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The Non-merger Virtual Merger: Is Corporate Law Ready for Virtual Reality?

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THE NON-MERGER VIRTUAL MERGER: IS CORPORATE LAW READY FOR VIRTUAL REALITY?

BY STUART R. COHN*

ABSTRACT

The term "virtual mergers" describes the relatively recent phenomenon of companies entering into contractual arrangements that are functionally, but not legally, equivalent to mergers prescribed by corporate statutes. Virtual mergers usually involve the shared use of assets contributed by each of the companies. A central element of the transaction is that the two companies remain legally independent, each with its own directors, officers, and shareholders. The arrangements can usually be terminated by either party, allowing each company to return to the status quo ante or exercise buyout rights if contractually provided.

Although virtual mergers have occurred among public companies in Europe, no U.S. public company has yet engaged in such a transaction. The advantages of the transaction are very likely to lead to its use in this country among both public and smaller companies. The application of corporate statutes to a virtual merger is not clear. This article examines the issue of shareholder voting and whether, and to what extent, current statutory provisions and judicial interpretation support shareholder voting and appraisal rights in these unusual forms of corporate combination.

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I. THE VIRTUAL MERGER PHENOMENON

A. Introduction

It is only a matter of time before United States companies employ a form of corporate combination utilized in Europe that has become known as the "virtual merger."1 Virtual mergers are functionally, but not legally, equivalent to mergers commonly understood under corporate law. Although the transaction format has attracted little attention or comment in this country, its advantages suggest that the import of the virtual merger to the United States is inevitable. Corporate law will be strained to adjust to this novel legal paradigm. A period of uncertainty within the business and legal communities will necessarily ensue regarding the "fit" of the virtual merger transaction into corporate statutory and case law. Among the principal issues will be shareholder voting and appraisal rights, in particular

1Virtual mergers of European-based companies are described in Peter H. Blessing, Virtual Mergers, 10 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 297 (2000); James L. Dahlberg & Jay D. Perry, Tracking Stock: Virtual Equity, Virtual Entities, and Virtual Mergers and Acquisitions, 10 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 241 (2000).
whether functional combinations of independent entities invoke elements of corporate democracy that are the basis for shareholder action in traditional merger contexts.

The virtual merger transaction raises issues similar to the "de facto merger" doctrine. But the analogy is not complete. Virtual mergers also raise questions under sale of assets analogies, delegation of management authority, and fiduciary duties. The latter is evidenced by the recent Omnicare decision in Delaware, which examined fiduciary duties of the board in the context of negotiated mergers. The court's admonition that "Delaware corporation law expressly provides for a balance of power between boards and stockholders which makes merger transactions a shared enterprise and ownership decision" could well be applied to business combinations that emulate mergers but are effected outside of traditional statutory processes.

The issues raised by the virtual merger transaction are at the core of a larger, more significant question, namely the extent to which shareholders ought to have a voice in fundamental business restructuring. The history of corporate law has been one of continual erosion of shareholder voting powers. In the nineteenth century, mergers required the unanimous consent of shareholders. That standard was reduced to an absolute majority when appraisal rights were developed. It was then further reduced to a majority of the quorum, and in some instances the shareholder vote has been entirely eliminated. The trend against shareholder voting is also seen in the recent MBCA amendment to sale of assets provisions, where shareholder voting is eliminated if the company retains at least twenty-five percent of it assets.

Acceptance of the virtual merger concept can effect a significant alteration in shareholder powers without statutory amendment, and it would be another major step away from shareholder authority. If virtual mergers can occur without shareholder approval and the related requirements of disclosure and appraisal, company managements will surely prefer a board-

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3Id. at 930.
4WILLIAM J. CARNEY, MERGERS AND ACQUISITIONS 19 (2000) (noting that the appraisal remedy was adopted to avoid the veto power of shareholders).
5MODEL Bus. CORP. ACT § 11.04(e) (2001).
6In some states, shareholders of the acquiring, surviving corporation do not have a vote if there is no change in their share holdings or the corporation's articles of incorporation. MODEL Bus. CORP. ACT § 11.04(g) (2001). Exchange and NASDAQ listing conditions impose voting requirements that might not otherwise exist, particularly if the merger will involve the issuance by the acquiring company of more than a specific percentage of additional shares.
7MODEL Bus. CORP. ACT § 12.02(a) (2001).
controlled process over the slower, riskier, disclosure-oriented statutory merger provisions. By imposing shareholder rights upon the functionally equivalent virtual mergers, existing statutory policies will be preserved. Thus, two underlying themes of this article are the balance of power between management and shareholders and the checks and balances that are appropriate in material operational decisions.

B. The Problem of Definition

What is a "virtual merger?" There is no bright-line definition. The few articles that have been written to date have not attempted to define the term. Although this article provides a description of principal features, any current definition of "virtual merger" is ambiguous at best. In dealing with result and function, not form and process, there is a danger in the "virtual merger" analysis of relying upon Justice Stewart's infamous "I know it when I see it" test. Indeed, that standard has been employed in some de facto merger cases. Despite definitional uncertainties, Part IV proposes objective guidelines for application of voting and appraisal processes. The guidelines are based on a combination of three principal factors: (1) the amount of assets transferred to joint control of the combining entities, (2) the degree of control retained by the transferring parties, and (3) the intended duration of the combined venture.

C. Virtual Mergers Compared to Traditional Alliance Forms

Intercorporate agreements not rising to the level of formal mergers are common, and are generally regarded as within the sole discretion of the board of directors. Joint ventures, strategic alliances, cross-ownership of

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4 Inasmuch as voting and appraisal rights are not accorded in many standard forms of merger and acquisitions, one may legitimately inquire why shareholder rights should exist for a diluted form of merger, the virtual merger. The answer lies, in my judgment, in the extraordinary nature of the virtual merger, which usually involves an abdication of control over corporate assets and a delegation of authority to non-elected management. These concerns are discussed infra Parts III and IV.

5 Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (concurring opinion) (referring to an attempt to define hard-core pornography for First Amendment purposes).

I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description; and perhaps I could never succeed in intelligibly doing so. But I know it when I see it, and the motion picture involved in this case is not that.

Id.

6 Rath v. Rath Packing Co., 136 N.W.2d 410, 415 (Iowa 1965) (characterizing a reorganization plan as a merger "under any definition of merger we know").
stock, and joint research and exploration efforts are common practices that typically require only board approval. These transactions are generally contractual in nature. Similarly, virtual mergers are contractual rather than statutory alliances.

Virtual mergers differ from other forms of alliance principally in degree rather than kind, but the differences may be significant. Virtual mergers are analogous to a joint venture. The main difference is that virtual mergers involve a significant percentage of assets allocated to joint control by each of the combining parties. Oil companies that share costs of exploration and drilling expend huge resources in the joint venture, but the bulk of their business operations remain independent. Automobile companies that agree to develop and market a new model may combine enormous resources, but again their independent businesses continue to be their dominant activities.

The terms virtual merger and joint venture are of course merely labels, legal conclusions based on a set of objective facts. What some parties might call joint ventures could be functional mergers. Indeed, labeling could be part of an attempt to avoid statutory processes and disclosure obligations. This article will use the term joint venture to indicate combined activities that do not involve significant interdependence of principal business operations. Although there is no template for a virtual merger, such functional combinations generally:

- involve a significant portion of the business operations of at least one of the two entities;
- result in a jointly-owned management unit that controls the use of the assets contributed by each of the parties;
- retain the distinct legal status, management, and shareholding groups of each of the respective companies;
- permit either party to withdraw from the arrangement; and
- permit the parties, following withdrawal, to (i) reclaim their respectively contributed assets or (ii) effect a buyout of the withdrawing company's interest, which would include the contributed assets.¹¹

In this author's opinion, a virtual merger differs from a typical merger or acquisition effected pursuant to statutory corporate law in several respects:

- a virtual merger is governed by contract without reference to statutorily determined procedures or consequences;
- a virtual merger does not result in the absorption of one company by another;
- a virtual merger does not result in cash-outs or exchanges with either shareholding group;
- the combining parties in a virtual merger retain either direct or residual ownership in the assets being contributed to the venture;
- each of the combining parties has the right to terminate the relationship and return to the status quo ante or apply other agreed upon termination provisions.

A recent case involving two hospitals in Poughkeepsie, New York, illustrates a virtual merger transaction.\(^\text{12}\) Limited financial resources caused the hospitals to enter into a joint venture to create several jointly operated care and diagnostic facilities.\(^\text{13}\) The success of the cooperative venture whetted the appetites of the hospital administrations, and one year later they entered into an agreement "to more closely integrate . . . to eliminate costly duplication of services" and "not to compete . . . with one another" for the provision of similar services.\(^\text{14}\) The hospitals retained their separate identities and ownership structures but used the joint venture entity to coordinate operational decisions. The joint venture management negotiated with insurers regarding rates and terms of service, allocated patients to the respective hospitals, and determined the appropriate division of general surgery revenues. The cooperative effort caught the attention of the New York Antitrust Division, which sought to apply state antitrust laws to the hospitals' relationship. The Division's action was successful, and the court concluded that what began as a legitimate collaboration for limited

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\(^{13}\) The hospitals combined operations for a cardiac catheritization laboratory, MRI unit, and mobile lithotripter. Rovner, supra note 12, at 4.

\(^{14}\) Spitzer, 94 F. Supp. 2d at 405-06.
purposes had evolved into horizontal collusion that decreased consumer choice and price competition.\(^{15}\)

This situation is not unusual. Rising costs of medical care and restrictive insurance practices create significant pressures among hospitals to reduce duplicative services, provide access to services not currently offered, and avoid the effects of market competition. Although some mergers have occurred, many hospitals have preferred the "virtual" route to maintain their individual identities. As one commentator noted:

Today, health care systems frequently are forgoing traditional mergers and consolidations in favor of forming hybrid-type organizations (HTOs). \ldots\) HTOs typically take the form of either a JOA [(joint operating agreement)] or a holding company model. A JOA consists of a contractual arrangement which may, but need not, involve the creation of a separate corporation, partnership, or limited liability company (JOC) to oversee the operations of the participating health care systems. Each participant retains ownership of its assets and continues to be liable for its own liabilities \ldots\) However, the participants' operations are both financially and structurally integrated.\(^{16}\)

To date there have been no virtual mergers involving a publicly-held United States company. Eventual adoption of the virtual merger transaction is inevitable, however, as companies recognize its merits.\(^ {17}\)

High tech industries are especially fertile grounds for joint ventures that could combine assets and management. The volatility of the high tech industry might lead companies to seek organizational relationships that offer both the potential of synergy and the ability to resume independent courses in case conditions alter. Alliances can also be expected in industries such as pharmaceuticals, oil, and communications, where research costs are extraordinarily high relative to benefit uncertainties.

\(^{15}\)Id. at 415 ("Here, defendants have engaged in an ongoing horizontal arrangement to divide the market for healthcare services in Poughkeepsie.").

\(^{16}\)Lockman & Silverman, supra note 11, at 14.

\(^{17}\)In February 2001, Coca Cola and Proctor & Gamble announced plans to create a jointly-owned limited liability company that would control the marketing of Coca Cola's Minute Maid juices and P&G's Pringles chips and Sunny Delight juice drinks. Nikhil Drogon & Betsy McKay, Coke and P&G Plan to Create a $4.2 Billion Juice and Snack Company, WALL ST. J., Feb. 21, 2001, at B1. Although the planned alliance did not go forward, the proposed relationship could have suited the virtual merger construct.
D. Advantages of the Virtual Merger

There are strong reasons to expect that the virtual merger transaction is just around the proverbial corner. In Europe, the transaction has been used principally in cross-border alliances where differing merger statutes and tax regulations posed problems with complete integrations. Similar concerns may arise if U.S.-based companies desire to merge with foreign entities. Tax and other concerns can arise as well in purely domestic combinations leading to virtual mergers between domestic companies.

Virtual mergers are particularly suitable in circumstances where neither company desires to give up permanent control of its assets and future business opportunities. Although any merger can theoretically be dissolved, parties to a virtual merger expressly provide for potential termination, and can plan for the reallocation and return of contributed assets if anticipated synergies are not achieved.

The ability to back out of an unfavorable alliance with a company's original assets and corporate structure intact is a key advantage over traditional merger transactions. There are undoubtedly many companies and shareholders today that wish they could undo various full-fledged mergers and return to the *status quo ante*. Moreover, the companies retain

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18*See Blessing, supra* note 1, at 299:
In certain cases involving potential cross-border business combinations of publicly listed companies, conventional legal forms of combination . . . may not be viable for tax, legal, commercial or intangible reasons. For example, . . . the combination may give rise to tax to the shareholders of one of the partners or even to an entity-level tax. The EC Merger Directive, and local implementing legislation, has dramatically reduced the frictions . . . but has no relevance where one or both parties are not members of the EC. Even if the combination could be arranged in a tax-efficient manner, if the combination is intended to be a "merger of equals" and the desirable tax structure is inconsistent with the intended commercial perception, its viability may be vitiated.

*Id.*

19*Sally A. Thurston, Planning Techniques for International Mergers and Acquisitions, 10 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 251, 274 (1999) ("Since the companies have not merged, many legal and regulatory approvals are presumably resolved.")

20*E.g.,* Eric B. Sloan *et al., Through the Looking Glass: Seeing Corporate Problems as Partnership Opportunities, 3 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 1037, 1050 (1999) (discussing use of a virtual merger to avoid taxation in a Morris Trust transaction in which A would acquire B after B spins off C. Instead of A acquiring B, which would likely be a taxable transaction, A and B would agree to conduct all of their business operations through a jointly-managed LLC.)

their independent boards, officers, and shareholders, thereby preserving opportunities for business development and capital financing in areas not controlled by the virtual merger transaction. Sometimes, as was the case in Poughkeepsie, a formal merger is not pursued because the respective entities serve different social or community missions. At other times virtual mergers may be motivated by the desire to avoid shareholder voting or merger provisions—a motivation hardly in keeping with corporate democracy principles but unquestionably a factor in the structuring of transactions. Even if the virtual merger transaction was not designed to avoid shareholder action, shareholder input and disclosure on fundamental corporate changes are established principles of corporate democracy.

E. The Uncertainty of Statutory Application

The virtual merger phenomenon has yet to attract significant corporate law attention. The relatively few commentaries in this area focus on tax and antitrust concerns. There has been little discussion regarding whether and to what extent virtual mergers are subject to corporate governance requirements applicable to traditional merger models.

Procedural requirements for mergers and acquisitions, including consolidations, statutory mergers, share exchanges, and asset transactions, are well prescribed in state statutes. Although twists on the basic

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23Subjecting the proposed transaction to shareholder vote could have several adverse consequences. Public disclosure of the terms could lead to competing bids from other companies, substantial delay in implementation of the proposed joint activities, critiques from analysts and institutional investors, and possible large cash payouts to dissenting shareholders. The perceived downsides are, conversely, reasons that support opening virtual merger transactions to shareholder and public scrutiny.

24Blessing, supra note 1; Dahlberg & Perry, supra note 1; Thurston, supra note 19; IRS Officials Consider Cross-Border Exchangeable Stock Deals, TAX NOTES TODAY, Jan. 29, 1999, at 19-3.


26There is a fair degree of uniformity among states regarding shareholder approval of mergers and acquisitions. Variations occur in voting percentages required for shareholder approvals and in provisions that except shareholder voting, particularly for surviving companies. This article will usually cite to the Model Business Corporation Act (MBCA), which has been substantially adopted in a majority of states.
statutory models occur, such as triangular and reverse triangular mergers, each variation can be fit within statutory analysis. The statutory fit is not as readily apparent for virtual mergers. In a virtual merger, the shareholders of both entities have had no change in their shareholder interests. Their company's identity has not been altered, and shareholders continue to have the right to elect company management and to vote on matters provided by law or charter. Although corporate assets have been transferred to the control of a new entity, the company's continuing managerial input into the employment of those assets may argue against the notion that there has been a disposition of assets warranting a shareholder vote. In short, current statutory provisions regarding mergers and asset transactions do not explicitly fit the virtual merger mode.

Corporate law is no stranger to the application of statutory standards to nonconforming commercial transactions. Courts have avoided rigid literalism in such matters as the de facto existence of corporations, the scope of ultra vires, whether shareholder debt should be deemed equity, and the application of statutory procedures to "de facto" mergers. The recent growth of "tracking stock" is simply another illustration of the corporate world's fascination with the thin line between abstraction and reality. The virtual merger presents a new challenge. In form it is not a merger, but in function it is. If shareholder approval is a sine qua non of the merger process, does the policy requiring shareholder voting apply to the non-statutory virtual merger transaction? Even more fundamentally, is

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27 Triangular and reverse triangular mergers both involve the merger of two corporations. The main differences with so-called statutory mergers involve the identities of the merging parties and the surviving corporation. Neither of the differences negate the express application of statutory provisions.


29 Jacksonville, Mayport, Pablo Ry. & Navigation Co. v. Hooper, 160 U.S. 514, 526 (1896) (stating that a charter limiting activities to a railroad company did not preclude the company from operating a resort hotel and engaging in other transactions auxiliary or incidental to its main business).

30 Arnold v. Phillips (In re Southern Brewing Co.), 117 F.2d 497, 502 (5th Cir. 1941) (holding that initial contribution to start-up company deemed to be capital even though evidenced by demand notes).

31 See generally Rath v. Rath Packing Co., 136 N.W.2d 410, 415-18 (Iowa 1965) (applying merger provisions to transactions despite structuring under non-merger provisions).

32 Dahlberg & Perry, supra note 1, at 248, 251 ("[T]he most significant and compelling reason for a corporation to issue tracking stock is to create a formalistic separation of two distinct businesses, without losing control of either business."). Tracking stock, in a sense, is the converse of a virtual merger. In the former instance, a single company creates two nominally independent shareholding groups. In the latter, two independent entities create a single operational unit.
this a question that can be addressed by courts, or are courts bound by legislative mandates that define the limited circumstances in which shareholders are given the right to approve or disapprove proposed transactions?\textsuperscript{33}

This article examines virtual mergers in the context of corporate governance issues, in particular the issue of shareholder voting rights and appraisal rights. Director and officer fiduciary duties are also implicated, as there is the potential for conflict of interest concerns as well as questions of full devotion to a company's corporate interests. Part II of this article will examine the virtual merger phenomenon and the alternative forms of corporate combination. Part III will discuss whether the virtual merger transaction fits into current legal modes requiring shareholder approval. Part IV will present a suggested approach to applying corporate standards to the virtual merger transaction. The direction of these comments is that traditional statutory modes and procedures should not inhibit acceptance of new forms of corporate combination. At the same time, the potential impact of the proposed alliance may be so significant as to warrant a shareholder disclosure and approval process.

II. VIRTUAL MERGER TOPOLOGY

There is no fixed template for virtual mergers. Any transaction between entities that results in joint control over assets and operations might be termed a virtual merger. The following alternatives are among the primary forms.

A. Equalization Agreement

An equalization agreement seeks to provide the shareholders of each of the two companies with economic interests in the combined entities equivalent to what would have been received in a traditional merger. As described by one commentator:

In this structure, [the entities] do not merge, but simply enter into an equalization agreement pursuant to which the

\textsuperscript{33}Shareholder voting rights are limited by statute to defined circumstances, e.g., amendments to articles of incorporation, mergers, dissolution, election and removal of directors, sale of all or substantially all assets, bylaw amendments, and matters on the agenda at annual and special shareholders' meetings. There are no voting rights extended to shareholders beyond these defined circumstances, except as might be set forth in the articles of incorporation. Hence the question arises whether courts can intervene to create shareholder voting rights where the statute is, at best silent, or, at worst, implicitly adverse.
parties agree to an "equalization ratio" which dictates, among other things, voting and dividend rights between the two corporations. The two corporations agree to pay dividends at the same time... to vote on all shareholder issues together, to manage the companies as though they were one corporation and to cause the public companies to have parallel boards.\textsuperscript{34}

In 1995, Rio Tinto Zinc (RTZ), a United Kingdom corporation, entered into an equalization agreement with Conzinc Rio Tinto of Australia (CRA), an Australian corporation, that amounted to a virtual merger.\textsuperscript{35} The transaction, referred to by the parties as a Dual Listed Companies Structure,\textsuperscript{36} resulted in the functional merger of the two companies' business operations, yet they maintained their separate identities, boards, and shareholder groups. The agreement described the arrangement as follows:

Under the DLC (Dual Listed Companies) merger structure, RTZ and CRA will continue as separate publicly quoted companies, retaining their corporate identities. The structure does not involve any change in the legal or beneficial ownership of any of the assets of the RTZ Group or the CRA Group. Rather, the DLC merger is to be effected by contractual arrangements and amendments to the companies' memoranda and articles of association designed to ensure that, as far as possible, the RTZ Group and the CRA Group operate together as a single economic enterprise. Amongst other things, the arrangements will:

- confer upon the shareholders of RTZ and CRA a common economic interest in both groups;
- provide for common boards of directors and a unified management structure;
- provide for equalised dividends and capital distributions;
- provide that the shareholders of RTZ and CRA will take certain key decisions, including the election of

\textsuperscript{34}Thurston, \textit{supra} note 19, at 273.

\textsuperscript{35}Blessing, \textit{supra} note 1, at 300 (describing an "example closest to a 'pure' equalization arrangement").

\textsuperscript{36}The RTZ-CRA Dual Listed Companies Structure description can be found at www.riotinto.com/library/reports_pdf/corppub_duallisted.pdf.
directors, through a joint electoral procedure in which the Public Holders of the two companies will effectively vote on a joint basis.\textsuperscript{37}

The respective voting strengths of the RTZ and CRA shareholders were determined by comparative valuations of the two companies. A ten-month comparison of stock market valuations resulted in a 76.5:23.5 ratio in favor of RTZ. Thus, through the issuance by CRA of special voting shares, RTZ shareholders held 76.5\% of the combined voting power of the two companies. Through a similar share issuance by RTZ, CRA shareholders held 23.5\% of the total voting power. Dividends would be shared in proportion to the ratio of the combined voting powers.\textsuperscript{38} RTZ and CRA mutually agreed that they would provide funds to the other if necessary to pay their respective cash dividends.

Both RTZ and CRA retained their own boards of directors and officers. Identical slates for board members were presented to both sets of shareholders. The elected boards of the respective companies appointed an identical set of officers to manage the two enterprises. Although the companies were to be jointly managed, the parties recognized that there might be some issues on which joint action was neither necessary nor appropriate. Three voting categories were established:

\begin{enumerate}
\item \textit{Joint Decisions}: Significant matters affecting both RTZ and CRA required approval by joint shareholder vote. They included the election and removal of directors, creation of new classes of shares, and any conflict-of-interest transactions requiring shareholder approval by applicable law.
\item \textit{Class Rights Actions}: Certain listed matters required independent approval by the shareholders of each of the two companies. They included such matters as share redemptions, adjustments to the Equalisation Ratio, and any other matter on which the two boards agreed should be decided by separate shareholder votes.
\item \textit{Other Actions}: Matters not listed within the Joint or Class Action listings would be reserved for decision solely by the shareholders of the affected corporation.
\end{enumerate}

\textsuperscript{37}\textit{Id.} at 4.

\textsuperscript{38}Therefore, a dividend distribution would be allocated 76.5\% to RTZ shareholders and 23.5\% to CRA shareholders in accordance with the respective holdings of such shareholders.
The RTZ-CRA Agreement provided for termination through a Class Rights Action vote. Inasmuch as each of the two companies retained ownership of their respective assets, it was not necessary to prepare a termination agreement involving the division and distribution of jointly-held assets. Instead, upon termination, a valuation would be made by an independent third party of each of the respective net assets of the two companies. To the extent that the ratio of the net asset valuations did not match the Equalisation Ratio, the company on the excess side of the valuation would pay to the other an amount that would result in the respective net assets equaling the Equalisation Ratio.

B. Jointly-Owned Operating Companies

A functional combination can be created by each of the entities transferring assets to a jointly-owned operating company. The starting point is once again the respective valuations of the companies. Valuation may be based on market capitalizations when publicly-traded companies are involved, or any other basis considered appropriate under the circumstances. If less than all the assets are subject to the combined operations, valuation is limited to the transferred assets. Valuation results in a ratio that determines respective voting strengths in and distributions by the jointly-owned company. Both of the transferring companies continue to exist independently, continue to have their own directors, officers, and shareholders, and are entitled to dividends and distributions based on an agreed formula. The boards of the combining companies jointly select the board of directors (if a corporation) or managers (if an LLC) of the jointly-owned company. The shareholders of the combining companies would continue to elect their respective boards but are one step removed from election of the joint operating company management. The situation is analogous to a triangular merger in which the acquiring company's shareholders are one entity removed from the merging parties, and therefore do not have voting rights as to the merger.

An example of a jointly-owned operating company was the so-called "South Texas Project," which involved the joint construction and

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39 Dual Listed Companies Structure, supra note 36, at 26-27.
40 See infra text accompanying notes 61-64.
41 Texas v. Houston Lighting & Power Co., 609 S.W.2d 263, 271 (Tex. Civ. App. 1980) (holding that ad valorem taxes were not owing by the two municipal participants, the cities of Austin and San Antonio).
ownership of a nuclear-fueled electric generating plant by four entities, consisting of two municipalities and two public utility companies. The relationship was governed by a "Participating Agreement," a sixty percent vote was required for principal decisions (meaning in effect a three-quarters approval by the participants), and a management team was composed of representatives from each of the four participants. Electric energy generated at the Project was distributed to each of the participants in accordance with their percentage interests, and was sold by each of them to the public through their individual distribution systems. Although the "Participating Agreement" had some elements analogous to a virtual merger, the two commercial participants retained substantial portions of their operations independent from the Project, and there was no sharing of revenues or profits. The Project, however, is an example of the kind of joint participation arrangement that, under differing circumstances, could be deemed a virtual merger. The joint contribution of assets, common control, and contractual provisions governing the rights among the parties are principal elements of a virtual merger.

C. Control Share Acquisition

The transfer of a significant equity interest by one corporation to another, along with an agreement by the parties to nominate directors and officers, could effectively constitute a virtual merger. A number of states have adopted Control Share Acquisition statutes as antitakeover measures. These statutes generally provide that an acquirer of a certain percentage of shares loses the voting rights to those shares unless approved by the remaining shareholders. The percentage of shares acquired need not be very high to constitute effective control, and the starting level for application of these provisions is usually twenty percent of the outstanding shares.

42 The participants and their respective ownership interests in the Project were the City of Austin (16%), City of San Antonio (28%), Houston Lighting & Power Co. (30.8%), and Central Power & Light Co. (25.2%). Id. at 266.
43 Id.
44 Id. at 267.
45 Houston Lighting & Power, 609 S.W.2d at 268. The lack of shared profits was the principal reason the court refused to find that a partnership existed among the participants. Id.
46 Indiana’s statute was upheld against constitutional challenge in CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987), and has served as a model for other states. The provisions, however, generally do not apply to negotiated acquisitions. See, e.g., Fla. Stat. ch. 607.0902(2)(d)(7) (West 2001).
A variation on this theme is exemplified by the cross-ownership transaction that General Motors (GM) and Fiat consummated in 2000. GM purchased a twenty percent equity interest in Fiat in 2000, while Fiat concurrently purchased a six percent interest in GM. The agreement included a "put option" that would eventually require GM to purchase the remaining eighty percent of Fiat's equity. Although the transaction was initially hailed as a "formidable union" by GM officials, it has fallen short of the anticipated benefits. Fiat's financial problems forced it to sell its stake in GM, and the parties have entered into discussions to relieve GM of its obligation to purchase the remainder of Fiat's equity.

D. Joint Management Entity

This functional combination involves a delegation of management authority by the combining entities to a jointly-owned and controlled management company. Assume that Companies A and B, engaged in similar activities within the same market, agree to coordinate their operations and leverage their combined purchasing power. A jointly-owned management company is formed with equal ownership by each of the combining companies, and the parties to the transaction designate the board of directors and officers of the management company. The management company is authorized to negotiate third-party contracts on behalf of the companies, bill and collect for services and products on behalf of each of the companies, allocate revenues in accordance with collections, and perform such other functions as the two companies might agree. This is similar to the attempt by the Poughkeepsie hospitals to create efficiencies

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49 Galloni & White, supra note 47, at A3.
50 Galloni, supra note 48, at A3.
51 Id.
in marketing and cost management, which in that instance raised substantial antitrust issues.

E. Alliances

Alliances are the least complex cooperative agreements from a structural standpoint, and are often used by companies engaged in complementary segments of the marketplace. Many of the nation’s major airlines have recently entered into code sharing agreements, which permit the participating carriers to share reservation systems and coordinate their respective routes and schedules. Biomedical companies have agreed to share research efforts and technical information. These arrangements do not involve co-ownership of any management or operating entity, division of profits, or other elements present in arrangements that involve more extensive combining of operational coordination. They do, however, constrain each of the companies within the parameters of the alliance terms.

F. Other Arrangements: The Oil and Gas Industry

Perhaps no industry is as familiar with the virtual merger concept as the oil and gas industry, because its members have utilized joint operating agreements for years. These agreements bind the parties to joint exploration and development programs while maintaining independent ownership structures. Common arrangements in the industry include:

(A) Equity and contractual joint ventures between state-owned enterprises and private oil companies. The sovereign and the multinational oil company share joint ownership of the entity, with the rights and obligations of the parties being defined by contract.

(B) Participation agreements in which a single company negotiates with a host country for a concession license on behalf of a consortium of petroleum companies. The participation arrangement is so common that a

53 See supra text accompanying notes 12-15.

54 Stephen Power et al., Delta-Northwest-Continental Plan Is Facing Restrictions Set by DOT, WALL ST. J., Jan. 20, 2003, at A2 (reporting that an agreement among airlines to allow each to sell seats on other’s flights is subject to antitrust scrutiny).


56 See ERNEST E. SMITH ET AL., INTERNATIONAL PETROLEUM TRANSACTIONS 463-64 (2d ed. 2000).
model form has been developed for management and sharing arrangements among companies.\textsuperscript{57}

Although the size and scope of joint arrangements involve substantial financial commitments, the ventures do not rise to levels that require anything more than board approval for most publicly-held oil and gas companies.

III. DO STATUTORY PROCEDURES APPLY TO VIRTUAL Mergers?

A. Statutory Merger and Acquisition Provisions

Shareholder democracy has finite boundaries. Unless the articles of incorporation provide otherwise (which they rarely do), shareholders do not vote except on matters specifically prescribed in the statute of the state of incorporation. Thus, unless the transaction comes within the specific purview of a statutory provision, there is no statutory mandate for a shareholder vote. A board can decide to present a non-mandated matter to the shareholders, but such decisions are rare. Shareholder voting procedures trigger substantial disclosure requirements,\textsuperscript{58} cause significant delays and costs, and may open the door to opposition by institutional investors and litigious shareholders. Hence, recourse to shareholder approval is usually invoked only in statutorily required circumstances.

The statutory provisions are exclusive unless shareholder voting is otherwise provided in the articles of incorporation or shareholder agreement. If a proposed transaction does not fit into one of the statutory pigeonholes, no shareholder vote is required. Shareholder appraisal rights also would not apply as appraisal rights are generally tied to voting rights.\textsuperscript{59}

The triangular merger is a prime example of the narrow application of statutory standards. Shareholders of the parent corporation in a triangular merger have no statutory right to vote because their corporation is technically not a party to the merger. Although shareholders of an acquiring corporation might have voting and appraisal rights if the target corporation merged directly into it, no voting or appraisal rights exist if the target merges into the acquiring corporation's subsidiary. The avoidance of a shareholder vote through the triangular merger has resulted in both

\textsuperscript{57}See id. at 463, 552.


\textsuperscript{59}Id. § 13.02(a)(1)-(3).
litigation and some statutory reform. In Terry v. Penn Central Corp., a preferred shareholder of Penn Central sought voting and appraisal rights in a proposed merger between a wholly-owned subsidiary of Penn Central and a target corporation. Under the merger terms, target company shareholders would receive Penn Central preference shares. Plaintiff argued that the transaction was equivalent to a merger between Penn Central and the target corporation and therefore triggered voting and appraisal rights for Penn Central shareholders. The court held that the Pennsylvania voting and appraisal provisions applied only to shareholders of corporations that were parties to the merger. Shareholders of parent corporations therefore are unlikely to have a voice in triangular mergers unless statutes expressly require shareholder voting in triangular merger proposals. Statutory provisions can be readily interpreted and applied to triangular mergers; however, virtual mergers do not fit into any statutory norm. Contrary to mergers or consolidations, virtual mergers do not result in a "survivor" corporation, nor in a merging corporation ceasing to exist, nor in the transfer by operation of law of property and liabilities from one corporation to another. Virtual mergers are also not analogous to share exchanges, for shareholders retain their shares in their respective entities. Given the limited voting rights accorded to shareholders in corporate statutes, it is difficult to argue that statutory merger provisions encompass virtual-merger type transactions.

B. The Sale of Assets Analogy

Sale of assets provisions appear more analogous to virtual mergers than statutory merger provisions because they mandate a shareholder vote

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60668 F.2d 188 (3d Cir. 1981).
61Id. at 188-89.
62Id. at 192-93 ("At the consummation of the proposed merger plan here, both Holdings and Penn Central would survive as separate entities, and it would therefore appear that Penn Central is not a party within the meaning of the Section 907."). Plaintiff's argument on a "de facto merger" theory was also rejected by the court, based on statutory revisions by the Pennsylvania legislature intended to negate earlier de facto merger decisions. Id. at 193-94.
63CAL. CORP. CODE § 181 (2001)
65Id. § 11.07(a)(2).
66Id. § 11.07(a)(3)-(4). Consolidation is not a term generally found in corporate statutes. The concept of two companies merging into a common third company is covered by the same provisions addressing companies that merge into each other. In a consolidation there are two mergers, not one, with each of the combining entities merging into the surviving combined entity. For discussion regarding the distinction between consolidations and mergers, see 15 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA CORPORATIONS § 7041 (perm. ed., rev. vol. 1999).
to approve a proposal to "sell, lease, exchange, or otherwise dispose" of all or substantially all of the corporate assets. Since one of the hallmarks of virtual mergers is that assets remain within the joint control of each of the combining entities, it is difficult to interpret a virtual merger transaction as involving a "sale," "lease," or "exchange of assets." That leaves for consideration the statutory phrase "otherwise dispose." Inasmuch as a virtual merger creates a potentially long-term shift from sole control to shared control of assets, does this change in control constitute a "disposition" of assets?

There is no statutory definition of the disposition concept. The venerable Black's Law Dictionary defines "disposition" as a "transferring . . . to another's care or possession," a definition that arguably applies to virtual mergers, and also as a "relinquishing of property," which arguably does not apply. Disposition is presumably somewhat analogous to the listed triggering transfers noted in the statute. Guidance might therefore be gained by examining the statutory exceptions to a shareholder vote in asset transactions.

The MBCA excludes the following asset transactions from shareholder approval:

1. dispositions "in the usual and regular course of business;"
2. mortgages, pledges, dedications to the repayment of indebtedness, and other encumbrances whether or not in the usual and regular course of business;
3. transfers of assets to wholly-owned subsidiaries or other entities; and
4. pro rata distributions of assets to shareholders.

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67 Model Bus. Corp. Act § 2.02 (2001). Most state statutes to use the "all or substantially all" standard to determine shareholder voting rights. In 1999, the MBCA was amended to adopt a twenty-five percent test, i.e. if a corporation retained at least twenty-five percent of assets and income producing activities, no shareholder vote would be required. To date, few states have adopted the revised MBCA version.

68 That is not to say that transactions might not be "sales" despite the lack of title conveyance. In Wilson v. Whinery, 678 P.2d 354, 357 (Wash. Ct. App. 1984), a lease of a parcel along with the conveyance of an easement over that parcel was deemed to be a "sale" for purposes of invoking plaintiff's right of first refusal.


71 Model Bus. Corp. Act § 12.01(1)-(4) (2002). States that do not follow the MBCA model might not differentiate between dispositions that are or are not in the usual or regular course of business. Delaware, for example, makes no such distinction. Del. Code Ann. tit. 8, § 271 (2001).
A virtual merger transferring management control over a substantial portion of the company's assets is unlikely to be a transaction in the "usual and regular course of business." Case law and commentary suggest that the "usual and regular course of business" concept is limited to companies organized for the purpose of acquiring and selling large portions of their assets on a continuing basis, such as real estate development companies. A virtual merger also does not qualify as a transfer of assets to a wholly-owned subsidiary or other entity. Virtual mergers involve the joint management and control of assets, and a transfer of assets would be to a jointly-owned or managed entity, not a wholly-owned subsidiary. Neither of the other two exceptions to shareholder voting come close to describing a virtual merger transaction.

The retention of a degree of control over contributed assets does not preclude application of the statutory transfer provisions. In *Campbell v. Vose*, the question arose whether the transfer of operating assets from a parent to a wholly-owned subsidiary involved a sale or other disposition of assets. The parent company argued that it continued to exercise control over the assets and thus continued to use and possess them. The appellate court rejected that argument, noting that the parent had divested itself of title and possession of the assets. Thus, shareholder approval of the transfer was required. *Campbell v. Vose* involved an express transfer of title in exchange for the subsidiary's stock. Virtual mergers could similarly involve express transfer of title to jointly-owned management companies. Even if title does not pass, control over the use of the assets is transferred. The policy evidenced in *Campbell v. Vose* might have application to virtual mergers, because a shareholder vote was required even though the parent company retained indirect control of the assets through its subsidiary.

Two factors favor analogizing sale of asset transactions to virtual mergers: the change in control over assets (1) is not in the usual and

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72 See Gottschalk v. Avalon Realty Co., 23 N.W.2d 606, 608-09 (Wis. 1946) (holding that a corporation organized to deal in real property may sell all of its property without shareholder approval). MBCA Commentary cites as examples of usual and regular dispositions the sale of a building by a corporation formed for the purpose of constructing and selling that building, sale of an entire business by a corporation formed to buy and sell businesses (and use of the proceeds to acquire another business), and investment companies whose portfolios turn over many times in short periods. 3 MODEL BUS. CORP. ACT Ann., Official Comment, MBCA § 12.01 (1998-1999).

73 515 F.2d 256 (10th Cir. 1975).

74 Id. at 259.

75 Id. ("[T]he property which [sic] was transferred is still subject to the Company's use, possession and control . . . .") (quoting company's brief).

76 Id. ("An exchange for stock and for evidence of indebtedness was made, and the indicia of ownership were held by the subsidiary.").
ordinary course of business, and (2) might involve all or substantially all of the operating assets.\textsuperscript{77} The fact that a shareholder vote is required when corporations \emph{lease} their assets belies the notion that the transfer must be permanent in order to invoke shareholder voting rights.\textsuperscript{78} Moreover, courts tend to emphasize a "qualitative" examination of an asset transaction to determine whether a shareholder vote is required. Thus, a sale of fifty-one percent of the company's assets was regarded as sufficient to warrant a shareholder vote because the transfer likely constituted a significant departure from the company's historically successful line of business.\textsuperscript{79}

In the context of a virtual merger, a requirement for a shareholder vote could also be supported by a qualitative analysis. The identify and quality of management is a dominant element in investment decisions. A transaction that results in management's control loss of sole control over assets through the formation of a jointly-managed entity would, to use the terminology from asset transfer cases, cause a "qualitative" change in the shareholders' relationship with the company. Although shareholders risk poor business decisions by management, they cannot be said to have agreed to risk decisions made by persons not originally within company's management.

The following hypothetical illustrates the significance of the qualitative element. Assume that Company A and Company B both engage in research and development of biomedical products. Their research facilities are their largest assets, neither company has yet to produce a significant product, and both companies face substantial cash shortages. For economic reasons, the companies agree to assign the use, but not ownership, of their research facilities to a jointly-controlled LLC for a two-year period, thereby reducing overlapping research facilities and

\textsuperscript{77}Some virtual mergers will involve only a single division of a company or a single line of business. In those instances, whether the "all or substantially all" standard applies will depend on qualitative and quantitative factors. See Gimbel v. Signal Cos., 316 A.2d 599, 605-06 (Del. Ch.), aff'd, 316 A.2d 619 (Del. 1974):

\begin{quote}
While it is true that [the all or substantially all] test does not lend itself to a strict mathematical standard to be applied in every case, the qualitative factor can be defined to some degree . . . . If the sale is of assets quantitatively vital to the operation of the corporation and is out of the ordinary [course] and substantially affects the existence and purpose of the corporation, then it is beyond the power of the Board of Directors.
\end{quote}

\textit{Id.}

\textsuperscript{78}\textsuperscript{ MODEL BUS. CORP. ACT § 12.02(a) (2002) ("A sale, lease, exchange, or other disposition of assets . . . . requires approval of the corporation's shareholders . . . .").

sharing all related costs. Any product created during the two-year period would be jointly owned and marketed. After two years, the facilities and personnel would be divided between the companies based on a valuation formula. In these circumstances, shareholders of each company are significantly affected by the transaction. Control over product development, a principal element in a shareholder's investment decision, has been reduced from 100% internal control to a 50-50 shared arrangement. Although the research assets were not sold, their possession and use have been significantly altered, as has the economic impact of any newly developed products. Although one may argue that technically there has been no sale, lease, exchange, or other disposition of assets, the qualitative result of the transaction represents a material alteration in shareholder expectations and potential economic return. Independence in direction and product development has been compromised. Diminution of control over research assets might be considered to "strike at the heart of the corporate existence and purpose.

C. The De Facto Merger Doctrine

Companies that combine their principal operations while remaining technically independent achieve a functional result equivalent to an actual merger. When this occurs, shareholders seeking approval and appraisal rights might invoke the de facto merger doctrine. This doctrine is grounded in equity, and therefore does not depend on statutory interpretation.

Rath v. Rath Packing Co. illustrates the role of equity in mandating voting requirements. Rath and Needham Packing Co. were publicly-held companies that joined in a functional merger without employing statutory merger procedures. The boards of the two corporations entered into an agreement, called a Plan and Agreement of Reorganization, under which Rath would issue to Needham shares of Rath common stock and a newly-created preferred stock. Rath would acquire all Needham's assets, assume Needham's liabilities, and assure the election of two Needham representatives to the Rath board. Needham agreed to dissolve and to distribute the Rath shares to its shareholders. Although Needham appeared

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80 As previously noted, the antitrust concerns regarding such arrangements are not the subject of this article. Many combinations, however, will avoid antitrust challenge because of the lack of market dominance.
81 Gimbel, 316 A.2d at 606.
82 136 N.W.2d 410 (Iowa 1965).
83 Id. at 411. The transaction had elements of both an asset transaction and an upside-down merger.
84 Id. at 412.
to be the target, and Rath the acquiring and surviving company, the number of shares issued by Rath to Needham and redistributed to Needham shareholders gave Needham shareholders voting control of Rath. The new corporation consisted of the combined assets and liabilities of both companies, and was controlled by the former shareholders of Needham. Rath's shareholders were asked to vote on three aspects of the transaction: (1) amendments to the articles of incorporation authorizing additional shares of common stock and the new class of preferred, and (2) a change of corporate name to Rath-Needham Corporation, and (3) the election of two Needham officers as Rath directors. These proposals received 60.1% shareholder approval, which was sufficient to approve the proposals but short of the two-thirds vote required by Iowa statute to approve a merger. Plaintiff shareholders argued that the two-thirds merger vote requirement was the appropriate standard, and that Rath's shareholder vote was insufficient to authorize the proposed transaction.

Defendant Rath Corporation's principal argument, accepted by the trial court, was that it was not required to comply with the merger provisions of the Iowa statute if it could achieve its intended results through the amendment and authorization procedures actually used. The corporation raised an "equal dignity" argument, asserting that all statutory provisions are independent and of equal standing. Thus, it was legally permissible to achieve a result under one set of provisions even if alternative provisions could have been used. The "equal dignity" argument was not without persuasive precedent, having been adopted by the Delaware Supreme Court two years earlier. The Iowa Supreme Court was not impressed by the Delaware position, however, noting that the Delaware opinion "contains little discussion and cites no authority that supports the decision." While agreeing that each statutory provision was of equal dignity, the Iowa court held that the challenged transaction must

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85Jd.
86Rath, 136 N.W.2d at 412.
87Jd. at 413.
88Jd.
89Jd. at 414:
The principal point of law defendants asked to have adjudicated . . . is that the provisions of chapter 496A . . . are legally independent of, and of equal dignity with, those relating to mergers and the validity of the action taken by defendants is not dependent upon compliance with the merger sections under which the same result might be attained.
90Hariton v. Arco Elec., Inc., 188 A.2d 123, 125 (Del. 1963) (holding that sale of assets provisions and merger provisions are of "equal dignity" and framers of a reorganization can resort to either type of corporate mechanics to achieve their desired end.).
91Rath, 136 N.W.2d at 414.
The Rath-Needham agreement was characterized by the court as "a merger of Rath and Needham under any definition of merger we know." The court recognized that, in requiring the application of the statutory merger provisions, it was favoring one process over another, but it supported its conclusion with the equitable principle that "regards substance rather than form." Having reached the conclusion that the substance of the transaction was a merger, it was a short step for the court to require application of the merger voting requirements.

The Rath case may have been the high-water mark of the de facto merger doctrine, because there have been few subsequent decisions in which courts have so boldly sidestepped express statutory provisions. The paucity of case law may be due in part to the influence of Delaware law and the "equal dignity" doctrine, and in some measure to a reluctance by corporate lawyers to plan transactions that may entail the risk of the de facto merger doctrine and the imposition of equitable remedies.

An attempt to assert a de facto merger doctrine in a virtual merger context would meet serious obstacles. Cases in which the doctrine was successfully invoked have involved an actual sale of assets and shift in management control through share ownership. In most cases, the transferring corporation was dissolved. Virtual mergers, on the contrary, are cooperative ventures that do not result in a permanent transfer of assets nor in the dissolution of either entity.

92Id. at 414, 416.
93Id. at 415.
94Id.
95Farris v. Glen Alden Corp., 143 A.2d 25 (Pa. 1958), is an oft-cited case supporting the de facto merger doctrine. The Pennsylvania Supreme Court, faced with an upside-down asset transaction and claims by acquirer's shareholders asserting dissenters' rights not available as the transaction was structured, described the rationale of the appraisal provisions to be when a corporation combines with another so as to lose its essential nature and alter the original fundamental relationships of the shareholders among themselves and to the corporation, a shareholder who does not wish to continue his membership therein may treat his membership in the original corporation as terminated and have the value of his shares paid to him. Id. at 29. Some courts have imposed a form of the de facto merger concept in asset transactions where creditors of the transferring corporation have asserted liability against the transferee, thus holding the transferee liable even in the absence of specific assumption of liability. See, e.g., Knapp v. North Am. Rockwell Corp., 506 F.2d 361 (3d Cir. 1974) (holding tort claimant could pursue claim against transferee); 300 Pine Island Assoc. v. Steven L. Cohen & Assoc., 547 So. 2d 255 (Fla. Dist. Ct. App. 1989) (permitting creditor to proceed with action against transferee of assets liable for transferor's liabilities where same ownership interests continued).
96See, e.g., Hesston Corp. v. Kays, 870 P.2d 17, 42 (Kan. 1994) (adopting the Delaware standard in light of the fact that the Kansas statute was modeled on Delaware law).
The difficulty in applying a de facto merger doctrine in a situation short of an actual sale of assets is illustrated by Good v. Lackawanna Leather Co.97 Good Bros. Leather Co. and Lackawanna were under common control and ownership. Good Bros. supplied leather hides to Lackawanna.98 A merger was proposed by the two boards, but strong minority opposition caused the merger proposal to be withdrawn.99 Subsequently, Good Bros. reduced its business operations but continued to purchase hides for re-sale to Lackawanna. Several years later the companies jointly established a new tannery. Site and building costs were borne by Good Bros., and Lackawanna donated the machinery. A new corporation was formed with Good Bros. and Lackawanna as the sole shareholders.100 Neither Good Bros. nor Lackawanna retained or engaged in any other operations. Plaintiffs were shareholders of both companies and argued that they were entitled to appraisal rights under a de facto merger theory. Plaintiffs cited the close working relationship of the two companies, the lack of any other businesses, and the shared use of assets.101 The court rejected the argument, noting that there was no transfer of assets, no assumption of liabilities, no exchange of shares, and that both companies retained their own identities, boards of directors, bank accounts, and investments.102 The court regarded appraisal rights as "predicated upon a fundamental change affecting the organic character of the corporation,"103 and concluded that no such fundamental change had occurred. The court specifically noted that "many of the economic objectives sought to be accomplished under the proposed and rejected statutory merger in fact [had] been achieved," but held that achievement of like ends does not trigger the de facto merger doctrine.104

The de facto merger doctrine is to some degree an "eye of the beholder" phenomenon. To one court, a combination might be viewed as so functionally equivalent to a merger that voting and appraisal right provisions should be applied. To a different court, the combined functions

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98Id. at 203. A majority of the shares of each company were owned by four shareholders, who also controlled the boards of directors.
99Although the merger vote received the necessary two-thirds shareholder approval by the shareholders of Lackawanna Leather Co., a sizeable amount of shareholders sought appraisal rights. As a result, controlling shareholders of Good Bros. Leather Co. decided to scuttle the transaction and voted against the proposed merger. Id. at 204-05.
100Id. at 205-07.
101Good, 233 A.2d at 207.
102Id. at 208-09.
103Id. at 211.
104Id. at 209.
might not constitute a merger at all. Once it is accepted that the term "merger" is subject to interpretation, there are no fixed parameters to differentiate virtual mergers from other forms of combined operations. Thus, except for the several jurisdictions that have specifically rejected the de facto merger doctrine, the doctrine remains a potentially powerful argument. The argument is not likely to prevail where companies combine portions of their operations and retain significant independence. The closer the arrangement comes to affecting the dominant aspects of the respective businesses, the greater the opportunity for an equitable doctrine that invokes substance over form analysis.

D. Delegation of Management Authority

Virtual mergers result in the transfer of decision-making control to the joint management of the combining entities. In the proposed Coca Cola-Proctor & Gamble venture, for example, an LLC would have managed the combined snack foods entity, with each of the corporations owning fifty percent of the LLC and electing fifty percent of the management. Although each of the corporations would have had some control over the marketing of its products, neither would have had the plenary power over its own assets that existed prior to the combination. The shift in control may be more marked if one of the combining parties has only a minority voting strength by reason of the respective valuations of contributed assets, as in the RTZ-CRA equalisation agreement.

The extent to which directors may lawfully delegate their management authority has long been an issue in corporate law. Manson v. Curtis, a case nearly 100 years old, continues to be a staple of corporate law textbooks. The Manson court's dogmatic statement that "[d]irectors are the exclusive, executive representatives of the corporation, and are charged with the administration of its internal affairs and the management and use of its assets" appears to be an overstatement in light of the modern corporate structure. There is increasing judicial recognition that important corporate decisions might necessarily be made by officers rather than the board. Statutory provisions recognize the power of shareholders to enter

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105 See supra note 17.
106 See supra notes 35-39 and accompanying text.
107 119 N.E. 559 (N.Y. 1918) (holding an agreement among shareholders to delegate sole management powers to one of shareholder violated statutory authority of the board).
108 Id. at 562.

As the corporation became a more common vehicle for the conduct of business it became increasingly evident that many corporations . . . did not normally
into agreements that eliminate board authority over specified matters. Indeed, statutes today expressly permit the elimination of boards of directors and the transference of board powers to third parties. As a result of both judicial and statutory trends, delegation of authority cases are few and far between. Courts continue to hold that some acts are beyond the powers of the officers alone, but the delegation doctrine is not one of corporate law's livelier issues.

Despite the trend away from a dominant, authoritarian board, the delegation doctrine remains viable because of the specific statutory powers of the board. Therefore, it cannot be wholly ignored. An officer's authority is limited to acts that are usual and ordinary within the context of the particular corporation. It would be a stretch of legal logic to conclude that a virtual merger that places a portion of the corporation's business under joint management with another company is a usual or ordinary decision. If a virtual merger decision is made at the board level, the transference of control to third parties over a significant portion of business operations runs headlong into the statutorily defined role of the board. The board might assert that the business judgment rule supports its action in the absence of bad faith, conflict of interest, or illegality, but it is precisely the illegality prong on which the business judgment presumption might fail. The limitation on transferring authority is reinforced by the Model Business Corporation Act provision requiring any transfer of board powers to third parties to be approved by unanimous shareholder consent in the formal ritualistic manner hitherto envisaged. While the boards of directors still nominally controlled corporate affairs, in reality officers and managers frequently ran the business with little, if any, board supervision.

*Id.* See also Galler v. Galler, 203 N.E.2d 577 (Ill. 1964) (upholding shareholder agreement regarding amount of dividends and salaries); Clark v. Dodge, 199 N.E. 641 (N.Y. 1936) (upholding shareholder agreement regarding continued employment of and salary to be paid to general manager).

110*Model Bus. Corp. Act* § 7.32(a)(1) (2002) (authorizing unanimous shareholder agreements that eliminate the board of directors or restrict the discretion or powers of the board). Delaware permits majority shareholder agreements in closed corporations that limit board powers or discretion.

111*Model Bus. Corp. Act* § 7.32(a)(6) (2002) (requiring unanimous shareholder consent to transfer to "shareholders or other persons all or part of the authority to exercise the corporate powers or to manage the business and affairs of the corporation").

112*In re ARKCO Props., Inc.*, 207 B.R. 624, 628 (Bankr. E.D. Ark. 1997) (holding that the president of the corporation lacked authority to file petition without board approval).

113Lee, 268 F.2d at 365 ("The rule most widely cited is that the president only has authority to bind his company by acts arising in the usual and regular course of business but not for contracts of an 'extraordinary' nature.").

114Miller v. American Tel. & Tel. Co., 507 F.2d 759, 764 (3d Cir. 1974) (holding that a board decision to forego collection of debt violated federal statute and thus could not be sustained under business judgment rule).
agreement. Board action that shifts fundamental control to persons not elected by the shareholders could well be regarded as violating "the most fundamental principle of corporate democracy, that management must represent and be chosen by, or at least with the consent of, those who own the corporation."\(^{115}\)

One response to the delegation question is that the shift in control might be only temporary and is definitely terminable. The ability to reassert sole control narrows the potential adverse impact of the arrangement. This suggests that the issue perhaps may be less one of delegation of decision-making authority than one of the boards' continuing business judgment as to whether the best interests of the companies are being served by the virtual merger agreement. Moving the issue into the business judgment realm relegates the issue to the board rather than to shareholders decision making. However, the shift in analysis to the business judgment rule might not be appropriate. It assumes that the respective companies could terminate the relationship and reassert control over their respective assets within a reasonably brief time frame. Depending on the nature of the assets and the terms of the virtual merger, termination might not be so easily or quickly accomplished.

The delegation problem exists even if the virtual merger arrangement can be terminated on short notice and control over assets retrieved quickly and efficiently. Termination implies a failure of expectations. For some period of time during the arrangement, the jointly-managed assets might be underperforming. There is inevitably a time problem in gathering and assessing information, analyzing the merits of continuing the joint management arrangement, negotiating potential solutions to existing problems, and ultimately providing whatever notice is legally required to terminate the venture and retrieve control of assets. The inability of the board to exercise plenary powers over company assets during the pretermination phase may raise justifiable concerns among shareholders and creditors. Thus, the delegation doctrine may be a viable argument for shareholder input despite the potentially temporary nature of the combined operations.

\(^{115}\)\( Model \ Bus. \ Corp. \ Act \) § 7.32(a)(6) (2001) (authorizing transfer by unanimous shareholder vote to "shareholders or other persons all or part of the authority to exercise the corporate powers or to manage the business and affairs of the corporation").

\(^{116}\)\( Essex Universal Corp. v. Yates, 305 F.2d 572, 575 (2d Cir. 1962) \) (holding that board cannot agree to a change in its control without concomitant shift in ownership of controlling shares).
A virtual merger might involve a conflict of interest among the approving directors, such that a shareholder vote would be an appropriate validation measure. The conflict could arise if management of the combining entities will also serve as management of the joint operating company. A virtual merger bifurcates a company, one portion remaining under the sole management control of elected directors and the second portion (the joint entity transaction) coming under control of a management team not elected by parent company shareholders. If there is an overlap in management personnel, the principal statutory provision regarding conflict transactions might literally come into play. This provision, common in many states, treats as a conflict any transaction "between a corporation and ... any other corporation, partnership, association, or other organization in which [one] or more of its directors or officers are directors or officers."\textsuperscript{117}

Quite apart from the literal statutory language, one may well envision potential conflicts in virtual merger transactions. The elected directors and management remain in place for each of the functionally combining entities, with a portion of the respective business assets of each of the two entities shifting to the control of a separate operating entity. If less than 100\% of the operating assets are allocated to the joint entity, three businesses will exist—the combined business of the joint entity and the residual business of each of the combining partners. To the extent that managers wear two hats, one for the new entity and the other for the preexisting parent corporation, the overlap will cause continual resource allocation questions. Among the issues that can be foreseen are: (1) which company should pursue financing opportunities; (2) whether profits derived from joint operations should be retained wholly within the joint enterprise or allocated to some degree to the parent corporation; (3) if new business opportunities arise, whether they should be pursued by the preexisting parent or by the new joint entity; (4) how much time and energy should management put into the development of the non-combined portions of the entities as opposed to the virtually merged portions; (5) if the joint entity is not meeting predetermined goals, should assets from the non-combined portions be used to shore up the joint entity; and (6) should the parent corporation guarantee any of the liabilities of the joint entity. To put all of

\textsuperscript{117} \textit{Del. Code Ann. tit. 8, § 144 (2002).} Similarly, \textit{Model Bus. Corp. Act} § 8.60 (2001) defines a "conflicting interest" to include a transaction between the corporation and "an entity . . . of which the director is a director, general partner, agent, or employee."
this into a direct question—to whom do the overlapping managers owe their principal fiduciary responsibilities?\(^{118}\)

The potential for conflicting interests does not itself mandate seeking shareholder approval of a virtual merger. The fundamental test in a conflict situation is fairness to the corporation. Indeed, shareholder approval would not by itself validate a conflict transaction, although it would shift the burden of proof regarding fairness to the challenging shareholders.\(^{119}\) Consequently, shareholder approval is not a \textit{sine qua non} for the validity of conflict transactions.\(^{120}\) Directors can choose to avoid a shareholder vote and take their chances, if challenged, on their ability to prove that the transaction is fair and reasonable to the corporation. However, directors would be undertaking a substantial risk by avoiding a shareholder vote, as derivative litigation would most likely ensue in \textit{post hoc} circumstances if the intended synergies of the combined entities have not developed. Arguments regarding the fairness of the terms might ring hollow in light of actual results, thus making the directors' burden of proof a difficult hurdle. Moreover, a director's immunity from personal liability does not extend to conflict transactions in which the director receives a benefit,\(^{121}\) which could apply if the overlapping managers received compensation or other benefits from both the joint and independent entities. The wiser course, therefore,

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\(^{118}\) An analogous issue of conflicting interests arises where a company issues tracking stock, thereby functionally dividing company assets and revenues among discrete company divisions. Directors' fiduciary duties must take into account the existence of the tracking stock and its separate group of shareholders. Decisions that affect both the parent company and the tracking stock unit could raise conflict questions. \textit{See} Jesse Drucker, \textit{Sprint Shows Pitfalls of Investing in Tracking Stocks}, \textit{Wall St. J.}, Mar. 7, 2003, at C1 (stating that Sprint board members own more shares and options in traditional business portion than in tracking stock portion, causing some stock analysts to complain about decisions that favor the shares of the traditional business portion).

\(^{119}\) \textit{Kahn v. Lynch Communication Sys.}, 638 A.2d 1110, 1117 (Del. 1994): The initial burden of establishing entire fairness rests upon the party who stands on both sides of the transaction. However, an approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff. \textit{Id.} \textit{See also} Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976) (finding that Delaware statute removes an interested director cloud and provides against invalidation solely because of a conflict, but nothing in the statute sanctions unfairness or removes the transaction from judicial scrutiny).

\(^{120}\) \textit{See generally} Marciano v. Nakash, 535 A.2d 400 (Del. 1987) (holding that a lack of board or shareholder approval of a self-interested transaction does not invalidate transaction if found to be fair and reasonable to the corporation.).

\(^{121}\) \textit{Del. Code Ann. tit. 8, § 102(b)(7) (2002)} (authorizing articles of incorporation to include a provision eliminating personal liability for directors but not as to "any transaction from which the director derived an improper personal benefit").
might be one of full disclosure to, and approval by, shareholders prior to the virtual merger transaction.

IV. PROPOSED STANDARDS FOR SHAREHOLDER CONSULTATION AND APPROVAL

A. Doctrinal Bases for Shareholder Input

Multiple arguments exist regarding the purposes and limitations of shareholder voting powers.\(^\text{122}\) The debate is at least as old as Adolf Berle's and Gardiner Means' venerable description of the dangers of separation of ownership and management and the ineffectiveness of shareholder proxy voting as a means to control management.\(^\text{123}\) Recent years have witnessed increased activism on the part of institutional investors, yet concerns have also been raised as to whether institutional investors are likely to vote in the best interests of the corporation.\(^\text{124}\) The debate over shareholder voting is consistently fueled by management's desire to aggrandize centralized decision-making authority.\(^\text{125}\)

To speak of shareholder voting rights is somewhat of a misnomer, even with regard to significant corporation actions. Shareholder voting power exists on a spectrum. The validity of nonvoting common stock is unquestioned.\(^\text{126}\) Voting shares can be stripped of voting power through amendment to the articles of incorporation.\(^\text{127}\) In most states, shareholder


\(^{124}\)See Edward B. Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 GEO. L.J. 445, 466-67 (1991) (explaining that institutional voting power may create agency problems for smaller shareholder similar to the lack of control over management).

\(^{125}\)Oesterle & Palmiter, supra note 122, at 493 ("Managers and their lawyers have sought, and predictably will continue, to neutralize the power of the shareholder vote. Increasing activism by institutional shareholders will fuel managerial attempts to insulate themselves from the effects of the ballot box.").

\(^{126}\)See, e.g., Lehrman v. Cohen, 222 A.2d 800, 807-08 (Del. 1966) (holding that public policy recognizes the separation of voting rights from beneficial stock ownership).

\(^{127}\)MODEL BUS. CORP. ACT § 10.01(b) (2002): "A shareholder of the corporation does not have a vested property right resulting from any provision in the articles of incorporation, including provisions relating to management, control, capital structure, dividend entitlement, or purpose or duration of the corporation."
agreements can modify or eliminate shareholder voting powers.\textsuperscript{128} In merger and share exchange contexts, shareholders of the surviving company often do not have approval powers.\textsuperscript{129} Shareholders of transferee corporations in asset transactions do not generally have approval powers, regardless of the amount of consideration paid or shares issued to the transferor.\textsuperscript{130} In a hostile takeover context, shareholders of neither the acquirer nor the target have formal voting powers. The variety of shareholder voting rights and their potentiality for modification or elimination render meaningless the notion of inherent shareholder voting powers, thus weakening any claim of inherent stockholder rights in virtual merger transactions.

It is not necessary to enter into a basic debate over the shareholder franchise. Shareholder voting rights are fewer than their historical antecedent.\textsuperscript{131} They continue to be whittled down through legislative amendments,\textsuperscript{132} and for most shareholders of publicly-held corporations voting rights are of relatively little value or consequence. All that conceded, shareholders continue to have voting and appraisal rights in many forms of mergers, particularly shareholders of target corporations.\textsuperscript{133} There are substantial policy justifications for such rights, including the potential impact of the proposed transaction upon share value, the importance of full disclosure to shareholders of the material elements of the transactions, and checks upon management accountability to assure that the proposed transaction has been fairly negotiated. These justifications apply equally to virtual mergers. Virtual mergers are extraordinarily unusual transactions, beyond the normal scope of anticipated management action.

\textsuperscript{128}MODEL BUS. CORP. ACT § 7.32(a)(4) (2002) (unanimous shareholder agreement may govern "in general or in regard to specific matters, the exercise or division of voting power by . . . the shareholders"). The provision is not applicable to companies whose shares are listed or regularly traded in the securities market. \textit{Id.} § 7.32(d).

\textsuperscript{129}MODEL BUS. CORP. ACT § 11.04(g) (2002). Approval of the merger or share exchange by shareholders of the surviving company is not required, unless the articles provide otherwise, if (1) the articles of incorporation remain unchanged (with minor exceptions); (2) each shareholder of the surviving company retains the same number of shares with identical preferences, limitations, and rights; and (3) shares issued by the surviving company do not exceed, directly or on a convertible basis, twenty percent of the voting power of the shares outstanding prior to the merger or share exchange. \textit{Id.}

\textsuperscript{130}MODEL BUS. CORP. ACT § 12.02(a) (2002).

\textsuperscript{131}See supra text accompanying notes 4-7.

\textsuperscript{132}See supra text accompanying notes 4-7.

\textsuperscript{133}Target corporation shareholders have voting and appraisal rights in all mergers and share exchanges in which the target company shareholders receive cash, stock, or other property for their target shares, although shareholders of the acquiring do not generally have such rights. MODEL BUS. CORP. ACT § 11.04(g) (2002).
Moreover, both of the combining entities are "targets" in the merger sense, as both companies give up control of substantial assets and autonomy.

Professors Oesterle and Palmiter suggest that "[c]ourts nonetheless have an institutional responsibility to determine ex post whether acts of the board violate arrangements upon which shareholders relied when they invested." Is it possible to determine a priori the control and management arrangements upon which shareholders rely? The close corporation presents the best opportunity to assess shareholder expectations. Indeed, in cases alleging oppression of minority shareholders, courts have explicitly sought to determine the ex ante reasonable expectations of the shareholders. In larger corporate structures, where shareholders are much further removed from management, shareholder expectations become more attenuated. Most shareholders of publicly-held corporations generally do not expect to have any meaningful input into company policy. If such shareholders object to the company's direction or decisions, their objection is best manifested through the sale of their shares. This is the primary reason why appraisal rights are generally not afforded to shareholders of publicly-held corporations.

It is not unreasonable, however, to conclude that shareholder expectations do not encompass substantial reorganizations of assets and management. These are far different in magnitude and type from ordinary business judgments left to the discretion of management. A joint venture to develop and market new products is within management's discretion, assuming that the joint venture does not dominate or adversely impact upon the companies' other business activities. Shareholders are also well aware that companies may decide to eliminate product lines, develop new product lines, change marketing strategies, acquire smaller companies, and

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134 Oesterle & Palmiter, supra note 122, at 525.
135 See, e.g., In re Kemp & Beatley, Inc., 473 N.E.2d 1173, 1179 (N.Y. 1984) (explaining that a court considering a petition alleging oppressive conduct must investigate what the majority shareholders knew or should have known to be petitioner's reasonable expectations in entering the enterprise).
136 MODEL BUS. CORP. ACT § 13.02(b)(2) (2001) (excluding appraisal rights for securities listed on the New York or American stock exchanges, the national market system of NASDAQ, or for which there are at least 2,000 shareholders and a $20 million market value).
137 Thus, for example, it would not be within the reasonable expectations of shareholders of either Coca Cola, Inc. or Nestle that their approval would be required for their company's decision to enter into a joint venture to develop and market new products. The same would be true for joint venture among automobile companies to develop and market a new brand of automobile, such as General Motors joint venture in China to develop an automobile for the Chinese market. General Motors 2000 Annual Report, available at http://www.gm.com/company/investor_information/docs/fin_data/gm00ar/fsns4.html. In these instances each of the contracting companies continue to maintain much larger independent business operations.
sell major divisions. Management is accorded a broad spectrum of discretion. Nonetheless, management's discretion is not boundless. Shareholder approval has not been eliminated for certain acts of significant impact. If a virtual merger is of such impact, then it would seem to be an undue application of form over substance to conclude that the absence of any direct statutory provision precludes submission of the proposed transaction for shareholder approval.

B. Equity and the Shareholder Franchise

Recourse to equity's protection of the shareholder franchise might be appropriate if a company's agreement to enter into a virtual merger were regarded as a device to avoid shareholder voting. Although there are evident business advantages to a functional rather than statutory merger, the choice of transaction might also be dictated by a concern regarding a potential shareholder vote and concomitant appraisal rights. Courts have applied equitable principles to mandate shareholder voting in circumstances where board action has deliberately or unreasonably thwarted shareholder voting rights.

Delaware courts have been particularly sensitive to board actions that, despite their statutory regularity, are deemed to be motivated in whole or in part by avoidance of shareholders' voting rights. In Blasius Industries, Inc. v. Atlas Corp., a proxy fight by an insurgent group sought to gain control of the company's board of directors. After proxy solicitation began, the board voted to expand the number of director positions and immediately filled the vacancies, thus assuring that any insurgent directors elected would not control the board. The board argued that it acted within its statutory powers to amend the by-laws, increase the number of board members, and fill the vacancies. Although the board was correct as a matter of law, the board's actions were invalidated by the court on equitable grounds. The court concluded that the primary purpose of the directors' acts was to impede the effectiveness of the shareholder franchise. In language that could arguably be transposed into a virtual merger context, the court stated:

Action designed principally to interfere with the effectiveness of a vote inevitably involves a conflict between the board and a shareholder majority. Judicial review of such action involves a determination of the legal and equitable obligations

\[\text{136} 564 \text{ A.2d 651 (Del. Ch. 1988).}\]
\[\text{137} \text{Id. at 658.}\]
of an agent towards his principal. This is not, in my opinion, a question that a court may leave to the agent finally to decide so long as he does so honestly and competently; that is, it may not be left to the agent's business judgment.\textsuperscript{140}

Courts have been particularly sensitive to the dominance of equity in protecting shareholder voting rights.\textsuperscript{141} Shareholder voting rights regarding the election and removal of directors are fundamental principles of corporate democracy.\textsuperscript{142} It is a stretch, however, to analogize shareholder voting rights in director elections to business combination transactions that emulate mergers. Indeed, Delaware courts have specifically rejected attempts to assert voting rights under a de facto merger theory.\textsuperscript{143} \textit{Hariton} and its progeny, however, did not involve transactions similar to virtual mergers. \textit{Hariton} involved a traditional sale of assets transaction in which the selling corporation received consideration presumably equal to the fair value of the transferred assets. In virtual merger transactions, corporate assets are transferred to the control of persons not elected as the corporate board. Without any payment, value, or other consideration coming to the corporation, a significant portion of its assets are being shifted to the control of persons not elected by shareholders, with the attendant risk that the assets could be adversely affected through faulty management decisions. The extraordinary nature of the virtual merger transaction suggests that the shareholder franchise, along with the concomitant disclosure obligations, are a healthy check on management decisions.

The Delaware Supreme Court recently asserted the dominance of equity in the \textit{Omnicare} case.\textsuperscript{144} The court, reviewing several deal protector devices intended to assure the completion of a proposed merger, stated that "[t]aking action that is otherwise legally possible ... does not \textit{ipso facto} comport with the fiduciary responsibilities of directors in all circumstances."\textsuperscript{145} The \textit{Omnicare} decision is particularly interesting in the virtual merger context. The court found that a combination of factors, including the target board's agreement to waive its fiduciary obligations in the event of receipt of a superior offer, constituted a breach of fiduciary duty. That breach resulted in effectively forcing shareholders to accept a

\textsuperscript{140}Id. at 660.
\textsuperscript{141}Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971).
\textsuperscript{142}Auer v. Dressel, 118 N.E.2d 590, 593 (N.Y. 1954).
\textsuperscript{143}See \textit{Hariton} v. Arco Elec., Inc., 188 A.2d 123, 125 (Del. 1963).
\textsuperscript{145}Id. at 937.
possibly inferior offer. The court noted that Delaware law "expressly provides for a balance of power between boards and stockholders which makes merger transactions a shared enterprise and ownership decision."\textsuperscript{146}

The notion of shared enterprise and ownership decisions among directors and shareholders has particular force for virtual mergers. In a traditional merger, target company shareholders receive cash or shares that approximate the value of the shares they have surrendered. If target shareholders dispute the valuation of their shares, appraisal rights are usually afforded.\textsuperscript{147} In a virtual merger, however, shareholders on neither side receive cash, shares, or other consideration. The fortunes of their companies have been dramatically altered, yet the shareholders have received no value or consideration for the material change in circumstances. If shareholder rights are afforded in mergers where consideration is offered to shareholders, the "shared enterprise" concept might apply with even greater import when functional mergers occur without the offer or payment of any consideration.

C. Proposed Guidelines for Shareholder Rights

Throughout this article virtual mergers have been referred to as involving "significant" or "substantial" transfers of assets and major shifts in control over the use of those assets. It was admitted earlier that defining a virtual merger is extremely difficult, if not impossible. The transaction is defined by its effect, not process, and the effect is functionally, but not legally, equivalent to a statutory merger. Under these circumstances, any attempt to be definitive has been avoided. The "I know it when I see it" approach, which has been used in the de facto merger context,\textsuperscript{148} could be justified by the fact that corporate law is no stranger to fuzzy standards, as illustrated by the "qualitative" analysis used by courts in determining when "all or substantially all of the assets" are being sold or transferred.\textsuperscript{149} It, however, may be important in this area to develop objective standards rather than reply on case-by-case analysis or somewhat open-ended terminology. Objective guidelines are particularly important insofar as virtual mergers are difficult to distinguish from joint ventures, alliances, and other cooperative measures that create operational links among two companies. Objective standards also permit company management and counsel to plan cooperative ventures with some degree of confidence as to

\textsuperscript{146}Id. at 930.
\textsuperscript{147}See discussion of appraisal rights infra Part IV.D.
\textsuperscript{148}Rath v. Rath Packing Co., 136 N.W.2d 410 (Iowa 1965), discussed supra notes 82-94.
\textsuperscript{149}Gimbel v. Signal Cos., 316 A.2d 599 (Del. 1974), discussed supra note 77.
whether such ventures are subject to shareholder approval and appraisal rights.\textsuperscript{150}

The principal factors in defining a virtual merger seem to be (1) the amount of assets transferred, (2) the degree of control over those assets retained by the transferor, and (3) the intended duration of the combined venture. The following circumstances may appropriately require shareholder approval in virtual merger transactions:

1. **Significant Transfer:** A transaction in which:
   (A) \(50\%\) or more of the assets of the company (or such assets that account for \(50\%\) of company revenues) are being transferred to joint control;
   (B) the company retains \(50\%\) or less management control over the transferred assets; and
   (C) the minimum duration is in excess of one year.

2. **Significant Duration:** A transaction in which:
   (A) \(50\%\) or more of the assets of the company (or such assets that account for \(50\%\) of company revenues) are being transferred to joint control; and
   (B) the agreement cannot be terminated for less than 2 years.

3. **Analogy To Sale of Asset Transactions:** A transaction in which:
   (A) \(70\%\) or more of the assets of the company (or such assets that account for \(70\%\) of company revenues) are being transferred to joint control; and
   (B) management decision-making over contributed assets is held by persons not elected by the company's shareholders nor appointed solely by the company's board of directors.

The three standards are based on different premises. The first, **Significant Transfer**, is based upon the concern that management control over a significant portion of company assets has been ceded to third parties for more than a minimal duration period. The fifty percent figure is below the amount usually (but not necessarily) regarded as necessary to invoke shareholder voting rights under sale of assets provisions.\textsuperscript{151} The standard,

\textsuperscript{150}The corporate bar's desire for objective standards is reflected in the recent amendment to the Model Business Corporation Act that sets a seventy-five percent limit on what constitutes "all or substantially all" assets for shareholder approval purposes. MODEL BUS. CORP. ACT § 12.02 (2002).

\textsuperscript{151}See supra text accompanying notes 77-79.
however, combines the fifty percent minimum figure with (1) an intended duration of at least one year and (2) the ceding of dominant control over the use of such assets.

The second standard, *Significant Duration*, applies to an agreement that cannot be terminated and the parties restored to the *status quo ante* until passage of a substantial period of time. If the arrangement turns out to be less than satisfactory, the company will suffer economic consequences regardless of the degree of control it retains over the assets. Even if an unhappy arrangement is terminable before a minimum duration period expires, managers of the joint company owe fiduciary responsibilities to the joint company and might not be able to pull the plug quickly or easily. This standard would also be applicable if there is no fixed duration period, but the nature of the agreement indicates that some reasonably long time frame is necessary before initial goals are achieved.

The third standard, the *Sale of Asset Analogy*, is similar to the "all or substantially all" standard found in most statutory asset transaction provisions. The "all or substantially all" formula has not been employed, the proposed standard instead favoring a numerical test that avoids the head-scratching that arises when less than all of the material assets are transferred.\(^{152}\) The most significant element is the amount of assets transferred to joint control. Insofar as management selected to control the distributed assets will have fiduciary duties to both of the combining companies, this form of transaction could have a substantial impact upon the transferring company regardless of the degree of control retained by its management.

Each of the proposed guidelines could be challenged on the ground that they could trigger shareholder voting even when the assets involved are less than the "all or substantially all" standard for shareholder voting on asset transfers. The virtual merger combination is not a permanent transfer of assets, so why should shareholders have voting rights greater than the statutory transaction? The answer lies in the unique nature of the virtual merger. When a corporation sells or transfers assets, it receives consideration, and corporate management retains full control over the use of that consideration. Thus, the sale of assets valued at $50 million provides management with $50 million in cash or other consideration. In a virtual merger, assets are transferred to the control of others outside of the corporation without a concomitant return to the transferring corporation. Shareholders who invested in a company with $100 million in assets now have an investment in a company whose management controls, e.g., $50

\(^{152}\)See *supra* text accompanying notes 77-79.
million in assets, and which has a contractual interest in, but not control over, the remaining assets. Shareholders are always at risk that assets might be lost through poor management or unfavorable market conditions, but those assets remain under the control of directors elected by shareholders. Virtual mergers remove assets from such control. Although the contributed assets of the combining party and the intended synergies of the combination could produce significant profits—indeed that is precisely the intended result—the risk of loss remains. It is a risk for which no consideration has been paid and whose outcome is controlled by persons not directly accountable to the shareholders.

D. Appraisal Rights

The foregoing discussion has focused on voting rights by shareholders. A distinct issue arises regarding appraisal rights. There is much debate regarding the purpose, significance, and application of appraisal rights. The debate raises fundamental issues requiring expansive scholarly exposition. That fray will not be entered. The policies that support appraisal rights in merger contexts apply equally to virtual merger transactions. Although there are distinct differences between mergers and virtual mergers in terms of impact upon shareholders and the corporate structure, both transactional forms have substantial effects on company direction, policies, asset utilization, and shareholder value.

Shareholder voting and appraisal rights create an environment of disclosure, justification, and accountability. Virtual mergers significantly affect the future of the company and remove from shareholders fundamental powers regarding the election of those who actually control the corporate assets. A virtual merger could cause a substantial revision of the revenue stream derived from the company's assets and the appropriation of wealth from one shareholding group to another. Although a virtual merger transaction might be entirely reasonable and beneficial to the corporation, it is appropriately subjected to the prophylactic measures of shareholder disclosure, voting, and appraisal rights.

153 For a doctrine that causes relatively little controversy in practice, there is a great deal of debate regarding appraisal rights' function and place in the corporate world. An early challenge to appraisal's role is in Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 Yale L.J. 223 (1962), in which the appraisal remedy was questioned as a vestige of an earlier, outdated concept of corporate ownership. A recent review of principal articles, as well as the exposition of an additional theory, is in Peter v. Letsou, *The Role of Appraisal in Corporate Law*, 39 B.C.L.R. 1121 (1998).
The counterargument against appraisal rights focuses on the terminable nature of the relationship and the continued, albeit reduced, control by management over asset utilization. Those elements lessen the transaction's long-term risk to shareholders, which in turn weakens shareholders' arguments for an immediate cash-out exit. There is an appeal to this argument, but it would require case-by-case analysis of virtual merger terms to determine which fall over or under a somewhat ambiguous line of fundamental change. A virtue of the current statutory policy is that, with few exceptions, appraisal rights are linked to shareholder voting on basic corporate transactions, thus providing companies and counsel with precise planning tools. An approach that differentiates among transactions based on particular characteristics is likely to raise difficult interpretive issues. In the prior section, a limited paradigm was suggested in which virtual merger transactions would be subjected to shareholder voting. Those standards should similarly trigger shareholder appraisal rights, subject to standard conditions and limitations.

V. CONCLUSION

Corporate law has proven its ability on numerous occasions to adjust to changing commercial circumstances. Examples abound in which courts have applied equitable doctrine to defeat or modify rigid statutory interpretation.

Virtual mergers present a new challenge to the application of corporate law. They are not mergers in the traditional sense, yet they involve such a significant alteration of a company's business that the policies supporting shareholder voting and appraisal rights in merger transactions should apply to the equally functional virtual merger. In the absence of statutory amendments, it will be difficult to apply literal statutory language to virtual mergers. The "sale of assets" provisions offer room for argument where a substantial percentage of a company's assets is being transferred to the joint control of the combining entities. However, the statutory argument is a difficult one, given the continuing exercise of some control over the assets by each of the combining entities and the contractual right to terminate the relationship and reassert unilateral control.

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154 Delaware, for example, does not accord appraisal rights to sale of asset transactions despite the requirement for a shareholder vote. Del. Code Ann., tit. 8, § 262 (2001).

155 Appraisal rights are generally not available for shareholders of publicly-held companies on the theory that the shareholders can obtain the equivalent of fair value through the sale of their shares in the secondary market. Model Bus. Corp. Act § 13.02(b) (2002).
Judicial doctrine in areas such as de facto mergers, delegation of authority, and fiduciary duties offers more promising bases for subjecting virtual mergers to a shareholder approval process. These doctrine do not interfere with directors' traditional ability to make major corporate decisions without recourse to shareholders. Shareholder approval, and appraisal rights, should apply only to transactions that emulate statutory mergers in significant measures regarding asset allocation, shifts in control, and duration. Subjecting virtual mergers to traditional shareholder approval and appraisal processes will assure full disclosure and review of potentially significant transactions. Due appreciation for shareholder rights would be appropriate checks on contractually-developed virtual mergers that are functionally equivalent to their statutory analogs.