, at 798 n. 41.

fairness test for lack of fair dealing may entitle the plaintiff to a "fairer" price and other damages that "eliminate the ability of the defendants to profit from their breaches of the duty of loyalty.[295] *Dole Food* held that even though the deal price fell within a range of fairness, the plaintiffs were still entitled to $150 million in recompense for the defendants' misconduct because that was the amount that shareholders may well have received absent that misconduct.[296]

Here, I advocate for the answer presented by cases such as *Dole Food*: Shareholders in such a situation should receive all that the evidence shows would have been the most likely result of an entirely fair course of dealing. Delaware courts have expressed sympathy for this approach in both old and new cases. For instance, then-Vice-Chancellor Strine provided a hypothetical of just such a case in one of his early opinions:

> Posit a scenario where a 43% stockholder who is the company's chairman and chief executive officer consummates a tender offer followed by a back-end, squeeze-out merger. Suppose the stockholder offered $25 a share, which is by any measure "fair," and obtains tenders from enough minority stockholders to enable him to cash out the remaining minority stockholders in a short-form merger at the same price. Undisclosed by the 43% stockholder, however, is the fact that a well-funded third party was willing to make a tender offer for $28 a share but had been rebuffed by the 43% stockholder, who did not even disclose the offer to the rest of his hand-picked board. . . . While $25 is a fair price, they had arguably been wrongfully denied the opportunity for $28.[297]

That scenario is remarkably akin to what happened in *PLX*: the proxy did not disclose that the buyer was willing to pay more than the offer being presented to shareholders. And

295. *In re* Dole Food Co., S'holder Litig., C.A. No. 8703-VCL, 2015 WL 5052214, at *2 (Del. Ch. Aug. 27, 2015); HMG/Courtland Props. v. Gray, 749 A.2d 94, 116 (Del. Ch. 1999) (awarding damages despite the possibility that deal price fell within range of reasonableness); *see also Bomarko*, 794 A.2d at 1183 (awarding damages after finding that plaintiffs' pre-squeeze-out shares had little value but also that the low value of the shares were inseparable from breaches of fiduciary duty related to the squeeze-out).

296. *Dole Food*, 2015 WL 5052214, at *44-46.

297. Andra v. Blount, 772 A.2d 183, 193 (Del. Ch. 2000).

in fact, language in *PLX* suggested that the court would have been sympathetic to a damages theory that that the board could have sold the corporation at a higher price but for the at-issue misconduct.[298]

Furthermore, this is akin to the standard for damages that the Court of Chancery recently invoked in the recent case of *In re Mindbody*, a *Revlon* case.[299] In *Mindbody*, Chancellor McCormick awarded damages based on the "fairer" price principles first introduced in entire fairness cases.[300] (Indeed, *Mindbody* specifically cited to *PLX*'s statements that the measure of damages should be based on the transaction that was foregone because of the misconduct.)[301] Notably, there was evidence in *Mindbody* that the defendants' employees—including the deal team—had actually made bets on the final deal price, with the line being $1 per share above the actual deal price.[302] The bets provided "compelling evidence as to what [the buyer] would have paid," and the court accordingly awarded $1 per share as damages.[303] Likewise, in denying a motion to dismiss, *Columbia Pipeline* also cited *PLX* to support its conclusion that a foregone transaction or otherwise lost opportunity forms a viable basis for a theory of damages.[304]

However, cases such as *Mindbody* and *Dole Food* that have awarded compensation for unfair dealing despite a finding of fair price on a lost-opportunity theory have been, at least until recently, the exception, not the rule.[305] One reason for this seems to be that plaintiffs' counsel do not raise lost-opportunity arguments,[306] a fact that may result from well-documented attorney biases and miscalculations,[307] rather than any bad faith or improper self-interest. Still, regardless of the reason, when

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298. *See PLX Trial*, 2018 WL 5018535, at *51.
299. *In re* Mindbody, Inc., S'holder Litig., C.A. No. 2019-0442-KSJM, 2023 WL 2518149 (Del. Ch. Mar. 15, 2023).
300. *Id.* at *44–46.
301. *Id.* at *45.
302. *Id.* at *25, 46.
303. *Id.* at *46.
304. *In re* Columbia Pipeline Grp., C.A. No. 2018-0484-JTL, 2021 WL 772562, at *56 (Del. Ch. Mar. 1, 2021).
305. *See supra* note 16 and accompanying text.
306. *See, e.g.*, Plaintiffs' and Petitioners' Opening Post-Trial Brief, *In re* Mindbody, S'holder Litig., No. 2019-0442-KSJM (Del. Ch. June 2, 2022).
307. *See generally* Elizabeth F. Loftus & Willem A. Wagenaar, *Lawyers' Predictions of Success*, 28 JURIMETRICS 437 (1988). Because lawyers often misestimate the chances of winning, plaintiffs' attorneys may (wrongly, but in good

plaintiffs' attorneys do not raise such damages theories even in the alternative, courts should seriously evaluate whether such counsel can fairly and adequately represent the interests of the class and rein in class counsel that is inadequately representing the class's interests.[308] All said, plaintiffs' attorneys are agents too, and effective corporate law—and the courts enforcing that law—must also manage the agency costs that such agents impose.[309]

B. *The Purpose of Poison Pills*

Williams and its predecessors, *Quickturn* and *Liquid Audio*, represent meaningful steps forward in poison pill jurisprudence and theory. They provided a long-needed rationalization of why poison pills should be allowed at all, considering that they inherently thwart the rights of shareholders, who are in theory the ultimate beneficiaries of the fiduciary duties that govern directors' conduct. According to these cases, the legitimacy of poison pills arises from how they help "channel[] critical corporate decisions through a fair election process."[310] This is the case regardless of whether the poison pill at issue is directed toward a hostile bidder or a mere activist. Thus, as Professors Kahan and Rock argue, courts' approach toward poison pills should aim to "maintain a balanced election process,"[311] i.e., that the courts should allow pills that "prevent gross imbalance in the electoral stakes [that is, the voting power] of the contestants."[312]

However, notwithstanding the charm of appeals to shareholder democracy, elections are only one of multiple means by which shareholders can and do exercise their fundamental rights as contributors of equity capital. If "[c]orporate democracy is not an attack"[313] because shareholders should have certain procedural rights (such as voting) to choose the future

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faith) estimate that high-return quasi-appraisal arguments are better than low-return lost-opportunity arguments.

308. *See* Del. Ch. Ct. R. 23(a)(4); Emerald Partners v. Berlin, 564 A.2d 670, 676 (Del. Ch. 1989); *accord* Fed. R. Civ. P. 23(g)(4).

309. *See In re* Trulia, Inc. S'holder Litig., 129 A.3d 884, 887 (Del. Ch. 2016).

310. Kahan & Rock, *supra* note 144, at 939–42; *see also* Ronald J. Gilson & Alan Schwartz, *Sales and Elections as Methods for Transferring Corporate Control*, 2 Theoretical Inquiries L. 783, 784 (2001).

311. Kahan & Rock, *supra* note 144, at 970.

312. *Id.* at 942.

313. *In re* Aerojet Rocketdyne Holdings, C.A. No. 2022-0127-LWW, 2022 WL 2180240, at *15 (Del. Ch. June 16, 2022).

of the corporation, then what justifies limiting shareholders' rights to willingly transfer their property or to otherwise vote with their feet? The so-called "Wall Street rule" of voting with management or selling explicitly recognizes this right,[314] and in numerous forms of business organizations (such as mutual funds), selling is effectively the sole method by which equityholders can pursue a different use of their capital. Insofar as poison pills limit the power of a willing buyer to purchase shares, they also limit the power of existing shareholders to sell their shares at a good price.

Allowing boards to hamstring shareholder rights with poison pills is also at odds with corporate law's traditional understanding of the power of markets. Even aside from well-founded doubts that elections are superior to markets as shareholder protection mechanisms,[315] the market already gives all shareholders (including directors and officers) the power to create their own balanced elections. Via the market, if any of a corporation's shareholders truly believes that an election should proceed with the two sides owning particular percentages of stock, such a shareholder may use their personal resources to buy an appropriate number of shares.[316]

Furthermore, what makes a "balanced" election, wherein the two slates are directly backed by roughly equal numbers of shares, truly fair or even desirable? After all, nobody suggests that controlling shareholders should relinquish all corporate decisions to a majority of the minority, even though by definition elections in controlled companies are unbalanced. And insofar as Professors Kahan and Rock themselves analogize to political elections,[317] it would hardly seem sensible in that context to limit the number of Democrats eligible to vote in Massachusetts, or the number of Republicans eligible to vote in Arkansas, so that the number of partisan voters is perpetually balanced and election results dependent on the choices of

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314. Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va. L. Rev. 675, 716 (2007).

315. Gilson & Schwartz, *supra* note 309, at 791–72; *see also* Zohar Goshen & Reilly S. Steel, *Barbarians Inside the Gates: Raiders, Activists, and the Risk of Mistargeting*, 132 Yale L.J. 411, 454 (2022) (explaining how minority activists may pose greater risks for shareholders than wholesale takeovers).

316. Likewise, a shareholder may bid up the price of the corporation's shares on the market until an activist feels economically persuaded to sell, or at least not purchase any more.

317. Kahan & Rock, *supra* note 144, at 940.

nominal independents. In any event, why should corporate law not let the competing sides put their money where their mouth is, so to speak, especially given the well-known problems with allocating decisions to unaffiliated shareholders who are often rationally indifferent?

As the above questions show, protecting decision-making processes is far from a neutral inquiry, and attempts to protect one process, such as the supposedly neutral shareholder vote, can encumber other processes, such as market transactions. The reverse is also true: if courts imposed more stringent restrictions upon poison pills, the result may well be that shareholder elections will hold less salience in the takeover or activism context as would-be acquirers and activists gain control or influence via the markets rather than the ballot box.

That all said, though I personally believe that the balance of evidence and logic tilts against poison pills and would suggest that the courts scrutinize them and other defensive mechanisms closely, the question is clearly within the realm of fair and reasonable disagreement. Even with eyes wide open about the challenges of regulating processes for shareholder decision-making, the potential for error remains.

C. *The Circularity of* Corwin

Critics have attacked *Corwin* as giving excessive leeway to corporate boards,[318] but it is uncertain that *Corwin* has in fact resulted in excessive leeway.[319] As the post-*Corwin* cases discussed in this Article show, courts can and do find that *Corwin* cleansing cannot be invoked and have not simply neutered the fully informed and uncoerced requirements.

Instead, the problem with *Corwin* seems to be that it has often complicated litigation rather than simplified it. Moreover, *Corwin* has created several new thorny legal issues relating to judicial review of cleansing votes.

First, *Corwin*'s requirement that cleansing votes be "fully informed" are at odds with other principles of corporate law. As mentioned, *Corwin* imports the materiality standard from federal securities law and asks whether omitted or erroneous information would have been important to a reasonable

318. Korsmo, *supra* note 5, at 89–94.
319. Gatti, *supra* note 130, at 401–12.

investor. The materiality standard thus requires courts not only to second-guess the directors' judgment regarding what to disclose, but also to speculate on what a "reasonable shareholder" would think of absent disclosures.[320]

In addition, as courts and commentators have noted, the subjective nature of the materiality standard lends itself to inconsistent and inaccurate judicial evaluation,[321] concern over which is a primary reason that Delaware courts have avoided evaluating economic substance. Additionally, determining materiality still necessitates (or at least should necessitate) significant business analysis. For example, even if the materiality standard "does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote,"[322] whether reasonable investors would change their votes is surely *probative* of materiality. Along these lines, should *PLX* still have found that the board's failure to disclose the buyer's desire to buy PLX was material if it could be known that stockholders would have still voted for the $6.50 deal as presented? Likewise, if it could have been known that full disclosure would have only resulted in a 25-cent increase in deal price, would the disclosure failure have still been material? What about 10 cents? 1 cent? Alternatively, consider a case involving Apple that alleges that it misstated its value by $25 billion. Is such a misstatement material? What if that $25 billion was reframed as being merely 1% of Apple's equity value? What if it was unclear what the ultimate financial impact of the misstatement is? And what if a misstatement or omission is significant to only a subset of investors?[323] How small can that subset be before the misstatement or omission is legally

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320. That said, some of the reasons behind the business judgment rule's deference to directors, namely that directors are statutorily charged with management of the corporation, do not apply to a court's hindsight evaluation of what "reasonable shareholders" would think.

321. *Supra* note 133. *See also* Thomas M. Madden, *Significance and the Materiality Tautology*, 10 J. BUS. & TECH. L. 217, 233 (2015); Wendy Gerwick Couture, *Opinions Actionable as Securities Fraud*, 73 LA. L. REV. 381, 384–85 (2013); SEC v. Bausch & Lomb, 565 F.2d 8, 10 (2d Cir. 1977). Suggestions that the "total mix" test be replaced with a market price test represent an improvement in some ways, but they suffer from other problems that are beyond the scope of this Article. *See generally* Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1 (1982).

322. Madden, *supra* note 321, at 223.

323. *See* J & R Mktg., SEP v. Gen. Motors Corp., No. 2:06-cv-10201, 2007 WL 655291, at *12 (E.D. Mich. Feb. 27, 2007).

immaterial? *Corwin* defers to federal securities law standards,[324] but why are those standards right for state corporate law?

Corwin's non-coercion requirement presents its own conceptual thorns, beginning with the definition of coercion. As commentators have noted, in view of the complex terms of modern M&A deals, "attempting to define coercion by trying to distinguish the merits of the deal from extraneous terms is akin to Sisyphus pushing the boulder up the mountain."[325] But if coercion exists when a board staples together a deal's "merits" and "extraneous" matters for a singular vote, then perhaps all would-be cleansing votes are inherently coercive, as a fiduciary liability release seems hardly integral to a deal's merits.[326]

Returning to *PLX*, suppose that the buyer would have returned with a $7 offer if stockholders had rejected the $6.50 offer, but also that it would have taken months to mail out new proxies and conclude a new vote, with any closing likewise delayed. In such a case, even completely informed stockholders may well have voted to approve the $6.50 deal anyway, thinking that "a bird in the hand is worth two in the bush."[327] (Certainly, Eric Singer thought so.) Under this hypothetical scenario, stockholders would have been deprived of $0.50 per share due to Potomac's breach of fiduciary duty.[328] Note that it assumes the antecedent to argue—as *Corwin* essentially does—that stockholders implicitly approved of the fiduciary breach by approving the deal, and therefore the law should offer no recourse. After all, a rational stockholder would prefer to have both the $6.50 in merger consideration and the $0.50 in compensatory damages for the breach. As cases such as *Saba*, *Sciabacucchi*, and *PLX* show, the threat in *Corwin* situations is that stockholders might agree to an underwhelming deal because they fully understand

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324. Although there is no bright-line test, a 5% threshold is often used for materiality when a financial misstatement is at issue. Tabak v. Canadian Solar Inc., 549 F. App'x 24, 27 (2d Cir. 2013). But why, *under Delaware fiduciary principles*, should stockholders be considered fully informed and deprived of a recovery if Apple misled them with respect to over $100 billion in equity value?

325. Gevurtz, *supra* note 131, at 1881.

326. *Cf. id.* at 1888.

327. *See id.* at 1878–83.

328. It is perhaps worth noting that Plaintiffs' estimate of PLX's cost of equity would have attached a cost of 46 cents per share to a six-month delay. Plaintiffs' Opening Post-Trial Brief, at 53, *In re* PLX Tech. S'holders Litig., C.A. No. 9880-VCL (Del. Ch. May 14, 2018).

that directors' breaches of fiduciary duty have made the deal the best option available.[329]

Therefore, *Corwin*'s coercion analysis must eventually return to an examination of the board's conduct, the same conduct that *Corwin* cleansing was supposed to allow courts to avoid analyzing. For example, the *Saba* court had to determine whether coercion resulted from a sale that the board pushed for only after the company's stock was delisted because of the board's nonfeasance.[330] As such, the proposition that an "uncoerced" stockholder vote should cleanse fiduciary breaches may in fact have little practical value because the fiduciary breaches that *Corwin* is supposed to cleanse themselves often result in coerced votes that do not provide for any cleansing.[331]

Corwin's progeny thus illustrates the limits of process-centered analyses. First, if a court is going to enforce any meaningful duties upon corporate boards who undertake a transaction, it must at some point delve into a critical analysis of that transaction. A court may find that it more sensible to take a harder look at the processes by which a board approved a deal and sidestep the substance, but it cannot infinitely use more layers of process (e.g., shareholder approval) to avoid review of underlying processes (e.g., board negotiations) and expect an intelligible legal framework. Second, even if a court can avoid significant evaluation of a deal's substantive merits by focusing on process (at least at the liability stage), it is impossible to completely avoid economic and financial analysis, not the least because the economic significance of the alleged process fault is often an important part of whether a purported failure to disclose the fault renders stockholders uninformed and whether the fault was so egregious as to render any vote intrinsically coercive.

Hence, this Article's proposals for *Corwin* are not so much that *Corwin* should be "strengthened" or "weakened" because *Corwin* does not innately embody a tough or lax standard of

329. *See also In re* USG Corp. S'holder Litig., C.A. No. 2018-0602-SG, 2020 WL 5126671, at *2 n.5 (Del. Ch. Aug. 31, 2020).

330. *In re* Saba Software, Inc. S'holder Litig., C.A. No. 10697-VCS, 2017 WL 1201108, at *16 (Del. Ch. Mar. 31, 2017).

331. *See* Gevurtz, *supra* note 131, at 1880. Similar problems might also arise in the *MFW* context, *i.e.*, that any controller-led transaction failing entire fairness cannot but result in an inherently coercive majority-of-the-minority vote, and thus *MFW* cleansing is ultimately but an inquiry into of whether the deal is entirely fair.

judicial review. Rather, courts applying *Corwin* must create a logically coherent, non-circular method for conceptualizing whether a vote is fully informed and uncoerced, and only then can a court make optimizations to calibrate the strength of judicial scrutiny.

As for coercion, courts should resolve whether and why a shareholder vote should be considered uncoerced despite occurring after a material breach of fiduciary duty. I might suggest that duty of loyalty breaches and instances of bad faith are inherently coercive. It is one thing to tell someone to try again (as stockholders do when they vote down a proposal) when that person has put in an honest effort. It is another to do so when you know that they were never trying to begin with.[332]

Likewise, notwithstanding the Delaware courts' adoption of securities law standards for materiality, courts reviewing state corporate law claims have yet to truly grapple with the meaning of materiality and whether it should differ from that used in securities law. The specific question under *Corwin* is whether investors knew enough that their vote should be credited to mean that they have consented to any director misconduct tied to the transaction.[333] Note that the common law applies a different standard of materiality for purposes of evaluating the effectiveness of a principal's ratification than do the securities laws. Under the common law, a representation is material even if a reasonable person would not "attach importance to it[]" so long as "the maker of the representation knows or has reason to know that its recipient regards or is likely to regard the matter as important in determining his choice of action, although a reasonable man would not so regard it."[334]

It is also worth noting that when pronouncing the standard for materiality in federal securities law, the U.S. Supreme Court was concerned that "if the standard of materiality is unnecessarily low . . . the corporation and its management [risk] be[ing] subjected to liability for insignificant omissions or

332. *But see supra* note 258 and accompanying text.

333. *See* Restatement (Third) of Agency § 4.06 (2006).

334. Restatement (Second) of Torts § 538 (1977) (cited by Restatement (Third) of Agency § 4.06 cmt. c). *See* Allan Horwich, *An Inquiry into the Perception of Materiality as an Element of Scienter Under SEC Rule 10b-5,* 67 Bus. Law. 1, 19 n.96 (2011) (noting that § 538 uses a broader meaning of "material" than the securities laws). *Contra Am. L. Inst., supra* note 201, at § 1.25.

misstatements."[335] Such risk is minimized under *Corwin* because *Corwin* is merely a ratification device, and failure to comply with *Corwin* does not directly entail liability. Even if a court erroneously found that *Corwin* cleansing did not apply because of the omission of supposedly "insignificant" matters, a plaintiff would still need to plead—and prove—an underlying fiduciary breach before obtaining any relief. Accordingly, courts should consider relaxing the materiality standard under *Corwin* by, for example, allowing plaintiffs to allege and prove the materiality of a misstatement or omission on the basis that the directors subjectively believed or had reason to believe that investors would find the information important to (1) their assessment of the transaction itself or (2) their assessment of the conduct of the directors while arranging and approving the transaction.

D. Marchand, Caremark, *and the Substance of Process*

One preliminary problem with post-*Marchand Caremark* case law is that Delaware courts have not clearly stated the applicable legal standard, especially with respect to *Caremark*'s monitoring prong. *Marchand* and *Caremark* couch the monitoring inquiry in terms of "central compliance risks," "mission-critical risks," "reasonable systems of monitoring." But, as discussed above, the case law gives reason to think that these words, though roughly related to the topic at hand, are nevertheless not quite accurate.[336]

Instead, taking *Marchand* and its progeny collectively, it seems that what the courts are really asking when considering *Caremark* is the following:

(1) Was there a significant corporate trauma?
(2) Was the trauma foreseeable (with red-flag claims inherently satisfying foreseeability)?
(3) Did the board do enough to prevent it?

There are two problems, however, with such an approach.

First, if this is a correct articulation of the test that courts are applying, then courts should clearly say so.

Second and more importantly, such an approach is fundamentally at odds with the general rule that courts should not

335. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448 (1976).
336. *Supra* Part II.B.

second-guess boards on issues of business judgment.[337] *Marchand* effectively requires courts to independently decide which corporate traumas are "significant" (for both monitoring and red-flags claims), which traumas are "foreseeable," (for monitoring claims only), and whether the board did "enough" in response (for both monitoring and red-flags claims). *Marchand* brings the current state of *Caremark* to a less-than-analytically-rigorous rule that "if a serious disaster happens to your company, you better have tried to stop it."

If anything, the economic significance of the trauma may be easiest to determine. Many of the caveats that ordinarily apply to judicial evaluation of economic substance do not apply here. Parties generally do not contest the amount of the loss, or the methodology by which the loss was calculated, as precision is often unnecessary in the *Caremark* context.[338] But even then, the question arises of where to draw the line between significant and insignificant, particularly in the context of multibillion dollar companies where millions of dollars might be a rounding error.[339]

The problems with judicial second-guessing escalate from there and are especially acute when determining foreseeability, which is necessary for *Caremark*'s monitoring prong to function. If boards are to owe enforceable monitoring duties, then somebody will have to decide what should be monitored. But as Vice Chancellor Laster has noted, "[t]ime and attention are precious commodities, and with limited supplies of each, officers and directors must make judgments about what risks to monitor."[340] Thus, a court enforcing monitoring duties cannot totally abstain from deciding which business risks the board should have been monitoring; it must eventually engage in what is essentially a reasonableness review of substantive business judgment.[341] Furthermore, it is hard to see how a nontrivial

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337. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 746 (Del. Ch. 2005).

338. At least until a *Caremark* claim goes to trial, which has yet to occur.

339. *Cf. Disney*, 907 A.2d at 767–68 & n.533 (determining that a $100 million+ executive contract was relatively immaterial).

340. *In re* McDonald's Corp. S'holder Derivative Litig., 291 A.3d 652, 679 (Del. Ch. 2023).

341. *Contra* City of Detroit Police & Fire Ret. Sys. v. Hamrock, C.A. No. 2021-0370-KSJM, 2022 WL 2387653, at *14 n.111 (Del. Ch. June 30, 2022) ("Generally speaking, even after *Marchand*, Delaware courts are not applying reasonableness review in *Caremark* cases."). Although penned before *Marchand*

judicial evaluation of whether a risk should have been monitored materially differs from essentially a hindsight evaluation of the magnitude of the corporate disaster—if nothing bad happened, how can it be claimed that the board should have been monitoring the issue? Conversely, despite boards' limited time and attention, how is a court to determine which possible catastrophes, including acts of God and force majeure, need *not* be monitored? After all, even global systematic risks such as climate change (and now worldwide pandemics) are on the radar for many corporations.

Even after having established what should be monitored, courts would still need to determine whether the monitoring system was adequate to prevent the monitored risk from actualizing into corporate catastrophe. In other words, what facts are necessary to rebut the court's ordinary deference toward directors in matters of business judgment? In answering that question, courts could look to the subjective good faith of directors, or they could hold directors to a more objective standard of whether the monitoring systems are adequate in fact. Obviously, determining subjective good faith requires a challenging inquiry into mental states that are not directly observable. *Marchand*, like many other legal approaches to evidence of mental state,[342] instead looks to observable conduct to determine unobservable mental states. Specifically, *Marchand* held that a lack of *systematic* monitoring constitutes bad faith sufficient to give rise to liability.[343] Moreover, *Marchand* indicates that presence of *ad hoc* monitoring is insufficient to overcome the absence of systematic monitoring in the determination of whether a good-faith effort existed.[344] Under *Marchand*, the

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was decided, Professor Robert Miller's article on *Caremark* presciently critiqued such an approach on a similar basis. Miller, *supra* note 223 at 947–49. However, I am skeptical of Professor Miller's suggestion that boards pass resolutions to set standards for director knowledge because (1) Professor Miller basically assumes that he has proposed a more efficient rule, *id.* at 947 ("The argument presented here assumes that shareholders will be better off in the long run by choosing the first prong of this dilemma"), and (2) the cases discussed in this subsection each concerned serious and significant matters that one reasonably might expect directors to include in such a standard-setting resolution, but the question of how *much* information and oversight is necessary still remains (and remained in these cases).

342. *See* Deborah W. Denno, *Criminal Law in a Post-Freudian World*, 2005 U. Ill. L. Rev. 601, 691–96 (2005).

343. *See* Marchand v. Barnhill, 212 A.3d 805, 822 (Del. 2019).

344. *Supra* note 227 and accompanying text.

"good faith effort" required by *Caremark*'s monitoring prong means something more than subjective good faith and instead something approaching "effort with a rational basis," if not "objectively rational effort."[345] *Marchand* thus contrasts with traditional notions of bad faith, which require "intentional dereliction of duty" or "conscious disregard for one's responsibilities"[346] and cannot be proven by even gross negligence.[347]

Even before *Marchand* was decided, critics have long anticipated the dangers posed by *Marchand*-like rules that require courts to assess the objective adequacy of monitoring processes. As Chancellor Chandler wrote a decade before *Marchand*,

> To the extent the Court allows shareholder plaintiffs to succeed on a theory that a director is liable for a failure to monitor business risk, the Court risks undermining the well settled policy of Delaware law by inviting Courts to perform a hindsight evaluation of the reasonableness or prudence of directors' business decisions.[348]

Such critics have renewed their concerns in *Marchand*'s wake.[349] *Caremark*'s monitoring prong cannot be made meaningful without judicial second-guessing of substantive business decisions.

By contrast, the adequacy of fiduciaries' efforts under the red-flags prong need not be as fraught. Although the red-flags prong requires fiduciaries to make good-faith efforts to address known issues,[350] "good-faith effort" need not be a high

345. *See* Caremark, 698 A.2d at 967 (distinguishing a "good faith effort" from a "rational" process).

346. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 63–67 (Del. 2006) (noting that the intentional dereliction and conscious disregard definitions are appropriate, if not exclusive, definitions of bad faith and that gross negligence alone "clearly" does not suffice).

347. *Cf. Marchand*, 212 A.3d at 822.

348. *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 126 (Del. Ch. 2009).

349. *See* Stephen Bainbridge, *After Boeing, Caremark is No Longer "The Most Difficult Theory in Corporation Law upon Which a Plaintiff Might Hope to Win a Judgment,"* PROFESSORBAINBRIDGE.COM (Sept. 8, 2021, 4:43 PM), https://www.professorbainbridge.com/professorbainbridgecom/2021/09/after-boeing-caremark-is-no-longer-the-most-difficult-theory-in-corporation-law-upon-which-a-plainti.html.

350. Lebanon Cnty. Emps' Ret. Fund v. AmerisourceBergen Corp., C.A. No. 2019-0527-JTL, 2020 WL 132752, at *20 (Del. Ch. Jan. 13, 2020), *aff'd*,

or exacting standard for the red-flags prong to be meaningful, given the amount of corporate misconduct that is intentionally swept under the rug until it can be concealed no longer.[351]

That said, a red-flags-only *Caremark* may leave many instances of corporate wrongdoing judicially unchallenged, especially in large, widely held corporations. The first red flags are often seen only by officers, who are involved in the day-to-day operations of the business, and not directors, who might meet on a monthly or even quarterly basis. By the time a board hears of issues, the problem may well already have metastasized beyond repair due to the mismanagement of the officers who stand at the front lines of a company's operations. However, a board may be nevertheless reluctant to pursue lawsuits against lackadaisical officers, lest the board mark itself as a difficult and capricious boss and unable to attract the best talent going forward.[352] Such reluctance arises not necessarily out of a board's disloyalty, but out of (presumably) good-faith considerations for shareholder interest. Nevertheless, the result is diminished accountability and potentially diminished shareholder value. By contrast, derivative suits pursued by shareholders and their attorneys significantly lessen these reputational impacts because officers cannot avoid derivative suits simply by working at a corporation with a pliant board (or even by avoiding public corporations—note that *Marchand* involved a privately held company). The problem is that, absent concurrent board misconduct, officers can rarely be held liable for breaches of

243 A.3d 417 (Del. 2020); *In re* McDonald's Corp. S'holder Derivative Litig., 289 A.3d 343, 378 (Del. Ch. 2023).

351. *See id.* at 378–80. A brief list suffices to illustrate additional examples of such misconduct: Theranos, Enron, WorldCom, Volkswagen, FTX.

352. Zucker v. Andreessen, C.A. No. 6014-VCP, 2012 WL 2366448, at *9 (Del. Ch. June 21, 2012) ("Denying [a CEO terminated for sexual harassment] any severance . . . could have undermined [the board's] efforts to attract outside executive talent"); *see* Shabbouei v. Potdevin, C.A. No. 2018-0847-JRS, 2020 WL 1609177, at *11 (Del. Ch. Apr. 2, 2020) (holding that in a CEO misconduct case, the board had no duty to pursue an antagonistic separation with the CEO); *In re* Boeing Co. Derivative Litig., C.A. No. 2019-0907-MTZ, 2021 WL 4059934, at *36 (Del. Ch. Sept. 7, 2021) (finding that it was reasonable to infer that allowing the CEO "to go quietly and with full pockets . . . was in furtherance of the legitimate business objective of avoiding further reputational and financial harm"). *Cf. McDonald's*, 291 A.3d at 692 (dismissing shareholder derivative suit against former CEO in light of the $105 million settlement in which McDonald's released its claims against the CEO).

fiduciary duty via a derivative suit because it is exceedingly unlikely that a plaintiff will be able to plead demand futility.[353]

I would therefore suggest that courts find a third way for *Caremark* as follows: first, courts should strip out the monitoring prong of *Caremark*, as it unavoidably invites judicial encroachment into business judgment. Instead, courts should limit *Caremark* to its red-flags prong, where courts can police behavior without touching near-intractable questions of what must be monitored and how much monitoring there should have been. Second, understanding that boards are often constrained when considering suits against officers, the courts should consider relaxing the pleading rules around demand futility when shareholders seek to press derivative *Caremark* claims against officers. That is to say, courts should consider that at times, demand may be futile because even fully loyal directors engaged in reasonable decision-making processes may face structural conflicts that make them unwilling to bring certain claims, while shareholders can derivatively bring such claims without facing such conflicts.

Conclusion

The distinction between process and substance is well-known to legal scholars, and this distinction is pervasive in how corporate law regulates the behavior of corporate fiduciaries.

Often, the primary question that courts ask is whether a corporation's managers used sensible processes to reach their decisions. Only after finding some issue with those processes do courts even consider examining the economic substance of the resulting decisions, and even then, reasons abound why such examinations will be invariably imperfect. These same reasons recommend against reforms that would transform courts into judicial arbiters of business skill.

The problem, however, is that only too often do questions of substance and process intersect and interact. Adopting process-centered standards does not guarantee that courts will be able to avoid difficult questions of business substance. Likewise, estimations of economic entitlements often depend on choices of procedural entitlements. Such interplay of substance and process has frequently increased the practical difficulty of

353. *See* Order Granting Dismissal Under Rule 23.1, *In re* McDonald's Corp. S'holder Derivative Litig., C.A. No. 2021-0324-JTL (Del. Ch. Mar. 1, 2023).

applying novel doctrines. Decisions such as *Corwin* that were expected to streamline litigation by shifting courts' focus toward process considerations have often met with limited success. At the same time, other decisions such as *Van Gorkom* that were intended to only reaffirm existing procedural requirements have been received as serious invasions of management's business judgment.

Of course, the courts have not been without their successes: recent Section 220 cases have made corporate misconduct harder to hide, while poison pill doctrine has evolved to be more protective of shareholder rights. As this Article has shown, courts may be able to more rapidly and more effectively reach the policy ends they seek for corporate law by crafting doctrines that are the result of active evaluation of the interactions between substance and process.

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STRUCTURED JUDICIAL DECISION-MAKING AND MINORITY PROTECTION

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A corporation controlled by a majority shareholder may engage in self-dealings that harm the interests of the minority shareholders. If a minority shareholder challenges the decision in court, what should be the appropriate methods for judicial decision-making? Theoretically, courts can choose between balancing or structured decision-making. Existing studies show that balancing has significant advantages over structured decision procedures in antitrust, discrimination law, and constitutional law. This article develops an economic theory to illustrate the advantages of structured decision-making in the context of corporate law. In Delaware, courts have adopted the structured decision-making method in the protection of minority shareholders. The underlying rationale for Delaware courts' approach can be illustrated using the law and economics theory of property rule and liability rule protection for minority rights. Delaware courts have essentially applied a combination of property rules and liability rules, an approach that this article refers to as "structured pliability rules," to protect minority shareholders. Courts can incorporate the consent of minority shareholders into their judicial rulings through the implementation of structured decision-making approaches, thereby altering the probabilities of success for various parties depending on whether the decision has received approval from a majority of minority shareholders.

The theory of structured pliability rules presented in this article has significant explanatory and normative implications. It explains the underlying rationale of Delaware law regarding self-dealings, offers normative guidance for the design of judicial decision-making methods in appraisal actions, and provides insights on enhancing corporate law in other jurisdictions.

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Furthermore, this article contends that structured pliability rules should extend beyond corporate self-dealings and be applied in other scenarios involving majority-minority conflicts. It further explores the potential application of structured pliability rules in the judicial review of constitutional law pertaining to takings. In cases where a government intends to expropriate private lands, courts should employ distinct decision-making rules based on the level of approval among the affected landowners.

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Introduction

In a business corporation where the majority shareholders can make a decision on a one-share-one-vote basis, a general concern is that the corporation may engage in self-dealing transactions that benefit the majority at the expense of the interest of the minority.[1] For example, a majority shareholder or group of shareholders may try to sell company assets to themselves at prices far below market value. Such actions enable the majority to profit from the transaction while adversely affecting the minority shareholders. Scholars have consistently highlighted the importance of legal safeguards that protect minority shareholders from tunneling practices, as these protections foster investment and contribute to the development of a robust capital market.[2] Four economists, Rafael La Porta, Florencio

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1. *See* Johnson Simon et al., *Tunneling*, 90 Am. Econ. Rev. 22 (2000). Zohar Goshen & Assaf Hamdani, *Corporate Control, Dual Class, and the Limits of Judicial Review*, 120 Colum. L. Rev. 941, 949 (2020). ("cash-flow rights conflicts involve either *a transaction* in which the controller stands on one side and the controlled corporation on the other or *an action* taken by the corporation that results in reallocation of discernible economic value from the minority to the controller (both cases are commonly referred to as self-dealing)"). For cases in which courts review self-dealings, *see, e.g.*, Kahn v. Lynch Commc'n Sys., 638 A.2d 1110 (Del. 1994) (merger between a controlling shareholder and the company); Levien v. Sinclair Oil Corp., 261 A.2d 911 (Del. Ch. 1969) (a dividend distribution decision relating to conflicted parent-subsidiary relationships). Another classical example is the so-called "opportunistic amendment hypothesis"—the majority or supermajority members of a corporation may amend the corporate charter in the midstream that harms the interests of the minority shareholders. *See, e.g.*, Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 Colum. L. Rev. 1549, 1573 (1989); Lucian Arye Bebchuk, *Foreword: The Debate on Contractual Freedom in Corporate Law*, 89 Colum. L. Rev. 1401 (1989). While I use "majority shareholders" for the sake of simplicity in this article, it should be noted that it sometimes also refers to "controlling shareholders" who hold a special class of shares that grant them additional voting rights and hence control of the corporation. Similarly, I use minority shareholders to refer to those shareholders that do not exercise meaningful control of the corporation, even though they may in fact hold a large proportion of shares.

2. American corporate law has long been regarded as exceptionally successful in protecting minority shareholders and has contributed immensely to the capital market in the United States. Erica Gorga & Michael Halberstam,

Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, collectively known by their acronyms as "LLSV," published a series of articles on law and finance, arguing that common law countries are superior in their protection of minority shareholders and thus have stronger capital markets.[3] It has been noted that courts in civil law jurisdictions, especially the French law jurisdictions, are constrained by more rigid rules and cannot effectively curb tunnelings by the majority shareholders or insiders of corporations.[4] Meanwhile, scholars have found that compared with other common law jurisdictions such as the United Kingdom (UK), courts in the United States, especially in Delaware, assume a notably pronounced role in safeguarding the rights of minority shareholders.[5] The thriving state of

Litigation Discovery and Corporate Governance: The Missing Story about the Genius of American Corporate Law, 63 Emory L.J. 1383, 1386 (2013) ("This comparative enterprise has been highly consequential in that the legal variables so identified have, in turn, been deemed 'preconditions' to the highly developed capital markets in the United States that other nations across Europe, Asia, and Latin America ought to emulate."); Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. Rev. 781, 783 (2001) (stating that the article seeks to "explain the complex network of interrelated legal and market institutions that supports strong markets in countries, like the United States and the United Kingdom."). In business corporations, minority shareholders' interests may be harmed by those in control, including the directors and the majority shareholders. John Armour et al., *Agency Problems and Legal Strategies*, *in* Anatomy of Corporate Law 36 (Kraakman et al. eds, Oxford University Press 2009). This article focuses solely on the conflicts between the majority and minority shareholders and does not consider directors' misconduct. Many corporate decisions may harm the interests of minority shareholders. This article will focus mainly on self-dealing transactions, which more directly affect the minority's rights. For other types of corporate decisions that might adversely affect minority shareholders, *see, e.g.*, Gordon, *supra* note 1; Bebchuk, *supra* note 1.

3. *See, e.g.*, Rafael La Porta et al., *The Economic Consequences of Legal Origins*, 46 J. Econ. Literature 285, 286 (2008) ("LLSV documented empirically that legal rules protecting investors vary systematically among legal traditions or origins, with the laws of common law countries (originating in English law) being more protective of outside investors than the laws of civil law (originating in Roman law), and particularly French civil law, countries."); Rafael La Porta et al., *Law and Finance*, 106 J. Pol. Econ. 1113 (1998)

4. Simon et al., *Tunneling*, *supra* note 1.

5. *See* Brian R. Cheffins, Company Law: Theory, Structure, And Operation 309, 333 (Oxford Univ. Press 1997) ("Ideally, judges will have sufficient awareness of key commercial dynamics to evaluate in a well-informed fashion the conduct of those involved in companies. There is some reason, however, that English judges are not particularly well-qualified on this count. . . English judges usually eschew judicial activism. As well, they are strongly inclined to follow rules set down in previous cases."); John Armour

the U.S. capital market has prompted scholars to investigate the legal factors that contribute to its success.[6] Some attribute this success to the inter-state competition within the federal system, which is considered a distinguishing characteristic of American corporate law, [7] while others attribute it to the civil procedures within the American legal framework.[8]

This article identifies another important feature of courts in the protection of minority rights in the United States—the mode of judicial decision-making. In Delaware, where most corporations are incorporated, courts have adopted structured decision-making methods and developed different decision-making rules in different circumstances.[9] By contrast, many other states have adopted a balancing approach.[10] The

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et al., *Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States*, 6 J. Empirical Legal Stud. 687, 688-90 (2009); Curtis J. Milhaupt & Katharina Pistor, Law and Capitalism: What Corporate Crises Reveal About Legal Systems And Economic Development Around The World 29 (Univ. of Chicago Press 2008) ("Despite its small size and diminutive stature in virtually all other areas of the U.S. political economy, it is the most attractive jurisdiction for incorporation among Fortune 500 companies").

6. *See, e.g.*, Milhaupt & Pistor, *supra* note 5, at 17–20; Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. Chi. L. Rev. 1233, 1234 (2002).

7. Roberta Romano, The Genius Of American Corporate Law 14–15, 118 (AEI Press 1993).

8. *See* Gorga & Halberstam, *supra* note 2. For other explanations, see John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. Pa. L. Rev. 2151, 2151–52, 2171–75 (2001); Mark J. Roe, *Can Culture Constrain the Economic Model of Corporate Law?*, 69 U. Chi. L. Rev. 1251, 1262–64 (2002); Mark J. Roe, Political Determinants of Corporate Governance: Political Context, Corporate Impact 1–5, 49–51, 201–04 (Oxford Univ. Press 2003).

9. See Louis Kaplow, *Balancing Versus Structured Decision Procedures: Antitrust, Title VII Disparate Impact, and Constitutional Law Strict Scrutiny*, 167 U. Pa. L. Rev. 1375, 1440 (2019) [hereinafter Kaplow, *Balancing Versus Structured Decision Procedures*]. Louis Kaplow, *On the Design of Legal Rules: Balancing Versus Structured Decision Procedures*, 132 Harv. L. Rev. 992, 997 (2019) [hereinafter Kaplow, *On the Design of Legal Rules*].

10. Courts in Germany, for example, have not adopted structured decision procedures. *See* Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 Cal. L. Rev. 393, 435 (2003) ("German law mandates liability-rule protection and leaves no freedom for the parties to contract for property-rule protection."). In the UK, courts sometimes review corporate decisions to protect minority shareholders in unfair prejudicial actions. However, courts have not developed similar standards that take into account the approval from the majority of minority shareholders. UK courts largely choose balancing rather than structured decision-making in these types of

utilization of structured decision-making within the United States legal framework has garnered significant scholarly attention in recent years. The most vocal critic has been Louis Kaplow, who argues that unconstrained balancing is more efficient than structured decision-making.[11] Kaplow's analysis focuses on constitutional law and antitrust law. It remains an interesting and important question whether the judicial decision-making methods are crucial to the success of Delaware law, and whether other jurisdictions should emulate this method of reviewing corporate decisions.[12]

This article endeavors to provide a novel perspective on the superiority of structured decision-making over unconstrained balancing when it comes to safeguarding the rights of minority shareholders from a law and economics perspective.[13] Law and economics scholars have long recognized the distinction between property rule and liability rule protection of a legal entitlement.[14] According to Calabresi and Melamed, if a legal entitlement is protected by property rules, it cannot be transferred without the consent of the owner of the entitlement.[15] If, however, a legal entitlement is protected by liability rules, it may be transferred as long as a court ensures that the owner has been awarded just compensation. This theoretical framework has also been employed to analyze the protection of minority shareholders under corporate law.[16] In a business corporation

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cases. PAUL L. DAVIES & SARAH WORTHINGTON, GOWERS AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 681-83 (Sweet & Maxwell 9th ed. 2012)

11. *See generally* Kaplow, *On the Design of Legal Rules*.

12. Courts in Germany, for example, have not adopted structured decision procedures. See Goshen, *supra* note 10, at 435 ("German law mandates liability-rule protection and leaves no freedom for the parties to contract for property-rule protection.").

13. In recent years, the use of structured decision-making is under attack. *See, e.g.*, Kaplow, *On the Design of Legal Rules*.

14. *See generally* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972). A legal entitlement confers interests to its owner and is a concept broader than a "right" since it may not have been formally recognized as a right.

15. *Id.* at 1092.

16. Many studies consider the protection of the entitlement to be a choice between these two rules. *See, e.g.*, IAN AYRES, OPTIONAL LAW: THE STRUCTURE OF LEGAL ENTITLEMENTS (Univ. of Chicago Press 2005); Ian Ayres & J.M. Balkin, *Legal Entitlements as Auctions: Property Rules, Liability Rules, and Beyond*, 106 YALE L.J. 703, 704 (1996); *see generally* Ian Ayres, *Protecting Property with Puts*, 32 VAL. U. L. REV. 793 (1998); *cf.* Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 YALE

where the majority shareholder can make a decision on a one-share-one-vote basis, a general concern is that the decision may harm the property interests of the minority shareholders.[17] The minority members can be protected by property rules. In that case, any changes to their interests must be approved by each of the minority members or a majority of the minority members. The second approach is for courts to review majority decisions to ensure the fairness of these decisions, which is considered as a form of *liability rules* protection.[18] This approach can overcome the problem of opportunistic holdouts by minority shareholders. However, liability rules face the challenge that judges may not have the necessary information and expertise to determine what is fair to the minority shareholders.[19] Due to this difficulty,

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L.J. 1027 (1995); Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 Harv. L. Rev. 713 (1996).

17. One classical example is the so-called "opportunistic amendment hypothesis"—a majority or supermajority of shareholders of a corporation may amend the corporate charter in the midstream that harms the interests of the minority shareholders. *See, e.g.*, Gordon, *supra* note 2, at 1573, 1574; *see generally* Bebchuk, *supra* note 1. This is similar to the "tyranny-of-the-majority" problem. *See* Alexander M. Bickel, The Least Dangerous Branch: The Supreme Court at the Bar of Politics 27 (Yale Univ. Press 1962).

18. For instance, let's consider a scenario where a majority shareholder intends to sell a valuable company asset to themselves at a significantly lower price than its market value. This self-dealing transaction could potentially benefit the majority shareholder while causing financial harm to the minority shareholders. Under a property rule approach, the minority shareholders' interests would be protected, and their approval would be required for such a transaction to take place. This ensures that any changes affecting their property rights are subject to their consent or the agreement of a majority of the minority shareholders. Alternatively, courts can play a crucial role in safeguarding minority shareholders' rights through a liability rule approach. In this case, the court would carefully examine the fairness and adequacy of the transaction, ensuring that the minority shareholders receive just compensation for any potential harm or loss resulting from the transaction.

19. Goshen, *infra* note 25, at 431 ("The vast majority of judges lack any expertise with the realities of the corporate world."); John C. Coffee Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 Colum. L. Rev. 1618, 1620 (1989); Lucian Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 Harv. L. Rev. 1820, 1855 (1989). Courts often need to rely on conflicting expert opinions, which gives rise to doubts as to whether courts are capable of adjudicating such disputes. Recent studies show that certain shareholder rights are impossible to evaluate, rendering it difficult for courts to determine whether a decision made by a corporation is fair to the minority or not. James E. Krier & Stewart J. Schwab, *Property Rules and Liability Rules: The Cathedral in Another Light*, 70 N.Y.U. L. Rev. 440, 461 (1995) ("[T]hese very same multiple-party cases entail high assessment costs as well as high transaction costs, and

courts in many jurisdictions do not actively review corporate decisions.[20] A widely shared belief is that property rules should be preferred when transaction costs are low, and liability rules are necessary when transaction costs are high.[21]

While current studies largely consider judicial review as simply offering liability rule protection,[22] this article argues that Delaware courts can be viewed as offering a combination of property rules and liability rules protection, which this article refers to as "structured pliability rules."[23] Within this approach, when a corporate decision obtains the backing of a majority of the affected minority members, courts invoke a specific set of rules that limit the scope of scrutiny and afford the corporation

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this might regularly be the case."). Eugene Kontorovich, *The Constitution in Two Dimensions: A Transaction Cost Analysis of Constitutional Remedies*, 91 VA. L. REV. 1135, 1147 (2005) ("When an entitlement is not traded in thick markets, or possesses elements of idiosyncratic value, it becomes more difficult to get an accurate judicial valuation."). Moreover, some collective rights, such as control rights, cannot be easily evaluated. *See generally* Goshen & Hamdani, *supra* note 1. Some members may hold the belief that their shares are worth more than the market price, as it does not reflect the intrinsic value of shares. When there is a market price for the rights, such as the price of a share in a stock market, the price only reflects the value at the margin to people who buy and sell shares. Meanwhile, some members may claim that their collective rights are worth more than the market price, only to hold out the decision for more compensation, which may delay the decisions that might benefit the members as a whole. Krier & Schwab, *supra* ("If parties can hide their valuations from each other, they can hide them from a judge.").

20. *See* CHEFFINS, *supra* note 5, at 309, 333; Goshen, *supra* note 10, at 431.

21. Krier & Schwab, *supra* note 19, at 450 ("Let the parties trade by themselves when they are able; presumably they can establish the relevant values by bargaining more cheaply and more accurately than can the judge by weighing the evidence.").

22. Thomas W. Merrill, *The Economics of Public Use*, 72 CORNELL L. REV. 61, 74 (1986) ("From this perspective, eminent domain provides a mechanism that allows government to convert property rules into liability rules. This model presumes that property rules work well where low transaction costs make consensual exchange of resources practical. Liability rules, on the other hand, are necessary where high transaction costs render consensual exchange difficult."); *See* Daniel Markovits & Alan Schwartz, *Who Owns What? Re-Thinking Remedies in Private Law* 36-37, (Working Paper, Jan. 17, 2019), https://economix.fr/uploads/source/doc/workshops/2019_6th_imle/Schwartz%20%20%26%20Markovits%20IML%26E%202019.pdf ("Productive property... is thus subject to what is commonly called liability rule protection").

23. The concept of structured pliability rules is new, while the idea of pliability rules was proposed by Bell and Parchomovsky. *See generally* Abraham Bell & Gideon Parchomovsky, *Pliability Rules*, 101 MICH. L. REV. 1, 6 (2002).

greater deference.[24] Conversely, if a decision lacks such support, courts undertake a comprehensive review to assess the fairness of the transaction.[25] Courts employ different *rules* and *standards*,[26] following structured decision-making procedures based on whether the corporate decision has been approved by the majority of minority shareholders.

This article further argues that structured pliability rules are superior to liability rules under two assumptions that normally hold. First, courts generally face limitations in their access to information and expertise, making it more challenging to ascertain the fairness of organizational decisions, as compared

24. In Delaware, when a corporation enters into a self-dealing transaction, the court will first consider whether the corporate decision has been approved by a majority of minority shareholders and an independent committee of directors. Kahn v. M&F Worldwide Corp., 88 A.3d 635 (Del. 2014); *In re* MFW S'holders Litig., 67 A.3d 496, 502, 536 (Del. Ch. 2013). If so, the court will grant a motion to dismiss based on the business judgment rule and will not proceed any further. Louis Kaplow, *Multistage Adjudication*, 126 Harv. L. Rev. 1179, 1180 (2013) ("U.S. civil litigation allows motions to dismiss and for summary judgment prior to trial."). Aronson v. Lewis, 473 A.2d 805, 812 ("The business judgment rule . . . [carries] a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.").

25. Similar standards of review are not seen in other jurisdictions. *See* Goshen, *supra* note 10, at 435 ("German law mandates liability-rule protection and leaves no freedom for the parties to contract for property-rule protection."). In the UK, courts sometimes review corporate decisions in unfair prejudicial actions. However, courts have not developed similar standards that take into account the approval from the majority of minority shareholders. *See* Davies & Worthington, *supra* note 10 at 681-83 (Sweet & Maxwell 9th ed. 2012). In Germany, shareholders can file a lawsuit based on Sec. 243 of the German Stock Corporation Act (AktG) to void the resolution, which creates a holdout leverage for the minority shareholder since it can delay the execution of the corporate decision. Due to the concern about frivolous lawsuits, Germany has developed a "fast-track" procedure that enables courts to deal with disputes quickly when evidence shows that the action is without merits or that the suit is merely used as a holdout. However, German courts do not consider the same factors as the Delaware courts. *See* Christian A. Krebs, *Freeze-Out Transactions in Germany and the U.S.: A Comparative Analysis*, 13 Ger. L.J. 941, 966 (2012) ("As long as an action to enjoin is pending, the squeeze-out cannot be registered with the commercial register, and therefore the transaction cannot become legally effective.").

26. For the distinction between the two, see Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 Duke L.J. 557, 621 (1992). Scholars have noted that discovery imposes significant costs on the parties. *See* Gorga & Halberstam, *supra* note 2.

to the investors themselves.[27] Second, the approval by a majority of minority shareholders can significantly enhance the probability that the decision aligns with the interests of the shareholders as a collective.[28] In light of these assumptions, structured pliability rules can integrate the parties' autonomy within judicial proceedings, thereby mitigating concerns regarding the institutional competence of the court.

The theory proposed in this article carries significant policy ramifications for comparative corporate law, providing insight into the underappreciated role of structured decision-making as a crucial element contributing to the success of American corporate law.[29] Notably, this approach has not received adequate recognition in current studies. For instance, German courts have yet to embrace this approach, resulting in challenges when it comes to regulating self-dealings.[30] Meanwhile, courts in the United Kingdom (UK) have adopted an approach that is functionally similar to that in Delaware.[31]

This article also contributes to the literature on comparative civil procedure law. Scholars have identified a tradeoff between procedural costs and the costs of error in the design of civil procedure rules.[32] Scholars have recognized that as procedures become more intricate, the associated procedural costs increase, while the costs of error generally decrease.[33] Various jurisdictions have adopted different approaches: some, like the

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27. The determination of the fairness of a transaction is usually recognized to be difficult even with the tools of modern corporate finance. Courts may need to rely on the opinions of investment bankers that are problematic. *See* Lucian Arye Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can be Done About It?*, 1989 DUKE L.J. 27, 37-46 (1989). Investment banks could choose among various justifiable estimates of share value to reach disparate conclusions. Ted. J. Fiflis, *Responsibility of Investment Bankers to Shareholders*, 70 WASH. U. L.Q. 497, 518 (1992). William J. Carney, *Fairness Opinions: How Fair Are They and Why We Should Do Nothing About It*, 70 WASH. U. L.Q. 523, 533 (1992).

28. Goshen, *supra* note 10, at 410 n.53.

29. For a discussion of the genius of American corporate law, *see generally* ROMANO, *supra* note 7; *see also generally* Gorga & Halberstam, *supra* note 2.

30. *See infra* Section II.C.1.

31. *See infra* Section II.C.2.

32. Geoffrey P. Miller, *The Legal-Economic Analysis of Comparative Civil Procedure*, 45 AM. J. COMP. L. 905 (1997).

33. *Id.* at 906–07. One example is the rule of discovery, which enables the court to collect information about the background of the corporate decision and identify wrongdoings while also incurring significant costs for the parties involved.

United States, have implemented complex procedural rules with relatively low costs of error, whereas others, like France, have opted for less costly procedural rules but with higher costs of errors.[34] In light of corporate litigation, this article argues for the adoption of dual sets of rules by courts, as opposed to a singular approach. The court should adopt procedural rules that are more complicated and costly when offering liability rules protection but can be changed if there is approval by the majority of minority shareholders. Consequently, the theory proposed in this article lends support to the employment of intricate judicial procedures, as the drawbacks associated with costly procedures can be significantly mitigated through the implementation of structured pliability rules.[35]

Structured pliability rules can be applied beyond the realm of corporate law. In line with this perspective, the article posits that courts should contemplate the application of structured pliability rules when evaluating eminent domain decisions, much like the review of self-dealing within corporate law. Specifically, when a government intends to acquire and assemble parcels of land in a given area, the collective approval of the majority of residents facing similar circumstances could be considered in determining the appropriate standard of review.[36] By adopting this approach, the article aims to demonstrate the superiority of structured pliability rules over current proposals addressing the safeguarding of individual property rights in eminent domain cases.

This article proceeds as follows. Part I develops the theory of how courts can combine property and liability rules in the protection of minority shareholder rights. Parts II further applies this theory to corporate fiduciary litigation and appraisal actions in Delaware in detail, explains its internal logics, and compares Delaware's approach with those of Germany and the United Kingdom. Part III applies this theory to judicial review in the areas of constitutional law. Part IV concludes.

34. *Id.* at 907.

35. *See infra* Section II.A.-B. for a detailed discussion.

36. This proposal is similar to the "Land Assembly District" (LADs) proposed by Heller and Hills. Michael Heller & Rick Hills, *Land Assembly Districts*, 121 HARV. L. REV. 1467, 1469 (2008). For a discussion of the similarities and differences between my proposal and LADs, see *infra* Section III.B.2.

I.
Judicial Review and Minority Shareholder Protection

Collective decision-making inherently possesses coercive qualities, as the actions taken by the majority can often result in harm to the interests of the minority within any large-scale organization. Scholars have long observed the problem of the "tyranny of the majority."[37] In a democratic society, the majority's decisions typically prevail due to the principle of majority rule. While majority rule is a fundamental aspect of democracy, the concept of the tyranny of the majority highlights its potential pitfalls. It emphasizes the need to protect the rights and interests of minorities, ensuring that they are not unfairly subjected to the decisions and actions of the majority. Similarly, when a corporation is controlled by a majority shareholder, there persists an ongoing risk that corporate decisions will unjustly prejudice the rights of the minority shareholders.

Law and economics scholars have applied the theoretical frameworks of property rules and liability rules to analyze different approaches to protecting minority rights. This part of the article considers these approaches and proposes that another approach—the application of structured pliability rules—can be employed to protect minority rights. The discussion primarily centers on corporate law, elucidating the notion of structured pliability rules through its application. In Part III, the theory will be extended to the realm of constitutional law.

A. *Property Rules, Liability Rules, and the Protection of Minority Rights*

In one of the most-frequently cited articles, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral,* Calabresi and Melamed propose a theoretical distinction between property rule and liability rule protection of legal entitlements.[38] Property rule protection ensures that an entitlement

37. *See generally* Bickel, *supra* note 17.

38. Calabresi & Melamed, *supra* note 14, at 1090. This distinction has become the foundation of numerous subsequent studies. *See, e.g.*, Saul Levmore, *Unifying Remedies: Property Rules, Liability Rules, and Startling Rules*, 106 Yale L.J. 2149 (1997); Ian Ayres & Paul M. Goldbart, *Optimal Delegation and Decoupling in the Design of Liability Rules*, 100 Mich. L. Rev. 1 (2001); Richard Craswell, *Property Rules and Liability Rules in Unconscionability and*

cannot be transferred, limited, or modified without the consent of the right-holders.[39] Under liability rules, by contrast, the transfer of an entitlement can be forced without the consent of the right-holders as long as they have been justly compensated.[40] The theoretical framework of property rules and liability rules can also be employed to analyze collective rights.[41]

1. *Property Rule Protection of Minority Rights*

In the context of collective decision-making, members of a particular group or organization can agree to a rule of unanimity, which can be viewed as a *strong form* of property rule protection for minority rights. Under this approach, decisions must receive the approval of the right-holders whose collective rights will be impacted. For instance, in a corporation, when the majority shareholder proposes a merger transaction, each minority shareholder could be granted a veto right, ensuring their consent is required for the decision to proceed.[42] This, however, would lead to an opportunistic holdout problem in collective decision-making when there are many members.[43]

Related Doctrines, 60 U. CHI. L. REV. 1 (1993); Robert C. Ellickson, *Alternatives to Zoning: Covenants, Nuisance Rules, and Fines as Land Use Controls*, 40 U. CHI. L. REV. 681 (1973); Ward Farnsworth, *Do Parties to Nuisance Cases Bargain After Judgment? A Glimpse Inside the Cathedral*, 66 U. CHI. L. REV. 373 (1999); Zohar Goshen, *Controlling Strategic Voting: Property Rule or Liability Rule?*, 70 S. CAL. L. REV. 741 (1997); Kaplow & Shavell, *supra* note 16. This article has been widely cited. *See, e.g.*, Fred R. Shapiro, *The Most-Cited Law Review Articles*, 73 CAL. L. REV. 1540, 1550 (1985).

39. Calabresi & Melamed, *supra* note 14, at 1092. Richard A. Epstein, *The Supreme Court, 1987 Term—Foreword: Unconstitutional Conditions, State Power, and the Limits of Consent*, 102 HARV. L. REV. 4, 19 n.36 (1988) ("'Property protection' means that control over the asset can only be lost by consent . . . .").

40. Calabresi and Melamed also considered the rule of inalienability, which means that an entitlement cannot be transferred even if the entitlement holder agrees. Calabresi & Melamed, *supra* note 14, at 1092. This rule is not widely used in the context of collective decision-making. I thus do not consider it in this article. *See e.g.*, Luca Enriques et al., *Related-Party Transactions*, *in* ANATOMY OF CORPORATE LAW 145 (Kraakman et al. eds., 2017).

41. *See generally* Goshen, *supra* note 10.

42. Goshen, *supra* note 10, at 410–11 n.53 (arguing that in the context of a self-dealing transaction entered into by a corporation, "a property rule conditioning a self-dealing transaction upon the unanimous consent of all voters protects each and every member of the minority on an individual basis, such that no voter can be coerced.").

43. Krier & Schwab, *supra* note 19, at 460 ("There are the special problems that arise when an exchange will necessarily benefit many people at once (giving rise to free rider problems) or when many people have to agree

Each member is likely to have an incentive to hold out on the decision in order to seek personal gain, even when the decision benefits all members as a whole.[44] To mitigate the challenge of minority holdouts, members often establish collective decision-making rules that permit decisions to be made based on criteria that do not require unanimous agreement. These rules, such as majority rule, majority of minority ("MoM") rule, or supermajority rule, can be seen as weaker forms of property rules.[45] In the context of corporate law, some corporations seek the approval of MoM shareholders when the majority shareholder has a conflict of interest.[46] A MoM rule or a supermajority rule can partially alleviate the opportunistic holdout problem arising from the requirement of unanimous consent. Even if some minority members oppose a decision, their votes alone cannot veto the outcome, ensuring a more balanced decision-making process.

The approval of MoM shareholders can significantly contribute to the fairness of a corporate decision, particularly when compared to a majority rule that permits conflicted shareholders to vote.[47] When a majority of minority shareholders vote in favor of a decision, it is likely to reflect the collective interests of the minority shareholders as a whole. This is because if the corporate decision proves detrimental to the minority shareholders, those who hold a majority of the minority shares would bear a substantial portion of the resulting losses.

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to an exchange in order for it to be consummated (giving rise to holdout problems).").

44. The majority and minority are locked into a "bilateral monopoly" situation. *Id.* at 461.

45. One may also consider this as a property rule if all minority shareholders can be considered as acting in a group. The majority of the minority then can be viewed as representing the collective will of all minorities. *See* Goshen, *supra* note 10, at 408 ("The fairness-test solution to self-dealing is best understood as a liability rule, and the majority-of-the-minority solution is best understood as a property rule . . . the majority-of-the-minority rule employs a subjective valuation and enables the minority to capture a greater part of the surplus."). For the opinion that collective decision-making should be considered as liability rule, see Markovits & Schwartz, *supra* note 22, at 36–37 ("Productive property . . . is thus subject to what is commonly called liability rule protection.").

46. Goshen, *supra* note 10, at 410–11 n.53. *See, e.g.*, *MFW*, 67 A.3d at 516.

47. James Si Zeng, *The Calculus of Shareholders' Consent: A Constitutional Economics Theory of Corporate Charter Amendment Rules*, 41 U. Pa. J. Int'l L. 429, 460 (2019).

However, the MoM approval is still subject to two major problems: free-riders and holdouts.[48] First, the minority shareholders may only hold a small proportion of interests and thus lack incentives to participate in the decision-making process, which creates the free-rider problem.[49] This problem becomes more pronounced when minority shareholders are dispersed and have limited coordination. Second, the MoM shareholders may hold out the decision, which sometimes over-regulate transactions beneficial to the corporation.[50] The MoM shareholders may hold out to seek private gains from the majority shareholder since they can decide whether to approve a self-dealing transaction.[51] They may hold out the decision for too much personal benefits or for too long and may eventually thwart the transaction even if the decision is beneficial for the corporation.[52] Therefore, entrusting the decision-making power solely to the MoM shareholders can sometimes lead to inefficiencies in corporate decision-making.

Whether the MoM approval indicates fairness of the corporate decision depends on the ownership structure of a corporation. When the minority shareholders' shares are held by institutional investors, known for their astute judgment in evaluating the equity of decisions, the MoM approval is more likely to serve as a reliable indicator of the decision's fairness.[53] Conversely, if the minority shareholders are retail investors prone to relying on others' decisions, a small group of minority shareholders could exert disproportionate influence. These shareholders may collude with the majority or engage in holdouts, thereby jeopardizing the interests of other minority shareholders.[54] Even though structured pliability rules

48. Goshen, *supra* note 38, at 751.

49. *Id.* at 751.

50. *Id.* at 753–54.

51. *Id.* at 756.

52. *Id.*

53. Zohar Goshen & Sharon Hannes, *The Death of Corporate Law*, 94 N.Y.U. L. Rev. 263, 270-71 (2019). ("When the principal has relatively low competence (as with retail investors) the parties are more likely to rely on a court for dispute resolution. By contrast, when the principal has relatively high competence (as with institutional investors), the parties are more likely to resolve these issues on their own through the use of discretionary control rights." (footnote omitted)).

54. Goshen, *supra* note 10, at 416 ("[A]t times these investors act, directly or indirectly, in collusion with management or the controlling owner against the remaining shareholders.").

encompass elements of property rules protection in the judicial review process, they are not immune to the challenges posed by free-riding and holdout behavior.

To illustrate, suppose a corporation enters into a freeze-out merger transaction that offers minority shareholders ten dollars per share. Suppose all shareholders value their shares at nine dollars. The transaction is beneficial to all shareholders. Suppose that one shareholder holds 0.01% of the shares and effectively controls the MoM vote while the rest of the shares are held by retail investors who do not participate in voting. She may hold out the approval for personal gain, given her disproportionate voting power.[55] If the corporation fails to gain the MoM approval, it would incur high litigation costs in courts, which may deter some transactions beneficial to all shareholders.

2. *Liability Rule Protection of Minority Rights*

Given that a rule of unanimity is rarely adopted, a collective decision is inevitably coercive. Majority or supermajority members may coerce minority members into accepting a collective decision. To counteract this inherent coerciveness, judicial review assumes a crucial role. Particularly within the domain of corporate law, judicial review serves as a vital mechanism for curbing self-dealing transactions that unjustly favor majority shareholders while adversely impacting the interests of the minority shareholders.

Many scholars view judicial review as offering liability rules to protect minority members against the tyranny of the majority (or the supermajority).[56] To do so, courts often review decisions to ensure that they are fair to minority members, which is often viewed as a liability rule approach.[57] For example, under corporate law, courts review whether majority decisions constitute self-dealing and, if so, whether the transactions are entirely fair. Moreover, they afford minority shareholders the opportunity to exercise the appraisal remedy in instances where they dissent

55. This situation is similar to what Berle and Means described as the separation of ownership and control. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 66 (1933).

56. Goshen, *supra* note 10, at 430 ("Given these characteristics, one would expect that, like the United States, the United Kingdom would adopt a fairness-test approach to self dealing transactions. Indeed, the default rule followed in the United Kingdom is a liability rule.").

57. *Id.* at 430; Bell & Parchomovsky, *supra* note 23, at 5.

from substantial alterations in the corporation's business trajectory.[58] While the majority is typically empowered to implement coercive collective decisions that bind all members, courts possess the authority to overturn such decisions if they are found to be unfair towards the minority.[59] Liability rules enable courts to foster efficiency by nullifying decisions that unfairly disadvantage the minority, while concurrently upholding decisions that enhance the welfare of shareholders.

Liability rules give rise to the concern that judges lack capacity in adjudicating decisions involving majority-minority conflicts. To tell whether a corporate decision is fair or not, courts often need to rely on expert opinions on the fair value of certain assets.[60] For example, to tell whether minority shareholders are to receive fair consideration in a freeze-out merger, the court would need to assess the fair value of a share. One possible approach of evaluating a share is the discounted cash flow (DCF) method.[61] Applying this method entails an analyst making estimations regarding the future cash flow that a shareholder could potentially obtain by incorporating assumptions regarding the corporation's costs, revenues, taxes, as well as macroeconomic factors such as inflation.[62] The analyst must also estimate the discount rate for future profit, which depends on the risks of the corporation.[63] Two analysts relying on justifiable assumptions often reach drastically different opinions about the fair value of a share.[64]

Another major challenge to valuation is that courts lack information about the subjective value of shares.[65] Shareholders often attribute different subjective values to their rights,

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58. Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 241–244 (1962).

59. Calabresi & Melamed, *supra* note 14, at 1119-21; Goshen, *supra* note 10, at 408 ("The fairness-test solution to self-dealing is best understood as a liability rule, and the majority-of-the-minority solution is best understood as a property rule.").

60. *See generally* Bebchuk & Kahan, *supra* note 27.

61. *See id.* at 35.

62. *Id.* at 35.

63. *Id.*

64. *Id.*

65. If a shareholder consents to a transfer of assets, it indicates that the transaction is efficient. Without such consent, however, it would be difficult to determine the subjective value. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 13, 89, 99 (4th ed. 1992). *See also* Lucian A. Bebchuk, *The Sole Owner Standard for Takeover Policy*, 17 J. LEG. STUD. 197, 201–03 (1988).

making it difficult to ascertain the precise subjective value of property rights. When there is a market price for shares in a stock market, the price only reflects the value at the margin to people who buy and sell shares. Some shareholders may perceive their shares to be worth more, asserting that the market price fails to capture the intrinsic value of their shares. This discrepancy may stem from differing perspectives on factors such as future cash flow potential, influenced by varying profits, tax rates, or macroeconomic conditions. Meanwhile, certain shareholders may overstate the value of their shares solely to delay decision-making in pursuit of greater compensation.[66] While scholars have proposed various valuation methods for use by courts in the United States, evaluating the worth of corporations and their shares remains a difficult task that necessitates courts possessing advanced expertise.[67]

More importantly, liability rules inherently entail coercion. One of the primary distinctions between liability rules and property rules lies in the fact that the former permits alterations to collective rights to occur without the agreement of the right-holders. This becomes evident in scenarios where a corporation, under the control of a majority shareholder, can freeze out minority shareholders without their consent.

3. *Choosing between Property Rules and Liability Rules*

Given the inherent limitations of both property rules and liability rules, numerous scholarly investigations approach the selection between these two frameworks as a delicate balance between transaction costs and assessment costs.[68] Property rules should be preferred when transaction costs are low, since property rules protect the subjective value of legal entitlements and

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66. Manning, *supra* note 58, at 238 ("He can abuse the procedural process under the appraisal statute to the cost and disruption of the enterprise.").

67. Krier & Schwab, *supra* note 19, at 462 ("If parties can hide their valuations from each other, they can hide them from a judge."). *See* William A. Groll & David Leinwand, *Judge and Banker—Valuation Analyses in the Delaware Courts*, 116 DICK. L. REV. 957, 959 (2012) ("The plaintiffs' bar and the Delaware courts have become quite sophisticated in reviewing valuation analyses and are thoroughly conversant in the related, highly technical financial arcana."). *See* Goshen & Hamdani, *supra* note 1, at 951 ("Entire fairness review is fundamentally reliant upon the ability and competence of a third party—in this case, the Delaware courts—to perform an objective valuation of the disputed transaction.").

68. Assessment costs are sometimes referred to as the litigation costs. Ayres & Talley, *supra* note 16, at 1037.

respect the will and autonomy of the holders of entitlements, whereas liability rules override the market mechanism and use coercive means to force transfers of entitlements, offering only objective compensation to the entitlement holders.[69] This perspective finds endorsement from Richard Posner, who espouses in his seminal textbook on law and economics that in settings characterized by high transaction costs, the optimal allocation of property rights should be achieved through legal mechanisms rather than relying solely on market forces.[70] Zohar Goshen extends this analytical framework to the protection of minority rights against self-dealing within the domain of corporate law, positing that "the choice between the two types of rules—property or liability—is a function of the total transaction costs in a particular legal system."[71]

This view, however, has been questioned by some scholars.[72] Krier and Schwab raise a valid point that in situations characterized by high transaction costs, assessment costs may also escalate, particularly in the context of multi-party bargaining.[73] The involvement of numerous participants can amplify transaction costs due to two significant challenges: free-riders and holdouts.[74] In the context of collective decision-making, members of an organization may free-ride on the negotiation efforts of others, leading to underinvestment in negotiations, which may produce results that are less than efficient. Meanwhile, some members may hold out on decisions for personal gains, which may also lead to high transaction costs and lower the likelihood of reaching socially desirable agreements. In scenarios where transaction costs are substantial, the assessment costs associated with bargaining among multiple parties can similarly surge.[75] A court may need to assess the value of the entitlement to each member, who may hold an opinion different from the opinions of the other members. Such circumstances pose

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69. Calabresi & Melamed, *supra* note 14, at 1107-08. For criticisms, see Krier & Schwab, *supra* note 19, at 453 n.44.

70. Richard A. Posner, Economic Analysis of Law 29 (Little, Brown, and Co., 1st ed. 1972).

71. Goshen, *supra* note 10, at 395.

72. *See generally* Krier & Schwab, *supra* note 19.

73. *Id.* at 461.

74. *Id.* at 460–61.

75. *Id.* at 461.

greater complexities compared to cases where the assessment of the value of a single property right suffices.[76]

In summary, when transaction costs are high, liability rules are not necessarily superior to property rules because assessment costs may also be high. Scholars disagree as to whether property rules or liability rules should be applied—some suggest that courts should intervene to adjudicate disputes when voluntary exchange is difficult to achieve, while others point out that liability rule protection also generates high assessment costs under such circumstances. [77]

4. *Pliability Rules*

Subsequent studies have offered other alternative approaches.[78] Scholars have noted that property rules and liability rules can be combined. Bell and Parchomovsky argue that in practice, legal entitlements are often protected by dynamic rules called *pliability rules*.[79] According to Bell and Parchomovsky, pliability rules are "contingent rules that provide an entitlement owner with property rule or liability rule protection as long as some specified condition obtains; however, once the relevant condition changes, a different rule protects the entitlement."[80]

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76. *Id.*

77. *See generally* Goshen, *supra* note 10, at 395; Krier & Schwab, *supra* note 19, at 461–62.

78. Ayres and Talley argue that liability rules may be more efficient in thin markets when divided entitlements can generate information. However, they acknowledge that such an approach may be efficient only when the "transactional barriers to trade can at least be surmounted." Ayres & Talley, *supra* note 16 at 1083. In collective decision-making, the major problem is that multiple parties may hold out, and the divided entitlement may exacerbate the holdout problem. *Id.* Krier and Schwab argue that even when transaction costs are high, liability rules may also be inefficient because assessment costs might be high. Krier & Schwab, *supra* note 21, at 455. They point out that many factors that lead to high transaction costs also give rise to high assessment costs. For example, in disputes involving multiple parties or bilateral monopoly, negotiation costs are usually high. However, courts may also find it difficult to assess damages. Similarly, in a monopoly situation where there is a lack of market price, both transaction costs and assessment costs would be high.

79. Bell & Parchomovsky, *supra* note 23, at 5.

80. *Id.* Bell and Parchomovsky distinguish different types of pliability rules. These rules include classic pliability rules, zero-order pliability rules, simultaneous pliability rules, loperty rules, title-shifting pliability rules, and multiple-stage pliability rules. Classical pliability rules involve "property rules that are transformed into liability rules." Zero order pliability rules are "property rules that become liability rules where the compensation for breach of the rule is zero." Under simultaneous pliability rules, the same entitlement

One typical example of a pliability rule is the protection of share ownership in freeze-out mergers. Shares are normally protected by property rules because they cannot be transferred without the consent of the shareholders. However, once a corporation decides to enter into a freeze-out merger, the minority shareholders may be forced to give up their shares; in a judicial review of the corporate decision, the court is to ensure the fairness of the compensation offered to the minority shareholders. According to Bell and Parchomovsky, the minority shareholders "lose the ability to refuse to part with their shares", and the legal protection of minority rights becomes a liability rule.[81]

B. *Structured Pliability Rules*

This article proposes that courts can combine property rules and liability rules even after a dispute has entered judicial proceedings rather than simply offering liability rules. This approach can be referred to as structured pliability rules. Analyzing the theoretical framework of property rules and liability rules in litigation sheds new light on the available choices for minority protection and highlights the importance of the structured decision-making method in corporate law that has largely been ignored in the literature. Courts can substantively review a corporate decision, imposing high litigation costs on parties when they seek to resolve their disputes via judicial review. However, courts can shift to a superficial substantive review or lower the litigation costs on the majority shareholders if the corporation has gone through MoM shareholder approval that alleviates the concern of minority protection. Under this

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holder holds "one type of rule protection with respect to some potential users" but a different rule applies with respect to different users. Loperty rules are rules in which liability rule protection "is transformed into property rule protection." Title shifting pliability rules "transform property rule protection in the hands of one entitlement holder into property rule protection in the hands of another entitlement holder." Multiple stage pliability rules change the rule protection more than once. *Id.* at 30–31.

81. Bell & Parchomovsky, *supra* note 23, at 31, 33 ("Classic pliability rules, as we noted, involve the transformation of an entitlement from property rule to liability rule protection. . . . [I]n most cases, a share is a property interest entitled to property rule protection, but the adoption of certain corporate decisions alters the nature of the shareholder's interest in his or her shares. The provision in state law requiring majority decisions to engage in a merger, freeze-out takeover or the like, should therefore be viewed as creating a classic pliability rule.").

approach, majority shareholders will be incentivized to seek the consent of minority members or disinterested directors to avoid high litigation costs. The majority shareholder may opt to offer a price that is sufficiently attractive to secure the agreement of a majority of the minority shareholders, thereby significantly reducing the risk of externalities. If the majority shareholder anticipates that a corporate decision would not gain the approval of MoM shareholders, it would expect to incur high litigation costs once the decision is challenged and is less likely to support such a decision unless it feels confident that it can demonstrate its fairness. Courts thus do not need to conduct an intensive substantive review when the corporate decision has been approved by the MoM shareholders, which significantly alleviates the concern for judicial capacity.

Structured pliability rules are superior to liability rules under two assumptions that normally hold. First, courts have an informational disadvantage compared with private parties. If courts could evaluate the fairness of a corporate decision with relatively low costs, they should provide liability rules by using an unconstrained balancing test to review corporate decisions rather than focusing on whether the decision has been approved by the MoM shareholders. However, as illustrated above, courts are subject to various informational and resource constraints and thus are at a comparative disadvantage compared with private parties.

Second, the MoM approval can to a great extent, improve the fairness of a corporate decision. For example, a MoM decision is likely to represent the interests of the minority shareholders as a whole because if the corporate decision is harmful to the minority shareholders, those who hold a majority of minority shares would bear a significant proportion of the losses.[82] The consent of MoM shareholders serves as a significant testament that a minority shareholder initiating a legal challenge might be pursuing self-interest through a frivolous lawsuit.

One may raise a challenge to the second assumption that going through the MoM approval procedure does not always guarantee that the corporate decision is fair. As illustrated

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82. For example, suppose a corporation has a controlling shareholder holding 51%. The controlling shareholder benefits from the deal, leaving the losses to be borne by the minority shareholders. Suppose a shareholder holds 26% and holds the majority of the minority votes. This shareholder would also bear a majority of the losses.

above, an MoM approval is subject to the problems of free-rider and holdouts.[83] Thus, relying on the MoM approval may cause two consequences: a decision backed by the MoM may be harmful to the minority shareholders but due to the free-rider problem, no shareholder acts to block the decision; a decision may be beneficial to the minority shareholders but because some minority shareholders hold out the decision for personal gains, the decision is not backed by the MoM.

Since structured pliability rules incorporate an element of property rules protection in the judicial review, they are also subject to the free-rider and holdout problems. To illustrate this point, consider a scenario where a corporation engages in a freeze-out merger, offering minority shareholders a price of ten dollars per share. Now, assume that all shareholders perceive the true value of their shares to be nine dollars, meaning the transaction is advantageous for all parties involved. However, there is one particular shareholder who holds a mere 0.01% of the shares yet possesses a significant degree of control over the MoM vote. This individual, driven by their disproportionate voting power, may deliberately withhold their approval in an attempt to extract personal gains from the situation. In this case, if the MoM approval is not obtained, the corporation would be compelled to enter into protracted and costly litigation proceedings. Such a predicament has the potential to discourage future transactions that would otherwise benefit all shareholders. The prospect of enduring substantial legal expenses acts as a deterrent, hindering the execution of transactions that could contribute to the collective interests of the shareholders.

Whether the second assumption holds depends on the ownership structure of a corporation. If the shares of the minority shareholders are held by institutional investors who can exercise good judgment on the fairness of the decision, the MoM approval is more likely to serve as a good indication of fairness of the corporate decision.[84] If, however, the shares held by minority shareholders are held by retail shareholders

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83. *See* Zohar Goshen, *Voting (Insincerely) in Corporate Law*, 2 THEORETICAL INQUIRIES L. 815, 819 (2001).

84. Goshen & Hannes, *supra* note 53, at 270–71 ("When the principal has relatively low competence (as with retail investors) the parties are more likely to rely on a court for dispute resolution. By contrast, when the principal has relatively high competence (as with institutional investors), the parties are more likely to resolve these issues on their own through the use of discretionary control rights.").

who tend to free-ride on the decisions of others, a few minority shareholders may dictate the outcome. They may either collude with the majority shareholders or hold out the decision, which may harm the interests of the other minority shareholders.[85] Currently, studies have shown that institutional investors play a significant role in corporate governance in the United States.[86] Since they are largely sophisticated investors holding a significant proportion of shares, the MoM approval is likely to serve as an important indication of the fairness of a corporate decision.

Under the above assumptions, structured pliability rules are superior to liability rules. If courts are to offer liability rules protection to minority shareholders, they can either conduct an *intensive review* or a *superficial review* of the fairness of the decision. Structured pliability rules are superior to the intensive review approach because the court does not conduct an intensive review unless the corporation fails to obtain the MoM approval. Structured pliability rules thus lessen the litigation costs compared to an intensive substantive review approach, including the procedural costs incurred in the legal proceedings and the costs of error resulting from the court making a wrong judgment as to the fairness of the corporate decision.

Meanwhile, compared to the superficial review approach, structured pliability rules would raise litigation costs but alleviate the costs of error to some extent. Unlike an intensive review, which incurs high procedural costs and relatively low costs of error, a superficial review incurs lower procedural costs and relatively high costs of error. The court only considers little evidence and often approves an unfair corporate decision or blocks a fair one.[87] Structured pliability rules employ the corporate decision-making procedures to help courts review the fairness of a corporate decision, which has significant advantages over the superficial review approach.

Current studies on the economics of civil procedural law note that different jurisdictions have adopted different civil procedure rules that balance two costs—complicated procedures increase procedural costs and reduce the costs of error, whereas simple procedures involve lower procedural costs but

85. This situation is similar to what Berle and Means described as the separation of ownership and control. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 66 (1933).

86. Goshen & Hannes, *supra* note 53.

87. *See* Miller, *supra* note 32, at 907.

increase the costs of error.[88] This article suggests that complicated procedures also have an additional function—imposing litigation costs on the corporation so that corporations can be induced to follow a certain decision-making process that alleviates the concern of minority protection. To be sure, it is important for courts to consider the fairness of a corporate decision to the minority, thereby ensuring that they reach the correct conclusion. Many of the procedural rules aim at collecting evidence and clarifying facts, which certainly help courts make the "right" decisions.[89] However, some may believe that the procedures may be too costly and prefer less costly procedures even though they may generate a higher cost of error.[90] This article offers an additional supportive argument for costly judicial review— the disadvantages of such an approach can be alleviated through structured pliability rules, and the litigation costs can be reduced in many cases.

Courts can also adopt a complete deferential approach. This approach can be regarded as an extreme form of superficial review. It may lead to insufficient regulation over oppression by the majority shareholder. Compared to such a regime, structured pliability rules incur higher litigation costs. While it is also true that the corporation can adopt benign decisions beneficial to all shareholders with fewer judicial constraint, such a regime is not likely to be better since the majority shareholder is very likely to engage in tunneling decisions or other decisions that harm the interests of minority shareholders, assuming that it is rationally maximizing its own interests.

C. *Structured Pliability Rules and Structured Judicial Decision-Making*

If courts are to offer structured pliability rules, what judicial methods can be employed? This Section argues that courts can employ a structured decision-making method rather than an unconstrained balancing test. Courts can also use a combination

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88. *Id.*

89. *See generally* Gorga & Halberstam, *supra* note 2.

90. *See* Miller, *supra* note 32, at 906 ("As the procedures involved in resolving a dispute become more and more summary, the probability that the finder of fact or law will make an error will usually increase."). *See* Joachim Zekoll, *Comparative Civil Procedure*, *in* THE OXFORD HANDBOOK OF COMPARATIVE LAW 1327, 1335 (Mathias Reimann & Reinhard Zimmermann eds., 2006).

of rules and standards and shift the burden of proof based on the presence or absence of MoM approval.

Courts in the United States have long utilized structured decision-making procedures in the process of judicial review. Louis Kaplow provides an analysis of the general procedures involved in structured decision-making.[91] Consider a scenario where Party A alleges that an action by Party B has caused harm and initiates a legal action against Party B. In response, Party B argues that the action has generated significant benefits. The court is tasked with determining whether liability should be assigned to Party B, either in the form of damages or injunctive relief, to deter or prevent the action in question. The court has two options: it can directly evaluate the benefits and harms through an unconstrained balancing test, or it can employ structured decision-making procedures to review the case. According to Kaplow, structured decision-making in a particular case involves three steps: first, the plaintiff must show that some harm exceeds a certain threshold; second, the defendant must show that the benefits of its actions exceed a certain threshold; third, the court considers the harm and the benefits.[92] Each step must be completed before the court proceeds to the next stage.[93] Structured decision-making is employed in the application of many doctrines in various areas of law, including corporate and constitutional law.[94]

In the context of corporate law, Delaware courts apply various standards of review, including the business judgment rule and entire fairness, to examine corporate decisions, which can be viewed as a structured decision-making approach. For example, in the context of a freeze-out merger, the court is faced with the decision of whether to block the merger from taking place. In theory, the court could utilize an unconstrained balancing

91. *See* Kaplow, *On the Design of Legal Rules*, *supra* note 9, at 1382.

92. *Id.* ("Under a structured decision procedure, it will be assumed that liability is determined by the following three-step protocol: (1) If $H > H^*$, proceed to step 2. Otherwise, assign no liability and stop. (2) If $B > B^*$, proceed to step 3. Otherwise, assign liability and stop. (3) If $H > B$, assign liability. Otherwise, assign no liability. And stop.").

93. *Id.*

94. In practice, structured judicial decision-making in constitutional law and corporate law sometimes does not follow the three steps above. *See id.* at 1449 ("Viewed in its particulars and as a whole, strict scrutiny doctrine does depart importantly from the stylized structured decision procedure introduced in subsection I.A.1 and, in varying degrees, from the other applications considered earlier in this [a]rticle.").

test, weighing the benefits accruing to shareholders against the harm suffered by dissenting minority shareholders. If the benefits outweigh the harm, the freeze-out merger would be allowed to proceed without regulation, in order to promote social efficiency.[95] However, in practice, the approach taken by Delaware courts aligns more closely with structured decision-making.[96] The court will readily grant summary judgment if it determines that the challenged merger decision was approved by a majority of the minority shareholders and a committee of independent directors and hence falls under the protection of the business judgment rule.[97] Consideration of the approval by minority shareholders is not directly relevant to the fair value of shares. Thus, courts are directed to consider different facts in the two stages of reviewing this type of corporate decision, which is different from an unconstrained balancing method in which courts only consider the fairness of the corporate decision to the minority shareholders.

Structured decision-making can better enable courts to offer structured pliability rules. This theory explains courts' reluctance to adopt the mode of unconstrained balancing of costs and benefits. If a court simply balances the costs and benefits of a collective decision, it essentially offers liability rule protection to the parties, which gives rise to the concern of judicial capacity since courts often lack information and expertise in reviewing collective decisions. Moreover, majority members would likely be dragged into frivolous lawsuits because of this.

Structured decision-making essentially offers two sets of rules. One set of rules apply when the courts offer liability rules protection. Courts impose high litigation costs on the parties, which generates more information and hence reduces the costs of error. Another set of rules apply when the MoM shareholders have approved the corporate decision. In the second case, the corporate decision is more likely to benefit the corporation as

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95. The analysis here assumes that we do not consider distributive goals and focus mainly on efficiency. It has long been accepted that economic analysis of law focuses mainly on efficiency. For a challenge, see Zachary Liscow, *Reducing Inequality on the Cheap: When Legal Rule Design Should Incorporate Equity as well as Efficiency*, 123 YALE L.J. 2478 (2013). This article accepts this assumption because it intends to analyze the efficiency of structured decision-making in the context of corporate law.

96. *See, e.g.*, *M&F Worldwide Corp.*, 88 A.3d 635.

97. *See, e.g.*, *id.*

a whole.[98] Thus, the litigation costs can be lowered to incentivize consent. In the academic literature, scholars have noted that complicated procedures usually incur high litigation costs while reducing the costs of error.[99] Current studies have examined cross-country variance in the civil procedure rules.[100] This article suggests that in one particular state, courts can employ two sets of decision-making rules in different circumstances.

In employing the structured decision-making method, courts can use a combination of rules versus standards.[101] Theoretically, rules are proposed ex ante and can offer clear guidance to the relevant parties, while standards are left open to be applied by courts when disputes arise.[102] Rules are written in a way that enables parties in a dispute to easily predict the outcome of the case, whereas standards are applied by courts on a case-by-case basis. Scholars have long been interested in the advantages of rules and standards.[103] In the context of corporate law, the business judgment rule is a clear rule. If the court applies this rule, the corporate decision would be given deference and the court would not review it, which incurs low procedural costs and a high cost of error.[104] By contrast, the standard of entire fairness is a standard that needs to be applied in a trial, incurring high litigation cost.

This article posits that rules and standards should be employed in different circumstances. When a corporate decision has gained the consent of the majority of the minority

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98. Goshen, *supra* note 10, at 410. ("Thus, a transaction will only transpire if the minority, or more precisely, a majority of the minority, has consented to it. This arrangement assures the minority more than a minimum fair price, however. It empowers the minority to look after its own interests and to strive to obtain the maximum price it can achieve. Placing the decision in the minority's hands maintains a regime of voluntary transactions and preserves the role of subjective valuations.").

99. *See generally* Miller, *supra* note 32.

100. *See, e.g.*, *id.*

101. *See* Kaplow, *supra* note 26, at 621.

102. *Id.* at 560 ("[T]he only distinction between rules and standards is the extent to which efforts to give content to the law are undertaken before or after individuals act.") (emphasis omitted).

103. *See* Kathleen M. Sullivan, *Foreword: The Justices of Rules and Standards*, 106 HARV. L. REV. 22, 62 (1992); Kaplow, *supra* note 26; Michael P. Dooley, *Rules, Standards, and the Model Business Corporation Act*, 74 L. & CONTEMP. PROBS. 45, 55 (2011) ("The great bulk of corporation law in the United States has been created by courts, not legislatures.").

104. The business judgment rule may block a challenge to a tunneling decision harmful to the minority shareholders, incurring the cost of error.

shareholders, rules should be employed to alleviate the litigation costs imposed on the parties. For example, the business judgment rule is a rule rather than a standard and can alleviate the procedural costs imposed on majority shareholder.[105] In *Kahn v. M&F Worldwide Corporation,* a Delaware court held that when a corporation enters into a freeze-out merger transaction with its controller, the business judgment rule applies if the majority shareholder has obtained the approval of a majority of the minority shareholders and a committee of independent directors.[106] This rule can incentivize majority shareholders to seek the consent from minority shareholders. Similarly, in appraisal actions where courts are to determine the fair value of shares that corporations should pay to dissenting shareholders in a merger, courts can make it a rule that they defer to the deal price when the transaction has been approved by a majority of the minority shareholders and a committee of independent directors.[107]

Standards should be used when a majority shareholder has failed to obtain consent from the minority shareholders because standards allow the court to conduct a more intensive review.[108] Using standards in this context encourages the majority shareholder to seek the MoM approval. By contrast, when a court employs rules to review a corporate decision, the litigation costs are significantly lower because parties can predict the outcome with ease.[109] Meanwhile, using rules in evaluating the fairness of corporate decision may incur high costs of error in the context of corporate law—using rules to adjudicate the fairness of a self-dealing transaction may either over-regulate or under-regulate the corporate decision. Thus, rules should only be employed when the MoM shareholders agree to the corporate decision.[110]

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105. *See infra* Section II.A.1 for a detailed discussion.
106. *M&F Worldwide Corp.*, 88 A.3d 635.
107. *See infra* Section II.B. for a detailed discussion.
108. To be sure, not all standards are more complex than rules. See Kaplow, *supra* note 26, at 598. This article merely considers the comparison in the limited context of corporate law and later in constitutional law.
109. For detailed illustrations, see *infra* Section III.
110. It should be noted that I am comparing here rules and standards with an equal level of complexity. If one compares a simple rule with a complex standard, perhaps the answer is clear—a complex and well-designed standard may better cope with the majority decision-making. However, this article goes further to argue that even if the rules and standards are of equal complexity,

It should be noted that structured decision-making is not the only way to implement structured pliability rules. Another approach is through the shifting of the burden of proof. After a court has decided to substantially review a corporate decision, it may vary the costs imposed on the parties by changing the burden of proof based on the presence or absence of MoM approval. In civil litigation, parties with the burden of proof must prove their claims. The preponderance of the evidence standard generally requires claimants to prove that their story is more likely to be true than the alternative story proposed by their opponents.[111] The allocation of the burden of proof and the preponderance of the evidence standard presume that courts cannot be certain about the facts of a case. If courts had a strong capacity for fact-finding, the allocation of the burden of proof would matter less. By shifting the burden of proof in a case, the court can increase or reduce a party's likelihood to win the case and hence can manipulate the costs imposed on the parties when the facts are unclear or difficult to prove.[112] The party bearing the burden of proof is likely to bear a majority of the cost of error.[113] In the context of corporate law, if a decision has gained the MoM approval, courts can alleviate the litigation costs on the majority by requiring the minority shareholder challenging the decision to bear the burden of proof. This approach would encourage the majority to seek the consent from the minority shareholders. It also enables the court to take into account the presence or absence of the MoM approval, strengthening its capacity of reviewing the fairness of the corporation. The reallocation of the burden of proof can be perceived as a less intense variation of structured decision-making, as it continues to afford the court the opportunity to undertake substantive evaluations of the decision. In contrast, structured decision-making would completely foreclose judicial proceedings under specific circumstances.

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standards are preferable simply because they are promulgated ex post. *See* Kaplow, *supra* note 26, at 586–90.

111. Edward K. Cheng, *Reconceptualizing the Burden of Proof,* 122 YALE L.J. 1254, 1259 (2012).

112. Miller, *supra* note 32, at 907.

113. For instance, within the context of a criminal case, the responsibility of the prosecuting attorney to establish guilt "beyond a reasonable doubt" reduces the cost of error borne by the criminal suspect. Cheng, *supra* note 111, at 1275.

II.
Structured Decision-Making under Corporate Law

The above discussion illustrates the conceptual underpinnings of structured decision-making in safeguarding minority rights. This section endeavors to demonstrate the practical implementation of judicial review concerning corporate decisions in the United States, [114] with particular emphasis on Delaware law given its significance.

A. *Fiduciary Litigation in the Merger Context in Delaware*

The theoretical framework presented in this article provides a comprehensive understanding of the function of structured decision-making. Furthermore, it offers significant implications for the theory of property rules and liability rules, as well as judicial decision-making procedures.

1. *Standards of Review for Freeze-out Mergers in the United States*

One of the most dominant forms of corporate litigation in Delaware is class action lawsuits challenging corporate decisions in the context of mergers.[115] Judicial review of corporate decisions plays a more important role in the context of mergers than in ordinary transactions.[116] Among these cases, the duty of loyalty claim serves as the most common basis for challenging corporate decisions, primarily arising in friendly deals where the majority shareholder possesses a conflict of interest with

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114. Corporate law generally deals with two major problems: the conflicts between the directors and the shareholders, and the conflicts between shareholders. This article focuses on the conflicts between the controlling and minority shareholders.

115. Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 Vand. L. Rev. 133, 167 (2004) ("[T]he overwhelming[] majority of fiduciary litigation in Delaware is in the form of challenges to director actions taken in the context of the sale of a company.").

116. *See id.* at 137 ("[A]pproximately 80 percent of the breach of fiduciary duty claims, the vast bulk of state court representative litigation, are class actions against public companies challenging director action in an acquisition."); *id.* at 167–68 ("The vast majority of the fiduciary duty claims against public companies are class actions (85 percent: 808 of 952). . . . Almost all (94 percent: 772 of 824) class action suits arise in an acquisition setting whereas almost all (90 percent: 123 of 137) of the derivative suits arise in a non-acquisition setting.") (emphasis omitted).

the corporation.[117] A typical scenario is a freeze-out merger, in which the majority shareholder merges with the corporation and the minority shareholders are cashed out.[118] In this context, there exists a conflict between the majority shareholder and minority shareholders. Given that the majority shareholder typically exercises control over the board of directors, they possess the authority to dictate the terms of the merger transaction, thereby jeopardizing the interests of the minority shareholders.[119]

Since a self-dealing transaction is very likely to harm the interests of the corporation, courts usually review mergers with conflicts of interest under the standard of entire fairness, as set out in the case of *Weinberger v. UOP*.[120] When courts adopt the standard of entire fairness, they will not readily grant summary judgment, and majority shareholders must demonstrate both fair dealing and fair price.[121] Courts will consider the process of deal-making and examine "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."[122] Courts will also consider the prices related to the proposed transactions, taking into account the "assets, market value, earnings, future prospects, and any other

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117. Thompson & Thomas, *supra* note 115, at 196.

118. *See* Goshen, *supra* note 10, at 413; Daniel Wilson, *Desirable Resistance: Kahn v. M&F Worldwide and the Fight for the Business Judgment Rule in Going-Private Mergers*, 17 U. Pa. J. Bus. L. 643 (2015). *See also MFW*, 67 A.3d at 502, 536. For a discussion of the standards of review of non-freezeout self-dealings, see Itai Fiegenbaum, *The Controlling Shareholder Enforcement Gap*, 56 Am. Bus. L.J. 583, 589 (2019).

119. *See* Goshen, *supra* note 10, at 400 ("A self-dealing situation can thus neutralize the voting mechanism's ability to determine group preference."); Wilson, *supra* note 118. *See* Charles R. Korsmo & Minor Myers, *The Structure of Stockholder Litigation: When Do the Merits Matter*, 75 Ohio St. L.J. 829, 855 (2014) ("The risks of managerial opportunism are greater in the context of a sale of corporate control than in conventional corporate decisions.").

120. Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983). *See* Thompson & Thomas, *supra* note 115, at 138. The Delaware court has exempted short-form mergers from the entire fairness review. Also, the majority shareholders can use a tender offer rather than a freeze-out merger to obtain the shares of the minority, which is also not reviewed based on the entire fairness standard. *See* Fernán Restrepo, *Do Different Standards of Judicial Review Affect the Gains of Minority Shareholders in Freeze-Out Transactions? A Re-examination of Siliconix*, 3 Harv. Bus. L. Rev. 321 (2013); Glassman v. Unocal Expl. Corp., 777 A.2d 242 (Del. 2001).

121. Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985).

122. *Weinberger*, 457 A.2d at 711.

elements that affect the intrinsic or inherent value of a company's stock."[123] As a result, the majority shareholders not only face a higher risk of losing but also incur additional litigation costs, including attorney fees and time spent in the process of discovery and in coping with the litigation.

In *Kahn v. Lynch*, a Delaware court held that even when a merger transaction has been approved by a special committee consisting of independent directors, the decision will still be subject to judicial review under the entire fairness standard.[124] Under this approach, a court will examine all aspects of a merger transaction in terms of both the negotiation procedures and substance.[125] However, the court will mitigate the extent of scrutiny if the self-dealing decision was approved by the majority of the minority shareholders, since the court will then shift the burden of proof of the fairness of the transaction to the minority shareholders challenging the decision.[126]

The Delaware Supreme Court took a turn in *Kahn v. M&F Worldwide Corporation* in 2014.[127] The court held that if a freeze-out merger is approved by both a majority of the minority shareholders and a special committee consisting of independent directors (collectively known as the "MFW conditions"), the merger decision may be shielded by the business judgment rule.[128] More specifically, the court will scrutinize whether the special committee exhibited independence, possessed complete authority to select advisors and reject the majority shareholder's offer, fulfilled its duty of care during negotiations, and whether the minority shareholders voted freely and were adequately informed.[129] If a freeze-out merger has been approved in this manner, Delaware courts will not second-guess the decisions

123. *Id.*
124. Kahn v. Lynch Commc'n Sys., 638 A.2d 1117 (Del. 1994).
125. *Weinberger*, 457 A.2d at 711.
126. *See* Kahn v. Lynch Commc'n Sys., 638 A.2d at 1117. *See also* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. Rev. 1009, 1025–26 (1997) (discussing the unique style of Delaware courts' writings).
127. *M&F Worldwide Corp.*, 88 A.3d 635; *MFW*, 67 A.3d at 502, 536.
128. *M&F Worldwide Corp.*, 88 A.3d 635; *MFW*, 67 A.3d at 502, 536. Wilson, *supra* note 118, at 644.
129. *M&F Worldwide Corp.*, 88 A.3d at 645.

and will grant summary judgment, which significantly alleviates the costs incurred by the majority shareholder.[130]

While some scholars criticize this body of law as being incoherent and overly complicated,[131] this article argues that the use of different standards of review and the burden of proof in reviewing corporate decisions offer a combination of property and liability rules protection to minority shareholders. When a merger transaction garners approval from the MoM shareholders free from conflicts of interest, the probability of detrimental impact on the minority shareholders' interests diminishes. As a result, the imperative for meticulous scrutiny diminishes, enabling courts to adopt decision-making rules that incur lower costs. For example, in a corporation with a majority shareholder holding 51% of the voting rights, a decision approved by 80% of the votes cast by all shareholders is less likely to be harmful to the minority shareholders than a decision approved by only 51% of the votes cast by all shareholders, assuming that the minority shareholders who approve the transaction are not colluding with the majority shareholder.

It should be noted that even when a majority of the minority shareholders has endorsed a merger decision, there is still a possibility that the merger transaction harms the interests of the minority dissenters. This scenario could arise if the majority of the minority shareholders were swayed or coerced into colluding with the majority shareholders, resulting in adverse consequences for the remaining minority shareholders.[132] Thus, Delaware courts would still review the merger transaction based on the entire fairness standard. Only when a merger has been approved by both the majority of the minority shareholders and a special committee of directors who are disinterested and independent will the courts grant the protection of the business judgment rule to the decision and refrain from substantively reviewing the decision.[133] A recent case suggests that

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

131. See Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1914 (1998) ("[I]n light of the importance of certainty in corporate law, Delaware law seems too indeterminate."). *See also* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 776 (1995) ("It is self-evident that the meaning and applicability of this language to specific factual settings is highly uncertain.").

132. Goshen, *supra* note 10, at 416.

133. *M&F Worldwide Corp.*, 88 A.3d at 645. Even then, the court may consider the fairness of the decision in appraisal actions. *See Infra* Section II.

majority shareholders are sometimes willing to seek the consent from the majority of the minority shareholders and the approval of a committee of independent directors to avoid litigation costs.[134]

It has been noted that Delaware courts are able to conduct an intensive review based on a set of procedural rules, including the rule on discovery.[135] Through discovery in corporate litigation, a plaintiff can investigate corporate affairs and uncover potential misconduct. The corporation "must search for, review, and produce almost all of the documents and witnesses," which generates significant assessment costs.[136] Additionally, such lawsuits have the potential to expose damaging information that could tarnish the reputation of the corporation and its insiders.[137] Structured decision-making, however, significantly limits the plaintiff's access to discovery since it allows the defendants to move to dismiss the lawsuit.[138] Under Delaware corporate

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B. for a detailed discussion. The rules in the United Kingdom in derivative actions are similar. *See* DAVIES & WORTHINGTON, *supra* note 10 at 686 PRINCIPLES OF MODERN COMPANY LAW 648 (Sweet & Maxwell 9th ed. 2012).

134. IRA Tr. FBO Bobbie Ahmed v. Crane, No. CV 12742-CB, 2017 WL 7053964, at *4 (Del. Ch. Dec. 11, 2017).

135. Gorga, *supra* note 2, at 1476. H.R. REP. NO. 104-369, at 37 (1995) (Conf. Rep.) ("[D]iscovery costs account for roughly 80% of total litigation costs in securities fraud cases"); Third Branch (Admin. Office U.S. Cts., D.C.), Judicial Conference Adopts Rules Changes, Confronts Projected Budget Shortfalls (Oct. 1999), https://www.uscourts.gov/news/1999/09/15/judicial-conference-adopts-rules-changes-confronts-projected-budget-shortfalls ("Discovery represents 50 percent of the litigation costs in the average case and up to 90 percent of the litigation costs in cases in which it is actively used.").

136. Gorga, *supra* note 2, at 1424.

137. M. Todd Henderson, *Impact of the Rakoff Ruling: Was the Judge's Scuttling of the SEC/BofA Settlement Legally Pointless or Incredibly Important-or Both?*, 13 WALL ST. LAW., 1, 6 (2009) ("[A] suit generates not only legal costs but also negative publicity and the potential that even more damning information will be revealed during discovery or the trial.").

138. Kaplow, *On the Design of Legal Rules*, *supra* note 9, at 1389-90 ("If a complaint's adequacy is challenged at a motion to dismiss, the only question before the court is whether the challenger has stated a plausible claim. Under a pure balancing test, the plaintiff must allege that H > B, whereas under the structured decision procedure the plaintiff must instead allege that H > H*. . . When a motion to dismiss is denied or none was filed, the case proceeds to discovery. Ordinarily, the scope of discovery covers all issues and all types of evidence, subject to limits regarding burdensomeness, what is now called 'proportional to the needs of the case.' The key point is that, unless a judge chooses to engage in substantial case management, the ordinary conduct of discovery does not involve sequencing.").

law, the business judgment rule establishes a "presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[139] This rule "operates as both a procedural guide for litigants and a substantive rule of law" in corporate litigation.[140] Defendants can file motions to dismiss based on the business judgment rule, thus limiting the adverse impacts caused by discovery and significantly reducing the litigation costs incurred by corporations.[141] Any shareholders challenging corporate

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139. *Van Gorkom*, 488 A. 2d at 872.

140. *See* Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989). Gorga, *supra* note 2, at 1394 ("[T]he twin hurdles of the demand requirement and the business judgment rule mean that most cases do not even go to discovery in the first place."); NCS Healthcare, Inc. v. Candlewood Partners, LLC, 827 N.E.2d 797, 803 n.3 (Ohio Ct. App. 2005) ("Delaware courts routinely dismiss complaints pursuant to Rule 12(b)(6) based on the business-judgment rule."); *see, e.g.*, *In re* Nat'l Auto Credit, Inc. S'holders Litig., 2003 WL 139768 (Del. Ch. Jan. 10, 2003).

141. Gorga & Halberstam, *supra* note 2, at 1394 ("[T]he twin hurdles of the demand requirement and the business judgment rule mean that most cases do not even go to discovery in the first place."); *Candlewood Partners, LLC*, 827 N.E.2d at 803 n.3 ("Delaware courts routinely dismiss complaints pursuant to Rule 12(b)(6) based on the business-judgment rule."); Fiegenbaum, *supra* note 118, at 586; Lawrence A. Hamermesh & Michael L. Wachter, *The Importance of Being Dismissive: The Efficiency Role of Pleading Stage Evaluation of Shareholder Litigation*, 42 J. Corp. L. 597, 602 (2017); Bernard S. Sharfman, *The Importance of the Business Judgment Rule*, 14 N.Y.U. J. L. & Bus. 27, 53-54 (2017) ("Duty of care claims that go beyond the judicially defined carve-out will quickly be dismissed without discovery even under the lenient standard of "reasonable conceivability," the standard of review that the Delaware courts use in determining whether a complaint will survive a defendant's motion to dismiss."); Lori McMillan, *The Business Judgment Rule as an Immunity Doctrine*, 4 William & Mary Bus. L. Rev. 521, 529 ("Realistically, it is difficult for a plaintiff to rebut the business judgment rule, given that, prior to discovery, the information needed might not be readily available."); Allison *ex rel.* Gen. Motors Corp. v. Gen. Motors Corp., 604 F. Supp. 1106, 1110 (D. Del. R), *aff'd*, 782 F.2d 1026 (3d Cir. 1985) (plaintiff initiating a shareholder litigation) ("Defendants. . . moved to dismiss and alternatively to obtain a stay of discovery pending resolution of the motions to dismiss and pending the GM Board's action on plaintiff's demand letter. On May 29, a stay was ordered except as to any discovery which might be relevant to the motions to dismiss."). Stoner v. Walsh, 772 F. Supp. 790, 800 (S.D.N.Y. 1991) ("At this time, the requested discovery will not be permitted. There is a presumption that a board's decision was the exercise of valid business judgment. As set forth below, because plaintiff's complaint fails to set forth facts leading to a reasonable inference that rebuts that presumption, her request for discovery should be denied."). Levine v. Smith, 591 A.2d 194, 199, 208 (Del. 1991), *overruled by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) ("When Levine initiated

decisions based on the fiduciary duty must plead "facts which if true would take defendants' actions outside the protection afforded by the business judgment rule" to survive a motion to dismiss.[142] The MFW conditions provide significant advantages for majority shareholders in the context of a freeze-out merger, as they can secure the protection of the business judgment rule. Consequently, this enables them to seek an early dismissal motion during the litigation process.[143]

While recent research indicates that an exhaustive discovery rule may impose excessive costs on the parties involved, this article proposes that structured pliability rules effectively mitigate this concern.[144] When litigation costs are high enough, the majority shareholder will be inclined to obtain consent from the majority of the minority shareholders to lower those costs, which offers *de facto* property rule protection to the minority shareholders even though the law does not mandate the majority-of-the-minority approval.

2. *Implications for the Theories of Property Rules and Liability Rules*

The aforementioned functional analysis of structured pliability rules introduces fresh insights into the theories of property rules and liability rules in the context of judicial review in the corporate law context. In the academic literature, Zohar Goshen was the first to employ the property rule and

discovery, GM and its directors moved to dismiss the complaint under Rule 23.1 and for a protective order pending disposition of the motion. Following briefing, limited to defendants' motion for a protective order, the Court of Chancery, in December 1987, granted defendants' motion and stayed further discovery. . .The court held that a shareholder plaintiff, alleging that a pre-litigation demand has been wrongfully refused, is not entitled to discovery prior to responding to a Rule 23.1 motion to dismiss."); Lewis v. Hilton, 648 F. Supp. 725, n.1 (N.D. 111. 1986); Dennis J. Block et al., *The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade*, 45 Bus. Law. 469, 497 ("[T]he three courts which have considered the issue under Delaware law - Levine v. Smith, Allison v. General Motors Corp. and Lewis v. Hilton - have held that a shareholder plaintiff may not take discovery in support of a claim that directors acted wrongfully in refusing a demand prior to responding to a motion to dismiss.").

142. Crescent/Mach I Partners, L.P. v. Turner, 846 A.2d 963, 984 (Del. Ch. 2000).

143. Bernard S. Sharfman, *Kahn v. M&F Worldwide Corporation: A Small but Significant Step Forward in the War against Frivolous Shareholder Lawsuits*, 40 J. Corp. L. 197, 212-14 (2014).

144. *See generally* Miller, *supra* note 32.

liability rule frameworks to analyze collective decision-making by shareholders in the context of self-dealing transactions.[145] Goshen's argument aligns with the prevailing notion that the selection between property rules and liability rules hinges on the balance between transaction costs and assessment costs.[146] According to Goshen, when a self-dealing transaction necessitates approval from the MoM shareholders, it is tantamount to employing property rules to safeguard the entitlement of the minority shareholders in the decision.[147] The MoM approval is similar to the minority shareholders as a group "consenting" to the transfer of their entitlement in the transaction.[148] Property rules generate transaction costs since minority shareholders may hold out on decisions that could benefit the corporation as a whole just to obtain personal gains.[149] Meanwhile, due to the free-rider problem, the MoM shareholder may not represent the interests of all the minority shareholders.[150] As a result, a property rule that requires the approval of a corporate decision by the majority of the minority shareholders, may not be socially efficient in some circumstances. In line with this reasoning, courts should serve as impartial third-party institutions to evaluate the fairness of decisions, effectively providing liability rule protection to minority shareholders by enabling majority shareholders to make decisions while ensuring fair compensation for the minority shareholders. This approach entails assessment costs as courts may face limitations in reviewing these decisions, but it reduces the transaction costs associated with property rules.[151]

145. *See generally* Goshen, *supra* note 10.

146. *Id.* at 417–18 ("[W]hen there are more efficient transactions, the risk of approving inefficient transactions is small, and a liability rule is preferable to save the negotiation costs associated with the property rule.").

147. *Id.* at 410.

148. *Id.* at 410, n. 53 ("Minority protections can afford protection to either individuals in the minority group or to minority members as a group. A property rule conditioning a self-dealing transaction on the consent of the majority of the minority protects the minority as a group.").

149. *Id.* at 402.

150. *Id.*

151. *Id.* at 415 ("Where transaction costs are incurred, however, the choice between a liability rule and a property rule depends upon which rule better ensures the realization of efficient transactions and the avoidance of inefficient ones. Although negotiation costs are primarily responsible for the failure to bring about efficient transactions, they might still be preferable to adjudication costs.").

This article introduces a third perspective on the matter, challenging the notion that judicial review solely provides liability rule protection to safeguard minority rights. Instead, it argues for a hybrid approach that combines elements of property and liability rules to offer comprehensive protection.[152] The aforementioned analysis highlights the inadequacy of a straightforward shift to liability rules by governments in response to high transaction costs. Instead, it suggests the implementation of structured decision-making and the design of diverse decision-making rules that impose varying assessment costs contingent upon the approval of minority shareholders. The assessment costs associated with judicial review can be further delineated into two categories: procedural costs and costs of error. The article contends that courts should adopt intricate and resource-intensive legal procedures when providing liability rule protection as they serve two crucial functions: first, they reduce the costs of error; second, high procedural costs encourage parties to reach agreements. If the procedural costs are too low, such an incentive structure would not be possible.

It should also be noted that the size of litigation costs imposed on parties can be adjusted dynamically over time depending on the transaction costs between the majority and minority shareholders. Higher litigation costs will likely generate stronger incentives for the majority shareholders to seek the approval from the MoM shareholders, thereby augmenting the role of property rules protection. In this case, the resolution of most disputes would lie with the MoM shareholders, as those lacking approval would not progress further. Conversely, diminished litigation costs amplify the significance of courts and diminish the significance of MoM approval. This article does not seek to offer a perfect solution for finding the right balance. Its objective lies in demonstrating that courts can adopt a third approach, distinct from property and liability rules, which integrates the element of consent even after disputes have entered judicial proceedings. Assuming that courts know less about the subjective value of parties' rights than the parties themselves, it is better for courts to create incentives for parties to reach

152. *Id.* at 421 ("if the legal system generates prohibitive adjudication costs, these mechanisms are likely to produce less expensive means of enforcement or to reduce negotiation costs to a point where recourse to the courts is unnecessary.").

agreements and to respect parties' autonomy using structured decision-making procedures.

3. *Implications for Judicial Decision-Making*

The theory above also has important theoretical implications for the discussion of judicial decision-making. This article suggests that structured decision-making is crucial to judicial review of corporate decisions, which contradicts the belief that unconstrained balancing is generally superior.[153] In a recent article, Louis Kaplow examines the choice between the two judicial decision-making modes and advocates for unconstrained balancing.[154] While recognizing the screening effect offered by structured decision-making, which serves to deter frivolous lawsuits where plaintiffs fail to illustrate significant harm, Kaplow contends that it would be more advantageous to gather information concerning both the harms and benefits of the challenged action at the initial stage of case screening. He argues that this approach capitalizes on the existence of information synergies, as much of the relevant information holds relevance to both the harms and benefits at hand.[155]

Kaplow's analysis mainly focuses on constitutional law and antitrust law and does not involve corporate law. In the context of judicial review of freeze-out mergers, the use of different standards of review can be classified as structured decision-making rather than unconstrained balancing, given that courts often do not directly assess the value of shares or the fairness of corporate decisions at the initial stage. Instead, they focus on whether the transactions have been approved by the majority of the disinterested shareholders and directors.[156] This method is significantly different from unconstrained balancing since courts only consider a restricted range of information at the initial stage rather than assessing all the costs and benefits.

This article demonstrates that, especially concerning minority protection, the corporate decision-making process can serve as a suitable indicator of the overall fairness of those decisions. Assessing the decision-making process is much more

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153. *See generally*, Kaplow, *Balancing versus Structured Decision Procedures*, *supra* note 9.
154. *Id.*
155. *Id.* at 1414.
156. *See, e.g.*, *MFW*, 67 A.3d at 502, 536.

straightforward compared to evaluating the substantive fairness of individual corporate choices. In the screening phase, applying liability rules without having access to all the essential information and expert opinions can lead to significant errors and costs. Consequently, employing structured decision-making is more suitable in the context of corporate law than in the tort context analyzed by Kaplow. Doing so alleviates the procedural costs imposed on parties and incentivizes majority shareholders to solicit the consent of minority shareholders.

B. *The Appraisal Remedy in Delaware*

The theory of structured pliability rules also has explanatory and normative implications for the appraisal remedy in Delaware.[157] Under Delaware law, subject to certain exceptions, shareholders may seek an appraisal from courts when their company engages in a merger transaction.[158] Currently, courts employ a variety of methods to determine the fair value of shares in appraisal actions, including using the pre-deal market price, the deal price, and the price determined by the discounted cash flow ("DCF") method.[159] Compared with the pre-deal market price and the deal price methods, the DCF method most resembles a "standard", rather than a "rule", that cannot be determined without going through litigation. Litigants usually provide opposing expert opinions as to the discounted future cash flows of the corporations at issue,[160] while the judges face the difficult burden of reaching a final determination of value.[161] It is widely accepted that the DCF method relies on subjective estimation of a set of factors that can lead

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157. *See* Liz Hoffman, *Wall Street Law Firms Challenge Hedge-Fund Deal Tactic*, WALL ST. J. (April 6, 2015, 8:53 PM), https://www.wsj.com/articles/wall-street-law-firms-challenge-hedge-fund-deal-tactic-1428362171.

158. DEL. CODE ANN. tit. 8, § 262 (2024).

159. Lawrence A. Hamermesh & Michael L. Wachter, *Finding the Right Balance in Appraisal Litigation: Deal Price, Deal Process, and Synergies*, 73 BUS. LAW. 961, 962, 969, 977, fn.80 (2018).("[O]ne school of thought posits that the merger price (or deal price) should presumptively be taken to reflect fair value. . . .").

160. *See* Albert H. Choi & Eric Talley, *Appraising the "Merger Price" Appraisal Rule*, 34 J. L. ECON. & ORG. 543, 544 (2018).

161. *In re* Appraisal of Ancestry.com, C.A. No. 8173, 2015 WL 399726, at *16 (Del. Ch. Jan. 30, 2015).

different experts to arrive at drastically different conclusions.[162] With empirical studies showing that final awards usually fall somewhere between the values provided by the experts on the opposing sides,[163] the academic debate on how courts should determine the level of compensation for dissenting shareholders is far from settled.[164]

Currently, an influential view in the academic literature is that courts should use the market price to determine the fair value of shares. In a recent study, Macey and Mitts argue against using the DCF method in appraisal proceedings and that the

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162. *Id.* at *1 ("I have commented elsewhere on the difficulties, if not outright incongruities, of a law-trained judge determining fair value of a company in light of an auction sale, aided by experts offering wildly different opinions on value."). Finkelstein v. Liberty Dig., Inc., No. Civ. A. 19598, 2005 WL 1074364, at *13 (Del. Ch. Apr. 25, 2005) ("[M]en and women who purport to be applying sound, academically-validated valuation techniques come to this court and, through the neutral application of their expertise to the facts, come to widely disparate results, even when applying the same methodology."). Choi & Talley, *supra* note 160, at 544; Prior to 1983, the Delaware court used the "Delaware block method" to evaluate stocks. The Delaware court considered the market price of the stock, the value of the assets of the corporation, and the value of its earnings. Later, the Delaware Supreme Court adopted finance theories such as discounted cash flow analysis to calculate the value. *See* Lawrence A. Hamermesh & Michael L. Wachter, *The Fair Value of Cornfields in Delaware Appraisal Law*, 31 J. CORP. L. 119 (2005).

163. *See* Charles R. Korsmo & Minor Myers, *Reforming Modern Appraisal Litigation*, 41 DEL. J. CORP. L. 279, 298 (2017).

164. The Delaware statute has not provided a clear method for calculating the value. DFC Glob. Corp. v. Muirfield Value Partners, L.P., 172 A.3d 346 (Del. 2017); William J. Carney & Keith Sharfman, *Appraisal in Delaware: Possible Improvement from the Bottom Up?*, EMORY LEGAL STUD. RSCH PAPER, (2018), https://ssrn.com/abstract=3138251 [http://dx.doi.org/10.2139/ssrn.3138251]. Scholars have proposed various methods for valuing stocks. William J. Carney & Keith Sharfman, *The Death of Appraisal Arbitrage: Ending Windfalls for Deal Dissenters*, 43 DEL. J. CORP. L. 61 (2018); Jonathan Kalodimos & Clark Lundberg, *Shareholder Rights in Mergers and Acquisitions: Are Appraisal Rights Being Abused?*, 22 FIN. RSCH. LETTERS 53 (2017); William J. Carney & Mark Heimendinger, *Appraising the Nonexistent: The Delaware Courts' Struggle with Control Premiums*, 152 U. PA. L. REV. 845, 847–48, 857–58, 861–66 (2003); Lawrence A. Hamermesh & Michael L. Wachter, *Rationalizing Appraisal Standards in Compulsory Buyouts*, 50 B.C. L. REV. 1021, 1023–24, 1034–35, 1044, 1046–54, 1067 (2009) (hereinafter referred to as *Rationalizing Appraisal Standards*); Lawrence A. Hamermesh & Michael L. Wachter, *The Short and Puzzling Life of the "Implicit Minority Discount" in Delaware Appraisal Law*, 156 U. PENN. L. REV. 1, 30–36, 49, 52, 60 (2007); Hamermesh & Wachter, *supra* note 162, at 128, 132–33, 139–42; Jonathan R. Macey & Joshua Mitts, *Asking the Right Question: The Statutory Right of Appraisal and Efficient Markets*, 74 BUS. LAW. 1015 (2019); Choi & Talley, *supra* note 160.

market price should be used in the appraisal proceedings.[165] In freezeout mergers, where the deal price is reached through a flawed procedure, the deal price may be unfair. However, Macey and Mitts argue that based on the efficient capital market hypothesis ("ECMH"), the market price reflects the intrinsic value of shares.[166] Since the pre-deal market price is untainted, courts should use it to determine the fair value.[167] Meanwhile, the DCF method relies on subjective valuation and thus is not reliable.[168] To conduct a DCF analysis, the court must first estimate the future profits of a corporation, which depend on a set of factors, including the future costs, revenues, and tax rates of the corporation.[169] The court must then determine the discount rate,[170] which, under the capital asset pricing model, depends on the risk-free interest rate and the risk premium.[171] The risk premium depends on how sensitive the share price is to the market portfolio.[172] Any differences in the estimation of these factors may lead to drastically different evaluation.[173]

This article offers a more nuanced view. It suggests a structured pliability rules approach—courts should consider using different methods in different circumstances based on the decision-making procedures of the corporation. While the DCF method leads to uncertain outcomes and certain costs of error, these costs imposed discourage the controlling shareholder from setting the compensation too low for fear of the minority shareholders challenging the decision in court. Meanwhile, courts may consider alleviating the litigation costs imposed on controlling shareholders when the challenged

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165. *See* Macey & Mitts, *supra* note 164. Similar arguments have been made by other scholars. Benjamin Hermalin & Alan Schwartz, *Buyouts in Large Companies*, 25 J. LEGAL STUD. 351, 360 n. 26 (1996).

166. Macey & Mitts, *supra* note 164, at 1042.

167. *Id.* Macey and Mitts acknowledge that there are multiple criticisms of the ECMH. These criticisms include asset bubbles, manipulation, and challenges based on behavioral economics. However, most of these criticisms can be addressed. *See id.* at 1023–28.

168. Other scholars also regard the indeterminacy generated by the DCF analysis to be a weakness of this method. *See* Carney & Sharfman, *supra* note 165 ("Indeterminacy has been an ongoing problem in Delaware corporate law.").

169. Bebchuk & Kahan, *supra* note 27, at 35.

170. *Id.*

171. STEPHEN ROSS ET AL., CORPORATE FINANCE, 357–60 (12th ed. 2018).

172. *Id.*

173. Bebchuk & Kahan, *supra* note 27, at 34–37.

merger transactions have gone through the MoM approval. While courts do not employ structured decision procedures in appraisal actions, they could decide to defer to the deal price or at least shift the burden of proof to the minority shareholders to prove that the deal price is unfair.

The proposed approach is preferable to exclusively relying on the pre-deal market price in appraisal proceedings for two major reasons. Firstly, the pre-deal market price primarily reflects the value of shares to buyers and sellers, failing to account for the subjective value individual shareholders place on their own shares. In theory, if a shareholder has no intention of selling their shares, the subjective value they attribute to those shares would be higher than the market price. Thus, compensating minority shareholders at the pre-deal market price would be inadequate.[174]

Second, and more importantly, this article argues that in a freeze-out merger where a controlling shareholder squeezes out minority shareholders, the pre-deal market price reflects the agency costs between the majority and minority shareholders. If the market anticipates that the majority shareholder may engage in acts of misappropriation or opportunism, thereby diverting corporate interests for its own gain, such concerns would be reflected in the market price of the shares.[175] In such instances, the rights and interests of minority shareholders are particularly vulnerable. Given the control wielded by the majority shareholder, the freeze-out merger can easily result in unfair treatment towards minority shareholders.

If courts accept the ECMH and always use the pre-deal market price to determine the fair value of shares, it would undermine the incentive for the controlling shareholder to offer prices that significantly exceed the pre-deal market price. Both the controlling shareholder and the minority shareholder can easily predict the decision of the court in appraisal litigation. As a result, minority shareholders would probably not exercise

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174. Macey and Mitts have also considered this. They argue, however, that no alternative can "operationalize this theoretical point in a manner that courts can utilize in an appraisal proceeding." Macey & Mitts, *supra* note 164, at 1053-1054.

175. To be sure, courts may impose restrictions on tunneling transactions. *See generally*, Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello, *Law and Tunneling*, 37 J. Corp. L. 1 (2011). However, corporate litigation is not perfect and not all wrongdoings would receive judicial oversight. Hamermesh & Wachter, *Rationalizing Appraisal Standards*, *supra* note 164, at 1035.

the appraisal rights at all. Given that the pre-deal market price might already factor in agency costs, the appraisal right does not seem to provide extra safeguards for minority shareholders. If the company negatively impacts minority shareholders, the share value may decrease. Consequently, in appraisal actions, the minority shareholders would receive a lower amount of compensation. The superiority of the structured pliability rules approach over the court's reliance on the pre-deal market price hinges on whether the heightened litigation costs imposed by judicial review are outweighed by the reduction in agency costs. The validity of this assumption remains an empirical matter that warrants further investigation.

Delaware courts have embraced the notion that a certain level of judicial oversight is essential in appraisal proceedings, diverging from complete deference to the market price.[176] The preceding theoretical analysis provides a coherent rationale for the decisions rendered by Delaware courts in this regard. Delaware courts held in several cases in recent years that they will generally defer to the deal price of a transaction as long as the negotiation process was fair.[177] In *Highfields Capital, Ltd. v. AXA Fin., Inc.*, the court held that "a court may derive fair value in a Delaware appraisal action if the sale of the company in question resulted from an arm's-length bargaining process where no structural impediments existed that might prevent a topping bid."[178] By contrast, Delaware courts generally award a higher compensation to minority shareholders if conflicts of interest exist in the transactions at issue.[179] For example,

176. *See* Hamermesh & Wachter, *supra* note 159, at 977–981.

177. *DFC Glob. Corp.*, 172 A.3d at 349 ("[E]conomic principles suggest that the best evidence of fair value was the deal price."). Cede & Co. v. MedPointe Healthcare, Inc., No. 19354-NC, 2004 Del. Ch. LEXIS 124, at *1-2 (Aug. 16, 2004). Gholl v. eMachines, Inc., No. 19444-NC, 2004 Del. Ch. LEXIS 171 (Nov. 24, 2004), *aff'd*, 875 A.2d 632 (Del. 2005). *See* Hamermesh & Wachter, *supra* note 159, at 977-981. Desiree M. Baca, *Curbing Arbitrage: The Case for Reappraisal of Delaware's Appraisal Rights*, 13 N.Y.U. J. L. & BUS. 425, 440 (2017) (describing the "trend of deferral" to the deal price by courts).

178. Highfields Cap., Ltd. v. AXA Fin., Inc., 939 A.2d 34, 59 (Del. Ch. 2007).

179. *See, e.g.*, Pinson v. Campbell-Taggart, Inc., No. CIV.A. 7499, 1989 WL 17438, at *7 (Del. Ch. Feb. 28, 1989) ("It should not be concluded that in an appraisal the Court will blind itself to or ignore, the manner and procedures by which the merger price was arrived at. If corporate fiduciaries engage in self-dealing and fix the merger price by procedures not calculated to yield a fair price, those facts should, and will, be considered in assessing the credibility of the Respondent corporation's valuation contentions.").

in *In Re Appraisal of Dell Inc.*, the Supreme Court of Delaware decided that the deal price was the intrinsic value of the shares given that the deal process was fair.[180] In *Glob. GT LP v. Golden Telecom, Inc.*, the court found that the corporation did "not engage in any sales efforts at all and instead concentrated solely on getting as good a deal as it could from VimpelCom," which was partially owned by the largest shareholder of the corporation.[181] The court thus rejected the deal price as the fair value of shares.[182] As Hamermesh and Wachter note, Delaware courts have identified several factors to ascertain the fairness of the deal process, including competition among bidders prior to the deal and the absence of "any specter of self-interest or disloyalty."[183] Appraisal actions impose additional litigation costs on controlling shareholders by enhancing the likelihood that dissenting minority shareholders will obtain compensation in an amount greater than the deal price when negotiation processes cannot be shown to be fair. This heightened probability consequently motivates controlling shareholders to seek approval from impartial shareholders and directors, as well as conduct market checks while determining merger prices, thereby mitigating concerns of opportunistic conduct.[184] Structured pliability rules further serve as a deterrent against minority shareholders abusing their rights, as they too bear procedural costs if they choose to exercise their appraisal rights and may potentially obtain even lower compensation as a result. Consequently, the theoretical framework presented herein justifies Delaware law's approach of employing a combination of standards and rules contingent upon whether the decision has garnered approval from the disinterested shareholders and directors.

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180. Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd., 177 A.3d 1, 28 (Del. 2017) ("[A]ny interested parties would have approached the Company . . . if serious about pursuing a deal."). *See* Macey & Mitts, *supra* note 165.

181. Glob. GT LP v. Golden Telecom, Inc., 993 A.2d 497, 508 (Del. Ch. 2010), *aff'd*, 11 A.3d 214 (Del. 2010).

182. *Id.* at 499.

183. Hamermesh & Wachter, *supra* note 159, at 984.

184. Studies have shown that when the majority pays a higher premium, the likelihood of the transaction being challenged later would decline. Korsmo & Myers, *supra* note 119, at 887.

C. *Comparing Delaware's Approach with other Jurisdictions*

Given the essential role of corporate governance in the development of a strong capital market, the theory offered in this article may offer guidance to governments in other countries that would like to emulate American corporate law. Presently, scholars have put forth various theories to explain the success of American corporate law, with some attributing it to federalism and others highlighting the impact of rigorous discovery rules.[185] This article shows that structured pliability rule serves the important functions of encouraging consent and alleviating the concern for judicial capacity. It is thus superior to a litigation where the court adjudicates disputes with an unconstrained balancing test. In this Section, I will compare the approach by the United States with those in Germany and the United Kingdom to illustrate the advantages of structured pliability rules.[186]

1. *Germany*

Concentrated ownership structures are traditionally prevalent in Germany.[187] German law thus is particularly concerned with the protection of minority shareholders' interests from

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185. *See generally* Gorga & Halberstam, *supra* note 2.

186. Other developing countries, such as China, also fail to adopt structured liability rules. For a discussion of the judicial decision-making methods employed by Chinese courts, *see e.g.*, James Si Zeng, *The Effectiveness of Judicial and Public Enforcement of Regulation on Related-Party Transaction in China*, 22 J. Corp. L. Stud. 505 (2022); James Si Zeng, *Does Regulation of Defensive Tactics with Mandatory Rules Benefit Shareholders? Evidence from Event Studies in China*, 66 Int'l Rev. L. & Econ. 105988 (2021); James Si Zeng, *Rules versus Standards in Chinese Law on Minority Shareholder Protection: A New Taxonomy and Empirical Analysis*, Am. J. Compar. L. (forthcoming 2024); *See also*, Zeng Si(曾思), Shangshi Gongsi Guanlian Jiaoyi de Huiyingxing Guizhi(上市公司关联交易的回应型规制)[Responsive Regulation of Related-Party Transaction of Listed Corporations], 6 Zhong Wai Fa Xue(中外法学)[Peking University Law Journal] 1599 (2021); *See also*, Zeng Si(曾思), Fan Shougou Tiaokuan de Qiangzhixing Guifan Guizhi: Yi Haili Shengwuan Wei Zhongxin(反收购条款的强制性规范规制: 以海利生物案为中心)[Regulation of Takeover Defenses with Mandatory Rules: An Analysis of the Hile Bio-tech Case], 2 Beifang Faxue(北方法学)[Northern Law Review] 54 (2021). However, stock exchanges in China sometimes adopt more flexible regulatory measures to protect minority shareholders. James Si Zeng, *Regulating Draconian Takeover Defenses with Soft Law: Empirical Evidence from Event Studies in China*, 20 Euro. Bus. Org. L. Rev. 823 (2019).

187. John Armour et al., *What is Corporate Law*, *in* Anatomy of Corporate Law 30 (Kraakman et al. eds., 2009).

abuse of power by the majority shareholders.[188] In Germany, shareholder derivative lawsuits are relatively rare.[189] However, judicial review plays an important role in nullifying resolutions that benefit majority shareholders at the expense of minority shareholders.[190] Under German law, many decisions of the company need to take effect by being entered into the commercial register.[191] Minority shareholders can block a resolution from being registered, thus protecting their interest.[192] In the famous *Linotype* case, a shareholder holding 96% of the shares initiated a resolution to dissolve the firm so that the profitable business operated by the firm can be integrated into the business of the shareholder.[193] The court held that the majority shareholder violated its duty of loyalty, and as a result, the resolution was nullified.[194] If the shareholder resolution "conveys special advantages" on certain shareholders, which is most likely the case when there is a majority shareholder dominating the decision, minority shareholders may raise a challenge under Section 243 of the German Stock Corporation Act (Aktiengesetz, hereinafter referred to as the "AktG").[195] Any shareholders can bring litigation if they obtained the shares before the notice of the meeting, attended the meeting and voiced their dissent, or were wrongfully refused to attend or attended a meeting that was not duly held.[196]

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188. Armour et al., *supra* note 2.

189. *See* Pierre-Henri Conac et al., *Constraining Dominant Shareholders' Self-dealing: The Legal Framework in France, Germany, and Italy*, 4 EUR. CO. FIN. L.R. 491, 508 (2007) ("As a consequence of the threshold for standing to sue in derivative suits and other hurdles to shareholder litigation, in Germany and Italy liability suits against directors have always been rare (even in the case of corporate groups).").

190. *Id.* at 513. ("Challenges to the validity of shareholder resolutions have traditionally been used as a shareholder remedy in Italy and Germany, because it is an effective bargaining tool against the company and its dominant shareholders.").

191. ANDREAS CAHN & DAVID C. DONALD, COMPARATIVE COMPANY LAW: TEXT AND CASES ON THE LAWS GOVERNING CORPORATIONS IN GERMANY, THE UK AND THE USA 745 (2010)

192. *See id.* at 749. This is mainly because German law does not recognize contingent fees. As a result, shareholders lack the incentives to bring derivative lawsuits, which benefits the company rather than shareholders directly.

193. *See* Conac et al., *supra* note 189, at 501. BGH 1.2.1988, II ZR 75/87, BGHZ 103, 185.

194. *Id.*

195. *See* CAHN & DONALD, *supra* note 191, at 750.

196. Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBI at 1089, § 245, translation at https://www.nortonrosefulbright.com/-/media/files/nrf/nrfweb/imported/german-stock-corporation-act.pdf.

German scholars have recognized the problem in using judicial review to curb the abusive actions of the majority shareholders and protect the interests of the minority shareholders.[197] On the one hand, judicial review is viewed as necessary to protect minority shareholders when the voting mechanism does not generate efficient outcomes. On the other hand, a minority shareholder may also abuse its power to bring frivolous lawsuits.[198] Certain professional litigation groups have incentives to file the litigation because they can obtain personal benefits in the form of settlement payment.[199] A minority shareholder may block a time-sensitive transaction and inflict harm on the majority shareholders by suing in court in the hope that the majority will offer some personal benefits to the minority.

To prevent the professional groups from abusing the litigation procedures, German law was amended in 2005 to allow corporations to sue in courts for registration of a resolution when a challenge is impermissible or unfounded, or when a delay would damage the company's interests.[200] Section 246(a) of the AktG provides that the court can, "at its discretion and conviction," hold that "the significant disadvantages for the company and its stockholders as presented by the petitioner outweigh the disadvantages the respondent stands to suffer."[201]

German law can be viewed as adopting liability rules protection to minority shareholders that focuses mainly on the fairness of corporate decisions rather than whether there is MoM approval. It imposed high litigation costs on the corporation prior to the 2005 amendment, especially when the transaction is time-sensitive, which can be regarded as an intensive substantive review approach that offers leverage to the minority members. However, such an approach allowed the minority shareholders to hold up the transaction by bringing frivolous lawsuits. Consequently, the 2005 amendment significantly reduced the litigation costs by restricting the rights of the minority shareholders, which can be regarded as a superficial substantive review approach. Following Section 246(a), courts are to substantially evaluate the damages caused to the company and the disadvantages of the shareholder, rather

197. *See* CAHN & DONALD, *supra* note 191, at 744.
198. *Id.*
199. *Id.*
200. *Id.* at 751. AktG § 246(a).
201. AktG § 246(a).

than to consider the decision-making process. While such an approach significantly alleviated the concern of prolonged lawsuits and hence reduced the procedural costs of the companies, it increased the costs of error—courts may allow a frivolous lawsuit without merit to proceed to a further stage or allow a legitimate challenge to be blocked. It may thus either over-protect or under-protect minority shareholders. Germany has largely failed to vary the litigation costs based on the presence or absence of MoM approval.[202] As a result, courts are likely to bear a significant burden of reviewing corporate decisions, while the majority shareholder lacks incentives to seek the approval from a majority of the minority shareholders.

German law on the appraisal rights of shareholders also faces a similar problem. When a corporation enters into a merger transaction, German courts will appoint an independent auditor to evaluate the fairness of the transaction.[203] Shareholders of an acquired corporation have the right to appraisal proceedings if the consideration is insufficient.[204] A recent study shows, however, that courts often face difficulty in appraisal proceedings because of the inherent problems of valuation.[205] In addition, courts cannot award a compensation lower than the merger price, rendering the appraisal right an "option" for minority shareholders—the minority shareholders thus have nothing to lose and are incentivized to always initiate the appraisal proceedings.[206] Scholars have already proposed that German courts should learn from the Delaware courts and focus their inquiry more on the decision-making process of the merger to alleviate the concern of uncertainty in valuation.[207]

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202. *See* Conac et al., *supra* note 189, at 501. For a detailed discussion of how German courts adjudicate similar disputes, *See* David Cabrelli, *Shareholders' Rights and Litigation*, *in* COMPARATIVE COMPANY LAW: A CASE-BASED APPROACH 401–03 (Mathias Siems & David Cabrelli 2d ed. 2018) (discussing how German law deals with a related-party transaction).

203. Krebs, *supra* note 25, at 957.

204. Andreas Engert, *How (not) to Administer a Liability Rule—The German Appraisal Procedure for Corporate Restructurings* 5 (Freie Universität Empirical Legal Stud., Working Paper No. 6, 2020), https://www.jura.fu-berlin.de/en/forschung/fuels/Output/Working-Papers/FUELS_WP-How-not-to-administer-a-liability-rule-2020.pdf.

205. *Id.* at 7.

206. *Id.*

207. Scholars have also proposed shifting the court's inquiry to the process. *Id.* at 13 ("Putting greater weight on a fair bargaining process in corporate

2. *United Kingdom*

The UK can be viewed as having adopted a similar approach of structured pliability rules to protect minority shareholders. The dominant form of ownership structure of corporations in the UK is dispersed ownership.[208] However, if a corporation engages in a transaction that harms the interests of a minority shareholder, the minority shareholder may receive similar protection. Under the 2006 Companies Act of the UK, directors bear fiduciary duties towards the corporation.[209] If the corporation enters a transaction that harms its interests, minority shareholders may bring a derivative action to seek damages.[210] The minority shareholders must first seek leave of the court. In deciding whether to grant leave, the court would consider whether the corporation has ratified the alleged breach with a vote of the disinterested members. The UK courts' approach thus would also take into account the consent of the disinterested shareholders in adjudicating corporate disputes.[211]

Under the UK's approach, if a majority of shareholders would like to initiate a transaction that may harm the minority's interest, the courts may substantively review the fairness of the decision.[212] However, the court would refrain from reviewing if the decision has been approved by the disinterested shareholders.[213] The UK courts thus can also be regarded as using a structured decision-making process that take into account the MoM approval in its judicial review. This approach alleviates the concern of the courts' lack of information and can, to a significant degree, enhance the legitimacy and the fairness of the decision. While current studies have emphasized the superiority of corporate laws in common law jurisdictions over those in civil law jurisdictions,[214] they have largely focused on

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restructurings could be a promising strategy for the German appraisal procedure as well.").

208. Armour et al., *supra* note 187, at 29.

209. Companies Act 2006,§172 (UK).

210. *Id.* at §260.

211. *Id.* at §239(4).

212. *See* David Cabrelli, *Shareholders' Rights and Litigation*, *in* COMPARATIVE COMPANY LAW: A CASE-BASED APPROACH 378–85 (Mathias Siems & David Cabrelli 2d ed. 2018).

213. *Id.* at 291(explaining that the votes of the interested shareholders would be ignored for the purpose of the vote on ratification and that if the corporate decision is ratified by the rest of the shareholders, the court would not permit the lawsuit to proceed further).

214. *See, e.g.*, La Porta et al., *supra* note 3.

the substantive rights of the shareholders and have ignored the judicial decision-making methods adopted by courts in different jurisdictions, which, this article argues, play a crucial role in minority shareholder protection.

III.
Structured Decision-Making under Constitutional Law on Takings

Structured pliability rules transcend the boundaries of corporate law and find relevance in diverse contexts characterized by majority-minority conflicts. This section delves into the realm of constitutional law. While most constitutional rights are not tradable and are thus different from the rights of shareholders, a specific set of constitutional laws—the law on takings—deals with the protection of minority property rights against majority expropriation.[215] The use of governmental taking power is an intrusion on the property rights of certain minority members of the state, which generates a conflict between the majority and the minority members of a state. For instance, when a government seeks to build a public highway and needs to expropriate private lands, the property holders can be viewed as minority members of the state, whose interests are adversely affected, while the expropriation benefits the majority of the members of the society. Since property rights can be expropriated by governments based on collective decisions, they can also be viewed as collective rights similar to those of shares owned by shareholders. How judges should review these collective decisions can thus be analyzed under the theory offered in this article.

215. Law and economics scholars have long sought to identify the common structures underlying different bodies of common law and develop unified theories that can explain them. Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 Cal. L. Rev. 1, 43 (1985) ("Economic theory is unified because its theorems are derived from its axioms. Consequently, the Economic Analysis of Law must be capable of being unified insofar as it is an application of economic theory."). There are, however, insufficient studies about unity in corporate and constitutional law. *See, e.g.*, Anupam Chander, *Minorities, Shareholder and Otherwise*, 113 Yale L.J. 119 (2003). One could, of course, provide a list of differences between the two bodies of law. This article, however, seeks to develop a theory that reveals their similar structures, which may yield important implications and further insights.

A. *Property Rules, Liability Rules, and the Case of Eminent Domain*

Like corporate law, the law on takings, i.e., the process of a government taking private land for public use, must resolve majority-minority conflicts; in the takings context, the minority is one property holder or a small group of property holders.[216]

The theory of property rules and liability rules can be applied to analyze the protection of private property in the takings context.[217] Under property rules protection, a government can only purchase property rights necessary for public use through voluntary exchange. The transaction costs would then be very high due to the "rent-seeking" problem—certain property holders might hold out on the decision in order to seek additional personal gain.[218] If the public project involves the assembly of many pieces of property, each property holder will have a veto right. For example, in *Kelo v. City of New London* (hereinafter referred to as "*Kelo*"), the city government intended to expropriate private lands for a development plan to potentially revitalize the local economy.[219] However, for the development plan to work, it was necessary to assemble all of the property rights in the area. In that scenario, no single property holder would bear the full cost of a delay of the development project. Therefore, they may have had an incentive to veto the decision even though the decision would benefit the community as a whole simply to bargain for more personal gain, leading to the problem of "anticommons" and the underuse of properties.[220]

Liability rules allow governments to coerce property holders into transferring the titles to their properties to the governments, while courts are to ensure that the property holders

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216. Some scholars have noted the similarities between constitutional and corporate law. *See* Heller & Hills, *supra* note 36, at 1522 ("Like the controlling shareholder, the landowner(s) within a LAD who control a majority of the property (measured by valuation, square footage, etc.) can force the owners of a minority share of the land to sell their interest against their will. In either case, the controlling shareholder or landowner effectively has a power of private eminent domain.").

217. Some scholars treat the use of eminent domain power as a constitutional liability rule or "pliability rule." Bell & Parchomovsky, *supra* note 23, at 25-26.

218. Merrill, *supra* note 22, at 76.

219. Kelo v. City of New London, 545 U.S. 469 (2005).

220. Heller & Hills, *supra* note 36.

receive just compensation. The major challenge under liability rules, however, is that given a lack of information, courts may either overcompensate or undercompensate property holders.[221]

B. *Structured Pliability and the Land Assembly District Proposal*

Currently, the Constitution of the United States can be viewed as offering a combination of property rules and liability rules protection to the property owners in the context of the taking of lands. The Fifth Amendment imposes two major constraints on the use of eminent domain: public use and just compensation.[222] Public use has long been considered an ambiguous term; different legal scholars and courts have offered various theories about the meaning of "public use."[223] Some argue that governments can only expropriate private property rights to provide public goods that are nonexcludable and nonrivalrous.[224] Such a view, however, is inconsistent with the existing case law.[225] In practice, courts have adopted a broad

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221. For example, some scholars argue that the government should pay 150% of the condemned property's opportunity costs. RICHARD A. EPSTEIN, TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN 175 (1985) ("The 50 percent figure may not be perfect, but it is far from arbitrary: perhaps a 25 percent premium is better, or perhaps 75 percent. But in these circumstances, one should not demand perfect precision because there is no way to provide it."). However, such an approach would render the compensation predictable, and all property owners would bargain for the 150% premium even if their subjective value is actually less.

222. U.S. CONST. amend. V ("[N]or shall private property be taken for public use, without just compensation.").

223. DAVID A. DANA & THOMAS W. MERRILL, PROPERTY: TAKINGS 191 (2002). *See* Merrill, *supra* note 22, at 72-74; Heller & Hills, *supra* note 36, at 1485 ("Much of the literature surrounding eminent domain revolves around whether courts should more aggressively control condemnations by barring condemnations that do not (in the judge's opinion) serve a "public use."). The Kelo case is a famous case that shows that the definition of public use remains heavily contested. *Kelo*, 545 U.S. 469. *See also* Hawaii Hous. Auth. v. Midkiff, 467 U.S. 229, 241 (1984) (holding that state may not take property only for another's private use, but may take the property if it is "rationally related to a conceivable public purpose"); Berman v. Parker, 348 U.S. 26, 33-35 (1954).

224. EPSTEIN, *supra* note 221, at 166.

225. *Kelo*, 545 U.S. 469. *See also Berman*, 348 U.S. 26.

interpretation of the meaning of public use and tend to defer to political decisionmakers.[226]

While the Fifth Amendment appears to have taken a liability rule approach—guaranteeing fair compensation but allowing the government to expropriate private lands, studies have shown that in practice, courts impose significant costs on the government in exercising the eminent domain power,[227] which thus incentivizes the government to first use voluntary exchange to obtain the property rights. Governments need to obtain legislative authority and go through burdensome litigation procedures, including drafting, filing, and engaging in trials. It is only when property owners hold up decisions and transaction costs become too high that governments turn to the use of their eminent domain power.[228] Interpreted in this way, the Fifth Amendment provides property rule protection for owners of property rights when there is a thick market; it offers governments the liability rule option in thin markets where owners hold out on decisions.[229] It thus encourages governments to transact with property owners and deter opportunistic actions.

However, the current approach still suffers from certain problems, especially in the context of land assembly because when the government is to collect several parcels of lands to form an assembly, it almost always faces a thin market.[230] To illustrate, suppose the government is to renew a neighborhood by building a shopping mall and the surrounding facilities such as roads and parking lots. The project requires the assembly of ten parcels of land that belong to ten different owners. The collective value of the project is estimated to be 5 million, while

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226. Merrill, *supra* note 22; Heller & Hills, *supra* note 36, at 1485.

227. *See generally* Merrill, *supra* note 22.

228. Thomas Merrill argues that judicial review can impose a procedural "due process tax" on governments, which encourages governments to use the market mechanism. *See* Merrill, *supra* note 22, at 81, 90 ("[C]ourts, in setting the limits of eminent domain, should ensure that just compensation is paid and enforce the due process 'tax'—the legislative and constitutional requirements that push the assessment costs of eminent domain above the costs of market exchange in thick market settings. . . . It would simply make market exchange the medium of choice, and eminent domain a method of last resort.").

229. *See* Merrill, *supra* note 22, at 78 ("Legislatures, agencies, and private parties will rely upon eminent domain only when such reliance is efficient, that is when market exchange would consume more resources.").

230. *See* Merrill, *supra* note 22, at 81-82.

each parcel may be worth only 0.3 million. Suppose the government has obtained the consent of nine owners, but one of the owners who holds the land on which the parking lot is to be built refuses to transact with the government. The owner has incentives to hold up because she knows that she is able to veto a 5 million project, even though her land is only worth 0.3 million. Since each owner has an incentive to hold out to obtain a higher surplus, the project may fail if they could not successfully reach an agreement. It seems that liability rules would be necessary in this context.

Meanwhile, liability rules also face significant difficulties because the courts lack information on the value of the property rights. The determination of just compensation is frequently a major issue of the taking dispute.[231] A landowner may claim that he or she attaches a higher subjective value to his or her land, which is difficult for a court to evaluate. Given the lack of information about the subjective value of the land, the court may choose to offer compensation based on the objective value. By doing so, however, it probably undercompensates the property owner because most people attach a higher subjective value to their houses, which is evidenced by the assumption that they would have sold their property rights if they believed the subjective value of the houses to be below market value.[232]

This article suggests that courts should offer structured pliability rules protection rather than liability rules protection to property owners in the land assembly context. When the state is to assemble multiple parcels of lands for a project that enhances their collective value, the problem is similar to a corporate freeze-out merger. The owners of the lands to be taken by the government are like the minority shareholders who are forced to sell their shares in a freeze-out merger. The government is like the majority shareholders of a corporation who represents the interests of a majority of the members of the society. The problems facing the court in both cases are similar.

Courts can consider adopting structured decision-making methods, changing the standards of review or shifting the burden of proof in these cases to offer different types of review

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231. *See* Thomas W. Merrill, *Incomplete Compensation for Takings*, 11 N.Y.U. Env't. L.J. 110, 117 (2002).

232. Those property owners who refuse to sell probably attach subjective value to the houses that is above the market price.

based on the rate of approval of the property owners. In practice, the taking of private property often involves many different property rights. In *Kelo*, for example, the government needed to expropriate approximately 114 pieces of private property and 32 acres of land to be used for different purposes, including a waterfront conference hotel, a pedestrian "Riverwalk," a new U.S. Coast Guard Museum, and research and development office space.[233] Courts can take into account the approval rate of all of the affected property holders in each case in order to determine whether the government has provided just compensation to them. While courts have not considered this factor under the current law on takings, some scholars have proposed incorporating a majority rule in eminent domain cases called the "land assembly districts" (LADs).[234] This Section first considers the current proposal and argues that there are important drawbacks in LADs, which can be addressed with structured pliability rules.

1. *The Current Proposal of Land Assembly Districts*

The LADs are proposed by Michael Heller and Rick Hills.[235] They recognize that when a state is to expropriate and assemble parcels of land for a certain project, each landowner has an incentive to hold out to obtain greater compensation for his or her land. Private voluntary contracting thus may lead to underassembly due to high transaction costs.[236] Similarly, conventional eminent domain encounters difficulty in the valuation of property rights.[237] Thus, Heller and Hills propose that landowners should form a collective organization in which they collectively decide whether to sell the assembly of property rights in a neighborhood to a developer or a government.[238]

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233. *Kelo*, 545 U.S. at 474.

234. *See* Heller & Hills, *supra* note 36, at 1469 ("[P]ersons who hold a legal interest in a neighborhood's land should collectively decide whether the land ought to be assembled into a larger parcel.") (emphasis omitted).

235. *Id.* Some have proposed to establish similar institutions in other jurisdictions. *See, e.g.*, James Si Zeng, *Establishing Land Assembly Districts: A Proposal to Chinese Law on Rural Land Takings*, 10 FRONTIERS L. CHINA 690 (2015).

236. Heller & Hills, *supra* note 36, at 1468.

237. *Id.* ("Failure to pay landowners the true value of land assembly can cause (1) the government to ignore those costs, leading to inefficient overassembly, or (2) the private landowner to fight land assembly too vociferously, leading to wasteful underassembly.") (emphasis omitted).

238. *Id.*

The LAD proposal essentially uses a majority or a supermajority vote to determine the level of compensation owed to right-holders,[239] which is essentially similar to a majority-of-the-minority approval of a freeze-out merger in a corporation.[240] It incorporates the opinions of right-holders in similar situations to determine whether a decision is fair to the minority. In doing so, it introduces a weak form of property rule protection. The majority of the property holders in a LAD do not have any conflicts of interest in deciding to sell the property rights collectively held by the LAD to the government. Their decisions are more likely to represent, at least to some extent, the interests of all the property holders than a single property holder. If the property holders in similar positions indicate their consent to the government's offer of purchasing the property, there is a higher likelihood that the compensation level is just and the dissenters are merely holding up the decision for further gains since the compensation accepted by the majority of the LAD's members likely reaches a reasonable level of subjective valuation.[241]

The LAD proposal builds on the assumption that the interests of property holders within a neighborhood are fairly homogeneous.[242] LAD members may still have heterogeneous interests—for instance, some members may have higher sentimental values attached to their property, while others may be in need of cash and are more inclined to reach a deal with the government. The theory of LAD posits that all LAD members share the same goal of maximizing the price at which to sell their properties.[243] In addition, if a court is worried that some owners of tangible property rights may attach higher subjective values to their properties than owners of shares of stocks and that the interests of the property holders in a LAD are not

239. For the sake of simplicity, I assume the voting rights of LAD members are fairly allocated based on the value of their property rights.

240. Heller & Hills, *supra* note 36, at 1521 (recognizing that "[t]he problem of corporate 'freezeouts' provides one of the closer analogies to LADs.").

241. *Id.* at 1498 ("The compensation offered by the LAD would presumably reflect the median neighbor's subjective value of his or her land, weighted by the landowner's proportional share of the land. Such a figure would be at least as great as the fair market value of each parcel, but it might be lower than the subjective valuation that an individual landowner places on his or her land.").

242. *Id.* at 1500.

243. *Id.* at 1503 (stating that "LAD's narrow agenda is focused exclusively on maximizing the sale price of a neighborhood.").

homogeneous, the court can require a higher approval rate (for example, 95%) to determine that compensation is fair.[244]

Moreover, a LAD can be expected to bring greater gains to property holders. When fragmented property rights are pooled together, they can be used for larger projects, generating "assembly value."[245] LADs enable their members to bargain for a share of the assembly value and not just the value of individual properties.

In addition, LADs enable the majority of property holders to bargain for the subjective values they attach to their property rights, which is arguably superior to the current approach. Currently, it is recognized that governments should pay more compensation in taking some properties, such as houses that have been owned by their property holders for a long time, because the property holders may attach higher sentimental value to them.[246] While it is possible for courts to award compensation in an amount higher than the market value, such an approach may give rise to overcompensation and prevent the taking of property for socially-desirable projects. To illustrate, suppose that a state sets the compensation level at 150% of the market value. This will effectively deter a government from expropriating properties for economic development plans that would increase the value of the properties by 40%. Thus, the main problem is not undercompensation but a lack of institutions that can effectively help courts measure subjective value.[247]

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244. Some may consider the LAD proposal to be in violation of the basic concept of property. As Charles Reich put it, "[p]roperty draws a circle around the activities of each private individual or organization. Within that circle, the owner has a greater degree of freedom than without. . . . [B]y creating zones within which the majority has to yield to the owner[,] [w]him, caprice, irrationality and 'antisocial' activities are given the protection of law." Charles A. Reich, *The New Property*, 73 YALE L.J. 733, 771 (1964). However, property rights in modern states are often subject to certain limitations such as the eminent domain power. The LADs merely replace the eminent domain power when voluntary exchange of property rights between the government and the property holders is blocked by the fragmentation of property rights. Heller & Hills, *supra* note 36, at 1492. The court is also to protect the property rights of each individual member of the LAD against the tyranny of the majority.

245. *Id.* at 1470.

246. Janice Nadler & Shari Seidman Diamond, *Eminent Domain and the Psychology of Property Rights: Proposed Use, Subjective Attachment, and Taker Identity*, 5 J. EMPIRICAL LEGAL STUD. 713, 715 (2008).

247. *See* Heller & Hills, *supra* note 36, at 1487 ("We need institutions that will encourage the parties themselves—condemnees and condemnors—to

While the LAD proposal may partially address the problem of determining the compensation for subjective value in eminent domain cases, it still faces certain challenges. A major problem is the tyranny of the majority within LADs. Different right-holders may have different subjective valuations of their properties. Hence, the consent of the majority of the right-holders in a neighborhood does not necessarily indicate that the decision is fair to the other rightsholders. It is quite possible that a majority of the neighborhood will unite to make a decision that harms the interests of the dissenting members.[248]

To address this problem, Heller and Hills have designed a right to "opt out" of LADs.[249] Under the proposal, property holders can decide to "opt out" of a LAD and to seek just compensation from a court if they are not satisfied with their LAD's decision.[250] This ensures that landowners receive "no less than the constitutional measure of just compensation,"[251] which can be viewed as offering liability rule protection to the members who disagree with the LAD majority decisions.

This solution, however, faces the same valuation challenge—it remains unclear how courts should evaluate the fair market value of the rights of opt-out holders and how courts can take into account majority approval in their determination of just compensation. Heller and Hills argue that few members would choose to opt out because of litigation costs.[252] However, it is also possible that litigation would impose significant costs on the government and other LAD members if the properties held by the dissenting minority in a particular case are crucial

reveal how much they value the rival uses of fragmented neighborhoods or assembled land.").

248. *Id.* at 1499 ("[T]he courts fear that a majority of neighbors will unite around the goal of restricting a nearby parcel's uses and thereby enhance the value of the neighbors' own land at the burdened parcel owner's expense.").

249. *Id.* at 1496.

250. *Id.* ("The final aspect of LADs is the right of any individual landowner to opt out of the proposal even if that proposal is approved by whatever type of majority vote the LAD statute requires. In such a case, the dissenting landowner would have the right to insist that his or her parcel be purchased through ordinary eminent domain procedures.").

251. *Id.* at 1497.

252. *Id.* ("[T]here would be few opt-outs because the contingency fee lawyers who litigate condemnation cases get paid only if they can improve on the LAD's initial offer.").

for the assembly value.[253] Take the *Kelo* case as an example. Suppose the holders of the properties affected by the development plan of the city of New London formed a LAD, which made a collective decision to sell the properties to the government. Kelo, however, decided to opt out and challenged the decision in court. If the court reviewed the governmental decision to purchase the land at a price agreed to by the LAD in the same way as it reviews a government taking of private land, the litigation process would impose significant costs on the government. The court could review whether the decision was for "public use." The judicial review would delay the process and affect the deal between the LAD and the government, given that Kelo's properties were part of the development plan. The right to opt out thus would destroy the purpose of having the LAD in the first place. The government might thus offer to pay the dissenting member a higher price. Expecting this, each member of the LAD would have an incentive to hold out on the decision even after the LAD collectively reached an agreement with the government if the collective decision was not binding. The government thus would lack the incentive to seek consent from the majority of the LAD members and might prefer to use directly its eminent domain power from the beginning and to defend its decision in court. [254]

The problem faced by LADs is essentially a problem of judicial decision-making. To promote the use of LADs and to encourage governments to seek consent from the MoM property holders, it is necessary for courts to offer some incentives to governments to obtain the LAD's consent.[255] The litigation costs imposed on governments should thus be alleviated to encourage a government in a particular case to try to obtain the consent of the majority of the property holders by offering a purchase price that is higher than the market price and partially compensates the property holders for their subjective valuations of their properties.

253. *Kelo*, 545 U.S. at 489, fn.24. (noting that some "argue to the contrary, urging that the need for eminent domain is especially great with regard to older, small cities like New London, where centuries of development have created an extreme overdivision of land and thus a real market impediment to land assembly.")

254. If, however, each member is bound by the LAD's decision, there might be a concern about the "tyranny of the majority" within the LAD.

255. Goshen, *supra* note 10, at 412 (explaining that "property-rule approach gives the minority more bargaining power.").

2. *Improving Land Assembly Districts with Structured Pliability Rules*

This article contends that the LAD proposal can be improved if courts more clearly incorporate the decisions made by the majority members of the LAD in judicial review. Courts can employ structured decision-making procedures to reduce the litigation costs of governments when they have obtained the support of a majority of a LAD. Specifically, courts can adjust the litigation costs of the parties in several ways.

First, if the majority of a LAD's members agree to the decision to sell the properties to the government, the court can develop a rule that bars the dissenting members of the LAD from challenging the government-set compensation level (which has been agreed to by the majority of the property owners in similar situations), similar to the business judgment rule unless the dissenting members can present evidence that strongly suggests that the negotiation process was coercive or otherwise not representative of the true will of the members.[256]

Second, the court can shift the burden of proof to the dissenters to show that despite the LAD's decision, the government's offering price is still below the fair value of the dissenters' property rights. This proposal is similar to that of the structure of corporate litigation in freeze-out mergers, where the majority shareholders can reduce the procedural costs imposed by judicial review by seeking the consent of a majority of the affected minority shareholders.[257] Moreover, it is possible to award dissenting members compensation lower than the deal price reached by the LAD and the government. As a result, the dissenting minority members of the LAD will be less inclined to hold out on the decision by suing because of the potential risk that they may receive compensation in an amount lower than the price agreed to by the LAD. Meanwhile, the government has a stronger incentive to reach an agreement with the LAD rather than using its eminent domain power to expropriate private

256. *MFW*, 67 A.3d at 502, 536.

257. To be sure, the dissenting minority's constitutional rights may be restricted under the proposed rules. I do not intend to discuss whether the proposed LAD mechanism would be constitutional. This article merely intends to show that structured decision-making may more effectively resolve the majority-minority conflict. Without structured decision-making or some rules that allow courts to alleviate the litigation costs of the government in taking cases, the LAD mechanism would likely face significant challenges.

properties because this increases their likelihood of winning. Compared with the first approach, the incentives offered in this approach are generally weaker since the government may still be dragged into a lawsuit that lasts for a long time.

Third, it is also possible for a court to reduce the costs imposed on the government by allowing the government to acquire the private property without any delay if the decision is supported by a majority of the LAD members and reviewing the fairness of the compensation afterwards, which is similar to the procedural design of appraisal actions. Currently, governments need to go through judicial proceedings if their use of eminent domain power is challenged, through which they incur significant costs.[258] In the famous *Kelo* case, for example, the local city council appointed the New London Development Corporation (NLDC) as its agent to develop a plan to revitalize New London.[259] The NLDC obtained most of the necessary properties through voluntary exchange, while a few property holders, including Kelo, refused to sell.[260] Kelo challenged the use of eminent domain power by claiming that the taking would violate the "public use" requirement, and the trial court granted a permanent restraining order prohibiting the taking of Kelo's properties, delaying the taking process for years.[261] If the transfer of properties had been approved by a majority of the LAD members in similar situations, the court might have considered allowing the transfer to be completed while reviewing whether the compensation offered to Kelo was fair. This approach would significantly alleviate the procedural costs imposed on governments and incentivize them to seek approval from LAD members.

To be sure, one may be concerned that such an approach would violate the takings clause in the Constitution since it essentially allows governments to bypass the requirement of public use. However, the Supreme Court of the United States already adopted a deferential attitude towards the element of

258. Merrill, *supra* note 22, at 77 ("Finally, both court-made and statutory law guarantee a person whose property is subject to condemnation some sort of hearing on the condemnation's legality and the amount of compensation due.").
259. *Kelo*, 545 U.S. at 475.
260. *Id.*
261. *Id.*, at 475.

public use in *Kelo* and a few other cases.[262] While it is possible that a dissenting member of a LAD may attach a higher subjective value to the property rights and hence demand higher compensation, allowing the member to delay the decision agreed to by the LAD members may frustrate the purpose of having LADs. If policymakers ever adopt LADs to help determine just compensation in the taking of private properties, a court should reduce the litigation costs imposed on a government if a LAD has agreed to sell an assembly of property rights to the government or its agents by a majority or a supermajority vote and if the negotiation process is fair.[263]

Thus far, the above discussion focuses on alleviating the litigation costs for governments. Legislatures and courts may also consider enhancing litigation costs for dissenting property holders in LADs by learning from the design of appraisal actions. For example, a dissenting property holder should not be allowed to receive a share of the payment made by the government to the LAD. As a result, the property holder needs to finance the litigation.[264] In addition, courts can make it clear that property holder may receive compensation in an amount lower than the price approved by their LAD.[265]

Under structured pliability rules, dissenting property holders would face a choice: they could either accept the government's offer and join their LAD's majority decision or litigate the case to its end. In the latter situation, the dissenters would have to show evidence in support of their claim of subjective value and bear the procedural costs as well as the uncertainty of the outcome.[266] Courts would then significantly raise the

262. *Id.*; Berman v. Parker, 348 U.S. 26 (1954); Haw. Hous. Auth. v. Midkiff, 467 U.S. 229 (2006).

263. Scholars have noted that "government officials frequently complain about the costs and delays of eminent domain." Merrill, *supra* note 22, at 80.

264. For the discussion of the procedural costs imposed on the dissenting members in appraisal actions, see ROBERT CHARLES CLARK, CORPORATE LAW 508 (1986); PETER V. LETSOU, CASES AND MATERIALS ON CORPORATE MERGERS AND ACQUISITIONS 429 (2006); Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 1005 (2006) (asserting that "[a]ppraisal litigation is complicated and expensive" and that "many shareholders find it difficult to meet the complicated procedural requirements and deadlines of the appraisal remedy").

265. Korsmo & Myers, *supra* note 119, at 865-66.

266. Heller and Hills also hinted that minority members in LADs may need to bear additional litigation costs if they choose to opt out, which incentivize them to agree to the LAD's decision. Heller & Hills, *supra* note 36, at 1497

litigation costs for dissenting property holders. Property holders would be less likely to opt out and resort to litigation unless they believed that their property had truly been undervalued. While the precise magnitude of the costs that the government and the property owners should bear is difficult to determine and falls outside the scope of this article, this article proposes that the approval rate of similarly situated property holders should at least be taken into account in setting these costs. This approach would be superior to the court applying the liability rules and assessing the value of the property directly.

C. *Responding to Potential Counterarguments*

The above analysis rests upon certain assumptions about the similarities between the behavior of business investors and governments. This section considers and defends against some potential counterarguments about the similarities between constitutional law and corporate law.

A major potential critique of the above analysis may be that legislatures and governments behave differently from majority shareholders. Theoretically, legislatures and executive governments do not pursue profits like shareholders. They thus may also consider the interests of the minority property holders in a state.[267] One may believe that while majority shareholders in corporations are free to initiate any merger transactions, governments may refrain from exercising their eminent domain power and only obtain legislative authority to pursue certain public goals.

("Nevertheless, we expect there would be few opt-outs because the contingency fee lawyers who litigate condemnation cases get paid only if they can improve on the LAD's initial offer."). This article further contends that for this mechanism to work, courts should adopt structured decision-making and employ standards to review the LAD's decision in order to impose a litigation "tax" on the minority, see *infra* Section III.B.2

267. *See generally* Matthew C. Stephenson, *The Price of Public Action: Constitutional Doctrine and the Judicial Manipulation of Legislative Enactment Costs*, 118 YALE L.J. 2 (2008) ("The deterrence rationale for a just compensation rule is therefore sensible only if we assume that the government is better informed than the court as to the consequences of the taking but gives insufficient relative weight to the interests of the property owners."). Some scholars argue that the majority also respects the minority rights, this question depends on empirical evidence. Jeremy Waldron, *The Core of the Case Against Judicial Review*, 115 YALE L.J. 1346, 1404 (2006).

While different scholars may have different views about the behavior of legislatures and governments, this critique does not affect the major conclusions of this article. Structured pliability rules address two important concerns in the protection of private properties—the difficulty in evaluating just compensation and the holdout problem. They do not aim to provide the right incentives for governments. If governments fail to internalize the costs imposed on property holders and act under a "fiscal illusion,"[268] structured pliability rules would incentivize the governments to seek consent from property holders to the greatest extent to reduce litigation costs. Structured pliability rules are thus superior to liability rules. If, on the other hand, governments act benevolently to expropriate private properties for public use, they still face the problems of evaluation and holdouts, and structured pliability rules may be employed to alleviate these problems.

Another potential challenge to the above analysis is that governments may not change their behavior even when heavier litigation costs are imposed by the court. This may be true because governments act as an agent of all members of a state and thus spend other people's money, or because governments do not pursue profits like shareholders and thus do not behave as rational actors.[269] For these reasons, even if courts impose

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268. DANA & MERRILL, *supra* note 223, at 41-46. BUCHANAN & TULLOCK, THE CALCULUS OF CONSENT 4 (1962) ("Political theorists, by contrast, do not seem to have considered fully the implications of individual differences for a theory of political decisions. Normally, the choice-making process has been conceived of as the means of arriving at some version of "truth" some rationalist absolute which remains to be discovered through reason or revelation, and which, once discovered, will attract all men to its support. The conceptions of rationalist democracy have been based on the assumption that individual conflicts of interest will, and should, vanish once the electorate becomes fully informed.").

269. *See* Daryl J. Levinson, *Making Government Pay: Markets, Politics, and the Allocation of Constitutional Costs*, 67 U. CHI. L. REV. 345, 345-48, 354-57 (2000) ("We cannot assume that government will internalize social costs just because it is forced to make a budgetary outlay. While imposing financial outflows on government will ultimately create political costs (and benefits), the mechanism is complicated and depends on the model of government behavior used to translate between market costs and benefits and political costs and benefits."); Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 568 (1986) ("Commentators assume that costs are discounted because they are not directly borne by the decisionmakers themselves. But neither are benefits. To the extent that both are discounted in roughly the same proportions, no bias should result."); Edward Rubin, *Rational States?*, 83 VA. L. REV. 1433, 1439-42 (1997) ("There is no such market in the political realm; thus, as

additional costs on the decision-making process, governments' behavior cannot be changed by adjusting litigation costs. The validity of this argument, of course, depends on empirical evidence about the particular government at stake and its behavior. Some scholars point out that many local governments are under strong budget constraints and thus would be cost-sensitive.[270] Under these circumstances, structured pliability rules will thus be more effective in promoting socially efficient outcomes.[271]

One may also raise the objection that property rights in land may be different from property rights in shares of corporations because citizens may attach higher subjective value to their lands while the interests of the shareholders are more homogeneous.[272] Thus, while the MoM shareholders generally make decisions to maximize the interests of minority shareholders as a whole, especially in United States-listed corporations,[273] a majority of LAD members may not represent the interests of all LAD members. To address this concern, courts should take into account the idiosyncratic value of land in a particular case and give less weight to the majority decisions made by the LAD than they do in corporate litigation. If a court finds that the structured decision-making goes too far, it could at least shift the burden of proof or slightly adjust the litigation costs of the parties through other relevant procedural rules.

Conclusion

Tyranny of the majority is a problem faced by both minority shareholders in a corporation and minority members of a state. Traditional law and economics theorists have identified property rule and liability rule protection for minority rights.[274]

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public choice suggests, there is no basis for simply ascribing rational behavior to political institutions.").

270. *See* Stephenson, *supra* note 267, at 29 ("While the federal government, as well as the governments of some states and large cities, may not be all that concerned about the amounts of public money that contemplated takings would require, many local governments are more financially constrained.").

271. Merrill, *supra* note 22, at 78 ("Legislatures, agencies, and private parties will rely upon eminent domain only when such reliance is efficient, that is when market exchange would consume more resources.").

272. Henry Hansmann, *Ownership of the Firm*, 4 J. L. Econ. & Org. 267, 302 (1988). ("[H]omogeneity of interest ... is evidently a significant factor in the widespread success of the modern investor-owned business corporation").

273. *Id.*

274. *See generally*, Guido Calabresi & A. Douglas Melamed, *supra* note 14.

This article proposes that courts can protect minority interests with structured pliability rules by adopting structured decision-making methods. Courts should encourage majority and minority members to reach agreements by taking into account the decision-making process in their judicial decisions. Courts can adopt different standards and rules to adjudicate the corporate dispute and shift the burden of proof to different parties to vary the litigation costs imposed on the parties. Given that courts generally lack information on the preferences of private parties and that both majority and minority members act as rational players, this incorporates the parties' consent in judicial review, which is superior to the liability rules approach. This theory has important policy implications for judicial review in appraisal actions and corporate litigation in other jurisdictions, highlighting the pivotal role played by judicial decision-making method in the United States in protecting minority shareholders, an aspect insufficiently emphasized in current literature.

Additionally, this article underscores the structural similarities between judicial review in corporate and constitutional law. The economic analysis of law has the potential to uncover shared structures underlying different areas of law.[275] While law and economics scholars have successfully explained private laws such as tort, property, and contract laws using unified economic theories,[276] there have been limited studies analyzing the common structures of corporate and constitutional law.[277] This article aims to demonstrate the analogous issues of minority protection in American constitutional law and American corporate law, suggesting that they share more in common than currently recognized. Such an approach brings new insights to existing theories in both domains.

275. Robert Cooter, *supra* note 215.
276. *Id.*
277. For a study on the similarities between corporate and constitutional law, see Chander, *supra* note 216.

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DECONSTRUCTING *TRINKO*

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Introduction

Recent monopolization cases against Google and Facebook brought by the Justice Department and the Federal Trade Commission signal that the United States is at the dawn of a new era of aggressive antitrust enforcement.[1] If those cases are to be harbingers of an antitrust renaissance, then antitrust enforcers must confront and successfully overcome the Supreme Court's 2004 decision in *Trinko*,[2] which has cast a long shadow over antitrust enforcement efforts in monopolization cases. In breathtakingly broad and provocative language that is decidedly unsympathetic to enforcement of §2 of the Sherman Act,[3] particularly in unilateral refusal to deal cases, and extends far beyond the facts of the case, *Trinko* has boldly re-written the antitrust narrative with respect to the monopolist and the offense of monopolization.

The once vilified monopolist has been re-cast as a key player in, and a necessary element of, the free market system,

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1. *See* Jonathan Kanter, Assistant Att'y Gen., U.S. Dep't Just., Antitrust Enforcement: The Road to Recovery, Keynote at the University of Chicago Stigler Center (Apr. 21, 2022) (transcript available at https://www.justice.gov/opa/speech/assistant-attorney-general-jonathan-kanter-delivers-keynote-university-chicago-stigler) ("the era of lax enforcement is over and the new era of vigorous and effective antitrust law enforcement has begun."); *See* David Lawrence, Policy Director, U.S. Dep't Just. Antitrust Div., Reemerging Areas of Common Ground, Keynote at Brigham Young University Law Conference (Oct. 21, 2022) (transcript available at https://www.justice.gov/opa/speech/antitrust-division-policy-director-david-lawrence-delivers-keynotebrigham-young) ("strong majority supports more aggressive and effective antitrust enforcement.").

2. Verizon Comm'ns Inc. v. Law Offices of Curtis V. Trinko, LLP., 540 U.S. 398 (2004).

3. 15 U.S.C. §2.

whose quest for short-term monopoly profits is what drives innovation and economic prosperity.[4] Accordingly, the monopolist's business decisions about firms with whom it will deal must be treated with deference by the courts, lest an ill-advised judicial intervention would thwart beneficially market behavior and possibly impair consumer welfare.[5] The Court went on to disparage well-accepted antitrust doctrines, such as leveraging,[6] which it had endorsed a decade earlier, and cast doubt on the continuing viability of the essential facilities doctrine.[7] Finally, the Court fashioned a minimalist enforcement agenda for the lower courts, stressing that the risks of false positives, error costs, administrative costs associated with increased antitrust filings, the inherent limitation on the abilities generalist judges to distinguish procompetitive from anticompetitive behavior, and the limitation on judicial tribunals to control certain market behavior, militated against antitrust intervention by the Courts.[8]

However, once you strip away the *Trinko* rhetoric and focus on what the Court actually *did*, as opposed to what it *said*, the opinion is quite narrow. The decision arose out of the unique set of factual circumstances in the technology-rich, ever-evolving telecommunications industry that is highly regulated and involves technologies and services that are not sold to the public. It was not a run-of-the-mill refusal to deal case and the court's application of antitrust principles to the highly regulated telecommunications field tells us little about how antitrust should apply to less regulated areas of the economy, such as digital markets. In addition, although *Trinko* did denigrate certain well-established antitrust doctrines, for all of its bluster, the Court did not overrule any cases, did not specify any legal tests for refusal to deal cases, and, indeed, recognized that under certain circumstances, a monopolist's refusal to deal with a rival can violate §2.[9] Viewed in this light, *Trinko*, while still a formidable hurdle for plaintiffs in monopolization cases, is not insurmountable. In short, *Trinko's* bark is far worse than

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4. *Trinko*, 540 U.S. at 407.
5. *Id.* at 407–08 (forced dealing "may lessen the incentive for the monopolist, the rival, or both to invest in…economically beneficial facilities").
6. *Id.* at 415.
7. *Id.* at 410–11 ("we have never recognized such a doctrine").
8. *Id.* at 411–16.
9. *Id.* at 408 ("however, '[t]he high value that we placed on the right to refuse to deal with other firm does not mean that the right is unqualified'").

its bite, and its invocation by defendants in a motion to dismiss does not sound the death knell to a monopolization claim.

This essay seeks to: (1) trace briefly the evolution of monopolization law; (2) delineate the precise holding of *Trinko*, separating holding from dicta and uncovering both what the court said and did not say – about antitrust liability for single firm conduct; (3) demonstrate that *Trinko* is a marked departure from prior case law with sweeping pronouncements about §2 that go far beyond the facts of the case; (4) dispel the myth that *Trinko* strikes that death knell for monopolization claims; and (5) highlight post-*Trinko* case law that provides a potential path to victory for plaintiffs in monopolization cases.

I. SECTION 2 OF THE SHERMAN ACT

Section 2 of the Sherman Act makes it unlawful for a person "to monopolize, attempt to monopolize, or combine or conspire with any other person or persons to monopolize any part of trade or commerce among the several states."[10] The statute does *not* condemn the mere status of monopoly; to be liable under §2, the monopolist must engage in anticompetitive *conduct* causing injury to competition.[11] Not surprisingly, the courts have had difficulty locating the line of demarcation separating lawful monopoly from unlawful monopolization.[12] To answer that question, the courts must ascertain precisely what Congress meant in enacting the anti-monopoly provisions of §2. The general wording of the statute provides little assistance. Section 2 appears to target conduct that is "'exclusionary' in nature, impairing rivals' opportunity to compete in a way that is inconsistent with competition on the merits."[13] Monopolization

10. 15 U.S.C. §2.

11. *Trinko*, 540 U.S. at 407.

12. *See* William E. Kovacic, *Designing Antitrust Remedies for Dominant Firm Misconduct*, 31 CONN. L. REV. 1285 (1999) ("Since that late nineteenth century when Canada and the United States began the first experiments with antitrust law courts, government officials and commentators have struggled to define when a firm has achieved or threatened to gain, substantial market power and to specify the difference between legitimate competitive behavior and wrongful methods of exclusion.").

13. Viamedia, Inc. v. Comcast Corp., 951 F. 3d 429, 452-53 (7th Cir. 2020).

may also be described as abuse of dominance[14] or bullying[15] behavior by the dominant firm. Still, given that the "means of illicit exclusion, like the means of legitimate competition, are myriad,"[16] the task of identifying single firm conduct that is anticompetitive has proven challenging for the courts. Indeed, one court has opined that "anticompetitive conduct comes in too many forms and shapes to permit a comprehensive taxonomy."[17] Precisely for that reason, "questions concerning the nature of behavior by a monopolist that violates Section 2 is one of the most uncertain areas of antitrust."[18] The standards have evolved over the time; but, even after some 135 years since the passage of the Sherman Act, those standards remain surprisingly underdeveloped.

A. *Evolution of Section 2 Standards*

1. *Alcoa*

Judge Learned Hand's opinion in *Alcoa*,[19] aptly demonstrates the difficulties that the courts have had in deciding whether to condemn the activities of a monopolist. Alcoa dominated virgin aluminum ingot with a 90% market share. The United States sued, alleging monopolization. Alcoa had some antitrust skeletons in its closet based on, among other things, admitted cartel participation that had terminated some 30 years prior to the government's enforcement action. In the intervening three decades, Alcoa continually expanded to meet the rising demand for aluminum but faced little competition from new entrants.

Hand began his opinion by condemning monopoly. He stated that "Congress did not condone 'good trusts' and

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14. Angelos Vlazakis & Angelik Varela, *Amazon's Antitrust Fair Play, A Transatlantic Evaluation*, 41 N. Ill. U. L. Rev. 64, 68 (2020) ("The rules on monopolization and abuse of dominance function almost identically.").

15. Richard M. Steuer, *The Simplicity of Antitrust Law*, 14 U. Pa. J. Bus. L. 543, 544 (2012).

16. United States v. Microsoft Corp., 253 F. 3d. 34, 58 (D.C. Cir. 2001) (en banc).

17. Novell, Inc. v. Microsoft Corp., 731 F. 3d 1064, 1072 (10th Cir. 2013).

18. Comment from Robert Pitofsky to the Antitrust Modernization Commission (Sept. 29, 2005) https://govinfo.library.unt.edu/amc/commission_hearings/pdf/Pitofsky.pdf.

19. United States v. Aluminum Co. of Am., 148 F. 2d 416 (2d Cir. 1945) [hereinafter *Alcoa*].

condemn 'bad ones'; it forbade all."[20] Further denigrating the monopolist, he describes monopoly as "narcotic" dulling competitive vigor, in contrast to rivalry, a "stimulant" to competition.[21] Later in the opinion, however, Hand switched gears and qualified his condemnation of monopoly *simpliciter*, noting that "the successful competitor, having been urged to compete, must not be turned on when he wins."[22] Hand further observed that a seller may not seek monopoly; rather, monopoly may have been "thrust upon" it as a result of (1) being a natural monopoly; (2) a change in taste or demand; or (3) "superior skill, foresight and business acumen."[23] Ultimately, the court held that Alcoa had violated §2, finding that its hegemony in aluminum had been achieved through repeated expansion that excluded rivals, and that its market dominance had not been thrust upon it.[24]

The *Alcoa* decision, especially with its "thrust upon" language was hardly definitive. Indeed, it raised more questions than it answered. A subsequent Second Circuit decision labeled *Alcoa* the "wishing well" opinion because readers could extract from it almost anything that they wished.[25]

2. *Grinnell*

Twenty years after *Alcoa*, the Supreme Court in *Grinnell*[26] articulated a more definitive test for monopolization. The Court held that the offense of monopolization has two elements: (1) monopoly power, i.e.; the power to control price or to exclude competition; and (2) "willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident."[27] In other words, *Grinnell* requires proof of size plus bad acts. Grinnell had grown dominant in the Central Station Protective Services ("CSPS") market through a series of restrictive agreements with its rivals. The Court concluded

20. *Id.* at 427.
21. *Id.* at 477.
22. *Id.* at 430.
23. *Id.* at 429–30.
24. *Id.* at 430–32.
25. Berkey Photo, Inc. v. Eastman Kodak Co., 603 F. 2d 263, 273 (2d. Cir. 1979).
26. United States v. Grinnell Corp., 384 U.S. 563 (1966).
27. *Id.* at 570–71.

that Grinnell had achieved its monopoly in CSPS, not through superior skill and business acumen, but rather by contracts in restraint of trade in violation of §1 of Sherman Act.[28] The Court held that monopoly power acquired through violations of §1 constituted unlawful monopolization, and upheld the decree below ordering Grinnell's dissolution.[29]

3. *Aspen*

Although *Grinnell* provided some measure of clarity to §2 analysis by specifying a conduct requirement in monopolization cases, it did not address the types of conduct by a lawful monopolist that would run afoul of §2. Some twenty years after *Grinnell*, the Supreme Court in the *Aspen*[30] case faced the question of whether a dominant seller's termination of a long-standing and profitable joint venture with a rival without economic justification constituted a unlawful refusal to deal.[31] *Aspen* involved two ski operators in Aspen, Colorado. Defendant operated three ski facilities and gained the lion's share of revenue from destination skiers; plaintiff operated only one facility. The two ski operators engaged on a joint venture that offered an all-Aspen ski pass, allowing skiers to buy one ticket and ski any mountain.[32] Defendant, over time, made greater and greater revenue demands on the plaintiff, to the point where defendant made plaintiff "an offer that [it] could not accept."[33] Defendant then, without any proffered business justifications, terminated the venture.[34] It thereafter rebuffed all attempts by the plaintiff to revive the venture, including its offer to pay full retail price for lift tickets at defendants mountains.[35]

The Supreme Court upheld the jury verdict for the plaintiff. In so ruling, the Court described the following facts: (1) the ongoing, voluntary and profitable nature of the venture; (2) its popularity with skiers; (3) the defendant's willingness to forsake short-term profits in order reap long-term monopoly profits;

28. *Id.* at 576.
29. *Id.* at 576–77.
30. Aspen Skiing Co. v. Aspen Highlands Ski Corp., 472 U.S. 585 (1985).
31. *Id.* at 587.
32. *Id.* at 589.
33. *Id.* at 592.
34. *Id.* at 593.
35. *Id.* at 593–94.

and (4) lack of any business justifications for the termination.[36] That said, the Court never suggested that any of these facts is a necessary element of a successful claim.

4. *Brooke Group*

In *Brooke Group*,[37] the Supreme Court addressed the question of whether price reductions by a dominant seller, causing a rival to lose sales, were predatory. The Court held that such price reductions did not run afoul of §2 of the Sherman Act unless plaintiff could prove that (a) defendant sold at prices below "an appropriate measure of its costs," and; (b) there was a dangerous probability that defendant would recoup its short-term losses by supra-competitive prices over the long term.[38] This objective, cost-based, standard simplified predatory pricing analysis and made clear that a monopolist could compete aggressively via price reductions, provided its prices were above its costs. *Brooke Group* also made the road to recovery in predatory pricing cases much more difficult for plaintiffs. On the other hand, the *Brooke Group* standard did not address predatory conduct that was not price-based.[39] The Court acknowledged that its legal test for predation was underinclusive but justified its stringent standard, noting that below cost pricing generally inures to the benefit of consumers and that various above-cost predatory schemes may be beyond the courts' practical ability to control.[40] As further justification, the Court observed that "predatory pricing schemes are rarely tried and even more rarely successful."[41]

5. *Kodak*

In *Eastman Kodak Co. v. Image Tech. Servs., Inc.*,[42] the Supreme Court, on defendant's summary judgment motion, upheld Plaintiff's monopolization claim on the theory of monopoly leveraging. Kodak manufactured high end copying machines;

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36. *Id.* at 605–10.
37. Brooke Grp. Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993).
38. *Id.* at 224.
39. *Id.* at 222 (the first element of a predatory pricing claim is proof that a defendant sold at prices that are below an appropriate measure of its costs.).
40. *Id.* at 223.
41. *Id.* at 226.
42. Eastman Kodak Co. v. Image Tech. Servs., Inc., 504 U.S. 451 (1992).

it also serviced those machines and sold spare parts to users. Kodak faced competition in machine maintenance from independent service organizations ("ISOs"), who generally provided maintenance services at prices lower than Kodak's. To increase its share of the services market, Kodak informed its customers that unless they purchased maintenance services from Kodak, or performed maintenance and repair on their machines themselves, Kodak would no longer supply them with spare parts for their copiers. Kodak customers then knuckled under these demands to the detriment of the ISOs. The ISOs sued Kodak alleging that Kodak was leveraging its market power in spare parts to drive ISOs from the field and thereby gain market power in maintenance services.[43] The Supreme Court agreed and held that "use of monopoly power 'to foreclosure competition, to gain a competitive advantage, or to destroy a competitor" constitutes a violation of §2.[44]

B. *Governing Standards Under §2*

With "time and a gathering body of experience, courts have been able to adapt this general inquiry to particular circumstances, developing considerably more specific rules for common forms of misconduct."[45] Courts have applied various legal tests in determining whether conduct violates §2. One approach is a multistep burden shifting/presumption analysis utilized by the D.C. Circuit in *Microsoft*.[46] Here, the plaintiff bears the initial burden of proving anticompetitive behavior.[47] The burden then shifts to the defendant to justify that behavior by establishing its procompetitive benefits.[48] Failure to do so results in judgment for the plaintiff.[49] If the defendant proves a valid procompetitive justification the burden shifts back to the plaintiff to prove that on balance anticompetitive effects outweigh procompetitive benefits.[50] This test is useful in that it can be applied to all forms of anticompetitive behavior. Its

43. *Id.* at 482–83.
44. *Id.* at 482–83.
45. *Novell*, 731 F. 3d at 1072.
46. *Microsoft*, 253 F. 3d at 64–67.
47. *Id.* at 59.
48. *Id.* at 59.
49. *Id.* at 72.
50. *Id.* at 67.

downside is that it forces that Court to engage in balancing, which by its very nature is inexact and potentially arbitrary.

A second test is the profit sacrifice test.[51] The question here is whether the defendant sacrificed short-term profits in return for long-term monopoly rents. This test works well in price-based anticompetitive schemes, such as predatory pricing. However, the test is a bad fit for non-price predation schemes.[52]

A third test is the "no economic sense test."[53] The question here is whether the conduct is irrational but for the anticompetitive effects that it achieves.[54] Thus, if the only reason for pursing a course of conduct is to gain monopoly rents, the conduct would be illegal. However, if the conduct creates efficiencies, then it makes economic sense and would be lawful. The problem with this test is that it shifts the Courts' attention away from defendant's *conduct*—the focus of the § 2 inquiry—and onto the efficiencies that conduct has allegedly generated.[55]

Courts have also identified common forms of misconduct, including (1) predatory pricing;[56] (2) exclusive dealing;[57] (3) refusals to deal;[58] (4) tying;[59] (5) monopolistic leveraging;[60] (6) fraud on the Patent Office;[61] (7) predatory innovation;[62] and (8) bundled discounts or rebates.[63] These § 2 violations have no fixed boundaries and, indeed, may be susceptible to more than one category of court-defined anticompetitive conduct. For example, conduct that is "characterized as exclusive dealing could also be described as tying" because "[t]he economic

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51. *See* Andrew I. Gavil, *Exclusionary Distribution Strategies by Dominant Firms: Striking a Better Balance*, 72 ANTITRUST L.J. 3, 55 (2004).

52. *See* Edward D. Cavanagh, *Trinko: A Kinder, Gentler Approach to Dominant Firms Under the Antitrust Laws?*, 59 ME. L. REV. 111, 122 (2007).

53. *Viamedia*, 951 F.3d at 461; *see* Gregory J. Werden, *Identifying Exclusionary Conduct Under Section 2: The "No Economic Sense" Test*, 73 ANTITRUST L.J. 413, 422 (2006).

54. *Comcast*, 951 F. 3d at 461.

55. *See* Andrew I. Gavil, *supra* note 51 at 5, 23.

56. *Brooke Grp.*, 509 U.S. at 226.

57. United States v. Dentsply Int'l Inc., 399 F.3d 181, 187 (3d Cir. 2005).

58. *Aspen*, 472 U.S. at 604-05.

59. *Microsoft*, 253 F.3d at 84.

60. *Image Tech. Serv.*, 504 U.S. at 482-83.

61. Walker Process Equip. Corp. v. Food Mach. & Chem. Corp., 382 U.S. 172, 179 (1965).

62. C.R. Bard, Inc. v. M3 Sys., Inc., 157 F. 3d 1340, 1346 (Fed. Cir. 1998).

63. LePage's Inc. v. 3M, 324 F.3d 141, 157 (3d Cir. 2003).

distinction between the two is most often slight or nil."[64] The existence of overlap should not deflect the court's attention from the goal of the antitrust inquiry and that is whether the conduct at issue harms the competitive process and thereby harms consumers. As the court in *Comcast* stated: "At bottom, the purpose of identifying these classes of [anticompetitive] conduct is to help determine 'the presence or absence of harmful effects, which are both the reason for any antitrust concern and often the simplest element to disprove.'"[65]

Courts have, in addition, identified conduct that poses no or minimal antitrust risk to the public. Thus, the monopolist is free to compete aggressively on the merits and need not operate in the marketplace with one hand tied behind its back.[66] A monopolist is free to innovate and to improve or to update the design of its products.[67] A monopolist may lawfully introduce multiple products simultaneously and thereby take advantage of its status as an integrated producer.[68] A monopolist may also offer price reductions on its products in order to increase market share.[69] Nor does monopolist have an obligation to lend a helping hand to rivals by, for example, pre-disclosing new products or technologies[70] or sharing its intellectual property.[71] It need not to deal with customers on terms which the customers deem most favorable,[72] nor is it required to, conduct its operations using the least restrictive alternative.[73] Under *Colgate*, "[i]n the absence of any purpose to create or maintain a monopoly," a monopolist is free to exercise its independent

64. *Viamedia*, 951 F.3d at 453 (citing Phillip E. Areeda & Herbert Hovenkamp, Antitrust Law ¶ 1800b (5th ed. 2022) [hereinafter, "Areeda & Hovenkamp"]).

65. *Comcast*, 951 F. 3d at 453 (citing Areeda & Hovenkamp ¶ 1701d).

66. *Berkey*, 603 F.2d at 275 ("The mere possession of monopoly power does not *ipso facto* condemn a market participant.").

67. *Id.* at 281.

68. *Id.* at 283.

69. Olympia Equip. Leasing Co. v. Western Union Tel. Co., 797 F.2d 370, 374-75 (7th Cir. 1986).

70. *Berkey*, 603 F.2d at 282.

71. *In re* Indep. Serv. Orgs. Antitrust Litig., 203 F.3d 1322, 1325 (Fed. Cir. 2000).

72. Pac. Bell Tel. Co. v. linkLine Commc'ns, Inc., 555 U.S. 438, 450-51 (2009) ("a firm with no duty to deal in the wholesale market has no obligation to deal under terms and conditions favorable to its competitors").

73. *Trinko*, 540 U.S. at 415-16.

judgment regarding the parties with whom it will deal or not deal.[74]

One significant exception to the *Colgate* rule is to so-called essential facilities doctrine under which a monopolist is required to deal with a competitor where: (1) the monopolist controls an essential facility; (2) the competitor cannot reasonably duplicate the essential facility; (3) without access the competitor cannot compete; and (4) it is feasible for the monopolist to provide access.[75] As more fully discussed below,[76] even though the essential facilities doctrine is well-established at the circuit level, the Supreme Court has never endorsed it as a basis for liability under § 2.[77] Indeed, in *Trinko*, the Justice Scalia went out of his way to kick dirt on the doctrine.[78] The essential facilities doctrine, if it does exist, is clearly an exception to the general rule that businesses are free to choose their customers.

Refusal to deal cases raising the essential facilities doctrine are rare. The more common and more difficult question is whether a monopolist's refusal to deal with a rival is pursuant to a purpose to create or maintain a monopoly. The Supreme Court has recognized that a seller's right to refuse to deal with other firms is not unqualified.[79] In *Aspen*, discussed above,[80] the Court held that a dominant firm's withdrawal from an ongoing and profitable joint market arrangement with (smaller) rival ski operator was unlawfully exclusionary in violation of § 2 where the withdrawal effectuated a significant change in the market and where the monopolist failed to offer a valid business justification for its conduct.[81] The Court noted that the defendant terminated the joint marketing arrangement even though that arrangement was popular with its customers and even though

74. United States v. Colgate & Co., 250 U.S. 300, 307 (1919).

75. *See* MCI Commc'ns Corp. v. AT&T Co., 708 F.2d 1081, 1132-33 (7th Cir. 1983).

76. *See infra*, notes 141-43 and accompanying text.

77. *Cf.* Unites States v. Terminal R.R. Ass'n, 224 U.S. 383, 397, 405 (1912) (upholding liability under §1 as a group boycott where essential facility was jointly owned).

78. *Trinko*, 540 U.S. at 411 ("We have never recognized such a doctrine.")

79. *Id.* at 408 ("The high value that we have placed on the right to refuse to deal with other firms does not mean that the right is unqualified.") (citation omitted).

80. *See supra* notes 31-36 and accompanying text.

81. *Aspen*, 472 U.S. at 604, 608-11.

plaintiff is willing to compensate defendant at full retail prices in order to keep the joint marketing arrangement alive.[82] The Court found that "the evidence supports an inference that [defendant] was not motivated by efficiency concerns and that it was willing to sacrifice short-run benefits and consumer good will in exchange for a perceived long-run impact on its smaller rival."[83]

II.
Trinko

A. *Background*

In 2004, the Court revisited *Aspen* in the *Trinko* case. As a threshold matter, it is important to understand the factual context in which *Trinko* arose. Under the 1984 Consent Decree that resolved the decades-long monopolization action by the United Stated against AT&T, AT&T agreed to exit the local telephone market.[84] The Decree established seven Regional Bell Operating companies that would provide local telephone services.[85] These seven companies, later reduced to four through mergers, were regulated monopolies that had exclusive rights to provide local telephone service in their designated areas.[86] Twelve years later, Congress enacted the Telecommunications Act of 1996 ("TCA") which opened local phone service markets to competition.[87] The TCA required these local service providers, referred to as Incumbent Local Exchange Carriers ("ILECs") by the Court in *Trinko*, to allow newly entering rivals, referred to as Competitive Local Exchange Carriers ("CLECs"), to interconnect with their equipment so that new entrants could effectively compete with the ILECs in local phone service.[88] The TCA provided for regulatory oversight by the Federal Communication Commission ("FCC") which included, inter alia, fines for non-compliance.[89]

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82. *Id.* at 593–94, 605.
83. *Id.* at 610–11.
84. Bell Atl. Corp. v. Twombly, 550 U.S. 544, 549 (2007).
85. *Id.* at 550 n.1.
86. *Id.* at 549, 550 n.1.
87. *Trinko*, 540 U.S. at 401; 47 U.S.C. § 251(c) (2000).
88. *Trinko*, 540 U.S. at 402; *Twombly*, 550 U.S. at 549.
89. *Id.* at 403–04.

The Law Firm of Curtis v. Trinko contracted with AT&T (a CLEC newly entering into local phone service in New York per the TCA) to provide local phone service.[90] AT&T sought to interconnect with Verizon, but Verizon was slow in filling AT&T's orders as well as orders from other CLECs.[91] Verizon's obstinacy did not escape the eyes of state and federal regulators; Verizon agreed to pay a fine of $3 million to the FCC and was fined $10 million by the New York Public Service Commission for its failure to comply with the TCA.[92] Thereafter, unable to receive local phone service from AT&T because of Verizon's foot-dragging, the Trinko firm sued Verizon in the Southern District of New York in 2000, alleging that Verizon's failure to comply with the TCA constituted a violation of § 2 of the Sherman Act.[93] The District Court dismissed the complaint, but the Second Circuit reversed and reinstated the claim.[94]

B. *The Decision*

The Supreme Court reversed the Second Circuit's ruling and directed dismissal of the complaint.[95] The Court might have, as three concurring justices urged, reached this outcome on standing grounds alone.[96] AT&T, was in a better position to sue rival Verizon than its customer Trinko.[97] Hence the more efficient plaintiff under *Associated General Contractors*.[98] Nevertheless, the Court, determined to reach the merits, elided over the standing issue and dismissed Trinko's complaint as a matter of law on the ground that it contained no allegations of Verizon's anticompetitive malice nor of Verizon's predatory motivation in its treatment of AT&T orders.[99] In reaching that outcome, the Court posed, and answered, four questions: (1) Does violation of the TCA give rise to an antitrust claim? (2) Did Verizon's conduct violate existing antitrust standards? (3) Did *Aspen* call

90. *Id.* at 404–05.
91. *Id.* at 404.
92. *Id.*
93. *Id.* at 404–405.
94. *Id.* at 405.
95. *Id.* at 416.
96. *Id.* at 416–18 (Stevens, J. concurring).
97. *Id.*
98. Associated Gen. Contractors of Cal. Inc. v. California State Council of Carpenters, 459 U.S. 519, 529-35 (1983).
99. *Trinko*, 540 U.S. at 409.

for antitrust liability? and (4) Should the Court create a new theory of antitrust liability? The Court answered each question in the negative.

1. *Does Violation of the TCA Give Rise to an Antitrust Claim?*

Trinko alleged that Verizon's failure to comply with mandatory facilities-sharing requirements of the TCA created a claim under the antitrust laws.[100] In rejecting that argument, the Court made three points. (1) the TCA imposed mandatory dealing requirements on Verizon that were more extensive than the antitrust laws would require; (2) the TCA also created a detailed regulatory structure to assure compliance with the TCA; and (3) although the existence of such a detailed regulatory structure might ordinarily raise the question of whether Verizon "was shielded from antitrust scrutiny altogether by the doctrine of implied immunity," the Court concluded that any implied immunity argument was foreclosed by the antitrust savings clause in the TCA, which provided that "nothing in this Act or the amendments made by this Act shall be constructed to modify, impair, or supersede the applicability of any of the antitrust laws."[101] Therefore, according to the majority, the TCA preserved application of the antitrust laws but implicitly excluded antitrust liability for conduct that also constituted violations of the TCA.[102] Put another way, the Court declared Verizon's duty to deal under the TCA as irrelevant to any antitrust analysis, on the ground that but for the TCA, Verizon never would have offered to deal with AT&T. The Court thus created an imaginary Verizon with no duty to deal but at the same time free to deal-or not deal-with rivals as it wished. Only by conjuring this imaginary Verizon could the Court hold that although the antitrust laws applied, they did not impose liability on Verizon for ignoring its duty to deal with AT&T under the TCA.

Had the Court stopped there, with the "unremarkable finding"[103] that a violation of the TCA does not create an antitrust

100. *Id.* at 405.
101. *Id.* at. 406.
102. *See Trinko*, 540 U.S. at 406 ("That Congress created these duties [to deal under the TCA], however, does not automatically lead to the conclusion that they can be enforced by means of an antitrust claim.").
103. Michael Kades, Deputy Assistant Att'y Gen, U.S. Dep't Just. Antitrust Div., Remarks at the University of Virginia Virginia Law and Business Review

claim, *Trinko* would likely not have caused much of a stir. *Trinko* might well have been read as a "decision confined to regulated telecommunications carriers engaged in trading unbundled network elements."[104] Instead, the Court sought to define the outer boundaries of § 2, and in the process created skepticism about every § 2 case.

2. *Did Verizon's Conduct Violate Existing Antitrust Standards?*

The Court then analyzed whether Trinko's complaint had stated an antitrust claim independent of the TCA. The Court rejected Trinko's claim based on existing antitrust principles, reasoning that, under *Grinnell*, an antitrust plaintiff must show unlawful *conduct* by Verizon and re-iterated that mere possession of monopoly power does not suffice to create § 2 liability.[105] Trinko's complaint failed to allege the requisite wrongful conduct by Verizon, and Verizon's mere delay in fulfilling AT&T's orders did not constitute unlawful behavior.[106] The Court treated Verizon's foot dragging as a unilateral refusal to deal and reasoned that under *Colgate* "as a general rule," a seller (whether or not a monopolist) is free to choose those with whom it will deal.[107] Therefore, Verizon had no *antitrust* obligation to deal with AT&T. Forced sharing, according to the Court, would not only undermine the long-recognized *Colgate* right, but it would also pose a threat to the competitive process. First, forced sharing may chill the incentive of the dominant firm to innovate.[108] The Court reasoned that firms may acquire monopoly power by creating an infrastructure that "renders them uniquely suited to serve their customer," suggesting that Verizon had done just that.[109] Any mandate to share its facilities with rivals might discourage investment in new infrastructure. Second, it would thrust courts into the role of central planners, a role for which judges are ill-suited.[110] Third, forced sharing would force rivals

2023 Symposium (Apr. 7, 2023) https://www.justice.gov/opa/speech/deputy-assistant-attorney-general-michael-kades-antitrust-division-delivers-remarks.

104. Jonathan Rubin, Norman Hawkes & D Adam Candeub, *Access Remedies after Trinko, in* NETWORK ACCESS, REGULATION AND ANTITRUST 55, 56 (Diana Moss ed. 2005).

105. *Trinko*, 540 U.S. at 407.

106. *Id.* at 410.

107. *Id.* at 408.

108. *Id.* at 407.

109. *Id.* at 408.

110. *Id.*

to negotiate with each other and thereby create the risk of collusive behavior, the "supreme evil" under the antitrust laws.[111]

3. *Does Aspen or the Essential Facilities Doctrine Call for a Different Result?*

The Court recognized that its ruling that Verizon had no antitrust duty to deal with AT&T did not end the inquiry because "under certain circumstances a refusal to cooperate with rivals, can constitute anticompetitive conduct and violate § 2."[112] Specifically, a refusal to deal may implicate § 2 where that conduct was pursuant to the seller's purpose "to create or maintain a monopoly."[113] In addition, courts have held that a dominant firm operating an essential facility has an obligation to grant rivals access to that facility, where access is essential to competition and where the rival's costs of creating its own facilities would be prohibitive.[114]

a. *Aspen*

In its 1986 decision in *Aspen*, the Court held that the decision of defendant dominant ski slope operator in Aspen to withdraw from a long standing and profitable joint selling arrangement for skiing tickets with the plaintiff, its smaller rival, (a) without economic justification and (b) despite the plaintiff's willingness to compensate defendant at full retail value order to continue the joint arrangement, constituted unlawful exclusionary conduct in violation of § 2.[115]

The Court in *Trinko* described *Aspen* as the "leading case for § 2 liability based on refusal to cooperate with rival" [116] but ruled that *Aspen* did not support the plaintiff's claim against Verizon. Without explanation, *Trinko* suggested that *Aspen* was *sui generis*, describing the decision as "at or near the outer boundary of § 2 liability."[117] The irony of describing *Aspen* as a leading case in the refusal to deal area but at the same time relegating it to the fringes of §2 liability appears to have been lost on the court.

111. *Id.*
112. *Id.*
113. *Colgate*, 250 U.S. at 307.
114. *Trinko*. at 410-11.
115. *Aspen*, 472 U.S. at 610-11.
116. *Trinko*, 540 U.S. at 408.
117. *Id.* at 409.

The Court then proceeded to distinguish *Aspen* on three grounds. First, *Aspen* involved the discontinuation of a long-standing, voluntary, and "presumably profitable" arrangement between the dominant seller and its smaller rival.[118] The decision to terminate the joint selling arrangement reflected a choice by a monopolist to make an important change in the character of the market and "suggested a willingness to forsake short-term profits to achieve and anticompetitive end."[119] In *Trinko*, on the other hand, the Court observed that the "complaint does not allege that Verizon voluntarily engaged in a course of dealing with its rivals or would have ever done so absent statutory compulsion."[120]

Second, the court reasoned that whereas in *Aspen* the defendant's "unwillingness to renew the ticket *even if compensated at retail price* revealed a distinctly anticompetitive bent," the same cannot be said of Verizon.[121] Because there was no prior voluntary dealing, "the defendant's prior conduct sheds no light upon the motivation of its refusal to deal-upon whether its regulatory lapses were prompted not by competitive zeal but by anticompetitive malice."[122] The *Trinko* Court further observed that unlike in *Aspen*, where the monopolist had sacrificed short-term profits for long-term monopoly rents, Verizon had not sacrificed profits.[123] Rather, payments to Verizon for TCA-mandated dealings were governed by FCC regulations and presumably profitable to Verizon at all times. Thus, Verizon's "reluctance to interconnect" at regulated rates "tells us little about dreams of monopoly."[124] On the other hand, the refusal of the defendants in *Aspen* to sell to the defendant at full retail price "suggest[s] a calculation that its future monopoly retail price would be higher."[125]

Third, *Aspen* involved refusal to sell a product—access to mountain ski-trails—that defendant already sold to retail customers, skiing. By contrast, Verizon had never marketed the interconnect services mandated by the TCA to anyone.[126]

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118. *Id.*
119. *Id.*
120. *Id.*
121. *Id.*
122. *Id.*
123. *Id.*
124. *Id.*
125. *Id.*
126. *Id.* at 410.

Accordingly, Verizon's insufficient assistance to its competitors did not give rise to a cognizable antitrust claim under *Aspen*.[127]

Curiously, the Court ignores perhaps the most consequential distinction between *Aspen* and *Trinko*—Aspen was decided on a full trial record, while *Trinko* was disposed of on a motion to dismiss. On a motion to dismiss, a court has a very narrowly defined task to of determining whether the complaint states a plausible claim for relief.[128] The facts pleaded in the complaint are assumed to be true and cannot be disputed by the defendant on its motion to dismiss.[129] Whether a complaint states a claim for relief is a question of law for the court, and the court may not make factual findings at the motion to dismiss stage.[130] Yet, the Court in *Trinko* went to great lengths to establish Verizon's *bona fides*. Without record support, the Court assumed that Verizon had made sizable monetary investments in infrastructure and that it did not want to share the fruits of that infrastructure with AT&T or any other rivals.[131] The complaint, in the Court's view, had failed to show that its delay in fulfilling AT&T orders was anything more than evidence that Verizon wanted to keep its system to itself.[132] The Court also stated that Verizon's delays in fulfilling orders may not have been motivated by the desire to maintain its monopoly, but, rather, might have been driven by other factors having nothing to do with exclusion.[133] Because the complaint did not refute an illicit competitive motive, the Court dismissed the claim.[134] That is precisely the kind of factual determination that the courts must avoid on a motion to dismiss. Verizon's refusal to deal may well have been motivated by its desire to maintain its monopoly, whether or not that is the case is for the jury to decide after trial and not for the judge.

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127. *Id.*

128. *Twombly*, 550 U.S. at 556.

129. *Id.*

130. Covad Commc'ns Co. v. Bell Atlantic Corp., 398 F. 3d 666, 676 (D.C. Cir. 2008).

131. *Trinko*, 540 U.S at 407-408 ("Firms may acquire monopoly power by establishing an infrastructure that renders them uniquely suited to serve their customers. Compelling such firms to share the source of their advantage is in some tension with the underlying purpose of antitrust law. . . . ").

132. *Twombly*, 550 U.S. at 566 (resistance to network sharing was "the natural, unilateral reaction of [Verizon] intent on keeping its regional dominance").

133. *Id.* at 414.

134. *Id.* at 411.

Nor are the Court's efforts to distinguish *Aspen* persuasive. Whether there was a prior course of dealing between AT&T and Verizon should not serve as a benchmark for § 2 liability, a view supported by the Seventh Circuit in *Olympia Equipment Leasing*.[135] In that case, Western Union, a monopolist in telex services planned to exit from the market and offered marketing services to rivals, but later withdrew that offer. Judge Posner, writing for the court, observed that "the law would be perverse if it made Western Union's encouraging gestures the fulcrum of an antitrust violation."[136] Indeed, "requiring a preexisting course or dealing as a precondition to antitrust liability risks the possibility that monopolists might be dissuaded from cooperating even in competitive joint venture arrangements for fear that, once in them, they can never get out."[137]

Furthermore, the absence of "profit sacrifice" does not exculpate Verizon from § 2 liability. The *Trinko* Court underscores profit sacrifice as a key fact supporting liability in Aspen but never embellished *Aspen* to the extent of ensconcing profit sacrifice as a *sine qua non* of a refusal to deal claim. Rather, it is one way to establish monopolization; other legal theories of monopolization have been endorsed and implemented by the courts.[138]

More importantly, nowhere in its opinion does the *Trinko* Court assert that profit sacrifice is a necessary element of a monopolization case. In any event, the profit sacrifice theory is totally inapposite to the *Trinko* record. Nothing that Verizon is alleged to have done involved profit sacrifice. Since Verizon's compensation for making its facilities available for interconnection by rivals was determined by FCC regulations, there were no profits for Verizon to sacrifice. The profit sacrifice theory simply does not fit the facts of *Trinko* and cannot be a basis of the holding therein.

b. *Essential Facilities Doctrine*

After dispatching *Aspen*, the Court turned briefly to the question of whether the essential facilities doctrine, discussed

135. *Olympia Equip.* Leasing, 797 F.2d.
136. *Id.* at 376.
137. *Novell*, 731 F. 2d at 1074.
138. *See e.g., id.* at 1075 (no economic sense test); *LePage's*, 324 F.3d at 151-52 ("exclusionary" conduct).

above, would compel Verizon to deal with AT&T.[139] The Court quickly dismissed that argument, noting that because the TCA already mandated that Verizon provide AT&T access to its infrastructure, the essential facilities doctrine would not apply.[140] The Court, however, did not stop there. Rather, it pointedly asserted that although the doctrine had consensus support at the Circuit level, the Supreme Court had not specifically embraced it, thereby raising some doubt as to whether the essential facilities doctrine in fact existed.[141]

4. *Should the Court Create a New Theory of Section 2 Liability?*

The Court considered, and rejected, "adding [*Trinko*] to the few existing exceptions from the proposition that there is no duty to aid competitors" under traditional antitrust principles.[142] Here, the Court revisited its earlier reasoning that violations of the TCA do not create a claim for relief under the antitrust laws. The Court noted that: (1) the regulatory system in place had effectively addressed Verizon's transgressions, and so the need for antitrust intervention was minimal; (2) the marginal benefits of adding an antitrust remedy were outweighed by their costs; (3) the difficulties that a generalist judge would have in applying § 2 requirements to complex business transactions; (4) significant risk of error; (5) high cost of false positives; and (6) creating a new exception could spawn interminable and costly litigation.[143] Furthermore, the Court suggested that conduct consisting of anticompetitive violation of the TCA, like above-cost predatory pricing schemes, may be "beyond the practical ability of a judicial tribunal to control."[144] It also noted that in order to grant plaintiff the compulsory access relief it sought, a court would have "to assume the day-to-day controls characteristic of a regulatory agency" but concluded that it was unlikely that an antitrust court would be "an effective day-to-day enforcer of these detailed sharing obligations."[145]

139. *See supra* note 76 and accompanying text. Verizon Commc'ns, Inc. v. Law Offs. of Curtis V. Trinko, LLP, 540 U.S. 398 (2004).
140. *Id.* at 411.
141. *Id.* ("We have never recognized such a doctrine ").
142. *Id.*
143. *Id.* at 411–15.
144. *Id.* at 414 (quoting *Brooke Grp.*, 509 U.S. at 223).
145. *Id.* at 415.

Finally, the Court observed that the goals of the TCA—to eliminate the monopolies enjoyed by the ILECs—were much more ambitious than the goals of the Sherman Act to prevent unlawful monopolization.[146] It cautioned Courts not to conflate those goals, stressing that the Sherman Act "does not give judges *carte blanche* to insist that a monopolist alter its way of doing business whenever some other approach might yield greater competition."[147]

III.
IMPACT OF *TRINKO*

Trinko has always been a controversial decision. The Court might have simply ended its inquiry once it concluded that a violation of the TCA does not give rise to a claim under the antitrust laws but instead it embarked on a broader antitrust journey to the ill-defined outer boundaries of monopolization law and enunciated antitrust principles seemingly applicable to all monopolization cases and not simply to those involving the highly regulated telecommunications industry.[148] The Court spent considerable time and effort making the case for a more tolerant approach to dominant firms, while at the same time eschewing any bright-line rules addressing monopolistic refusals to deal.

The threshold question is whether the *Trinko* holding has implications for monopolization cases generally, or should be limited to cases involving the telecommunications industry. One view is that *Trinko* merely reaffirms the status quo ante in refusal to deal cases and that anything the Court said beyond that a violation of the TCA does not create an antitrust claim is dicta.[149] A second view suggests that *Trinko* has profoundly reshaped the § 2 landscape.[150] It is perilous, if not reckless, to

146. *Id.*
147. *Id.* at 415–16.
148. Rubin et al., *supra* note 104, at 56, 67.
149. *See, e.g.*, Jonathan L. Rubin, *The Truth About Trinko*, 50 ANTITRUST BULL. 725, 725-26 (2005) ("the truth is that *Trinko* is largely a restatement of the *status quo ante* of monopolization doctrine," and .viewed in the light of the regulatory context of *Trinko* "the antitrust discussion in the opinion emerges as mere dicta."); *see also* Kades, *supra* note 103 ("The refusals to deal of the kind at issue in *Trinko* are highly context-specific and driven by the unique facts and circumstances at issue in that case.").
150. *See, e.g.*, New York v. Facebook, Inc., 549 F. Supp. 3d 6, 25 (D.D.C. 2021) (refusals to deal are "essentially per se lawful" or "presumptively legal"),

dismiss a large portions of the *Trinko* decision as dicta especially since the lower courts do not necessarily distinguish between dicta and holding when Supreme Court speaks and, as in the case of *Facebook*, have given wide berth to the *Trinko* decision.[151] Moreover, the Court still stands solidly behind *Trinko*, having recently re-affirmed that decision in *LinkLine* and *Alston* on claims not involving TCA issues.[152]

A. *Courts Post-Trinko*

Despite the analytical and theoretical shortcomings of *Trinko*, the Supreme Court is not likely to overrule it any time soon. Two recent decisions underscore *Trinko's* continuing viability in the Supreme Court. First, in *LinkLine*,[153] the Court reaffirmed the *Trinko* holding and extended its reasoning to preclude recovery in price-squeeze cases, ruling that "a firm with no antitrust duty to deal in the wholesale market has no obligation to deal under terms and conditions favorable to its competitors."[154] The Court there also re-iterated the institutional concerns expressed in *Trinko* that the "[c]ourts are ill-suited 'to act as central planners, identifying the proper price, quantity, and other terms of dealing.'"[155] More recently, in *Alston*,[156] a § 1 case involving NCAA rules restricting payments to college athletes, the Court echoed the broader themes of *Trinko* that antitrust courts must (1) "have a healthy respect for the practical limits of judicial administration;" (2) avoid "continuing supervision of a highly detailed decree" that could wind up suppressing rather than enhancing competition; and (3) be aware that costs of compliance with judicial decrees may exceed any efficiencies gained.[157]

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aff'd sub nom. New York v. Meta Platforms, Inc., 66 F. 4th 288, (D.C. Cir. 2023); *but see* Steward Health Care Sys., LLC v. Blue Cross & Blue Shield of R.I., 311 F. Supp. 3d 468, 483 (D.R.I. 2018) (*Trinko* should not be viewed as "pulling back the reins on refusal-to-deal claims.").

151. *Facebook*, 549 F. Supp. 3d at 25.

152. *Pac. Bell Tel.*, 555 U.S. at 449 (holding that Trinko forecloses any challenges to AT&T's wholesale prices); NCAA v. Alston, 141 S. Ct. 2141, 2161 (2021) (underscoring the view expressed in *Trinko* that courts need to avoid "mistaken condemnations of legitimate business arrangements").

153. *LinkLine*, 555 U.S. 438.

154. *Id.* at 440.

155. *Id.* at 452 (quoting *Trinko*, 540 U.S. at 408).

156. *Alston*, 141 S. Ct. 2141.

157. *Id.* at 2763.

Some lower Courts have also replayed *Trinko's* broader themes and even taken the *Trinko* holding one step further. For example, in *Novell*, the Tenth Circuit per then-Judge Gorsuch, after underscoring concerns expressed in *Trinko* that forced sharing might lead to collusion and prove difficult for courts to administer, suggested that refusals to deal by a dominant firm should be viewed as presumptively lawful, describing refusals to deal as a "narrow-eyed needle" of antitrust liability.[158] He further suggested that courts should respect the general rule of "firm independence" and that in close cases "perhaps it is better that it should err on the side of firm independence—given its demonstrated value to the competitive process and consumer welfare—than on the other side where we face the risk of inducing collusion and inviting judicial central planning."[159] The appellate court also extracted from *Aspen* a two-pronged bright-line rule in refusal to deal cases requiring (1) prior course of dealing; and (2) defendant's profit sacrifice.[160] At the same time the court appeared to ignore that there was a course of dealing in that case, at least at the critical development stage.[161]

More recently, the D.C. District Court in *Facebook* followed the reasoning in *Novell*. The Court in *Facebook* opined that unilateral refusals to deal were essentially per se lawful or presumptively legal, subject to the narrow exception of *Aspen*.[162] The *Facebook* court re-iterated concerns expressed in *Trinko* that forced sharing could (1) chill innovation; (2) force judges to be central planners; and (3) foster collusion.[163] *Facebook* also prescribed its own three step rule in analyzing unilateral refusals to deal, even though the Court in *Trinko* chose not to adopt any rigid test in refusal to deal cases.[164] The D.C. Circuit

158. *Novell*, 731 F.3d at 1073–74.
159. *Id.* at 1076.
160. *Id.* at 1074–75.
161. *See id.* at 1068-69 (Microsoft allowed Novell access to its namespace extensions ("NSEs") in beta form as Novell was developing applications for its PerfectOffice but subsequently withdrew access to Microsoft's NSEs, forcing Novell to develop workarounds that left it at a competitive disadvantage).
162. New York v. Facebook, Inc., 549 F. Supp. 3d 6, 25 (D.D.C. 2021).
163. *Id.*
164. *Id.* at 27 (the three prongs of the test are: (1) preexisting, voluntary and profitable course of conduct, (2) sale of products that defendant already sells to other similarly situated customers; and (3) willingness to forsake short-term profits in order to achieve an anticompetitive goal).

subsequently affirmed the lower court without extensive discussion of *Trinko*.[165]

On the other hand, some courts have taken a narrower view of *Trinko*. For example, in *Covad*,[166] a telecommunications case decided shortly after *Trinko*, the D.C. Circuit upheld Covad's claim against rival DSL provider Bell Atlantic that Bell Atlantic's refusal to sell its DSL services to would-be customers who had orders for DSL services pending with Covad constituted an unlawful refusal to deal.[167] The court ruled that Covad's allegations that Bell Atlantic's actions were predatory were sufficient to withstand a motion to dismiss.[168] The court went on to reject Bell Atlantic's defense that its conduct was economically justified because that defense raised fact issues not properly before the court on a motion to dismiss.[169]

The more recent Seventh Circuit decision in *Viamedia, Inc. v. Comcast Corp.*[170] merits detailed discussion not only because its facts are complex, but also because it "maps" onto *Aspen*.[171] In that case, Viamedia alleged that Comcast engaged in unlawful exclusionary behavior in the sale of cable television advertising services. The case involved two distinct markets: the market for interconnect services and the market for advertising representative services. Interconnect services "are cooperative selling arrangements for advertising through an 'Interconnect' that enables providers of retail cable television services to sell advertising targeted efficiently at regional audiences."[172] It is essentially a clearinghouse for sales of cable television advertising. The clearinghouse is operated by the largest cable television provider in the region; small cable television providers pay the clearinghouse operator a fee to participate.[173] Comcast was

165. New York v. Meta Platforms, Inc., 66 F. 4th 288, 305 (D.C. Cir. 2023) ("To fit itself within [the *Aspen*] exception, a plaintiff must allege that, among other things, before the defendant refused its competitors access the defendant 'voluntarily engaged in a course of dealing with its rivals, or would…have done so, absent statutory compulsion.'").
166. Covad Commc'ns Co. v. Bell Atl. Corp., 398 F.3d 666 (D.C. Cir. 2005).
167. *Id.* at 675–76.
168. *Id.* at 676.
169. *Id.*
170. *Viamedia*, 951 F.3d.
171. *Id.* at 454.
172. *Id.* at 434.
173. *Id.* at 434, 443.

concededly a monopolist in the interconnect market for the three regions at issue in the case.[174]

In the second market—the market for advertising representative services—ad reps assist cable television providers with the sales and delivering of national regional and local advertising slots.[175] Viamedia and Comcast competed in this space for several years. Then, Comcast, allegedly in furtherance of its plans to monopolize ad rep services, presented its rival cable television operators with an ultimatum: either cease dealing with Viamedia—its only competitor in ad rep services—or be cut off from access to the Interconnect services needed to compete effectively.[176] Comcast pursued this course fully aware that it would cost the company millions of dollars in the short run but achieve monopoly power in ad rep services in the longer term.[177] Viamedia saw its customers for ad rep services disappear, not because Comcast offered better services at lower prices but rather because otherwise, those customers would be locked out of interconnect services.[178]

Revisiting the trial Court's dismissal of the complaint, the Seventh Circuit pointedly rejected Comcast's argument that after *Trinko*, the notion that a monopolist had a duty to deal with rivals "bit the dust."[179] Rather, "*Trinko* itself said just the opposite" that "[u]nder certain circumstances, a refusal to cooperate with rivals can constitute anticompetitive conduct and violate Section 2."[180] The Circuit Court further found that "*Aspen Skiing* . . . maps onto Comcast's conduct"[181] and that even though *Trinko* described *Aspen* as "at or even near the outer boundary of §2 liability,"[182] "Viamedia has presented a case that is well within those bounds and appears even stronger than *Aspen Skiing*."[183] Moreover, *Viamedia* contains elements present in *Aspen* and missing in *Trinko*—"a prior course of voluntary

174. *Id.* at 434.
175. *Id.*
176. *Id* at 434–35.
177. *Id.* at 435.
178. *Id.*
179. *Id.* at 455.
180. *Id.*, (quoting *Trinko*, 540 U.S. at 408).
181. *Id.* at 409.
182. *Trinko*, 540 U.S. at 409.
183. *Comcast*, 951 F. 3d at 458.

conduct, sacrifice of short-term profits, and refusal to sell to rivals on the same terms as other potential buyers."[184]

The court stressed that *Aspen* calls for a case-by-case analysis to determine whether the refusal to deal runs afoul of § 2,[185] and refrained firm any "precise delineation of the requirements of a refusal-to-deal pleading."[186] Rather the court found that "it is enough to allege plausibly that the refusal to deal has some of the key anticompetitive characteristics identified in *Aspen Skiing*."[187] The court specifically left open the question of whether profit sacrifice is a necessary element of a refusal to deal claim.[188] It further noted that other factors, including "a prior course of conduct, exploitation of power over a cooperative network, refusal to sell at retail price, and discriminatory treatment of rivals" could suggest that "a refusal to deal is prompted by anticompetitive malice."[189]

Nor is a refusal to deal the only way to run afoul of § 2. Courts have recognized a variety of market behaviors by dominant firms that may meet the conduct element of a § 2 violation, including among others, refusal to deal, tying and exclusive dealing.[190] Moreover, as the *Comcast* court noted, "[c]onduct that can harm competition may fit into more than one of these court-devised categories."[191] The fact that there may be an overlap in these categories of conduct should not shift the court's focus from its task of determining the basic question of whether the conduct in question—however denominated—causes harm to the competitive process.[192] The purpose of identifying these categories of conduct is to assist in ascertaining "the presence or absence of harmful effects, which are both the reason for any antitrust concern and often the simplest element to disprove."[193] At the end of the day, the process of bucketizing various categories of alleged misconduct can prove more of a

184. *Id.* at 463.
185. *Id.* at 457 ("the *Aspen* factors help case by case assessments of whether a challenged refusal to deal is indeed anticompetitive, even though no factor is always decisive by itself.").
186. *Id.* at 463.
187. *Id.* at 462.
188. *Id.* at 463.
189. *Id.*
190. *Id.* at 453.
191. *Id.*
192. *Id.*
193. *Id.*

hindrance than a help to a court assessing whether the conduct at issue is anticompetitive.

Comcast concluded that neither *Trinko* nor *Aspen* established a bright-line rule for § 2 violations generally, nor for unilateral refusals to deal in particular. Rather, the question in both cases was whether the refusal to deal was predatory, *i.e.*, whether the monopolist was "attempting to exclude rivals on some basis other than efficiency."[194] This inquiry is context-specific and fact-intensive. The factors considered in *Aspen*, such as termination of prior course of dealing, can be helpful, but not necessarily decisive.[195] For example, whether there was a course of prior dealing is less significant where predatory purpose is obvious from other facts.[196] Courts may also look to other factors, such as whether defendant's conduct was rational but for its anticompetitive effect[197] or whether the refusal to deal was driven by a valid business decision.[198] In analyzing § 2 cases, "the challenge for an antitrust court lies in stating a general rule distinguishing between exclusionary acts, which reduce social welfare, and competitive acts, which increase it."[199] In short, *Comcast* provides antitrust plaintiff's a valuable roadmap as to how to neutralize and overcome *Trinko*.

IV.
The Case for Viewing *Trinko* Narrowly

A. *Trinko Itself*

The *Trinko* decision itself provides a strong reason for taking a narrow view of the case. The Court stated that "[a]ntitrust analysis must always be attuned to the particular structure and circumstances of the industry at issue."[200] Subsequently, in *Alston*, the Court echoed these words from *Trinko* regarding specific nature of the antitrust inquiry, stating that "whether an

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194. *Aspen*, 472 U.S. at 605.

195. *Comcast*, 951 F. 3d at 457 ("the *Aspen Skiing* factors help case-by-case assessments of whether a challenged refusal to deal is indeed anticompetitive, even though no factor is always decisive by itself.").

196. *See, e.g.*, Otter Tail Power Co. v. United States 410 U.S. 366, 378 (1973) (defendant's refusal to wheel power to municipalities was motivated by its goal to monopolize the retail energy market).

197. *See, e.g.*, *Novell*, 731 F. 3d at 1075.

198. *See, e.g.*, *Aspen*, 472 U.S. at 608.

199. *Microsoft*, 253 F. 3d at 58.

200. *Trinko*, 540 U.S. at 411.

antitrust violation exists necessarily depends on a careful analysis of market realities. If those market realities change, so may the legal analysis."[201] The *Trinko* holding is inextricably bound to its particular facts involving Verizon's conduct in the highly regulated telecommunications field, where the regulators actively monitored the marketplace and had done so effectively, having already imposed monetary penalties on Verizon for the very conduct that plaintiff alleged in its antitrust suit. On these facts, the Court reasoned that further antitrust intervention would not be necessary and indeed could be counterproductive.[202] The highly specific facts in *Trinko* do not lend themselves well to generalization, and hence *Trinko* is not a good vehicle for re-writing the law of refusals to deal in particular or the law of monopolization generally indeed. The facts of *Trinko* are even more specific than the facts of *Aspen*, described by the court in *Trinko*, as "the leading case for § 2 liability based on refusal to cooperate with a rival."[203] If we are to take seriously the Court's dicta that antitrust analysis is attuned to the structure of the particular industry at issue, it would seem that *Aspen* stands for the general rule and *Trinko* is the exception, sitting just beyond "the outer boundary of §2 liability."[204]

B. *Refusals to deal*

The Court in *Trinko* recognized that a seller's right to choose its own customers was not unqualified and that in certain instances, refusal to deal with a rival could give rise to liability under § 2.[205] The Court said nothing of a rule per se legality as presumptive legality for refusals to deal. Nor did it overrule *Aspen* or *Otter Tail*, two leading refusals to deal precedents, although it did distinguish both cases on the facts.[206]

In addition, the Court did not articulate any bright line rule specifying the elements of a refusal to deal case. The Court did emphasize certain facts in *Aspen*, including the existence of an ongoing consensual business relationship between the

201. *Alston*, 141 S. Ct. at 2158.
202. *Trinko*, 540 U.S. at 414.
203. *Id.* at 408.
204. *Cf. Trinko*, 540 U.S. at 409; (*Aspen Skiing* is "at or near the outer boundary of §2 liability.").
205. *Id.* at 408.
206. *Id.* at 409–10.

parties and defendant's profit sacrifice but did rule that either of these was a necessary element of a refusal to deal claim.[207] Rather they are factors that a court may consider in assessing the legality of the conduct. In line with *Alston*, courts can make decisions in refusal to deal cases on a case-by-case bases.

C. *Nature of Conduct Violative of §2*

Trinko recognized that the "means of illicit exclusion, like the means of legitimate competition, are myriad."[208] There is no requirement that antitrust claims come before a court with a pre-fixed label, such as refusal to deal, tying, exclusive dealing, or predatory pricing. The goal is to identify conduct that is unreasonably exclusionary and inconsistent with competition or the merits.

D. *Trinko's Broad Statements Regarding §2 Liability Are Not Essential to the Holding and Are Suspect Both Legally and Factually*

In deciding the *Trinko* case, the Court ventured beyond refusals to deal and opined broadly about the parameters of § 2 liability. These sweeping statements were not essential to the holding and are at odds with both prior case law and economic theory. It is unclear whether Justice Scalia is writing as provocateur or as decision-maker. Most troubling is his attempt to re-write the antitrust narrative and recast the monopolist as "an important element of the free market system."[209] Historically, courts have viewed the monopolist with suspicion and certainly not as a positive force in the marketplace.[210] Scalia viewed the monopolist as a key player in the free market system because: [t]he opportunity to charge monopoly profits—at least for a short period—is what attracts business acumen in the first place."[211] The notion that the lure of monopoly profits is what drives innovation is contrary to the Court's earlier decision in *Northern Pacific*[212] wherein the Court per Justice Black stated:

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207. *Id.* at 409.
208. *Id.* at 414.
209. *Id.* at 407.
210. *See Alcoa*, 148 F. 2d at 427 ("immunity from competition is a narcotic").
211. *Trinko*, 540 U.S. at 407.
212. N. Pac. Ry. Co. v. U.S., 356 U.S. 1 (1958).

> The Sherman Act was designed to be a comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade. It rests on the premise that the unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic political and social institutions.[213]

In short, rivalry—not monopoly—is what drives economic prosperity.

Equally important, the argument that the lure of monopoly rents fosters innovation and risk-taking is out of step with economic theory.[214] The bump in revenue that results from successful innovation, known as quasi rents, "are surplus returns that reward innovation"[215] and "it is a mistake to enter into antitrust law the notion that innovation and risk-taking require temporary monopoly rents as an incentive."[216] Scalia's reasoning on this point is especially inapt because Verizon did not earn its monopoly through innovation or by superior performance in the marketplace; rather, the monopoly was bestowed on it by government decree.[217]

The Court's willingness to cede monopoly profits to the monopolist/innovator in the short-term is also puzzling. What would stop the monopolist/innovator from reaping *long-term* monopoly profits? Presumably, the Court is of the view that market forces would intervene to thwart the monopolist's attempt to achieve long-term monopoly rents. That view is naïve and out of touch with economic reality. In fact, market power can prove durable, as experiences with Alcoa, AT&T and Microsoft, among other durable monopolies, amply demonstrate.[218]

Furthermore, the Court's view that forced sharing of assets would chill Verizon's, as well as any rival's incentive to innovate is also questionable. It may be that access to Verizon

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213. *Id.* at 4.
214. *See* Rubin et al., *supra* note104, at 64.
215. *Id.*
216. *Id.* at 64.
217. *Id.*
218. *See* Jonathan Baker, *Taking the Error Out of "Error Cost" Analysis: What's Wrong with Antitrust's Right*, 80 ANTITRUST L.J. 1, 10 n. 39 (2015).

infrastructure would lessen AT&T's incentives to duplicate Verizon's infrastructure, but the interconnect duties reflect the legislative judgment made in the TCA that sharing would, on balance enhance competition in local phone services. Moreover, mandated interconnection could very well incentivize AT&T and similarly situated companies to offer new products not offered by Verizon.

In addition, the Court's concern that forced sharing would require parties to negotiate and thereby possibly lead to collusion—"the supreme evil of antitrust"[219]—is speculative in nature. It may well be that forced sharing does create a risk of collusion; but again Congress, in enacting the TCA, appears to have decided that the risk of any collusion could be effectively addressed by vigorous antitrust enforcement. In any event, there is simply no legal basis for concluding that violation of § 1 necessarily more insidious that violations of § 2. Certainly, cartel behavior is pernicious and warrants the attention of antitrust enforcers; but the notion that collusion is the supreme evil of antitrust seems pure *ipse dixit*.[220] It is also at odds with the *Microsoft*[221] decision, which used the same burden-shifting technique that is used in § 1 cases in deciding § 2 issues and thus treated violation of § 1 and § 2 as equivalent harms.[222] Also, the legislative history of the Sherman Act offers no support for the "supreme evil" concept.[223]

Finally, *Trinko* should not be read as a call for minimalist antitrust enforcement. The Court did indeed decline to recognize a new exception to the general rule that a monopolist has no duty to deal that would sustain the plaintiff's complaint. Although that portion of the opinion checks all the boxes of a Chicago School minimalist antitrust agenda, the Court was clearly speaking in the context of a complex and ever-changing

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219. *Trinko*, 540 U.S. at 408.

220. Spencer Weber Waller, *Microsoft and Trinko: A Tale of Two Courts*, 2006 UTAH L. REV. 741, 750 (2006) ("Privileging Section 1 of the Sherman Act... over section 2, or believing that concerted action is inherently more anticompetitive than equivalent action by a single entity with similar power, is an equally astonishing assertion with no textual support in the antitrust laws.").

221. *Microsoft*, 253 F. 3d at 64-67.

222. Spencer Weber Waller, *The Role of Monopolization and Abuse of Dominance in Competition Law*, 20 LOY. CONS. L. REV. 123, 125 (2008).

223. Waller, *supra* note 222, at 750 ("there is simply no indication that the drafters of the Sherman Act differentiated between [monopolization and collusion], or indeed particularly understood that there was a difference.").

telecommunications field that is heavily regulated wherein Verizon had already been assessed significant fines for its foot-dragging in complying with AT&T's orders. Given that situation, the Court concluded that the marginal benefits of additional antitrust enforcement in this space was outweighed by its cost. The Court was not addressing antitrust enforcement generally.

E. Trinko *is Shaky Authority*

Finally, *Trinko* is shaky authority and ought not to be extended beyond its facts. First, the Court's sweeping statements about § 2 liability were made on a truncated record. Only the complaint was before the court in *Trinko* on Verizon's motion to dismiss. Faced with a motion to dismiss, a trial court must (a) assume the truth of all properly pleaded allegations of fact; and (b) avoid making factual determinations. The Court simply disregarded these legal standards and proceeded to piece together from appellate briefs and prior administrative proceedings a factual record supporting Verizon's position.

> Not only did the Court fail to assume the truth of the allegations of the complaint, it went further, prying out and piecing together from the appellate briefs and prior administrative hearings—there was no answer to reference—a "factual record" supporting Verizon's motion to dismiss. Among the Court's "findings" were: (1) Verizon had created a valuable infrastructure, (2) the unbundled elements to which access is mandated by the telecommunications Act of 1996 "exist only deep within the bowels of Verizon."[224]

It then concluded that Verizon had no antitrust obligation to deal with AT&T, even though one could easily infer from the complaint that Verizon was seeking to maintain its monopoly in providing local exchange services.

Second, given the sparseness of the record properly before the court, its dismissal of the plaintiff's claim was clearly premature. It would have been preferable for the Court to make its sweeping pronouncements on § 2 liability on a fully developed trial record.

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224. *See* Cavanagh, *supra* note 52, at 118-19.

Third, Trinko clearly lacked standing to assert its antitrust claim. For that reason alone, the Court's extensive statements on § 2 liability were unnecessary and hence suspect.

Fourth, the two unstated shadows cast over this opinion are that (a) *Trinko* was an unappealing plaintiff that could viewed as opportunistically piling on to deliver even more punishment to Verizon; and (b) few jurists are willing to second-guess Justice Scalia on an issue of antitrust jurisprudence.

Conclusion

For the last two decades, *Trinko* has stood as a formidable obstacle to all varieties of claims under § 2 of the Sherman Act. Yet, it is not insurmountable. The key to unravelling *Trinko* is cutting the case down to size by persuading the courts to separate its rhetoric from its holding; the *Trinko* Court talked quite broadly but actually ruled very narrowly. A head-on assault of *Trinko* is unlikely to succeed. A multi-front guerilla attack is necessary. Ben Franklin once said that "[a] great Empire, like a great Cake, is most easily diminished at the edges."[225] The same is true in the law. *Trinko* is best overcome by attacking it at the edges.

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225. *See* Nick Bunker, An Empire on the Edge 11 (2015) (quoting Benjamin Franklin).

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THE GOOD, THE BAD, AND THE UGLY: FRANCHISING HAS A JOINT EMPLOYMENT AND INDEPENDENT CONTRACTING PROBLEM

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Legal turmoil originating from the ambiguity of independent contractor and joint employment law has been exacerbated by the COVID-19 pandemic and the growth of e-commerce and the gig economy. Chaos and uncertainty have hindered business advancement, especially for franchises. Still, there are exemplary international approaches, proposed U.S. and state laws, uniform tests or guarantees, and fresh methodologies as well as legal presumptions. By narrowing the definition of "independent contractor" and expanding the definition of "joint employer," evolving legal interpretations will foster, inter alia, franchisee collective bargaining and other avenues toward fair and efficient compromise. Greater legal clarity could stimulate business growth and lead to stronger, fairer franchise systems.

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INTRODUCTION

The ongoing evolution of independent contracting and joint employment law presents a significant challenge for businesses, particularly franchises. That, in turn, raises questions about the status and benefits of workers, and they create a host of tax implications. At the heart of the hiring relationship lies a fundamental question: Is the individual being hired actually an employee of the company? This determination is crucial

because it triggers a range of financial and legal obligations under various federal and state laws that do not apply to independent contractors. This classification of a hiree as either an employee or an independent contractor is controlled by the terms of the relationship, which are dictated by the hiring company. Therefore, determining a hiree's classification must be done on a case-by-case basis.

Moreover, while related to independent contractor relationships, joint employer status is an analytically distinct issue. The Fair Labor Standards Act (FLSA) classifies an employer's status as a joint employer when an employee not only works for that employer but also simultaneously benefits another entity or individual, who may thus constitute a second, joint employer.[1] While that additional employer may not consider certain workers to be its employees, the law may disagree, holding both employers responsible for compliance with the FLSA's minimum wage and overtime provisions as well as other labor laws. Issues surrounding joint employment and independent contracting are frequently intertwined. For example, a disgruntled worker may allege wage disputes against two discrete entities—putative joint employers—which in turn prompts a battle over whether the worker was an employee of the second enterprise (e.g., the franchisor) in the first place.[2]

This highlights the critical importance of correctly classifying the relationship between employers and their workers. In the franchise model, where rapid expansion is the goal, any uncertainty surrounding workers' employment status may lead to legal disputes and stall growth.[3] Unfortunately, the current state of independent contractor and joint employment law is governed by a perplexing mix of judicial, legislative, and

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1. *See generally* 29 U.S.C. § 203 (2018). The Department of Labor announced and then later rescinded a "final rule" that updated and revised its interpretation of joint employer status. Important for franchise systems, the final rule specified that an employer's franchisor, brand and supply, or certain contractual agreements or business practices do not make joint employer status under the FLSA more or less likely.

2. *See, e.g.*, Andrew Elmore, *The Future of Fast Food Governance*, 165 U. PA. L. REV. ONLINE 73, 80 (2017) (noting that labor contractors and employees in low-wage industries economically depend on a lead firm for work, but the lead firm is seldom held liable as a joint employer in the franchise relationship).

3. *See* Daniel B. Yaeger, *Fiduciary-isms: A Study of Academic Influence on the Expansion of the Law*, 65 DRAKE L. REV. 179, 204, 207 (2017) (arguing that franchisors are not fiduciaries of franchisees, but that franchisees are like independent contractors and franchisors are like employers).

administrative law. To make matters worse, e-commerce,[4] the rise of the gig economy,[5] and the COVID-19 pandemic[6] have compounded the problem, threatening to make an already confusing area of law unworkable.

The unclear and ever-shifting guidance on both independent contracting and joint employment law becomes even more confusing when one attempts to apply it to the modern franchising environment. It seems the existing framework is not built to accommodate the continuously evolving franchise business model, resulting in a murky legal landscape for both franchisors and franchisees to navigate.

In an attempt to clarify the situation, this article commences by discussing the current state of franchising in the United States, and what makes this business model unique. Next, it is necessary to examine how the current landscape of independent contractor and joint employment law, alongside the administrative twists and turns, has shaped the current guidance available to employers and workers. This discussion explains the multitude of different tests used by administrative agencies and the courts to classify these relationships. After detailing how recent developments in the broader business environment have exacerbated the need for clearer standards, this article concludes by recommending several solutions drawn from foreign standards, uniform tests, improved bargaining, and a shift in priorities and presumptions.

I. The Franchise Business Model

The franchise model is a widely used business arrangement that allows for rapid, inexpensive expansion.[7] Franchised

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4. *See infra* Section IV.A.

5. *See* Melissa Lewis, *Independent Contractor Laws and the Sharing Economy*, 36 GPSolo 15, 16 (2019) (noting that the gig-economy is also known as the "sharing economy," in which assets or services are shared between private individuals through a host company).

6. *See infra* Section IV.C.

7. Westfield Ctr. Serv., Inc. v. Cities Serv. Oil Co., 432 A.2d 48, 52 (N.J. 1981) (noting that, by employing the franchise business model, franchisors can expand more quickly than traditional models and with less capital investment). The American concept of franchising is expanding rapidly throughout the world, with an increasing share of international commerce. *See* Robert W. Emerson, *Franchise Encroachment*, 47 Am. Bus. L.J. 191, 196–97 n.23 (2010) (detailing the numerous statistics indicating the phenomenal

businesses account for roughly 40% of all retail sales in the United States,[8] with over 821,000 operating franchised units directly employing about 8.9 million people.[9] They indirectly account for close to twice as many jobs.[10] These franchised businesses also create a direct and indirect economic output of $826.6 billion, accounting for 7% of the U.S. GDP.[11]

Logistically, this franchising business model operates on a system where a franchisor licenses its name, trademark, and business model to independent franchisees in exchange for an initial franchising fee and recurring royalty payments.[12] This arrangement allows the franchisee to benefit from the franchisor's experience, knowledge, research and development, capital, and reputation.[13] As a result, the franchisee can

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growth of franchising worldwide, both throughout Europe and such diverse and important national economies as those of Australia, Brazil, China, India, and Japan).

8. This is an estimate of the International Franchise Association. Honey v. Gandhi, *Franchising in the United States*, 20 LAW & BUS. REV. AM. 3, (2014) https://scholar.smu.edu/lbra/vol20/iss1/2. At the very least, franchising's share of the total retail economy, since at least the year 2001, has been one-third. ROGER D. BLAIR & FRANCINE LAFONTAINE, THE ECONOMICS OF FRANCHISING 26–27 n.28 (2005); Emerson, *supra* note 7, at 196–97; Robert W. Emerson, *Franchising Covenants Against Competition*, 80 IOWA L. REV. 1049, 1050–51 n.4 (1995) (citing numerous sources concerning the rapid growth of franchising in both the 1980s and the early 1990s).

9. 2024 Franchising Economic Outlook, INTERNATIONAL FRANCHISE ASSOCIATION, https://www.franchise.org/franchise-information/franchise-business-outlook/2024-franchising-economic-outlook.; *see* Robert W. Emerson, *Franchisors in a Jam: Vicarious Liability and Spreading the Blame*, 47 J. CORP. L. 571, 573–74 (2022) (noting a 4% downturn in the number of franchised outlets at the start of the COVID-19 pandemic, but with a strong recovery thereafter).

10. 2024 Franchising Economic Outlook, *supra* note 9.

11. *A Look at How Franchises Impact the U.S. Economy*, FRANCHISE DIRECT (July 26, 2022), https://www.franchisedirect.com/information/a-look-at-how-franchises-impact-the-economy.

12. BLAIR & LAFONTAINE, *supra* note 8, at 6–8; ELIZABETH CRAWFORD SPENCER, THE REGULATION OF FRANCHISING IN THE NEW GLOBAL ECONOMY 7 (2010). A study of 100 randomly selected fast-food franchises found the medial initial franchise fee to be $25,000. In the same study, the median royalty payment was 5% of revenue. Robert W. Emerson, *Franchise Contract Interpretation: A Two-Standard Approach*, 2013 MICH. ST. L. REV. 641, 686–89 (2013) (hereinafter Emerson, *Two-Standard Approach*). The author's study of 200 fast-food franchise contracts in 2023 found the median initial franchise fee to have risen to $35,000. Robert W. Emerson, *Franchise Contract Standards Based on Legal Counsel, Sophisticated Parties, Ardent Admonitions, and Collective Negotiations* (Aug. 14, 2023) (hereinafter, "Emerson, *Franchise Contract Standards*") (unpublished manuscript) (on file with author).

13. Emerson, *Two-Standard Approach*, *supra* note 12, at 642.

effectively operate its own business without having to invest its limited resources in perfecting a new product or business model.[14]

A. *Operational Guidance, Advertising Strategies, and Controls*

One of the most important benefits that franchisees receive, apart from affiliation with the franchisor's brand, is operational guidance from the franchisor.[15] It is typically provided throughout the life of the franchise relationship and includes training, consultation services, and operations manuals that establish required procedures and best practices.[16] Ordinarily, this guidance addresses various areas of the franchisee's business, such as site selection, regional product preferences, and store displays and layouts.[17] The value of such guidance is high because it is informed by sophisticated market research that would otherwise be unavailable to most fledgling businesses.[18] Therefore, the franchise business model provides franchisees with the tools necessary to compete with established businesses, placing them on a relatively equal footing with other business owners who sell similar products or services and use the same or similar business model.[19]

Apart from this guidance, the franchisee derives further benefit from cooperative advertising, which often occurs on a national scale. For example, even when the franchisee is allowed to run its own advertisements, the franchise system's national

14. Robert W. Emerson & Uri Benoliel, *Are Franchisees Well-Informed? Revisiting the Debate over Franchise Relationship Laws*, 76 ALB. L. REV. 193, 203 (2013).

15. Emerson, *Two-Standard Approach*, *supra* note 12, at 686, 691–92.

16. *Id.* Many courts in different countries recognize that savoir-faire—the transfer of know-how from franchisor to franchisee—must regularly occur, either as a legal requirement (e.g., in France, Belgium, Italy, and Spain) or at least as a practical matter (e.g., in the United States). *See* Robert W. Emerson, *The Faithless Franchisor: Rethinking Good Faith in Franchising*, U. PA. J. BUS. L. 411, 444–45 (2022); Robert W. Emerson, *Franchise Savoir Faire*, 90 TUL. L. REV. 589, 592 (2016).

17. Emerson, *Two-Standard Approach*, *supra* note 12, at 686, 690–91.

18. Robert W. Emerson & Lawrence J. Trautman, *Lessons About Franchise Risk from Yum Brands and Schlotzsky's*, 24 LEWIS & CLARK L. REV. 997, 1007 (2020) (stating franchisees gain the benefit of the franchisor's research and development when entering into a franchise agreement).

19. *Id.*

campaign is coordinated, with uniform goals expressed at the outset.[20]

These practices, operational guidance, and cooperative advertising are even more important in the context of vicarious liability because a franchisor's liability turns on traditional agency law.[21] Thus, in assessing a franchisor's liability, courts will look to whether the franchisor had the right to control the franchisee's marketing plan and, if so, the degree of control that the franchisor had.[22] The more direct a role the franchisor played in advertising and providing operational guidance, the greater the potential for successfully alleging vicarious liability.[23]

B. *Financial Developments in Franchising*

Franchisees not only benefit from coordinated advertising campaigns and operational guidance but also often enjoy increased access to financial assistance. Depending on the franchise agreement, financing may be provided to enable the opening of new locations or renovating of existing ones.[24] Even if the agreement does not provide such assistance, the franchisee may still receive financing on more favorable terms simply by virtue of its affiliation with an established and reputable brand. This is because the franchisor has already performed some of the vetting that a loan officer normally would do, eliminating much uncertainty in the proposed business model.[25]

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20. Emerson, *Two-Standard Approach*, *supra* note 12, at 686, 696.

21. *See* Robert W. Emerson, *Franchise Independence: Still Awaiting Customer Recognition*, 15 N.Y.U. J. L. & Bus. 287, 297–98 (2019) (discussing the Restatement (Third) of Agency, cases, and commentary related to the franchisor's vicarious liability for the wrongful acts of its franchisees).

22. *See* Friedman v. Massage Envy Franchising, LLC, No. 3:12-cv-02962, 2013 WL 3026641, at *8–9, *12 (S.D. Cal. June 13, 2013).

23. *See* Agne v. Papa John's Int'l, Inc., 286 F.R.D. 559, 562–64 (W.D. Wash. 2012).

24. Robert W. Emerson, *Franchise Contract Clauses and the Franchisor's Duty of Care toward Its Franchisees*, 72 N.C. L. Rev. 905, 941–42 (1994).

25. The franchisor's vetting process includes running credit checks and gathering information regarding the franchisee's assets, as well as maintaining permission to run periodic asset level checks of the franchisee. The level of due diligence and pre-contract vetting will largely depend on the franchisor's risk tolerance and desire for contractual protections in the case of franchisee default. *See* Jason B. Binford et al., *Structured Workouts: Franchisor Strategies for Dealing with the Financially-Challenged Franchisee*, 2015 A.B.A. F. on Franchising 4.

Furthermore, struggling franchisees can benefit from periodic support furnished by their franchisors in the form of capital improvements, renovations, and even the waiver of burdensome requirements imposed by the franchise agreements.[26] The franchisor is incentivized to provide financial assistance due to the costs involved in vetting, training, and establishing new franchisees.[27] Moreover, a franchisor may suffer negative reputational consequences if a franchisee burns out and sells off its franchise or closes a location completely.[28] While the franchisor may offer financial assistance to franchisees, it must avoid crossing the line into providing financial compensation for franchise operations, because doing so may trigger joint employment issues. This would enable disgruntled workers to pursue legal action against the franchisor's deeper pockets in the event of a labor dispute. As discussed below, courts typically apply the economic realities test or the right to control test in such cases.[29]

Franchisors can face high upfront costs when developing operations manuals, contracts, and disclosures to support and control their franchisees. Not only is this a matter of self-interest

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26. *See* Emerson, *supra* note 24, at 938, 942, 953.

27. Training of a new franchisee remains one of the most serious functions of the franchisor or its designees. For example, surveys of 100 U.S. restaurant systems' franchise contracts in 2013 and 200 such systems' franchise contracts in 2023 showed that 100% of the contracts examined in 2013 and 98.5% in 2023 required that the franchisor provide training for the franchisee. Emerson, *Two-Standard Approach*, *supra* note 12, at 686, 691. Emerson, *Franchise Contract Standards*, *supra* note 12.

28. A high proportion of franchise turnovers in a relatively short period of time is generally read as indicative of a franchise system in turmoil—a system to be avoided by prospective franchisees or other investors. *See* Eric Bell, *What the Top 10 Franchises Have In Common*, FRANCHISE GATOR (Sept. 27, 2016), https://www.franchisegator.com/articles/what-the-top-10-franchises-have-in-common-12613/. According to Franchising USA Magazine, the average turnover rate among franchise systems between 2010 and 2014 was right around 10%. Our Top 10 franchises had an average turnover rate of 7.3%. Three concepts saw a percentage under 5%, while another four were in the 6% – 10% range. Notably, FASTSIGNS, our #1 ranked franchise system, had 451 units open at the beginning of 2012. Over the next three years, only 20 units ceased operation, and only four in 2015. That is the kind of turnover rate that those seeking to invest in a franchise should be looking for. *Id. See also* Bill Bradley, *What Do Franchise Turnover Rates Mean?* SMALLBIZCLUB (May 29, 2014), https://smallbizclub.com/startup/franchise-center/what-do-franchise-turnover-rates-mean/ ("A higher than usual FTR [Franchise Turnover Rate] might not be a deal-breaker, but it's worth digging deeper to find the reason.").

29. *See infra* Sections II.B, III.A.

but it is also sometimes legally required to limit franchisors' exposure. To accomplish this, franchisors may include explicit disavowals of any business relationship that could establish fiduciary duties between themselves and franchisees, as well as disclose these disavowals to both customers and franchisees.[30] The Franchise Disclosure Document (FDD), which may include a section on independent contracting, is required to be given to franchisees.[31] For example, such a section may state the following:

> You and we understand and agree that this Agreement does not create a fiduciary relationship between you and us, that you and we are and will be independent contractors, and that nothing in this Agreement is intended to make either you or us a general or special agent, joint venturer, partner, or employee of the other for any purpose. You agree to identify yourself conspicuously in all dealings with customers, suppliers, public officials, Franchised Business personnel, and others as the Franchised Business's owner under a franchise we have granted and to place notices of independent ownership on the forms, business cards, stationery, advertising, and other materials we require.

In Oregon, a proposed piece of legislation, House Bill 4152, would have required mandatory disclosures of financial performance in a franchise sale.[32] The bill further provided that

30. Item 21 of the Franchise Disclosure Document requires that "disclose and include three years of audited financial statements of the franchisors company. The financial statements must be comprised of income statements, cash flow statements, and balance sheets for the fiscal three year period preceding the issuance of the FDD." *FDD Item 21 Financial Statement Disclosure Requirements*, INTERNICOLA LAW FIRM, https://www.franchiselawsolutions.com/franchising/financial-statement-disclosure-requirements/ (last visited July 22, 2022).

31. 16 C.F.R. § 436.2 (2024).

32. The American Association of Franchisees and Dealers (AAFD), the oldest and largest national not-for-profit trade association advocating for the rights and interests of franchisees, claims that this bill protects franchise owners so that they have freedom of association, rights in termination and renewals, and fair sourcing of goods and services. Franchisees benefit in that they are able to bring action for damages and equitable relief for franchisor's violation of the Act. Letter from Robert L. Purvin, Jr, Chair, Board of Trustees, Am. Ass'n Franchisees & Dealers, to Janelle Bynum, Or. State Rep., (Jan. 21, 2021), https://www.aafd.org/wp-content/uploads/2021/01/AAFD-Support-of-2021-Oregon-HB-2946.pdf. Note that Oregon House Bill 4152 proposed

"[a] franchise agreement may not . . . [p]ermit a franchisor to have direct or indirect control of a franchisee's employees or of the day-to-day operations of the franchisee's business."[33] While Oregon House Bill 4152 and similar laws are designed to help parties ensure that the franchise agreement is entered into in good faith,[34] the requirements they impose can result in increased costs that must be borne by the parties.

C. *The Preferred Organizational Identity for Franchisees*

The selection process for a franchisor and potential franchisee goes beyond addressing financial and legal concerns. Issues of identification and association may also come into play because they can impact the success of a particular franchisee. As a business model, franchising is designed around standardization and uniformity to give the franchisor better control and protection of its brand.[35] To maintain standardization across franchisees, the franchisor must carefully select franchisees who are willing and able to adopt its brand.[36] Franchisors may "avoid selecting prospective franchisees that have high entrepreneurial tendencies, as they are more likely to deviate from the franchisor's standardized procedures."[37] However, there may be benefits to having an entrepreneurial franchisee that shares the franchisor's entrepreneurial spirit.[38] Finding the

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as part of the 2022 session was, in most respects, HB 2946 from 2021 reintroduced in the 2022 session.

33. H.D. 4152, 2022 Leg. (Or. 2022). Revisions to Section 4(1)(g) of the bill include mandatory disclosure of the financial performance or forecasted financial performance of existing franchises to any prospective franchisee; a new cause of action if a franchisor develops a new location in close geographical proximity to an existing location and the existing franchisee suffers a material adverse effect; retroactive application of the new statutory sections. *See* Nathan D. Imfeld, *Proposed Revisions to Oregon Franchise Law A Lawsuit Waiting to Happen*, FOLEY & LARDNER, LLP (Feb. 10, 2021), https://www.foley.com/en/insights/publications/2021/02/proposed-revisions-oregon-franchise-law.

34. H.D. 4152, *supra* note 33. The bill died in committee upon adjournment.

35. Anna Watson et al., *When do Franchisors Select Entrepreneurial Franchisees? An Organizational Identity Perspective*, 69 J. BUS. RSCH. 5934, 5934 (2016).

36. Catherine L. Wang, *Entrepreneurial Orientation, Learning Orientation, and Firm Performance*, 32 ENTREPRENEURSHIP THEORY & PRAC. 635, 638 (2008).

37. Watson et al., *supra* note 35, at 5934.

38. *See* Olufunmilola Dada et al., *Toward a Model of Franchisee Entrepreneurship*, 30 INT'L SMALL BUS. J. 559, 561 (2013) (discussing how innovations by entrepreneurial franchisees can have system-wide benefits). McDonalds

right balance between enforcing strict adherence to standards and allowing for adaptability remains a major management challenge for franchisors.[39]

As a way of explaining the franchise selection process, commentators have developed the organizational identity theory; it highlights the importance of franchisees relating to the franchisor organization and thereby maintaining a healthy business relationship.[40] This theory also applies outside of the franchise context, as individuals generally benefit from working for a company with which they identify.[41] Furthermore, employees are more likely to be satisfied and devote more resources to their job, which can lead to better performance and longer retention.[42] Relatedly, market orientation is a prerequisite for both gaining a competitive advantage and maintaining franchisee satisfaction. By utilizing market orientation processes, franchisors can develop a business model for growth and retention.[43] This process relates back to the organizational identity and selection process that gives rise to satisfaction in the franchise business model. Franchisors with "institutionalized entrepreneurial activities" tend to select franchisees with values similar to their own,[44] which leads to better franchise performance.[45] Market-oriented franchisors should seek out similarly oriented franchisees to maintain this identity throughout the franchise system.

The selection process and organizational identity affect the traditional agency relationship between the franchisor as

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franchisees, for example, were responsible for creating the Egg McMuffin and other popular menu items. *Id.* at 563. Patrick J. Kaufmann & Raviv P. Dant, *Franchising and the Domain of Entrepreneurship Research*, 14 J. Bus. Venturing 5 (1998) (detailing a study of franchisors, which found that entrepreneurially oriented franchisors were more likely to select similarly entrepreneurial franchisees when expanding their systems; additionally, providing survey data suggesting that franchise systems perform better when franchisors and franchisee share this entrepreneurial orientation).

39. Kaufmann & Dant, *supra* note 38, at 13.

40. Watson et al., *supra* note 37, at 5935, 5937 ("The loss of individual identity is the hallmark of the franchise relationship, and thus in the context of franchising, organizational identity appears to be particularly pertinent . . .").

41. Steven L. Blader et al., Research in Organizational Behavior, Organizational Identification And Workplace Behavior: More Than Meets The Eye, 34 19 (2017).

42. Yong-Ki Lee et al., *Market Orientation and Business Performance: Evidence from Franchising Industry*, 44 Int'l J. Hosp. Mgmt. 28, 36 (2015).

43. *Id.*

44. Watson et al., *supra* note 37, at 5942.

45. *Id.*

principal and the franchisee as agent. While the principal may seek to limit the agent's opportunistic behavior as its residual beneficiary, the principal directly benefits from locating agents whose interests align with its own.[46] Similarly, in the context of franchising, "where identification is present, franchisors may become stewards of the system: that is, the organizational identification further aligns franchisees' motives with their principal (franchisor) such that franchisees do not engage in self-serving behavior to the detriment of the system."[47] This symbiotic relationship benefits the franchise's overall performance as a whole and minimizes disputes during the relationship.

As it stands, a conflict exists between standardization and entrepreneurial values, as uniformity is mandated but franchisee freedom is desired. However, research indicates that there is a benefit to affording franchisees more entrepreneurial flexibility, which suggests the need to incorporate innovative ideas within the standardization process of the franchise system—effectively wedding these opposed goals.[48] By doing so, franchisors can gain the benefits of having entrepreneurial franchisees, while ensuring a uniform product and experience for consumers. To reap the full benefits under this theory, the franchisor and franchisees must be aligned in their identities as both entrepreneurial (liberated) and organizational (constrained).[49] However, businesses must remain cautious because greater standardization increases the chance of worker classification as an employee under certain tests.

II.
Independent Contracting Law

Independent contractors constitute a significant portion of the United States workforce—around 7%, or over 10.6 million people.[50] Interestingly, more than one in three are over the age of 55.[51] Independent contracting has become increasingly

46. *Id.* at 5943.
47. *Id.*
48. *Id.*
49. *Id.*
50. *Contingent and Alternative Employment Arrangements—May 2017*, U.S. Dep't of Labor, Bureau of Lab. Stat., https://www.bls.gov/news.release/pdf/conemp.pdf. This is the latest official collection of data.
51. *Id.* at 6. Paula Span, *Our Uber Driver Is 'Retired'? You Shouldn't Be Surprised*, N.Y. Times (Oct. 25, 2019), https://www.nytimes.com/2019/10/25/

prevalent in areas such as management, financial operations, sales, construction, and extraction occupations, outpacing traditional business arrangements.[52]

In the United States, a worker is either an employee or an independent contractor.[53] An employee is generally defined as a person who is hired by an employer for a continuous period and is subject to the employer's control over both the desired result of their work and how it is achieved.[54] An independent contractor, on the other hand, is a worker who performs services for the hirer, usually under contract, while maintaining some measure of autonomy and control over the method and final product.[55] This is a vital distinction, as it may implicate a host of issues for hirers and their workers, including employment benefits, workers' compensation, unemployment compensation, wage and hour laws, taxes, and protection under Title VII of the Civil Rights Act, the Americans with Disabilities Act, and the Family and Medical Leave Act.[56]

An essential factor in determining whether a worker is an employee or an independent contractor is the level of control the business exerts over them.[57] The more control exerted by the hirer, the more it seems the worker is an employee rather than an independent contractor.[58] The potential for business savings through decreased tax liability and benefit pay-outs provides a keen incentive for hirers to classify a worker as an independent

health/seniors-nontraditional-jobs.html (indicating that those working non-traditional jobs, such as driving for Uber, often do not fit the age and socioeconomic level people associate with those positions). These unexpected demographics, and other considerations—such as that many gig workers may take jobs to supplement income or fill their time, not as a principal occupation—should be factored into the independent-contractor-or-employee public policy debate.

52. U.S. DEP'T OF LABOR, *supra* note 50, at 6.

53. *How to Determine a Worker's Classification*, NFIB GUIDE TO INDEPENDENT CONTRACTORS (last visited June 20, 2022), https://www.nfib.com/Portals/0/PDF/AllUsers/legal/guides/independent-contractors-guide-nfib.pdf (hereinafter NFIB GUIDE).

54. *Id.*

55. *Id.*

56. Lynn Rhinehart et al., *Misclassification, the ABC Test, and Employee Status*, ECON. POL'Y INST. (June 16, 2021), https://www.epi.org/publication/misclassification-the-abc-test-and-employee-status-the-california-experience-and-its-relevance-to-current-policy-debates/.

57. *Id.*

58. *Id.*

contractor.[59] A 2013 report from the Treasury Inspector General for Tax Administration concluded that employers could save an average of $3,710 per employee earning an annual income of $43,007 by misclassifying the employee as an independent contractor.[60] However, employers can face heavy fines, litigation costs, and back pay if a worker is misclassified as an independent contractor and therefore does not receive the protections afforded employees by law.[61] Even innocent misclassifications can result in stiff penalties.[62] For example, a franchise owner who misclassifies *all* workers as independent contractors will incur significant penalties and have to reclassify their workforce as employees from the date of the initial misclassification.[63] Other penalties may include a $50 fine for each Form W-2 the employer failed to file on a misclassified employee, as well as a penalty of up to 3% of the wages, 40% of the FICA taxes that were not withheld from the employee, and 100% of the matching FICA taxes the employer should have paid.[64]

If the IRS concludes that an employer intentionally misclassified employees, the penalties are even greater, and may make employers liable to their misclassified employees.[65] Accordingly, making an accurate designation is crucial, but the tests courts

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59. *Misclassification of Employees as Independent Contractors – 2016 Fact Sheet*, Dep't for Professional Employees (June 15, 2016), https://www.dpeaflcio.org/factsheets/misclassification-of-employees-as-independent-contractors. Employment, income, and Social Security taxes account for 20-40% of labor costs (citing *Hearing Before the S. Comm. on Health, Education, Labor, and Pensions*, 111th Cong. 2 (2010) (statement of Seth D. Harris, Deputy Sec'y of the U.S. Dep't of Lab.), https://www.help.senate.gov/imo/media/doc/Harris4.pdf).

60. *Id.* (citing *Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings*, Treasury Inspector General for Tax Administration (June 14, 2013), http://www.treasury.gov/tigta/auditreports/2013reports/201330058fr.pdf).

61. Rhinehart et al., *supra* note 56; MBO Partners, *Top 5 Employee Misclassification Penalties to Avoid* (Oct. 21, 2022), https://www.mbopartners.com/blog/misclassification-compliance/employee-misclassification-penalties/ (Oct. 21, 2022).

62. *See* Richard Reibstein, *Cares Act III: Pandemic Unemployment Assistance Extended Yet Again for Independent Contractors*, Locke Lord (Mar. 11, 2021), https://www.lockelord.com/newsandevents/publications/2021/03/cares-act-iii-pandemic-unemployment-assistance-ext.

63. *Id.*

64. Burr Forman, *2021 Update – IRS Misclassifications and Costly Penalties: Independent Contractor or Employee* (June 16, 2021), https://www.jdsupra.com/legalnews/2021-update-irs-misclassifications-and-8009270/.

65. 26 U.S.C. § 7434 (1998) calls for civil damages for the fraudulent filing of information returns.

use to determine worker status are perplexing and vary on a case-by-case basis, leading to uncertainty.[66]

A. *The Common Law Test: FedEx Home Delivery, to SuperShuttle, to Atlanta Opera*

The traditional or common law test, also known as the "right to control" or "master-servant" test,[67] focuses primarily on the level of control an employer has over its employee.[68] The more control and authority an employer holds over the worker, the more likely that worker is an employee.[69] This test has its origins in agency and tort law, where plaintiffs seek to establish vicarious liability against employers for the actions of their employees.[70] Courts examine multiple factors when determining the right to control, including:

> (1) The extent of control which it is agreed that the employer may exercise over the details of the work; (2) whether or not the worker is engaged in a distinct business or occupation; (3) the kind of occupation, and whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision; (4) the skill required in the particular occupation; (5) whether the employer or the worker supplies the instrumentalities, tools, and the workplace; (6) the length of time for which the person is employed; (7) the method of payment, whether by the time worked or by the job; (8) whether or not the work is part of the regular business of the employer; (9) whether or not the parties believe they are creating an employer-employee relationship; and

66. *See* Fortner v. Specialty Contracting, LLC, 217 So. 3d 736 (Miss. Ct. App. 2017) (holding that Mississippi courts could use the control test and the nature of work test, which looks at (1) the character of the work, such as how skilled is the work, how much of the work is a separate calling or enterprise, and to what extent the work considers its accident burden; (2) the work's relation to the employer's business; (3) whether the work is continuous or intermittent; and (4) the length of time needed to do the work).

67. Oria O'Callaghan, *Independent Contractor Injustice: The Case for Amending Discriminatory Discrimination Laws*, 55 Hous. L. Rev. 1187, 1194 (2018).

68. *Id.* at 1194.

69. *Id.*

70. *Id.*

(10) whether or not the worker does business with others.[71]

No single factor is meant to be controlling in this analysis, and the determination is made on a case-by-case basis.[72]

Eighteen states, the District of Columbia, and the National Labor Relations Board (NLRB) use a version of this test.[73] The NLRB's use of this test is especially significant because independent contractors do *not* have a protected right under the National Labor Relations Act (NLRA) to form labor unions,[74] highlighting the impact of employee classification on workers' bargaining power.

Moreover, the NLRB's recent *Atlanta Opera* decision makes it easier for workers to be classified as employees and to access the privileges afforded by the NLRA.[75] While the NLRB follows the common law test, the 2019 *SuperShuttle* ruling[76] reintroduced the worker's "entrepreneurial opportunity for gain or loss" as the test's "animating principle."[77] Despite the traditional hallmarks of control exercised by the hirer in *SuperShuttle*, which included mandatory uniforms and established set fares the drivers could charge, the NLRB found that the drivers were independent contractors given their "freedom to keep

71. Myra H. Barron, *Who's an Independent Contractor? Who's an Employee?*, 14 Lab. Law. 457, 459 (1999).

72. *See How to Apply the Common Law Control Test in Determining an Employer/Employee Relationship*, Soc. Sec. Admin., https://www.ssa.gov/section218training/advanced_course_10.htm#4.

73. Shelbie Watts, *Independent Contractor Laws: What You Need to Know*, Homebase (Oct. 31, 2023), https://joinhomebase.com/blog/independent-contractor-laws/; *See* Office of Public Affairs, *NLRB Returns to Long-Standing Independent-Contractor Standard*, Nat'l Lab. Rels. Bd., (Jan. 25, 2019), https://www.nlrb.gov/news-outreach/news-story/nlrb-returns-to-long-standing-independent-contractor-standard; Minnesota Timberwolves Basketball, LP, 365 N.L.R.B. 124 (2017).

74. David J. Pryzbylski & Emily Lodge, *Classifying Workers as Independent Contractors May Soon Become More Complicated*, Barnes & Thornburg (July 18, 2022), https://btlaw.com/en/insights/blogs/labor-and-employment/2022/classifying-workers-as-independent-contractors-may-soon-become-more-complicated.

75. The Atlanta Opera, Inc., 372 N.L.R.B. 95 (2023).

76. SuperShuttle DFW, Inc., 367 N.L.R.B. 75 (2019).

77. Hirschfeld Kraemer LLP, *NLRB Returns to Employer-Friendly Standard for Employee vs. Independent Contractor Test; Little Impact Foreseen for CA Employers*, Blog: The Cal. Workplace Advisor, (Mar. 7, 2019), https://www.hkemploymentlaw.com/nlrb-returns-to-employer-friendly-standard-for-employee-vs-independent-contractor-test-little-impact-foreseen-for-ca-employers/.

all fares they collect, coupled with their unfettered freedom to work whenever they want."[78]

The *SuperShuttle* approach was in sharp contrast to the NLRB's previous analysis under *FedEx Home Delivery*, which focused on whether workers were "*in fact*, rendering services as part of an independent business."[79] By emphasizing a worker's "*potential* for entrepreneurial activity,"[80] and adjusting the focus of its test in this manner, the NLRB effectively made it easier for employers to draft working agreements that keep workers as independent contractors based on the *potential* for entrepreneurial activity by the worker, whether actualized or not.[81] In theory, a restaurant may be able to classify its wait staff as independent contractors by allowing servers to decide the lengths of their shifts based on how busy the restaurant is. Instead of having a manager create a weekly schedule, in this arrangement, the servers would have the entrepreneurial opportunity to pursue more tips by coming to work during the restaurant's busiest hours and serving additional customers during these shifts.

The implications of the *SuperShuttle* Board's employment test may best be illustrated with an example. Consider a courier service that picks up and delivers items within a bounded locale. We will call this hypothetical service, "SuperiorCourier." SuperiorCourier, seeking to limit its liability through use of independent contractors, could force its couriers to enter into non-negotiable, uniform "franchising" agreements that outline required standards and operating procedures, and which expressly bar couriers from working for other courier operations. These agreements could also mandate that the couriers utilize SuperiorCourier's proprietary software as the sole means for accepting jobs. SuperiorCourier could retain the right to modify the terms of this agreement for any reason, and at any time. Further still, SuperiorCourier could compel its couriers to accept coupons, recognize promotions, lease vehicles to couriers with poor credit, and employ largely unskilled laborers. As the dissenting NLRB member in *SuperShuttle* points out, each of these requirements contradicts the traditional notions

78. *Id.*
79. FedEx Home Delivery, Inc. 361 N.L.R.B. 55 (2014).
80. Hirschfeld Kraemer LLP, *supra* note 77.
81. *See id.*

of agency law.[82] Nevertheless, under the majority's reasoning, SuperiorCourier would be able to operate in this manner and still classify its workers as independent contractors.

Nonetheless, the NLRB has since abandoned this employer-friendly standard. In *Atlanta Opera*, the Board overruled *SuperShuttle* and decided to return to the *FedEx* approach.[83] Following this decision, the NLRB again evaluates worker-business relationships using the ten factors of the common law test, with no single factor being determinative.[84] This is a more holistic approach, as it allows workers to specify many factors indicating that they should be classified as employees, rather than focusing on minimizing their potential opportunity for entrepreneurial gain. In theory, this will make it easier for workers to be classified as employees and thereby access NLRA protections.

B. *The Economic Realities Test*

While the "right to control" test is still in use, new tests have developed in accord with a heightened emphasis on workers' protections, rather than imposition of tort liability.[85] These tests have led courts to consider factors other than control when distinguishing between employees and independent contractors.[86] One such test is the "economic realities" test.[87] The Department of Labor (DOL) uses a version of this test to determine whether a worker is an employee and thereby entitled to minimum wage and overtime protections under the FLSA, or an independent contractor without such protections.[88]

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82. SuperShuttle, 367 N.L.R.B. at 75.

83. Steven J. Porzio, Joshua S. Fox & Alexander J. Blutman, *Third Act: NLRB Reinstates Employee-Friendly Independent Contractor Analysis under the NLRA*, NAT'L L. REV. (June 15, 2023), https://www.natlawreview.com/article/third-act-nlrb-reinstates-employee-friendly-independent-contractor-analysis-under.

84. *Id.*

85. *See* Richard Carlson, *Why the Law Still Can't Tell an Employee When It Sees One and How It Ought to Stop Trying*, 22 BERKELEY J. EMP. & LAB. L. 295, 301–34 (2001).

86. *See id.*

87. *See id.* For a discussion of the key terms in the "economic realities" test, *see infra* notes 215–18 and accompanying text.

88. *See* Michael D. Koppel, *Independent Contractor or Employee? Varying Tests*, THE TAX ADVISOR (Dec., 1, 2019), https://www.thetaxadviser.com/issues/2019/dec/independent-contractor-employee-tests.html. A number of jurisdictions use this test, while others use a "hybrid" test which analyzes the economic realities of the work relationship while emphasizing the hiring party's

According to the DOL, significant factors for determining worker classification under the FLSA include:

> (1) The extent to which the services rendered are an integral part of the principal's business; (2) the permanency of the relationship; (3) the amount of the alleged contractor's investment in facilities and equipment; (4) the nature and degree of control by the principal; (5) the alleged contractor's opportunities for profit and loss; (6) the amount of initiative, judgment, or foresight in open market competition with others required for the success of the claimed independent contractor; and (7) the degree of independent business organization and operation.[89]

As the DOL notes, the U.S. Supreme Court, interpreting the FLSA, has held that there is no one rule, factor, or test for determining whether an individual is an independent contractor or an employee for purposes of the FLSA; rather, one must look to the totality of the circumstances.[90] "In the application of the FLSA an employee, as distinguished from a person who is engaged in a business of his or her own, is one who, *as a matter of economic reality*, follows the usual path of an employee and is *dependent* on the business which he or she serves."[91] This is a departure from the common law test because the working relationship under the FLSA is determined by "economic reality" rather than "technical concepts."[92] Under the broader scope of this test, each case is examined on a case-by-case basis, and it is the total activity or situation which controls the outcome, not contractual language.[93]

"right to control the 'means and manner' of the worker's performance." Blake E. Stafford, *Riding the Line Between Employee and Independent Contractor in the Modern Sharing Economy*, 51 Wake Forest L. Rev. 1223, 1228 (2016).

89. *Fact Sheet 13: Employment Relationship Under the Fair Labor Standards Act (FLSA)*, Dep't of Lab. (Revised July 2008), https://www.dol.gov/agencies/whd/fact-sheets/13-flsa-employment-relationship.

90. *Id.*

91. *Id.* (emphasis added) (paraphrasing Hopkins v. Cornerstone Am., 545 F.3d 338, 343 (5th Cir. 2008) (citing Herman v. Express Sixty–Minutes Delivery Serv., Inc., 161 F.3d 299, 303 (5th Cir. 1998))).

92. *See id.* (citing Brock v. Mr. W Fireworks, Inc., 814 F.2d 1042, 1043–44 (5th Cir. 1987)).

93. *See, e.g.*, Beliz v. W.H. McLeod & Sons Packing Co., 765 F.2d 1317, 1329 (5th Cir. 1985) ("The principles governing employer status . . . turn on economic reality, not contractual niceties.").

Interestingly, Donald Trump, late in his presidency, attempted to change the economic realities test, which has existed in its current form for several decades.[94] On January 7, 2021, the Trump Administration issued a "simplified" version of the test,[95] which primarily focused on two core or primary factors, but also considered three additional or secondary factors.[96] The core factors would have been (1) the nature and degree of the worker's control over the work, and (2) the worker's opportunity for profit or loss.[97] The three additional factors would have been (1) the amount of skill the work required, (2) the permanence of the working relationship, and (3) how integrated the worker's role was to the organization's operation.[98] However, before the business-friendly Trump version of the test made it through the formal rulemaking process, President Joe Biden ordered its withdrawal by the DOL, and it never took effect.[99] Publicly, the DOL stated that the rule was not "fully aligned with the FLSA's text or purpose or with decades of case law describing and applying the multifactor economic realities test."[100]

Accordingly, on October 13, 2022, the DOL proposed a new rule which would provide guidance for employers in classifying their workers.[101] The framework to be used under this proposed rule is intended to be more "consistent with

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94. *See DOL Withdraws January 2021 Trump Administration Independent Contractor Test*, McGuire Woods (May 6, 2021), https://www.mcguirewoods.com/client-resources/Alerts/2021/5/dol-withdraws-january-2021-trump-administration-independent-contractor-test.

95. *See* Tahir Boykins & Mark Konkel, *The Trump-era Independent Contractor Rule is Officially Out*, JDSupra (May 11, 2021), https://www.jdsupra.com/legalnews/the-trump-era-independent-contractor-8408573/.

96. *See id.*

97. *See id.*; note the resemblance of this approach to the aforementioned Trump-era *SuperShuttle* decision, which also highlighted a worker's potential for entrepreneurial activity in the employee-independent contractor analysis.

98. Mark A. Konkel, *Independent Contractor Final Rule (For Now)*, Kelley Dry (Jan. 12, 2021), https://www.labordaysblog.com/2021/01/independent-contractor-final-rule-for-now/.

99. *See* Lindsey R. Camp et al., *DOL Rescinds Trump-Era Rule Regarding Employment Status Under the FLSA*, Holland & Knight (May 19, 2021), https://www.hklaw.com/en/insights/publications/2021/05/dol-rescinds-trump-era-rule-regarding-employment-status-under-the-flsa.

100. *Id.*

101. Notice of Proposed Rulemaking: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, 87 Fed. Reg. 62218 (Oct. 13, 2022) (to be codified at 29 C.F.R. pts. 780, 788, 795); *U.S. Department of Labor Announces Proposed Rule on Classifying Employees, independent Contractors;*

longstanding judicial precedent," and would provide greater protection for workers.[102] The DOL took public comments on the proposed rule until December 13, 2022, and a final version of the rule took effect in March 2024.[103] This action signals President Biden's intent to make workers' protections and rights a continuing priority of his administration.

C. *The ABC Test*

Currently, the ABC test is the most commonly used assessment, with over two-thirds of states adopting it.[104] Under this test, a worker is deemed an independent contractor only if all three components are met: (A) the business does not control the worker's performance of the service, (B) the work is either outside the business's usual course or performed outside of all the business's locations,[105] and (C) the worker is customarily engaged in an independent trade or occupation of the same nature as the work performed for the hiring entity.[106] While a degree of ambiguity is manifest in these factors, which allows agencies applying the ABC test freedom to examine the totality of a worker's relationship to the hirer, the most important factor to consider is the degree of control the hirer has over the worker.[107] The practical effect of the ABC test is to place a large burden on hirers seeking to designate workers as independent

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Seeks to return to Longstanding Interpretation, DEP'T OF LAB. (Oct. 13, 2022), https://www.dol.gov/newsroom/releases/WHD/WHD20221011-0.

102. *See* U.S. DEP'T OF LAB., *supra* note 101.

103. *Employee or Independent Contractor Classification Under the Fair Labor Standards Act*, OFF. OF INFO. AND REGUL. AFFS. (2023), https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202304&RIN=1235-AA43. On January 10, 2024, the Department of Labor published a final rule, effective March 11, 2024. *Final Rule: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, RIN 1235–AA43*, U.S. DEPT. OF LAB. (2024), https://www.dol.gov/agencies/whd/flsa/misclassification/rulemaking.

104. NFIB GUIDE*, supra* note 53, at 11. *See also* Watts, *supra* note 73 (indicating that 33 states use the ABC test).

105. *I.e.*, (1) is the work substantially different from an employer's usual course of business (*e.g.*, installing a fence for a law firm), or (2) is the work not performed in a location where the hirer typically does business. *Information for Independent Contractors & 1099 Workers*, N.J. DEP'T OF LAB. & WORKFORCE DEV., https://www.nj.gov/labor/worker-protections/myworkrights/independentcontractors.shtml (last visited Sept. 5, 2022).

106. NFIB GUIDE*, supra* note 53, at 11; *ABC Test*, CAL. LAB. & WORKFORCE DEV. AGENCY, https://www.labor.ca.gov/employmentstatus/abctest/ (last visited Oct. 1, 2022).

107. *Id.*

contractors, as the test presumes that workers are employees unless all three components are established.[108]

Component A of the ABC test corresponds with the common law test, which emphasizes control over a worker to the exclusion of other factors.[109] However, to qualify as an independent contractor, components B and C must also be met, both of which suffer from ambiguity.[110] Component B closely examines the service performed and demands that one of two requirements be met.[111] For example, if the service is integral to the nature of the business, then it must be performed outside of the location where the hirer typically conducts its business.[112] This constraint greatly limits the types of workers businesses can hire without designating such workers as employees.[113] The issue with component B lies in the lack of a universally accepted definition for a company's "usual course of business."[114] While state and federal courts have provided interpretations, they often apply the "strictest" description of what the business does.[115] Similarly, component C, which requires the worker's business to operate separately and independently from the hiring entity, suffers from the same issue—consistently and accurately defining what a business does is difficult.[116]

To further complicate matters, there is no uniform version of the test. States that use the ABC test vary in the wording of and emphasis placed on its components.[117] For example, in 2004, the Massachusetts legislature removed the latter factor from component B, which focuses on the location where

108. Erik Sherman, *PRO Act & ABC Test: No One Knows What the Effects Will Be*, FORBES, (Mar. 24, 2021), https://www.forbes.com/sites/eriksherman/2021/03/24/pro-act-and-abc-test-no-one-knows-what-the-effects-will-be/?sh=5c2606a3339e; Koppel, *supra* note 88.

109. *See supra* notes 68–71 and accompanying text.

110. Koppel, *supra* note 88.

111. *See* N.J. DEPT. OF LAB. & WORKFORCE DEV., *supra* note 105.

112. *Id.* For example, if a law firm hires an outside attorney to perform document review, that attorney must perform the work outside of the firm's offices if the firm wishes to characterize the attorney as an independent contractor. Otherwise, they will be more readily found an employee by a reviewing court or agency.

113. *See* Watts, *supra* note 73.

114. *See* Sherman, *supra* note 108.

115. *Id.*

116. *Id. See also* Anna Deknatel & Lauren Hoff-Downing, *ABC on the Books and in the Courts: An Analysis of Recent Independent Contractor and Misclassification Statutes*, 18 U. PA. J.L. & SOC. CHANGE 53, 70 (2015).

117. *See, e.g.*, Watts, *supra* note 73.

the work is performed.[118] As a result, under Massachusetts law, the presumption that a worker is an employee is even more robust than in the typical ABC test, as a worker is considered an employee unless the worker's services are demonstrated to be "outside the usual course of business."[119] This standard has led courts in Massachusetts to classify workers in several industries as employees, regardless of the level of control exerted over them.[120]

California has implemented its own version of the ABC test. Under wage orders set by California's Industrial Welfare Commission (IWC), an individual is employed by a business if said business "suffered or permitted" the individual's performed work to be carried out.[121] In the absence of a clear meaning of "suffered or permitted," however, the courts were left to develop their own interpretation.[122] The court in *Martinez v. Combs*[123] took up that role, creating a three-part test, which establishes that a business "suffers or permits" work where it: has knowledge that work is occurring and fails to prevent it.[124] The clear upshot of this definition is that it allows employment status to be triggered not only through an individual's actions but also through inaction, thereby protecting non-traditional or irregular working relationships previously not recognized at common law.[125]

With *Martinez* as its foundation, the California Court of Appeals further clarified employment status in *Dynamex* by

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118. MASS. GEN. LAWS ch. 149, § 148B (2019).

119. *Id.*

120. *See* Schwann v. FedEx Ground Packages Sys., Inc., 2013 WL 3353776 (D. Mass. July 3, 2013) (holding delivery drivers to be employees of delivery company under § 148B); Chaves v. King Arthur's Lounge, Inc., 2009 WL 3188948 (Mass. Super. July 30, 2009) (holding exotic dancers to be employees of strip club in which they performed); Awuah v. Coverall N. Am., Inc., 707 F. Supp. 2d 80 (D. Mass. 2010) (holding cleaning workers who were classified as franchisees to be employees).

121. Martinez v. Combs, 231 P.3d 259, 273 (Cal. 2010).

122. *See* Alexander Moore, *Reexamining Joint Employment Wage and Hour Claims Following Dynamex and AB 5*, 54(3) LOY. OF L.A. L. REV. 917, 939–40 (2021).

123. *See Martinez*, 231 P.3d at 281 (holding that a business owner "shall not *employ* by contract, nor shall he *permit* by acquiescence, nor *suffer* by a failure to hinder" the work (quoting Curtis & Gartside Co. v. Pigg, 134 P. 1125, 1129 (Okla. 1913))).

124. *Id.*

125. *Id.*

instituting the ABC test.[126] Under the ABC test, a worker is *presumed* to be an employee unless the business proves: (A) that the worker is free from the control and direction of the hiring entity in connection with the performance of the work, as per the contract and the relationship in fact; (B) that the worker performs work that is outside the usual course of the hiring entity's business; *and* (C) that the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed.[127] This test has been applied in a number of franchise cases in numerous states.[128] For each jurisdiction, however, just because an independent contracting versus employment test applies in one field does not mean that it applies in another field.[129]

126. Moore, *supra* note 122, at 950.

127. *See* Dynamex Operations W., Inc. v. Superior Court, 416 P.3d 1, 35 (Cal. 2018). Note that his is the same test as that codified in 2019 by California's AB 5. *See supra* Part IV.B.ii. It should also be noted that while *Martinez* arose from a joint employment action, *Dynamex* and AB 5 deal with misclassification of independent contractors. *Dynamex*, 416 P.3d at 5. Finally, *Dynamex*'s ABC test has since been held by the California Supreme Court to apply to "all nonfinal cases that predate the effective date of the *Dynamex* decision." Vazquez v. Jan-Pro Franchising Int'l, Inc., 478 P.3d 1207, 1216 (Cal. 2021).

128. *See* Mujo v. Jani-King Int'l, Inc., 13 F.4th 204, 210 (2d Cir. 2021) ("individual can be an employee . . . if an application of the ABC test would deem that individual an employee, even if that same individual is also a franchisee"); Vazquez v. Jan-Pro Franchising Int'l, Inc., 986 F.3d 1106, 1124 (9th Cir. 2021) (upholding the application of the ABC test to franchises); Depianti v. Jan-Pro Franchising Int'l, Inc., 39 F. Supp. 3d 112, 124 (D. Mass. 2014) (citing Jan-Pro Franchising Int'l, Inc. v. Depianti, 712 S.E.2d 648, 649–52 (Ga. Ct. App. 2011) and likewise applying a form of the ABC test, as found in Massachusetts law, to deny the claims of janitorial franchisees that they were misclassified as independent contractors and were actually employees of both their regional master franchisee and the franchisor); Jason Robert's, Inc. v. Administrator, Unemployment Compensation Act, 15 A.3d 1145 (Conn. App. 2011) (holding that the ABC test applies to franchises); Patel v. 7-Eleven, Inc., 183 N.E.3d 398, 412 (Mass. 2022) (concluding, "the independent contractor statute [the ABC statute] applies to the franchisor-franchisee relationship and is not in conflict with the franchisor's disclosure obligations set forth in the FTC Franchise Rule.").

129. Most states do apply the "ABC" test in their analyses for unemployment insurance eligibility under the National Labor Relations Act and the Fair Labor Standards Act. *See* Shu-Yi Oei, *The Trouble with Gig Talk: Choice of Narrative and the Worker Classification Fights*, 81 L. & CONTEMP. PROBS. 107, 122 (2018). Professor Oei notes, "determination of worker classification is done separately for each area of law. However, there is overlap in the substantive considerations that each field takes into account, although there may be differences at the margin." *Id.*

D. *The IRS Control Test*

Finally, the Internal Revenue Service (IRS) employs its own test, primarily used in federal tax law, which centers on the fundamental control test.[130] The IRS recently released Publication 15-A, outlining new and revised criteria for independent contractors and employers and their tax concerns.[131] While Publication 15-A does not change the previous IRS criteria, it offers more focused guidance moving forward.[132] For example, the longstanding "20 factor" test remains valid.[133] As the name indicates, that test includes 20 criteria used to evaluate whether a worker is an employee or an independent contractor.[134] A worker does not have to meet all 20 criteria, and no single factor is outcome determinative.[135] However, the IRS's overarching concern, for purposes of distinguishing between employees and independent contractors, is now the hirer's level of control and ability to direct the worker's actions.[136] Starting January 1, 2020, the IRS began grouping factors into three broad "areas" of control:

> (1) Behavior control - these factors look at whether the business has a right to direct and control how the workers do the tasks for which they were hired;
>
> (2) Financial control - these factors assess the facts that show whether the business has a right to control the business aspects of the worker's job, including how the worker is paid, the worker's investments in the tools used, and how business expenses are reimbursed; and

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130. I.R.S. Pub. No. 15-A, *Employer's Supplemental Tax Guide* (Dec. 23, 2019), https://www.irs.gov/pub/irs-pdf/p15a.pdf; David Houston, *The "New" IRS Independent Contractor Test — The More Things Change the More They Stay the Same*, FRASER TREBILCOCK BLOG (Jan. 30, 2020), https://www.fraserlawfirm.com/blog/2020/01/the-new-irs-independent-contractor-test-the-more-things-change-the-more-they-stay-the-same/.

131. Houston, *supra* note 130.

132. *Id.*

133. Rev. Rul. 87-41, 1987-1 C.B. 296; Koppel, *supra* note 88.

134. Or. Dep't of Agric., *IRS 20 Factor Test – Independent Contractor or Employee?*, https://www.oregon.gov/oda/shared/Documents/Publications/NaturalResources/20FactorTestforIndependentContractors.pdf (last visited Mar. 26, 2023).

135. *Id.*

136. Houston, *supra* note 130.

> (3) Type of relationship - these factors assess the facts that show the nature of the relationship, including the terms and conditions of the written contract, the length of the relationship, and whether the services involve regular business activity of the employer.[137]

It is questionable why the IRS uses its own worker classification test despite its similarities to the common law test.[138] Perhaps the reason lies in the IRS's goal to properly assess tax liability and collect revenue. If a worker is deemed an employee, the employer usually must withhold federal income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee.[139] However, if a worker is deemed an independent contractor, the business is usually not liable for these taxes.[140] Focusing on the Social Security tax[141] illustrates the practical impact of worker classification. Currently, the Social Security tax rate is 12.4% of income.[142] If a worker is classified as an employee, both the employee and employer split the tax burden, with the employer withholding 6.2% from the employee's paychecks (i.e., the employee's tax contribution) and matching the remaining 6.2% of the tax liability.[143] Conversely, independent contractors must pay the full 12.4% Social Security tax on their income as part of the "Self-Employment tax."[144] With this simple example

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137. *Id.*

138. I.R.S. Pub. 15-A, *supra* note 130.

139. *Id.*

140. *Id.*

141. Formally, the Social Security tax is known as Old-Age, Survivors, and Disability Insurance (OASDI). *What Are the Major Federal Payroll Taxes, and How Much Money Do They Raise?*, TAX POL'Y CENTER, URBAN INST. & BROOKINGS INST., https://www.taxpolicycenter.org/briefing-book/what-are-major-federal-payroll-taxes-and-how-much-money-do-they-raise (last visited Sept. 5, 2022).

142. *Id.* Note, the overall Social Security tax is 12.4% of income, but as of 2021 a maximum of $142,800 can be taxed to cover Social Security. *Contribution and Benefit Base*, SOC. SEC. ADMIN., https://www.ssa.gov/oact/cola/cbb.html (last visited Sept. 5, 2022); *Topic No. 751 Social Security and Medicare Withholding Rates*, I.R.S. (Jan. 1, 2024), https://www.irs.gov/taxtopics/tc751.

143. *See* Donna Fuscaldo, *What Small Businesses Need to Know About FICA Tax*, BUS. NEWS DAILY (Oct. 26, 2023), https://www.businessnewsdaily.com/16185-fica-taxes.html.

144. *Self-Employment Tax (Social Security and Medicare Taxes)*, I.R.S., (Aug. 3, 2023), https://www.irs.gov/businesses/small-businesses-self-employed/self-employment-tax-social-security-and-medicare-taxes. However, it is not all bad news for independent contractors. First, independent contractors are able to deduct up to half of their Self-Employment tax from their adjusted

in mind, it is not hard to imagine why businesses seek to have workers classified as independent contractors—it significantly benefits their bottom line.[145] Still, despite the IRS's attempt to offer more focused guidance, the test's inherent flaws only contribute to the confusion between employee and independent contractor status. As tax expert Michael D. Koppel points out, proper classification can only be determined after a case-by-case analysis in court.[146]

III.
Joint Employment Law

The franchise model is built on the premise that the franchisor has developed a system that it licenses to *independent*

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gross income. Additionally, independent contractors may be eligible to claim the Earned Income Tax Credit (EITC). *Id.; see also* 26 U.S.C. § 199A. I.R.C. § 199A provides that individuals who are independent contractors can qualify for a 20% tax deduction on their independent contractor income as long as certain eligibility requirements are met. With this additional incentive, several outcomes are possible: (1) workers who are currently employees could abandon their employee jobs and do independent contractor jobs instead, (2) workers who are currently employees could try to re-characterize their current jobs as independent contractor work, or (3) firms could convert employee jobs into independent contractor jobs. Interestingly, independent contractors consistently report higher levels of job satisfaction than standard full-time workers, with over 80% of independent contractors satisfied with their employment type. In the "very-satisfied" category, independent contractors reported 56.8% versus 45.3% for traditional full-time employees. U.S. Gov't Accountability Off., GAO-15-168R, Contingent Workforce: Size, Characteristics, Earnings, and Benefits 24 (2015), https://www.gao.gov/assets/gao-15-168r.pdf.

145. In 2019 alone, federal payroll taxes generated $1.2 trillion (35.9% of federal revenues), and this figure rose to $1.3 trillion (32.5%) in 2021. *See Policy Basics: Federal Payroll Taxes*, Ctr. on Budget and Pol'y Priorities, https://www.cbpp.org/research/federal-tax/federal-payroll-taxes (Oct., 25 2022) (citing *Budget of the United States Government, Fiscal Year 2019*, Off. of Management & Budget, Historical Tables). Although the Biden Administration initially planned to rollback Trump era tax cuts and strengthen Social Security, they later decided to extend those cuts for households earning under $400,000, making future projections uncertain. *See* Richard Rubin, *Biden Seeks Extension of Trump Tax Cuts for Most Households*, Wall. St. J. (Mar. 9, 2023, 4:16 PM), https://www.wsj.com/articles/biden-seeks-extension-of-trump-tax-cuts-for-most-households-9109b53f.

146. Koppel, *supra* note 88; *see also* Alan Gassman, *What Is an Independent Contractor? Here's Why It Matters Under the Trump Tax Law*, Forbes (Oct. 5, 2018), https://www.forbes.com/sites/alangassman/2018/10/05/what-is-an-independent-contractor/?sh=198481861692.

contractors.[147] These contractors then own and operate their own individual businesses under the terms of the franchise agreement.[148] In many cases, franchisees establish a separate business entity under which they operate their franchise, such as a corporation or LLC. As one commentator puts it, "The view that the franchisor is somehow an employer of the franchisee, or *even a joint employer of those who work for the franchisee*, is inconsistent with the fundamental concept of franchising."[149] Such a determination presents, in effect, a high, if not insurmountable, bar to treating franchisors as jointly responsible for actions allegedly taken by persons working at or for a franchise entity. Third parties who are considering lawsuits or other challenges against franchise parties may justifiably view joint employment to be a critical factor that should be considered early in the process. If an entity (e.g., a franchisor) is in fact found to be a joint employer, this entity could be held liable for (1) the labor violations alleged by an employee against the other joint employer (e.g., the franchisee),[150] or (2) the negligent acts of a joint employee under *respondeat superior*.[151]

The conclusion that joint employment is antithetical to franchising is debatable. Those opposed to classifying franchisors as joint employers of their franchisees' workers argue that this status would "create an immense amount of legal risk" for

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147. Barry M. Heller, *Employee and Independent Contractor Classification: Still the Top Legal Issue in Franchising*, DLA PIPER (Mar. 29, 2021), https://www.dlapiper.com/en/insights/publications/intellectual-property-and-technology-news/2022/ipt-news-q1-2021/employee-and-independent-contractor-classification.

148. *Id.*

149. *Id.* (emphasis added).

150. Stephanie L. Adler-Paindiris et al., *Class Action Trends Report, Fall 2018: Are You My Employer?*, 70 LAB. L.J. 75, 76 (2018). For example, "[a] rental car company that uses the services of an outside agency to staff customer service call centers may be held liable under the FLSA if the staffing agency fails to pay overtime to those employees." *Id.* at 77.

151. For example, an employee at a franchised store outlet fails to maintain a safe, clean environment, resulting in a customer's injuries from a slip and fall. For a detailed analysis of bases for finding franchisor liability related to the behavior of franchisees, particularly focusing on issues related to trademark licensing and agency law principles, *see* Emerson, *supra* note 9, at 580–600; *see also* Robert W. Emerson, *An International Model for Vicarious Liability in Franchising*, 50 VAND. J. TRANSNAT'L L. 245, 271–90 (2017) (discussing various approaches that the European Union and many nations have employed when analyzing possible cases of franchisor vicarious liability for a franchisee's actions or inaction).

franchisors.[152] These commentators theorize that if franchisors could be classified as joint employers based on the level of support provided to their franchisees, they would "back off providing that kind of indirect support to their franchisees to make a business successful."[153] Indeed, there is anecdotal support that some franchisors did pull back on support to franchisees in the wake of the *Browning-Ferris* decision in 2015, though it is unclear what the extent of this effect was and how pervasive it was in franchising as a whole.[154] The support and training provided by franchisors to franchisees is one of the primary appeals of the franchising system, and the concern is that discouraging this support would derail the franchising model entirely.[155]

However, this concern is likely overblown. While providing a higher level of support to franchisees indicates greater control, and thus makes a finding of joint employer status more likely, franchisors still have legal incentives to provide this support.[156] By entirely withdrawing support to franchisees, franchisors open themselves up to breach of contract liability to franchisees who entered into the franchise agreement expecting to receive this support.[157] Franchisors simply ceasing to offer integral services to avoid classification under a new joint employment standard is likely unreasonable in light of the legal liability to which it would expose these franchisors. Further, there are additional steps that franchisors can take to avoid being classified as joint employers, such as offering a wider range of approved suppliers for franchisees to pick from and making it clear that policies outlined in any manuals provided

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152. Aneurin Canham-Clyne, *IFA Forms Law Center to Fight Joint Employer Rules*, RESTAURANT DIVE (Nov. 2, 2023), https://www.restaurantdive.com/news/international-franchise-asscoiation-forms-law-center-to-fight-joint-employer-rules/698618/; *see also Joint Employer*, INTERNATIONAL FRANCHISE ASSOCIATION, https://www.franchise.org/advocacy/brand-standards/joint-employer#:~:text=For%20many%20franchisees%2C%20an%20expanded,less%20support%20from%20their%20brands.

153. Canham-Clyne, *supra* note 152.

154. Joyce Mazero et al., *Drawing Lines in Franchisor Support — Is It Necessary and Where Are the Lines to Draw in Today's Joint-Employment Environment?*, 38 FRANCHISE L.J. 327, 347-49 (2019). The authors, Mazero et al., collected responses from 32 franchisors or franchisees, and many of the respondents noted that there had been a withdrawal of some support functions in their franchise systems following the Browning-Ferris decision. *Id.*

155. *See supra* notes 5–47, and accompanying text.

156. Mazero et al., *supra* note 154, at 327.

157. *Id.* at 329.

to franchisees are truly suggestions.[158] For franchisors who wish to avoid joint employer classification, ceding more operational control to franchisees likely remains an option.

Even if a greater presumption of joint employment in franchising increases some costs for franchisors, there is a strong argument that this burden is outweighed by the benefits to those employed within the franchise system. Various studies conducted in the past decade suggest that billions of dollars in wages and other benefits have been illegally withheld from low-wage employees across a wide range of industries, with the effects being particularly bad in franchised businesses, such as fast-food restaurants.[159] One of the root causes of this problem is the lax joint employment standard traditionally applied to the franchise context, which has made it difficult for employees to protect themselves from wage theft and other related labor violations in the franchise context.[160] Under the existing joint employment regime, many large franchisors were able to resist bargaining with franchise workers, and largely avoided liability for labor violations.[161] By classifying franchisors as joint employers of franchise workers, the franchisors can, it has been contended, be made to engage in collective bargaining; that, in turn, offers opportunities for workers to secure greater protections and hold franchisors accountable for any labor violations they may commit.[162] While this higher standard will likely come with additional costs to franchisors, these costs are necessary in exchange for the millions or even billions of dollars in additional wages and other benefits that workers across the country could potentially receive through more equitable bargaining.

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158. *See id.*

159. Alex Park, *The Fast Food Industry Runs on Wage Theft,* The New Republic (May 26, 2022), https://newrepublic.com/article/166611/fast-food-wage-theft; David Cooper & Teresa Kroeger, *Employers Steal Billions from Workers' Paychecks Each Year,* Econ. Pol'y Inst. (May 10, 2017), https://www.epi.org/publication/employers-steal-billions-from-workers-paychecks-each-year/.

160. Marni von Wilpert, *States with Joint-Employer Shield Laws Are Protecting Wealthy Corporate Franchisers at the Expense of Franchisees and Workers,* Econ. Pol'y Inst. (Feb. 13, 2018), https://www.epi.org/publication/states-with-joint-employer-shield-laws-are-protecting-wealthy-corporate-franchisers-at-the-expense-of-franchisees-and-workers/.

161. *Id.*

162. *See* Robert Baker & Robert Entin, *NLRB's Final Rule Revamps Definition of Joint Employers–What Employers, Franchisors, and Staffing Agencies Should Know,* JD Supra (Oct. 27, 2023), https://www.jdsupra.com/legalnews/nlrb-s-final-rule-revamps-definition-of-5943094/.

Besides the omnipresent question of whether a worker is an independent contractor or employee, there is the related issue of whether a franchisor and franchisee are joint employers. A joint employer relationship exists when control over an employee is held jointly by more than one entity.[163] While it is conceivable for a franchisor to be held liable as a joint employer,[164] the debate does highlight a fundamental contradiction between a "classic" franchise model and modern concepts of joint employment and independent contracting.

If franchisees do simply "get what they bargain for," then—under the traditional approach—they may be unable to achieve meaningful bargaining power by joining a union.[165] While employees may unionize under the NLRA,[166] franchisees would effectively remain in a lower class, partly because of their own choices under the franchise contract. Other employees could pursue legal remedies against a joint employer that are unavailable to similarly affected employees or other third parties working in a franchise setting.[167]

There are two types of joint employment: horizontal and vertical. Horizontal joint employment is where an employee has two or more employers who are sufficiently associated or related to the employee such that they jointly employ the worker as a "single enterprise."[168] A vertical joint employment relationship, on the other hand, exists where an employee

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163. *See, e.g.*, Adler-Paindiris et al., *supra* note 150, at 76. The various tests employed to reach this determination are the subject of this section.

164. *See infra* Parts III.A & III.B.

165. Independent contractors are prohibited from forming unions under the National Labor Relations Act. National Labor Relations Act of 1935 (NLRA), 29 U.S.C. §§ 151–169 (2018). In franchising, there thus remains a challenge for franchisees seeking to use collective power to counter or negotiate with their franchisor. *See* Robert W. Emerson, *Franchising and the Collective Rights of Franchisees*, 43 VAND. L. REV. 1503, 1558–62 (1990) (proposing the enactment of right-of-association statutes and of antitrust exemptions for franchisee associations, thus providing franchisees, individually and as a group, with protections from some franchisor practices to undermine the development and influence of their associations; the franchisees would have a recognized right to organize and to push for, *inter alia*, collective bargaining with their franchisors, although without lawmakers having taken the final step of treating franchisee associations as having a right, comparable to that of certified labor unions, to compel collective bargaining).

166. National Labor Relations Act of 1935 (NLRA), 29 U.S.C. §§ 151–169 (2018). The NLRA prohibits employers from interfering with the right to organize and collectively bargain.

167. *See* Adler-Paindiris et al., *supra* note 150, at 79.

168. *Id.* at 79–80.

has an employment relationship with one employer, such as a staffing agency, subcontractor, labor contractor, or other intermediary employer. However, the economic realities show that the worker is economically dependent on, and thus employed by, another entity involved in the work.[169] This latter employer, who typically contracts with the intermediary employer to receive the benefit of the employee's labor, would be a potential joint employer.[170]

In the context of franchising, employment relationships often involve horizontal association between the franchisee and franchisor. Employees of a franchise work in the franchisee's business but are also associated with the franchisor,[171] for instance, they wear uniforms bearing the franchisor's logo and name. Vertically, these employees are economically dependent on the franchisee, as the franchised unit's success is the source of their income; then again, they are also dependent on the franchisor, as any financial or public relations issues can jeopardize the employee's livelihood.[172]

The franchise model carries a large portion of potential joint employers. Often, indicia of joint employment arise when the franchisor seeks to protect its brand.[173] Franchisors go to great lengths to protect their brand—arguably their most valuable asset—by imposing standards on the franchisee that serve to both create a uniform experience for the customer and

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169. *Id.* at 77; *see also* Seth C. Oranburg, *Unbundling Employment: Flexible Benefits for the Gig Economy*, 11 DREXEL L. REV. 1, 39–40 (2018) (noting that recent developments in case law have made vertical employment even easier to find than horizontal employment, and that vertical joint employment now seemingly shifts the burden of persuasion to employers who will have to prove they are completely dissociated).

170. Adler-Paindiris et al., *supra* note 150, at 75.

171. *See* Allen Smith, *Are You a Joint Employer?*, SHRM (Jan. 21, 2016), https://www.shrm.org/topics-tools/employment-law-compliance/joint-employer.

172. Adler-Paindiris et al., *supra* note 150, at 75. One manifestation of this sequence of events is the poor publicity given to a franchisor, perhaps due to a founder's political views, which in turn impacts the earnings of franchisees, which may subsequently affect the pay and other job conditions of those franchisees' employees. *See* Robert W. Emerson & Jason R. Parnell, *Franchise Hostages: Fast Food, God, and Politics*, 29 J.L. & POL'Y 353, 353–56, 370 (2014) (discussing prominent examples including, *inter alia*, Chick-fil-A, Papa John's, Denny's, and Citgo).

173. Michael Brennan et al., *Joint Liabilities for Franchisors: Employment, Vicarious Liability, Statutory and Other Liabilities*, 14 INT'L J. FRANCHISING L. 3, 16 (2016).

build brand loyalty, benefiting both the franchisor and franchisee.[174] These standards are a double-edged sword, however, as the more control the franchisor exerts over the franchisee, the more likely it is that joint employment status exists.[175] For example, the high degree of control exerted by McDonald's over its franchisees allows McDonald's to maintain system-wide brand integrity and efficiency. However, this involvement in the franchisees' operations has served as the basis for the NLRB to establish McDonald's as a joint employer of every franchisee's employees.[176]

The designation of joint employer status can have significant financial implications for businesses, making it vital for them to determine their status accurately. However, the joint employment determination is currently lacking clarity, similar to the employee-independent contractor classification. Nevertheless, there may be new developments in this area as the Federal Trade Commission (FTC) issued a "Request for Information" (RFI) on March 10, 2023, seeking public input on franchise agreements and franchisor business practices.[177] The RFI focuses specifically on how franchisors exert control over franchisees and their workers, which, as discussed below,[178] is a factor in determining joint employer status.[179] The FTC solicited input from a variety of parties, including franchisors, franchisees, government entities, economists, attorneys, academics, consumers, and current and former employees.[180] The RFI, with time extensions for more input, aims to gather insight into how franchisors disclose certain aspects and contractual

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174. *Id.*

175. John T. Bender, *Barking Up the Wrong Tree: The NLRB's Joint-Employer Standard and the Case for Preserving the Formalities of Business Format Franchising*, 35 FRANCHISE L.J. 209, 211 (2015); for example, it is one thing for a franchisor to recommend operation policies or to provide software and payroll systems to its franchisee, but it is another to mandate policies that directly impact the franchisee's employees' terms and conditions of employment. Adler-Paindiris et al., *supra* note 150, at 79.

176. Alisa Pinarbasi, *Stop Hamburglaring Our Wages: The Right of Franchise Employees to Union Representation*, 47 U. PAC. L. REV. 139, 155 (2016). Still, this remains uncertain, as Labor Board rulings have varied over the years.

177. *See FTC Seeks Public Comment on Franchisors Exerting Control Over Franchisees and Workers*, FED. TRADE COMM'N (Mar. 10, 2023) (hereinafter *FTC Seeks Public Comment*), https://www.ftc.gov/news-events/news/press-releases/2023/03/ftc-seeks-public-comment-franchisors-exerting-control-over-franchisees-workers.

178. *See infra* Section III.A.

179. *See FTC Seeks Public Comment*, *supra* note 177.

180. *Id.*

terms of franchise relationships amidst growing concerns about unfair and deceptive practices in the franchise industry.[181]

A. *A Right-to-Control Test*

As with the employee-independent contractor determination, a patchwork of tests is used to determine joint employer status. The most common of these is the right-to-control test, which generally asks whether the putative employer has the right to control the means and manner of the employee's work.[182] Factors in this analysis typically look at whether the purported employer has control over the hiring and firing, compensation and training, and day-to-day activities of the employee.[183] Moreover, the court will look at the tools used to perform the work, who owns them, and the length of time the contractual relationship has been in place.[184] In the franchising context, courts have generally held that the "master-servant" relationship required for joint employer vicarious liability develops only when the franchisor maintains extensive controls over the daily operations of the franchisee, distorting the traditional franchise relationship.[185]

In April 2020, the NLRB, whose standard is the model for many jurisdictions, took steps to clarify and simplify this analysis by issuing a final rule regarding the right-to-control test.[186] Before discussing the most recent version of the test, however, a brief history of the NLRB's rule is needed. Prior to 2015, the NLRB classified companies as joint employers only if the companies had control over their workers' essential employment terms and conditions *and actually exercised* such control.[187] This

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181. *Id.*

182. Adler-Paindiris et al., *supra* note 150, at 82.

183. *Id.*

184. *Id.*

185. *See, e.g.*, Drexel v. Union Prescription Ctrs., Inc., 582 F.2d 781, 786 (3d Cir. 1978) (noting that, while some degree of control is inherent in the franchisor-franchisee relationship, whether sufficient control exists to trigger a master-servant relationship depends upon a case-by-case assessment of the "nature and extent" of such control).

186. Courtney M. Malveaux & Richard F. Vitarelli, *NLRB Joint-Employer Rule Effective April 27, 2020*, JACKSON LEWIS (Mar. 31, 2020), https://www.jacksonlewis.com/publication/nlrb-joint-employer-rule-effective-april-27-2020.

187. *NLRB Reverses* Browning-Ferris *Ruling, Says Obama-Era Board's Retroactive Application of Joint Employer Standard Unjust*, KAHN, DEES, DONOVAN & KAHN (July 30, 2020), https://kddk.com/2020/07/30/nlrb-reverses-browning-

changed in 2015 with the *Browning-Ferris Industries of California, Inc.*[188] decision. Under *Browning-Ferris*, the standard expanded, and companies could be designated as joint employers if they had even indirect control, or the potential to control, another company's workers.[189] Dissatisfied with the *Browning-Ferris* interpretation of the rule, the NLRB briefly reversed course and reinstated the prior standard in its *Hy-Brand Industrial Contractors, Ltd.*[190] decision. The change was only temporary, however, as the *Hy-Brand* ruling was vacated, and thus the *Browning-Ferris* decision remained controlling law.[191]

When the NLRB's new final rule became effective on April 27, 2020, the pre-*Browning-Ferris* standard was, in most respects, reaffirmed.[192] A business again had to possess *and exercise* "substantial direct and immediate control" over essential terms or conditions of employment.[193] Critically, the rule defined what "substantial direct and immediate control" is.[194] According to the NLRB, it was control "that has a regular or continuous consequential effect on an essential term or condition of employment of another employer's employees.[195] Such control is not 'substantial' if it is only exercised on a sporadic, isolated, or *de minimis* basis."[196] The 2020 rule also clarified that the essential terms and conditions of employment include wages, benefits, hours of work, hiring, discharge, supervision, and direction.[197] Further, the party asserting joint employment

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ferris-ruling-says-obama-era-boards-retroactive-application-of-joint-employer-standard-unjust/.

188. Browning-Ferris Indus. of Cal., Inc., 362 N.L.R.B. 1599 (2015).

189. Mintz, *The NLRB's Final Joint-Employer Rule Will Soon be in Effect*, JDSupra (Apr. 24, 2020), https://www.jdsupra.com/legalnews/the-nlrb-s-final-joint-employer-rule-34561/.

190. Hy-Brand Indus. Contractors, Ltd., 365 N.L.R.B. No. 156, at 1 (2017).

191. Hy-Brand Indus. Contractors, Ltd., 366 N.L.R.B. No. 26, at 1 (2018).

192. Joint Employer Status Under the National Labor Relations Act, 85 Fed. Reg. 11184 (Feb. 26, 2020) (codified at 29 C.F.R. § 103.40).

193. 29 C.F.R. § 103.40(a) (2022).

194. Mark G. Kisicki, *Long-Awaited NLRB Joint-Employer Rule Sets Employer-Friendly Standard for Joint-Employer Determinations*, Ogletree Deakins (Feb. 27, 2020), https://ogletree.com/insights-resources/blog-posts/long-awaited-nlrb-joint-employer-rule-sets-employer-friendly-standard-for-joint-employer-determinations/.

195. *Id.*

196. *NLRB Issues Joint-Employer Final Rule,* NLRB Off. of Pub. Affs. (Feb. 25, 2020), https://www.nlrb.gov/news-outreach/news-story/nlrb-issues-joint-employer-final-rule.

197. *NLRB Finalizes New Joint Employer Standard,* Horton Mgmt. L. (Mar. 6, 2020), https://hortonpllc.com/nlrb-finalizes-new-joint-employer-standard/

bears the burden of proving that a joint employer relationship exists.[198]

This iteration of the rule is clearly franchisor friendly as it narrows the definition of joint employer to those who actually exercise control over employees. However, in September 2022, the NLRB, now holding a 3-2 Democratic majority, released a Notice of Proposed Rulemaking outlining its proposed changes to the joint-employer standard under the NLRA.[199] This sea change in interpretation aims to replace the joint-employer rule that came into effect in April 2020.[200] On October 26, 2023, the NLRB issued a final version of this rule,[201] which was to take effect for cases filed after February 26, 2024.[202] Under the new final rule, it would be much easier for entities to be deemed joint employers. In fact, the changes would ground the joint-employer standard in established common law agency principles, and consider both direct and indirect control over essential terms and conditions of employment when analyzing joint-employer status.[203] For example, the rule defines two or more employers as joint employers if they "share or codetermine

(noting that exercising control over wages and actually determining the wage rates is an example of direct and immediate control which would lead to a finding of joint employment).

198. 29 C.F.R. § 103.40(a) (2022).

199. NLRB, *NLRB Issues Notice of Proposed Rulemaking on Joint-Employer Standard* (Sept. 6, 2022), https://www.nlrb.gov/news-outreach/news-story/nlrb-issues-notice-of-proposed-rulemaking-on-joint-employer-standard (hereinafter "NLRB, Joint-Employer Rulemaking"); Standard for Determining Joint-Employer Status, 87 Fed. Reg. 54641 (Sept. 7, 2022).

200. NLRB, Joint-Employer Rulemaking, *supra* note 199.

201. This rule was challenged in federal court. On March 8, 2024, in Chamber of Com. of U.S. v. NLRB, No. 6:23-cv-00553, 2024 U.S. Dist. LEXIS 43016 (E.D. Tex. Mar. 8, 2024), the court vacated the rule, concluding that it was arbitrary and capricious. *Id.* at *50. The court found that step one of the rule's joint employment test swallows step two and, based on the language, another section of the rule may establish joint employment without first proving the first step. *Id.* at *37–38, *40–41. The court's ruling, along with its declaration that the NLRB's recission of the agency's 2020 rule was arbitrary and capricious, likely means that the NLRB's 20 C.F.R. § 103.40 (2020) promulgation is controlling for now. *Id.* at *51. The ruling very likely will be appealed. David J. Pryzbylski & Scott J. Witlin, *Hold Please: Texas Judge Blocks Labor Board's Joint-Employer Rule*, THE NAT'L L. REV. (Mar. 11, 2024), https://www.natlawreview.com/article/hold-please-texas-judge-blocks-labor-boards-joint-employer-rule.

202. NLRB, *Board Issues Final Rule on Joint-Employer Status* NAT'L LAB. REL. BD. (Oct. 26, 2023), https://www.nlrb.gov/news-outreach/news-story/board-issues-final-rule-on-joint-employer-status; Standard for Determining Joint Employer Status, 88 Fed. Reg. 81344 (Nov. 22, 2023).

203. *Id.*

those matters governing employees' essential terms and conditions of employment,"[204] which are defined exclusively as:

> (1) wages, benefits, and other compensation; (2) hours of work and scheduling; (3) the assignment of duties to be performed; (4) the supervision of the performance of duties; (5) work rules and directions governing the manner, means, and methods of the performance of duties and the grounds for discipline; (6) the tenure of employment, including hiring and discharge; and (7) working conditions related to the safety and health of employees.[205]

Further, under the new rule, a business does not need to actually exercise control over any of the seven listed factors to be found a joint employer; it only needs to be shown that the business had the authority to do so.[206]

About the only strong pro-franchisor procedural position remaining under the proposed rule might be the burdens of proof. While the ABC Rule presumes employment over independent contractor status,[207] the legal test concerning joint employment is somewhat different. There is the usual civil standard (i.e., burden) of proof, a preponderance of evidence; and this therefore requires the party asserting that someone is a joint employer carry the burden of proof.[208] Typically, in the

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204. ". . . means for an employer to possess the authority to control (whether directly, indirectly, or both) or to exercise the power to control (whether directly, indirectly, or both) one or more of the employees' essential terms and conditions of employment." Standard for Determining Joint-Employer Status, *supra* note 199, at 54658 (offering the dissenting view of NLRB board members Marvin E. Kaplan and John F. Ring, and quoting from the proposed new version of 29 CFR § 103.40(c)).

205. NLRB, *supra* note 201; *See also The Never-Ending Story? NLRB Proposes New Rule Shifting Back to Broad Definition of 'Joint Employer,'* FISHER PHILIPS (Sept. 7, 2022), https://www.fisherphillips.com/news-insights/the-never-ending-story-nlrb-proposes-new-rule-shifting-back-to-broad-definition-of-joint-employer.html.

206. Todd Lebowitz, *NLRB Vastly Expands Joint Employer Definition*, JD SUPRA (Oct. 30, 2023), https://www.jdsupra.com/legalnews/nlrb-vastly-expands-joint-employer-2321926/.

207. To conclude, instead, that there is an independent contracting relationship, the three, "ABC" elements are needed. *Supra* notes 105–09 and accompanying text. This, of course, is counter to the position franchisors desire, to avoid any number of administration and financial burdens, such as taxes and vicarious liability.

208. *See* 29 C.F.R. § 103.40(g). The final rule of October 2023 did not alter the standard used under the 2020 rule and earlier precedent. *See also*

franchising context, this means that employees at a franchise would have to show they are more than just franchisee employees, but also have a second employer, the franchisor. However, under the new rule for determining joint employer status, the tests, such as for control over the employee, all would seem to favor the party asserting a franchisor's status as joint employer, and meeting the procedural burden of proof is just a matter of providing evidence even slightly greater than a 50% probability.

Presumably, reaching the top of a tiny summit (meeting that most basic of civil burdens of proof) is all the easier when the climb itself (the finding and presenting of evidence) has been made so smooth, and is along such a shiny new pathway (the presumptions to be invoked). Potential but unexercised indirect control could be sufficient to consider a business a joint employer for labor relations purposes, without requiring actual, direct control;[209] the new rule would extend the analysis to evaluate evidence of reserved and indirect control (or control through an intermediary or via a contractually reserved but never exercised right of control).[210] Accordingly, this rule was set to alter the liability landscape significantly, with its effects suppose to be felt as soon as early 2024.[211] However, the new standard presented under the rule has been attacked by proponents of franchising,[212] and, following the introduction of

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Standard for Determining Joint-Employer Status, *supra* note 199, at 54651 (confirming the case law in *Browning-Ferris* and citing 29 CFR § 103.40(g) for the proposition that "[a] party asserting that an employer is a joint employer of particular employees has the burden of establishing that relationship by a preponderance of the evidence").

209. *See* 29 C.F.R. §103 at 73947. Moreover, neither a party's possession of authority to control, nor its exercise of the power to control is defined in the proposed rule.

210. By following this approach, the proposed rule eliminates the requirement that control be exercised directly and immediately. Instead, the new rule would follow the *Browning-Ferris* formula.

211. *See supra* note 187 and accompanying text. The rule was to become effective on February 26, 2024, meaning that the standard would have been applied to cases filed after that date. Standard for Determining Joint Employer Status, 88 Fed. Reg. 81344 (Nov. 22, 2023). However, with the Chamber of Com. of U.S. v. NLRB, No. 6:23-cv-00553, 2024 U.S. Dist. LEXIS 43016 (E.D. Tex. Mar. 8, 2024), the rule was, at least for the time being, vacated.

212. The International Franchise Association (IFA) called on Congress to overturn the rule, arguing that among other things, the rule will decrease the independence of franchisees because franchisors will be forced to exercise more control in order to avoid liability. *See* Mary Vinnedge, *IFA Urges Congress to Undo Revised Joint Employer Rule*, FRANCHISEWIRE (Oct. 27, 2023 at 5:00 AM), https://www.franchisewire.com/ifa-urges-congress-to-undo-re-

a Congressional Review Act to overturn the rule, it remains uncertain if and when the rule will actually take effect.[213] Indeed, all may hinge on the 2024 election and the consequential long-term makeup of federal courts, the NLRB, and - most important—actual statutory changes, such as from a united Democratic Congress and President.[214]

B. *The FLSA Standard*

Another test that is commonly applied in joint employment cases is the "economic realities" test. This test looks at the economic or financial realities of the relationship between a worker and the putative joint employer to determine whether that worker is financially dependent upon that employer.[215] Essentially, it measures the worker's economic independence vis-à-vis an alleged joint employer,[216] and it is primarily used in

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vised-joint-employer-rule/; *see also New Report Shows Expected Consequences of Proposed Joint Employer Rule kn Franchised Businesses*, INT'L FRANCHISE ASS'N (Sept. 7, 2023), https://www.franchise.org/media-center/press-releases/new-report-shows-expected-consequences-of-proposed-joint-employer-rule.

213. The same day that the NLRB issued the final rule, Senators Bill Cassidy and Joe Manchin announced they would introduce a Congressional Review Act (CRA) to overturn the rule. *Ranking Member Cassidy, Manchin Announce CRA to Overturn New Biden Rule Threatening American Franchise Model, Local Businesses*, U.S. S. COMM. ON HEALTH, EDUC., LAB. & PENSIONS (Oct. 26, 2023), https://www.help.senate.gov/ranking/newsroom/press/ranking-member-cassidy-manchin-announce-cra-to-overturn-new-biden-rule-threatening-american-franchise-model-local-businesses-1. The CRA needs 51 votes in the Senate to pass, and the initiative has the support of the IFA. *See* Matt Haller, *Send a Message to Congress (Now!) To Overturn the NLRB's New Joint Employer Rule*, FRANCHISING.COM (Oct. 30, 2023), https://www.franchising.com/articles/send_a_message_to_congressnowto_overturn_the_nlrbs_new_joint_employer_rule.html.

214. *See* Diego Areas Munhoz, *Senate Rejects NLRB Joint Employer Rule as Biden Promises Veto*, BLOOMBERG LAW, Apr. 10, 2024, https://news.bloomberglaw.com/daily-labor-report/senate-rejects-nlrb-joint-employer-rule-as-biden-promises-veto (noting that the House of Representatives and Senate both narrowly passed resolutions to block the 2022 NLRB joint employer rule under the Congressional Review Act; however, President Biden was certain to veto the bill and neither House nor Senate has any prospect of overriding a veto with the necessary two-thirds vote).

215. *See* Griffin T. Pivateau, *The Prism of Entrepreneurship: Creating a New Lens for Worker Classification*, 70 BAYLOR L. REV. 595, 606 (2017) (noting that the economic realities test is most commonly used by courts deciding cases brought pursuant to the FLSA); *see also* Adler-Paindiris et al., *supra* note 150, at 77.

216. Pivateau, *supra* note 213.

cases involving the FLSA.[217] And while this test does retain a control element, it considers both functional and formal control and considers them in the context of the relationship as a whole.[218]

The test was endorsed by an Obama-era DOL, which stated that a finding of joint employment "hinges on numerous factors that look at the 'economic realities' of the employment relationship, such as the nature of the work being performed, whether workers were integral to a company's business, and whether companies could potentially control working conditions."[219]

Dissatisfied with the wide-ranging application of the test, the DOL under President Trump announced a final rule in January 2020 aimed at significantly limiting the circumstances in which joint employment status would apply.[220] Under this rule, the DOL applies a four-factor balancing test considering whether the putative joint employer (1) hires or fires the employee, (2) supervises and controls the employee's work schedule or conditions of employment to a substantial degree, (3) determines the employee's rate and method of payment, and (4) maintains the employee's employment records.[221] Like the economic realities test used in independent contractor cases, the test here requires that a potential employer actually exercise control over the worker, rather than simply possess the *capacity* to exercise control.[222]

But this version of the rule was short-lived. Not long after it was issued, U.S. District Judge Gregory H. Woods struck down

217. Jim Paretti et al., *Department of Labor Proposes to Roll Back Joint Employment, Independent Contractor Rules*, LITTLER (Mar. 11, 2021), https://www.littler.com/publication-press/publication/department-labor-proposes-roll-back-joint-employment-independent.

218. McArdle-Bracelin v. Cong. Hotel, Inc., 2022 WL 486805, at *3–4 (N.D.N.Y. Feb. 17, 2022).

219. Daniel Wiessner, *DOL, Backed by Biz Groups, Defends 'Helpful' Joint Employer Rule from States' Challenge*, REUTERS LEGAL (July 20, 2020), https://today.westlaw.com/Document/I48ec8490cadb11ea853294a23e704d3f/View/FullText.html?contextData=(sc.Default)&transitionType=Default&firstPage=true&OWSessionId=c7b59be016da4f5eb9827c111c3cb3d7&skipAnonymous=true&bhcp=1.

220. Carissa Davis, *The DOL Has Rescinded the Recently Enacted Federal Test for Joint Employment Under the FLSA*, SHERMAN & HOWARD (Aug. 3, 2021), https://shermanhoward.com/the-dol-has-rescinded-the-recently-enacted-federal-test-for-joint-employment-under-the-flsa/.

221. Joint Employer Status Under the Fair Labor Standards Act, 85 Fed. Reg. 2820 (Mar. 16, 2020).

222. *Id.*

major parts of the rule, finding its narrow interpretation of the FLSA contrary to the FLSA.[223] This decision was appealed to the Second Circuit, but given that President Biden's DOL formally rescinded the rule on July 30, 2021,[224] the Court dismissed the appeal as moot, while also vacating the district court's ruling.[225] At present, uncertainty remains, with no official DOL guidance having come down since the Second Circuit's dismissal. Consequently, the state of joint employment law under the FLSA remains unsettled, with some courts applying an expansive version of the test, while others narrow the scenarios wherein joint employment exists.[226]

IV.
A Changing World

Considering the multiple major tests and the numerous jurisdictional variations, it is evident that both independent contractor and joint employment law require clarification. Although guideposts such as the NLRA and FLSA have undergone periodic updates, they are rooted in decades-old concepts of the workplace. Similarly, while independent contractor and joint employment law have benefited from occasional reinterpretation, recent events necessitate further clarification. Specifically, the rise of e-commerce and the gig economy, along with the impact of the COVID-19 pandemic, have fundamentally changed the workplace and the environment in which franchises operate. To address the resulting issues from these unprecedented changes, the ideal solution would place one virtue above all others: simplicity.

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223. New York v. Scalia (Scalia II), 490 F. Supp. 3d 748, 796 (S.D.N.Y. 2020) (striking all of 29 C.F.R. § 791.2 except for subsection (e)).

224. Rescission of Joint Employer Status Under the Fair Labor Standards Act Rule, 86 Fed. Reg. 40939 (July 30, 2021) (to be codified at 29 CFR § 791), https://www.federalregister.gov/documents/2021/07/30/2021-15316/rescission-of-joint-employer-status-under-the-fair-labor-standards-act-rule.

225. Jon Steingart, *2nd Circ. Tosses Review of DOL's Dead Joint Employer Rule*, LAW36 (Oct. 29, 2021), https://www.law360.com/employment-authority/articles/1436183/2nd-circ-tosses-review-of-dol-s-dead-joint-employer-rule.

226. Daniel Wiessner, *DOL rescinds Trump-era rule on joint employment*, REUTERS, July 29, 2021, https://www.reuters.com/legal/transactional/dol-rescinds-trump-era-rule-joint-employment-2021-07-29/. New York, for example, construes the FLSA's definition quite broadly, noting that it includes "parties who might not qualify as [employees] under a strict application of traditional agency principles[.]" *McArdle-Bracelin*, 2022 WL 486805 at *2 (citations omitted).

A. *E-commerce*

An emerging issue for franchise systems in the twenty-first century is the advent of e-commerce and its proper implementation across franchises. E-commerce is business conducted through the use of electronic devices, often utilizing the internet, as opposed to traditional paper-based exchanges.[227] The rapid acceptance and promulgation of e-commerce stems from the recognition of its potential to allow a firm to augment its business potential and identity by building and managing online relationships with customers, suppliers, employees, and partners.[228] The implementation and growth of e-commerce and the increase of companies embracing this approach to conduct business offers various benefits. This includes providing on-demand customer service support, thereby granting customers access to products throughout the world, and allowing customers direct access to information about products and services at any time.[229]

With regard to the implementation of e-business doctrines and technologies into traditional models, the current literature suggests focusing on internal integration and external diffusion.[230] Internal integration can be understood as "the degree of inter-connectivity among organizational activities and [information systems][231] applications," with its aim being to enhance communication along the value chain and thus increase the

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227. *Electronic Commerce (E-commerce)*, L. Dictionary, https://thelawdictionary.org/electronic-commerce-e-commerce/ (noting that the public largely participates in e-commerce, and that e-commerce devices include "computers, telephones, fax machines, barcode readers, credit cards, [ATMs]," etc.).

228. Laura Lucia-Palacios et al, *E-business Implementation and Performance: Analysis of Mediating Factors*, 24(2) Internet Rsch. 223, 225-227 (2014) (contemporary definitions recognize that e-business can "potentially transform a firm into a networked entity with seamless supply chains and value creation process by helping to build and manage relationships with customers, suppliers, employees and partners"). Mohanbir Sawhney & Jeff Zabin, *The Seven Steps to Nirvana*, McGraw-Hill (2001). *See also* Hsiu-Fen Lin & Szu-Mei Lin, *Determinants of E-Business Diffusion: A Test of the Technology Diffusion Perspective*, 28 Technovation 135, 135 (noting that, in contrast to traditional technological innovation, "e-business represents a new way to integrate Internet-based technologies with core business potentially affecting the whole business").

229. Lucia-Palacios et al., *supra* note 227, at 227.

230. *Id.*

231. Information systems can be defined as "complementary networks and interconnected components that amass, disseminate, and otherwise make data useful to bolster management's decision-making processes." *What Are Information Systems, and How Do They Benefit Business?*, Wash. State Univ.,

efficiency of the organization as a whole.[232] External diffusion refers to the degree to which an organization "integrates its trading partners and transactions with them" through e-business systems,[233] and it is positively affected by internal integration.[234] In other words, internal integration is the degree to which an organization can, utilizing information technologies, stitch together its constituent parts to streamline the sharing of information, whereas external diffusion is a measurement of the same process concerning entities external to the business.[235]

A study of franchisors across the United States and Spain illustrates the importance of e-commerce and e-business to franchises.[236] This study tested organization performance effects on differentiation, enterprise agility, customer relationship development, and partner attraction.[237] It aimed to test the effects of e-business implementation for franchisors in terms of both internal integration and external diffusion.[238] In all, the study surveyed 600 Spanish and 1,218 U.S. franchises and collected data from their top executives.[239] In the United States, the study yielded interesting results, finding that external diffusion has a positive influence on "differentiation,[240] agility,[241] relation-

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CARSON COLL. OF BUS. (June 8, 2020), https://onlinemba.wsu.edu/blog/what-are-information-systems-and-how-do-they-benefit-business/.

232. Hsiu-Fen Lin & Szu-Mei Lin, *supra* note 226, at 139.

233. Lucia-Palacios, *supra* note 226, at 227 (citing Hsiu-Fen Lin & Szu-Mei Lin, *supra* note 228).

234. Hsiu-Fen Lin & Szu-Mei Lin, *supra* note 226, at 139.

235. *Id.*

236. Lucia-Palacios, *supra* note 226, at 223.

237. *Id.*

238. *Id.* at 224.

239. *Id.* at 231 (noting that many franchise chains are not big enough to have a dedicated IT department, and thus it is usually the CEO who determines whether or not to innovate).

240. Carol M. Kopp, *Product Differentiation: What It Is, How Businesses Do It, and the 3 Main Types*, INVESTOPEDIA (updated July 6, 2021), https://www.investopedia.com/terms/p/product_differentiation.asp ("differentiation" involves strategic business planning, with elements of design, marketing, packaging, and pricing each creating aspects of a company that "distinguish [the] company's products or services from the competition [and, when successful,] lead[] to brand loyalty and an increase in sales.").

241. Enterprise "agility" is not easily defined, nor does it necessarily have a direct impact on business performance. Lucia-Palacios, *supra* note 226, at 239. "Agility," in the business context, "is a complex construct that could be divided into the ability to sense and to respond to market changes." *Id.* At most, agility's impact on business success, or not, is likely to be indirect. *Id.* (citing Paul A. Pavlou & Omar A. El Sawy, *From IT Competence to Competitive Advantage in Turbulent Environments: The Case of New Product Development*, 17

ship management, and partner attraction."[242] Furthermore, the researchers found that the economic health of American franchises is supplemented by the successful management of the franchisor's relationship with its franchisee and that this positive relationship can be furthered using information technologies.[243]

In sum, the implementation and adoption of new technologies has a proven ability to provide franchisees greater insights into the markets where they operate and positively impact intra-franchise relationships—clearly benefiting the franchise network as a whole. So, franchisors should strive to adopt and implement technologies, especially in external processes (i.e., their franchisees), if they hope to remain competitive in a world that is increasingly guided by information technologies.[244]

B. *The Gig Economy*

1. *Pros and Cons*

The rise of the gig economy[245] has also significantly influenced franchises and the laws surrounding them. This increasingly popular[246] form of employment tends to refer to

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INFO. SYS. RES. 198 (2006); Arun Rai et al., *Firm Performance Impacts of Digitally Enabled Supply Chain Integration Capabilities*, 30 MIS Q. 225 (2006)).

242. Lucia-Palacios, *supra* note 226, at 237.

243. *Id.* at 239. The relationship between franchisor and franchisee is extremely important. To ensure a healthy franchise system, franchisors support a franchisee's business through payroll support, employee training, revenue management, and brand value. This support is frequently expressed as "being in business for yourself, but not by yourself." Mazero et al., *supra* note 154, at 328.

244. Lucia-Palacios, *supra* note 226, at 239; *see also* Hsian-Ming Liu & Hsin-Feng Yang, *Network Resource Meets Organizational Agility*, 58 MGMT. DECISION, 58, 68 (2020) (noting that a bridging function across interfirm networks can have the potential to provide entrepreneurial advantages and opportunities to those in the network, responding to the needs of customers and challenges from its competitors). *See infra* Part IV.B.

245. This alternative style of work can be best understood as "[n]ontraditional, short-term . . . contract work" à la Uber, TaskRabbit, or DoorDash. Monica Anderson et al., *The State of Gig Work in 2021*, PEW RSCH. CTR. (Dec. 8, 2021), https://www.pewresearch.org/internet/2021/12/08/the-state-of-gig-work-in-2021/. *See also* Peter Buckley, *Bill AB5 and the Gig Economy*, 29 U. MIA. BUS. L. REV. 49, 51–54 (2021).

246. As of early 2021, gig work was the "primary source of income" for one in ten workers, Lauren Wingo, *What is a Gig Worker?* CO— (Mar. 16, 2021), https://www.uschamber.com/co/run/human-resources/what-is-a-gig-worker, and, as of December of that year, 16% of Americans had reported

"people using apps to earn money from assets they own or their ability to do a certain type of work."[247] This popularity is due, at least in part, to the freedom this form of employment offers—workers are largely able to set their own hours and may dictate the means by which a project is completed.[248] While it is often considered desirable to be one's own boss, there are concomitant drawbacks including low wages, lack of overtime, no association with unions, and out-of-pocket health insurance costs.[249]

One of the most apparent benefits to businesses operating under this model is the ability to draw from a pool of readily available workers in exact proportion to the work available, allowing them to reduce labor costs during fluctuations in demand.[250] What is more, the risk of litigation due to worker negligence is reduced because, in the gig economy, a worker is typically not an employee of the firm.[251] Despite these advantages, however, businesses are hesitant to enter the gig economy due to the nature of the industry,[252] as well as the risk that the firm will not be able to exert a high degree of control over the worker.[253] When a business hires traditional employees, the firm can con-

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earning at least some money from an online gig platform, Anderson et al., *supra* note 243.

247. Anirudh Mnadagere, *Examining Worker Status in the Gig Economy*, 4. J. Int'l & Compar. L. 389, 389 (2017).

248. *Id.* at 390.

249. Andrew G. Malik, *Worker Classification and the Gig-Economy*, 69 Rutgers U. L. Rev. 1729, 1734 (2017). Drivers for companies like Uber and Lyft have reported that, depending on the fluctuating price of gas, their average net earnings hover around nine to twelve cents per mile. Ryan Arbogast, *"Every Time I Get Behind the Wheel, I lose Money;" Uber Driver Weighs in [on] Gas Crisis*, WKBW 7 News Buffalo (Feb. 18, 2022), shorturl.at/txz46.

250. Malik, *supra* note 247, at 1735.

251. *See e.g.*, Sarah Kessler, *The Gig Economy Won't Last Because it is Being Sued to Death*, Fast Company (Feb. 17, 2015), https://www.fastcompany.com/3042248/the-gig-economy-wont-last-because-its-being-sued-to-death.

252. The issues associated with the gig economy, and the corresponding symptoms of these issues, are legion: class action lawsuits, ominous rumblings of regulatory intervention, aggrieved letter-writing campaigns, etc. *Id.* These and other problems yet (or never) to be worked out somewhat deflate the billion-dollar-plus valuations that companies like Uber have been able to conjure up.

253. *Id. See also* Stephen Fishman, *Pros and Cons of Hiring Independent Contractors*, Nolo.com, https://www.nolo.com/legal-encyclopedia/pros-cons-hiring-independent-contractors-30053.html (last visited July 10, 2022) (arguing that while there are some benefits to hiring independent contractors, the disadvantages must be addressed in order to make an informed hiring decision).

trol its brand more closely and build consumer loyalty through strict standards of quality.[254] The use of gig workers frustrates this to a certain extent, but allows the business to save on costs such as withholding taxes and retirement contributions.[255]

2. *Assembly Bill No. 5 and Changes to Worker Status in California*

While the gig economy offers numerous benefits, it also challenges the already blurry line between employee and independent contractor.[256] To combat this, California has taken steps to clarify the employment status of gig workers. Effective January 1, 2020, the California legislature enacted Assembly Bill No. 5 (A.B. 5), which expands the Supreme Court of California's decision in *Dynamex Operations West, Inc. v. Superior Court*[257] and codifies the common law ABC test.[258] Under A.B. 5, workers who are "suffered or permitted to work" under wage orders

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254. Malik, *supra* note 247, at 1735.

255. John Sullivan, *What's Wrong with Hiring a Gig Workforce? Pretty Much Everything*, DRJOHNSULLIVAN.COM, (July 8, 2019), https://drjohnsullivan.com/articles/whats-wrong-with-hiring-a-gig-workforce-pretty-much-everything/ (noting, among ten problems with using gig workers instead of a permanent workforce, "Low gig worker engagement will hurt productivity"). *But see* C. Whitfield Caughman et al., *Employment Law Issues in a Global "Gig" Economy*, ACC DOCKET (Apr. 3, 2019), https://docket.acc.com/employment-law-issues-global-gig-economy (recognizing that an outsourced contractor may still be required to adhere to industry standards for safety and control, which have been recognized as legitimate within subcontracting relationships).

256. *See* Matter of Vega, 149 N.E.3d 401, 405 (2020) (holding that Postmates exercised the necessary control over the couriers to make the couriers employees, not independent contractors operating their own businesses); Razak v. Uber Techs. Inc., 951 F.3d 137, 144 (3d Cir. 2020) (vacating and remanding the lower court's decision to grant summary judgment because the court found that there was a genuine issue of material fact as to whether Pennsylvania UberBLACK drivers are independent contractors or employees).

257. *Dynamex*, 416 P.3d 1 (Cal. 2018).

258. Assemb. B.5, 2019–2020 Leg., Reg. Sess. (Cal. 2019) (enacted) (codified at CAL. LAB. CODE §§ 2750.3, 3351 and CAL. UNEMP. INS. CODE §§ 606.5, 621). A.B. 5 is an expansion of the previous *Dynamex* ruling in that it extends application of the ABC test beyond wage orders to all claims brought pursuant to the Labor and Unemployment Insurance Codes. *Beyond Dynamex – Assembly Bill 5 Codifies, Expands, and Creates Exceptions to the Landmark California Supreme Court Decision*, HOPKINS CARLEY, https://www.hopkinscarley.com/blog/client-alerts-blogs-updates/employment-law-client-alerts/beyond-dynamex-assembly-bill-5-codifies-expands-and-creates-exceptions-to-the-landmark-california-supreme-court-decision (last visited Oct. 12, 2022).

are now classified as employees *unless* the employer can establish the three factors of the ABC test.[259]

Pursuant to A.B. 5, the ABC test will now be uniformly applied across industries in a much-needed effort to streamline classification issues. It does contain, however, two notable exceptions. First, there are some professions that are entirely exempted from A.B. 5, including engineers, attorneys, architects, barbers, freelance writers, and travel agent services, to which the multi-factor *Borello* test will still be applied.[260] These exemptions point to traditional distinctions between independent contractors and employees. Second, the California Assembly Committee on Labor and Employment considered market strength, rate setting, the relationship between contractor and client, and technological neutrality in laying out the classes of workers that are exempt from A.B. 5.[261]

3. *Proposition 22*

In May 2020, allegations against Uber and Lyft for misclassifying their drivers as independent contractors were brought by California Attorney General Xavier Becerra and city attorneys from San Francisco, Los Angeles, and San Diego.[262] The lawsuit alleges that Uber's and Lyft's business models led the company to hire its drivers as independent contractors, rather than employees.[263] The attorneys sought to compel the ride-sharing platforms to conform to the mandates of A.B. 5 and provide back wages, meal and rest period premiums, business expenses, and civil penalties, all of which could total in excess of hundreds of millions of dollars.[264] While this claim does not raise any new issues, it does provide a leg up to potential plaintiffs in

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259. *See supra* Part II.

260. Roxanne M. Wilson & Jeffrey B. Weston, *Hiring ABCs*, 44 L.A. L. 14, 17 (June 2021); *see also Independent contractor versus employee*, STATE OF CAL. DEP'T OF INDUS. RELS. (Jan. 2023), https://www.dir.ca.gov/dlse/faq_independentcontractor.htm#:~:text=What%20difference%20does%20it%20make,employees%2C%20but%20not%20independent%20contractors. (The Borello test includes thirteen factors to be considered in evaluating a relationship between a worker and the hiring party, none of which are dispositive to the analysis).

261. *See* Cal. Assemb. B. 5., *supra* note 256.

262. Kate Conger, *California Sues Uber and Lyft, Claiming Workers are Misclassified*, N.Y. TIMES (July 14, 2020), https://www.nytimes.com/2020/05/05/technology/california-uber-lyft-lawsuit.html.

263. *Id.*

264. *Id.*

the future, as the Attorney General and the various city attorneys have resources available to them that individual litigants ordinarily do not.[265]

While these issues were still pending in court, Uber and Lyft took to the ballot box to lobby against A.B. 5, seeking to carve out an exemption for their drivers.[266] Although it cost Uber and Lyft over $200,000,000—making it the most expensive initiative in California's history—Proposition 22 was ultimately passed. Thus, gig economy companies can continue classifying their drivers as independent contractors, albeit with some benefits traditionally afforded to employees, such as minimum wage guarantees and health insurance subsidies to qualifying drivers.[267]

4. *The Department of Labor's Proposed Rule*

In October 2022, Biden's DOL made good on promises he had made repeatedly throughout his 2020 Presidential campaign to support organized labor and workers' rights.[268] The DOL proposed a new rule to be applied by federal agencies in determining whether a worker is an employee or independent

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265. *Id.*

266. *Id.*

267. *See* Kate Conger, *Uber and Lyft Drivers in California Will Remain Contractors*, N.Y. TIMES (Nov. 7, 2020), https://www.nytimes.com/2020/11/04/technology/california- uber-lyft-prop-22.html; Suhauna Hussain et al., *How Uber and Lyft Persuaded California to Vote Their Way*, L.A. TIMES (Nov. 13, 2020), latimes.com/business/technology/story/2020-11-13/how-uber-lyft-doordash-won-proposition-22; Adam Y. Siegel & Benjamin A. Tulis, *Proposition 22 Passes – What Does It Mean for the Gig Economy in California?* LEXOLOGY (Nov. 6, 2020), https://www.lexology.com/library/detail.aspx?g=6047a367-e14d-4a27-bf21-6adc24d222f6. On August 20, 2021, Alameda County Superior Court Judge Frank Roesch ruled, among other things, that Proposition 22 violated the California constitution by restricting the state legislature's power to regulate workers' compensation rules and also by failing to meet the state constitutional provision requiring initiatives to be limited to a "single subject." *See* Castellanos v. State of California, No. RG21088725, 2021 WL 3730951 (Cal. Super., Alameda Cnty. Aug. 20, 2021). On March 13, 2023, the California Court of Appeal, in a 2-1 ruling, overturned Judge Roesch's determinations, above, and thus upheld Proposition 22. Castellanos v. State of California, 89 Cal. App. 5th 131,(Cal. Ct. App. Mar. 13, 2023), https://www.courts.ca.gov/opinions/documents/A163655.PDF. Certainly, the decision will be appealed to the California Supreme Court.

268. *See* Andrew Solender, *Biden Vows To Be 'Strongest Labor President You've Ever Had' At Union Event*, FORBES (Sep. 7, 2020), https://www.forbes.com/sites/andrewsolender/2020/09/07/biden-vows-to-be-strongest-labor-president-youve-ever-had-at-union-event/?sh=dab4e295d5dd.

contractor under the FLSA, which promises to have significant impacts on gig workers.[269] Whereas the current rule, an artifact of the Trump era, places greater weight on certain "core factors," including control over the worker, the proposed rule would return to a "totality-of-the-circumstances" analysis, which would afford federal agencies increased mobility in conducting holistic analyses of a given worker's specific circumstances.[270] Such an analysis could be of great benefit to gig workers who, given the non-traditional nature of their jobs, tend to evade uniform systems of classification.[271]

While this proposed DOL rule is distinct from the NLRB's current request for briefing on the correct standard to be employed in this analysis,[272] it demonstrates the importance with which the current administration views these issues. Indeed, the DOL proposal starts with an admonition: "To the extent that prior administrative rulings, interpretations, practices, or enforcement policies relating to determining who is an employee or independent contractor under the [Fair Labor Standards] Act are inconsistent or in conflict with the interpretation stated in this part, they are hereby rescinded."[273] From a franchising perspective, the most obvious criticism of the DOL proposed rule is that the initial discussion, over 70,000 words with 599 footnotes and lengthy analysis of many topics, never

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269. Notice of Proposed Rulemaking: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, *supra* note 101; *see* John C. Fox, *OFCCP Week in Review: January 9, 2023*, DIRECT EMPS. ASS'N (Jan. 9, 2023), https://directemployers.org/2023/01/09/ofccp-week-in-review-january-9-2023/#omb-fall-2022-regulatory-agenda.

270. Notice of Proposed Rulemaking: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, *supra* note 101, at 62232.

271. For example, whereas 80% of gig drivers work fewer than 20 hours each week, and 70% drive fewer than 20 weeks per year, some derive their entire income as gig drivers. Curran McSwigan, *Explainer: Benefits Models for Gig Workers,* THIRD WAY (Apr. 12, 2022), https://www.thirdway.org/report/explainer-benefits-models-for-gig-workers. Accordingly, a standard that can be applied on a case-by-case basis might help to ensure fewer drivers fall between the cracks, losing deserved benefits.

272. Rachel M. Cohen, *The coming fight over the gig economy, explained*, VOX (Oct. 12, 2022), https://www.vox.com/policy-and-politics/2022/10/12/23398727/biden-worker-misclassification-independent-contractor-labor?link_id=17.

273. Notice of Proposed Rulemaking: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, *supra* note 101, at 62274.

once even mentioned franchises or any other franchise derivative term such as franchisees, franchisors, or franchising.[274]

5. *The Implications for Franchises*

Both the *Dynamex* decision and A.B. 5 threaten to impose greater liability in economic sectors that rely more heavily on independent contractors. Franchising is one such sector, and it is large: There are more than 77,000 franchise establishments employing over 755,000 people in California.[275] Operating as something of a zero-sum game, benefits promised to workers under A.B. 5 come at the threat of additional costs for franchises operating in California; A.B. 5 apparently created a presumption of employment between franchisees and franchisors.[276] This, in conjunction with the California legislature's refusal to create an exemption for franchises, has led many to question the viability of franchise operations in that state.[277] While A.B. 5 is limited to app-based rideshare and delivery companies, the passage of the law and the support it received may pave the way for franchises, as well as other companies dependent upon independent contractors for their labor force, to pursue similar classification of their franchisees or workers.[278]

Indeed, some franchisors have already taken steps to avoid the application of A.B. 5. The largest, oldest, most powerful trade group in franchising, the International Franchise Association (IFA), brought a pre-enforcement challenge, claiming A.B. 5 was pre-empted by both the FTC Franchise Rule and

274. Likewise, the NLRB's Notice of Proposed Rulemaking, Standard for Determining Joint-Employer Status, 87 Fed. Reg. 54641 (Sept. 7, 2022), *see supra* note 199, has 128 footnotes and nearly 30,000 words. Yet franchising is rarely mentioned in this Notice – only at length in one paragraph.

275. IHS Markit Economics, *Franchise Business Economic Outlook for 2018*, IFA Foundation (Jan. 2018), https://www.franchise.org/sites/default/files/Franchise_Business_Outlook_Jan_2018.pdf.

276. Jess A. Dance, *Evolving Worker Classification Standards and the Future of Franchising*, Nat. L. Rev. (Nov. 11, 2020), https://www.natlawreview.com/article/evolving-worker-classification-standards-and-future-franchising.

277. *Id.* For more on developments in California, *see* Dean T. Fournaris & Robert S. Burstein, *The California FAST Act: Suspended but High Risk Remains Straight Ahead*, 42 Franchise L.J. 209 (2023) (discussing the California Fast Food Accountability and Standards Recovery Act of 2022, also known as Assembly Bill 257, now suspended pending the results of a voter referendum to occur in the November 2024 state-wide election; also discussing subsequent California bills and, *inter alia*, the future of franchisor joint and several liability for franchisee actions).

278. Siegel & Tulis, *supra* note 265.

the Lanham Act.[279] The IFA sought federal intervention and brought dormant commerce clause and regulatory taking claims.[280] The court refused to reach the merits of these allegations, dismissing the case for lack of Article III standing.[281] Specifically, the court held that the IFA had failed to establish a "reasonable or imminent threat of prosecution,"[282] and thus had not presented a case sufficiently ripe for judicial review. The court further held the IFA had not established a concrete intent to violate A.B. 5, and that prudential concerns also militated in favor of dismissal.[283]

This decision effectively instructs that these claims will have to wait until the ABC test is actually applied to a franchise. Recently, the U.S. Court of Appeals for the Ninth Circuit affirmed the decision of a trial court that a group of franchisees were not employees of their franchisor.[284] The franchisees argued that California law required them to be classified as employees instead of independent contractors.[285] However, the trial court rejected their argument based on the fact that the franchisees were engaged in a different business line and held themselves out to be business owners.[286]

On appeal, the franchisees argued that the "ABC" test for California wage violations adopted in *Dynamex* should have been applied.[287] The Ninth Circuit agreed that the ABC test should have been used since the claims accrued after 2020 and are therefore governed by A.B. 5.[288] However, despite the error, the court deemed it harmless given the extensive factual findings made by the trial court.[289] These findings showed that the three parts of the ABC test were met, thereby supporting the

279. Int'l Franchising Ass'n v. California, No. 20-cv-02243-BAS-DEB, 2022 WL 118415 (S.D. Cal. Jan. 12, 2022); Daniel J. Oates & Susan E. Tegt, *Annual Franchise and Distribution Law Developments 2022*, ABA Forum on Franchising (2022).

280. *Int'l Franchising Ass'n*, 2022 WL 118415, at *1.

281. *Id.*

282. *Id.* at *5.

283. *Id.* at *5–6.

284. Haitayan v. 7-Eleven, Inc., No. 21-56144, 2022 WL 17547805, at *1 (9th Cir. Dec. 9, 2022).

285. *Id.*

286. *Id.*

287. *Id.*

288. *Id.*

289. *Id.*

conclusion that the franchisees were not employees of their franchisor.[290]

C. *COVID-19: Effects and Implications*

1. *Legislative Initiatives*

As it has for many things in the world, the COVID-19 pandemic has had, and continues to have, a significant impact on independent contracting and joint employment in the franchising context. One area in which this impact can be seen is legislation. For example, two key pieces of legislation were passed and signed into law, providing relief not only to traditional employees but also to independent contractors and gig workers. The U.S. Coronavirus Aid, Relief, and Economic Security (CARES) Act brought sweeping aid to families and businesses, and it included independent contractors and self-employed individuals who were not normally eligible for unemployment compensation.[291] Further, the Families First Coronavirus Response Act (FFCRA) offered expanded paid sick and family leave available to independent contractors—relief that was previously unavailable to this class of workers.[292]

Under the CARES Act, independent contractors were entitled to economic assistance during the pandemic if they were able and willing to work or telework for pay but were unable to do so due to pandemic-related reasons.[293] The qualifications were stringent, however, requiring workers to have worked for a minimum amount of time and earned a minimum amount of

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290. *Id.*

291. *Guide to Independent Contractors' CARES Act Relief*, U.S. Chamber of Com. (Oct. 13, 2020), https://www.uschamber.com/report/independent-contractors-guide-cares-act-relief.

292. Although independent contractors are not usually included in paid sick leave benefits, the FFCRA entitles eligible self-employed individuals to a paid sick or family leave tax credit. *See* Nathan Gibson, *Benefits for Independent Contractors Under the Coronavirus Aid, Relief and Economic Security (CARES) Act and the Families First Coronavirus Response Act (FFCRA)*, Employee or Independent Contractor? (Apr. 14, 2020), https://nathansgibson.org/benefits-for-independent-contractors-under-the-coronavirus-aid-relief-and-economic-security-cares-act-and-the-families-first-coronavirus-response-act-ffcra/#:~:text=Although%20independent%20contractors%20are%20not,or%20family%20leave%20tax%20credit.

293. Emma Janger et al., *Making Unemployment Insurance Work for Working People*, 68 UCLA L. Rev. 102, 107 (2020).

wages prior to losing their job to qualify for the program.[294] For independent contractors who were only partially unemployed, pandemic unemployment assistance (PUA) was also available.[295] This allowed them to obtain some measure of relief retroactively from January 27, 2020, through December 31, 2020.[296]

The FFCRA was enacted on March 18, 2020, and became effective on April 1, 2020.[297] It offered both paid sick time under the Emergency Paid Sick Leave Act and expanded family and medical leave under the Emergency Family and Medical Leave Expansion Act.[298] Previously, relief under each of these Acts was limited to employees, but given exigent circumstances created by the pandemic, self-employed individuals became eligible as well.[299] The FFCRA defines such individuals in Sections 7002(b) and 7004(b) as those who "regularly carr[y] on a trade or business . . . and would be entitled to receive paid leave . . . if [they] were an employee of an employer (other than himself or herself)."[300] Independent contractors were eligible for paid sick leave for up to ten days if they were unable to work or telework due to COVID-19-related government quarantine or isolation orders, self-quarantine advice from a healthcare provider, or the contractors' experiencing symptoms of COVID-19 and seeking medical attention.[301]

While the federal government thus provided a much-needed form of "unemployment" relief for freelancers, gig workers, and other independent contractors, state agencies for the most part failed to conform their online processes to expedite the

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294. *Id.*

295. *Unemployment Insurance Provisions In The Coronavirus Aid, Relief, And Economic Security (Cares) Act*, NELP (Mar. 27, 2020), https://www.nelp.org/publication/unemployment-insurance-provisions-coronavirus-aid-relief-economic-security-cares-act/.

296. *Id.* Under the initial CARES Act ("CARES I"), independent contractors who had income from both self-employment and wages paid by an employer were still eligible for PUA. However, the worker was usually only eligible for state-issued benefits. With the passage of the second stimulus bill ("CARES II"), this restriction was removed and eligible workers received federal PUA benefits also.

297. Families First Coronavirus Response Act, Pub. L. No. 116-127, 134 Stat. 178 (2020).

298. *See id.*

299. Richard Reibstein, *March and April 2020 Independent Contractor Misclassification and Compliance News Update*, JDSupra (May 11, 2020), https://www.jdsupra.com/legalnews/march-and-april-2020-independent-96614/.

300. *Id.*

301. *Id.*

relief to these "self-employed individuals."[302] Instead, most state workforce agencies required independent contractors to first apply for unemployment benefits as employees.[303] Only after being denied as non-employees were they permitted to proceed with the process as self-employed.[304]

Beyond these measures, two additional stimulus bills were signed into law that extended unemployment assistance to independent contractors, as well as other self-employed individuals.[305] The first bill, colloquially named "CARES Act II," contained the "Continued Assistance for Unemployed Workers Act of 2020."[306] This Act extended the original CARES Act unemployment provisions from December 31, 2020, through to March 14, 2021.[307] The second bill, the American Rescue Plan Act of 2021, once again extended many of the CARES Act unemployment and FFCRA provisions from March 14, 2021, until September 6, 2021.[308]

In all, these legislative efforts granted independent contractors and self-employed individuals protections that they have rarely been afforded.[309] These acts bring hope that continued support will be provided for the self-employed and the gig economy as a whole.[310] With greater financial security and growth in these areas, there may be an increase in highly skilled individuals entering these industries. This could benefit businesses by providing reliable and skilled labor, increasing flexibility and

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302. *Id.*

303. *Id.*

304. *Id.*

305. Jessica Menton, *COVID-19 Relief Package: $1,400 Checks, $300 Bonus for Federal Unemployment Benefits*, USA TODAY, Mar. 9, 2021, https://www.usatoday.com/story/money/2021/03/09/stimulus-checks-unemployment-benefits-covid-relief-package-economy/6894224002/.

306. Richard Reibstein, *CARES Act, Take 2: Pandemic Unemployment Assistance Extended for Independent Contractors*, LOCKE LORD, Dec. 27, 2020, https://www.independentcontractorcompliance.com/2020/12/27/cares-act-take-2-pandemic-unemployment-assistance-extended-for-independent-contractors/.

307. *Id.*

308. Stephen Fishman, *Financial Relief for Independent Contractors During Coronavirus Outbreak*, NOLO, https://www.nolo.com/legal-encyclopedia/relief-for-independent-contractors-during-coronavirus-outbreak.html (last visited Feb. 15, 2023).

309. *See supra* Part IV.B; *see also Unemployment Insurance Provisions In The Coronavirus Aid, Relief, And Economic Security (Cares) Act*, *supra* note 293 (explaining that individuals who would otherwise not qualify for unemployment compensation may be permitted to qualify for Pandemic Unemployment Assistance due to economic consequences of the COVID-19 pandemic).

310. *Id.*

efficiency while affording workers greater protections such as wage and insurance protections.[311]

2. *Misclassification of Worker Status*

While the recent legislative acts provide necessary relief to workers around the country, they perpetuate the issue of independent contractor classification discussed earlier in this article. Here, however, a new issue has emerged in the form of procedural misclassification. Independent contractors who filed PUA applications often failed to designate themselves as self-employed, resulting in hurried claims officers presuming them to be employees due to time constraints.[312] This highlights the importance of thoroughly reviewing the nature of the relationship between the hiring business and the independent contractor to avoid misclassification.[313] Misclassification can expose a business to greater legal obstacles for reclassification and the business may even forfeit the right to challenge the ruling altogether if it fails to timely dispute the finding.[314] Accordingly, businesses must take prompt action to contest misclassifications in order to avoid erroneous tax liability and audits into the classification of their workers.[315]

3. *The Impact on Franchise Structure and Environment*

Beyond these legislative initiatives, COVID-19 has had a significant impact on the franchise industry. As a result of the pandemic, nearly 20,000 franchise locations were forced to shut down their operations in 2020, leading to a loss of 900,000 jobs.[316] Nevertheless, this unfortunate development has opened

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311. *COVID-19: Your Contingent Workforce May Be Changing Forever*, OPENFORCE (May 7, 2020), https://oforce.com/for-contracting-companies/covid-19-your-independent-contractor-workforce-may-be-changing-forever/.

312. Richard Reibstein, *CARES Act II – Independent Contractors Gain 11-Week Extension of Unemployment Assistance and Paid Sick and Family Leave Benefits,* JDSUPRA (Dec. 23, 2020), https://www.jdsupra.com/legalnews/cares-act-ii-independent-contractors-22342/.

313. *Id.*

314. *Id.*

315. *Id.*

316. Emman Velos, *Franchise Marketing Statistics You Should Know in 2021*, THRIVE (July 29, 2021), https://thriveagency.com/news/franchise-marketing-statistics-you-should-know-in-2021/. This is in stride with the state of the affairs generally in 2020, which saw 60% of extant companies fail as a result of the pandemic. *Id.*

new opportunities for individuals looking to enter the franchise market. As economic conditions began to improve, the franchise market readily recovered.[317] For example, the third quarter of 2021 witnessed a surge in franchise investment, attributed to various factors such as pent-up demand, favorable economic conditions, and increased vaccination rates, enabling a return to work.[318] This resulted in an impressive $3 trillion business investment and a growth of almost 3% in the number of franchised establishments.[319] Overall, after experiencing shutdowns in 2020, franchises made a remarkable comeback with output surging over 16% in 2021, resulting in a total output of almost $788 billion.[320]

While there are always risks associated with starting a new business, franchises offer certain advantages that allow them to remain competitive despite market vagaries, including (1) a proven, stable, uniform business model; (2) ready capital with which to purchase supplies and inventory; (3) an informed and experienced support system; and (4) the ability to split certain operation costs such as marketing.[321] For these and other reasons, the franchise business model will certainly continue to be popular, even in a post-COVID era.[322]

For those franchisees that do remain or enter the market, they should be aware that COVID-19 has multiplied the influence e-commerce and the gig economy have on business. For example, consumers began avoiding showrooms to purchase appliances, opting instead for touch-free delivery that promised

317. *Id.*

318. *A Look Back: How Franchises Fared in 2021*, INT'L FRANCHISE ASSOC., https://www.franchise.org/blog/a-look-back-how-franchises-fared-in-2021 (last visited Mar. 31, 2023).

319. *Id.*

320. *2022 Economic Forecast Shows Franchising Leads U.S. Recovery*, INT'L FRANCHISE ASSOC., https://www.franchise.org/media-center/press-releases/2022-economic-forecast-shows-franchising-leads-us-recovery (last visited Mar. 31, 2023).

321. Rebecca Papi & Dickinson Wright, *Post-COVID Opportunities and Legal Considerations to Franchise Resale*, JDSUPRA (May 4, 2020), https://www.jdsupra.com/legalnews/post-covid-opportunities-and-legal-66898/.

322. History provides further proof of the strength of the franchise business model. While many businesses failed during the Great Recession of 2008, franchises fared better than most retail chains and small businesses. *A Look at How Franchises Impact the U.S. Economy*, FRANCHISE DIRECT (Jul. 26, 2022), https://www.franchisedirect.com/information/a-look-at-how-franchises-impact-the-economy.

both ease and peace of mind.[323] This is in accordance with an increasing trend among consumers to turn to the internet for their essentials, including groceries, prescriptions, and medical supplies.[324] In fact, brick-and-mortar department stores saw a 25% decline in sales in the first quarter of 2020, followed by a 75% decline in the second.[325] Thus, it is no surprise that, according to IBM's U.S. Retail Index, the pandemic accelerated the shift to digital storefronts by roughly five years,[326] meaning that companies have been forced to adapt—or else.[327]

As a result of this shifting economic landscape, businesses will likely seek cost-saving initiatives, and thus it is likely we will begin to see an increase in independent contracting in areas of the economy where gig labor has not been historically prevalent.[328] Numerous examples serve to support this proposition. Instacart, a grocery delivery service, has more than doubled

323. *COVID-19: Your Contingent Workforce May Be Changing Forever*, *supra* note 309.

324. *Id.* A great example of the increasing popularity of online shopping and delivery is delivery giant Instacart. Instacart has more than doubled its workforce to over 500,000. Cathy Bussewitz & Alexandra Olson, *More American Gig Workers Facing Competition for Work as COVID-19 Ravages Economy, All While Trying to Avoid Virus Themselves*, CHI. TRIB. (July 5, 2020, 12:14 PM), https://www.chicagotribune.com/coronavirus/ct-nw-covid-19-gig-workers-20200705-ssoy3lggwngnvdkoobxiq26wj4-story.html. Similarly, Uber Eats grew 53% in the first quarter of 2020, gaining more than 200,000 new delivery drivers. *Id.*

325. Sarah Perez, *COVID-19 Pandemic Accelerated Shift to E-commerce by 5 years, New Report Says*, TECHCRUNCH (Aug. 24, 2020, 11:42 AM), https://techcrunch.com/2020/08/24/covid-19-pandemic-accelerated-shift-to-e-commerce-by-5-years-new-report-says/.

326. *Id.*

327. *COVID-19: Your Contingent Workforce May Be Changing Forever*, *supra* note 309. There is a stark difference between innovation during normal times, in which companies pilot digital initiatives with the intent of learning from them one dimension at a time. However, companies in crisis mode must pilot digital programs at massive scale. While there are many challenges that this presents, it also brings opportunities, such as real time feedback on the organization's approach. *See* Simon Blackburn et al., *Digital Strategy in a Time of Crisis*, MCKINSEY & CO. (Apr. 22, 2020), https://www.mckinsey.com/business-functions/mckinsey-digital/our-insights/digital-strategy-in-a-time-of-crisis.

328. *See* Arthur H. Kohn et al., *The Gig Is Up? COVID-19 & Remote Work Trend Toward Growth in Gig Labor*, CLEARY GOTTLIEB (June 1, 2020), https://www.clearymawatch.com/2020/06/the-gig-is-up-covid-19-remote-work-trend-toward-growth-in-gig-labor/. Kohn et al. further note that, in the medium and long term, the pandemic may support trends toward gig-based employees in sectors not yet significantly gig-based, such as white-collar, business industries. *Id.*

its fleet of shoppers to around 500,000.[329] Similarly, with many restaurants and bars closed or still in the process of reopening, food delivery services like Uber Eats rocketed into eminence, establishing a dominant position in the market and forcing businesses that never considered delivery to either sign on or else suffer the headache of attempting delivery themselves.[330] For most, there really is no other option.[331]

This growing shift among consumers toward what has been termed "convenience culture"[332] is best demonstrated through the success of the now-ubiquitous, and aforementioned, Uber Eats, which grew by 53% in the first quarter of 2020, gaining more than 200,000 new delivery drivers.[333] Compare this to the franchise industry, which saw the evaporation of 940,000 jobs in 2020, and the picture of what's to come is placed in greater relief. [334]

4. *Virtual Restaurants and "Ghost" Kitchens*

The accelerated shift to a world overwhelmingly dominated by e-commerce and the gig economy only exacerbates the shortcomings of independent contractor and joint employment law discussed previously. No better is this need for improvement and clarity illustrated than in the rapid growth of virtual restaurant brands. Under this business model, a virtual brand operator develops, acquires, or licenses a restaurant brand and

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329. Bussewitz & Olson, *supra* note 322.

330. *Id.*; *see also* Laura LaBerge et al., *How COVID-19 Has Pushed Companies Over the Technology Tipping Point—and Transformed Business Forever*, McKinsey & Co. (Oct. 5, 2020), https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/how-covid-19-has-pushed-companies-over-the-technology-tipping-point-and-transformed-business-forever (noting that, according to a Global Survey of executives, companies have accelerated supply-chain interactions and internal operations by three to four years due to the COVID-19 pandemic).

331. Deepti Sharma, *The True Cost of Convenience*, Eater (Jan. 22, 2021, 11:03 AM), https://www.eater.com/22228352/convenience-of-delivery-apps-destroying-restaurants-uber-eats-doordash-postmates (explaining how restaurant owners who resist aggressive tactics by third-party delivery platforms are sometimes added to the service anyway without the owner's permission).

332. *Id.*

333. Bussewitz & Olson, *supra* note 322.

334. Dani Romero, *Why franchises fare as badly as small restaurants amid COVID, Delta variant surge*, Yahoo Finance (Sept. 5, 2021), https://news.yahoo.com/why-franchises-are-faring-as-badly-as-small-restaurants-amid-delta-variant-surge-160127931.html.

creates a menu offering—and thus a virtual brand is born.[335] This process, the genesis of the virtual brand, can be fairly traditional, simply involving the development of a limited menu that is then appended to an existing restaurant. This is the case with It's Just Wings, which has seen roaring success selling wings out of active Chili's and Maggiano's locations since June 2020.[336] Alternatively, a virtual brand may simply snag a social media personality and, leveraging the person's fame, develop a focused menu that typically possesses the related virtues of being easy to produce, highly marketable, and deliverable.[337]

Once a virtual brand has been developed, the virtual brand operator then engages a brick-and-mortar restaurant to process and prepare orders.[338] From there, the entity that prepares the food either delivers it themselves or through a third-party straight to the customer.[339] This innovative model spares the virtual brand operator the expenses traditionally involved with food preparation and enables restaurants to leverage underutilized kitchen space and expand their offerings.[340]

While the term "virtual restaurant" is often used synonymously with "ghost kitchen," the two are discrete.[341] Whereas a virtual restaurant, as explained, operates out of an active restaurant, ghost kitchens are delivery-only, having no connection to a dine-in space and potentially running one or several online

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335. Lisa Jennings, *Are Virtual Restaurant Brands the New Frontier for Franchising?* NATION'S RESTAURANT NEWS (Aug. 18, 2021), https://www.nrn.com/delivery-takeout-solutions/are-virtual-restaurant-brands-new-frontier-franchising.

336. Jonathan Maze, *Chili's owner has some big plans for It's Just Wings*, RESTAURANT BUSINESS (Oct. 28, 2020), https://www.restaurantbusinessonline.com/financing/chilis-owner-has-some-big-plans-its-just-wings. The company claimed that It's Just Wings, as of late 2020, was already generating $150 million per year.

337. Take, for example, Virtual Dining Concepts' partnership with Jimmy Donaldson, a hyper-successful YouTuber better known as MrBeast. *Our Brands,* VDC, https://joinvdc.com/brands/. Together, the pair developed MrBeast Burger, which sports a menu comprised of a handful of burgers and sandwiches, fries, and a cookie. *Mr. Beast Burger Menu,* MRBEAST BURGER, https://mrbeastburger.com/menu/.

338. Mike Isaac & David Yaffe-Bellany, *The Rise of the Virtual Restaurant*, N.Y. TIMES (Aug. 14, 2019), https://www.nytimes.com/2019/08/14/technology/uber-eats-ghost-kitchens.html.

339. *Id.*

340. Jennifer Marston, *Anatomy of a Digital Restaurant*, THE SPOON (May 2, 2021), https://thespoon.tech/anatomy-of-a-digital-restaurant/.

341. *See* Jeff Stump, *Ghost Kitchen vs. Virtual Kitchen: What's the Difference?*, CLOUDKITCHENS (Nov. 7, 2023), https://cloudkitchens.com/blog/ghost-kitchen-vs-virtual-kitchen/.

brands out of the same facility.[342] And while such a business model might seem the stuff of parody,[343] it serves to eliminate some of the tension that currently exists as the restaurant industry tries to assimilate itself with the rise of e-commerce.[344] Traditional restaurants that sign on with DoorDash or Uber Eats have widely reported difficulty turning a profit, with the third parties taking as much as 30% off the top of every order while forbidding restaurants from passing these costs onto customers.[345] This may prove prohibitive in an industry plagued by razor-thin margins.[346] A ghost kitchen, on the other hand, has significantly reduced overhead as it need only provide a kitchen space and a skeleton crew of cooks.[347] Accordingly, they can better bear a Postmates-sized hole in their profits, and as such, this model may signal what is to come: digital restaurants for a digital world.

While virtual restaurants and ghost kitchens involve highly innovative ideas, there is no question they foster a host of legal issues. Chief among these, particularly in the case of virtual restaurants, is determining whether the virtual brand operator is a franchisor. Virtual Dining Concepts (VDC), one of the largest virtual brand operators,[348] does not think so.[349] Under their model, restaurant operators select the turnkey brands they want, and VDC gives the restaurant a market license that requires no sign-on fee, and "has no obligation on [the restaurant's] side."[350] While VDC provides standardized marketing

342. Henry De Groot, *The Invisible Workforce of Delivery-Only Kitchens*, Working Mass (Apr. 28, 2021), https://working-mass.com/2021/04/28/the-invisible-workforce-of-delivery-only-kitchens/.

343. One can imagine an article in The Onion on the subject, perhaps entitled *Fresh New Concept, Ghost Kitchen, Seeks to Modernize the Dining Experience by Eliminating Restaurant Entirely*.

344. Sharma, *supra* note 329.

345. *Should You Use Uber Eats Delivery at Your Restaurant?*, Host Merchant Service, https://www.hostmerchantservices.com/articles/should-you-use-uber-eats-delivery-at-your-restaurant/.

346. *See Bottom line impact of rising costs for restaurants*, Nat'l Rest. Assoc. (Aug. 24, 2022), https://restaurant.org/research-and-media/research/economists-notebook/analysis-commentary/bottom-line-impact-of-rising-costs-for-restaurants/ (pointing to 2019 data showing the average profit margin for restaurants was 5% of gross sales and discussing how rising costs following the pandemic have only compressed this margin further).

347. De Groot, *supra* note 340.

348. *See* MrBeast Burger, *supra* note 337.

349. Jennings, *supra* note 333.

350. *Id.*

materials and recipes to participating restaurants, it does not appear to exercise the same level of organizational control as a typical franchisor would. In this space, brand operators are situated along a spectrum from franchise to non-franchise.[351] Whatever the designation for each operator may end up being, business models such as these represent a challenge that franchise and employment law must evolve to meet.

V.
Recommendations

There are a number of approaches to clarifying the independent contracting standards in the franchising context. When parties contest whether franchisees are in fact the franchisor's employees, and when parties dispute whether a franchisor is the joint employer of its franchisees' employees, there are ways to proceed fairly and efficiently. With lessons from abroad, uniform tests or guarantees, and fresh methodologies as well as legal presumptions, we can build stronger, more just franchise systems.

A. *Foreign Standards*

One option for addressing the shortcomings of current independent contractor and joint employment law is to supplement existing U.S. law with concepts that have proven successful abroad. To begin, a general survey of foreign franchise and employment law should be conducted. Many foreign jurisdictions, such as Canada, follow some variation of the common law "right to control" test.[352] However, beyond the right to control, there are additional approaches followed in these and other jurisdictions, including Civil Law nations, which warrant attention. Canada, for example, has adopted the "common employer" doctrine, so that "a sufficient nexus" between franchisee and franchisor could leave both parties responsible for something done by or to a franchise unit's employee.[353]

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351. *See id.*

352. *See* Canada Revenue Agency, *Employee or Self-employed*, Government of Canada, https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/rc4110/employee-self-employed.html#toc8.

353. Brad Hanna & Mitch Koczerginski, International Franchising CAN/39–40 (Dennis Campbell ed., 2d ed. 2022) (acknowledging, however that applying this doctrine to franchisors "would likely be a stretch" because

1. *Examples from Abroad*

Consider *Sobeys Capital Incorporated/Sobeys Capital Incorporie*,[354] in which Sobeys, a national grocery chain with both company and franchised stores, had a collective bargaining agreement with the United Food and Commercial Workers International Union, Local 1518 (the "Union").[355] Sobeys informed the Union that it intended to franchise some stores and that the franchisees would succeed Sobeys as the employers under the collective agreement.[356] The Union subsequently sought a declaration under British Columbia's *Labour Relations Code* that Sobeys continued as a common employer.[357] With all three rulings, in 2020, 2021, and the ultimate decision on July 6, 2023, the British Columbia Labour Relations Board ruled that Sobeys exercised sufficient control over its franchisees to constitute a common employer relationship.[358]

Likewise, Canada's Supreme Court held that a franchisor exerting significant control over the operations of a part-time cleaning business franchisee was subject to employment standards.[359] Although the franchising arrangement was purported to be an independent contractor relationship, the franchisor could perform quality control checks over the franchisee without notice and at any time, and the franchisor was in charge of

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"franchisees are typically independent and not affiliated with their franchisors"). This potential, shared liability of the franchisor and the franchisee could be due to a wrong, such as a tort, committed *by* the employee (think of vicarious liability) or because of some other wrong, such as a tort or a contract breach (e.g., wrongful dismissal), carried out *against* the employee.

354. B.C. Lab. Rel. Bd. 97 (2020) (the "Original Decision"); B.C. Lab. Rel. Bd. 78 (2021) (the "Reconsideration Decision"); B.C. Lab. Rel. Bd. 105 (2023).

355. B.C. Lab. Rel. Bd. 97 (2020) (the "Original Decision").

356. *Id.*

357. B.C. Lab. Rel. Bd. 78 (2021) (the "Reconsideration Decision").

358. B.C. Lab. Rel. Bd. 105 (2023). The Board concluded, "individual franchisees and a franchisor can be declared common employers where it prevents the erosion of bargaining rights, the franchise arrangement has not resulted in a shift in the locus of power and the seat of real economic control from the franchisor, and the franchisees exert some control but not substantial control." *Id.* at para. 485 (p. 85). Andres Barker, Vice-Chair of the Board, elaborated further, "Sobeys and the Franchisees constitute more than one entity carrying on a business or activity through the franchising and operation of the . . . stores . . . [The] entities are under common control or direction, and there is a labour relations purpose for making a common employer declaration." *Id.* at para. 486 (p. 85).

359. Mod. Cleaning Concept Inc. v. Comité paritaire de l'entretien d'édifices publics de la région de Québec, (2019) 2 S.C.R. 406 (Can.).

assigning the customers to the franchisee, who in turn: (1) could only use the franchisor's tools and equipment, (2) had to report any complaints directly to the franchisor, (3) was required to identify itself as a member of the franchisor's network, (4) was bound to a non-compete covenant, (5) was obliged to obey the franchisor's demands for the termination of employees that the franchisor deemed unacceptable, and (6) was limited to performing cleaning services for only the franchisor-assigned "clients."[360] The Canadian high court held that the existence of a franchise agreement cannot transform an employee into an independent contractor.[361] To understand the nature of the relationship, one must "examine the specific facts of the relationship."[362] The high court further emphasized that independent contractors take business risks pursuing profits, while employees do not; here, Canada's Supreme Court found that the franchisor took these risks and otherwise constituted an employer.[363]

Australia has heretofore employed the common law multi-factor test, which is comprised of no fewer than ten factors, including many found in the United States and other nations, such as control, ownership of tools and equipment, and whether or not the worker's labor is essential to and in the business of the hirer.[364] As a multi-factor test, a court essentially tallies all of the relevant factors on a case-by-case basis and determines whether a given worker falls more on one side of the spectrum or the other.[365] Indeed, a worker in Australia who is determined to be an independent contractor under the common law test may nevertheless be treated as an employee in limited contexts.[366] Presumably, this approach could apply to franchising.

360. *Id.*

361. *Id.* at para. 38.

362. Hanna & Koczerginski, *supra* note 351, at CAN/40–41.

363. *Mod. Cleaning Concept Inc.*, *supra* note 357, at paras. 57–59.

364. McCullough Robertson Lawyers, *Employee or Contractor? A Guide for Public Practitioners*, CPA Austl., https://www.cpaaustralia.com.au/-/media/project/cpa/corporate/documents/achivies/deciding-between-an-employee-or-contractor.pdf, at 2-3 (last visited Aug. 9, 2023).

365. *Id.* at 2–3.

366. *Id.* at 3. For example, under the Superannuation Guarantee (Administration) Act 1992 (Cth) (Austl.), individuals who, despite being classified as independent contractors, operate under contracts that are "wholly or principally" for their labor, will be classified as employees for purposes of that Act. *Id.* at 3–4.

Germany's labor laws, by contrast, have developed through a complex interrelation between statutes and judicial holdings, emphasizing the protection of employees.[367] Under this regime, certain types of agreements between franchisor and franchisee may be considered employment contracts, even if the franchisee works for its own account and risk.[368] According to some German Federal Labor Court cases, quasi-employees (i.e., bona fide franchisees) differ from employees in that they are not personally dependent to the same degree as are employees—the essence of this distinction being in the quasi-employees' added ability to freely dispose of their time.[369] Thus, in Germany, employees are personally dependent upon their hirer and possess a duty to comply with instructions.[370] The franchisee, on the other hand, is merely *economically* dependent upon the hirer.[371]

An added wrinkle in German labor law is that a prima facie case of "mere" economic dependence can nevertheless be overridden by showing that the worker's social position is dependent upon the hirer, thus requiring the protection of labor law.[372] "Social position" in this context is effectively a

367. STEFAN BRETTHAUER, INTERNATIONAL FRANCHISING GER/32 (Dennis Campbell ed., 2d ed. 2022).

368. *Id.* It is fair to say that, compared to the United States, many other nation's "legal cultures" have been more receptive to contract claims based on fairness rather than simply a strict interpretation of a clause's literal wording. SOUICHIROU KOZUKA & ALBRECHT SCHULZ, INTERNATIONAL FRANCHISING: A PRACTITIONER'S GUIDE 163, 171 (Marco Hero ed., 2010) (noting that U.S. "legal culture is governed by an individualistic rationalism which relies on the wording of a contract," but acknowledging that judges are moving beyond the merely literal – "judges now tend to introduce elements of equity when deciding on contractual relationships, especially if they are based on standard form contracts"); *see* Robert W. Emerson, *Judges as Guardian Angels: The German Practice of Hints and Feedback*, 48 VAND. J. TRANSNAT'L L. 707 (2015) (citing precedent, procedures, and pursuit of justice as grounds for the U.S. legal system to incorporate something akin to the German judge's duty to provide *hinweispflicht* (hints and feedback) to parties and lawyers).

369. BRETTHAUER, *supra* note 365, at GER/33.

370. *Id.*

371. *Id.* The franchisee's lack of *personal* dependence on the hirer does leave the franchisee less bound to instructions and thus more likely to be judged "independent." *Id.* at GER/33–35; *see* Walter Ahrens, *Germany*, GETTING THE DEAL THROUGH: LABOUR & EMPLOYMENT LAW 1, 10 (2023), https://www.morganlewis.com/-/media/files/special-topics/gtdt/2023/getting-the-deal-through-labour-employment-2023-germany.pdf?rev=11a5cf7577e64053b64a025948d9030e (discussing "personal dependence").

372. BRETTHAUER, *supra* note 365, at GER/33. This approach is also followed in other legal systems. *See* LOUIS VOGEL & JOSEPH VOGEL, FRENCH DISTRIBUTION LAW 555 (2020) (stating, "The franchisee must not be subordinate

worker's earning potential separate from the hiring entity, or that worker's ability to pursue gainful employment outside of the hirer's business.[373] For example, one so-called franchisee was, despite a superficial degree of economic independence (as opposed to a genuine measure of independence[374]), deemed an employee under German labor law because the franchise contract expressly indicated that the entirety of the franchisee's day was to be devoted to franchisee duties.[375] These determinations, given their dependence on the substance of the legal relationship rather than mere contractual formalities, are necessarily made on a case-by-case basis.[376] Consequently, German franchisors seeking to avoid employer status should afford their franchisees a certain degree of freedom, both informally (in practice) and contractually, and should hesitate before interfering with a franchisee's operations, working hours, and sources of supplies.[377]

France's franchise market, already first among European countries, continues to show steady growth.[378] French franchise relationships are primarily governed by the standard rules of contract law, and the legal franchise doctrine has, through the

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to the franchisor" continuing, "otherwise the franchise agreement should have anticipated the behavior (e.g., sunning)," and otherwise the franchise agreement should be "recharacterized as an employment agreement").

373. Bretthauer, *supra* note 365, at GER/33.

374. *Id.* at GER/34–35 (noting that franchise agreements "should always leave the franchisee as much scope for independent entrepreneurial activity as possible," with truly independent franchisees both "personally and economically independent," such as by determining their own prices and who they will hire and fire).

375. *Id.* at GER/33. By comparison, analysis of 100 U.S. restaurant systems' franchise contracts in 2013 and of 200 such systems' franchise contracts in 2023 revealed that only 45% in 2013 and 40% in 2023 required that the franchisee work full-time concerning the franchised business. Emerson, *Two-Standard Approach*, *supra* note 12, at 693; Emerson, *Franchise Contract Standards*, *supra* note 12.

376. *Id.* (citing Eismann, Bundesarbeitsgericht [BAG] [Federal Labor Court] [NJW] 2973 (1997) (Ger.); Eismann, Bundesgerichtshof [BGH] [Federal Court of Justice] [NJW] (1999) [BGHZ] 218, 220 (Ger.)).

377. Bretthauer, *supra* note 365, at GER/35 (noting the inherent conflict a franchisor must grapple with in striking the proper balance between affording too much and too little freedom). German franchisors should also carefully weigh their interests when requiring a franchisee to have a non-delegable duty to render services in-person; this is a standard aspect of many labor contracts, but may prove the tipping point in the franchisee-not franchisee analysis.

378. Alexander Blumrosen & Fleur Malet-Deraedt, International Franchising FRA/1 (Dennis Campbell ed., 2d ed. 2022).

efforts of the courts, become a unified body of law with rather clearly established rules.[379] It is perhaps unsurprising then that French law imposes certain contractual requirements, especially vis-à-vis disclosures, that must be observed by parties entering into a franchise agreement.[380] A franchisor operating in France must provide its would-be franchisees with such "truthful information" as will allow them to enter into the agreement with "full knowledge of the facts."[381] These disclosures must be provided, along with a draft of the contract, no less than twenty days prior to the signing of the agreement.[382] Failure to observe these formalities, if found to have actually vitiated the consent of the franchisee,[383] results in nullification of the contract or—if the franchisee so desires—damages.[384]

Control is a major factor in characterizing a franchise agreement as an employment contract under French law, and French courts have the power to "re-characterize" a franchise agreement as an employment agreement.[385] In fact, a certain degree of control has even been found to satisfy one of the most difficult conditions predicate for there to be re-characterization: the existence of a hierarchical reporting line.[386] The *cour de cassation*, France's highest court,[387] affirmed the re-characterization of a franchise agreement to an employment contract on the grounds that the franchisor imposed detailed obligations on the franchisee (who was really merely a licensee). In effect, the franchisor rendered that licensee a "mere executing agent deprived of any autonomy."[388] Even absent re-characterization, a franchisee who is found to fit the definition of a branch manager can be afforded the

379. *Id.*
380. *Id.* at FRA/2.
381. *Id.*
382. *Id.* at FRA/3.
383. *Id.* (citing Cour de cassation [Cass.] [supreme court for judicial matters], 20 March 2007, No. 06-11290 (Fr.)).
384. *Id.*
385. *Id.* at FRA/9–10 (recognizing that several decisions have held that a franchisee can qualify as an employee where the franchise is an independent contractor running its own business). *Id.* at FRA/9 (alternatively, French courts can, applying the Labor Code § L.7321-2, characterize the franchisee as an employed branch manager).
386. *Id.* at FRA/10.
387. *See Role of the Court of Cassation*, COUR DE CASSATION (Feb. 23, 2023), https://www.courdecassation.fr/en/about-court
388. BLUMROSEN & MALET-DERAEDT, *supra* note 376, at FRA/10.

protections of both the Commercial and Labor Codes, bestowing upon these workers the protections associated with both employees and independent contractors.[389] Indeed, the labor code's application to the franchise relationship can be costly for franchisors.[390]

More generally, two important principles of French law, *abus de droit* ("abuse of right")[391] and *abus de dépendance économique* ("abuse of economic dependence"),[392] may also apply in many

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389. *Id.*

390. *See* Blumrosen & Malet-Deraedt, *supra* note 376, at FRA/11 (amounts paid due to an employer-employee relationship could include holiday pay, overtime, reimbursement of fees and training costs, and, for an unjustified termination, as much as three years of back wages).

391. Nicolas Dissaux & Charlotte Bellet, Le Guide de la Franchise 271 (Nov.7, 2020) (evaluating *abus de droit*). The abuse of right concept is found in many countries, such as Greece and Poland, *see, e.g.,* Yanos Gramatidis, Fundamentals of Franchising: Europe 203, 208 n.8 (Robert A. Lauer & John Pratt, eds., 2017) (stating that in Greece "[t]here are no statutory requirements regarding the content of a franchise agreement, although general principles of law are applied"; and then citing "good faith, morality, *abuse of rights*, and commercial practices" (emphasis added) as those general principles); Magdalena Karpińska, Fundamentals of Franchising: Europe 315, 320 (stating, "no party is allowed to perform any of its rights in a manner that would be contrary to the rules of social coexistence; such actions are deemed an abuse of a right and are not protected by law"; further noting that "the rules of social coexistence generally relate to selected moral norms . . . commonly approved of as fair and justified," including good faith and fair dealing).

392. Cyril Grimaldi, Serge Méresse & Olga Zakharova-Renaud, Droit de la Franchise 85–94 (2017) (reviewing *abus de position dominante* and *abus de dépendance économique*); Gilles Menguy, Fundamentals of Franchising: Europe, *supra* note 391, at 157 ("The commercial code provides special rules applicable to the distribution sector, which tend to introduce a certain level of transparency and to prohibit abusive behavior of those businesses that hold a strong market position."). Many other Civil Law nations have also applied the abuse of economic dependence as a potential basis for intervention on behalf of franchisees. *See* Judit Budai, Fundamentals of Franchising: Europe, *supra* note 391, at 221, 226 (concluding, Hungary's "Competition Act does protect the franchisee against the abuse of a dominant position by the franchisor"); Hikmet Koyuncuoglu, Fundamentals of Franchising: Europe, *supra* note 391, at 413, 421 ("'abuse of economic dependence' has been invoked by the court of appeals several times in disputes involving supplier–agency, employee–employer, and lessor–lessee relationships; . . . it is likely that this notion [of abuse] could be invoked by the court in a dispute concerning a franchising agreement."); Petr Mrázek, Fundamentals of Franchising: Europe, *supra* note 391, at 115, 118–19 (noting that the New Civil Code of the Czech Republic requires good faith and fair dealing in all contractual relationships, thus including franchising; further noting that while this code does not explicitly define who could be the weaker party or whether a franchisee is to be treated as a consumer (who is protected), the code does provide

contexts, including commercial cases such as franchising.[393] These claims of abuse contest behavior that is allegedly in bad faith, profoundly unfair, or otherwise against fundamental moral tenets, with party X challenging party Y's (1) use of a right in an abusive manner (*abus de droit*), or (2) taking wrongful advantage of X's economically disadvantaged position (*abus de dépendance économique*).[394] As one commentator concluded, a franchisor can take steps to control franchisees' behavior and thereby safeguard the franchise identity and know-how, but "such control cannot exceed what is strictly necessary to achieve these objectives."[395] Indeed, recent French appeals court decisions have pushed back on franchisor-imposed contract clauses whose cumulative effect limit franchisees' ability to leave the franchise network or that otherwise restrict their

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protections for "the weaker party," as it "prohibits the entrepreneur/business person with respect to other persons in economic transactions to abuse his or her expertise or economic position to create or take advantage of the dependence of the weaker party and to achieve a clear and unjustified imbalance in the mutual rights and duties of the parties").

393. DIDIER FERRIER & NICOLAS FERRIER, DROIT DE LA DISTRIBUTION 214–17, 264, n. 733, 416 (9th ed. 2020) (discussing *abus de dépendance économique* and *abus de droit*). Commentators from many nations have noted the centrality of these protection from an abuse of right or, if an economically dependent person, from abuse by a dominant person, or both (abuse of right and due to economic dependence). *See, e.g.*, ALDO FRIGNANI, FUNDAMENTALS OF FRANCHISING: EUROPE *supra* note 391, at 247, 256 (stating, "Italian courts have established that although a franchising relationship falls into the application of the Law against the abuse of economic dependence, the franchisor's nonrenewal of the franchise agreement is abusive only if it is unforeseeable and unreasonable."); PASCAL HOLLANDER, FUNDAMENTALS OF FRANCHISING: EUROPE, *supra* note 391, at 71, 77 ("under Belgian law [Article 1134 of its Civil Code], franchise agreements must be performed in good faith. . . . [T]his implies that the parties may not abuse the rights that the franchise agreement gives them[, whether by using] (1) a right solely with the intent to harm the other party, [or] without any interest in it while creating major inconvenience to the other party, or (3) [when] the advantages drawn from the use of the right are out of proportion with the inconvenience suffered by the other party.")

394. FERRIER & FERRIER, *supra* note 392, at 214–17, 264 n.733, 417 (discussing *abus de dépendance économique* and *abus de droit*); GRIMALDI, MÉRESSE & ZAKHAROVA-RENAUD, *supra* note 392, at 85–94 (reviewing *abus de position dominante* and *abus de dépendance économique*); LOUIS VOGEL & JOSEPH VOGEL, DROIT DE LA FRANCHISE 64–66 (2nd ed. 2020) (examining *abus de position dominante* and *abus de dépendance économique*).

395. Xavier Henry, *Contrat de franchise: analyse par la cour d'appel de Paris de quelques comportements et clauses*, ACTU-JURIDIQUE.FR (Mar. 12, 2019) https://www.actu-juridique.fr/affaires/contrat-de-franchise-analyse-par-la-cour-dappel-de-paris-de-quelques-comportements-et-clauses/ (trans., Robert W. Emerson).

freedom of contract.[396] Certainly, this reasoning could be used to protect franchisees as if they were employees, not independent contractors.

In Norway, franchising "has gained wide acceptance" and is increasing as a business form.[397] Like its French counterpart, Norwegian franchising is principally governed by contract law, but Norway is less strict than France with regard to the exact provisions of franchise agreements, instead favoring an expansive freedom of contract.[398] Accordingly, a franchise agreement under Norwegian law can essentially be "whatever the parties want it to be," so long as they are not "unreasonable, or acting in violation of good business practice."[399] The effect of Norway's treatment of franchise agreements is to grant the franchisor considerable power to direct the franchisee, even as the latter operates at its own account and risk.[400] The issue is that there are no settled limits on how far such control can go before the franchise relationship violates "good business practice," and the franchisee is deemed an agent of the franchisor.[401] However, it is generally accepted that franchisees who lack control over their business operations can thus be rendered employees or agents of the franchisor.[402] Depending on the context, Norwegian franchisors can be liable to their franchisees or others under the nation's Employment Protection Act or its Agency Act, and also liable as joint employers of their franchisees' employees.[403] Therefore, overall, Norwegian franchisors have the same franchise-labor issues as in most nations, including the

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396. Cour de cassation [Cass.] [supreme court for judicial matters] Oct. 4, 2016, Bull. civ. IV, No. 14-28013 (Fr.); Cour d'appel [CA] [regional court of appeal] Paris, civ., Oct. 11, 2017, 15/03313; Cour d'appel [CA] [regional court of appeal] Paris, civ., April 19, 2017, 15/24221; Cour d'appel [CA] [regional court of appeal] Paris, civ., Sept. 18, 2013, 12/03177.

397. KNUTE BOYE, INTERNATIONAL FRANCHISING NOR/2 (Dennis Campbell, 2d ed., 2022).

398. *Id.*

399. *Id.* at NOR/15, NOR/9. That said, for a franchise contract term to have any significance at all, it should at least conform to common understanding. *Id.* The Unidroit Model Franchise Disclosure Law may prove a useful guide in this regard. *Id.* at NOR/15; *see also* UNIDROIT MODEL FRANCHISE DISCLOSURE LAW (2002), https://www.unidroit.org/english/modellaws/2002franchise/2002modellaw-e.pdf (last visited Sept. 12, 2022).

400. Boye, *supra* note 397, at NOR/15.

401. *Id.* (acknowledging that Norwegian law permits considerable direction of the operation of the franchisee and that the franchise legal framework is based on reality rather than formalities).

402. *Id.* at NOR/17.

403. *Id.*

United States, and thus should steer clear of expanding their control over (e.g., their ability to direct) a franchisee's business outside the core scope of the franchise concept. Otherwise, the franchisor is at risk of assuming an employer or principal status based on excessive control over franchisees and/or franchisee employees.[404]

2. *Franchisee Compensation upon Termination*

Although the above examples represent only a small sample of approaches taken by foreign countries to franchising, they underscore the strength of the franchise model: its ability to thrive under disparate legal regimes. Beyond proving the robustness of the franchise model, the ubiquity of this business model abroad can help us to identify advantageous aspects of other systems' classification and regulation of franchising and related methods of doing business. For example, French law is readily inclined to classify strongly controlled franchisees as employees,[405] and German jurisprudence may reach similar conclusions by considering the franchisee's social status and, relatedly, the franchisee's degree of dependence on the franchisor.[406] These are key signs of franchisor dominance, and they can provide us with new insights into the dynamics of the franchisee-franchisor relationship.[407] In turn, we may see additional ways to bolster franchisees' or workers' protections in American statutes, regulations, or case holdings.

One simple refinement would be to bolster the franchisee's right to compensation upon termination, or due to nonrenewal.[408] Numerous grounds for the franchisor's

404. *Id.*

405. *Supra* notes 385–90 and accompanying text (discussing French law and franchisors' control over franchisees).

406. *Supra* notes 370–75 and accompanying text (discussing German law and how franchisees may be personally dependent to the same extent as are employees, not merely economically dependent on the hirer; this economic dependence can override franchise law showing that the worker's social position depends on the hirer and necessitates the protection of labor law).

407. For a consideration of some notions of franchising and power dynamics, *see* Andrew Elmore & Kati L. Griffith, *Franchisor Power as Employment Control*, 109 CALIF. L. REV. 1317 (2021) (examining 44 fast-food franchise contracts from 2016 and considering, with respect to joint employer liability, franchisors' influence upon the working conditions in their network of restaurants).

408. Franchise termination (franchisor cancellation of the franchise before the end of the contract term) should not be confused with franchise non-renewal (franchise expiration, because the parties have not agreed to

termination of the franchise are spelled out in the vast majority of franchise contracts.[409] The franchisor's or franchisee's opportunity to seek a renewal is also delineated in the vast majority of franchise agreements, although the provisions tend to focus on these matters: the length and number of renewal periods, and the notice period required to invoke a right of renewal. For franchisees who have been wrongfully terminated or who have simply not been renewed but did act in good faith, their entitlement to compensation is manifest.[410] In France and Germany, for instance, there certainly are somewhat stronger protections against allegedly arbitrary non-renewals than is typically the case in the United States.[411]

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continue the franchise after its contract term has finished). The law typically covers these two end points – termination and nonrenewal - quite differently. For termination, there usually are many bases for legal challenges, although franchisee success is mixed at best. *See* Robert W. Emerson, *Franchise Terminations: "Good Cause" Decoded*, 51 Wake Forest L. Rev. 103, 122 (2016) (analyzing 342 franchise termination cases decided on their merits in U.S. courts between 1961 and 2013; in these cases, the principal reasons for termination were - "at will" (that either party simply could terminate, and the franchisor did so), 14.3%; breach of contract, failure to comply with an agreement, or failure to meet performance standards, 30.7%; failure to cure defaults, 4.7%; failure to pay, 21.9%; misuse of trademark, 6.7%; other reasons, 16.4%; and violation of covenant not to compete/competitive conduct, 5.3%). Nonrenewal challenges, on the other hand, usually require the challenger's argument to go beyond the terms of the contract, as franchise agreements tend to broadly recognize the parties' right to walk away from the contract once the initial term is completed. The challenging franchisee ordinarily must prove that the franchisor's reasons for nonrenewal were pretext, in bad faith, violated the parties' rightful expectations (which were not in contradiction of express contract terms), or otherwise violated public policy).

409. Emerson, *Two-Standard Approach*, *supra* note 12, at 697–99; Emerson, *Franchise Contract Standards*, *supra* note 12.

410. *See* Robert W. Emerson, *Franchise Goodwill: Take A Sad Song and Make It Better,* 46 U. Mich. J.L. Reform 349 (2013) (discussing the numerous ways in which a franchisee may garner goodwill for the benefit of the franchise system and subsequently face the franchisor's capture of that goodwill upon the franchise's cessation).

411. *See* Robert W. Emerson & Zachary R. Hunt, *Franchisees, Consumers, and Employees: Choice and Arbitration*, 13 Wm. & Mary Bus. L. Rev. 487 (2022) (noting that franchisors in the United States "generally enjoy 'unbridled discretion' in choosing whether to renew the franchise agreement."). However, regardless of the nation, there is no automatic right of franchise renewal, and the parties generally have no duty to justify a decision against renewal; the parties simply must comply with the contractual and any applicable statutory notice provisions. Vogel & Vogel, *supra* note 370, at 655–62 (discussing franchise terminations and non-renewals under French law); Marco Hero, International Franchise Sales Laws (eds. Kendal H. Tyre, Jr. & Michael R. Laidhold, 3d ed. 2023) (specifying the flexibility of German law regarding franchise renewals

It is simply easier for franchisees to renew their franchise in much of Europe than is found in the United States. These European franchise contracts are more easily renewed if: (1) neither the franchisee nor the franchisor notified the other side that it would *not* renew (French law), or (2) regardless of any notice provision, a franchise holdover went beyond the franchise term originally agreed upon (French and Brazilian law), or (3) the franchisor failed to show "good cause" or otherwise follow an elaborate process for avoiding the automatic renewal of a franchise (German law).[412] Indeed, German franchisees receive the same legal protections as do commercial agents,[413] with frequent compensation extended to ex-franchisees, both to pay for their losses due to termination and to pay "reasonable remuneration" related to any non-compete covenant the parties signed.[414] While French franchisees certainly have limited rights, based on both contract terms and jurisprudence,[415] they often have extensive rights to compensation for losses due to termination or, in exceptional cases (e.g., related to faulty notice), even nonrenewal,[416] regardless of whether the franchisor is blameworthy.[417]

Supplementing American franchise law with foreign concepts would undoubtedly improve the state of franchising in this country, but it ultimately necessitates a more radical and fundamental change.

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and terminations; the franchisor should disclose "the prerequisites for a renewal [and] all provisions dealing with the termination of the franchise agreement," such as "possible grounds for giving notice of default or termination.").

412. Emerson & Hunt, *supra* note 411, at 378–79 ("Many other nations, such as Finland, Iceland, Italy, Japan, Malaysia, Paraguay, and Singapore, follow these pro-renewal approaches.").

413. FUNDAMENTALS OF FRANCHISING: EUROPE, *supra* note 391, at 1, 31.

414. *Id.*

415. The late Professor Didier Ferrier, a formidable commentator on French distribution law, noted that "as the franchisee's autonomy is almost nil, the franchisee must respect all of the franchisor's standards and cannot develop its own customers," referencing the holdings of two courts of original jurisdiction (*tribunaux de grande instance*). Ferrier & Ferrier, *supra* note 393, at 499 (Robert W. Emerson trans.).

416. *See* VOGEL & VOGEL, *supra* note 372, at 662, 667–70.

417. *Id.* at 678 (citing a May 24, 2016 French Supreme Court decision affirming that "an amicable termination of the [franchise] contract does not constitute a waiver of the franchisee's right to seek reparation of the injury caused by [the franchisor's] breach," and concluding, "[t]he franchisee's right to compensation is not limited to cases of termination at the fault of the franchisor.").

B. *A Uniform ABC Test Guaranteeing Uniform Rights*

1. *Uniform Institution of the ABC Test*

As detailed above, the main issue with independent contractor and joint employment laws may simply be their perplexing nature. Jurisdictions vary in their legal tests, and the test applied may change based on the source of the legal action. The clear solution would be to enact a single, uniform test to provide a clear-cut standard for independent contractor and joint employment lawsuits. This Article recommends the adoption of California's ABC test, put forth in *Dynamex*. This test boasts several advantages, the first of which is that it is rooted in a strong foundation of what it means to be "employed."[418]

The ABC test is a major expansion of employment rights for workers improperly classified as independent contractors, as it *presumes* that a worker is an employee of the hiring firm.[419] This presumption shifts the burden to the business—the party best able to control employment status. As such, this Article recommends that future legislation be applied equally, as much as is practical, to both joint employment and independent contractor law. As previously mentioned, joint employment and independent contractor issues are frequently intertwined, and are often causes of action in the same suit.[420] Due to their similarities, applying a single test to both inquiries would provide sorely needed clarity.

Beyond this clarity, *Dynamex*'s ABC test incorporates the common law in its "A" prong, which focuses on the "control and direction" that the business has over the hiring, firing, and performance of the worker.[421] This has the effect of harmonizing the common law and the IWC's "suffer or permit" standard, thus rendering a worker who meets *either* test an employee.[422] Additionally, given that the "suffer or permit" standard operates

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418. *See* Moore, *supra* note 122, at 936–50.
419. *Dynamex*, 416 P.3d at 31–32, 36–40.
420. *See supra* notes 2–4 and accompanying text.
421. *Id.*
422. Elmore, *supra* note 2. ("[B]ecause a worker who is subject, either as a matter of contractual right or in actual practice, to the type and degree of control a business typically exercises over employees would be considered an employee under the common law test, such a worker would, a fortiori, also properly be treated as an employee for purposes of the suffer or permit to work standard."). For more on the delineation of "suffering or permitting," *see supra* notes 122–26 and accompanying text.

"independent of the question of control,"[423] courts are given the flexibility to properly address nuanced issues that are likely to arise in circumstances such as e-commerce or the gig economy.

The California ABC test captures the intent of the FLSA, whose purpose was perhaps best expressed under President Obama's DOL, which espoused a broad reading of the FLSA.[424] The court in *Dynamex* affirmed that the IWC shares this aim by acknowledging that the standard was intended to "bring within the 'employee' category *all* individuals who can reasonably be viewed as working '*in* [the hiring entity's] *business.*'"[425] This expanded interpretation offers greater protection to the party that needs it most—the worker.[426] While the broader standard likely increases business costs due to a greater chance of litigation, businesses are able to shift these costs to consumers,[427] an avenue for recourse that individual workers ordinarily lack.

The Biden administration seeks to codify the *Dynamex* ABC test in its proposed act, the Protecting the Right to Organize (PRO) Act.[428] While the Act covers so many areas[429] that it could be seen as overreaching, the Act's codifying of the ABC test is a good step not just toward legal clarity, but to workplace fairness. Indeed, that test may be the capstone provision of the many clauses designed to be a collective boost of the hiree's rights and its power, individually or collectively, to effectively negotiate with the hirer (the employer). The PRO Act seeks to

423. *Id.* at 37.

424. *See supra* Part III.B.

425. Dynamex Ops. W. v. Superior Court, Cal. Rptr. 3d 1, 27 (2018) (quoting Martinez, 231 P.3d at 281) ("A proprietor who knows that persons are *working in his or her business* without having been formally hired, or while being paid less than the minimum wage, clearly suffers or permits that work by failing to prevent it, while having the power to do so.") (emphasis added).

426. Moore, *supra* note 122, at 945.

427. *See* Utpal M. Dholakia, *If You're Going to Raise Prices, Tell Customers Why*, HARV. BUS. REV. (June 29, 2021), https://hbr.org/2021/06/if-youre-going-to-raise-prices-tell-customers-why ("Many companies, and even entire industries, routinely raise prices without ever telling customers.").

428. Peter R. Spanos, *The Biden Administration and The Pro Act*, TAYLOR ENGLISH (Jan. 7, 2021), https://www.taylorenglish.com/newsroom-alerts-The-Biden-Administration-and-The-PRO-Act.html.

429. *Infra* note 455 (declaring how far-reaching, in so many ways, the PRO Act is, and listing as examples eight PRO Act provisions, mainly about labor relations outside the scope of this article). These and other PRO Act provisions need not be addressed in order to simply apply the PRO Act's version of the ABC test and a few directly related concepts from that Act. (e.g., collective bargaining). Infra notes 452-540 and accompanying text. Other PRO Act provisions are separable and may be pursued in future political and legal contests.

expand the protections offered under the NLRA to more workers.[430] To this end, the Act would also redefine "joint employers" to include, beyond separate companies that have direct control over employees, those that possess indirect or even potential control,[431] and would stiffen penalties for employers found to have violated a worker's rights.[432]

The PRO Act did pass the House of Representatives in February 2020 but failed to clear the Senate before the close of that session of Congress.[433] The Act was reintroduced the following session, and on March 9, 2021, the House of Representatives again passed it.[434] Once more, this bill died in the Senate,

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430. The California labor and workforce development agency explains how the ABC test is applied and breaks down each condition. *See ABC Test*, https://www.labor.ca.gov/employmentstatus/abctest/ (last visited Feb. 27, 2023). The PRO Act makes substantial amendments to the National Labor Relations Act. Section 2(a)(1) amends the definition of "Joint employer" providing:

Section 2(2) of the National Labor Relations Act (29 U.S.C. 152(2)) is amended by adding at the end the following: Two or more persons shall be employers with respect to an employee if each such person codetermines or shares control over the employee's essential terms and conditions of employment. In determining whether such control exists, the Board or a court of competent jurisdiction shall consider as relevant direct control and indirect control over such terms and conditions, reserved authority to control such terms and conditions, and control over such terms and conditions exercised by a person in fact: Provided, that nothing herein precludes a finding that indirect or reserved control standing alone can be sufficient given specific facts and circumstances. Furthermore, the definition of "Employer" is amended as well, adding at the end of Section (2)(3) of the National Labor Relations Act (29 U.S.C. § 152(3)) "An individual performing any service shall be considered an employee (except as provided in the previous sentence) and not an independent contractor, unless." *See* Protecting the Right To Organize Act of 2019, H.R. 2474, 116th, https://www.govtrack.us/congress/bills/116/hr2474/text (last visited Sept. 12, 2022); *see also* 29 U.S.C. § 152 (2020).

431. *Id.*; Amy Harwath & Michael Correll, *Labor Law Under the Biden Administration: A Preview of the PRO Act*, EMPLOYMENT LAW WATCH (Mar. 8, 2021), https://www.employmentlawwatch.com/2021/03/articles/employment-us/labor-law-under-the-biden-administration-a-preview-of-the-pro-act/.

432. Alex Gangitano, *Biden calls for passage of PRO Act, $15 minimum wage in joint address*, THE HILL (Apr. 28, 2021), https://thehill.com/homenews/administration/550845-biden-calls-for-passage-of-pro-union-pro-act-and-15-minimum-wage.; *see* Robert W. Emerson & Charlie C. Carrington, *Devising a Royalty Structure that Fairly Compensates a Franchisee for Its Contribution to Franchise Goodwill*, 14 VA. L. & BUS. REV. 279, 285–92 (2020) (discussing independent contractor and joint employment issues).

433. Spanos, *supra* note 426.

434. Natale V. Di Natale & Kayla N. West, *U.S. House Passed the PRO Act: How It Could Affect the Future of Labor Law*, THE NAT'L L. REV. (Oct. 3, 2021), https://www.natlawreview.com/article/us-house-passed-pro-act-how-it-could-

awaiting passage.[435] Then, in January 2023, the Republicans took back control of the U.S. House of Representatives that they had lost in the 2018 Congressional elections; this killed the chances for the PRO Act, in either Congressional chamber, at least until new elections and another Congress forms in January 2025.[436]

Beyond the PRO Act, there are several NLRB decisions rendered during the Trump Administration that the current Board could revisit. Most impactful on franchising – still a matter for reflection, resolution, and dealing with its aftermath - is the *Browning-Ferris Industries* case from 2015.[437] While uncertainty remains about what the Biden Administration's NLRB will ultimately accomplish, all signs point to continuing changes in labor policy, including a serious strategic impact on franchise systems.[438]

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affect-future-labor-law. The bill passed in the House of Representatives by a vote of 225 to 206 on March 9, 2021. Five House Republicans (Brian Fitzpatrick, John Katko, Chris Smith, Jeff Van Drew, and Don Young) joined the House Democrats in voting for it, while one Democrat (Henry Cuellar) voted against it. *Id.*

435. *See id.* The bill is unlikely to pass in the Senate as that would require 60 votes to overcome any filibuster, meaning universal or near-universal Democratic support and as many as ten Republican crossover votes.

436. Of course, as support for the PRO Act has been almost entirely the domain of the Democratic Party, with Republicans nearly uniformly opposed to the PRO Act, its being signed into law would, in addition to Democratic ascendancy in both houses of Congress, almost certainly require that the Democrats retain control of the Presidency.

437. 362 N.L.R.B. 1599 (2015). In this decision, the NLRB expanded the joint-employer standard by holding that status as a joint employer rested on the employer's "reserved right to control employees as well as its indirect control over employees." This relaxed the previous joint employment standard, potentially allowing employees to assert their right to bargain with both their direct employer and the company that contracted their services. Independent contractors are frequently put in a position where they are without protection of any workplace laws. By clarifying that the lead employer may also be responsible as a joint employer for the conditions of employment, administrative boards and courts in cases such as *Browning-Ferris Industries* have turned franchisor-as-employer into a clarion call for worker rights and for unionization at disparate, large, franchised chains. It is more a battle overpay, working conditions, and unionization generally – of the obvious employees versus those above them in both local and national "management" (the franchisees and the joint-employer franchisor, respectively) than simply a fight to label franchisees as the franchisor's employees.

438. Until the ABC test becomes the federal standard, workers in states that have adopted the ABC test may have difficulty bringing claims in federal court if it is determined that there is a conflict between the state and federal standards. *See* Patel v. 7-Eleven, Inc., 8 F.4th 26 (1st Cir. 2021) (affirming dismissal

2. *A Uniform Guarantee of Rights*

Assuming that the ABC test is adopted at the federal level and made to apply uniformly across jurisdictions, states that value the "right to contract" may nevertheless hold the provisions of a franchise agreement to apply even against a worker determined to be an employee under the ABC test.[439] For that reason, any effort to make uniform the ABC test should include a concomitant guarantee of the rights associated with being an employee; otherwise, workers designated as employees may receive nothing more than a change in their formal designation, without the practical benefits associated with that status.

C. *Dependent Contracting and Collective Bargaining*

Without question, legislating a single uniform standard to determine worker classification would help clarify both independent contracting and joint employment law. However, that is not the only option. Another solution is to change how franchisors and franchisees come to an agreement in the first place.

From the start, franchisees are at a disadvantage. They are often inexperienced businesspeople who gravitate towards franchising because of the structure and assistance the franchise model offers.[440] Additionally, franchisees are prone to recency,[441] outcome,[442] and optimism biases,[443] making them more likely to jump at an attractive venture without proper pause or time for reflection. Meanwhile, franchisors or their representatives often are quick to advertise low starting costs and high

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of case brought by workers alleging they had been misclassified given a potential conflict between the Massachusetts and FTC standards).

439. *See* Mujo v. Jani-King Int'l, Inc., 13 F.4th 204 (2d Cir. 2021).

440. Emerson & Benoliel, *supra* note 14, at 202–15.

441. Lawrence A. Cunningham, *Behavioral Finance and Investor Governance*, 59 Wash. & Lee L. Rev. 767, 777 (2002).

442. Suandy Chandra, *Outcome Bias*, LinkedIn (Dec. 13, 2020), https://www.linkedin.com/pulse/outcome-bias-suandy-chandra/?trackingId=APT8jYv4Q8S%2BZBa4YeaQRA%3D%3D ("Outcome bias is [the] tendency to judge a decision by its eventual outcome instead of judging it based on the quality of the decision at the time it was made.").

443. Robert W. Emerson, *Fortune Favors the Franchisor: Survey and Analysis of the Franchisee's Decision Whether to Hire Counsel*, 51 San Diego L. Rev. 709 (2014); *see also* Robert W. Emerson & Steven A. Hollis, *Bound by Bias? Franchisees' Cognitive Biases*, 13 Ohio St. Bus. L.J. 1, 24 n.126 (2019) (on the optimism bias that franchisees so frequently have); Tali Sharot, *The Optimism Bias*, 21 Current Biology R941 (2011).

probabilities of success.[444] For example, the oft-quoted statistic for franchise success rates is between 90% and 95%.[445] Whether this is true or not, the typical franchisee's lack of business experience makes it difficult to reasonably assess the franchisee's chance of success.[446]

Moreover, franchisees have little ability to meaningfully dictate contract terms throughout the negotiation process, given the franchisor's frequent refrain of "take it or leave it."[447] From the franchisor's perspective, it is far better to forego choosing a franchise applicant who has refused to comply from the outset, especially if it is relatively easy for the franchisor to find other interested parties. Once negotiations are completed, that initial power imbalance tends to continue throughout the term of the agreement. Furthermore, the oversight and control that franchisors retain over their franchisees during the course of the relationship renders franchisees independent in name only.[448]

And yet, franchisees continue to be viewed under the law as independent contractors, and thus, under the current version of the NLRA, they do *not* have a protected right to form

444. Robert W. Emerson, *Assessing* Awuah v. Coverall North America, Inc.*: The Franchisee as a Dependent Contractor*, 19 STAN. J.L., BUS. & FIN. 203, 221 (2014).

445. *See* Carol Blitzer, *Franchise Owners Weather Turbulent Economic Times*, PALO ALTO ONLINE (Dec. 11, 2011), http://www.paloaltoonline.com/news/2011/12/11/small-franchise-owners-weather-turbulent-economic-times; TOP 3 FRANCHISE QUESTIONS, http://www.murphybusiness.com/franchise-sales/top-3-franchise-questions (last visited June 27, 2022).

446. Emerson, *supra* note 443.

447. Robert W. Emerson, *Franchising and the Parol Evidence Rule*, 50 AM. BUS. L.J. 659, 713 (2013) ("[L]ikened to an adhesion contract, with the power disparity very much weighted toward the franchisor, the franchise agreement 'carries within itself the seeds of abuse.'").

448. Surveys of 100 U.S. restaurant systems' franchise contracts in 2013 and 200 such systems' franchise contracts in 2023 demonstrated that a large majority of contracts, only increasing in percentages from 2013 to 2023, showed, *inter alia*, great controls by the franchisor over: (1) the franchised business' site selection, layout, and alterations, (2) the training of the franchisee, (3) franchisor-issued operation manuals, (4) quality control standards and product line control, (5) price restrictions, (6) franchise outlet hours of operation, (7) franchisor specifications about franchisee employees, (8) the franchisor's right to inspect the franchisee's business premises, and (9) restrictions concerning trademark display and the use or sale of trademarked goods. Emerson, *Two-Standard Approach*, *supra* note 12, at 690–93; Emerson, *Franchise Contract Standards*, *supra* note 12.

labor unions.[449] Without the freedom to work *with* one another, the franchisees are forced to compete *against* each other. Even absent these restrictions, franchisees who attempt to organize are often met with retaliation.[450] Furthermore, while franchisor advisory councils do exist to work towards promoting communication between franchisors and franchisees, they are frequently ineffective, and actually have the inverse effect of establishing new obstacles for franchisees.[451]

The change this article advocates is an increase in franchisees' ability to communicate, organize, and bargain with their franchisors. The PRO Act contains several provisions that would significantly bolster franchisee negotiating power and franchisee protections. First, the Act would remove the ban on franchisee collective bargaining, thus facilitating union organization and leveling the playing field between franchisors and franchisees.[452] Second, the Act would prohibit mandatory arbitration agreements and class action waivers,[453] giving franchisees the power to pursue litigation if union and franchisor negotiations prove unfruitful, thereby giving franchisors increased incentive to participate in these negotiations in good faith. Finally, the Act would impose financial penalties against employers who interfere with workers' organization efforts,[454] affording franchisees a means to combat franchisor retaliation.

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449. *See Frequently Asked Questions – NLRB*, Nat'l Lab. Rels. Bd., https://www.nlrb.gov/resources/faq/nlrb (last visited Sept. 12, 2022).

450. Robert W. Emerson & Uri Benoliel, *Can Franchisee Associations Serve as a Substitute for Franchisee Protection Laws?*, 118 Penn. St. L. Rev. 99, 112, 124 (2013).

451. Emerson, *supra* note 165, at 1536; Emerson & Benoliel, *supra* note 450, at 119–21.

452. Marc Lieberstein et al., *Is Franchising Being Threatened (Again)?*, N.Y. L. J. (May 20, 2021, 12:45 PM), https://www.law.com/newyorklawjournal/2021/05/20/is-franchising-being-threatened-again/?slreturn=20210904135308.

453. Celine McNicholas, Margaret Poydock & Lynn Rhinehart, *How The PRO Act Restores Workers' Right To Unionize*, Economic Policy Institute (Feb. 4, 2021), https://www.epi.org/publication/pro-act-problem-solution-chart/#:~:text=Collective%20and%20class%20action%20waivers,employees%E2%80%94without%20violating%20the%20NLRA.

454. Harwath & Correll, *supra* note 429. PRO Act provisions would increase the damages available to employees for unfair labor practices - (a) back pay no longer offset by interim earnings such as unemployment pay or earnings from a new job, and (b) liquidated damages equal to twice the amount of other damages awarded. H.R. 842, 117th Cong. §109 (2021). They also subject employers to penalties starting at $50,000 for each failure to comply

In sum, these parts of the PRO Act would be a much-needed step in the right direction.[455] It is abundantly clear that, under the current state of the law, franchisors can benefit from the franchise model even as they impose controls upon the franchisee that cut against the very nature of this model. Among other things, the PRO Act's collective bargaining protections, heightened enforcement of a right to organize, and bans on class action waivers and mandatory arbitration clauses[456] would in effect acknowledge and combat these controlling practices by some franchisors. These reforms can be more than just a way to reset the balance in individual franchise relationships. These changes in the law can halt or at least diminish franchisor practices that tend to discourage, if not outright destroy, franchisee initiative and productivity, but that are ultimately self-defeating for franchise systems as a whole. To right the balance in power between franchisee and franchisor, throughout the term of the franchise relationship, may not simply help franchisees but, in the end, serve the long-term interests of all who desire a strong, nimble franchise network, including the franchisors themselves.

with a Board order, which could be doubled if a similar unfair labor practice occurred in the past five years, and the penalties could apply to employers' directors and officers. *Id.*

455. The PRO Act has many other provisions, but they are outside the scope of this article, such as: (1) prohibiting state "right to work" laws; (2) outlawing required employee attendance of "captive audience" meetings, where employers present their arguments against unionization; (3) requiring that employers report all payments for labor relations advice and other services from lawyers; (4) mandating that, prior to any organizing election, employers give their employees' personal contact information to union organizers; (5) allowing secondary boycotts; (6) providing for increased use of bargaining orders if the employer engaged in misconduct (instead of a new election, the union is certified despite losing the first representation election); (7) changing the definition of "supervisor," by limiting the classification to those who perform "supervisory" duties "for a majority of the individual's worktime," and by eliminates two factors that often have indicated supervisory status: "assigning" work and having the "responsibility to direct" the employees' work; and (8) restoring, and placing in the NLRA, the Browning-Ferris rule (*see supra* notes 188–92 and accompanying text), so a putative joint employer's reserved and indirect control could subject it to joint employer status and liability. H.R. 842, 117th Cong. §§101-107, 111, 202 (2021).

456. *Supra* notes 452–54 and accompanying text.

D. *A Paradigm Shift*

A large share of the issues in franchising stem from confusion over the classification of the various parties. The question of whether franchisees are genuinely independent contractors or, instead, their independence is a guise used to protect franchisors from liability, arises from the unique nature of franchising relationships.[457] Further, as many franchisees establish a corporate entity through which to operate their franchise, this classification may appear to necessitate the clearing of an additional hurdle—the setting aside of the franchisee's corporate identity in order to classify that franchisee as the franchisor's employee.[458] Given this novelty, perhaps the solution lies in adapting the legal lens through which we view these relationships.

1. *An Intermediary Theory of Liability*

One viable approach has been developed by Professor Kati L. Griffith, which challenges many of the assumptions that

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457. Emerson, *supra* note 9, at 592–93 ("most customers lack the leverage to force disclosure of a non-public franchisee's financial strength, and, of those people who do, most have not engaged in transactions that would make that kind of analysis feasible or cost-effective. As a consequence, this problem comes to the surface: financially irresponsible franchisees may compete on a seemingly level playing field, under the guise of a trademark, with those franchisees who are financially responsible. These irresponsible franchisees may thus abuse the franchise business model by reaping all the benefits without assuming any risk. A response, however, would be that the franchisor has complete control in vetting and choosing a franchisee.").

458. However, in practice, choosing to adopt a corporate entity status has not proven to be a method for somehow working around compliance with laws (for safety, child labor, or other fundamental public policy concerns) as they arise in a multi-layered business structure. For instance, assume that a corporation ("C") has licensed a limited liability company ("LLC") to carry out certain contractual functions, and that LLC has managers who hire workers to perform functions that carry out LLC's duties under the C-LLC licensing arrangement. The form of the arrangement will not somehow triumph over the substance of wage law violations, nor will certain persons responsible for violations be insulated from suits or charges due to their status as key employees of a franchise party. *See* Patel v. 7-Eleven, Inc., 183 N.E.3d 398, 405 (Mass. 2022) (citing the criminal and civil remedies for Massachusetts wage statute violations, and noting that employers who misclassify their employees "do so at their peril"; further noting, "[t]hese sanctions apply to both business entities and certain individual officers" because the statutes and the precedent clearly indicate they create "liability for both business entities and individuals, including corporate officers, and those with management authority over affected workers").

undergird franchise jurisprudence.[459] Chief among these is the trend, current among some courts, to accept the letter of franchisor contracts at the expense of the true character or substance of these relationships.[460] Take, for example, a contract which provides that a franchisor may make certain recommendations to the franchisee, but which expressly claims that such recommendations are by no means to be considered mandatory.[461] Otherwise, such "recommendations" might be construed as what they often surely are: direct commands, which may only be rejected at the franchisee's peril. Regardless, the interpretation of such devices as nothing more than "recommendations" is contradicted both by the scholarly literature, which questions the allegedly "arms-length" nature of franchise transactions, as well as by the fact that franchisors frequently evaluate franchisees *on their adherence to the "recommendations."*[462]

Accordingly, courts seeking to correctly characterize the parties to franchise agreements should look to the actual substance of the relationship rather than the contractual provisions establishing such a relationship; they should prize the function of the device, rather than the form. Doing so would not only allow them to rightly view the aforementioned recommendations as requirements that franchisors take pains to meet,[463] but might also pave the way towards shifting altogether the underlying control analysis.

At present, courts operating under the FLSA and NLRA evaluate a franchisor's control by characterizing it as either direct or indirect.[464] A more nuanced analysis, however, as Professor Griffith suggests, would consider the nature of franchise relationships, and thus might assess the nature and extent of the

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459. Kati L. Griffith, *An Empirical Study of Fast-Food Franchising Contracts: Towards a New "Intermediary" Theory of Joint Employment*, 94 WASH. L. REV. 171, 203 (2019).

460. *Id.* at 207–08.

461. *Id.*

462. *Id.* at 208–09 (interpreting such 'recommendations' correctly as 'requirements'); Andrew Elmore, *Regulating Mobility Limitations in the Franchise Relationship as Dependency in the Joint Employment Doctrine*, 55 U.C. DAVIS L. REV. 1227, 1229 (2021) ("Although franchisors nominally 'recommend' these policies, franchisees nonetheless follow them because they need the franchisor's approval for their survival.").

463. This follows, even absent explicit mechanisms for enforcement, from the dependent nature of franchisees. *See* Griffith, *supra* note 457, at 210; Elmore, *supra* note 460, at 1229, 1238.

464. Griffith, *supra* note 457, at 211.

control.[465] This would open up a number of avenues through which courts could dig into the substance of a franchise relationship in an effort to adequately apprehend the nature of the relationship, rather than to assess and prematurely disrupt the relationship based upon cleverly constructed franchising boilerplate.

As a result of such a paradigm shift, an entirely new theory of liability could be predicated upon indirect control that is nevertheless actually visited upon franchisees, their managers, and their frontline workers. This theory, which might be termed an "intermediary theory" of liability,[466] would look to the meaningful control that franchisors indirectly exert over frontline workers as a result of the myriad ways they control franchisees and their managers. For example, under this theory of liability, a franchisor could be found to effectively control its franchisee's frontline workers given that it requires the franchisee to carry insurance for employment liability.[467] Or control could be established over frontline workers via a franchisor's requiring managers to attend various training sessions which frequently center on the managers' role vis-à-vis the frontline workers.[468]

2. *Presuming Joint Employment*

Courts might also too narrowly construe control when they ignore mobility limitations that franchisors impose upon their franchisees, such as policies prescribing operational standards. These standards, while intended to ensure a uniform product and customer experience, can make a franchisee dependent upon the franchisor.[469] Professor Andrew Elmore demonstrates how these mobility limitations harm workers.[470] He proposes that the implementation of various presumptions and *per se*

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465. *Id.*
466. *Id.* at 205.
467. *Id.* at 206. Such an expansion of our current understanding of control would be critical, as franchisors are careful to disavow more traditional control over frontline workers such as wages to be paid, or day-to-day supervision. *Id.*
468. *Id.* at 209 n.154 (pointing to the training McDonald's requires of its managers and how the lessons derived from such training is implemented at the frontline level).
469. This is due to the aforementioned recommendations as requirements phenomenon. Elmore, *supra* note 460, at 1227, 1236.
470. *Id.* at 1238.

rules would negate the judicial tendency to assume franchisors are not joint employers.[471]

Consider how rules for competition might extend to employment and franchising. Under the existing antitrust framework, low-wage workers in franchised fast-food operations face an almost insurmountable barrier attempting to bring their claims of anti-competitive practice in the form of no-poaching agreements.[472] This is largely to do with courts' failing to bifurcate their analysis between labor and product markets; labor monopsony has been shown to have benefits in the latter market (products) even as it worsens conditions in the labor market.[473] Thus, courts should adjust their analysis of no-poaching agreements to the effects they have on the

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471. *Id.* at 1233–34.

472. No-poaching agreements in a low-wage context are likely to lead to wage stagnation (restricted worker mobility and lessened employer competition over wages) and are unlikely to be beneficial in protecting trade secrets and employer investments (much less intellectual property to protect with respect to lower, entry-level employees than for managers, marketers, etc.). Especially concerning with respect to these low-wage workers is the fact that they likely do not know their rights and may not easily be able to access and afford a lawyer; thus, these workers are exceptionally susceptible to the *in terrorem* effects of both (1) non-compete covenants directly limiting their mobility and (2) even more probable, the no-poaching provisions that *indirectly* harm these workers by inhibiting employers otherwise inclined to give them job offers. *See* Rachel Arnow-Richman, *The New Enforcement Regime: Revisiting the Law of Employee Competition (and the Scholarship of Professor Charles Sullivan) with 2020 Vision*, 50 SETON HALL L. REV. 1223, 1252 (2020) (reviewing the relevant literature and concluding that "*in terrorem* effects of noncompete agreements are not hypothetical"); Cynthia L. Estlund, *Between Rights and Contract: Arbitration Agreements and Non-Compete Covenants as a Hybrid Form of Employment Law*, 155 U. PA. L. REV. 379, 423 (2006) ("Even a manifestly invalid non-compete may have *in terrorem* value against an employee without counsel."); Viva R. Moffat, *The Wrong Tool for the Job: The IP Problem with Noncompetition Agreements*, 52 WM. & MARY L. REV. 873, 888 (2010) (noting that – even if a non-compete covenant may not apply, the *in terrorem* effect of a potential lawsuit may cause ex-employees to refrain from seeking a new job during the term of that covenant). As stated in the seminal work on noncompetes, Harlan M. Blake, *Employee Agreements Not to Compete*, 73 HARV. L. REV. 625, 682 (1960) ("For every covenant that finds its way to court, there are thousands which exercise an *in terrorem* effect on employees who respect their contractual obligations and on competitors who fear legal complications if they employ a covenantor . . . ."), the same reasoning and concerns apply equally well to franchising covenants against competition.

473. Clayton J. Masterman, Note, *The Customer Is Not Always Right: Balancing Worker and Customer Welfare in Antitrust Law*, 69 VAND. L. REV. 1387, 1398–413 (2016).

labor market.[474] In conducting these analyses, a *per se* rule may be called for given the difficulty that low-wage earners have in bringing their claims. However, given the courts' usual reluctance to expand their purview, the best approach appears to be not a broad *per se* rule but a "quick-look analysis."[475] Unlike traditional, rule-of-reason analysis, challenged restraints would be presumed to be anticompetitive, with plaintiffs having no burden to prove market power.[476]

Among other proposals, Professor Elmore encourages courts to adopt a presumption that franchisors who impose significant mobility limitations on their franchisees jointly employ their franchisees' employees.[477] This presumption could be rebutted with a showing that the franchisor does not actually exert undue control over the franchisees' workplaces despite the mobility limitations.[478] This sort of presumption could do a great deal to protect the independence of franchisees while simultaneously avoiding over-inclusivity by limiting its scope only to those franchisors who are *actually* exerting inordinate control over their franchisees. Functionally, mobility limitations would serve as a red flag, alerting courts to potential issues

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474. While no-poaching agreements can decrease the price charged to consumers for their burgers and fries (pro-competitive viz. products market), they cut against organic wage growth (anti-competitive viz. labor market); given that these effects are cultivated in the labor market, their eventual impact on the products market should not be considered, at least not such as to overcome the deleterious effects on the labor market. This realization almost certainly would lead courts to consider the quick-look analysis in cases like the franchising context given the substantiated anticompetitive effects of the agreement. *See* Ioana Marinescu & Eric A. Posner, *Why Has Antitrust Law Failed Workers?* 105 CORNELL L. REV. 1343, 1388 (2020) ("[C]ollusion appears to be easier in labor markets than in product markets, because labor markets are often more concentrated than product markets are.").

475. *See* United States v. Brown Univ., 5 F.3d 658, 669 (3d Cir. 1993) (describing "quick-look analysis" as an "intermediate" standard between rule of reason and *per se* condemnation).

476. Cal. Dental Ass'n, v. FTC, 526 U.S. 756, 770 (1999) ("[Q]uick-look analysis carries the day when the great likelihood of anticompetitive effects can easily be ascertained."). If a case goes to rule of reason, then any trial decision almost always favors the defendant. *See* Richard Posner, *The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision,* 45 U. CHI. L. REV. 1, 14 (1977) (describing the rule of reason as "little more than a euphemism for nonliability"); Michael A. Carrier, *The Rule of Reason: An Empirical Update for the 21st Century*, 16 GEO. MASON L. REV. 827, 829–30 (2009) (finding that defendants won 221 out of 222 rule of reason cases that reached final judgment from 1999–2009).

477. Elmore, *supra* note 460, at 1263.

478. *Id.*

while leaving them free to consider the totality of the circumstances before drawing their conclusions.

On the other hand, a *per se* rule that requires a finding of joint employment wherever certain contractual provisions are present, something for which Professor Elmore also advocates,[479] might serve to unnecessarily restrict parties to a franchise agreement who possess a bona fide desire for those provisions. For example, a *per se* rule which says that any franchise agreement containing a no-poaching clause is invalid, while enabling intrafirm competition for valuable workers, could also reduce franchisees' ability to safeguard its investments in its workers. While no-poaching agreements have historically had anti-competitive effects,[480] certainly these provisions could be tailored to avoid such externalities, in which case a *per se* rule might create new issues even as it puts others to rest. So, a compromise might be to proscribe most contract clauses that restrict competition, only permitting narrowly phrased and purposed clauses, such as a ban of poaching within the franchise network if that ban protects trade secrets or intense training.[481] Therefore, no-poaching agreements must still be narrowly tailored to protect franchisors' legitimate interests, especially when franchisors or their franchisees are dealing with higher-level, managerial franchisees in possession of franchisor intellectual property, such as trade secrets.[482]

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479. *Id.* at 1276–77.

480. Michael Lindsay & Katherine Santon, *No Poaching Allowed: Antitrust Issues in Labor Markets*, 26 ANTITRUST 73 (2012).

481. Professors Marinescu and Posner argue that the contractual barring of poaching within a franchise network "may be justified in narrow cases." Marinescu & Posner, *supra* note 472, at 1387–88 (recognizing that intrafirm no-poaching agreements may be justified even in the fast food industry if they are sufficiently tailored to protect certain investments in various classes of workers). Two of these relatively rare classes of people would be "managerial employees," specifically those "given access to proprietary information about the franchise's method of business" (presumably, that information could constitute trade secrets) or those "who have received intensive training at the franchise level." *Id.* Rather than arguing about vertical versus horizontal restrictions (the standard approach in antitrust law), Marinescu and Posner focus on individual specifics – what employees have received and thus may take to a competitor; when the restrictions are instead rather broad (e.g., they are "untailored to the skill-level and responsibility of employees or [they] apply to low-skill employees"), those wide-ranging proscriptions against hiring workers from another franchise within the network "should trigger the *per se* rule." *Id.*

482. Michael Iadevaia, *Poach-No-More: Antitrust Considerations of Intra-Franchise No-Poach Agreements*, 35 ABA J. LAB. & EMP. L. 151, 180, 180 nn.206–09 (2020) (citing RESTATEMENT (THIRD) OF EMPLOYMENT L. § 8.07 (AM. L. INST. 2015)).

In the end, it seems imperative that franchising must be viewed as *sui generis*. It does not fit squarely within the current shape of employment law, nor should it have to.[483] Rather than force franchises to conform to the law, the law should assess and refine its tools for analysis to better accomodate the franchise parties, both franchisors and franchisees. In so doing, franchisees and their workers might be better protected, while still allowing a strong and proven business model to flourish.

Conclusion

The current state of independent contractor and joint employment law is a mess. Multiple tests promulgated by various agencies and established as precedent by courts in jurisdictions across the country are applied to establish worker classification. In addition, because there is no overarching standard, numerous versions of each test are used. However, the recommended reforms – (1) accelerated consideration of the franchising realities already recognized in many foreign legal environments, (2) adoption of a uniform, simpler test for independent contractor status, (3) a push toward legal principles that enhance the prospect of collective bargaining and perhaps even implementation of "dependent contracting" concepts, and (4) enactment of some core PRO Act rights and obligations - can go a long way towards eliminating the confusion and improving the law of franchising.

Federal codification of the ABC Test will provide a uniform standard, and narrowing the definition of "independent contractor" while expanding the definition of "joint employer" will decrease the uncertainty surrounding proper classification. Passage of several PRO Act provisions will only directly reach business practices and law cases insofar as they involve *federal* law, but they should also serve as a persuasive model for state and local jurisdictions. The PRO Act provides much-needed protection for workers and relief for franchisees. This article's proposed reforms would grant some needed rights to franchisees, who as a special class of hirees often are no better off than entry-level employees without even some of the legal protections associated with employment. Some franchisor privileges may serve mainly to deny or at least delay fundamental

483. *See supra* Part V.A (noting the strength of the franchising model even under disparate legal regimes).

franchising reform. Even if, in the short term, these improvements may increase the cost of doing business, these changes are necessary for the continued advancement of healthier, fairer forms of franchising.