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DEAL PROTECTION PROVISIONS IN THE LAST PERIOD OF PLAY

Sean J. Griffith[*]

ABSTRACT

The ability to protect mergers is important to both targets and acquirors. A series of recent Chancery Court decisions, however, challenges the validity of deal protection provisions in merger agreements and threatens the stability of Delaware's established change of control paradigm. This article argues that last period concerns animate the Chancery Court's decisions and finds, in the last period problem, a theoretical principle capable of harmonizing these decisions with existing jurisprudence and providing a coherent approach to the practical problems raised by deal protection provisions.

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I. INTRODUCTION

Deals, like most things in this world, fall apart.[1]

A number of events can disrupt a merger. The business of either party to the deal may suddenly change for the worse. Stock market gyrations may erode the value of the merger consideration. Swings in interest rates may render financing unattainable. And intervening bidders may arise to challenge the intended deal with a premium bid.

Merger agreements are vulnerable to outside interference during the interim period between the signing of the merger agreement and the closing of the deal.[2] During this time, third party bidders may make a premium offer for the target conditioned on the cancellation of the existing merger agreement. From the target shareholders' perspective this may hardly seem like a problem. After all, more money is always better than less, and premium offers mean more money for target shareholders. However, both targets and acquirors may have legitimate reasons for seeking to minimize outside interference in their merger plans. Most obviously, the acquiror will have significant sunk costs in the initial transaction, including the fees of legal and financial advisors, loan commitments, research and diligence costs, and perhaps most significantly, management time and foregone business opportunities.[3] As a result, acquirors will insist that targets commit to closing the deals they have signed.[4] In addition, targets have reasons of their own for avoiding non-binding merger agreements. A particular merger may present unique business

1. W.B. Yeats, The Second Coming (1922) ("Things fall apart; the center cannot hold.").

2. The delay between the signing and closing of a merger is caused by the need to obtain regulatory approval and shareholder consent. Del. Code Ann. tit. 8, § 251(c) (2002). The process for receiving shareholder consent includes, for public companies, the preparation of a proxy statement and the solicitation of proxies in compliance with the federal securities laws, and the holding of a shareholder meeting. Because the process is likely to be much less burdensome for private companies, this article focuses on mergers involving large public companies.

3. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161, 1178 (1981) [hereinafter Easterbrook & Fischel, *The Proper Role*] (noting the extensive sunk costs incurred by would-be acquirors in identifying and approaching target companies).

4. If acquirors cannot get such a commitment, they are likely on the whole to bid less for target companies. Each acquiror will withhold its reservation value for a target on the chance that another bidder will emerge and force up the price in an auction contest. *See infra* note 146 and accompanying text.

opportunities or "synergies" for the target that an intervening financial bidder cannot match. Moreover, if an initial acquiror can easily back out of a signed deal, the target may be left "in play" without a suitable buyer.[5] When a target's business is in such an unstable position, its customers and creditors may be reluctant to enter long term contracts for fear that the contracts will soon be taken over by a buyer that they do not know and do not trust. Worse, negative market reactions to failed deals may pressure targets to abandon long term strategies in hopes of finding a buyer to replace the initial acquiror.[6]

Although there is relatively little that the parties to a merger agreement can do to protect themselves from fluctuations in the business cycle or financial markets,[7] the threat of hostile interference with a merger agreement can be minimized through the use of deal protection provisions. These provisions are designed generally to immunize the transaction from the interference of unsolicited bidders. More specifically, deal protection provisions may include terms that prevent the target from soliciting the interest of other prospective bidders ("no-shop" provisions),[8] or from negotiating with other bidders once approached ("no-talk" provisions).[9] Other deal

5. A target company is considered to be "in play" when it is known to be considering acquisition proposals. The announcement of a deal places a price tag on the target company, opening it to rival bidders and offering competitors a window on the health of the target's business.

6. Market pressure may be a result of suspicions that the initial deal fell apart due to weaknesses in the target's businesses, prompting target shareholders to sell, and rendering the target still more vulnerable to an acquiror hunting for bargains.

7. Protection against these events usually comes in the form of an exit right, or "out," from the merger contract. Material Adverse Effect clauses offer an out for merger parties if the business of one party turns for the worse. *See, e.g.*, *In re* IBP, Inc. S'holders Litig., 789 A.2d 14 (Del. Ch. 2001) (providing a close judicial reading of a material adverse effect clause). Collars provide an out if the value of the merger consideration drops below a certain level. And financing covenants typically offer an out if an acquiror, having exercised some level of effort, is unable to secure financing for the deal.

8. The following example is derived from a public company merger agreement: "The Target shall not . . . solicit, initiate or encourage (including by way of furnishing information), or take any other action designed to facilitate, any Alternative Transaction. . . ." *Panel on Negotiating Acquisitions of Public Companies,* 10 U. Miami Bus. L. Rev. 219, 286 (Appendix F) (2002) [hereinafter *Negotiating Acquisitions*].

9. The following no-talk example contains a "fiduciary out" (in italics):

> The Target shall not . . . participate in any negotiations or discussions regarding any Alternative Transaction; *provided, however,* that if, at any time prior to the adoption of this Agreement by the stockholders of the Target, the Board of Directors of the Target determines in good faith, based on advice from outside counsel, that the failure to provide such information or participate in such negotiations or discussions would result in the breach of the fiduciary duties of the Board of Directors of the Target to the Target's stockholders under applicable law, then the Target may . . . furnish information with respect to the Target and its subsidiaries . . . pursuant to a customary confidentiality agreement containing terms no less restrictive

protection provisions may prevent termination of the merger agreement until a specified date,[10] trigger payments of cash or stock to the jilted acquiror upon termination of the merger agreement,[11] or grant the merger partner a low-cost option to acquire the target's prized assets if the agreement is terminated.[12]

A package of deal protection provisions insulates the original

> than the terms of the confidentiality agreement entered into between the Target and the Acquiror . . . and . . . participate in discussions regarding such proposal.

Id. On fiduciary outs generally, see *infra* note 14.

10. The failed First Union/Wachovia merger contained a non-termination provision that was invalidated by the North Carolina Business Court. *See* First Union Corp. v. SunTrust Banks, Inc., No. 01-CVS-10075, ¶ 166 (N.C. Bus. Ct. Aug. 10, 2001), *available at* http://www.ncbusinesscourt.net/opinions (invalidating the non-termination provision).

11. For example: "Termination Fee Payable by Target after Triggering Event or Competing Bid. If . . . this Agreement is terminated . . . [due to withdrawal of support by target board], then the Target shall pay to the Acquiror, in cash . . . an amount equal to [4% of the aggregate transaction value]." *Negotiating Acquisitions*, *supra* note 8, at 298 (appendix J) (emphasis omitted). The limits of termination fees are debatable. Delaware courts customarily accept fees in the range of 3-4% of deal value and have gone as high as 5%. *See, e.g.*, Matador Capital Mgmt. Corp. v. BRC Holdings, Inc., 729 A.2d 280 (Del. Ch. 1998) (approving a termination fee at approximately 5% of deal value). However, in *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, the court stated that 6.3% may be excessive. *See* Nos. 17398, 17383, 17427, 1999 Del. Ch. LEXIS 202, at *5 (Del. Ch. Sept. 27, 1999). *See generally* John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 Stan. L. Rev. 307 (2000); Jonathan T. Wachtel, Comment, *Breaking Up Is Hard to Do: A Look at* Brazen v. Bell Atlantic *and the Controversy over Termination Fees in Mergers and Acquisitions*, 65 Brooklyn L. Rev. 585 (1999). Cross-options, for example, options granted on 19.9% of the merger partner's stock—although originally granted as "pooling killers" to defeat a subsequent acquiror's attempt to use now defunct "pooling-of-interest" accounting—can also be seen as termination fees, increasing the cost of a subsequent acquisition. *See* Business Combinations, Accounting Principles Board Opinion No. 16 (Fin. Accounting Standards Bd. 1970) (stating the rules for "pooling of interests" accounting).

12. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 178, 183 (Del. 1986) (noting the grant to Revlon's "white knight" acquiror of an option to purchase Revlon's Vision Care and National Health Laboratories divisions for "some $100-$175 million below the value ascribed to them" if another acquiror succeeded in purchasing 40% of Revlon).

In addition, covenants requiring the target board to recommend the agreement to their shareholders also have served to protect the original deal. However, as a result of the 1998 amendments to Delaware General Corporation Law ("DGCL") § 251, which enabled boards to submit merger agreements to a shareholder vote with a negative recommendation, submit-to-vote covenants no longer have the same protective effect, and courts are unlikely to hold boards to a promise not to change their recommendation since such a promise disables the board from disclosing its actual views to shareholders and, therefore, managing the corporation in their best interests. *See generally* John F. Johnston, *A Rubeophobic Delaware Counsel Marks Up Fiduciary-Out Forms* (pts. 1 & 2), Insights, Oct. 1999, at 2, Insights, Feb. 2000, at 16 (2000) (discussing the fiduciary out provisions in a typical merger agreement and arguing that the appropriate time to consider fiduciary obligations is, with respect to most deal protections,t the time of signing, but with respect to recommendation covenants, at the time the recommendation is issued).

merger agreement from hostile interference by raising the risk and cost of competing bids. No-talk provisions, for example, prevent the target company from furnishing prospective bidders with diligence information, making any subsequent bid a much greater financial risk for a would-be acquiror. Similarly, termination fees will preclude prospective bidders who value a deal with the target at a marginal amount less than the cost of the fees that must be paid in connection with the termination of the original agreement.[13] While none of these provisions may completely foreclose the possibility of an intervening bid, a package of strong deal protection provisions—including, for example, a high termination fee and no-talk and no-shop provisions without fiduciary outs[14]—may well have the practical effect of winnowing the field of potential bidders to zero.

Recently, deal protection provisions have excited controversy in the Delaware courts,[15] suggesting perhaps that complete insulation from unwanted bids, even in the context of a friendly merger,[16] is unacceptable. Although the Delaware Supreme Court has not yet spoken authoritatively to the issue,[17] the Delaware Court of Chancery

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13. If, for example, the original transaction has a market value of $100 million and a 5% termination fee, a prospective bidder who values the target at $104.5 million will not bid. Bidders will only emerge (and the return to shareholders will only improve) if they value the target at an amount greater than $105 million.

14. A fiduciary exception or "out" permits a board of directors to get out of a particular contract term or an entire agreement if it determines in good faith that it cannot comply with the contract consistent with its fiduciary duties. *See generally* William T. Allen, *Understanding Fiduciary Outs: The What and the Why of an Anomalous Concept*, 55 Bus. Law. 653 (2000). For an example of a fiduciary out provision, see *supra* note 9.

15. Delaware law is the focus of this paper because Delaware is the state of incorporation of the vast majority of America's most significant corporations and because its corporation law is followed by many other states. *See generally* Leo Herzel & Laura D. Richman, Forward to R. Franklin Balotti & Jesse A. Finkelstein, The Delaware Law of Corporations & Business Organizations F-1 (Supp. 2001) (noting that over 40% of NYSE listed companies and over 80% of the public Fortune 500 companies that have re-incorporated have migrated to Delaware). That is not to say, of course, that Delaware is the only state that has produced decisions with respect to deal protection provisions. Other states have developed approaches to these issues at either end of the deference-strictness spectrum. California, for example, permits boards to foreswear third party bids during the period between signing and closing. *See* Jewel Cos. v. Pay Less Drug Stores N.W., Inc., 741 F.2d 1555, 1564 (9th Cir. 1984). Nebraska, by contrast, seems to require an exit right for target boards in the event that they are approached with a superior offer. *See* ConAgra, Inc. v. Cargill, Inc., 382 N.W.2d 576, 587 (Neb. 1986).

16. "Friendly" acquisitions involve negotiations between the boards of the target and the acquiror. By contrast, in "hostile" acquisitions the acquiror bypasses the target board and seeks to secure control of the company by appealing directly, whether by tender offer or proxy solicitation, to the target shareholders. The functional differences are that in a hostile acquisition, unlike a friendly acquisition, it is possible to gain control of the target without the consent of the target board and management. For further discussion of the legal ramifications of this distinction, see *infra* Part II.

17. The issue of deal protection provisions in negotiated acquisitions recently

has produced four opinions addressing deal protection provisions—*Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*,[18] *ACE Ltd. v. Capital Re Corp.*,[19] *In re IXC Communications, Inc. Shareholders Litigation*,[20] and *Wisconsin Investment Board v. Bartlett*.[21] Unfortunately, these opinions seem to be inconsistent not only with prior Delaware jurisprudence but also with each other. All four of the cases involve the use of deal protection provisions in the context of friendly acquisitions. Yet two of the Chancery Court's recent decisions—*Phelps Dodge* and *ACE*—cast serious doubt on the validity of strong deal protection provisions, portraying them as a potential violation of the board's duty of care, while the other two decisions—*IXC* and *Bartlett*—suggest that deal protection provisions should be deemed valid as an exercise of the target board's business judgment.

The Chancery Court's deal protection decisions introduce a lack of legal clarity into an area of high economic stakes. The ability to protect deals may have a direct bearing on the U.S. merger market, which in spite of a steady decline over the past two years, still represented $134.6 billion in completed transactions in the third quarter of 2002.[22] Until the Delaware Supreme Court issues a reasoned opinion resolving these inconsistencies,[23] the lack of clarity of the law in this area threatens to burden the merger market with uncertainty, leaving the ultimate rule on deal protections unknown.

This article draws upon the insights of game theory and cognitive psychology to supply a theoretical account of deal protections. It will argue that the Chancery Court's decisions can be understood as a response to the last period problem facing the target management team in its last period of play. By focusing the analysis on the last period problem of target managers, this article seeks to harmonize the apparent inconsistencies in the Chancery Court's decisions and to

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arose in the Delaware Supreme Court's order reversing the Chancery Court and enjoining the merger between NCS Healthcare and Genesis Health Ventures. *See* Omnicare, Inc. v. NCS Healthcare, Inc., Nos. 605, 649, 2002 Del. LEXIS 723 (Del. Dec. 10, 2002). When this article went to print, the Supreme Court's opinion explaining the order had not been issued. As discussed in Part II.C., however, this decision is not likely to represent the final word on the issue since whatever opinion ultimately issues from the court is likely to include a strong dissent and to be highly contestable on a number of bases. *See infra* Part II.C (analyzing the order in the context of the opinion below and the issues presented in this article).

18. Nos. 17398, 17383, 17427, 1999 Del. Ch. LEXIS 202 (Del. Ch. Sept. 27, 1999).

19. 747 A.2d 95 (Del. Ch. 1999).

20. Nos. 17324, 17334, 1999 Del. Ch. LEXIS 210 (Del. Ch. Oct. 27, 1999).

21. C.A. No. 17727, 2000 Del. Ch. LEXIS 42 (Del. Ch. Feb. 24, 2000).

22. *See M&A Scoreboard 3Q2002*, Mergers & Acquisitions, Nov. 2002 (compiling data from the Thompson Financial Merger & Corporate Transactions database).

23. The opinion finally issued in connection with *Omnicare* is not likely to settle the issues raised by deal protections in negotiated acquisitions. *See infra* Part II.C. (analyzing the order in the context of the opinion below and the issues presented in this article).

situate the Chancery's approach within a broader corporate law context. It proceeds as follows:

Part II situates the Chancery Court's deal protection decisions within existing Delaware law. It finds that Delaware courts have addressed deal protections on prior occasions, but generally in opinions concerning hostile takeover battles, a context that is not clearly applicable to friendly mergers. The Chancery Court's deal protection decisions do not fit the analytical standards derived from the takeover context and require a more subtle analysis than the simple creation of categories for either deference or scrutiny.

Part III reviews the existing commentary on the Chancery Court's decisions. No commentator has yet produced a theory capable of harmonizing these decisions either with each other or with current Delaware law. Instead, the commentary attempts to fit the Chancery's deal protection decisions into one set or another of outmoded or inapplicable doctrinal principles. The result is a collection of incompletely theorized, predominantly normative accounts that criticize the opposing side of the *Phelps Dodge*, *ACE/IXC*, *Bartlett* divide.

Part IV identifies the last period problem of the target's management team as the impetus of judicial concern in merger decisions. An exploration of the forces ordinarily thought to constrain the decision-making of managers and directors reveals that these constraints no longer apply in the last period of play. Unconstrained in their choice of a merger partner, the decisions of managers and directors may serve their crass self-interest or may be subtly infected with psychological biases.

Part V explores Delaware's approach to unconstrained last period incentives in the context of corporate law, focusing on the notorious decision of the Delaware Supreme Court in *Smith v. Van Gorkom*.[24] In spite of a roundly criticized conclusion, the substance of which was later repealed by the Delaware legislature,[25] the *Smith* opinion yields a useful approach to the last period problem, focusing on procedural constraints rather than judicial oversight.

Part VI assesses the Chancery Court's deal protection decisions as a response to the last period problem. Viewed in this light, the decisions are consistent with each other, each reaching a different conclusion as a result of the presence or absence of constraints in the last period. The decisions are thus a further development of the approach of the Delaware Supreme Court in *Smith*, seeking to

24. 488 A.2d 858 (1985).

25. *See* Del. Code Ann. tit. 8, § 102(b)(7) (2001) (authorizing a corporation to include in its certificate of incorporation a provision limiting or eliminating the personal liability of directors for good faith breaches of the duty of care).

reinvigorate procedural constraints in order to protect shareholder welfare.[26]

The article then closes, in Part VII, with a brief summary and conclusion.

II. CASES

Delaware courts had addressed deal protection provisions prior to the announcement of the Chancery Court's recent decisions.[27] However, most earlier decisions seek to apply the enhanced scrutiny/change of control paradigm that evolved out of the court's classic hostile takeover cases—that is *Unocal*, *Revlon*, *Time Warner*, and *QVC*. This paradigm is not well suited to handle the problems raised by deal protection provisions in friendly acquisitions and, ultimately, fails to explain the Chancery Court's decisions.

A. *Takeover Cases and Deal Protections*

The first of the classic Delaware decisions in the takeover context is *Unocal Corp. v. Mesa Petroleum Co.*,[28] in which Unocal, an oil company with a liquidation value in excess of its market capitalization, attracted the attention of notorious "raider" T. Boone Pickens. In an effort to win control of Unocal away from its incumbent board, Pickens launched a two-tiered, front-end loaded tender offer for Unocal shares. In response, Unocal proposed to buy back a portion of its own shares in a self-tender offer, but excluded Pickens' shares from the offer. In its evaluation of the Unocal board's response to Pickens' offer, the Delaware Supreme Court seemed to announce a rule that would narrow the scope of the business judgment rule, at least in the context of hostile takeovers.

> When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the

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26. This article treats shareholder welfare maximization as the fundamental purpose of corporate law. The conclusions regarding the potential destructiveness of management decision-making in the last period and the explanation of the Chancery Court's deal protection decisions as a response to this structural problem, however, do not require the adoption of any one view of the purpose of corporate law. The arguments and conclusions of this article should thus comport with any corporate law theory, except perhaps one that stresses CEO welfare maximization.

27. *See, e.g.*, Renaissance Communications Corp. v. Nat'l Broad. Corp., Inc., Civ.A. No. 14446, 1995 WL 1798510, at *14 (Del. Ch. Aug. 1, 1995) (Allen, C.) (suggesting that strong deal protections would be permitted after an auction had been conducted on the basis that it would be "self-defeating" for the law to say that all higher and later prices require a breach of the original agreement since the auction would never end and the bidders' best prices would therefore never emerge); Rand v. W. Air Lines, C.A. No. 8632, 1994 Del. Ch. LEXIS 26 (Del. Ch. Feb. 25, 1994) (Berger, V.C.) (upholding, under *Revlon* analysis, a no-shop provision with no fiduciary out).

28. 493 A.2d 946 (Del. 1985).

> corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment. There are, however, certain caveats to a proper exercise of this function. Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.[29]

The Unocal decision established a two-part test. First, the board must identify a reasonable threat to the target corporation's policy and effectiveness. Second, the board's response to that threat must be proportional to the threat presented.[30] Because a two-tiered, front-end loaded tender offer amounts to a "structurally coercive" takeover tactic,[31] the court found Unocal's exclusionary self-tender to be an appropriate response.

The second classic decision, *Revlon, Inc. v. MacAndrews & Forbes Holdings*,[32] involved another raider, this time Ron Perelman, and another underperforming corporation, Revlon. After working through a series of maneuvers designed to evade Perelman, Revlon ultimately decided to pursue a leveraged deal with a "white knight" acquiror, Forstmann Little, which agreed to buy Revlon and let incumbent management run it, provided that Revlon would sell off some of its business divisions and remained capable of servicing its debt obligations. The Revlon board agreed to the Forstmann deal even as Perelman agreed to exceed any Forstmann offer. This, the Delaware Supreme Court said, was too much. Because either transaction would result in the breakup of the corporation, the board would be required to get the best deal for its shareholders.

> [I]t became apparent to all that the break-up of the company was inevitable. The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board

29. *Id.* at 954.

30. *Id.* at 955 ("If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed.").

31. *See* Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 Bus. Law. 247, 267 (1989) [hereinafter Gilson & Kraakman, *Delaware's Intermediate Standard*] (categorizing the types of coercion present in a tender offer). A two-tiered, front-end loaded tender offer creates pressure to tender by creating a kind of prisoner's dilemma on the part of the target's shareholders. The collectively optimal outcome for the target's shareholders might be to hold out for a higher offer. By promising, however, to treat shareholders who tender better than shareholders who refuse, a two-tiered, front-end loaded offer creates pressure to defect from the collectively optimal outcome.

32. 506 A.2d 173 (Del. 1986).

> had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. . . . The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.[33]

With this holding, the Delaware Supreme Court created so-called "*Revlon* duties" requiring the maximization of short term value to shareholders when the company is broken up or sold. After *Revlon*, the question remained: what triggered *Revlon* duties?[34]

It took a combination of subsequent decisions to define the *Revlon* trigger. The first of these came in *Paramount Communications, Inc. v. Time, Inc.*,[35] which can be read to stand for the broad proposition that "strategic" mergers do not trigger *Revlon* duties. In *Time Warner*, Paramount launched a hostile bid for Time after Time and Warner had agreed to merge. Fearing that its shareholders would reject the Warner merger in favor of Paramount's premium offer, thus destroying "Time Culture,"[36] Time and Warner maneuvered to protect their transaction.[37] When Paramount and a number of Time shareholders sued to enjoin these defensive maneuverings, the

33. *Id.* at 182.

34. *See* Ronald J. Gilson & Reinier Kraakman, *What Triggers* Revlon?, 25 Wake Forest L. Rev. 37 (1990) (discussing various possible bases for the change of control test, all but one of which has now assumed the character of roads not taken).

35. 571 A.2d 1140 (Del. 1989).

36. *See id.* at 1143, n.4. A more cynical view of "Time Culture" may see the phrase as a lawyer-magician's incantation of the magic words necessary to avoid judicial scrutiny of the multi-million dollar contracts and millions in stock options extended to Time's senior management in connection with the merger with Warner. *See* Richard M. Clurman, To the End of Time: The Seduction and Conquest of a Media Empire 234-37 (1992) (detailing the economics of the side-deals with management). If "Time Culture" meant anything, it appeared to mean the simple preservation of an entity without regard to its external cultural or economic functions. *See* Joel Edan Friedlander, *Corporation and* Kulturkampf*: Time Culture as Illegal Fiction*, 29 Conn. L. Rev. 31, 39-40 (1996) [hereinafter Friedlander, Kulturkampf] ("At the time of its combination with Warner, Time had ceased devoting itself to uncovering the truth underlying the week's news, and it had subordinated the interests of its shareholders to the claims of the corporate body itself.") (citations omitted).

37. Among the broad deal protection maneuverings engaged in by the Time board was a restructuring of the transaction to eliminate the need for a vote by Time's shareholders. DGCL § 251 requires a vote of the shareholders to approve a stock merger. Because the merger had been structured with Time as the acquiror, its shareholders were not required to vote under Delaware law. However, New York Stock Exchange rules require companies issuing over 20% of their voting equity in connection with a transaction to obtain shareholder approval. *See* New York Stock Exchange Listed Company Manual, Listing Standard 312.03(c). Because Time was to issue over 20% of its equity, it would be required to obtain shareholder approval pursuant to the NYSE rules. Structured as a cash acquisition, however, the NYSE rules would not apply and Delaware law does not require shareholder approval for either party to a cash acquisition. Thus the requirement of a shareholder vote was effectively eliminated.

Delaware Supreme Court refused to apply *Revlon* duties. Instead, because Time had not "abandon[ed] its long-term strategy [to] seek[] an alternative transaction involving the breakup of the company,"[38] the Time board was not required to maximize the consideration paid in the deal.[39] It could continue to follow its long-term plans, and when those plans included a "synergistic" merger, it was not required to abandon them in order to chase after short-term share prices.

In the Chancery Court, Chancellor Allen rested his decision on the fact that Time was diffusely held before the deal and would be diffusely held after the deal.[40] Control of Time did not change, in other words, because control remained in the market.

> If the appropriate inquiry is whether a change in control is contemplated, the answer must be sought in the specific circumstances surrounding the transaction. Surely under some circumstances a stock for stock merger could reflect a transfer of corporate control. That would, for example, plainly be the case here if Warner were a private company. But where, as here, the shares of both constituent corporations are widely held, corporate control can be expected to remain unaffected by a stock for stock merger.... [N]either corporation could be said to be acquiring the other.

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38. *Time Warner*, 571 A.2d at 1150. The Supreme Court noted the circumstances under which *Revlon* generally applied:

> Under Delaware law there are ... two circumstances which may implicate *Revlon* duties. The first, and clearer one, is when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company. However, *Revlon* duties may also be triggered where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the breakup of the company.

Id. (citation omitted). Time's negotiations with Warner thus had not triggered the requirement that it maximize short term share value by putting itself up for sale to any and all comers.

39. It is worth noting that Paramount asserted only a *Unocal* claim against Time, while the Time shareholders asserted, in addition, a *Revlon* claim. The Supreme Court's resolution of the *Unocal* claim, on the proportionality prong, was predicated upon its *Revlon* analysis. In the words of the court: "Here ... Time's responsive action to Paramount's tender offer was not aimed at 'cramming down' on its shareholders a management-sponsored alternative, but rather had as its goal the carrying forward of a pre-existing transaction in an altered form. Thus, the response was reasonably related to the threat." *Id.* at 1154-55. In other words, a response will be reasonably related to the threat posed as long as it amounts to the carrying forward of a pre-existing strategy, and a board is free to carry forward strategies other than short term value maximization provided that it is not subject to *Revlon* duties. In other words, as long as the target board is not under *Revlon* and can argue that its plan pre-dates the appearance of the unsolicited bid, *Unocal* will not force it to deal with unsolicited bidders.

40. Paramount Communications, Inc. v. Time, Inc., C.A. Nos. 10866, 10670, 10935, 1989 Del. Ch. LEXIS 77, at *68-69 (Del. Ch. July 14, 1989, *revised* July 17, 1989) (Allen, C.).

> Control of both remained in a large, fluid, changeable and changing market.[41]

The Supreme Court in *Time Warner* accepted Chancellor Allen's findings regarding the diffuse shareholdings of the combined company,[42] but it ultimately decided the case on different grounds—that is, *Revlon* duties did not apply where there was no looming break-up of the target.[43] Chancellor Allen's control-in-the-market reasoning ultimately returned, however, in *Paramount Communications, Inc. v. QVC Network, Inc.*,[44] where it furnished the basis of what is now the test for a change in control.

QVC involved the bidding contest between QVC and Viacom for Paramount. Once it had agreed to merge with Viacom, Paramount protected its agreement with deal protection provisions and refused to negotiate further with QVC.[45] When QVC sued, asserting that Paramount had violated its fiduciary duties in refusing to negotiate, the Delaware Supreme Court held that the Paramount-Viacom merger had indeed triggered *Revlon* duties which the Paramount board violated by not dealing with QVC.[46] Although this was a stock-

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41. *Id.* Professor Eisenberg offers a concise criticism of this theory:

> This control-remains-in-the-market concept cannot be taken at face value. The market is not a sentient creature. It does not vote, it does not install managers, it does not remove managers and, in short, it does not have control. If shareholdings are so widely dispersed that no shareholders have control, still *someone* has control. We have known since *Berle & Means* who that someone is—management. Therefore, in any transaction involving the combination of two corporations with widely dispersed shareholdings in which one corporation's management ends up in the driver's seat, control of the other corporation *has* shifted.

Melvin Aron Eisenberg, *The Director's Duty of Care in Negotiated Dispositions*, 51 U. Miami L. Rev. 579, 602 (1997).

42. *See Time Warner*, 571 A.2d at 1150 ("The Chancellor's findings of fact are supported by the record and his conclusion is correct as a matter of law.").

43. *Id.* at 1151.

44. 637 A.2d 34 (Del. 1993).

45. The deal protection provisions included a no shop provision, a termination fee, and a stock option agreement favoring Viacom. *See id.* at 39-40. The no-shop stated that Paramount would not discuss business combinations with any third party unless (i) the third party bid was not subject to any financial contingencies and (ii) the Paramount board decided that its fiduciary duties required it to negotiate with the third party. The termination fee gave Viacom $100 million if the deal fell through, and the stock option agreement provided that if the termination fee was triggered, Viacom would also have the option of buying 24 million shares of outstanding Paramount stock at $69 per share, a discount from the then-current market price. The option agreement further gave Viacom the right to require Paramount to pay the difference between the $69 and the market price for the 24 million shares instead of having to buy and then sell the shares itself. Paramount was also protected by a poison pill which it agreed to redeem in order to merge with Viacom but refused to redeem for QVC.

46. *Id.* at 44 ("In the sale of control context, the directors must focus on one primary objective—to secure the transaction offering the best value reasonably available for the stockholders—and they must exercise their fiduciary duties to further that end.") (citing *Revlon*).

for-stock deal structurally similar to the Time-Warner merger, the result of the Paramount-Viacom combination would be that a single shareholder, Sumner Redstone, dominated the corporation. Thus, in contrast to the entity resulting from the Time-Warner merger, which would remain diffusely held, shareholders in the new Paramount-Viacom entity would find that they were minority shareholders in a corporation dominated by one man.

> In the case before us, the public stockholders (in the aggregate) currently own a majority of Paramount's voting stock. Control of the corporation is not vested in a single person, entity, or group, but vested in the fluid aggregation of unaffiliated stockholders. In the event the Paramount-Viacom transaction is consummated, the public stockholders will receive cash and a minority equity voting position in the surviving corporation. Following such consummation, there will be a controlling stockholder who will have the voting power to: (a) elect directors; (b) cause a break-up of the corporation; (c) merge it with another company; (d) cash-out the public stockholders; (e) amend the certificate of incorporation; (f) sell all or substantially all of the corporate assets; or (g) otherwise alter materially the nature of the corporation and the public stockholders' interests. Irrespective of the present Paramount Board's vision of a long-term strategic alliance with Viacom, the proposed sale of control would provide the new controlling stockholder with the power to alter that vision.[47]

Redstone's ability to cash out the minority shareholders at his whim and the minority's inability ever again to sell for a control premium, since Redstone alone possessed control and could sell it and keep any resulting premium for himself, caused the court to note that something "of considerable significance to the Paramount stockholders" had occurred.[48] Most basically, the Paramount-Viacom merger represented the last chance the Paramount shareholders would ever have to be paid a control premium, and as a result, the board was under *Revlon* duties to negotiate the best deal it could get.[49] The logic of the *QVC* rule thus followed Chancellor Allen's reasoning in *Time Warner*: a sale that resulted in a diffusely held corporation coming under the influence of a controlling shareholder would result in a "change in control," triggering *Revlon* duties.[50]

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47. *Id.* at 43.
48. *Id.*
49. The court went on to say:

> Once control has shifted, the current Paramount stockholders will have no leverage in the future to demand another control premium. As a result, the Paramount stockholders are entitled to receive, and should receive, a control premium.... [T]he Paramount directors had an obligation to take the maximum advantage of the current opportunity to realize for the stockholders the best value reasonably available.

Id.

50. In *Arnold v. Society for Savings Bancorp, Inc.*, the court made clear that it

What rule can be extracted from this line of cases? Most simply: *Revlon* duties are triggered by a sale of control. A sale of control involves a sale of all shares for cash, as in *Revlon*, or an exchange of shares for stock resulting in a combined company with a majority shareholder, as in *QVC*. If, on the other hand, the deal involves an exchange of shares and results in the combined company being diffusely held, there is no change in control and, as long as the merger is undertaken as a part of the long term strategic thinking of the board, no duty to negotiate with other bidders, as in *Time Warner*. The conduct of the board and the terms of the agreement in this context would receive business judgment deference from the Delaware courts. If, however, the deal is *not* a result of the long-term strategic thinking of the board but rather a short-term defensive tactic, *Unocal* may apply to subject the transaction and its terms to enhanced scrutiny. Still, as in *Time Warner*, *Unocal* should not apply to force negotiations with a subsequent bidder where the initial transaction is entered as a result of a pre-existing strategy of the board.

Unfortunately, rules derived from these classic takeover cases do not apply cleanly to deal protection provisions in the context of friendly acquisitions. At first glance, *Unocal* may appear to supply the most appropriate standard since deal protection provisions are arguably "defensive" in the sense that they defend the merger agreement from unwanted interference.[51] As further support for this view, a dictum in the *Time Warner* opinion suggests that deal protection provisions adopted in response to an actual "threat" from another bidder would receive enhanced scrutiny: "such [structural safety] devices are properly subject to a *Unocal* analysis."[52] Moreover, recent remarks of Vice Chancellor Strine, albeit issued from the lectern rather than the bench, support the application of *Unocal* to deal protection provisions.[53]

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would grant deference to stock mergers even when a company with a very large market capitalization acquires a company with a very small market capitalization. *See* 650 A.2d 1270 (Del. 1994).

51. Two former Chancery Court clerks have argued that deal protection provisions should trigger enhanced *Unocal* scrutiny because they are "defensive." Mark Lebovitch & Peter B. Morrison, *Calling a Duck a Duck: Determining the Validity of Deal Protection Provisions in Merger of Equals Transactions*, 2001 Colum. Bus. L. Rev. 1, 8 [hereinafter Lebovitch and Morrison, *Duck*].

> Deal Protections are inherently defensive in nature. They give rise to the omnipresent specter of director self-interest. The potential for self-interested behavior arising from defensive action triggers enhanced scrutiny. Therefore, courts should apply *Unocal* with full force to Deal Protections in the merger of equals context.

Id. at 14.

52. Paramount Communications v. Time Warner, 571 A.2d 1140, 1151 (Del. 1989).

53. In statements issued from the lectern rather than the bench, Vice Chancellor

Even on its own terms, however, the threat/response paradigm drawn from *Unocal* does not easily fit the context of deal protection provisions. As an initial matter, it is not at all clear how the "threat" should be defined in the context of a friendly deal. The most commonly cited "threat" of a hostile tender offer is that shareholders will tender at a sub-optimal price as a result of coercion.[54] In the context of a stock merger, however, bidders cannot coerce a sale because they must go through the target's board of directors, and shareholders only vote on potential transactions brought to them by the board. Because of this intervening role of the board in the context of stock deals as opposed to cash tender offers, the threat that the company will be forced into a sale at a sub-optimal price is not a real possibility. Directors will not bring inadequate bids before their shareholders, and if they do, the shareholders will vote no. There is simply no coercion.

Moreover, *Unocal* does not appear to apply to deal protections adopted prior to the appearance of a hostile bidder. In this context, target boards may view deal protections as a means of guarding against being put in play—that is, becoming vulnerable to hostile bids as a result of merger negotiations.[55] In *Time Warner*, the Delaware Supreme Court stated that deal protections adopted for this reason would be accorded business judgment deference:

> [T]here is substantial evidence to support each of the trial court's ... conclusions. Thus, the court found that [the various safety devices] predated any takeover threat by Paramount and had been adopted for a *rational business purpose*: to deter Time and Warner from being "put in play" by their March 4 Agreement.[56]

The implication of this language is that deal protection provisions adopted outside of the context of a hostile takeover fight should be judged according to the business judgment rule and thus permitted as serving a "rational business purpose." Moreover, because all deal

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Strine seems to have endorsed the application of *Unocal* scrutiny to deal protection provisions. *See* Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 Bus. Law. 919, 939 (2001) [hereinafter Strine, *Categorical Confusion*] ("In the end, practitioners looking for reasonable certainty might do better under a regime that requires courts to apply the *Unocal* standard to deal protection measures. . . .").

54. Commentators have suggested three broad categories of threats from which target boards may seek to defend themselves—opportunity loss, structural coercion, and substantive coercion—all focusing on the risk that target shareholders will accept an under-priced hostile offer. *See* Gilson & Kraakman, *Delaware's Intermediate Standard, supra* note 31, at 267; *see also* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1384 (Del. 1995) ("This Court has held that the 'inadequate value' of an all cash for all shares offer is a 'legally cognizable threat.'") (citation omitted).

55. *See supra* Part I.

56. *Time Warner,* 571 A.2d at 1151 n.15 (emphasis added). The deal protection provisions, or "structural safety devices," referred to by the court were contained in the parties' Share Exchange Agreement.

protection provisions in friendly merger agreements can be said to have been adopted for the rational business purpose of preventing the parties from being put in play, this language strongly suggests that all deal protection provisions in stock mergers should be deemed valid under the business judgment rule.

Time Warner thus simultaneously provides support for applying either *Unocal* scrutiny or business judgment rule deference to deal protections.[57] Which of the two levels of scrutiny applies depends, according to the logic of the *Time Warner* decision, upon whether the deal protections were adopted in connection with a transaction that is the culmination of the board's long term strategic thinking—in which case the agreement and the business judgment that it embodies will not be disturbed—or whether the transaction containing the provisions amounted to a short term defensive tactic, more responsive to a hostile bidder's offer than any long term strategy, in which case *Unocal* scrutiny will apply. The Supreme Court's takeover decisions thus suggest dividing deal protection provisions into two categories: those that are adopted in response to an unsolicited takeover bid and those that are adopted to deter merger partners from being put in play, with the former to receive *Unocal* scrutiny and the latter to receive business judgment rule deference.

Fortunately, one need not linger over the coherence of this division—after all, the desire to avoid being put in play does not merely amount to a foresightful expression of the wish not to receive unsolicited takeover bids—because the Chancery Court's deal protection decisions explode such simplistic categorizations. Two of the four decisions, *IXC* and *Bartlett*, are inconsistent with the approach treating deal protection provisions as preemptive responses to takeover bids and therefore deserving of enhanced scrutiny. The other two decisions, *Phelps Dodge* and *ACE*, are inconsistent with the approach that would treat all deal protection provisions with deference under the business judgment rule as responses to the threat of being put in play.

57. Notwithstanding the importance of this distinction for placing transactions in one doctrinal category or another, the application of *Unocal* scrutiny may not differ substantially in practical effect from the application of business judgment deference. *Unocal* has been de-fanged. It no longer substantially constrains board conduct. According to an empirical study conducted by Professors Thompson and Smith, between 1985, when *Unocal* came down, and the end of 2000, only thirty-four Court of Chancery opinions and eight Supreme Court opinions worked through the entire *Unocal* analysis to a conclusion. In almost every one of these cases a legally cognizable threat is found and, although the Chancery Court is more aggressive under the proportionality prong, the Supreme Court has not found defensive tactics to be disproportionate outside of a *Revlon* context and, where a Chancery Court finding of disproportionality has been appealed, has consistently reversed or voided this finding. *See* Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 Tex. L. Rev. 261, 284-86 (2001).

The Chancery Court's decisions show that standards and categories evolved from takeover cases ill-fit the analysis of deal protections in the context of friendly acquisitions. Instead, the Chancery Court's decisions reveal a more subtle dynamic at play on target boards in the context of a friendly acquisition—that is, target management's awareness of its last period of play. The Chancery Court's tentative response to this problem produces a more nuanced approach than the basic doctrinal categories derived from the old takeover cases. Moreover, the Chancery Court's approach does draw upon a doctrinal ancestor, but as discussed in Part V below, this ancestor is *Smith v. Van Gorkom*, not the Supreme Court's takeover cases.

B. *The Chancery Court's Deal Protection Decisions*

The first of the Chancery Court's decisions involved the hostile exchange offer of Phelps Dodge Corporation for both Cyprus Amax Minerals Company and Asarco Inc. after Cyprus and Asarco had agreed to merge.[58] The merger agreement between Cyprus and Asarco contained strong deal protection provisions, including a no-talk provision, which prohibited either of the parties to the agreement from negotiating with, among others, Phelps Dodge.[59] Phelps Dodge therefore sued to enjoin the merger agreement as a breach of the fiduciary duties of the Cyprus board.

The decision of the court, if restricted to the narrow holding, is unremarkable. Chancellor Chandler refused to issue the injunction because there was no likelihood of irreparable harm since, given the upcoming shareholder vote, the Cyprus shareholders could simply reject the original merger, thus freeing the board to pursue the Phelps Dodge bid.[60] In dicta, however, the Chancellor expressed his discomfort with strong deal protection provisions, specifically no-talks, and suggested that Phelps Dodge had demonstrated a "reasonable probability of success on the merits" in its challenge to such provisions.[61]

> [T]he decision not to negotiate, in my opinion, must be an informed one. A target can refuse to negotiate under Time Warner, but it should be informed when making such refusal.
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> . . .
>
> . . . No-talk provisions . . . are troubling precisely because they prevent a board from meeting its duty to make an informed

58. *See Phelps Dodge Proposes To Acquire Asarco and Cyprus Amax in Stock Transactions at Approximate 30% Premiums*, Bus. Wire, Aug. 20, 1999.

59. This was a particularly strong no-talk provision because it did not contain any fiduciary out. For a discussion of fiduciary outs, see *supra* note 14.

60. *See* Phelps Dodge Corp. v. Cyprus Amax Minerals Co., Nos. 17398, 17383, 17427, 1999 Del. Ch. LEXIS 202, at *5-6 (Del. Ch. Sept. 27, 1999).

61. *Id.* at *3.

> judgment with respect to even considering whether to negotiate with a third party.[62]

The Chancellor based his remarks on the board's duty of care.

> Now, this should not be understood to suggest that Cyprus or Asarco were legally required to or even should have negotiated, privately or otherwise, with Phelps Dodge. It is to say, rather, that they simply should not have completely foreclosed the opportunity to do so, as this is the legal equivalent of willful blindness, a blindness that may constitute a breach of a board's duty of care; that is, the duty to take care to be informed of all material information reasonably available.[63]

After the court's decision, both Cyprus and Asarco postponed their shareholder meetings to explore alternatives and later entered into merger agreements with Phelps Dodge.[64]

The second of the Chancery Court's quartet of deal protection cases arose from the bidding contest between two British Virgin Islands-based insurance companies, ACE Limited and XL Capital Limited, for the New York-based reinsurer Capital Re Corporation. After Capital Re suffered two bad quarters,[65] ACE, which had an existing strategic relationship with Capital Re, including a $75 million investment commitment, two board seats, and a joint venture,[66] entered into a merger agreement with Capital Re, whereby Capital Re shareholders would be given ACE shares in exchange for their Capital Re stock. The merger agreement contained a no-talk provision with an exception permitting Capital Re to negotiate with third party bidders if it received written advice from counsel that such negotiations were "required in order to prevent the Board of Directors . . . from breaching its fiduciary duties."[67] Significantly, ACE also obtained voting agreements from holders of 33.5% of Capital Re's shares, which, together with its own 12.3% stake, made shareholder approval of the merger agreement highly likely.[68] However, because the market price of ACE stock slid considerably in the months following the signing of the agreement,[69] XL Capital

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62. *Id.* at *3-4.

63. *Id.* at *4-5.

64. *See* Morton A. Pierce et al., *Delaware Court: 'No Talk' Provisions No Good*, N.Y.L.J., Nov. 13, 2000, at S9 (noting further that the Phelps Dodge/Asarco agreement was ultimately terminated when Asarco received a superior proposal from a third party).

65. *See XL Quits Cap Re Bidding War; Cap Re Posts Net Loss*, BestWire, Nov. 10, 1999 (noting that in 1999 Capital Re posted a $39.2 million third-quarter net loss after posting a $106.8 million second quarter net loss).

66. *See* Gavin Souter, *Value of ACE Offer Tied to Stock Price: XL Bids for Capital Re*, Bus. Ins., Oct. 11, 1999, at 1.

67. ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 98 (Del. Ch. 1999).

68. *See id.* at 97-98.

69. The fall in the ACE share price caused the consideration offered to fall from over $17 per Capital Re share to less than $10 per share, with the total deal value

launched a competing bid for the company. Capital Re then entered negotiations with XL Capital and threatened to terminate its agreement with ACE unless ACE increased its offer. After increasing its offer only to be topped a second time by XL Capital, ACE sued for injunctive relief to prevent Capital Re from terminating the agreement on the grounds that without a written opinion from counsel regarding the board's fiduciary duties, the merger contract barred Capital Re from negotiating with XL Capital.

ACE has a unique set of facts—contractually guaranteed shareholder approval and a fiduciary out provision that appeared to disable the decision-making authority of the board. Given the procedural posture of the case—an acquiror suing to prevent the target from trying to increase the value of the transaction to its shareholders—it is not surprising that the court would refuse to issue the injunctive relief. After reciting several arguments for his refusal to grant the restraining order,[70] each of which was closely related to the unique facts of the case, Vice Chancellor Strine went on to state in broad language:

> It is one thing for a board of directors to agree not to play footsie with other potential bidders or to stir up an auction. That type of restriction is perfectly understandable, if not necessary, if good faith business transactions are to be encouraged. It is quite another thing for a board of directors to enter into a merger agreement that precludes the board from considering any other offers.... Such a contractual commitment is particularly suspect when a failure to consider other offers guarantees the consummation of the original transaction, however more valuable an alternative transaction may

falling from $605.9 million (BVI) when made to $375.3 million (BVI) when XL Capital launched its offer. *See* Gavin Souter, *Buying Spree Sets Up ACE, XL Showdown*, Bus. Ins., Dec. 20, 1999, at 16.

70. First, because ACE's voting stake and voting agreements virtually assured shareholder approval of the transaction, Capital Re would be forced to consummate the merger in spite of the dramatic decline in value of the merger consideration (ACE stock). Although this may have been exactly what the parties bargained for in the merger agreement, the court emphasized the harshness of this result, thus implying a duty to negotiate further at least when the market value of the merger partner's stock tanks. *See ACE*, 747 A.2d at 103. Second, limiting the target's ability to negotiate to a written determination of counsel that such negotiations were a fiduciary requirement amounted to an "abdication" or "self-disablement" on the part of the board to manage corporate affairs in its own good faith judgment. *Id.* at 106-07. *But see* Michael J. Kennedy, *Whole Lotta Fiduciating Goin' On!*, M&A Law., Feb. 2002, at 1 ("[T]he only way a board composed of lay people can decide, in good faith, what its legal obligations are, is to ask a lawyer."). Third, ACE's interpretation of the no-talk clause would render the exception meaningless since, in a non-change of control setting, there is no situation in which a target board is legally required to negotiate with another bidder. *See ACE*, 747 A.2d at 107-08. Fourth and finally, if the Capital Re board mistakenly believed that it had negotiated a meaningful exception to the no-talk provision when it in fact had not, that mistake itself may be seen as a failure of the duty of care, supplying the court with a reason to protect the Capital Re shareholders from the error of their directors. *Id.* at 108-09.

> be and however less valuable the original transaction may have become....[71]

Moreover, Vice Chancellor Strine stated clearly that although a stock-for-stock merger involves no "change of control" and therefore no "*Revlon* duties" to maximize short term shareholder value,[72] the absence of such duties may not make a difference:

> The fact that the board has no *Revlon* duties does not mean that it can contractually bind itself to sit idly by and allow an unfavorable and preclusive transaction to occur that its own actions have brought about.[73]

Although these broad statements are technically dicta, the court's willingness to imply a fiduciary duty to investigate other deals when the agreement is otherwise locked up indicates a willingness to invalidate strong deal protection provisions.

Unusual though the facts in *ACE* were, similar issues arose in a dispute involving a suit to enjoin the shareholder vote on the merger agreement between IXC Communications, Inc. and Cincinnati Bell, Inc., the third case in the Chancery's quartet of deal protection decisions. The IXC/Cincinnati Bell merger agreement contained strong deal protections, including no-talk and no-solicitation provisions,[74] and, like the Capital Re/ACE agreement, was secured by voting agreements locking up approximately 45% of the target's stock.[75] Unlike the agreement in *ACE*, however, the IXC/Cincinnati Bell agreement emerged from a process in which IXC had solicited the interest of a number of prospective bidders. The IXC board had engaged an investment banker and announced that it would consider transaction proposals. Having generated considerable interest leading to negotiations and diligence review with a number of companies in the industry,[76] the IXC board decided on a stock merger with Cincinnati Bell. A number of IXC shareholders then sued to enjoin the agreement, alleging, among other things, breach of fiduciary duty in agreeing to the deal protection provisions.

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71. *ACE*, 747 A.2d at 106 (footnotes and citations omitted).

72. *Id.* at 105; *see supra* text accompanying note 50 (discussing the change of control trigger of *Revlon* duties).

73. 747 A.2d at 108.

74. The no-talk provision was removed by the parties prior to entering litigation, perhaps as a response to the *Phelps Dodge* decision. However, Vice Chancellor Steele approved the validity of the provision as agreed at the time the agreement was signed, so the removal of the no-talk was not a factor in the court's analysis. *See In re* IXC Communications, Inc. S'holders Litig., Nos. 17324, 17334, 1999 Del. Ch. LEXIS 210, at *16-17 (Del. Ch. Oct. 27, 1999).

75. The voting agreement was in connection with a side transaction between Cincinnati Bell and General Electric Pension Trust ("GEPT") in which Cincinnati Bell agreed to acquire GEPT's IXC shares and GEPT agreed, in connection with that sale, to support the IXC/Cincinnati Bell merger. *See id.* at *7-8.

76. *See id.* at *4-5.

In stark contrast to the Chancery decisions in *Phelps Dodge* and *ACE*, however, Vice Chancellor Steele deferred to the business judgment of the IXC board in approving the deal protections in the IXC/Cincinnati Bell merger agreement. Not only did the court in *IXC* depart from the *ACE* court in its treatment of a key factual issue—the 40-50% voting arrangements, treated as a "locked up" vote in *ACE* but merely as "almost locked up" in *IXC*[77]—but the opinion also seems directly to contradict the dicta in *Phelps Dodge* and *ACE* suggesting that no-talk provisions may be invalid per se. In *IXC*, Vice Chancellor Steele stated:

> Further, the assertion that the board "willfully blinded" itself by approving the now defunct "no-talk" provision in the Merger Agreement is unpersuasive.... Provisions such as these are common in merger agreements and do not imply some automatic breach of fiduciary duty.[78]

Dispensing with the plaintiffs' assertions that the IXC board had failed adequately to inform itself of other proposals, the court endorsed the pre-merger solicitation process employed by IXC's investment bankers. Balancing the desire to avoid appearing "desperate,"[79] thus creating a "fire sale"[80] atmosphere unlikely to result in the best deal for its shareholders, against the desire to identify potential suitors, IXC announced that it would consider the possibility of a sale or merger but did not make outbound solicitations. Nevertheless, this simple announcement led to "a series of contacts with varying degrees of interest expressed and efforts undertaken in pursuit of those expressions."[81] Citing this process with approval, the Chancery Court emphasized IXC's pre-signing market

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77. In *ACE*, the Capital Re shareholder vote was 45.8% locked up, while in *IXC* the vote was just over 40% locked up, a difference of approximately 5%, but enough for Vice Chancellor Steele to comment:

> The defendants have not, in fact, "locked up" an absolute majority of the votes required for the merger .... Plaintiffs ... tacitly admit that the vote-buying agreement does not make the outcome of the vote a foregone conclusion. They can only say that the ... deal "*almost* completely lock[s] up the vote—thus giving shareholders *scant* power to defeat the Merger . . ." (emphasis added). "*Almost* locked up" does not mean "locked up," and "*scant* power" may mean less power, but it decidedly does not mean "no power."

Id. at *23-24. For Vice Chancellor Strine in *ACE*, "almost locked up" did appear to mean "locked up" and "scant power" came close enough to "no power" to invalidate the no-talk provision, yet Vice Chancellor Steele went on in *IXC* to conclude that because "a numerical majority of IXC shareholders are still in a position independently to void [the] vote-buying transaction," the shareholders are not disenfranchised and the shareholder vote remains as a valid test of the IXC/Cincinnati Bell transaction. *Id.* at *24.

78. *Id.* at *16-17.

79. *Id.* at *4.

80. *Id.* at *14.

81. *Id.* at *15.

test, during which "[n]o superior offers were received and therefore none were turned away,"[82] and refused to enjoin the merger agreement or invalidate any of its deal protection devices.

Soon after *IXC*, Vice Chancellor Steele had the opportunity to reaffirm this less restrictive view of deal protection devices. In *Bartlett*, a manager of Wisconsin pension funds sued to enjoin the shareholder vote on the merger between Medco Research and King Pharmaceuticals, claiming that the Medco directors had violated their duties of care and loyalty in agreeing to the deal protection provisions in the Medco/King merger agreement.[83] After spending over two years in search of a merger partner, during which time it had retained an investment bank to solicit potential bidders, Medco agreed to merge with King. The resulting agreement contained strong deal protections, including no-shop and no-talk provisions, a termination fee, and the grant of a stock option designed to defeat future attempts at pooling-of-interest accounting.[84] In challenging the agreement, plaintiffs asserted that the Medco board members had not "adequately inform[ed] themselves" and that the deal protections "allowed [the company, through its negotiator] to steamroll past other more favorable potential deals."[85]

As in *IXC*, Vice Chancellor Steele applied the business judgment rule to the actions of the Medco board and to the deal protection devices employed in the merger agreement. Responding to the claim that the Medco board had failed adequately to inform itself, the court noted that "the evidence equally supports the view that Medco's board proceeded with the King merger because its efforts had failed to find a viable combination with other suitors,"[86] and emphasized the solicitation of bids performed by Medco's investment bankers.

> Medco, with the experience and assistance of [its investment bank, H&Q], aggressively *sought out suitors* who might benefit from Medco's existing drug pipeline and income stream. In fact, H&Q played an integral part in Medco's efforts to *canvass the market* to seek a more economically viable business combination.[87]

The court also suggested that it was appropriate for the company to rely on its investment bank's advice that "appearing 'over-shopped' could frustrate any deal,"[88] thus implying that at some point in the solicitation process, it is appropriate for a target to select its partner

82. *Id.* at *16.
83. *See* Wisconsin Inv. Bd. v. Bartlett, C.A. No. 17727, 2000 Del. Ch. LEXIS 42, at *1-3 (Del. Ch. Feb. 24, 2000).
84. *Id.* at *21 n.16. On the grant of stock options as "pooling killers," see *supra* note 11 (discussing grant of 19.9% options as "pooling-killers").
85. *Bartlett*, 2000 Del. Ch. LEXIS 42, at *7-8.
86. *Id.* at *17.
87. *Id.* at *16 (emphasis added).
88. *Id.* at *18.

and protect its agreement. However, the court also noted that as an agreement with King became imminent, Medco's bankers attempted to "stimulate interest one last time regarding merger discussions with other suitors."[89] Having repeatedly emphasized Medco's repeated pre-signing market checks, the court went on to endorse Medco's use of deal protection provisions in relatively broad language:

> Delaware law permits lock-ups and related agreements "where their adoption is untainted by director interest or other breaches of fiduciary duty." Therefore, in the absence of breach of fiduciary duty in agreeing to the lock-up devices, these provisions are reviewable as business judgments and are, thus, granted deference. Neither the collar, termination fee, no talk/no shop provision, nor stock option agreements were used here as defensive mechanisms instituted to respond to a perceived threat from a potential acquiror making a competing bid for Medco.[90]

The Chancery Court's treatment of deal protection provisions in *Phelps Dodge* and *ACE* is thus difficult to square with its treatment of these provisions in *IXC* and *Bartlett*. In *Phelps Dodge* and *ACE*, the court applied heightened scrutiny to the contract and invalidated the deal protection provisions. In *IXC* and *Bartlett*, the court was deferential to the business judgment of the board in negotiating the merger contract and validated the deal protection provisions.

One factual distinction between the cases is that in *Phelps Dodge* and *ACE*, the target company had not shopped itself extensively or at all prior to entering a highly protected merger agreement, while in *IXC* and *Bartlett*, the target company had shopped itself considerably before agreeing to deal protections. It is not clear, however, why this factual distinction should make such a difference. Especially where, as here, target boards are under no *Revlon* duty to maximize the value of the transaction,[91] it is not clear why a market-tested merger agreement should receive greater deference than a merger agreement that has not been extensively shopped. In the absence of a duty to maximize the consideration received, it seems, courts should apply the same standard to all such transactions regardless of the process by which agreement was reached. What is needed, then, is a theoretical foundation to account for the different treatment of deal protections under Delaware law.

89. *Id.* at *22.

90. *Id.* at *30-31 (citing *Revlon*).

91. *See supra* text accompanying note 50 (discussing *Revlon* duties and the change of control paradigm). The court in *ACE* acknowledged that *Revlon* duties do not apply to the analysis of deal protections. *See* ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 108 (Del. Ch. 1999).

C. *Making a Muddle: the Supreme Court's Order in* NCS Healthcare

Unfortunately, recent developments in the Delaware courts suggest that the lack of doctrinal clarity surrounding deal protections is likely to persist, if not deepen. On December 10, 2002, a divided Delaware Supreme Court issued an order enjoining the merger between NCS Healthcare and Genesis Health Ventures.[92] Although the order contained very little analysis, it plainly suggests that merger agreements with a submit-to-vote covenant,[93] when combined with voting agreements securing majority shareholder approval of the transaction, must also contain provisions permitting the target corporation to terminate the merger agreement in favor of a subsequent superior offer.[94] In other words, a complete fiduciary out is required, and strong deal protection provisions are not permitted, in any deal that both (i) requires the directors to submit the transaction to a shareholder vote and (ii) guarantees, through voting agreements with holders of a majority of the target's shares, shareholder approval of the transaction. In the few sentences devoted to the basis of its ruling, the court stated:

> [T]he deal protection measures must be reasonable in relation to the threat and neither preclusive nor coercive. The action of the NCS board fails to meet those standards because, by approving the Voting Agreements, the NCS board assured shareholder approval, and by agreeing to a provision requiring that the merger be presented to the shareholders, the directors irrevocably locked up the merger. In the absence of a fiduciary out clause, this mechanism precluded the directors from exercising their continuing fiduciary obligation to negotiate a sale of the company in the interest of the shareholders.[95]

The terms "preclusive" and "coercive" suggest *Unocal* analysis and, with it, the application of principles drawn from the takeover cases, which this article has described as out-moded and ill-suited to the context of negotiated acquisitions.[96]

This ruling creates a further muddle out of Delaware's deal protection jurisprudence, apparently supporting the outcome of *Phelps Dodge* and *ACE* over outcomes in line with the *IXC* and *Bartlett* line of cases, but without providing a firm theoretical or doctrinal basis. The lack of clarity surrounding the order's underlying

92. Omnicare, Inc. v. NCS Healthcare, Inc., Nos. 605, 649, 2002 Del. LEXIS 723 (Del. Sup. Ct. Dec. 10, 2002).

93. *See supra* note 12 (discussing the validity of submit-to-vote covenants under DGCL § 251(c)).

94. *See Omnicare*, 2002 Del. LEXIS 723, at *7 (remanding to Chancery "for the entry of a preliminary injunction . . . precluding the implementation of the NCS/Genesis merger").

95. *Id.* at *6-7.

96. *See supra* Part II.A.

principles is due in part to the fact that, as of the time this article went to print, the court had not yet released an opinion elaborating the basis of the decision. So, the Delaware Supreme Court has a lot of explaining to do, but worse, there is good reason to believe that the opinion that finally does emerge from the Court will not put these issues to rest. The ruling was issued by a closely divided bench, which voted 3-2 in favor of the order. Chief Justice Veasey and Justice Steele refused to join in the ruling, and it is worth noting that Justice Steel, before he was promoted to the Supreme Court, authored the Chancery Court's opinions in *IXC* and *Bartlett*.[97] As a result, the *Phelps Dodge/ACE*, *IXC/Bartlett* divide is likely to persist in the issuance of the opinion and any dissent.

The *NCS Order* arose out of merger negotiations involving NCS, Omnicare, and Genesis.[98] NCS began its search for a merger partner after changes in the level of health care reimbursements by the government and third party insurers affected its viability as a stand alone business.[99] According to the Chancery Court, this search led NCS, through its financial adviser, to contact "over fifty different entities to solicit their interest in a variety of transactions with NCS."[100] Over time, this field of potential buyers narrowed to Omnicare and Genesis. After Genesis had submitted a proposal which Omnicare had failed on numerous occasions to match,[101] NCS entered into an exclusivity agreement with Genesis and began negotiations on a draft merger agreement as well as draft voting agreements with two shareholders, Outcalt and Shaw, who together

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97. *See supra* notes 74-91 and accompanying text.

98. This recitation of facts is taken from the three Chancery Court opinions issued prior to the Supreme Court's order. *See generally In re* NCS Healthcare, Inc., S'holders Litig., C.A. No. 19786, 2002 Del. Ch. LEXIS 133 (Del. Ch. Nov. 25, 2002) (addressing the fiduciary duty claims), *reversed by* Omnicare, Inc. v. NCS Healthcare, Inc., Nos. 605, 649, 2002 Del. LEXIS 723 (Del. Sup. Ct. Dec. 10, 2002); Omnicare, Inc. v. NCS Healthcare Inc., et al., C.A. Nos. 19800, 19786, 2002 Del. Ch. LEXIS 131 (Del. Ch. Oct. 29, 2002) (addressing contractual interpretation issues); Omnicare, Inc. v. NCS Healthcare, Inc., et al., 809 A.2d 1163 (Del. 2002) (denying initial motion to dismiss). Unless otherwise stated, references to the "Chancery opinion" hereinafter refer to *In re NCS Healthcare*, C.A. No. 19786, 2002 Del. Ch. LEXIS 133 (Del. Ch. Nov. 25, 2002).

99. *See In re NCS Healthcare*, 2002 Del. Ch. LEXIS 133, at *7.

100. *Id.* at *8.

101. *Id.* at *18-19.

> Although the two proposals are somewhat awkward to compare, due to their different transaction forms, the Genesis proposal was clearly far superior to the latest bid from Omnicare. First, the Noteholders were to receive 100% of the face value of the Notes, rather than between 70% and 80%. Second, the stockholders were to receive approximately $ 1 per share, as opposed to nothing. Finally, given the structure of the transaction as a merger, rather than an asset sale in bankruptcy, the trade and other unsecured creditors stood to receive full value for their claims.

Id.

controlled a majority of the voting power of NCS common stock.[102] Further negotiations led the NCS board to enter into a merger agreement with Genesis and approve the Outcalt and Shaw voting agreements,[103] notwithstanding an intervening bid by Omnicare, which was considered and rejected by an independent committee of the NCS board.[104]

The merger agreement between NCS and Genesis contained a submit-to-vote covenant and a no-talk provision as well as a termination fee.[105] Although the no-talk provision included a fiduciary out permitting the board to consider unsolicited bids that the NCS board believed in good faith would result in a superior transaction,[106] the out did not allow the board to avoid its obligations under the submit-to-vote covenant. As a result, and given the Outcalt and Shaw voting agreements, which assured shareholder approval of the transaction once submitted to a shareholder vote,[107] the consummation of the NCS/Genesis merger seemed certain. Omnicare reacted by filing a lawsuit to enjoin the merger and launching a tender offer for common shares of NCS.[108]

In rejecting Omnicare's challenge to the NCS/Genesis transaction, the Chancery Court recited the rhetoric of the takeover cases and

102. *Id.* at *19. Genesis insisted on exclusivity as a condition of pursuing further negotiations in order to avoid being made into a stalking horse for a deal with Omnicare or any other bidder.

> We didn't want to be someone who set forth a valuation for NCS which would only result in that valuation ... being publicly disclosed, and thereby creating an environment where Omnicare felt to maintain its competitive monopolistic positions, that they had to match and exceed that level.

Id. at *15 (quoting deposition of an NCS advisor).

103. According to the Chancery Court:

> After a thorough discussion of the July 26 letter from Omnicare, the board concluded that "balancing the potential loss of the Genesis deal against the uncertainty of Omnicare's letter, results in the conclusion that the only reasonable alternative for the Board of Directors is to approve the Genesis transaction."

Id. at *26 (citation omitted).

104. NCS considered the Omnicare bid in spite of its exclusivity agreement with Genesis and, according to the Chancery Court, "concluded that discussions with Omnicare ... presented an unacceptable risk that Genesis would abandon merger discussions." *Id.* at *22.

105. *See id.* at *27-28.

106. *See id.*

107. The Outcalt and Shaw voting agreements provided, according to the Chancery Court, that:

> Neither Outcalt nor Shaw would transfer their shares prior to the stockholder vote on the merger agreement; Outcalt and Shaw agreed to vote all of their shares in favor of the merger agreement; and Outcalt and Shaw granted to Genesis an irrevocable proxy to vote their shares in favor of the merger agreement.

Id. at *28.

108. *See id.*

seemed to apply the *Unocal* "reasonableness" standard,[109] which this article has criticized as inappropriate in the context of negotiated acquisitions.[110] However, the ultimate outcome of the Chancery Court—applying deference to board decision-making when the board, acting through independent committees, engaged in a broad solicitation of interest on the market for corporate control prior to entering into a set of agreements that essentially guaranteed the consummation of the transaction with a chosen partner—is consistent with the account of deal protections advanced in this article. That is, the Chancery Court, as it had done in *Bartlett* and *IXC*, permitted strong deal protection provisions in the context of a market-tested transaction.[111] The importance of soliciting the interest of others in the market was emphasized in the Chancery Court opinion:

> After looking for more than two years for a transaction that offered fair value to all NCS stakeholders, the board acted appropriately in approving the Genesis merger proposal, including the "deal protection" devices demanded by Genesis.[112]

Without an opinion, it is impossible to know precisely what the Supreme Court found unacceptable in the Chancery Court's analysis of the NCS/Genesis transaction or exactly how far the implications of the NCS Order are to be taken. As noted above, however, there is some indication that the majority of the court sought to apply principles from the takeover cases that are, at best, contradictory and indeterminate and perhaps completely irrelevant to the concerns that, according to the argument of this article, ought to be guiding the analysis. The practical implication of this analysis is that the combination of a merger agreement containing a submit-to-vote covenant with voting agreements aggregating a majority of the target's voting power is illegal per se. While such analytics and implications muddle the proper analysis of deal protection provisions, one can perhaps take heart in the fact that there is likely to be a strong dissent, written by Chief Justice Veasey or Justice Steele. As a result, whatever opinion emerges from the NCS Order is not likely to be the final word on the controversy, but is instead likely to bring the debate surrounding the proper analysis of deal protection provisions, at long last, to the attention of the Delaware Supreme Court.

III. PRIOR COMMENTARY

Prior commentary on the Chancery Court's deal protection decisions has not produced a theory capable of harmonizing the cases with each other or of situating them within established Delaware law.

109. *See id.* at *54-60.
110. *See supra* Part II.A.
111. *See supra* Part II.B.
112. *See In re NCS Healthcare*, 2002 Del. Ch. LEXIS 133, at *54.

The commentary instead focuses on outmoded or inapplicable doctrinal paradigms. Commentators supporting enhanced scrutiny of deal protections have centered their analysis on the duty of care's requirement of informed decision-making, arguing that deal protection provisions prevent target boards from becoming "fully informed" and therefore violate the duty of care. By contrast, commentators supporting business judgment rule deference for deal protection provisions focus their attention on Delaware's change in control paradigm, arguing that the deal protection decisions upset it and warning that any doctrinal instability within this paradigm may harm the deal economy. The commentators generally do agree on one thing, however: Delaware's current deal protection jurisprudence is inconsistent and wrong.

A. *Enhanced Scrutiny and Full Information*

The interpretation that is most faithful to the Chancery Court's language explains the deal protection decisions in light of the target directors' duty to be "fully informed" when making decisions on behalf of the company.[113] A recent Note in the *Columbia Business Law Review* argues that because no-talk provisions impede the flow of information between targets and their would-be acquirors, they should be strictly scrutinized and likely invalidated as an obstacle preventing target directors from becoming "fully informed."[114]

There is good support in both common sense and Delaware precedent for the view that directors have not acted with sufficient care if they have not informed themselves of the relevant facts in undertaking a business decision.[115] The principle is illustrated nicely

113. The Chancery Court's "fully informed" rhetoric is most pronounced in *Phelps Dodge*, where Chancellor Chandler repeatedly referred to the duty of a board to be "informed of all material information reasonably available" and stated that "the decision not to negotiate . . . must be an informed one." Phelps Dodge Corp. v. Cyprus Amax Minerals Co., No. 17398, 1999 Del. Ch. LEXIS 202, at *3-4 (Del Ch. Sept. 27, 1999). To the Chancellor, the central offense of no-talk provisions was that they "prevent a board from meeting its duty to make an informed judgment with respect to even considering whether to negotiate." *Id.* at *4. In *ACE*, Vice Chancellor Strine echoed the Chancellor's remarks on the "duty to make an informed judgment." ACE, Ltd. v. Capital Re Corp., 747 A.2d 95, 109 (Del. Ch. 1999) (quoting *Phelps Dodge*, 1999 Del. Ch. LEXIS 202, at *3-4). The duty of a board to be fully informed was also recited in *IXC* and *Bartlett* though neither of those cases found the duty to have been breached. *See In re* IXC Communications, Inc., S'holders Litig., C.A. Nos. 17324, 17334, 1999 Del. Ch. LEXIS 210, at *13-14 (Del. Ch. Oct. 27, 1999); Wisconsin Inv. Bd. v. Bartlett, C.A. No. 17727, 2000 Del. Ch. LEXIS 42, at *19 (Del. Ch. Feb. 24, 2000).

114. Kimberly J. Burgess, Note, *Gaining Perspective: Directors' Duties in the Context of "No-Shop" and "No-Talk" Provisions in Merger Agreements*, 2001 Colum. Bus. L. Rev. 431 [hereinafter Burgess, *Gaining Perspective*].

115. The relationship between a board's being "fully informed" and acting with due care was noted by the Delaware Supreme Court in *QVC*.

The need for adequate information is central to the enlightened evaluation in the classic casebook decision, *Francis v. United Jersey Bank*,[116] in which Mrs. Pritchard, along with her two sons, inherited a directorship in a reinsurance firm owned by her deceased husband. Sadly, Mrs. Pritchard was a bedridden alcoholic, overcome with grief from the passing of her husband, and as a result, never attended the meetings of the firm's directors. If she had, she would have learned that her two dastardly sons were looting the firm. When she passed away and her sons' conduct was discovered, the court allowed recovery against her estate for breach of the duty of care. That she was unaware of her sons' conduct was no excuse, the court held, since as a director, she had a duty to remain informed of the corporation's affairs, a duty that, had she carried it out, would have led her to discover the fraud.[117]

Because the duty to remain informed is part of the duty of care, however, one might expect it to be shielded by the business judgment rule, which generally serves as a bar to suits for breach of the duty of care.[118] Nevertheless, it is well established that the business judgment rule does not apply to cases of gross negligence,[119] and it is possible, as in Mrs. Pritchard's case, that not remaining minimally informed may amount to gross negligence. The business judgment rule, after all, shields rational business decisions from judicial second-guessing, and it is probably not a *rational* decision, or at least not a rational *business* decision, to consume several martinis before lunch and go back to bed instead of attending one's board of directors meeting. Nevertheless, in less extreme cases, the business judgment rule should apply to insulate the good faith decisions of directors, including their decisions in determining how much information to gather before setting out on a course of action.

Becoming *fully* informed, however, has no limiting principle and no end point. It permits judges to second-guess board decision-making

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> of a transaction that a board must make. This requirement is consistent with the general principle that "directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them."

Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 44 (Del. 1994) (internal quotations omitted).

116. 432 A.2d 814 (N.J. 1981).

117. *Id.* at 826 ("[I]f Mrs. Pritchard had read the financial statements, she would have known that her sons were converting trust funds. When financial statements demonstrate that insiders are bleeding a corporation to death, a director should notice and try to stanch the flow of blood.").

118. *See* Dennis J. Block et al., The Business Judgment Rule: Fiduciary Duties of Corporate Directors 110 (5th ed. 1998) ("[A] plaintiff seeking to establish a breach of the duty of care first must establish facts sufficient to overcome the business judgment rule presumption that the directors acted with due care.") (citing cases).

119. *Id.* at 111 ("Director liability is predicated upon concepts of gross negligence and gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one for purposes of overcoming the business judgment rule's presumption." (internal quotations omitted)).

by finding fault with the amount of information gathered and may, in the context of friendly acquisitions, be stretched into a requirement that directors participate in an exchange of information—that is, negotiate—beyond the signing of the merger agreement and throughout the period between signing and closing. In fact, this is precisely the position taken by those commentators most faithfully applying the Chancery Court's "fully informed" language:

> The execution of the merger agreement, where directors have fulfilled the duty of care in the negotiation and decision to enter into the agreement, does not signal a point at which the directors can be relieved of this duty. Rather, the fiduciary duty of care to act on an informed basis and in the best interests of the company continues through until stockholders have voted.[120]

Once one accepts the logic of this position, it cannot be said, as Chancellor Chandler has, that the duty to be fully informed does not imply a duty to negotiate.[121] The requirement that one be fully informed is question-begging. Informed of what? The answer, obviously, is other bids. And a care-based requirement that the board entertain other bids would seem to imply that there is some bid that the board would be duty-bound to pursue, which is inconsistent with the existing Delaware change of control paradigm that implies no duty to negotiate in the context of a diffuse stock-based merger.[122] This tacit duty to negotiate would hold directors in breach of their duty of care for failure to engage in discussions with unsolicited bidders at any point in the merger process.

Although this approach is consistent with the Chancery Court's rhetoric, it suffers from the fault of divorcing the court's "fully informed" language from the real-world context of the merger process, and indeed from any basis in common sense. Directors are more than mere reporters or information-gatherers. Directors must also make decisions and act for the benefit of shareholders. They must, in other words, act as deal makers in the context of a merger or other fundamental business transactions. However, interpreting a duty to be "fully informed" to require discussions at any moment between the signing and closing of a deal imposes constantly recurring decision-nodes on directors, leaving them fundamentally unable to make final decisions.[123] In Hohfeldian terms, this view of the full

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120. Burgess, *Gaining Perspective*, *supra* note 114, at 468.

121. *See Phelps Dodge*, 1999 Del. Ch. LEXIS 203, at *3-4.

122. *See supra* Part II.A (discussing *Revlon*, *Time Warner*, *QVC*, and the current change of control paradigm).

123. *See also* Brian C. Brantley, Note, *Deal Protection or Deal Preclusion? A Business Judgment Rule Approach to M&A Lockups*, 81 Tex. L. Rev. 345, 375 (2002) (advocating the application of the business judgment rule to deal protections generally and noting that "[e]nforcing merger agreements (and lockups contained therein) allows a board to effectively end the bidding process").

information requirement emphasizes *duty* at the expense of *power*,[124] when Delaware law clearly requires directors to have both "powers and duties."[125] Moreover, because no decision is ever final and no deal is ever actually "done" until the shareholder vote, merger *contracts* essentially become merger *options* until the deal closes.[126] This will reduce the value of the transaction to acquirors and target shareholders alike,[127] causing some bids never to be made and increasing the transaction costs and delays associated with mergers and acquisitions.[128]

Finally, the "fully informed" rhetoric misunderstands the role of information in the merger process. No-talk provisions are the single most offensive deal protection measure under the "fully informed" rubric because, the argument goes, they inhibit the flow of information to directors, preventing them from learning about other offers and rendering them unable to satisfy their duty of care.[129] But no-talk provisions are not "no-listen" provisions. They prevent the outflow of information from directors to prospective bidders, but they cannot prevent the inflow of information from, for example, a bear-hug letter or a voice mail message. Bidders can embed as much information in these letters and messages as they choose, and indeed

124. *See generally* Wesley Newcomb Hohfeld, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 23 Yale L.J. 16 (1913). Following Hohfeld, the corporation can be seen as a bundle of rights, duties, privileges, and powers. In altering the relationship of the legal concepts in the corporate bundle, this interpretation of the duty of care fundamentally alters the corporation.

125. Del. Code Ann. tit. 8, § 141(a) (2001) ("[T]he powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation").

126. *See* Paul K. Rowe, The Future of the "Friendly Deal" in Delaware 1 (July 10, 2000) (unpublished manuscript, on file with Fordham Law Review) [hereinafter Rowe, Friendly Deal] (insisting that "Delaware is not an 'option' state; there *is* such a thing as a real merger agreement").

127. *See generally* Peter Cramton & Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7 J.L. Econ. & Org. 27, 41 (1991) (discussing auction theory in the context of takeovers and noting that "[p]ostauction negotiations create the possibility of ex post opportunism and consequent ex ante welfare losses").

128. Merger negotiations are expensive for targets as well as acquirors, requiring an investment of high level management's time and attention, advisory fees, and the loss of interim business opportunities. Requiring targets to switch paths partway through a negotiation and start over with another bidder only increases these costs. Seen in this light, the premium offered by the intervening bid must exceed the cost of additional negotiations—i.e., the additional commitment of management time and energy, additional advisory fees, and additional foregone opportunities—in order to justify its pursuit.

129. *See* Burgess, *Gaining Perspective*, *supra* note 114, at 470.

> An aggressive no talk, which may prohibit the board from even speaking with a third party, could prevent the board from learning about a potentially superior proposal. Such a provision would block directors' access to information which they are bound by their fiduciary duty to consider in order to act in the interests of the corporation.

Id.

they have an incentive, in attempting to persuade targets to break their existing contract, to include precisely those items, such as price and governance terms, in which the target directors are most likely to be interested. There is nothing to stop the target directors from *receiving* these messages, informing themselves, and passing the relevant information on to their shareholders. No-talk provisions do, however, operate to prevent directors from conveying information to the bidder. In particular, no-talks prevent targets from sharing sensitive financial information and other diligence materials with bidders, information that is highly relevant to bidders in determining how much the target company is actually worth and, therefore, how much to bid. In other words, no-talks do not operate to prevent target directors from learning about bidders but rather to prevent bidders from learning about the target, thus creating a substantial information asymmetry between the intended suitor and other would-be acquirors and thereby increasing the financial risk of unsolicited bids. Rhetoric that would require directors to be fully informed thus fails to understand that the information-relevant party in no-talk provisions is not the target, but rather prospective bidders.[130] Targets can be informed without talking.

The benefit of interpreting the deal protection cases along the lines of the court's "fully informed" rhetoric is doctrinal clarity. It invokes a familiar doctrinal category—the duty of care—that leads to a clear doctrinal consequence: enhanced scrutiny. But what is gained in doctrinal clarity is lost in subtlety and flexibility. Formal categorization is too crude a response to capture the complexity of the merger process and thus threatens to compromise the flexibility of corporate law jurisprudence in an area where subtlety and flexibility are most needed.

In an effort to preserve this flexibility, other commentators have advocated an *ad hoc* adoption of procedural checks on the target board's use of deal protection provisions.[131] This recommendation,

130. In light of the direction of this information flow, arguments that no-talks inhibit full information can, taken to an extreme, be read to imply that target directors have a fiduciary duty to ensure that prospective bidders are fully informed in order to preserve their incentives to bid. Taken to an extreme, in other words, the duty to inform thus runs with the flow of information that no-talks seek to restrict—i.e., from directors to a universe of prospective bidders rather than to its own shareholders. Such implications, which are clearly anathema to the change of control paradigm and to Delaware corporate law generally, are a consequence of being carried away by rhetoric.

131. Gregory V. Varallo & Srinivas M. Raju, *A Process Based Model for Analyzing Deal Protection Measures*, 55 Bus. Law. 1609 (2000) [hereinafter Varallo & Raju, *Process Based Model*]. The authors later modified their process based model into a set of questions from which, they argued, an "optimal" standard might emerge. *See* Gregory V. Varallo & Srinivas M. Raju, *A Fresh Look at Deal Protection Devices: Out from the Shadow of the Omnipresent Specter*, 26 Del. J. Corp. L. 975 (2001).

First, what is the specific measure designed to protect *against*, and how does unlike the more rigid call for enhanced scrutiny on the basis of the target board's failure to remain "fully informed," is flexible and therefore better suited to the fast evolution of corporate decision-making and the fact-intensive nature of Delaware jurisprudence.[132] However, in remaining resolutely atheoretical, it fails to resolve the incipient doctrinal tensions which can lead to uncertainty and, in the words of Vice Chancellor Strine, "categorical confusion."[133] Unless one is able to explain why the decisions come down as they do, there can be no basis for predicting where the law will lead or which provisions and procedures will be deemed acceptable. Similarly, mandating process without an intelligible theoretical basis will increase transaction costs without increasing the value of the outcome.[134]

Regrettably, the recitation of familiar doctrinal categories, such as the duty of care's requirement of informed decision-making, does not supply a sound theoretical basis for understanding the problems beneath the surface of the Chancery Court's deal protection decisions.

B. *Business Judgment Deference and the Deal Economy*

Commentators on the opposite side of the strict scrutiny/business judgment deference divide focus not on the duty of care, but on the

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> it relate to the rest of the agreement or agreements?
>
> *Second*, what, if anything, did the board get in exchange for agreeing to this provision or package of provisions and what process did it follow in agreeing to the subject transaction?
>
> *Third*, what is the effect of the provision on the ability of the board to continue to gather information about the underlying transaction up until the shareholders are asked to vote on it?
>
> . . .
>
> *Finally*, are the shareholders able to enjoy a meaningful and informed exercise of their franchise without penalty or coercion implicit in their vote . . . ?

Id. at 983-84. Although these inquiries may produce sensible outcomes in individual cases, they do nothing to bring the question of deal protection provisions closer to a coherent core principle.

132. *See generally* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. Rev. 1009 (1997) (describing the fact-intensive nature of Delaware jurisprudence).

133. *See* Strine, *Categorical Confusion*, *supra* note 53. Varallo and Raju explicitly defer to the Delaware Supreme Court to resolve the uncertainty surrounding deal protection provisions, offering their account merely as interim practical advice. *See* Varallo & Raju, *Process Based Model*, *supra* note 131, at 1635 ("Given the support for and problems with both the business judgment rule and the *Unocal/Unitrin* standard for analyzing deal protection measures, certainty with respect to this issue may have to await further decisions by the Delaware Supreme Court.").

134. Consider, for example, the surge in value (and cost) of investment banker "fairness opinions" after the *Van Gorkom* decision. As courts and commentators struggled to find the theory underlying the decision, practitioners rushed to the safe-harbor of fairness opinions. *See infra* note 236 (questioning the value of fairness opinions); *infra* note 269 (noting that the surge in the use of fairness opinions was not long-lived).

evolution of Delaware's change in control paradigm. They argue that the deal protection decisions may undermine the doctrinal stability of this paradigm, ultimately resulting in fewer deals.

Under the current change of control paradigm as it has developed from *Revlon* through *QVC*, diffuse stock-based mergers, unlike cash deals, involve no change in control and do not, therefore, trigger *Revlon* duties.[135] Because boards in stock deals are free to pick merger partners for reasons other than short term share price maximization, by implication, they should also be free to find strategic merger partners without undergoing an auction where they must negotiate with unwanted acquirors. In the words of one commentator:

> *Time-Warner* was a promise to corporate America—you can do strategic stock-to-stock deals without having to talk to everyone who comes out of the woodwork. You can pick your new partner. So long as the stockholders approve your deal, you can do your deal. You will not lose control over your destiny.[136]

The deal protection decisions appear to break this promise because each case involves a stock merger and therefore no change in control, yet in *Phelps Dodge* and *ACE*, the Chancery Court did not accord traditional business judgment rule deference, but rather applied a form of enhanced scrutiny. This has led some to suggest that the deal protection decisions represent the creeping of *Revlon* duties into the context of stock-based transactions, thus undermining the doctrinal stability of the established change in control paradigm.[137]

Apparent instability within the change of control paradigm is overstated, and the threat of creeping *Revlon* duties is illusory. Provided that the Chancery Court's expansive "fully informed" rhetoric is avoided,[138] the deal protection decisions can be read in a way that leaves the change of control paradigm completely untouched. A careful analysis of the deal protection decisions reveals that (i) judicial review of the merger contract is limited to a narrow factual setting, (ii) judicial review of the contract, if triggered, is confined to particular provisions and not the contract as a whole, and (iii) any such review is premised on narrow procedural principles drawn more from duty of care analysis than substantive duty of loyalty analysis.

As discussed in Part VI below, judicial review of deal protection provisions will only occur in the context of an otherwise unconstrained last period problem. A last period situation increases

135. *See supra* Part II.A.
136. *See* Rowe, Friendly Deal, *supra* note 126, at 30.
137. *See, e.g.*, Pat Vlahakis, *Fiduciary Duties and Fiduciary Outs: Is There a New Delaware Standard?*, 2 M&A J. 13 (2000).
138. *See supra* Part III.A.

the structural likelihood that target managers have been motivated by factors other than shareholder welfare maximization in their decision to merge.[139] It is very difficult to determine, after the fact, what their motivations in fact were, and opening this question for judicial inquiry threatens to greatly increase the scope of judicial review and correspondingly narrow the business judgment rule. Fortunately, the Chancery Court's decisions develop an alternate approach. As long as the target's merger decision is subject to structural constraints, such as the market for corporate control, the ability of its management to defect from the goal of shareholder welfare maximization will be limited and judges need not intervene. Only where there are no such constraints, as in an unconstrained last period, do courts need to intervene to limit the effectiveness of deal protection provisions. As developed at length below,[140] a merger agreement protected by strong deal protection provisions without a market check represents an unconstrained last period situation, calling for some level of judicial intervention.

Even if judicial intervention of the merger agreement is triggered by last period considerations, the deal protection decisions reveal a narrow scope of review, directed to particular contractual provisions and not the transaction as a whole, thus leaving the business judgment rule largely intact. Judicial review of a *transaction* is distinct from the application of scrutiny to a *contractual provision.* Scrutinizing a transaction to determine if it offers the best value for target shareholders implies a consideration of all features of the contract, especially the form and amount of consideration offered. The examination of a single provision in the merger contract, however, need not call into question the value of the transaction as a whole. A court may declare a particular contractual provision void as against public policy without opening the question of the value of the consideration. If, for example, *X Co.* and *Y Co.* agree to a business combination and include in their merger agreement a provision requiring *X Co.* to burn down its competitors' factories, a court could clearly scrutinize (and invalidate) that provision without examining the consideration offered in the deal or the value of the contract as a whole.[141] Similarly, even where the Chancery Court decisions imply that judicial intervention is appropriate, such intervention is limited to the deal protection provisions alone, not whether the contract as a whole is likely to achieve the substantive end of maximizing the consideration paid to target shareholders.[142]

139. *See infra* Part IV.
140. *See infra* Parts IV-VI.
141. Indeed, drafters are well aware of this fact and typically embed in their contracts a severability provision stating that if one provision is found to be void for whatever reason the rest of the contract shall remain in effect.
142. Even when *Revlon* duties apply, Delaware courts generally do not compare

Finally, the change in control paradigm is not implicated by the deal protection decisions because, as a doctrinal matter, the change in control paradigm is a form of duty of loyalty analysis, while the narrow procedural considerations under review in the deal protection cases more appropriately belong to duty of care analysis. As developed at length below, the Chancery Court's review of a target board's conduct in agreeing to deal protection provisions is *procedural* rather than *substantive*. Setting aside the expansive reach of its rhetoric, the court's stated concern is that deal protection provisions render target boards uninformed in their merger decisions. Having enough information to make a rational decision is an aspect of the duty of care and may be thought of as a procedural aspect of the merger decision. By contrast, the amount of consideration agreed to in the deal may be thought of as a substantive element of the merger decision. Substantive aspects of a deal are more often considered a part of analyses of the duty of loyalty, which in its strongest form, "entire fairness" review, requires an explicit weighing of the consideration.[143] The Chancery Court's decisions do not dwell on or even seriously compare the consideration offered in any of the competing transactions. Their analysis is limited to the target board's decision-making process, not the outcome of that process. In this way, the doctrinal ancestor of the Chancery Court's deal protection decisions is *Smith*, not *Revlon*. As developed in Part V below, in *Smith*, a duty of care analysis triggered by the absence of structural or procedural constraints in the board's last period decision-making supplied the grounds for judicial intervention. By contrast, in *Revlon*, the rationale for applying enhanced scrutiny rather than the business judgment rule was based upon a duty of loyalty analysis and the self-interest of the Revlon directors.[144]

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the consideration offered by one bidder to that of another. *See infra* text accompanying notes 150-51. However, in such instances the courts' review of director conduct is directed towards the substantive end of maximizing consideration paid to shareholders. In the deal protection context, by contrast, the Chancery Court's review of these provisions has not been directed towards the substantive goal of maximizing consideration, but rather the structural goal of limiting the ability of target management to make selfish and self-serving decisions. *See infra* Part VI.

143. *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1988) (describing the "exacting standards of entire fairness").

144. One of the reasons the Revlon directors preferred the deal of "white knight" Forstmann was Forstmann's promise to restructure certain debt to relieve the Revlon directors of personal liability to the company's creditors. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986) ("The principal benefit went to the directors, who avoided personal liability to a class of creditors.... [W]here a significant by-product of [board] action is to protect the directors against a perceived threat of personal liability..., the action cannot withstand... enhanced scrutiny.").

The court may have focused on this aspect of the directors' decision-making because the duty of loyalty was (and is) a much firmer basis for adjudication than the duty of care. At the time *Revlon* was decided, only a few months after *Smith* and in

Once these features of the Chancery Court's decisions are exposed, it is plain that any fear of doctrinal instability in the change in control paradigm is overstated. In the deal protection decisions, the Chancery Court confined its review of merger agreements to a narrow factual trigger, which, if activated, led to a review of a particular provision and not the transaction as a whole. Thus understood, the deal protection decisions raise procedural concerns, not a substantive review of the merger transaction. In other words, *Revlon* should not be seen to be encroaching on *Time/Warner* as a result of the deal protection decisions because *Revlon* is simply not implicated by the deal protection decisions.

Even if they do not upset the doctrinal stability of the *Revlon–Time Warner* change of control paradigm, commentators warn that the deal protection decisions will lead to fewer mergers because they imply that targets may be unable to protect their deals. Just as the "*Time Warner promise* led to [an] unprecedented level of merger activity,"[145] the deal protection decisions threaten to cause a decline in the number of deals. Because corporations are extremely reluctant to be put in play or to be forced into a situation where they must respond to, and potentially accept, offers from uninvited bidders, the intrusion of enhanced scrutiny into negotiated stock deals may cause boards to think twice before entering into such transactions in the first place. Fewer transactions may occur, and those that do occur may actually be for a lower price if the bidder saves its reservation value in order to respond to an overbid that never comes.[146] From this perspective, the issue is simple: "does Delaware want to encourage mergers or not?"[147]

The question whether a significant decline in merger activity would result from the application of enhanced scrutiny to stock-based transactions raises an interesting issue. Why should Delaware care if there is a decline in merger activity?[148] Several commentators have

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the midst of the fervor over that decision, the duty of care was less fully developed and more controversial than the duty of loyalty. Then, as now, only the *Smith* decision had ever imposed liability on directors for a violation of the duty of care.

145. Rowe, Friendly Deal, *supra* note 126, at 31.

146. *See id.* ("[H]ow many deals will be announced at less attractive exchange rates for the side believed [to be] vulnerable to an overbid; so that the bidder can keep some powder dry?").

147. *Id.* Whether limiting the ability to protect deals would lead to a reduction in merger activity is, of course, an open empirical question for which data is not available. The experience of practitioners, however, suggests that it would. In the words of a prominent practitioner, "dozens" of transactions would not have been done at all "if lawyers and bankers had advised boards that even [a merger of equals] puts you (legally) in play" compared to a "handful" of deals in which alternatives were not considered due to deal protection provisions. *Id.* at 31.

148. Theorists positing a race to the bottom may respond to this question by arguing that Delaware should care if changes in its law lead to a decline in merger activity because companies that want to merge without restrictions on their ability to protect their deals will leave Delaware to incorporate in other states. As a result, these theorists would answer, Delaware should care very much if changes to its law

suggested that there is no reason to believe that the explosion of merger activity in the mid-1990s was good for anyone, except perhaps investment bankers, corporate lawyers, and a handful of top executives. In fact, there is considerable evidence to the contrary, suggesting that the vast majority of deals were harmful to shareholder welfare and that the shareholders of targets and acquirors alike suffered as a result of the merger wave of the 1990s.[149] Is it really the role of corporate law to facilitate socially wasteful transactions?

It may be, however, that the only thing worse than a regime that facilitates wasteful transactions is a regime that permits judges to sift good deals from bad ones and to block the bad ones as a matter of law. Fortunately, the Delaware courts are acutely aware of this risk, as evidenced by Chancellor Allen's admonition in his *Time Warner* opinion that "[i]t is not part of the function of the court to evaluate whether the . . . deal is a good deal for Time shareholders or a poor one"[150] and the oft-repeated concern of making judges into "super-directors."[151] The deal protection decisions do none of that. As the next section argues, the Chancery Court's deal protection decisions can be understood as a response to the structural risk that managers and directors will serve themselves more than their shareholders in the context of merger negotiations. This structural risk stems from the management team's recognition that the merger of their company with an acquiror places them in their last period of play, thus freeing them from the influences that ordinarily constrain their decision-making and increasing the probability of self-serving decisions. This account provides a theoretical framework capable of squaring the deal

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will lead to a decline in mergers and, if so, should resist changing its law. *See generally* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale L.J. 663 (1974); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 Texas L. Rev. 469 (1987). *But see* Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U. L. Rev. 913 (1982); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. Econ. & Org. 225 (1985); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 Cardozo L. Rev. 709 (1987); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251 (1977).

149. *See, e.g.*, James A. Fanto, *Braking the Merger Momentum: Reforming Corporate Law Governing Mega-Mergers*, 49 Buffalo L. Rev. 249 (2001) (citing studies that merger activity is harmful to shareholder welfare).

150. Paramount Communications, Inc. v. Time, Inc., Civ.A. Nos. 10866, 10670, 10935 (Consolidated), 1989 Del. Ch. LEXIS 77, at *52 (Del. Ch. July 14, 1989, *revised* July 17, 1989) (Allen, C.).

151. *See, e.g.*, *In re* RJR Nabisco, Inc. S'holders Litig., Civ.A. No. 10389, 1989 Del. Ch. LEXIS 9, at *41 (Del. Ch. Jan. 31, *amended* Feb. 14, 1989) (Allen, C.) ("To recognize in courts a residual power to review the substance of business decisions for 'fairness' or 'reasonableness' or 'rationality' where those decisions are made by truly disinterested directors in good faith and with appropriate care is to make of courts super-directors."); Wanvig v. Johnson Controls, Inc., No. 663-487, slip op. at 17-18 (Wis. Cir. Ct. Mar. 29, 1985) ("[T]he only alternative to the business judgment rule would be to set judges up as super directors. . . .").

protection cases with each other and with existing Delaware jurisprudence while avoiding doctrinal rigidity and preserving a robust deal economy.

IV. THE LAST PERIOD PROBLEM IN THE CONTEXT OF FRIENDLY ACQUISITIONS

Corporate law generally accords a great deal of faith in directors to manage corporations.[152] Even stupid decisions will be protected by the business judgment rule except in egregious cases of self-dealing, fraud, duress, or illegality.[153] This freedom from judicial second-guessing, however, does not mean that corporate decision-making is completely unconstrained. In most circumstances, directors' decision-making is subject to a number of significant constraining forces. The last period of play is one notable exception.

A. *Mid-Stream Constraints*

Freedom from judicial second-guessing does not mean that directors are free to do as they please. There are a number of non-judicial constraints on management decisions in the ordinary course of business.

In the place of regular judicial supervision, the law places several *structural* constraints on management decision-making, such as annual meetings for the election of directors, regular reports to shareholders, and securities law disclosure requirements as well as the constraints of more general areas of law, including for example, agency, debtor/creditor and criminal law. Moreover, the law is not the only or even the main source of restraint on corporate decision-making.[154] Managers and directors are constrained by the mechanisms of various markets, including product markets, capital markets, labor markets, and the market for corporate control. In addition, most firms develop an internal set of norms to limit the ability of managers and directors to use investors' money foolishly or selfishly.

Market rewards and punishments provide an incentive for managers and directors to act as wise and loyal agents of their shareholders. In order to survive, firms must compete in product markets, capital markets, labor markets, and the market for corporate control. A firm whose managers consistently make foolish decisions and whose directors are unwilling to remove or replace bad managers

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152. *See, e.g.*, Del. Code Ann. tit. 8, § 141(a) (2002).

153. *See, e.g.*, Kamin v. Am. Express Co., 383 N.Y.S.2d 807 (1976) (applying the business judgment rule to a dividend decision that effectively cost shareholders $8 million).

154. *See* Robert B. Thompson, *The Law's Limits on Contracts in a Corporation*, 15 J. Corp. L. 377, 379 (1990) [hereinafter Thompson, *Limits*] (arguing that the ability of parties to opt out of the corporate contract should depend on the effectiveness of the "nexus of constraints" in the intracorporate relationship).

will not be able to compete. It will not be able to produce its products as efficiently or sell its products as profitably as its competitors. Similarly, bad firms will have diminished access to capital markets and will be unable to raise equity or debt financing on the same terms as their more appealing competitors. Managers and directors also face pressures from the labor market both inside and outside of the firm.[155] Inside the firm, labor market pressures arise from the ambition of lower-level managers and employees who would like to have their boss's jobs. Outside the firm, labor market pressures relate to the ability of the firm to attract talented employees, who, given a choice of employers, are less likely to select a consistently underperforming firm. The pressures of product markets, capital markets, and labor markets are likely to influence the business decisions of managers and directors, forcing them to make good decisions for the firm or face competitive decline and, ultimately, failure of the business. However, these markets are less likely to prevent managers or directors from behaving selfishly.[156] A firm with good products and good earnings may have continued access to product, capital, and labor markets regardless of whether those earnings are actually paid out to shareholders or kept within the firm to line the pockets of managers and directors.[157]

The market for corporate control, however, directly limits the ability of managers and directors to usurp shareholder welfare.[158]

155. *See generally* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288 (1980).

156. *See* Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan. L. Rev. 819, 839 (1981) [hereinafter Gilson, *Structural Approach*] ("The role of low-cost market mechanisms in restraining managerial discretion is more limited with respect to management's incentive to allocate itself an excessive portion of the corporation's income.").

157. Of course, if each of these markets is truly competitive, managers and directors will not be able simply to usurp these cash flows. Instead, to the extent that the firm's competitors reinvest earnings on research and development or expansion, the firm will be forced to reinvest its earnings in order to retain its competitive position. Managers and directors will thus be able to divert profits to themselves only to the extent of their competition, who, facing the same competitive pressures, will do so only minimally, if at all, preferring instead to use their cash flows to improve their competitive position. That, at least, is the theory.

158. This has made it a popular subject for legal academics, following the insight of Henry Manne. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110, 112 (1965); *see also* John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 Mich. L. Rev. 1 (1986); Easterbrook & Fischel, *The Proper Role*, *supra* note 3; Gilson, *Structural Approach*, *supra* note 156, at 841 (arguing that "where that favoritism is expressed in subtle ways, the market for corporate control may be the only potentially serious force for limiting management discretion"); Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. Fin. Econ. 5, 6 (1983) (stating that the market for corporate control "limits [management's] divergence from shareholder wealth maximization"). *But see* James P. Walsh & Rita D. Kosnik, *Corporate Raiders and Their Disciplinary Role in the Market for Corporate Control*, 36 Aca. Mgmt. J. 671 (1993).

Assuming the market price of a stock roughly reflects of the value of the firm's business,[159] the current market value of any firm reflects the extent to which management diverts corporate resources to itself. Other things being equal, the shares of a firm with selfless management will be worth more than the shares of a firm with selfish management, thus creating an arbitrage opportunity where all selfishly run firms become potential targets. A firm that would be worth $100 if run selflessly, but that is trading at $80 because its managers divert $20 of shareholder welfare to themselves, will be an attractive target to entrepreneurs and financiers, eager to buy the company and get at that $20.[160] Moreover, in a competitive control market, the presence of other would-be acquirors will drive the price of the target up to an amount close to its "selfless value." In the event of such an acquisition, the target shareholders will be paid and the former (selfish) managers and directors will be replaced by a team selected by the entrepreneur/financier, who will be forced to run the company more efficiently to justify the premium paid in the acquisition and to service any debt obligations.[161] The potential for these would-be acquirors, even if no bid is actually made for the firm, will pressure managers and directors to behave less selfishly, take less of the firm's profits for themselves, and improve the firm's share price or face replacement in an acquisition.[162] The market for corporate

159. That is, the value of assets as employed by the firm. Events in financial markets over the last decade make this an increasingly dubious supposition. Moreover, numerous financial economists have raised doubts regarding the efficient capital markets hypothesis. *See, e.g.*, Andrei Shleifer, Inefficient Markets: An Introduction to Behavioral Finance (2000) (collecting empirical evidence contrary to the efficient capital markets theory). However, perfect stock market efficiency is not required in order for the market for corporate control to have an effect on the behavior of managers and directors. All that is required is a that a control market exist and that potential targets *believe* that a firm's desirability as a target is related to the skill and loyalty of its management team. This belief is demonstrated in the statements of "raiders" and in the popular and academic literature. *See, e.g.*, Clifford G. Holderness & Dennis P. Sheehan, *Raiders or Saviors? The Evidence on Six Controversial Investors*, 14 J. Fin. Econ. 555 (1985); Carl C. Icahn, *Icahn on Icahn*, Fortune, Feb. 29, 1988, at 54; T. Boone Pickens, *Professions of a Short-Termer*, Harv. Bus. Rev., May 1986, at 75.

160. This amount will be less than $20 after transaction costs.

161. In this way, everyone benefits except the former managers: "Selling shareholders receive more for their stock than its value under previous management; new management receives an entrepreneurial reward through the increased value of acquired shares; and society benefits from more efficiently used resources." Gilson, *Structural Approach*, *supra* note 156, at 842.

162. Companies that are "contestable"—less protected by anti-takeover provisions—are constrained by the control market in their day-to-day decision-making, while less contestable companies—companies with strong anti-takeover provisions—are relatively insulated from the control market. *See* John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable are U.S. Public Corporations?*, 24 J. Corp. L. 837 (1999). Less contestable companies are constrained by the control market only when *Revlon* duties apply and, as this article shall argue, when they place themselves in a last period situation by agreeing to merge. In this era

control, where it is operational,[163] thus provides an elegant constraint on managers' ability to behave foolishly or selfishly.

In addition to the constraints of various markets, firms are likely to develop their own norms to guide and govern the behavior of their managers and directors.[164] Intra-firm norms are those rules or standards enforced within the firm itself, not by a court or other external rule maker. These include day-to-day items such as a firm's dress code or credos[165] and other elements of "corporate culture."[166]

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of anti-takeover provisions, would-be targets effectively re-enter the control market by pursuing a transaction. That is not to say, however, that the duties of a target board in the context of a friendly merger are the same as *Revlon* duties. The target in a friendly merger can always abandon the transaction and remain independent, an option that is not available under *Revlon* once sale has become "inevitable." *See infra* note 286 (discussing the ability of a target to "just say no" and remain independent).

163. Firms adopting anti-takeover provisions, such as poison pills and staggered boards, may be able to repel acquisition attempts and therefore not be subject to the market for corporate control on an ordinary basis.

164. This account of "intra-firm norms" tracks the concept of non-legally enforceable rules and standards ("NLERS") developed by Professors Rock and Wachter. *See* Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. Pa. L. Rev. 1619, 1642 (2001) [hereinafter Rock & Wachter, *Islands of Conscious Power*]. Rock and Wachter advance a theory of the firm according to which the firm's boundary is determined precisely by whether it is efficient to structure behavior according to NLERS versus according to contract and third party rules.

> [T]he [transaction cost economics] and property rights models provide a foundation for a more comprehensive positive theory of corporate law. By focusing on contractual incompleteness, this theory begins with the intuition that the choice between intermarket and intrafirm transactions is the choice between relying primarily on legally enforced contract, on the one hand, and heirarchy, centralized management, and private governance on the other.

Id. at 1639-40. Although the account of deal protection provisions developed in this article is consistent with the theory of the firm developed by Professors Rock and Wachter, this article's account of deal protection provisions in the last period of play does not rely on any particular theory of the firm.

165. *See, e.g.*, Kelly Barron, *The Forbes 400: Charlie's Pal, Otis*, Forbes, Oct. 12, 1998, at 126 (characterizing a popular Warren Buffett credo as "When you've got a good thing, don't sell it."); Owen Edwards, *Form Follows Emotion*, Forbes, Nov. 12, 1999, at 237 (describing Harmut Esslinger's work "to implement his credo: Form follows emotion"). Such credos inform the business judgment of executives and shape the business environment of the firm when implemented by management. In the words of Jack Welch, former CEO of General Electric:

> Take an idea like Six Sigma. I'll throw Six Sigma out and say, "Here's my vision." I'll exaggerate the case to create a sense of urgency, and I'll insist that only the best people be assigned to work on it. I'll make these pronouncements about every initiative over and over again. A relentless drumbeat. Tens of thousands of people engage in the initiative, Six Sigma or whatever, and I go to countless meetings and make it the focal point of the session. Every meeting builds on the one before. At each meeting, we learn what the great people in a particular business have done with the idea. Then we go to the next stop. It's the people who keep enriching and expanding the idea.

Harris Collingwood & Diane L. Coutu, *Jack on Jack*, Harv. Bus. Rev., Feb. 2002, at 94.

166. *See* Benjamin E. Hermalin, *Economics & Corporate Culture*, *in* Handbook of

More fundamental intra-firm norms include the firm's policies on rewarding achievement (bonuses and incentive compensation) and disciplining failure (demotion or dismissal), and can be seen to include the very standards by which the firm judges success or failure.[167] Intra-firm norms that seek to enhance the value of the firm, promote sound decision-making, and maximize shareholder welfare may discipline the board and management for mistakes and limit the ability of individual directors and managers to serve their own interests rather than the interests of their shareholders.

All of these constraints on managers and directors work together in the ordinary course of business to guide decisions and discipline mistakes. That is, they constrain managers in making the mid-stream or mid-life decisions of a firm,[168] decisions including whom to hire, what to produce, and whether to expand the business by acquiring another firm.

B. *The Last Period Problem*

The corporate form is perpetual,[169] but not all corporations live forever. Some firms go bankrupt and some are bought and broken apart or merged into other business entities. Under such conditions, the ordinary mid-stream constraints of firm operation give way to last period decision-making, and mechanisms that ordinarily constrain the decision-making of a management team, including markets and intra-firm norms, no longer apply with sufficient force to deter foolish or selfish decisions.

Organizational Culture and Climate (S. Cartwright et al. ed., 2001).

167. A firm can adopt norms that either enhance social welfare (such as the norm of shareholder welfare maximization) or reduce it (such as norms that tolerate slacking or self-interest); however, as with business decisions generally, competitive markets should drive firms to adopt welfare-enhancing norms. *See* Rock & Wachter, *Islands of Conscious Power*, *supra* note 164, at 1645 ("Unless competitive forces are operating, there is no particular reason to expect NLERS to be socially efficient. When markets are sufficiently competitive, a firm with suboptimal NLERS will be driven out of business.").

168. The force of each constraint depends upon whether the enterprise is ongoing. Markets will not punish poor quality when goods can be dumped into the market once and for all. The threat of never receiving another loan disappears if the debtor knows it will not ask for one. Intra-firm norms also require an ongoing enterprise.

> For these governance arrangements to function properly, the ability to punish opportunistic play is important, and the high-frequency, long-duration interactions among the parties operating together inside the firm allows ample opportunity to sanction bad play and encourage good play. Similarly, frequent transacting also generates a high return for investing in a good reputation.

Edward Rock & Michael Wachter, *Dangerous Liasons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 Nw. U. L. Rev. 651, 666 (2002).

169. Del. Code Ann. tit. 8, § 122(1) (2002) ("Every corporation created under this chapter shall have power to [h]ave perpetual succession by its corporate name, unless a limited period of duration is stated in its certificate of incorporation....").

The last period problem is a recognized phenomenon in game theory and rational choice economics.[170] Cooperative undertakings predictably deteriorate in the last period because participants are more likely to pursue selfish objectives once they recognize that the system of rewards and punishments favoring cooperation during the life of the enterprise soon will no longer apply. In game theory, this phenomenon is most visible in the final period of "social dilemma" games, such as the prisoner's dilemma.[171] A cooperative strategy, such as tit-for-tat, may emerge as the best strategy for an iterated prisoner's dilemma game.[172] However, if the participants are told that the next round of the game will be the last, the cooperative strategy no longer applies and each participant has a strong incentive to defect in order to maximize her individual welfare.[173]

Less abstract manifestations of the last period problem abound. Tenants commonly face last period incentives in connection with the payment of their final month's rent, a problem that landlords seek to solve by requiring rent payments on the first of the month and, perhaps, an additional month's rent in advance. Employees face last period incentives to slack when they know their employment is

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170. *See generally* John O. Ledyard, *Public Goods: A Survey of Experimental Research*, *in* The Handbook of Experimental Economics 142, tbl. 2.9 (John H. Kagel & Alvin E. Roth eds., 1998) (summarizing results from studies by Isaac, McCue, and Plott; Kim and Walker; and Isaac, Walker, and Thomas, showing that the incidence of cooperation dropped from the 50-68% range in the initial period to the 8-19% range in the last period).

171. The prisoner's dilemma, in which a prisoner must decide whether to cooperate with (by remaining silent) or defect from (by confessing) the pact made with his partner in crime, is one example of a collective action problem, a conflict between an individual's own best interest and the interests of the collective entity or enterprise. Other manifestations of the same conflict include "social traps," the "tragedy of the commons," and "public goods/free riding" problems, all of which can be described generally as "social dilemmas." *See, e.g.*, Toshio Yamagishi, *The Structural Goal/Expectation Theory of Cooperation in Social Dilemmas*, 3 Advances in Group Processes 51, 53-57 (1986) (noting the many names under which the general problem of individual/group conflict may be described).

172. *See generally* Robert Axelrod & William Hamilton, *The Evolution of Cooperation*, 211 Science 1390, 1393 (1981) (the strategy of tit-for-tat involves "cooperating on the first move and then doing whatever the other player did on the preceding move").

173. The last period problem may be abstracted to apply even to mid-stream decisions since if players do not know when the last period will come, they may treat each period as the last and defect from the very beginning. However, the empirical evidence is strong that they generally do not do so. Cooperation often emerges in mid-stream decision-making. *See* Robyn M. Dawes, *Social Dilemmas*, 31 Ann. Rev. Psychol. 169 (1980) (seeking to explain the emergence of cooperation in social dilemmas); Robyn M. Dawes & Richard H. Thaler, *Anomalies: Cooperation*, 2 J. Econ. Persp. 187 (1988) (collecting studies on the emergence of cooperation); David Sally, *Conversation and Cooperation in Social Dilemmas: a Meta-Analysis of Experiments from 1958-1992*, 7 Rationality and Soc. 58 (1995) (compiling studies).

coming to an end,[174] and the sick or the elderly may face last period incentives given the proximity of death.[175]

For corporate managers, the most obvious last period scenario involves bankruptcy and the looming failure of the business. As their company fails, managers may react with desperation to save it and themselves.[176] Professor Rose-Ackerman has pointed out how the approach of the last period may provoke increasingly risky investment choices:

> When a firm moves from expected solvency to expected insolvency, the manager who only cares about survival shifts discontinuously from the lowest variance project available to the highest variance one.[177]

This shift may favor negative net present value projects, provided they entail a high degree of variance over low variance *positive* net present value projects. Simply stated: managers facing collapse may favor a one in a million shot at making enough money to save the company over a more moderate project with stable cash flows. This principle is illustrated nicely by the *Tri-State Paving* case,[178] in which managers who had taken their company's remaining cash on a gambling mission to Las Vegas defended their actions on the grounds that the company was in such dire straights that risking the money on the tables at Vegas was the best available investment alternative.[179]

Another negative net present value project that managers in their last period of play may consider is securities fraud. Professors Arlen and Carney have shown that last period incentives may drive "fraud

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174. *See, e.g.*, Edward B. Rock & Michael L. Wachter, *The Enforceability of Norms and the Employment Relationship*, 144 U. Pa. L. Rev. 1913, 1932 (1996).

> Norms work least well when the power of future sanctions is eliminated or reduced. This scenario most often occurs when an employer has a reasonable prospect of going out of business. This raises the 'end-game' problem and converts a relationship that is near termination from a repeat game into a nonrepeat one.

Id.

175. *See* Richard A. Posner, Aging and Old Age 59 (1995) ("People keep promises, obey the law, avoid shirking, and do other good things, economists assume, because the prospective gains from doing them exceed the prospective loses. But what if they have no prospects, because they are about to die, or, more realistically, their prospects are truncated because of the proximity of death. . .?").

176. Managers lose their jobs when the business fails, as in a Chapter 7 liquidation, and nearly as often, when it enters a Chapter 11 reorganization. *See* Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. Fin. Econ. 241, 241 (1989) (finding a 52% probability of a change in senior management associated with default); Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. Pa. L. Rev. 125 (1990) (finding that forty CEOs in a sample of forty-three had lost their jobs in Chapter 11 reorganizations before the bankruptcy plan was confirmed).

177. Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. Legal Stud. 277, 288 (1991).

178. *In re* Tri-State Paving, 32 Bankr. 2 (Bankr. W.D. Pa. 1982).

179. *See* Rose-Ackerman, *supra* note 177, at 290 n. 35.

on the market" schemes.[180] In securities law, "fraud on the market" consists of issuing false statements to increase or maintain the firm's stock price.[181] A manager's mid-stream incentives generally do not favor committing fraud on the market because at some point the statements are likely to be revealed as false, causing the paper gains in stock price to vanish. Moreover, when the statements are revealed as false, the manager is likely to be fired.[182] Yet fraud on the market occurs, Professors Arlen and Carney argue, as a result of the last period problem:

> [A]n agent generally will not commit Fraud on the Market so long as his future employment seems assured. When the firm is ailing, however, an agent's expectations of future employment no longer serve as a constraint on behavior. In this situation a manager may view securities fraud as a positive net present value project. Aside from criminal liability, in a last period the expected costs of fraud (civil liability and job loss) are minimal, while the expected benefits of fraud may have increased. As remote as the prospects for success may seem, these benefits include possible preservation of employment as well as the value of the manager's assets related to the firm's stock, if by committing fraud he is able to buy sufficient time to turn the ailing firm around.[183]

Managers facing the failure of their business may thus prefer to risk lying to the market, potentially incurring legal liability, than to suffer the immediate and certain consequences of the market's reaction to the truth—that is, the further decline of their share price and creditworthiness and the further degradation of their business prospects.

Far from academic abstraction, these concerns can be seen to motivate several of the recent accounting scandals, including Enron and WorldCom.[184] Putting aside the apparent self-interest of Enron's chief financial officer,[185] the use of off-balance sheet financing activities seems to have been directed towards the end of keeping

180. Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. Ill. L. Rev. 691 [hereinafter Arlen & Carney, *Vicarious Liability*].

181. *See* 9 Louis Loss & Joel Seligman, Securities Regulation 4395 (3d ed. 1992).

182. If the lying manager was not removed, not only would the paper gains vanish, but the stock would also likely trade at a discount for dishonest management. Because the manager internalizes all of the risk of this activity (including liability for fraud) and only a fraction of the gain (because she does not own all of the company's shares), the cost/benefit calculus will generally disfavor the commission of fraud on the market.

183. Arlen & Carney, *Vicarious Liability*, *supra* note 180, at 702-03.

184. *See, e.g.*, William W. Bratton, *Does Corporate Law Protect the Interests of Shareholders and Other Stakeholders?: Enron and the Dark Side of Shareholder Value*, 76 Tul. L. Rev. 1275, 1328-29 (2002) (noting, but ultimately rejecting, last period concerns as the root of the problem at Enron).

185. *See* Rebecca Smith & John R. Emshwiller, *Enron CFO's Tie to a Partnership Resulted in Big Profits for the Firm*, Wall St. J., Oct. 19, 2001, at A1.

news of Enron's increasing losses from the market until a turnaround in the company's fortunes occurred.[186] The turnaround never came, the financing activities revealed management as dishonest, and the company failed. Similarly, the dishonest financial reporting of WorldCom may be seen as management's attempt to conceal the truth about a fast-failing company long enough for a market turnaround (or an extension of credit) to save their jobs.[187] Again, they failed.

Another corporate law last period problem occurs when a company is sold, as in a "bust up" acquisition. In the film *Wall Street*, for example, Michael Douglas portrayed a prototypically loathsome raider, proposing to buy Blue Star Airlines, auction its fleet of airplanes, fire its employees, and use its pension fund to finance the acquisition, thus plunging the fictional company into a paradigmatic last period scenario.[188] In such situations, ordinary mid-stream constraints will not operate with their usual force and may not operate at all. Blue Star managers and directors will be indifferent to product market constraints because the firm, ceasing to operate as a going concern, will no longer take products to market, indifferent to capital market constraints because the firm will no longer need to raise capital, indifferent to labor market constraints because there will be no more hirings or promotions, indifferent to the market for corporate control because control has already been wrested from them, and indifferent to intra-firm norms because the firm will soon be extinct. Faced with the destruction of the firm and, perhaps, the end of their careers, directors and managers are freed from the concerns that ordinarily constrain their decision-making and may therefore be more apt to behave foolishly or selfishly.

Although the drama and hyperbole of a bust up acquisition is typically not present in the context of a "friendly" merger—after all, the business continues to operate and many employees keep their jobs—last period features are still present at the level of the board of directors and senior management, many of whom are likely to be in the last period of their employment. In the context of a merger, the last period dilemma of the target company takes place within the management *team*.[189] Individual managers or directors may be

186. *See generally* Diana B. Henriques, *The Brick Stood Up Before. But Now?*, N.Y. Times, Mar. 10, 2002, at B1 (quoting Professor Gilson on Enron: "Structured finance is used for a zillion different and worthwhile purposes. The problem is Enron used it to create a structure that was genuinely not transparent, to hide things.").

187. *See generally* Kurt Eichenwald, *Lawyer Says WorldCom Ex-Chief Knew of Improprieties*, Wall St. J., July 12, 2002, at A1; Jared Sandberg, et al., *WorldCom Internal Probe Uncovers Massive Fraud*, Wall St. J., June 26, 2002, at A1.

188. Wall Street (Twentieth Century Fox 1987).

189. *See generally* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247 (1999) (arguing that managers and other employees make "match specific" investments in a particular firm so that firm outputs

brought aboard at the surviving company (or may be offered lucrative "consulting" contracts), but the destruction of the team notwithstanding the continuation of the business entity raises last period concerns. Indeed, it may be impossible to look at the composition of the board and management of the merged company *ex post* and say whether last period incentives played a role *ex ante* since *some* senior managers may be offered positions while others are not and *some* directors may be invited to continue while others are not. It may be that those who left acted in the best interests of the company notwithstanding their individual last period dilemma while those who were invited to stay faced no such dilemma. It may also be that those who stayed would not have been asked had it not been for the impact of the last period problem on their decision-making while those who left faced the same last period concerns but lacked the negotiating power to force their way into the continuing entity.[190] From the *ex post* perspective of judicial decision-making, it is probably impossible to say.

The last period problem thus exists as an *ex ante* structural concern each time the management team of a target firm faces restructuring following a prospective acquisition. Simply stated, although the firm may continue to operate in product, capital, and labor markets, from the perspective of the old management team, it is no longer *their* company, and these are no longer *their* products. Therefore these and other market constraints are no longer *their* problem. The constraining force of the target's intra-firm norms undergoes a similar weakening with respect to the firm's managers and directors. The combined entity will still have norms, but they will be new, the product of a different corporate culture and management team. This, if anything, is the truth behind the Time board's concern for the loss of "Time Culture"[191]—that is, the fear that the norms of an independent news organization supposedly focused on journalistic integrity would be swallowed by the norms of an entertainment conglomerate.[192] With the intra-firm norms of the independent target coming to an end, the new norms of the combined entity are not likely to constrain the crumbling management team. After all, these are not *their* norms.

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follow a model of "team production").

190. *See, e.g.*, McMillan v. Intercargo Corp., 768 A.2d 492, 503 (Del. Ch. Apr. 20, 2000) (Strine, V.C.) (noting, in the dismissal of shareholder-plaintiffs' allegations of CEO self-interest, that the self-interest of officers and directors can be attacked for agreeing to transactions in which they retain employment just as it can in resisting transactions in which they lose their jobs).

191. Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1146 (Del. 1989).

192. *See* Friedlander, Kulturkampf, *supra* note 36 (describing "Time Culture" as the legacy and vision of the company's original CEO, Henry Luce); *see also* James G. March & Herbert A. Simon, Organizations 160 (2d ed. 1993) (discussing the motivational and cognitive aspects of culture on an organization's behavior).

Because it simultaneously releases managers and directors from their ordinary mid-stream constraints and increases the temptation to enrich oneself at the expense of a dying corporation and its anonymous shareholders,[193] the last period signals a structural dilemma in corporate law, a point at which managers and directors have greater incentives to favor selfish objectives rather than the best interests of their shareholders. In the context of a negotiated acquisition, the target corporation's board and management may demand side payments from the acquiror, thus effectively diverting a portion of the merger consideration from the shareholders to the management team.[194] If the management team is able to protect the self-serving transaction with deal protection provisions, it will be further insulated from the disciplinary effect of the market for corporate control, leaving the outgoing management team free to serve their own self-interest with relative impunity.

In addition to the unrestrained pursuit of their own self-interest, directors and managers in the last period may depart from the best interests of the corporation and its shareholders due to a variety of non-pecuniary, but equally selfish, motivations. Directors and managers may favor one deal over another because it is more in line with their self image and view of the world or because it is more likely to cause them to be remembered fondly by employees or the business press. Neither of these motivations are necessarily consistent with the best interests of the company and its shareholders. An analysis of management and director behavior reveals several cognitive biases that may contribute to sub-optimal decision-making in the last period of play.

C. *Behavioral Analysis of the Last Period Problem*

Rational self-interest may account for a large portion of human behavior, but probably not all of it. It is difficult to deny, after all,

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193. *See, e.g.*, Rock & Wachter, *Islands of Conscious Power*, *supra* note 164, at 1662 (stating "if one can get seriously rich, one can move to Aspen and ski for the rest of one's days").

194. Most obviously, target directors and management could be interested in keeping their own jobs. Lebovitch and Morrison emphasize the self-interest of directors with the following hypothetical:

> [A]ssume that the LMN board proposes a merger with a 60/40 equity split favoring ABC's stockholders. The LMN board, however, insists on assuming full managerial control over the combined corporation and will terminate ABC's directors and management. The XYZ board, on the other hand, offers a 50/50 equity split, but plans to double the size of the board for the combined entity, thus preserving the jobs of each director and resulting in co-chief executive officers and co-chairpersons of the board.
>
> . . .[I]t is . . . possible that ABC's board has accepted the XYZ offer out of self-interest.

Lebovitch & Morrison, *Duck*, *supra* note 51, at 13-14. Although they do not identify it as such, the authors have offered a classic illustration of the last period problem.

that people sometimes do stupid things.[195] Recent efforts at providing a more accurate and nuanced account of human behavior have uncovered various cognitive biases which may lead to systematic inaccuracies in perception and judgment.[196] Among these are "self-serving bias" and "in-group bias." Such biases may affect the judgment of a management team at any time, but in the ordinary course of business, several features—including structural constraints, markets, and norms—limit the ability of management successfully to operate under such biases.[197] As discussed in the previous section, however, ordinary mid-stream constraints do not operate in the last period. In the absence of these constraints, the last period signals a time when otherwise common behavioral biases may lead to serious deviations from the welfare of the corporation and its shareholders.

Self-serving bias involves selective information processing, according to which a subject sees what it wants to see[198] and "conflate[s] what is fair with what benefits oneself."[199] The existence of this bias has been shown in numerous studies, including those in which over 50% of respondents rate themselves in the top 50% of the population in the possession of a desirable skill or trait[200] and those comparing spousal estimates of their portion of household work, which typically sum to more than 100%.[201]

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195. *See generally* Bob Fenster, Duh!: The Stupid History of the Human Race (2000) (citing examples).

196. *See generally* Christine Jolls, Cass R. Sunstein, & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 Stan. L. Rev. 1471 (1998); Cass R. Sunstein, ed., Behavioral Law & Economics (Cambridge University Press 2000) (collecting the works of various authors in the field).

197. *See supra* Part IV.A.

198. *See, e.g.*, John M. Darley & Paget H. Gross, *A Hypothesis-Confirming Bias in Labeling Effects*, 44 Personality & Soc. Psychol. 229 (1990). More than passive "seeing," self-serving bias involves fitting what one has seen with what one has chosen to believe.

> People attempt to construct a rational justification for the conclusions that they want to draw. To that end, they search through memory for relevant information, but the search is biased in favor of information that is consistent with the desired conclusions. If they succeed in finding a preponderance of such consistent information, they are able to draw the desired conclusion while maintaining an illusion of objectivity.

R. Sanitioso, Z. Kunda, & G.T. Fong, *Motivated Recruitment of Autobiographical Memories*, 59 J. Personality & Soc. Psychol. 229, 229 (1990).

199. Linda Babcock & George Loewenstein, *Explaining Bargaining Impasse: The Role of Self-Serving Biases*, 11 J. Econ. Persp. 109, 110 (1997) [hereinafter, Babcock & Loewenstein, *Impasse*].

200. *See, e.g.*, R.C. Baumhart, An Honest Profit: What Businessmen Say About Ethics in Business (1968) (ethics); Ola Svenson, *Are We All Less Risky and More Skillful Than Our Fellow Drivers?*, 47 Acta Pscyhologia 143 (1981) (driving); Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. Personality & Soc. Psychol. 806 (1980) (health).

201. *See* Michael Ross & Fiore Sicoly, *Egocentric Biases in Availability and Attribution*, 37 J. Personality & Soc. Psychol. 322 (1979).

Self-serving bias operates as a kind of buffer against stressful information.[202] In situations of sufficient ambiguity,[203] individuals will interpret information that would otherwise threaten their worldview or self-esteem as somehow inapplicable to themselves, leaving them free to consider themselves good drivers and good spouses. In this way, people tend to attribute their successes to skill and their failures to bad luck or other external circumstances.[204] Self-serving bias is thus linked to over-optimism. Optimism is not always warranted, of course, and because self-serving bias causes individuals to shift their attitudes and beliefs to be consistent with their positive view of the world and themselves,[205] it will lead to systematic errors in judgment.[206]

Under self-serving bias, managers and directors will tend to conflate their own preferences with the best interests of the company. The empire-building CEO, for example, may favor deals that keep her empire together. Managers who see their own roles as integral to the success of the company may favor deals that preserve their jobs and, blaming the company's poor performance on fickle investors or an irrational stock market, spurn bids that do not represent their overoptimistic appraisal of the company's "intrinsic value."[207] There is no self-dealing in these situations. The managers are not taking anything that shareholders should get. Managers and directors laboring under the influence of self-serving bias favor choices that are consistent with their view of the firm and themselves and, although such choices may clash with the best interests of their shareholders,

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202. *See* Jeff Greenberg, et al., *Why Do People Need Self-Esteem? Converging Evidence That Self-Esteem Serves an Anxiety-Buffering Function*, 63 J. Personality & Soc. Psychol. 913 (1992).

203. If the situation is unambiguous, self-serving bias may not be able to interpret away the stress of the information. *See* Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. Pa. L. Rev. 101, 144 (1997) [hereinafter Langevoort, *Organized Illusions*] ("Self-serving inference is an anxiety buffer, not an anxiety eliminator."): *see also* Hillel J. Einhorn & Robin M. Hogarth, *Decision Making Under Ambiguity*, 59 J. Bus. S225 (1986) (modeling decision making under conditions of ambiguity); Robin M. Hogarth & Howard Kunreuther, *Risk, Ambiguity, and Insurance*, 2 J. Risk and Uncertainty 5 (1989) (applying the psychological model of decision making under ambiguity to the context of insurance contracts).

204. *See* Miron Zuckerman, *Attribution of Success and Failure Revisited, or: The Motivational Bias Is Alive and Well in Attribution Theory*, 47 J. Pers. 245 (1979).

205. *See* Elliot Aronson, The Social Animal 178-79 (7th ed. 1995) (using cognitive-dissonance theory to show that attitudes and beliefs shift to support commitments once made, thus preserving consistency).

206. This result of the "self-serving" bias begs the question of whether it would be more aptly termed "self-defeating" bias. However, psychological research has shown that self-serving bias may promote happiness, productivity, and mental health. *See generally* Babcock & Loewenstein, *Impasse*, *supra* note 199.

207. For a discussion of Delaware's use of the "intrinsic value" concept, see *infra* note 239.

they do not necessarily further their own narrowly defined pecuniary interests at their shareholders' expense.[208]

Some may object that self-serving bias, while it may infect a number of respondents in psychological experiments, is less likely to motivate the decision-making of firms because bias leads to errors and errors will be punished by markets, including the firm's product and capital markets.[209] Putting aside the possibility that the business environment is one in which self-serving bias and over-optimism are likely to thrive,[210] it is worth emphasizing again the insight of the previous section: that market constraints are not fully operational in the last period.[211] Thus, once a firm enters its last period, whatever constraints markets and norms generally exert over the self-serving biases of its directors and managers are likely to fail.

Overconfidence and optimistic biases may be compounded by the group context of corporate decision-making. Management teams as a whole may thus be susceptible to particular forms of self-serving bias.[212] As described by a leading commentator:

> When a member brings up some information that suggests that the group's decision making has failed to consider something troubling, a threatening form of stress is introduced into the environment. Without realizing it, each member is inclined to dismiss or ignore danger signals, leading to less informed decision making that more closely resembles collective rationalization than prudent choice. Moreover, even if a group member privately wonders whether some bit of information is troubling, the very fact that other group members do not appear to be concerned is a reason to let the matter drop, a process of social learning that has a dangerous circularity to it.[213]

208. *See* Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 Ariz. L. Rev. 639, 655 (1996) ("Under ambiguity, the last period problem is more likely to introduce a self-serving bias in the assessment of the firm's best interests than deliberate disregard of them.").

209. *See supra* text accompanying notes 155-62 (describing the disciplinary force of markets).

210. Employers want to hire optimists and occasionally design tests to evaluate the level of optimism in prospective employees. *See, e.g.*, Martin E. P. Seligman, Learned Optimism 100-12 (1991). Moreover, in the words of one commentator, "there is good reason to believe that the tournament-like competition for promotion up the executive ladder overweights optimism and its associated behavioral traits, inflating such behavior towards the top of the hierarchy." Langevoort, *Organized Illusions*, *supra* note 203, at 140. In this way, the mechanisms of hiring and promotion may cause one disgraced optimist merely to be replaced by another.

211. *See supra* Part IV.B.

212. *See, e.g.*, Chip Heath & Forest J. Jourden, *Illusion, Disillusion, and the Buffering Effect of Groups*, 69 Org. Behavior and Human Decision Processes 103 (1997) (finding that "[a]fter performing a task, groups typically hold positive illusions about their performance while individuals hold negative illusions," and suggesting that groups may serve as a buffer against post-performance disillusionment).

213. Langevoort, *Organized Illusions*, *supra* note 203, at 138.

In other words, group members may not bring troubling information to the group's attention precisely because no other member has already done so, and because all members face the same incentives, the troubling information is likely never to reach the group as a whole. This is the phenomenon known as "groupthink."[214] In the context of a merger, groupthink may prevent independent directors from challenging the decisions of a self-interested manager and from questioning an accepted strategic vision or financial assumption.

In addition to exacerbating problems of self-serving bias, groups may develop an identity and biases of their own, described by Professors Cox and Munsinger as "in-group bias,"[215] which leads to judgment errors systematically favoring one's own group (the in-group) over other groups (out-groups). Boards of directors may be particularly susceptible to in-group bias due to several structural and adaptive factors pushing them towards a high degree of group cohesion. This process starts with the selection of directors, who are chosen on the basis of their "fit" and their "probable identification with and acceptance of the company's goals and methods of operation."[216] Because it involves selection to a cohesive and highly prestigious social unit, board membership validates one's self-worth.[217] It thus inverts Woody Allen's neurotic reluctance at belonging to any club that would have him as a member.[218] Being named a director increases one's already high self-esteem. It is, in the words of one commentator, "a little bit like being knighted."[219]

Once this distinct unit is formed, in-group bias operates to cause group members to identify their self-worth with the value of the group

214. *See* Irving L. Janis, Groupthink (2d ed. 1982).

215. James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 Law & Contemp. Problems 83 (1985) [hereinafter Cox & Munsinger, *Bias*] (arguing that the biases of directors, rooted in social and psychological drives, which equally infect independent directors, prevent directors from neutrally evaluating shareholder litigation, especially derivative suits).

216. Cox & Munsinger, *Bias*, *supra* note 215, at 91. Board members also choose colleagues who are like themselves. The relative homogeneity of boards is well documented. *See, e.g.*, G. William Domhoff, Who Rules America? (1967) (concluding that upper class cohesion is based on cultural similarity); *see also* G. William Domhoff, The Bohemian Grove and Other Retreats: A Study of Ruling-Class Cohesiveness 103 (1974) (finding interlocking relationships between significant social and policy organizations and the managers of large corporations); Thomas R. Dye, Who's Running America? The Bush Restoration (7th ed. 2002). The spate of stories in business magazines during the 1990s describing the twenty-year-old *wunderkinderin* at the helm of significant American corporations seems to have declined since the bubble burst and corporations have gone back to earning money the old fashioned way.

217. Cox & Munsinger, *Bias*, *supra* note 215, at 94 ("Through attachment to a group, especially one of high prestige, individuals satisfy their needs to validate their self-worth, particularly by the group's feedback.").

218. Annie Hall (MGM 1977).

219. M. Mace, Directors: Myth and Reality 88 (1971).

and consequently to favor the interests of the in-group over the interests of out-groups. This is not merely the rational pursuit of group interest. Rather in-groups seek to magnify the *differences* between themselves and threatening out-groups, even at the expense of their welfare.[220] That is, choosing the alternative that maximizes *difference* rather than simply maximizing their own return.[221]

In the context of management team decision-making, when presented with an acquisition proposal, the influence of in-group bias may be significant. Unsolicited bidders are the paradigmatic "threatening out-group." Especially when the bidder is an industry rival, the groups will have spent years in competition, which may well have bloomed into inter-organizational if not inter-personal acrimony. To protect their own sense of self, which has become inextricably bound with the group identity, managers and directors are likely to resist combinations with hated rivals and unseemly financiers. Such motivations form the background of numerous acquisitions, including that of Revlon, where the court speculated that Perelman's repeated bids for the target were rebuffed "perhaps in part based on Mr. Bergerac's strong personal antipathy to Mr. Perelman."[222]

In-group bias further suggests that if cooperation does develop as an alternative to individually motivated self-interest and defection, the cooperation that does develop will likely be between the members of the management team,[223] not between the management team and

220. *See* Cox & Munsinger, *Bias, supra* note 215, at 99.

221. *See* Tajfel, *Experiments in Intergroup Discrimination*, Sci. Am., Nov. 1970, at 96, 101-02 (showing that the strategy of maximizing the difference in welfare caused competing groups to forsake profit-maximizing options).

222. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 176 (Del. 1986).

223. The direction of cooperation is an under-appreciated aspect of social dilemmas. Studies of social dilemmas often focus on whether self-interest or cooperation are likely to develop under a particular set of conditions. Of course, the presence of the experimenter (and an experimenter's agenda) can influence the outcome. Dawes is sensitive to this issue, noting:

> claims that cooperation results from the rewards accruing to individuals qua individuals approach vacuity, given the standard instructions to subjects to "get as many points for yourself as you can." Experimental subjects who are cooperative with other subjects by foregoing dominating strategies are cooperating with the experimenter by embracing them in order to maximize their own payoffs.

Robyn M. Dawes, Alphons J.C. van de Kragt, & John M. Orbell, *Cooperation for the Benefit of Us—Not Me, or My Conscience*, *in* Beyond Self-Interest 100 (Jane J. Mansbridge ed., 1990). The possibility of defecting within the prisoner's dilemma game in order to cooperate with the experimenter raises the interesting question of who is cooperating with whom. In the corporate law context, adopting the shareholder welfare norm, we would like the management team to cooperate with the corporation's shareholders. However, the in-group bias suggests that members of the management team are most likely to cooperate with other members, with whom they have developed group cohesion and to whom they have bound their self-image. In-group cooperation has no necessary connection to shareholder welfare, and the two may be expected occasionally to coincide and occasionally to conflict. In other words, its shareholders, another out-group, who are at best passive and anonymous and at worst interfering institutional investors demanding excessive inclusion in the internal affairs of the corporation.[224] In the last period of play, whether it is in the context of bankruptcy or merger, it is precisely this in-group that is destroyed. Because the management team, through in-group bias, has developed norms of loyalty, cohesion, and mutual support,[225] it is likely that its decision-making in the last period will reflect deference to its own members rather than concern for the firm's shareholders, deference which may extend to the CEO's choice of a merger partner.

Recognized cognitive biases, including self-serving bias, over-optimism, and in-group bias, are exacerbated in the last period of play because none of the ordinary constraints on management team behavior apply to punish mistakes. Combined with the greater risk of crass self-interest in the last period, these biases cast serious doubt on the faith that one can put in the last period decision-making of corporate boards. Simply stated: last period decisions are structurally less likely to be good for the corporation and its shareholders than mid-stream decisions.

V. DELAWARE'S RESPONSE TO THE LAST PERIOD PROBLEM: THE CASE OF *SMITH V. VAN GORKOM*

When ordinary mid-stream constraints apply to limit the ability of managers and directors to defect from the best interests of their shareholders, courts can confidently apply the business judgment rule and avoid intervention in the internal affairs of the corporation.[226] As the last section has shown, however, under the shadow of the last period, managers and directors are less likely to be adequately constrained by this incentive structure. Instead, the last period problem ushers in an opportunity for management team defection and shareholder exploitation. How then, should courts respond to the issues raised by the predictable collapse of restraints in the last period?

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members of the management team may occasionally choose to *cooperate* with other members of the management team *by defecting* from the interests of shareholders.

224. *See, e.g.*, Panel: *The Institutional Investor's Goals for Corporate Law in the Twenty-First Century*, 25 Del. J. Corp. L. 35 (2000) (announcing a corporate governance agenda from the perspective of institutional investors).

225. *See* Cox & Munsinger, *Bias*, *supra* note 215, at 99 (arguing that "powerful psychological factors are at work within the boardroom, creating a cohesive, loyal, conforming ingroup that will support its members for positive and negative reasons, under low and high levels of motivation and group values").

226. *See* Rock & Wachter, *Islands of Conscious Power*, *supra* note 164, at 1671-86 (reviewing business judgment rule cases and finding that courts were likely not to apply the business judgment rule in situations where NLER-governance could be expected to fail); Thompson, *Limits*, *supra* note 154, at 390 ("Fiduciary duties become important when the temptation to advance personal gain is high and the threat of discipline from other sources is low.").

The answer of the Delaware Supreme Court, though poorly communicated and often misunderstood, is sketched by the case of *Smith v. Van Gorkom*.[227]

Smith arose as a result of the efforts of Jerome Van Gorkom, the Chairman and CEO of Trans Union, to sell the company. Because it contained certain non-transferable tax assets that it could not use as a free standing entity and because it generated cash flows large enough to sustain high levels of debt,[228] Trans Union was a natural acquisition candidate. Having worked out a rough estimate of what the company's shares might be worth in a deal, Van Gorkom approached buy-out specialist Jay Pritzker of the Marmon group to solicit his interest in the company.[229] Pritzker responded with an offer for the company at exactly the price Van Gorkom had estimated the shares to be worth, a premium of roughly 50% over the current market price, and gave the company only three days to decide.[230] At a hastily convened board meeting, after two hours of unusually intense questioning,[231] Trans Union's directors accepted the outline of the proposal as the exact details of the merger agreement were still being worked out by the company's lawyers.[232] The board, however, required that the company be permitted to consider other offers, emphasizing that their approval of the Pritzker merger was intended only to bring the offer before Trans Union's shareholders, not to seal the deal.[233]

In what is generally regarded as an unfortunate decision,[234] the Delaware Supreme Court concluded that this seemingly casual process amounted to a breach of the Trans Union directors' duty of care.[235] The court then went on to note a number of procedural mechanisms, including reliance on an investment bank's fairness

227. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

228. *Id.* at 864.

229. *Id.* at 866-67. Van Gorkom determined that a price of $55 per share would be acceptable. From 1975 to 1979, Trans Union stock traded over the New York Stock Exchange between $24 1/4 and $39 1/2. *Id.* at 866 & n.5.

230. *Id.* at 867.

231. One director referred to the meeting as "one of the most questioning meetings we ever had." William M. Owen, Autopsy of a Merger 70 (1986).

232. *Smith*, 488 A.2d at 868-69.

233. *See id.* at 869.

234. *See, e.g.*, Fred S. McChesney, *A Bird in the Hand and Liability in the Bush: Why* Van Gorkom *Still Rankles, Probably*, 96 Nw. U. L. Rev. 631, 631 (2002) ("Considered a legal disaster in 1985, it is judged no less disastrous today.") (citations, noting criticisms of the decision, omitted).

235. *Smith*, 488 A.2d at 893.

> [W]e hold that the directors of Trans Union breached their fiduciary duty to their stockholders (1) by their failure to inform themselves of all information reasonably available to them and relevant to their decision to recommend the Pritzker merger; and (2) by their failure to disclose all material information such as a reasonable stockholder would consider important in deciding whether to approve the Pritzker offer.

Id.

opinion,[236] that, if present, would have made it more inclined to find that the duty had not been breached. In this way, *Smith* is generally read as an aberration in Delaware's duty of care jurisprudence. The more interesting aspects of the case, however, relate to the court's approach to deal protection provisions in a last period context.

Van Gorkom, at the age of sixty-three, was within two years of mandatory retirement at Trans Union and was thus in the last period of his employment with the company.[237] Whatever happened to Trans Union five years hence, Van Gorkom would not be involved. He was therefore less susceptible to ordinary mid-stream constraints on his decision-making.[238] In addition, as a large shareholder of Trans Union stock, Van Gorkom's limited future association with the company and pending retirement may have altered his time horizon and risk preferences. It was possible, after all, that changes in the tax law or the capital markets would cause the value of Trans Union stock to rise to its "intrinsic value" at some point in the future.[239] If that point was ten to twenty years away, Van Gorkom might not be alive to see it, yet here he was presented with a 50% premium over the stock's ten year trading range. In this way, given a relatively short time horizon, one might expect someone in Van Gorkom's place to be quite receptive to an offer of $55 cash in hand rather than the riskier

236. Viewed in isolation, each of the court's procedural mechanisms is easily discredited. The court suggested that the board should have read the draft merger agreement. But does the court really believe that board members closely examine the turgid legalese of lengthy agreements? A more sensible approach would be for the company's inside and outside advisers to work on the details of the documents and for the board to exercise decision-making authority over the key terms, which indeed is how the procedure was handled at Trans Union. *See id.* at 868-69. Moreover, the fairness opinion aspect of the decision has been so widely and ably criticized—as "the Investment Bankers' Full Employment Act"—that it is hardly necessary to add anything on that point. *See* Dierdre A. Burgman & Paul N. Cox, *Corporate Directors, Corporate Realities and Deliberative Process: An Analysis of the* Trans Union *Case*, 11 J. Corp. L. 311, 333 n.146 (1986) (noting the reaction of New York professionals to the *Smith* decision). Indeed, the Delaware Supreme Court later revealed skepticism of its own regarding fairness opinions when it realized that bankers occasionally brought blank opinions to board meetings, with the price term to be filled in later, once the board had decided what it wanted the price to be. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 712 (Del. 1983).

237. This fact did not escape the Delaware court: "It is noteworthy . . . that [Van Gorkom] was then approaching 65 years of age and mandatory retirement." *Smith*, 488 A.2d at 866.

238. *See supra* Part IV.

239. The court discusses the "per share intrinsic value" of Trans Union stock. *See Smith*, 488 A.2d at 866. For commentary on the concept of "intrinsic" or "hidden" value and Delaware's implicit departure from the efficient capital markets hypothesis, see, for example, Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 Nw. U. L. Rev. 521 (2002); John C. Coates IV, *"Fair Value" as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions*, 147 U. Pa. L. Rev. 1251 (1999); Lawrence A. Hamermesh, *A Kinder, Gentler Critique of* Van Gorkom *and Its Less Celebrated Legacies*, 96 Nw. U. L. Rev. 595 (2002); Macey & Miller, *supra* note 148.

propositions of remaining independent and never reaching the $55 level, or rejecting the $55 bid to pursue other bids that might never arise. These changes in Van Gorkom's incentives brought on by the recognizable approach of the last period were noted in the business press at the time: "[b]ecause Mr. Van Gorkom at age 63 is approaching retirement, insiders suspect he would rather sell out than at this late stage take on the challenge of restructuring the company."[240]

But Van Gorkom was not the only player facing last period incentives. Because the most feasible way for Trans Union to profit from its tax position was through an acquisition, and the company's high cash flows made it an attractive target for a highly leveraged bust up deal, other senior managers might also have realized that they were in the last period of their employment or, at the very least, that the Trans Union management team would soon face substantial change. The last period problem suggests that such actors will be less constrained by the mid-stream incentive structure that might otherwise prevent them from acting in their own self-interest.[241] And indeed, the other members of Trans Union senior management formed their own group to acquire the company with the help of the buyout firm of Kohlberg, Kravis, Roberts & Co., or "KKR."[242] Management buyouts, as Van Gorkom himself was well aware,[243] can involve a conflict of interest between the management team, which will seek to pay as little as possible for the company, and shareholders, who desire to be paid as much as possible for their shares. Although there are procedural mechanisms for mitigating such conflicts,[244] the interests of senior managers in their own deal may have tainted their view of other transaction proposals. Indeed, anecdotal accounts of the situation inside Trans Union suggest that many managers were motivated to preserve their positions, operating units, and employees rather than to maximize shareholder value.[245]

240. Herbert Greenberg, *Behind the Turmoil at Trans Union*, Crain's Bus. Daily, Jan. 12, 1981, at 1.

241. *See supra* Part IV.

242. *See Smith*, 488 A.2d at 884 ("In late September, [the] group contacted KKR about the possibility of a leveraged buy-out by all members of Management, except Van Gorkom.").

243. *See id.* at 865 (stating the basis of Van Gorkom's opposition to the Management buy-out as the "potential conflict of interest for Management").

244. *See* Jonathan R. Macey, Smith v. Van Gorkom*: Insights About C.E.O.s, Corporate Law Rules, and the Jurisdictional Competition for Corporate Charters*, 96 Nw. U. L. Rev. 607, 612 (2002) (noting that "an independent board of directors can intercede to negotiate against management on behalf of the shareholders").

245. Owen describes the position of Jack Kruizenga, manager of Trans Union's tank car leasing operation, the company's most profitable business unit, as follows: "The Pritzker operations were unknown entities, and Kruizenga and his people were deeply concerned about their future as employees. His comments were not about stockholder concerns. Instead, his focus was on the employee situation." Owen, *supra* note 231, at 88. Owen describes the view of another Senior Vice President who

Because last period constraints on the behavior of managers and directors are predictably weak when compared to other incentives, such as personal enrichment and job preservation,[246] one might expect managers and directors to stop serving the firm's or shareholders' interests in favor of their own. Although there were no accusations of self-dealing,[247] Van Gorkom may have been motivated to sell to Pritzker in order to cash in his shares according to his now shortened time horizon.[248] Similarly, other members of the management team may have pursued the management buyout in order to preserve their own positions and serve their own interests within the company. If management teams serve their own interests and insulate their own decisions, as expressed in the merger agreement, from the market for corporate control, their shareholders will be worse off. This was the threat embodied in the Trans Union/Marmon Group merger agreement.

As initially negotiated, the merger agreement between Trans Union

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had joined the buyout group that "the company had obligations to its employees, its customers, and its shareholders—and that the employees clearly came before the shareholders in his order of priorities." *Id.* at 92. And Sidney H. Bonser, an Executive Vice President and director of Trans Union, is said to have openly voiced his concerns regarding his future employment with the company, while other executives appeared to be in a "stupor" and were "deeply shaken and disheartened." *See id.* at 68.

246. *See supra* note 194.

247. *See Smith*, 488 A.2d at 873 ("Here, there were no allegations of fraud, bad faith, or self-dealing, or proof thereof.").

248. The economic facts surrounding the case suggest that Van Gorkom may indeed have gotten the best value any Trans Union shareholder could have hoped for from her shares. By the time the deal closed, the five year projections for the profitability of the acquired businesses, which were essential in order to service the massive acquisition debt, were proven optimistic as a result of skyrocketing interest rates. In the words of Jay Pritzker:

> [U]nfortunately, [the five-year projections] were not very reliable, primarily because interest rates have climbed so considerably since that time, which perhaps one could not have anticipated. As a result, it has an impact, a substantial impact, on earnings and a substantial impact on the ability to divest some of the divisions that [we] anticipated we would divest....

Owen, *supra* note 231, at 200 (quoting the testimony of Jay Pritzker). Corroborating these comments, Trans Union's interest expense had risen 46% in 1980 as a result of rising interest rates, depressing the company's previously strong cash-flow as a greater share of revenue was used to service increasingly expensive operating debt. *See id.*

Of course, the fact that *ex post*, the company's actions benefited shareholders does not mean that *ex ante*, the company's primary interest was in maximizing shareholder welfare. Hindsight bias, in this case, makes Van Gorkom's financial decision appear to be quite good, but that does not mean the decision was not made as a result of last period influences. Perhaps a manager with a different time horizon, seeing that the escalation in interest rates was preventing a serious $60 bid from being made, would have decided to reject the Pritzker merger agreement and table future negotiations until interest rates returned to a more reasonable level. Of course, who knows when interest rates would come down, maybe next month, maybe next year, maybe never, but Van Gorkom clearly did know that other bidders would be interested in Trans Union under the right financial conditions. His time horizon may have made him disinclined to wait for those financial conditions to resurface.

and the Marmon Group contained strong deal protections, including terms that were functionally similar to today's termination fee, no-shop, and no-talk provisions. The sale of one million Trans Union shares to Pritzker at a price just above the then-current market price functioned as a kind of termination fee. If Trans Union was sold to another bidder, the new acquiror would also be forced to buy these shares, thus incurring an additional cost to its bid and paying Pritzker for serving as a "'stalking horse.'"[249] The merger agreement also contained a relatively straightforward no-shop provision, which purported to limit the ability of Trans Union actively to solicit other offers but which permitted Trans Union to consider other offers if made.[250] Finally, as originally drafted, the merger agreement contained a provision that would have prevented Trans Union from sharing non-public information with competing bidders.[251] This provision thus functioned as a no-talk provision, limiting the amount of diligence information that prospective bidders would be able to gather on the company, thereby creating a substantial information asymmetry between the Marmon Group and future bidders.[252]

Ultimately, however, none of these provisions would present a major obstacle to an intervening bidder. The no-shop and no-talk provisions did not survive. The no-talk provision was removed before the definitive merger agreement was signed as a result of the board's objection to it at the initial (two hour) board meeting. Similarly, although the no-shop provision was incorporated into the merger agreement, it was later amended to permit the company actively to solicit competing bids, and Trans Union hired Salomon Brothers to do so.[253] Moreover, the only deal protection provision that did survive through to the consummation of the merger—the termination fee—would not now be seen as preclusive. Although the million shares sold to Pritzker upon signing the deal would represent a substantial profit to the Marmon Group if Trans Union were to be acquired by another bidder,[254] as a percentage of deal value, the cost of buying out

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249. *Smith*, 488 A.2d at 866. In the further words of Jay Pritzker:

> [I]f all we did was make an offer at $55, and were left naked with that offer, what we would have done is kicked off an auction contest at great expense to ourselves, the expense being substantial commitment fees for financing, substantial legal fees, substantial lost opportunity cost at no recompense, and then someone else could have come out and said well, we'll pay $55.10.

Owen, *supra* note 231, at 60-61.

250. *Smith*, 488 A.2d at 868-69.

251. *See id.* at 869.

252. *See supra* text accompanying note 13.

253. *See Smith*, 488 A.2d at 869-70.

254. If, for example, another acquiror bought Trans Union for $55 per share, Pritzker's profit from the one million shares would be $17 million. If another acquiror bought Trans Union for $60, the profit on those shares would equal $22 million.

the shares never exceeded 3%,[255] a percentage that is well within the range of termination fees typically deemed acceptable by the Delaware courts.[256] Thus, none of the deal protection provisions initially drafted in the merger agreement had the effect of insulating the deal from the market for corporate control.

Nevertheless, the court spends considerable time analyzing the validity of the market check and finally concludes that the Trans Union/Marmon Group merger agreement never received an adequate market test.[257] Moreover, the court was probably correct in this conclusion. In spite of Salomon Brothers' efforts, canvassing over 100 prospective bidders,[258] only two serious contenders emerged: GE Capital and the management buyout proposal, backed by KKR. A handful of other prospective bidders expressed interest,[259] but these expressions ultimately came to nothing, as did discussions with KKR and GE Capital. When the solicitation period ended, there was only one merger proposal remaining: Pritzker's. If the economics of the acquisition were so appealing—essentially buying tax credits and paying for them with debt serviced by the target's large cash-flow—why did no other serious proposals emerge? Answer: it's the economy, stupid.

The prime lending rate was 7.5 percentage points higher in February 1981, when Trans Union's shareholders approved the Trans Union/Marmon Group merger agreement, than it had been in September 1980, when was the agreement was signed. In fact, interest rates had climbed to an all time high during the period of the market test. This unprecedented escalation in interest rates is detailed in Table 1.

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255. *See* Owen, *supra* note 231, at 51-53, 120-22.

256. *See supra* note 11.

257. *Smith*, 488 A.2d at 878 ("[T]he directors had no rational basis for expecting that a market test was attainable, given the terms of the Agreement.").

258. *See* Owen, *supra* note 231, at 122.

259. *See id.* at 190-91 (noting that apart from KKR and GE Capital, Trans Union executives met with only three potential suitors—Borg Warner, Bendix, and Genstar—all of whom dropped out of the auction process without making a serious bid).

Table 1: CHANGES IN THE PRIME RATE, SEPTEMBER 1980 THROUGH FEBRUARY 1981.[260]

Date	Rate	Date	Rate
9/1/80	11.5%	11/21/80	17%
9/8/80	12%	11/26/80	17.75%
9/12/80	12.25%	12/2/80	18.5%
9/19/80	12.5%	12/5/80	19%
9/26/80	13%	12/10/80	20%
10/1/80	13.5%	12/16/80	21%
10/17/80	14%	12/19/80	21.5%
10/29/80	14.5%	1/2/81	20.5%
11/6/80	15.5%	1/9/81	20%
11/17/80	16.25%	2/3/81	19.5%

One effect of this jump in interest rates was to increase the cost of capital for Trans Union's prospective bidders. Having received its loan commitments in September, the Marmon Group was effectively guaranteed a much less expensive source of financing than any rival bidder could hope for. Indeed, the most serious rival proposal to acquire Trans Union, the KKR-backed management bid, collapsed on multiple occasions as a result of its inability to secure financing.[261] With rising interest rates, the income of the company would have to be increasingly robust in order to service the debt. Unfortunately, the surge in interest rates also reduced Trans Union's vaunted net income as more of the company's cash flow was directed towards operating debt.[262] As a result, parties interested in bidding for Trans Union would have found such an acquisition increasingly expensive. Moreover, the Marmon Group would have a significant competitive advantage in any bidding contest as a result of the interest rates it had previously locked. Because Pritzker had received the majority of his loan commitments in September and October of 1980, including a \$450 million loan at 14%,[263] they would have to borrow less at prevailing rates in subsequent rounds of bidding than competing bidders.[264] Aware that they were dealing with a competitor with

260. Data taken from the Federal Reserve Board of Governors, Archive of the Daily Prime Rate, *available at* http://www.federalreserve.gov/releases/h15/data/d/prime.txt (last visited Jan. 10, 2003). A similar table appears in Owen, *supra* note 231, at 128.

261. *See* Owen, *supra* note 231, at 133-34, 179-83, 187-88.

262. Trans Union's net income dropped 30% in the last quarter of 1980. *Id.* at 188.

263. *See id.* at 196-97.

264. If, for example, a rival bid of \$60 per share was put together on December 10, 1980, it would have been less expensive for the Marmon Group to match it than it would have been for the rival bidder to make it. Assuming both bids are based on 80% leverage, Marmon's blended interest rate for \$602 million (roughly 80% of the total acquisition price) would have been approximately 15.5% (\$450 million at 14%

significantly lower cost of capital, prospective bidders may have simply decided not to bother waging an extremely expensive bidding war that they were likely, ultimately, to lose. The escalation in interest rates and the concomitant impact on the cost of acquisition capital thus provided greater protection for the Trans Union/Marmon Group merger agreement than its relatively weak deal protection terms.

Because a contestable market for corporate control not only ensures that shareholders receive the greatest value for their shares, but also limits the ability of managers and directors to serve their own interests in the last period,[265] the court was right to focus on the validity of the market test. If the market is not effectively contested, managers and directors may exploit shareholders and serve their own interests instead. It is unclear whether the Trans Union management team did in fact neglect their shareholders in favor of their own interests, but it is clear that they were facing last period incentives. It is also clear that the merger agreement produced under these last period incentives was effectively insulated from the constraining influence of the market for corporate control. If the market for control of Trans Union had been functioning adequately, the court could have accepted the directors' contention that the best deal won.[266] Without a properly functioning market, however, the court could not know whether the Pritzker deal reflected the best deal for shareholders or the management team's last period problem.[267]

The unfortunate aspect of the decision is that the court blamed the Trans Union directors for bad economic conditions, the antithesis of good business judgment rule jurisprudence. If the market for corporate control had been functional, then the actions of the Trans Union directors would have been appropriate. However, that the market for corporate control was not functional was no fault of the Trans Union directors. The deal protection provisions embedded in the final draft of the merger agreement were relatively weak. The failure of the market for corporate control was, rather, a result of escalating interest rates. The directors intended to test their deal on

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and $152 million at 20%) compared to the rival bidder's interest rate, drawn entirely from prevailing rates, at 20%. As a result rival bidders would have to value Trans Union significantly more than Marmon (or be significantly more optimistic about its future cash flows) in order to enter a bidding contest at such a disadvantage.

265. *See supra* text accompanying notes 158-62.

266. KKR and the management group, after all, were trying to assemble a bid at $60 per share. Smith v. Van Gorkom, 488 A.2d 858, 884 (Del. 1985). It does not take much economic analysis to see that $60 is better than $55 just as surely as $55 is better than $38.

267. Following the oft-recited justification for the business judgment rule, courts cannot know whether a particular deal is best. A judge, even a Delaware Chancellor, can never be in the position of a director acting in good faith *ex ante*, and judicial scrutiny of deal-making suffers from hindsight bias. *See* Block et al., *supra* note 118, at 12-18 (discussing rationales for the business judgment rule).

the market, but the market failed. The court thus held the directors of Trans Union responsible for fluctuations in interest rates. Van Gorkom not only sold Trans Union just before its cash flows plummeted, he also protected his chosen deal with one of the best deal protection devices available: skyrocketing interest rates. He could not have planned either. That is why the *Smith* decision rankles: fundamentally, the court blamed the board for interest rates.

In spite of this error, the *Smith* court sketches a sensible approach to the failure of mid-stream constraints in the last period. First, the court recognized that the Trans Union management team faced last period incentives. Second, because mid-stream constraints do not apply to check the decision-making of management in the last period, the court understood that it could not apply ordinary business judgment rule deference. It therefore sought a procedural mechanism to constrain the management team's potentially self-interested or self-serving decision-making. The best such mechanism would have been the market for corporate control—that is, a valid market test. Failing that, the court sought other procedural mechanisms, such as investment banker fairness opinions.

Seen in this way, the *Smith* decision does not, as is sometimes suggested,[268] mandate any particular procedure.[269] Rather, *Smith* merely stands for the proposition that there must be some check on the behavior of the management team in the last period. Because no such check in fact existed in the Trans Union/Marmon Group merger, the court over-rode the board's decision-making authority. It was a mistake of the *Smith* court to hold the Trans Union directors responsible for the failure of a market test that was no fault of their own. But it was the virtue of the *Smith* court to recognize the last period problem in the context of a negotiated acquisition and to recognize the potential role of the market for corporate control in constraining management in spite of their last period incentives. The opinion thus sketched the contours of an approach to the last period problem that has been followed by the Chancery Court in its recent deal protection decisions.

268. *See, e.g.*, Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 Bus. Law. 1437, 1453-54 (1985) (arguing that procedures mandated by the *Smith* decision constitute a "tax" on control transactions).

269. Indeed, empirical analysis has shown that the decision did not lead to a marked increase in fairness opinions, as is often supposed. *See* Helen M. Bowers, *Fairness Opinions and the Business Judgment Rule: An Empirical Investigation of Target Firms' Use of Fairness Opinions*, 96 Nw. U. L. Rev. 567, 577 (2002) (finding that the initial surge, in the year following *Smith*, in the use of fairness opinions has not been sustained: "overall, the average number of target firms utilizing fairness opinions post-*Van Gorkom* (58%) is essentially the same as the percentage pre-*Van Gorkom* (57%)").

VI. THE CHANCERY COURT'S DECISIONS: DEAL PROTECTIONS IN THE LAST PERIOD OF PLAY

The riddle of the Chancery Court's deal protection decisions may now be solved. Seen in light of the last period problem, the decisions are consistent with each other and present a coherent approach to deal protection provisions.

The last period problem forms the basis of the Chancery Court's approach. In the last period of play, such as a merger, an actor's incentives to cooperate and behave in good faith predictably break down. The absence of mid-stream constraints exposes shareholders to the risk of exploitation through their management team's self-interest and self-serving biases. Ordinarily, merger decisions would be constrained by the market for corporate control, as one good bid may lead to another, but deal protection provisions disable the constraint of the control market. Succinctly stated: deal protection provisions are troubling precisely because they permit management to insulate its last period decisions from the constraint of the market for corporate control.

Each of the Chancery Court's four recent deal protection decisions involves the last period problem. An acquisition is present in each case, thus throwing the management team of the target into its last period. In addition, several of the cases took place against a dire financial background. In *ACE*, Capital Re had reported poor financial results for two quarters, was in the midst of a "capital crunch," and was faced with a second Moody's downgrade of its creditworthiness, which threatened seriously to affect earnings.[270] Similarly, IXC had suffered bad financial results, causing "erosion in the company's stock price and concern within the IXC board about the company's management."[271] In response, each of these companies launched a search for merger partners, effectively serving notice to the management team that it was in its last period of play.

To say that each of these companies faced last period incentives is not to say that all (or any) of their management teams actually defected from the best interests of the corporation and its shareholders. In fact, the procedural posture of most of the deal protection cases points in the other direction. In *ACE*, for example, the Capital Re board wanted to negotiate with another bidder, but ACE sued to enforce the no-talk provision of the contract and enjoin Capital Re from talking. It is not easy to tell a story about the target management team serving its own interests under these circumstances. A self-interested management team will not agree to a deal in the first place, one might assume, unless the deal favors their

270. *See* ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 97 (Del. Ch. 1999).

271. *See In re* IXC Communications, Inc. S'holders Litig., C.A. Nos. 17324, 17334, 1999 Del. Ch. LEXIS 210, at *3 (Del. Ch. Oct. 27, 1999).

selfish interests. Once that deal has been agreed, the management team is unlikely to abandon it, as the Capital Re board did, the moment a higher bid comes along. Still, it is not impossible to tell a story about self-interest even under these circumstances. After all, the second deal may be even more favorable to management than the first, providing management with a clear self-serving motivation to get out of their initial agreement.[272] Thus, it turns out that telling whether a management team's actions are selfishly motivated is as difficult as telling, from the *ex ante* perspective, whether a given business decision will be wise or foolish.

Courts can avoid opening the question of whether a management team has behaved selfishly, just as they can avoid questioning the wisdom of business decisions, by focusing on structural concerns. Where the decision-making of management teams is entirely unchecked by the constraints of markets or norms, as is often the case in the last period, courts must intervene to ensure that their decisions are made in the best interests of the corporation and its shareholders. If, however, the management team's decision-making remains constrained by markets or norms, courts can apply business judgment rule deference and stay out of the hard questions. The court in *ACE* thus avoided the question of the motivation of Capital Re's executives and examined instead the deal protection provisions in the merger agreement. Because the agreement contained strong deal protections with no additional constraint on the decision-making of the management team, it signaled that the company had been in an unconstrained last period problem. The recognition of this structural problem caused the court to invalidate the deal protections.

In focusing on the structural concern addressed by the court, it is important to emphasize what the court did not do. The court did not intercede to deem either of the two competing deals to be superior, nor did the court second-guess any of the other last period business decisions made by management. Instead, recognizing the structural dilemma of an unconstrained last period, the court simply declined to apply business judgment rule deference to the company's inclusion of strong deal protections in its merger agreement, refusing to enforce

272. There is some reason to believe that ACE held out the promise of not changing Capital Re's management structure as a means of sweetening its bid. After the merger was announced, ACE CEO Brian Duperreault stated that Capital Re would provide ACE with "a well-developed infrastructure and a highly skilled management team," suggesting that a large scale restructuring of target management was not planned. Dan Lonkevich, *ACE Ltd. To Acquire Capital Re for Stock*, Nat'l Underwriter Prop. & Casualty-Risk & Benefits Mgmt., May 31, 1999. And after closing, Mr. Duperreault made similar statements. *See* Janina Clark, *ACE Plays the Winning Card for Capital Re*, Reinsurance Mag., Dec. 1, 1999, at 1 ("Brian Duperreault, chief executive of Ace, said that he plans to operate Capital Re as a stand-alone unit of the Ace Group and has no plans at present for any management changes at the reinsurer.").

the no-talk provision that prevented the company from negotiating with other suitors. In other words, the court simply refused to allow the parties to insulate their last period decisions from the structural constraint of the market for corporate control.

That strong deal protections signal an unconstrained last period problem does not mean that such provisions will always be invalid. One way to solve an unconstrained last period problem is to introduce constraints. If fairness opinions actually provided a disinterested appraisal of the fairness of a transaction, management's ability to provide a fairness opinion from a reputable investment bank might be an adequate restraint on their ability to behave selfishly in the last period. Because most commentators and courts are understandably skeptical of the value of fairness opinions,[273] the best means of constraining the selfishness of management may be through a market check.

A market check inserts constraints into what might otherwise be an unconstrained last period decision by reintroducing the market for corporate control. As discussed above, a competitive control market prevents selfish managers from usurping, and foolish managers from wasting, shareholder welfare.[274] In the context of a friendly acquisition, selfish managers may agree to a transaction paying shareholders sub-optimal consideration provided that a portion of the marginal difference between what the acquiror pays and what the target is worth is deflected to themselves in the form of side payments, such as future employment or consulting arrangements. Similarly, foolish managers may agree to a transaction at a sub-optimal price simply because they do not know what the company is really worth. The insertion of the control market will constrain managers in each of these situations.[275] Most obviously, foolish managers will not be deceived in the real value of the company since the solicitation of other bids will either result in an overbid or incentivize the initial bidder to offer a price close to its reservation value in hopes of deterring other bidders.

A market check in the context of a friendly acquisition should constrain selfish managers even though, based on the current change of control paradigm, they are under no duty to accept unwanted overbids. In the absence of *Revlon* duties to accept the highest price offered for the target's shares, the control market may seem to provide little or no constraint on the part of selfish managers

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273. *See supra* note 236.

274. *See supra* notes 155-63 and accompanying text.

275. Following the numerical example introduced above, *supra* text accompanying note 160, members of the target management team will be unable to support a bid at $80 rather than $100 and appropriate the additional $20 for themselves since the potential presence of other bidders will force the buyer to bid closer to the full $100 value in order to guarantee a successful acquisition.

determined to refuse all bids except the one that serves their selfish interests. However, the application of a market test in this context provides at least two kinds of constraints. First, a market challenge to management's preferred deal exposes management's selfishness to board scrutiny. Second, solicitation of interest from the control market increases the likelihood that an intervening bid will arise causing shareholders to reject the selfish transaction favored by management.

It is unlikely that every member of the board of directors and every member of the management team is in cahoots to favor a sub-optimal deal over the best deal for shareholders. It would be extremely expensive for the acquiror to bribe every member of the board and management with side payments. Less cynically, at least some members of the board of directors are likely to take seriously their charge to promote shareholder welfare. If not every member of the board or management team is in cahoots to favor a sub-optimal bid, it may be possible to win disinterested directors' support for a sub-optimal bid only insofar as they do not know that a particular bid is in fact sub-optimal. Selfish managers may be able to spin a convincing story about how their particular deal has amazing synergies for shareholders that are truly unique and unlikely to be matched by any other company. Such stories may be persuasive to disinterested managers and board members as long as they are not confronted with any other bids. But the moment a premium bid arises, there will be pressure on selfish managers to explain themselves to their disinterested colleagues. They may argue that their deal creates even greater value than the competing bid, but their colleagues are likely to do the math and, if the competing bid offers a significant premium on the favored deal, demand a truly compelling account of the supposed synergies. In other words, the presence of competing bids exposes the "selfishness discount" of management's favored bid. Selfish managers may be able to explain away this discount to their disinterested colleagues, and they may be assisted in this endeavor by the cognitive biases inducing their colleagues to believe them, but plainly exposing the magnitude of the discount will put pressure on their story. Disinterested directors who prefer to think of themselves as loyal shareholder representatives rather than as shills or dupes of their selfish colleagues are likely to insist that the final deal price approach the optimal price for the target company, even though there is no legal rule requiring a sale at the best price, as there is in the *Revlon* context.

Shareholders present the second line of defense against a selfish deal. The activation of the market for corporate control, even though management is not required to accept unwanted overbids, awakens the constraining influence that shareholders can exert on the selfish decision-making of management. By engaging in a market test, the target encourages other bidders to arise. If a premium bidder arises during the market test period, target managers may still reject it and go forward with the favored transaction. In the merger agreement with the preferred acquiror, managers may then include deal protection provisions, but in this context the spurned premium bidder is likely to rise again notwithstanding the terms of the merger agreement. As noted at the beginning of this article, the primary purpose of deal protection provisions is to discourage intervening bids by creating transaction costs and information asymmetries.[276] Where a spurned bidder has already decided that the target is worth more than the value reflected in the merger agreement, however, it is not likely to be troubled by information asymmetries and, as long as the transaction costs are within the customary range,[277] may announce its offer for the company notwithstanding the deal protections. Although target management is under no duty to accept this offer, target shareholders still get to vote. Given the choice between approving the sub-optimal deal and rejecting the sub-optimal deal in the hope that management will pursue the higher offer after its favored deal has fallen through, they are likely to reject the sub-optimal deal.

In this way, the reinsertion of the market for corporate control will constrain the last period decision-making of management in spite of the fact that managers are under no *Revlon* duties to accept offers arising from that market. The exposure of management's transaction, whether pre-signing or post-signing, to the market for corporate control, should reasonably assure boards and shareholders that no significantly better deal was, in fact, available. Once this assurance is made, strong deal protections become palatable. Deal protection provisions will still insulate the agreement from the market for corporate control, but if the market for corporate control was operational prior to the execution of the agreement, then a sufficient constraint may have existed *ex ante* to make the absence of post-signing constraints irrelevant. Pre-signing discussions with potential bidders, a "pre-signing market check," should be a sufficient basis for approving strong deal protection provisions, even no-talks without a fiduciary out. A post-signing solicitation of interest, a "post-signing market check," may be inconsistent with strict no-talk and no-shop provisions, since the market check requires talking,[278] but may provide an appropriate constraint in agreeing to other kinds of deal protections, including termination fees and option agreements. Such details aside, the conceptual point is simple: the reintroduction of the

276. *See supra* text accompanying notes 8-14.

277. *See supra* note 11 (noting that 3-4% of deal value is a commonly accepted termination fee).

278. No-talk and no-shop provisions that explicitly carve out a post-signing canvassing of the market may be consistent with a post-signing market check.

control market prevents management from defecting in its last period decisions.[279]

Where there has been a market check, and thus a reinsertion of the constraining influence of the market for corporate control, the court can apply business judgment deference to all decisions of the management team, including the decision to agree to deal protections in the merger agreement. The market check introduces constraints into what would otherwise be an unconstrained last period decision. The presence of a market check is thus the key distinguishing feature between *Phelps Dodge* and *ACE*, on the one hand, and *IXC* and *Bartlett*, on the other.[280] In neither *Phelps Dodge* nor *ACE* had the management team engaged in any kind of market check to test the deal it made in the initial merger agreement,[281] and in each of those cases management further insulated the untested deal from the market for corporate control with strong deal protections. The combination of strong deal protections and no market test signaled an unconstrained last period problem, causing the court to invalidate the deal protections.

By contrast, in both *IXC* and *Bartlett*, the target company had engaged in a form of market test. In *IXC*, the board, through its investment banker, had canvassed the universe of potential bidders to such an extent that the list of companies consulted read like "a who's who of telecommunications players."[282] Similarly, in *Bartlett*, "Medco, with the experience and assistance of [its investment bankers], aggressively sought out suitors."[283] Because each of these companies had engaged in a process that reintegrated the market for corporate control into what otherwise would have been unchecked last period decisions, the court could apply business judgment deference to the

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279. *See supra* note 275.

280. *See* Michael A. Stanchfield, *Fiduciary Duties in Negotiated Acquisitions: Questioning the Legal Requirement for "Outs,"* 27 Wm. Mitchell L. Rev. 2261 (2001).

> The cases turn on an analysis of the directors' conduct and diligence in the process of investigating the acquisitions market and negotiating the merger agreement.... A common theme runs through the cases that have found violations of this duty of care: the target board of directors' lack of information on the market for control of the corporation.

Id. at 2282.

281. In *ACE*, Vice Chancellor Strine states that Capital Re had been "exploring a possible business combination or capital infusion" for more than a year but does not elucidate the process through which this exploration took place. ACE, Ltd. v. Capital Re Corp., 747 A.2d 95, 97 (Del. Ch. 1999). Was it entirely internal, involving spreadsheets and management estimates? Or did solicitations take place? In any case, the court clearly does not regard this exploratory process as a valid market check.

282. *In re* IXC Communications, Inc. S'holders Litig., C.A. Nos. 17324, 17334, 1999 Del. Ch. LEXIS 210, at *4-5 (Del. Ch. Oct. 27, 1999) (listing AT&T, MCI WorldCom, Teleglobe, Bell Atlantic, Cable & Wireless, Bell South, IDT, RSL, GTS, and Qwest as companies with which IXC had communicated regarding a potential deal).

283. Wisconsin Inv. Bd. v. Bartlett, C.A. No. 17727, 2000 Del. Ch. LEXIS 42, at *16 (Del. Ch. Feb. 24, 2000).

agreed-upon deal protections.

The Chancery Court's approach to the problem of deal protections in the last period of play is thus a further development of the Delaware Supreme Court's approach to the problem in *Smith*. Neither court has mandated a particular procedure for dealing with the collapse of mid-stream incentives in the last period. Whether that procedure involves a fairness opinion or a market check or some other means of introducing a constraint on the management team is irrelevant. Rather, each court insists on a showing that the structural problem of last period incentives has been solved by the target company's process in deciding upon the deal. Thus, as a practical matter, corporate counselors need not advise their clients that they must shop every friendly deal any more than they needed to advise their clients, post-*Smith*, that every board decision required a fairness opinion. However, deal protection provisions are troubling precisely because they eliminate the last period constraint of the control market, and the best and easiest way to reïnsert that constraint is through a market check. If a company conducts a valid market check, then even the strongest deal protections should receive business judgment rule deference.[284] If a company does not conduct a valid market test, corporate counsel will have to exercise some creativity in devising a procedural check that will persuade a court that the board did not make its decision in an unconstrained last period of play. Otherwise, the court will invalidate the deal protections.

Finally, the Chancery Court's last period analysis of deal protection provisions does not suggest that a company is putting itself in play by agreeing to a friendly merger. Neither assessing the interest of other bidders prior to agreeing to deal protection provisions nor entering into a more weakly protected merger agreement forces a target to *accept* unwanted offers, either during the solicitation period or during the period between signing and closing. Of course, if an unwanted offer does arise and represents a significant premium over the intended deal, the target's shareholders may reject the initial deal.[285] The shareholders, however, have no power to force the target to accept the competing bid, and there is no reason to believe, assuming that it has the usual anti-takeover provisions in place, that the target could not remain independent after the initial deal fell apart. For

284. Interestingly, the safe harbor of a market check may provide negotiating leverage to a target who prefers not to include deal protection provisions in the merger agreement. Essentially, the target can offer to include the provision but only if the buyer agrees to allow a market check, which the buyer may seek to avoid since a market check exposes it to the risk that others will bid the price up. The buyer who has not emerged as a result of a solicitation process will thus be in the position of choosing between a market check and a contestable merger agreement.

285. This is true, of course, whether or not the initial deal is protected in the merger agreement. As discussed above, *supra* notes 8-14 and accompanying text, the real value of deal protection provisions is to make intervening bids less likely.

example, if a target company felt that it could achieve desired "synergies" only with the chosen partner and not with an intervening bidder, it would not be forced to deal with the intervening bidder after its shareholders vetoed the deal with the chosen partner. It could, instead, "just say no" to the intervening bidder and seek to explore other strategic options with the chosen partner or, alternately, continue on exactly the same path it had been on prior to entering negotiations with its chosen partner.[286]

CONCLUSION

This article has applied insights drawn from game theory and cognitive psychology to answer whether and when target companies may make binding promises to their intended suitors not to consider other offers. Target companies may agree to deal protection provisions when they are not in the midst of an unconstrained last period problem. Because mergers throw the target's management team into a last period situation, the target must introduce some form of procedural constraint, such as a market check, as a prerequisite to protecting its deal. Having introduced such a constraint into its management team's last period decision-making, the target company should be free to agree to strong deal protection provisions.

The Chancery Court's deal protection decisions follow this rule. *Bartlett* and *IXC* provide examples of last period problems that were checked by the constraint of a market test, thus validating the merger agreements' deal protections, while *Phelps Dodge* and *ACE* provide examples of uncontested, unchecked last period problems, requiring an invalidation of deal protections. The theoretical perspective of the last period problem thus brings internal consistency to the Chancery Court's deal protection quartet. Moreover, far from rewriting the law on mergers and acquisitions, these decisions reawaken an aspect of the Delaware Supreme Court's decision in *Smith,* providing a sound theoretical basis for the Delaware Supreme Court's eventual consideration of the issue as well as pragmatic guidance for deal-makers. Companies can agree to strong deal protections provided that they have conducted a market check or engaged in some other procedural mechanism to control unconstrained last period incentives.

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286. *See* Moore Corp. v. Wallace Computer Servs., Inc., 907 F. Supp. 1545 (D. Del. 1995) (endorsing the ability of a board to remain independent after receiving and rejecting a takeover offer). Last period analysis supports the decision of target companies to "just say no" to the bids of would-be acquirors, to leave their anti-takeover provisions in place, and to remain independent. Although an in-depth analysis of the takeover market from the perspective of the last period problem is outside of the scope of this article, it would appear that a target's decision does not give rise to an unchecked last period problem because in continuing its business, the company will remain sensitive to the mid-stream constraints of markets and norms.