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The Geography of *Revlon*-Land

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ARTICLES

THE GEOGRAPHY OF *REVLON*-LAND

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In Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., *the Delaware Supreme Court explained that, when a target board of directors enters* Revlon-*land, the board's role changes from that of "defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."*

Unfortunately, the Court's colorful metaphor obfuscated some serious doctrinal problems. What standards of judicial review applied to director conduct outside the borders of Revlon-*land? What standard applied to director conduct falling inside* Revlon-*land's borders? And when did one enter that mysterious country?*

By the mid-1990s, the Delaware Supreme Court had worked out a credible set of answers to those questions. The seemingly settled rules made doctrinal sense and were sound from a policy perspective.

Indeed, my thesis herein is that Revlon *and its progeny should be praised for having grappled—mostly successfully—with the core problem of corporation law: the tension between authority and accountability. A fully specified account of corporate law must incorporate both values. On the one hand, corporate law must implement the value of authority in developing a set of rules and procedures providing efficient decision making. U.S. corporate law does so by adopting a system of director primacy.*

In the director primacy (a.k.a. board-centric) form of corporate governance, control is vested not in the hands of the firm's so-called owners—the shareholders—who exercise virtually no control over either day-to-day operations or long-term policy, but in the hands of the board of directors and their subordinate professional managers. On the other hand, the separation of ownership and control in modern public corporations obviously implicates important accountability concerns, which corporate law must also address.

Academic critics of Delaware's jurisprudence typically err because they are preoccupied with accountability at the expense of authority. In contrast, or so I will argue, Delaware's takeover jurisprudence correctly

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recognizes that both authority and accountability have value. Achieving the proper mix between these competing values is a daunting—but necessary—task. Ultimately, authority and accountability cannot be reconciled. At some point, greater accountability necessarily makes the decision-making process less efficient. Making corporate law therefore requires a careful balancing of these competing values. Striking such a balance is the peculiar genius of Unocal *and its progeny.*

In recent years, however, the Delaware Chancery Court has gotten lost in Revlon*-land. A number of chancery decisions have drifted away from the doctrinal parameters laid down by the Delaware Supreme Court. In this Article, I argue that they have done so because the Chancellors have misidentified the policy basis on which* Revlon *rests. Accordingly, I argue that chancery should adopt a conflict of interest–based approach to invoking* Revlon, *which focuses on where control of the resulting corporate entity rests when the transaction is complete.*

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INTRODUCTION

Corporation law statutes commonly offer two basic mechanisms by which a company may be acquired: namely, the merger and the sale of all or substantially all corporate assets.[1] In addition to these statutory acquisition techniques, there are a number of nonstatutory acquisition methods, including the proxy contest, the tender offer, and stock purchases.[2] Among many factors distinguishing the two categories, one of the most important is the role of the target's board of directors. Statutory forms, such as a merger or asset sale, require approval by the target's board.[3] In contrast, the nonstatutory techniques do not. A proxy contest obviously does not require board approval, although a shareholder vote is

1. *See, e.g.*, DEL. CODE ANN. tit. 8, § 251 (2011) (merger); *id.* § 271 (sale of all or substantially all corporate assets). *See generally* STEPHEN M. BAINBRIDGE, CORPORATE LAW 338–40 (2d ed. 2009) (describing basic merger and asset sale techniques, as well as key variants thereof).

2. *See* BAINBRIDGE, *supra* note 1, at 340–41 (describing these techniques). The appellation "statutory acquisition" refers to a form expressly created by state corporation codes. Its counterpart, the term "nonstatutory acquisition," simply means that it is a form whose existence is not dependent on such a code. In general, however, the latter are not unregulated. Instead, they typically are governed by federal securities law and, in some cases, various state laws. *Id.* at 337 n.1.

3. *See, e.g.*, DEL. CODE ANN. tit. 8, § 251(b) ("The board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation and declaring its advisability."); *id.* § 271(a) ("Every corporation may at any meeting of its board of directors or governing body sell, lease or exchange all or substantially all of its property and assets . . . as its board of directors or governing body deems expedient and for the best interests of the corporation . . . .").

still required.[4] A tender offer requires neither board approval nor a shareholder vote; if the buyer ends up with a majority of the shares, it will achieve control.[5]

The need for board approval creates insurmountable barriers to use of a statutory form if the bidder is unable to secure board cooperation. Initially, the nonstatutory forms eliminated this difficulty by permitting the bidder to bypass the target's board and obtain control directly from the stockholders. Since the 1970s, however, the development of takeover defenses allowed the target's board to play a gatekeeping role in tender offers, not unlike its role in statutory acquisition techniques.

The target board's gatekeeping function poses the most basic question of corporate governance; namely, who decides? Is the decision to accept or reject an offer one for the shareholders or, as with all other important policy questions, is it at least initially one for the board?[6]

One of the more interesting contexts in which that question arises is the jurisprudential territory known as "*Revlon*-land."[7] In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[8] the Delaware Supreme Court explained that when a target board of directors enters *Revlon*-land, the board's role changes from that of "defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[9]

Unfortunately, the court's colorful metaphor obfuscated some serious doctrinal problems. What standards of judicial review applied to director conduct outside the borders of *Revlon*-land? What standard applied to director conduct falling inside *Revlon*-land's borders? And when did one enter that mysterious country?

By the mid-1990s, the Delaware Supreme Court had worked out a credible set of answers to those questions.[10] The seemingly settled rules

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4. *See* Morton A. Pierce, *Mergers and Acquisitions in the 80's and 90's*, *in* CONTESTS FOR CORPORATE CONTROL 279, 288 (1997) ("The proxy contest is a way to bypass the board and enlist the help of stockholders to exert enough pressure on the board to obtain the desired result.").

5. Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 95 (Del. Ch. 2011) (noting that "traditionally the board has been given no statutory role in responding to a public tender offer").

6. *See* Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 521 (1992) (suggesting that "the fundamental governance question presented by unsolicited offers" is whether the "right to decide whether to accept or reject the offer resides with the shareholders or is it, like all other important policy questions, initially a decision for the board to make until it reveals itself to be disabled by self-interest").

7. The results of a search of the Westlaw DE-CS database identified the earliest judicial use of the term *Revlon*-land as the Delaware Supreme Court's decision in *Arnold v. Society for Savings Bancorp, Inc.*, 650 A.2d 1270 (Del. 1994), in which the court observed that terms like "*Revlon* duties" and "*Revlon*-land" were used "colloquially but inappropriately" to refer to "the enhanced scrutiny courts accord to certain types of [takeover] transactions." *Id.* at 1289 n.40.

8. 506 A.2d 173 (Del. 1986).

9. *Id.* at 182.

10. *See infra* Part II.D (discussing relevant precedents).

made doctrinal sense and were sound from a policy perspective.[11] Indeed, my thesis herein is that *Revlon* and its progeny should be praised for having grappled—mostly successfully—with the core problem of resolving the tension between authority and accountability. A fully specified account of corporate law must incorporate both values.[12]

Academic critics of Delaware's jurisprudence typically err because they are preoccupied with accountability at the expense of authority.[13] In contrast, or so I will argue, Delaware's takeover jurisprudence correctly recognizes that both authority and accountability have value.[14] Achieving the proper mix between these competing values is a daunting—but necessary—task, because authority and accountability cannot be reconciled.[15] Making corporate law therefore requires a careful balancing of these competing values. Striking such a balance is the peculiar genius of *Revlon* and its progeny.

In recent years, however, the Delaware Chancery Court has gotten lost in *Revlon*-land. A number of chancery decisions have drifted away from the doctrinal parameters laid down by the Delaware Supreme Court.[16] In this Article, I argue that they have done so because the Chancellors have misidentified the policy basis on which *Revlon* rests. Accordingly, I argue that chancery should adopt a conflict of interest–based approach to invoking *Revlon*, which focuses on where control of the resulting corporate entity rests when the transaction is complete.

In order to accurately map *Revlon*-land, some of the surrounding doctrinal territory must also be explored. Accordingly, Part I of this Article begins the analysis by contrasting the target board of directors' role in negotiated acquisitions, such as mergers or asset sales, with its role in hostile takeovers. Part I argues that the target board faces important conflicts of interest in both settings, but that the conflicts presented in the latter setting are especially significant. Because *Revlon* deals only with a subset of hostile takeover fights, Part I examines in some detail the Delaware Supreme Court's prior decision in *Unocal Corp. v. Mesa Petroleum Co.*,[17] which laid the broader doctrinal foundation on which *Revlon* rests. In addition, Part I explores the policy tensions the Delaware courts were forced to resolve in *Unocal* and its progeny.

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11. *See infra* Part II.C (discussing relevant precedents).

12. *See* Dooley, *supra* note 6, at 463–64 (arguing that "any feasible governance system must and does contain elements of both . . . Authority or Responsibility").

13. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 171–74 (1991) (arguing that there are systemic agency cost effects when management resists a takeover bid); Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 993–94 (2002) (discussing the role of the hostile takeover as a constraint on agency costs).

14. *See infra* Part II.D (summarizing Delaware law).

15. *See* Dooley, *supra* note 6, at 464 (noting that authority and accountability "are also antithetical, and more of one means less of the other").

16. *See infra* Part IV.

17. 493 A.2d 946 (Del. 1985).

Part II traces the development of *Revlon* up to the point in the mid-1990s at which the law seemed well settled. Part III maps *Revlon*-land as it had been carved out in that evolutionary process. In both parts, the Article argues that the end result of that process made both doctrinal logic and sound policy sense.

Part IV critiques the recent chancery court cases that have departed from the prescribed borders of *Revlon*-land. In it, the author argues that those cases are inconsistent with prior law and with sound policy.

I. *REVLON*'S ANTECEDENTS

Revlon and its progeny are a subset of the much larger body of takeover jurisprudence whose modern roots go back to *Unocal Corp. v. Mesa Petroleum Co.*[18] As a result, one of *Revlon*-land's critical landmarks is the location of the crossing point at which the case is no longer governed by *Unocal* but rather by *Revlon*.[19] Of course, one also is constrained to ask what, if anything, changes when directors morph from "defenders of the corporate bastion" into "auctioneers."[20] Accordingly, devoting some attention to both the policy questions the *Unocal* court faced and the evolution of the standard that the court developed to answer them is necessary to lay the foundation for the analysis of *Revlon* that follows.

A. Who Decides?

There is no more basic governance question than that of "who decides?" Or, put another way, which organizational constituent possesses the ultimate right of control?

Ownership and control rights typically go hand in hand. A principal is entitled to control his agent, for example.[21] Each partner is entitled to equal rights in the management of the partnership business.[22]

In the corporation, however, ownership and control are decisively separated. The Delaware General Corporation Law vests control in the board of directors, for example, by providing that the corporation's "business and affairs . . . shall be managed by or under the direction of a board of directors."[23] In contrast, the firm's owners—the shareholders—exercise virtually no control over either day-to-day operations or long-term

18. *Id.* For a discussion of Delaware's pre-*Unocal* takeover jurisprudence and the ways in which *Unocal* superseded it, see BAINBRIDGE, *supra* note 1, at 386–91 (describing the evolution of Delaware law).

19. *Cf.* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1150–51 (Del. 1989) (noting that, in some cases, "*Revlon* duties are not triggered, though *Unocal* duties attach" to the target's board of directors and managers). *See generally infra* note 214 and accompanying text (discussing *Revlon*-triggering events).

20. *See infra* note 217 and accompanying text (discussing whether the *Revlon* and *Unocal* standards differ).

21. *See* RESTATEMENT (THIRD) OF AGENCY § 8.09 (2006) (setting out an agent's duty to obey the principal).

22. UNIF. P'SHIP ACT § 4.01(a)(1) (1997).

23. DEL. CODE ANN. tit. 8, § 141(a) (2011).

policy.[24] Shareholder voting rights are limited to the election of directors and a few relatively rare matters such as approval of charter or bylaw amendments, mergers, sales of substantially all of the corporation's assets, and voluntary dissolution.[25] As a formal matter, moreover, only the election of directors and amending the bylaws do not require board approval before shareholder action is possible.[26] In practice, of course, even the election of directors (absent a proxy contest) is predetermined by virtue of the existing board's power to nominate the next year's board.[27] The shareholders' limited control rights thus are almost entirely reactive rather than proactive.[28]

The sharply "limited governance role assigned to shareholders is intentional and is, in fact, the genius of the corporate form."[29] This is so because, taken together, the rules empowering directors and disempowering shareholders create a board-centric form of corporate governance, in which the board of directors is not a mere agent of the shareholders, but rather is a *sui generis* body whose powers are original and nondelegated.[30] To be sure, the directors are obliged to use their powers toward the end of shareholder wealth maximization, but decisions as to how that end shall be achieved are vested in the board, not the shareholders.[31]

The prestigious American Bar Association's Committee on Corporate Laws, which has drafting responsibility for the widely adopted Model Business Corporation Act, recently affirmed that director primacy both is and ought to be the basic organizing principle of corporate law. The Committee explained that "the deployment of diverse investors' capital by

24. *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 6 (1932) (describing the effects of the separation of ownership and control). I use the term "ownership" here in its colloquial sense, while recognizing that, "[i]n the dominant nexus of contracts theory of the firm, ownership is not a meaningful concept because shareholders are simply one of the inputs bound together by this web of voluntary agreements." Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 4 n.9 (2002).

25. *See* MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 174–77 (1995) (summarizing state corporate law on shareholder voting entitlements).

26. *See* DEL. CODE ANN. tit. 8, §§ 109, 211 (setting forth shareholder rights).

27. *See* Bayless Manning, Book Review, 67 YALE L.J. 1477, 1485–89 (1958) (reviewing J.A. LIVINGSTON, THE AMERICAN STOCKHOLDER (1958)) (describing how incumbent directors control the proxy voting machinery).

28. *Cf. In re* CNX Gas Corp. S'holders Litig., 4 A.3d 397, 415 (Del. Ch. 2010) (holding that "director primacy remains the centerpiece of Delaware law, even when a controlling stockholder is present").

29. Michael P. Dooley, *Controlling Giant Corporations: The Question of Legitimacy*, *in* CORPORATE GOVERNANCE: PAST & FUTURE 28, 38 (Henry G. Manne ed., 1982).

30. The discussion of director primacy herein draws on earlier work, especially Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003).

31. *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself . . . .").

centralized management maximizes corporate America's ability to contribute to long-term wealth creation."[32] As the Committee further explained, the "board centric" model gives shareholders

> the regular opportunity to elect the members of the board, but during the directors' terms, the board has the power, informed by each director's decisions in the exercise of his or her fiduciary duties, to direct and oversee the pursuit of the board's vision of what is best for the corporation.[33]

The board of directors thus is an example of what Nobel laureate economist Kenneth Arrow identified as authority-based decision-making structures.[34] Such structures are characterized by the existence of a central agency to which all relevant information is transmitted and which is empowered to make decisions binding on the whole.[35] They tend to arise where the constituents of an organization have differing interests, there are information asymmetries among the constituents, and collective action problems make participatory democracy infeasible.[36]

The public corporation is a classic example of just such an organization. As my colleague Iman Anabtawi observes, "On close analysis, shareholder interests look highly fragmented."[37] She documents divergences among investors along multiple fault lines, such as short-term versus long-term investment horizons, diversified versus undiversified portfolios, inside versus outside shareholders, investors with social goals versus those with solely economic goals, and hedged versus nonhedged investors.[38] Even if that were not the case, moreover, shareholders would still face difficult collective action problems in making routine corporate decisions.[39]

Accordingly, the public corporation succeeded as a business organization form because it provides a hierarchical decision-making structure well suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs. In such a firm, someone must be in charge. "Under conditions of widely

32. COMM. ON CORPORATE LAWS OF THE AM. BAR ASS'N SECTION OF BUS. LAW, REPORT ON THE ROLES OF BOARDS OF DIRECTORS AND SHAREHOLDERS OF PUBLICLY OWNED CORPORATIONS (2010), *available at* http://www.hunton.com/media/SEC_Proxy/PDF/SEC_Agenda_Section2.PDF.

33. *Id.*

34. KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68–70 (1974).

35. *See id.* at 69 (providing examples of authority-based decision-making structures).

36. Bainbridge, *supra* note 30, at 557.

37. Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 564 (2006).

38. *See id.* at 577–93 (describing such differences in investor interests and preferences).

39. *See* Blake H. Crawford, *Eliminating the Executive Overcompensation Problem: How the SEC and Congress Have Failed and Why Shareholders Can Prevail*, 2 J. BUS. ENTREPRENEURSHIP & L. 273, 312 (2009) ("The collective action problem occurs when dispersed shareholders, who lack the power to make significant changes individually, remain passive in their decisions . . . ."); *cf.* Lewis v. Vogelstein, 699 A.2d 327, 338 (Del. Ch. 1997) (noting that courts "are not unmindful of the collective action problem faced by shareholders in public corporations").

dispersed information and the need for speed in decisions, authoritative control at the tactical level is essential for success."[40] As we have seen, corporate law rests that control in the board rather than the shareholders.

The ABA Committee justified that statutory allocation of control on somewhat different grounds, explaining that if board of director decisions were subjected to frequent shareholder review "the time and attention of managers could, in many cases, be diverted from activities designed to pursue sustainable economic benefit for the corporation."[41] In addition, the Committee expressed concern that broad shareholder decision-making powers might be abused by "particular shareholders who may have interests that diverge from those of other shareholders or interests other than sustainable economic benefit."[42] This concern was exacerbated in the Committee's view because noncontrolling "shareholders generally do not owe fiduciary duties to each other or the corporation," which meant that they could not be held responsible for how they used the levers of shareholder democracy.[43]

The core question posed in *Unocal* and its progeny is whether corporate takeovers present unique considerations justifying a less board-centric governance regime than that which thus pervades the rest of corporation law. As we shall see, the Delaware courts have concluded that they do not.[44] In my opinion, the Delaware courts have gotten it broadly right in so holding.[45]

B. The Board As Gatekeeper

In their efforts to decide who decides, the Delaware courts have grappled with the limits of a target corporation's board of directors' power to act as a gatekeeper in corporate acquisitions. In other words, to what extent can the target's board of directors prevent the target's shareholders from deciding whether the company should be acquired?

In a merger, two corporations combine to form a single entity.[46] In an asset sale, the selling corporation transfers all or substantially all of its

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40. ARROW, *supra* note 34, at 69.

41. COMM. ON CORPORATE LAWS, *supra* note 32, at 5.

42. *Id.*

43. *Id.*

44. *See infra* Part I.D (discussing *Unocal* and its progeny).

45. *See infra* Part I.E (discussing policy aspects of *Unocal*).

46. Under Delaware law, effecting this transaction requires four basic steps. First, an "agreement of merger" must be drafted, specifying the deal's terms and conditions, including the terms required by Delaware General Corporation Law § 251(b). DEL. CODE ANN. tit. 8, § 251(b) (2011). The board of directors must adopt a resolution approving the agreement. The shareholders then must approve the agreement. Unlike most corporate actions, which only require approval by a majority of those shares present and voting, a merger requires approval by a majority of the outstanding shares. Finally, either the agreement or a certificate of merger must be filed with the Secretary of State.

assets to the buyer. In both transactions, approval by the target board of directors is an essential precondition.[47]

In both major forms of statutory acquisitions, the board thus has a gatekeeping function. Shareholders have no power to initiate either a merger or asset sale, because the statute makes board approval a condition precedent to the shareholder vote.[48] If the board rejects a merger proposal, the shareholders thus have no right to review that decision.[49] Instead, the shareholder role is purely reactive, coming into play only once the board approves a merger proposal.[50]

> The board also has sole power to negotiate the terms on which the merger will take place and to enter a definitive merger agreement embodying its decisions. Shareholders have no statutory right to amend or veto specific provisions, their role typically being limited to approving or disapproving the merger agreement as a whole . . . .[51]

If the board disapproves of a prospective acquisition, the would-be acquirer therefore must resort to one of the nonstatutory acquisition devices. The proxy contest, share purchase, and tender offer all allow the bidder to bypass the target board and make an offer directly to the target's shareholders. Since the 1960s, the tender offer has been the most important and powerful of these tools.[52] Almost as soon as the hostile tender offer emerged as a viable acquirer tactic, however, lawyers and investment bankers working for target boards began to develop defensive tactics designed to impede such offers.[53] If validated by the courts, these takeover defenses promised to reassert the board's primacy by extending its gatekeeping function to the nonstatutory acquisition setting.

Consider the poison pill, for example, which has been called the "*de rigeur* tool of a board responding to a third-party tender offer."[54] Poison pills take a wide variety of forms, but most are based on a form of security known as a right.[55] Traditional rights are issued by corporations in forms

47. *See id.* § 251(b) (imposing requirement of board approval of a merger); *id.* § 271 (setting forth requirements for asset sale).

48. Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239, 259 (1990).

49. *See id.* at 259 n.83 (explaining that "the rejection decision [is] vested in the unilateral discretion of the board of directors").

50. *Id.* at 259.

51. *Id.*

52. *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, 276 (2001) (noting "the widespread use of the cash tender offer in the 1960s and the rise in prominence of hostile takeovers in subsequent decades").

53. For an overview of takeover defenses, see BAINBRIDGE, *supra* note 1, at 376–86.

54. *In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 431 (Del. Ch. 2002).

55. BAINBRIDGE, *supra* note 1, at 379. The Delaware General Corporation Law authorizes corporations to "create and issue . . . rights or options entitling the holders thereof to acquire from the corporation any shares of its capital stock of any class or classes, such rights or options to be evidenced by or in such instrument or instruments as shall be approved by the board of directors." DEL. CODE ANN. tit. 8, § 157(a) (2011).

giving the holder the option to buy stock in the issuer on specified terms.[56] In contrast, the poison pill has no real financing purpose.[57] Instead, it is intended to prohibitively raise the cost of acquiring the issuer without the consent of its board.[58] In order to do so, the pill includes three additional elements not found in traditional rights: a flip-in element, a flip-over element, and a redemption provision.[59]

The pill's flip-in element is triggered by the acquisition by a potential bidder of some specified percentage of the issuer's common stock.[60] If triggered, the flip-in pill entitles the holder of each right—except the potential bidder and its affiliates or associates—to buy authorized but unissued shares of the target issuer's common stock or other securities at a substantial discount from the market price.[61] The deterrent effect of such a flip-in pill arises out of the massive dilution the pill causes to the value of the target stock owned by an unwanted acquirer.[62]

The pill's flip-over feature typically is triggered if, following the acquisition of a specified percentage of the target's common stock, the target is subsequently merged into the acquirer or one of its affiliates.[63] In such an event, the holder of each right becomes entitled to purchase common stock of the acquiring company, at a substantial discount to market, thereby impairing the acquirer's capital structure and drastically diluting the interest of the acquirer's other stockholders.[64]

Because the rights trade separately from the issuer's common stock, an acquirer remains subject to the pill's poisonous effects even if an overwhelming majority of the target's shareholders accept the bidder's tender offer.[65] In the face of a pill, a prospective acquirer thus has a strong incentive to negotiate with the target's board. Pills therefore include a redemption provision pursuant to which the board may redeem the rights at

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56. *See* WILLIAM A. KLEIN ET AL., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 295 (11th ed. 2010) (describing stock rights); *see also* Grimes v. Alteon, Inc., 804 A.2d 256, 264–65 (Del. 2002) (holding that the term "right" as used in section 157 includes but is not limited to "options or option-like transactions").

57. *See* Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 440 n.135 (1998) (explaining that "one of the criticisms of the 'poison pill' was . . . that [it] had no economic substance . . . unless and until a hostile acquisition or some other defined triggering event occurred").

58. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1369 n.6 (Del. 1995) (explaining that a poison pill "dilutes the would-be acquiror's stake in the company and increases the costs of acquisition").

59. *See* KLEIN, *supra* note 56, at 196 (describing these elements). Note that the board of directors adopts the pill by resolution without any shareholder action. *Id.*

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.*

65. *See, e.g.*, Grand Metro. Pub. Ltd. v. Pillsbury Co., 558 A.2d 1049, 1051 n.2 (Del. Ch. 1988) (explaining that, if triggered, Pillsbury's poison pill would have reduced Grand Met's interest in Pillsbury from 85 to 56 percent and cut the value of Grand Met's Pillsbury holdings by more than $700 million dollars).

a nominal price at any time prior to the right being exercised if a friendly deal can be negotiated.[66] Proponents of pills contend that these plans thus do not deter takeover bids, but rather simply give the target board leverage to negotiate the best possible deal for their shareholders or to find a competing bid.[67] In any case, it is clear that "the poison pill has made the board the 'gatekeeper' instead of the shareholders."[68] As a result, target boards have been empowered to play an active—and often determinative—role in the very class of transactions originally designed to bypass them entirely.

C. The Target Board's Conflict of Interest

Corporate law's allocation of primary responsibility for negotiating a merger agreement to the target's board of directors[69] is sound policy. The board knows much more than its shareholders about the company's business goals and opportunities.[70] The board also knows more about the extent to which a proposed merger would promote accomplishment of those goals.[71] In addition to this information asymmetry, the familiar array of collective action problems that plague shareholder participation in corporate decision making obviously preclude any meaningful role for shareholders in negotiating a merger agreement.[72] Taken together, these factors justify corporate law's allocation of the sole power to negotiate mergers to the board. It also justifies the requirement that shareholders vote on the merger agreement as a whole, rather than allowing them to approve or disapprove specific provisions.

As with any conferral of plenary authority, the board's power to make decisions about negotiated acquisitions gives rise to the potential for abuse. Because the target's board of directors must approve a merger proposal before the transaction is submitted for shareholder approval, the bidder at the very least may have to compensate the incumbents for the loss of the rents associated with their offices, thereby reducing the amount that can be

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66. *See* KLEIN, *supra* note 56, at 196 (describing redemption provisions).

67. *See id.* (describing purported purpose of the pill).

68. Wayne O. Hanewicz, *When Silence Is Golden: Why the Business Judgment Rule Should Apply to No-Shops in Stock-for-Stock Merger Agreements*, 28 J. CORP. L. 205, 237 (2003).

69. *See supra* notes 48–51 and accompanying text (discussing relevant statutes and case law).

70. *See* Stephen M. Bainbridge, *Is "Say on Pay" Justified?*, 32 REG. 42, 47 (2009) ("Whatever flaws board governance may have, they pale in comparison to the information asymmetries and collective action problems that lead most shareholders to be rationally apathetic.").

71. *See, e.g.*, 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, 1198–99 (1981) (arguing that corporate law grants the board decision-making authority because the directors have a competitive advantage over the shareholders in choosing between competing alternatives).

72. *See In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 619 (Del. Ch. 2005) ("A good board is best positioned to extract a price at the highest possible level because it does not suffer from the collective action problem of disaggregated stockholders.").

paid to the target shareholders for the sale of the firm. In addition, the bidder may seek to purchase the board's cooperation by offering directors and/or senior managers side payments, such as an equity stake in the surviving entity, employment or noncompetition contracts, substantial severance payments, continuation of existing fringe benefits, or other compensation arrangements.[73] Although it is undoubtedly rare for side payments to be so large as to materially affect the price the bidder would otherwise be able to pay target shareholders, side payments may affect target board decision making by inducing the board to agree to an acquisition price lower than that which could be obtained from hard bargaining or open bidding.[74] At the extreme, moreover, incumbents may be unwilling to surrender their positions on any terms that are acceptable to the bidder.

Despite this well-known conflict of interest, the Delaware cases consistently apply the business judgment rule to board decisions to approve a merger.[75] This judicial hesitation to second-guess board merger decisions is also sound policy, reflecting an appropriate balance between the competing claims of authority and accountability.

Most corporate law scholars "believe that the fundamental concern of corporate law is 'agency costs.'"[76] To be sure, this belief has a hallowed pedigree. After all, Berle and Means famously claimed that "the separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear."[77] Noted economists Jensen and Meckling, moreover, subsequently formalized this concern by developing the concept of agency costs.[78]

73. *See, e.g.*, Samjens Partners I v. Burlington Indus., Inc., 663 F. Supp. 614, 617, 620 (S.D.N.Y. 1987) (white knight offered target management equity stake); Singer v. Magnavox Co., 380 A.2d 969, 971 (Del. 1977) (target directors offered employment contracts); Gilbert v. El Paso Co., 490 A.2d 1050, 1052 (Del. Ch. 1984) (plaintiff alleged tender offeror modified bid to benefit target managers).

74. Pupecki v. James Madison Corp., 382 N.E.2d 1030, 1031–32 (Mass. 1978) (plaintiff claimed that consideration for sale of assets was reduced due to side-payments to controlling shareholder); Barr v. Wackman, 329 N.E.2d 180, 184 (N.Y. 1975) (plaintiff claimed target directors agreed to low acquisition price in exchange for employment contracts). In many cases, there may also be at work "a force more subtle than a desire to maintain a title or office in order to assure continued salary or prerequisites," as where managers' self-identity is wrapped up in their employer. Paramount Commc'ns, Inc. v. Time Inc., 1989 WL 79880, at *715 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1990).

75. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

76. Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283, 295 (1998).

77. BERLE & MEANS, *supra* note 24, at 6.

78. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). Agency costs are defined as the sum of the monitoring and bonding costs, plus any residual loss, incurred to prevent shirking by agents. *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983). In turn, shirking is defined to include any action by a member of a production team that diverges from the interests of the

Granted, deterrence and punishment of misconduct by the board and senior management is a necessary function of corporate governance.[79] Accountability standing alone, however, is an inadequate normative account of corporate law.[80] In order for corporations to be governed efficiently and effectively, deference must be paid to the corporation's authority-based decision-making structure. Because corporate law could substantially reduce agency costs by eliminating the board's discretionary powers, but has chosen not to do so, it is reasonable to infer that substantial efficiency gains follow from vesting the board with discretionary authority. A complete theory of the firm therefore requires one to balance the virtues of discretion against the need to require that discretion be used responsibly.[81]

The problem is that achieving an appropriate mix between authority and accountability is a daunting task. Ultimately, authority and accountability cannot be reconciled. At some point, greater accountability necessarily makes the decision-making process less efficient, while highly efficient decision-making structures necessarily entail nonreviewable discretion. This is so because, as Arrow observed, "If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem."[82]

Shareholder oversight of board decisions—whether through the vote or in courts—would effect just such a shift. Such oversight necessarily contemplates outside review of management decisions, with shareholders or judges stepping in to make corrections and changes when management performance falters. If shareholders could easily obtain such reviews, directors likely would be more accountable to them, but the board's powers would become merely advisory rather than authoritative. The efficient separation of ownership and control that makes the modern corporation possible thus is inconsistent with routine shareholder—or judicial—review of board decisions.

The importance corporate law places on deference to the board's authority is forcefully illustrated by the classic decision in *Bayer v. Beran*,[83] which held that the business judgment rule exists so as to "encourage freedom of action on the part of directors, or to put it another way, to

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team as a whole. As such, shirking includes not only culpable cheating, but also negligence, oversight, incapacity, and even honest mistakes. Dooley, *supra* note 6, at 465.

79. The discussion herein of the tradeoff between authority and accountability again draws on earlier work. *See* Bainbridge, *supra* note 30, at 572–73.

80. *See* Dooley, *supra* note 6, at 463 (arguing that neither authority nor accountability standing alone "could provide a sensible guide to the governance of firm-organized economic activity because each seeks to achieve a distinct and separate value that is essential to the survival of any firm. Accordingly, any feasible governance system must and does contain elements of both.").

81. *See id.* at 471 (arguing that the business judgment rule reflects a tension between "conflicting values" that Dooley refers to as "[a]uthority" and "[r]esponsibility").

82. ARROW, *supra* note 34, at 78.

83. 49 N.Y.S.2d 2 (Sup. Ct. 1944).

discourage interference with the exercise of their free and independent judgment."[84] Accordingly, business decisions are:

> [L]eft solely to [the directors'] honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.[85]

At the same time, however, *Bayer* also recognized the key limitation on judicial deference to the board's authority, in that "[t]he 'business judgment rule' . . . yields to the rule of undivided loyalty. This great rule of law is designed 'to avoid the possibility of fraud and to avoid the temptation of self-interest.'"[86]

Where the directors' decision is tainted by the potential for considerations other than shareholder wealth to drive their choice, as where the directors will be tempted to engage in self-dealing, the question is no longer one of honest error but of intentional misconduct. The affirmative case for disregarding honest errors simply does not apply to intentional misconduct.[87] To the contrary, given the potential for self-dealing in an organization characterized by a separation of ownership and control, the risk of legal liability may be a necessary deterrent against such misconduct.[88] As former Delaware Chief Justice Veasey observed, "[I]nvestors do not want self-dealing directors or those bent on entrenchment in office. . . . Trust of directors is the key because of the self-governing nature of corporate law. Yet the law is strong enough to rein in directors who would flirt with an abuse of that trust."[89]

The law is able to defer to most director decisions because agency costs are adequately constrained by market and other extralegal forces. Although the partition admittedly is somewhat artificial, it is useful to begin the defense of that proposition with the distinction between judicial review of operational issues and structural choices, especially those creating a final period situation, such as takeovers.[90]

Operational decisions appropriately receive much less probing review than do decisions relating to final period transactions.[91] This is so because most operational decisions do not pose much of a conflict between the interests of directors and shareholders. In game theory terminology,

84. *Id.* at 6.

85. *Id.* (quoting Pollitz v. Wabash R. Co., 100 N.E. 721, 724 (N.Y. 1912)).

86. *Id.* (quoting *In re* Ryan's Will, 52 N.E.2d 909, 912 (N.Y. 1943)).

87. *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 266–67 (2002) (discussing the differences between self-dealing and errors of judgment).

88. *See id.* at 306–07 (discussing the necessity for judicial review of loyalty issues).

89. E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 BUS. LAW. 681, 694 (1998).

90. *See* E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 394 (1997) (drawing a similar distinction between "enterprise" and "ownership" decisions).

91. *See* BAINBRIDGE, *supra* note 87, at 284–86 (discussing precedents).

operational decisions take place in a board-shareholder relationship consisting of an ongoing series of repeat transactions.[92] In repeat game settings, the actors' decisions are constrained by the threat that cheating in one turn will be punished by the other party in future turns. To be sure, shareholder discipline is not a very important check on directorial self-dealing, for the reasons we have already discussed.[93] Yet, shareholder voting is just one of an array of extrajudicial constraints that, in totality, incentivize directors to exercise reasonable care in decision making. In particular, directors and managers are subject to important constraints imposed by the product and job markets.[94] True, these constraining forces do not eliminate the possibility of director error. The directors will still err from time to time. That is precisely the sort of error, however, that the courts traditionally—and appropriately—eschew reviewing.

In contrast, structural decisions—such as corporate takeovers—present a final period problem entailing an especially severe conflict of interest. Even so, however, in an arm's-length merger, the board's potential conflict of interest is again policed by a variety of extralegal constraints. First, independent directors and shareholders must be persuaded to approve the transaction.[95] Second, ill-advised acquisitions are likely to cause the acquiring firm problems in the capital markets, which may constrain its willingness to divert gains from target shareholders to the target's board and managers.[96]

Third, and even more important, negotiated acquisitions are subject to the constraining influences of the market for corporate control. Where the target's board accepts a low initial offer, a second bidder may succeed by offering shareholders a higher-priced alternative.[97] Of course, the competing bidder's transaction cannot be structured as a merger or asset sale if it is unable to persuade target management to change sides. Even so, the intervener has a formidable alternative in the tender offer, which provides a safety valve by eliminating the need for target board cooperation

92. *Id.*

93. *See supra* notes 23–28 and accompanying text.

94. *See* Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987) (arguing that "competition in the product and labor markets and in the market for corporate control provides sufficient punishment for businessmen who commit more than their share of business mistakes"); Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 429 (2005) ("As members of these various communities, directors have strong incentives to perform their duties in a manner that does not damage their reputation within these communities.").

95. *Cf.* Schoon v. Smith, 953 A.2d 196, 207 (Del. 2008) ("Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.").

96. *Cf.* Mark L. Mitchell & Kenneth Lehn, *Do Bad Bidders Become Good Targets?*, 98 J. POL. ECON. 372 (1990) (documenting that firms that overpay in acquisitions frequently become targets for other acquirers).

97. *Cf.* Heath Price Tarbert, *Merger Breakup Fees: A Critical Challenge to Anglo-American Corporate Law*, 34 LAW & POL'Y INT'L BUS. 627, 633 (2003) (explaining that "second bidders usually succeed").

by permitting the bidder to buy a controlling share block directly from the stockholders.[98]

In a hostile acquisition, the prospective acquirer must bypass the board from the outset. In the absence of the poison pill or other takeover defenses, however, any conflicted interests on the part of target directors or managers are mitigated because shareholders are free to sell or not as they see fit. Where the target deploys a pill or takes other defensive actions, those actions are inevitably tainted by the specter of self-interest.[99] Unlike the negotiated takeover, moreover, there is no market safety valve. It was precisely this policy concern that motivated the Delaware Supreme Court to adopt the more intrusive *Unocal* standard of review for dealing with defenses against unsolicited takeovers.

D. Unocal

Target board resistance to an unsolicited takeover bid presented the Delaware Supreme Court with a difficult doctrinal choice. Whether the problem is framed as a question of care or of loyalty has vital—indeed, potentially outcome determinative—consequences.[100] If the court invoked the duty of loyalty, with its accompanying intrinsic fairness standard of review, the defendant directors would be required—subject to close and exacting judicial scrutiny—to establish that the transaction was objectively fair to the corporation.[101] Because this burden is an exceedingly difficult one to bear, takeover defenses would rarely pass muster.[102] Accordingly, a court should treat resistance to unsolicited takeovers as implicating the board's duty of loyalty only if it concludes that takeover defenses are almost per se adverse to shareholder interests.

On the other hand, if the court treated takeover defenses as a care question, plaintiff would have to rebut the business judgment rule's presumptions by showing that the decision was tainted by fraud, illegality,

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98. *See supra* notes 52–53 and accompanying text (explaining how a tender offer allows an acquirer to bypass the target's board).

99. *Dynamics Corp.*, 794 F.2d at 256 ("When managers are busy erecting obstacles to the taking over of the corporation by an investor who is likely to fire them if the takeover attempt succeeds, they have a clear conflict of interest, and it is not cured by vesting the power of decision in a board of directors in which insiders are a minority . . . .").

100. *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1988) (recognizing that the choice of duty of care versus duty of loyalty would be outcome determinative); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) (same).

101. *See* Robert M. Bass Grp., Inc. v. Evans, 552 A.2d 1227, 1239 (Del. Ch. 1988) (discussing the relevant standard of review); *cf.* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 722 (Del. 1971) (discussing the application of the intrinsic fairness standard to fiduciary duties of majority shareholders).

102. *Cf.* Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993) (explaining that the court's decision to apply entire fairness standard of review in cases implicating the duty of loyalty invokes a standard so exacting that it frequently, albeit not always, results in a finding of liability).

self-dealing, or some other exception to the rule.[103] Absent the proverbial smoking gun, plaintiff is unlikely to prevail under this standard.[104] A duty of care analysis thus makes sense only if one thinks management resistance to takeovers is almost always constrained so as to ameliorate the conflict of interest inherent therein.

In *Unocal*, the Delaware Supreme Court attempted to steer a middle course by promulgating what has been called an "intermediate" or "enhanced business judgment" standard of judicial review, but is perhaps best described as a "conditional business judgment rule."[105] In *Unocal*, famed corporate raider T. Boone Pickens's Mesa Petroleum Company, whom the court referred to as having "a national reputation as a 'greenmailer,'"[106] made an unsolicited, structurally coercive two-tier takeover bid for Unocal.[107] In response, Unocal's board of directors authorized the company to make a discriminatory self-tender offer for its own stock.[108] Mesa sued, arguing that Unocal's board of directors had breached its fiduciary duties.

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103. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (stating that the business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company").

104. *See* Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982) ("[T]he fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labeled the business judgment rule."), *cert. denied sub nom.* Citytrust v. Joy, 460 U.S. 1051 (1983).

105. DOOLEY, *supra* note 25, at 547.

106. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 956 (Del. 1985).

107. Pickens initially acquired 13 percent of Unocal's voting stock through his main corporate vehicle, Mesa Petroleum. *Id.* at 949. Mesa thereafter launched what the court called "a two-tier 'front loaded' cash tender offer for 64 million shares, or approximately 37 percent, of Unocal's outstanding stock at a price of $54 per share." *Id.* If that offer succeeded, the second-tier transaction would consist of a freeze-out merger to eliminate the remaining shares, in which the consideration would be junk bonds ostensibly worth $54 per Unocal share. *See id.* (describing the "back-end" transaction).

Mesa's offer is now regarded as being "structurally coercive." Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 259 (1989). To simplify the problem, suppose Target's pre-bid stock price was $50. Bidder 1 makes a two-tier offer with differing prices: $80 cash in the first-step tender offer and $60 cash in the second step freeze-out merger. Assuming the first-step tender offer seeks 50 percent of the shares plus one, the blended offer price is $70 with a blended premium of $20 per share (calculated by taking the weighted average of the two steps). Bidder 2 offers $75 in cash for any and all shares tendered, a premium of $25 per share. As a group, shareholders are better off with Bidder 2. Yet, Bidder 1's offer creates a prisoners' dilemma. Those shareholders who "cheat," by taking Bidder 1's front-end offer, end up with $80 rather than $75. With a large noncohesive group in which defectors bear no cost—such as shame or reprisals—rational investors should defect. Because everyone's individual incentive is to defect, the shareholders end up with the offer that is worst for the group. Mesa's offer differed from this example by offering the same price in both steps, but the far less attractive form of consideration to be paid in the second step would have similarly coercive effects.

108. *Unocal*, 493 A.2d at 951. The offer was discriminatory because Pickens could not tender into it. *Id.* Under Unocal's counter offer, if Mesa's front-end tender offer succeeded in giving Mesa a majority of Unocal's stock, Unocal would repurchase the remaining

In rejecting Mesa's claims, the Delaware Supreme Court reaffirmed the target board's general decision-making primacy, while also reaffirming the board's obligation to determine whether the offer is in the best interests of the shareholders.[109] In light of the board's potential conflict of interest vis-à-vis the shareholders, however, judicial review was to be somewhat more intrusive than under the traditional business judgment rule.[110]

Unocal thus affirmed that the target board of directors has not just the power but also the "fiduciary duty to act in the best interests of the corporation's stockholders," which sometimes may include resistance to an unsolicited takeover bid.[111] The board's powers in this regard, however, "are not absolute."[112] Accordingly, the target's board "does not have unbridled discretion to defeat any perceived threat by any Draconian means available."[113]

The initial burden of proof is on the target's board of directors, which must show that they had reasonable grounds for believing that a danger to corporate policy or effectiveness was posed by the unsolicited takeover bid.[114] The board satisfies that burden "by showing good faith and reasonable investigation."[115]

Assuming the directors carry this initial burden, they next must prove that the defense was "reasonable in relationship to the threat posed" by the

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minority shares with debt securities worth $72. *Id.* It would leave the company drained of significant assets and burdened by substantial debt, albeit still "a viable entity." *Id.* at 950.

109. *See id.* at 954 ("When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders.").

110. *Id.* ("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.").

111. *Id.* at 955; *see also* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1152 (Del. 1989) ("We have repeatedly stated that the refusal to entertain an offer may comport with a valid exercise of a board's business judgment.").

112. *Unocal*, 493 A.2d at 955.

113. *Id.*

114. *Id.* ("In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership."). In addition, *Unocal* requires proof that the target's board of directors had the authority under the governing statutes and the corporation's organic documents to take the specific action in question. Moran v. Household Int'l, Inc., 500 A.2d 1346, 1350–51 (Del. 1985).

115. *Unocal*, 493 A.2d at 955 (quoting Cheff v. Mathes, 199 A.2d 548, 555 (Del. 1964)). This standard requires, inter alia, a showing that the directors acted in response to a perceived threat to the corporation and not for the purpose of entrenching themselves in office. *See id.* (holding that the target board must show that it "had reasonable grounds for believing that a danger to corporate policy and effectiveness existed"). The reasonable investigation element requires a demonstration that the board was adequately informed, with the relevant standard being one of gross negligence. *See* CRTF Corp. v. Federated Dep't Stores, Inc., 683 F. Supp. 422, 437 (S.D.N.Y. 1988) (interpreting Delaware precedents to require the court to "consider whether the Board made an 'informed' decision based on reasonable investigation, considered under a standard of gross negligence").

hostile bid.[116] If the directors meet this two-step burden, the business judgment rule applies, but if the directors fail to carry their initial burden, the duty of loyalty's intrinsic fairness test applies.[117]

E. Evaluating Unocal

Many academic commentators have argued that target directors should have a modest gatekeeping role—if any—in unsolicited takeovers. Professors Frank Easterbrook and Daniel Fischel, for example, went to the extreme of proposing that complete passivity should be required of incumbent directors and managers of a target company in the face of an unsolicited offer.[118] In *Unocal*, however, the Delaware Supreme Court explicitly rejected Easterbrook and Fischel's passivity approach.[119]

Given the Delaware courts' "normal sensitivity to conflicts of interest"[120] and the undeniable fact that a passivity rule would do a more thorough job of constraining the board's conflicted interests than does *Unocal*, is it surprising Delaware courts rejected passivity and adopted a standard permitting target resistance?[121] Analysis should begin with the proposition that all doctrinal responses to corporate conflict of interest transactions have two features in common. First, so long as the board of directors is disinterested and independent, it retains full decision-making authority with respect to the transaction.[122] Second, the board's independence and

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116. *Unocal*, 493 A.2d at 955. Note that both the decision to adopt and any subsequent decision to implement a set of takeover defenses are subject to challenge and judicial review. *See Moran*, 500 A.2d at 1354. In *Moran v. Household Int'l, Inc*., plaintiffs sued when the target first adopted a poison pill, before any takeover bid had been made. The court upheld the pill as valid, but explained:

> When the Household Board of Directors is faced with a tender offer and a request to redeem the [pill], they will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism, the same standard as they were held to in originally approving the [pill].

Id. at 1354. In *Hills Stores Co. v. Bozic*, 769 A.2d 88 (Del. Ch. 2000), the chancery court explained that:

> Delaware case law has assured stockholders that the fact that the court has approved a board's decision to put defenses in place on a clear day does not mean that the board will escape its burden to justify its use of those defenses in the heat of battle under the *Unocal* standard.

Id. at 106–07.

117. *See* Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 257, 271 (Del. Ch. 1989).

118. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982); Easterbrook & Fischel, *supra* note 71. For a critique of Easterbrook and Fischel's argument that takeovers have systemic effects generating social welfare from both *ex ante* and *ex post* perspectives, see BAINBRIDGE, *supra* note 87, at 697–700, 715–18.

119. *Unocal*, 493 A.2d at 955 n.10 (noting academic suggestions that "a board's response to a takeover threat should be a passive one," the court opined that "that clearly is not the law of Delaware").

120. Dooley, *supra* note 6, at 515.

121. *See id.* (noting that "many have been perplexed and some dismayed by the [Delaware] courts' refusal to ban or at least severely limit target board resistance").

122. *See id.* at 488.

decision-making process is subject to judicial scrutiny.[123] Corporate law thus neither prohibits transactions nor requires complete board passivity in connection with them simply because they potentially involve conflicts of interest. Instead, it regulates them in ways designed to constrain self-interested behavior. *Unocal* simply brought these well-established rules to bear on the conflicts of interest created by target resistance to unsolicited offers.[124] Unless one believes that the conflict of interest inherent when boards choose to resist an unsolicited offer differs in kind rather than just degree from other conflicted interests, there was no need to develop a radically different set of rules to deal with such resistance.[125]

II. *REVLON* AND PROGENY

In *Revlon*, the Delaware Supreme Court was obliged to determine whether the *Unocal* standard applied to so-called deal protection devices. These corporate finance tools come into play in two basic situations. First, they may be used in a negotiated acquisition to deter competitive bids.[126] Second, in corporate control contests, such as the one that took place in *Revlon*, they may be used to ensure that a white knight prevails over the hostile bidder.[127]

A. Revlon

In response to an unsolicited tender offer by Pantry Pride, Revlon's board undertook a variety of defensive measures, including a variant on a poison pill.[128] When Pantry Pride responded not by giving up on its effort to acquire Revlon, but by increasing the price per share it was prepared to offer, Revlon's board responded by authorizing management to pursue negotiations with other prospective bidders.[129] The search for a white knight culminated in an agreement between Revlon and leveraged buyout-

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123. *See id.* at 488–90.

124. The point is well illustrated by the Delaware Supreme Court's decision in *Williams v. Geier*, 671 A.2d 1368 (Del. 1996), in which an antitakeover dual class stock plan received approval by the disinterested shareholders. In light of the shareholder action, the court held that the *Unocal* standard was "inapplicable here because there was no unilateral board action." *Id.* at 1377. In other words, as with all other conflicted-interest transactions, shareholder approval provides substantial protection from judicial review for the board's decision, which in turn confirms that *Unocal* can be situated in Delaware's set of conflict of interest doctrines.

125. For an argument that the conflict of interest created by resistance to an unsolicited offer does not differ in kind from other conflicted-interest transactions, see BAINBRIDGE, *supra* note 87, at 712–15.

126. *See* BAINBRIDGE, *supra* note 87, at 349–51 (discussing exclusivity provisions).

127. *See id.* at 385–86 (discussing the use of lockup options to deter or end competitive bidding). "In corporation law parlance, a 'white knight' is a friendly alternative partner who rescues the target company from the purported clutches of a hostile bidder." Gilbert v. El Paso Co., 575 A.2d 1131, 1136 n.12 (Del. 1990).

128. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (1986) (discussing Revlon's "first relevant defensive measure . . . , which would be considered a 'poison pill'").

129. *Id.* at 182.

specialist Forstmann Little, which included a lockup arrangement, as well as other measures designed to prevent Pantry Pride's bid from prevailing.[130]

The Delaware Supreme Court reviewed (and upheld) Revlon's initial defensive tactics using standard *Unocal* analysis.[131] In turning to the lockup arrangement, however, the court struck out in a new direction:

> 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 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. This significantly altered the board's responsibilities under the *Unocal* standards. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. 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.[132]

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130. *See id.* at 175 (describing exclusivity terms in the Revlon-Forstmann agreement). Broadly defined, the term "lock up" includes any agreement between a target and a prospective acquirer intended to prevent or end competitive bidding. Bainbridge, *supra* note 48, at 250. More commonly, however, the term is used to refer to so-called "lock-up options," which consist of agreements granting a prospective acquirer an option to buy shares or assets of the target. *Id.*

In *Revlon*, the agreement in question was a lockup option pursuant to which Forstmann would be entitled "to purchase Revlon's Vision Care and National Health Laboratories divisions for $525 million, some $100–$175 million below the value ascribed to them by Lazard Freres, if another acquiror got 40% of Revlon's shares." *Revlon*, 506 A.2d at 178. In *Revlon*, the lockup's deterrent effect thus consisted of the substantial discount Forstmann would receive. In most cases, however, the lockup's deterrent effect arises because "the subject of the option is usually either the assets most desired by a competing bidder or those essential to the target's operations." Bainbridge, *supra* note 48, at 251. Accordingly, asset lockup options are also known as "crown jewel options," because the asset subject to the option is the target's most valuable or desirable asset. *Id.*

Stock lockups consist of agreements by which the target gives a favored bidder an option to purchase authorized but unissued target shares. *Id.* at 250. The risk that the option will be exercised, thereby driving up the number of shares that must be acquired in order to obtain control and thus increasing the overall acquisition cost, is intended to deter competing bids. *Id.* at 250–51. In addition, if the option is exercised prior to the shareholder vote on the merger agreement, the favored bidder can vote the additional shares in favor of the merger, helping to assure that the requisite approval will be obtained. *Id.* at 251. Finally, if a competing bidder emerges and prevails, "the favored bidder can exercise the option and sell the additional shares on the open market or tender them to the successful bidder, thereby" at least recouping some of the costs incurred in the losing acquisition effort. *Id.*

Lock-up options find use in both negotiated and hostile acquisitions. In the former case, they are a powerful supplement to exclusive merger agreements, both deterring competitive bidding and pressuring shareholders to approve the favored bidder transaction. *See id.* at 287–89 (discussing coercive effects of lockup options). In the latter, they can be used to end competitive bidding by locking up the deal for the favored bidder. *See Revlon*, 506 A.2d at 183 (noting that lock ups can "end an active auction and foreclose further bidding").

131. *See Revlon*, 506 A.2d at 180–81 (discussing *Unocal*'s application to Revlon's initial defensive moves).

132. *Id.* at 182.

Because the lockup ended the auction in return for minimal improvement in the final offer, it was invalidated.[133]

B. Initial Progeny

Thus was born the jurisprudential territory that came to be known as *Revlon*-land. Finding one's way around it proved surprisingly troublesome. For example, did *Revlon* establish special duties to govern control auctions, or are the so-called "*Revlon* duties" really just the general *Unocal* rules applied to a special fact situation? The courts waffled on this issue, although the latter interpretation ultimately prevailed.[134]

Whether the *Revlon* duties are distinct or just a subset of *Unocal* does not address what exactly directors are supposed to do once their role changes from "defenders of the corporate bastion to auctioneers." Prior to the pivotal *Paramount* decisions discussed below,[135] a few things seemingly could be said with confidence. It was clear, for example, that target directors need not be passive observers of market competition.[136] The board's objective, however, "must remain the enhancement of the bidding process for the benefit of the stockholders."[137]

Finally, when did directors stop being "defenders of the corporate bastion" and become "auctioneers"? Again, prior to the *Paramount* decisions, it seemed well settled that the auctioneering duty is triggered when (but apparently only when) a proposed transaction would result in a change of control of the target corporation. For example, if a defensive recapitalization, which most of these cases involved, transferred effective voting control to target management or some other identifiable control block, the courts treated the transaction as a "change in control" of the corporation requiring adherence to *Revlon*'s auction rule.[138] If no

133. *See id.* at 183–84 (discussing the lockup's impermissible "destructive effect on the auction process . . . in return for very little actual improvement in the final bid").

134. In 1987, for example, the Delaware Supreme Court drew a rather sharp distinction between the *Unocal* standard and what it then called "the *Revlon* obligation to conduct a sale of the corporation." Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1338 (Del. 1987). Two years later, however, the court indicated that *Revlon* is "merely one of an unbroken line of cases that seek to prevent the conflicts of interest that arise in the field of mergers and acquisitions by demanding that directors act with scrupulous concern for fairness to shareholders." Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989).

135. *See infra* Part II.C.

136. CRFT Corp. v. Federated Dep't Stores, Inc., 683 F. Supp. 422, 441 (S.D.N.Y. 1988) (applying Delaware law).

137. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1287 (Del. 1989). Directors did not need to blindly focus on price to the exclusion of other relevant factors. *See* Cottle v. Storer Commc'n, Inc., 849 F.2d 570, 577 (11th Cir. 1988). The board could evaluate offers on such grounds as the proposed form of consideration, tax consequences, firmness of financing, antitrust or other regulatory obstacles, and timing. *Id.*

138. *See Mills Acquisition Co.*, 559 A.2d at 1285 (holding that the requisite "sale" could take "the form of an active auction, a management buyout, or a 'restructuring'"); *see also* Robert M. Bass Grp., Inc. v. Evans, 552 A.2d 1227, 1243 (Del. Ch. 1988); *cf.* Black & Decker Corp. v. Am. Standard, Inc., 682 F. Supp. 772, 781 (D. Del. 1988) (reading Delaware law to require the directors of a company to maximize the amount received by shareholders

identifiable control block formed (or changed hands), however, defensive measures were subject solely to standard *Unocal* review.[139]

C. Paramount *Law*

The evolution of the *Revlon* doctrine—and that of *Unocal*, for that matter—took major leaps in a pair of cases involving Paramount Communications. Taken together, they laid out a basic geography of *Revlon*-land that persists to this day. They also confirm that analysis of the board's motives remains a critical guide to application of *Revlon* to specific cases.

1. *Time-Warner*

In the first of these cases, *Paramount Communications, Inc. v. Time Inc.*,[140] the Delaware courts refereed a takeover struggle between Time, Warner Communications, and Paramount. The back story to this clash of media titans opened with Time's board of directors approving a management-developed long-term strategic plan to address the changing environment facing the publishing and entertainment industries.[141] The plan included a recommendation that Time seek a business combination with Warner Communications. Following negotiations between the two companies' respective managements, Time's board of directors approved a merger with Warner in which former Warner shareholders would receive newly issued Time shares representing approximately 62 percent of the shares of the combined entity. As was typical in negotiated acquisitions in that era, the parties also sought "to discourage any effort to upset the transaction" by agreeing to a lockup option giving each party the option to trigger an exchange of shares.[142] In addition, the merger agreement included a no-shop clause, supplemented by commitments from various banks that they would not finance a takeover bid for Time.[143]

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once it is clear to them that the "corporation is to be subject to a change in control" (quoting Freedman v. Rest. Assocs., 1987 WL 14323, at *661 (Del. Ch. Oct. 16, 1987))); *Ivanhoe Partners*, 535 A.2d at 1345 (noting that *Revlon* was not triggered where the management ally had less than 50 percent voting control after defensive recapitalization).

139. *See* Paramount Commc'ns, Inc. v. Time Inc., 1989 WL 79880, at *22 (Del. Ch. July 14, 1989) ("Clearly not every offer or transaction affecting the corporate structure invokes the *Revlon* duties."), *aff'd on other grounds*, 571 A.2d 1140 (Del. 1989).

140. 1989 WL 79880 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989).

141. *Time*, 571 A.2d at 1144.

142. *Time*, 1989 WL 79880, at *9.

143. *Id.* at *10. No-shop clauses are merger agreement provisions intended to discourage competitive bids for the target from other offerors by prohibiting the target from soliciting any such competing offer. *See* BAINBRIDGE, *supra* note 1, at 350 (describing such clauses). Basic no-shop clauses do, however, permit the target's board of directors to consider an unsolicited bid and, if such an unsolicited offer is made, to negotiate with the new bidder. *See id.* (discussing relevant provisions). In contrast, a no negotiation covenant prohibits the target from entering into negotiations with a competing bidder making an unsolicited offer. *See id.* (discussing relevant provisions). An intermediary variant, the no-merger clause, permits the target to negotiate with a prospective competing offeror, but prohibits it from

Shortly before Time's shareholders were to vote on the merger plan, Paramount made a cash tender offer of $175 per share for Time, conditioned, inter alia, on termination of the Time-Warner merger agreement.[144] Time's board rejected the offer as inadequate, without entering into communications with Paramount.[145] To forestall Paramount from going forward with a hostile tender offer, the Time and Warner boards then agreed to a new structure for the transaction, under which Time would make a cash tender offer for a majority block of Warner shares to be followed by a freeze-out merger in which the remaining Warner shares would be acquired.[146] This structure had the advantage of eliminating any need for approval of the transaction by Time's shareholders, which was deemed essential because a substantial majority of Time's shares were now held by arbitragers and institutional investors considered likely to favor the Paramount offer and who were therefore expected to vote against the merger with Warner if given the opportunity to do so.[147] If the revised plan succeeded, Time's shareholders therefore would end up as minority shareholders in a company saddled with substantial debt and whose stock price almost certainly would be lower in the short run than the Paramount offer.[148]

a. Why Not Let the Shareholders Decide?

The substantial differences in shareholder wealth likely to result from a decision to merge with Warner rather than to sell to Paramount forcefully presented the question of who should make that decision.[149] Paramount naturally insisted that Time's board had an obligation to give the "shareholders the power and opportunity to designate whether the company should now be sold."[150] Chancellor Allen, however, squarely rejected that proposition, holding that "the financial vitality of the corporation and the value of the company's shares is in the hands of the directors and managers

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entering into a merger agreement with the second bidder until the initial bid has been voted on by the target's shareholders. *See id.* (discussing relevant provisions).

144. *Time*, 1989 WL 79880, at *10.

145. *See id.* at *11 (describing the reaction of Time's board). The no-shop clause in the Time-Warner merger agreement contained an exception permitting Time to "communicate" with a competing offeror, after consultation with Warner, in the event "a hostile tender offer for 25% or more of Time's stock [was] announced (or 10% of its stock [was] purchased)."). *Id.*

146. *See Time*, 571 A.2d at 1148 (describing the terms of the revised deal).

147. *See Time*, 1989 WL 79880, at *14 (noting that "most such money managers would be tempted by the cash now").

148. Among other things, the new plan required Time to incur between seven and ten billion dollars in additional debt. *See Time*, 571 A.2d at 1148 (describing the effects of the revised deal).

149. As Chancellor Allen put it, the "overarching question is where legally (an easy question) and equitably (more subtle problem) the locus of decision-making power does or should reside in circumstances of this kind." *Time*, 1989 WL 79880, at *20.

150. *Id.*

of the firm."[151] Accordingly, Allen squarely rejected the argument "that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares."[152] The Delaware Supreme Court explicitly endorsed Allen's analysis.[153]

Time thus implicitly rejects the argument that a shareholder's decision to tender his shares to the bidder no more concerns the institutional responsibilities or prerogatives of the board than would the shareholder's decision to sell his shares on the open market or, for that matter, to sell his house.[154] *Time* was correct to do so, because none of the normative bases for the contrary argument prove persuasive. That shareholders have the right to make the final decision about an unsolicited tender offer does not necessarily follow, for example, from the mere fact that shareholders have voting rights.[155]

Likewise, a right for shareholders to choose between competing offers is not a necessary corollary of the shareholders' ownership of the corporation. A shareholder's right to dispose of his stock is not a species of private property, but rather arises out of the contract established by the firm's organic documents and the state of incorporation's corporate statute and common law.[156] As Vice Chancellor Walsh observed of that contract, "shareholders do not possess a contractual right to receive takeover bids. The shareholders' ability to gain premiums through takeover activity is subject to the good faith business judgment of the board of directors in structuring defensive tactics."[157]

b. The Emergence of Motive As the Determinative Factor

Because shareholder choice has little independent normative significance, if any, the real question was whether the Time board's foreclosing of shareholder choice was based on proper or improper motives. In other

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151. *Id.* at *30.

152. *Id.*

153. *Time*, 571 A.2d at 1153–54 (explaining that courts should not substitute their judgment for that of the board).

154. *See, e.g.*, Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 254 (7th Cir. 1986) (advancing that argument), *rev'd on other grounds*, 481 U.S. 69 (1987); Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264, 282 (2d Cir. 1986) (same); Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 258 (2d Cir. 1984) (same).

155. *See* TW Servs., Inc. v. SWT Acquisition Corp., 1989 WL 20290, at *8 n.14 (Del. Ch. Mar. 2, 1989) ("While corporate democracy is a pertinent concept, a corporation is not a New England town meeting; directors, not shareholders, have responsibilities to manage the business and affairs of the corporation, subject however to a fiduciary obligation.").

156. *See, e.g.*, New Orleans Opera Ass'n v. S. Reg'l Opera Endowment Fund, 993 So. 2d 791, 797–98 (La. Ct. App. 2008) ("A corporate charter or articles of incorporation are a contract between the corporation and its shareholders and forms a contractual relationship between the shareholders themselves, which sets forth rights, obligations and liabilities . . . . A corporation is in law a contractual creature, a nexus of contracts." (citations and internal quotation marks omitted)).

157. Moran v. Household Int'l, Inc., 490 A.2d 1059, 1070 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985).

words, did the board exercise its prerogative in ways suggesting that the transaction was driven by management self-interest? This is so because it had become increasingly clear that the Delaware courts were—albeit sub silentio—varying the standard of review according to the likelihood that the actions of the board or managers were tainted by conflicted interests in a particular transactional setting and the likelihood that nonlegal forces effectively constrained those conflicted interests in that setting. In other words, the target board's motives had emerged as a crucial—if not determinative—factor in the analysis.[158]

As former Delaware Chancellor Allen explained in the closely related context of management buyout transactions, "The court's own implicit evaluation of the integrity of the . . . process marks that process as deserving respect or condemns it to be ignored."[159] Assuming that a special committee of independent directors would be appointed to consider the proposed transaction, Allen went on to explain:

> When a special committee's process is perceived as reflecting a good faith, informed attempt to approximate aggressive, arms-length bargaining, it will be accorded substantial importance by the court. When, on the other hand, it appears as artifice, ruse or charade, or when the board unduly limits the committee or when the committee fails to correctly perceive its mission—then one can expect that its decision will be accorded no respect.[160]

There is considerable evidence that the same emphasis on conflicted interests and motives underlies much of the *Unocal* and *Revlon* analysis. Former Delaware Supreme Court Justice Moore argued, for example, that during his tenure on the court he and his colleagues focused on the question of "whether the directors acted properly in accepting or rejecting the competing offers," even if hindsight demonstrated that that decision turned out "to be wrong."[161] A federal court similarly described the *Unocal* standard as asking "whether a fully informed, wholly disinterested, reasonably courageous director would dissent from the board's act in any material part."[162]

Motive is the consistent theme throughout these summations of Delaware law. Accordingly, in many cases it appeared that, if the conflict of interest inherent in target board actions in cases governed by those standards had matured into actual self-dealing, the court would invalidate the defensive

158. *See generally* Dooley, *supra* note 6, at 517–24 (discussing the significance of board motives in Delaware's takeover jurisprudence).

159. William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 BUS. LAW. 2055, 2060 (1990).

160. *Id.*

161. Andrew G.T. Moore, II, *The 1980s—Did We Save the Stockholders While the Corporation Burned?*, 70 WASH. U. L.Q. 277, 287–89 (1992).

162. Southdown, Inc. v. Moore McCormack Res., Inc., 686 F. Supp. 595, 602 (S.D. Tex. 1988).

tactics. If the board acted from proper motives, even if mistakenly, however, the court would leave the defenses in place.[163]

We see a similar emphasis on motive in cases involving corporate control auctions subject to *Revlon*. As the Eleventh Circuit has noted, all corporate control "auctions must end sometime, and lockups by definition must discourage other bidders."[164] In assessing the validity of lockups and related devices, the proper questions thus are "whether [the target] conducted a fair auction, and whether [the favored bidder] made the best offer."[165] If those questions can be answered in the affirmative, the court has objective evidence that the board acted from proper motives even though its actions effectively precluded anyone other than the favored bidder from acquiring the company.[166]

c. *How* Time *Policed the Board's Conflict of Interest*

Time's initial decision to merge with Warner was made by a board comprised principally of outsiders with no readily apparent conflicts of interest. Once the Paramount bid emerged, however, the directors

163. See, for example, *Henley Group, Inc. v. Santa Fe Southern Pacific Corp*., 1988 WL 23945 (Del. Ch. Apr. 12, 1988), in which the defendant corporation adopted a poison debt plan pursuant to which pay-in-kind debentures were distributed to the company's shareholders as part of a restructuring. *Id.* at *6. A variety of antitakeover provisions were built into the debentures, making the company a much less attractive takeover candidate. *See id.* at *7 (summarizing the plaintiff's allegations). Vice Chancellor Jacobs, however, deemed the debentures to be valid under *Unocal*. *See id.* at 14–16 (discussing *Unocal* issues). The Vice Chancellor's conclusion was driven in large part by the board of directors' "diligent efforts" to sell the company prior to embarking upon the restructuring. *Id.* at 14. Those efforts "deprive[d] the plaintiffs' argument—that the defendants were motivated to entrench themselves—of its force." *Id.*

Other examples of the outcome-determinative nature of motive include: Gilbert v. El Paso Co., 575 A.2d 1131, 1146 (Del. 1990) (upholding the settlement of a hostile takeover contest because "there is not a scintilla of evidence to intimate that this arrangement was the result of improper motives" on the board's part); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987) (upholding defensive tactics because the "board acted to maintain the company's independence and not merely to preserve its own control"); Henley Grp., Inc. v. Santa Fe S. Pac. Corp., 1988 WL 23945 (Del. Ch. Apr. 12, 1988) (upholding a corporate restructuring where the board's "diligent efforts" to sell the company before embarking on the restructuring "deprive[d] the plaintiffs' argument—that the defendants were motivated to entrench themselves—of its force."); Freedman v. Rest. Assocs. Indus., [1987–1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,502 (Del. Ch. 1987) (holding that a board committee's handling of a management-led leveraged buyout proposal would be reviewed under the business judgment rule because the plaintiffs had "failed utterly to offer any legal justification for the court's second-guessing the decision of the special committee.").

164. Cottle v. Storer Commc'n, Inc., 849 F.2d 570, 576 (11th Cir. 1988) (citations omitted).

165. *Id.*

166. Indeed, *Revlon* itself can be seen as a case in which the board's actions strongly suggest self-interest. Why would an auctioneer approve a transaction other than the highest bid if not for improper motives, at least assuming the competing proposals are identical in all respects other than price? In fact, it appears that Revlon's directors were mainly concerned with protecting themselves from litigation by the company's debt holders. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

undertook a drastic course of action whose sole purpose was preventing their shareholders from accepting Paramount's offer. As suggested by the analysis in the preceding section, this attempt to foreclose shareholder choice without first conducting a fair competition for control posed heightened accountability concerns because it provides circumstantial evidence from which one might reasonably infer the presence of self-interested decision making.

Consistent with the analysis offered in the preceding section, the *Time* courts chose differing standards of review reflecting the differing conflicts posed by the various challenged board actions. The Time board's initial decision to merge with Warner was protected by the business judgment rule.[167] In contrast, the lockup, the decision to recast the transaction as a tender offer for Warner, and the various other measures undertaken to stave off Paramount's competing bid involved a conflict of interest sufficiently severe to require application of a more exacting standard of review.[168] The preliminary question, however, was whether *Unocal* or *Revlon* provided the applicable standard.

d. Time *and* Paramount *Meet in* Revlon-*land*

For somewhat different reasons both Chancellor Allen and the Delaware Supreme Court concluded that *Revlon* had been not triggered. Chancellor Allen followed a line of chancery court cases holding that *Revlon* applied to any transaction constituting a change in control,[169] but he determined that the Time-Warner merger agreement would not result in a transfer of control because control of the combined entity remained "in a large, fluid, changeable and changing market."[170]

Although the Delaware Supreme Court indicated Allen's analysis was correct "as a matter of law," it rejected plaintiff's *Revlon* claims on "different grounds"[171]:

> Under Delaware law there are, generally speaking and without excluding other possibilities, 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.[172]

167. Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1142 (Del. 1989).
168. *See id.* at 1152 (noting that "the revised agreement was defense-motivated").
169. *See supra* notes 138–39 and accompanying text (discussing relevant precedents). The analysis in this section borrows in part from BAINBRIDGE, *supra* note 1, at 393–400.
170. Paramount Commc'ns, Inc. v. Time Inc., 1989 WL 79880, at *23 (Del. Ch. July 14, 1989).
171. *Time*, 571 A.2d at 1150.
172. *Id.*

This passage is not a model of clarity. What are the other nonexcluded possibilities? How do the first and second identified possibilities differ? If the court was deciding the case on broader grounds than Allen, can change of control transactions not involving a breakup of the company still trigger *Revlon*? In particular, does *Revlon* apply when the target "initiates an active auction process seeking to sell itself," but the auction participants do not contemplate breaking up the company? Indeed, what exactly does the court mean by a "breakup of the company"? What does seem clear, however, is that the Delaware Supreme Court intended to ensure that *Revlon* did not swallow the field of takeover litigation.[173]

To be sure, *Time* did not leave the lockup and other bid-preclusive measures immune from challenge. Instead, the lockup and Time's subsequent recasting of the acquisition as a tender offer were defensive measures to be analyzed under *Unocal*.[174] The courts' refusal to apply the business judgment rule to these deal protective devices was perfectly proper given the conflict of interest inherent when target managers use them to tip the outcome of a takeover contest to one bidder over another, at least before there has been a fair competition between the two bidders to elicit the best price for the shareholders.[175]

e. Did the Time *Opinion Adequately Respond to a Target Board's Conflict of Interest?*

In many of the pre-*Time* chancery court cases upon which Chancellor Allen had relied, the competing bid was created internally by the target's managers rather than being made by an outside white knight.[176] In these cases, the target's board typically created or refused to redeem an existing poison pill. While the hostile bidder was delayed by the pill, the target's board approved a defensive restructuring intended to give management effective voting control or to otherwise make the target unpalatable to potential bidders.

In a common scenario, the target paid a dividend to its shareholders consisting of cash (often borrowed) and debt securities, which had the effect of reducing the post-dividend value of the target's stock to the extent of the distribution. In some cases, the transaction also was structured so that

173. *See generally* Marc I. Steinberg, *Nightmare on Main Street: The Paramount Picture Horror Show*, 16 DEL. J. CORP. L. 1, 15 (1991) (arguing that the Delaware Supreme Court's *Time* opinion "narrowly constru[ed] *Revlon*'s scope"); Charles Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1869 (1992) (arguing that "doctrinally, *Time* was about delimiting the appropriate scope of the *Unocal* and *Revlon* standards").

174. *See Time*, 571 A.2d at 1152 (affirming the chancery court's ruling "that *Unocal* applied to all [Time] director actions taken, following receipt of Paramount's hostile tender offer, that were reasonably determined to be defensive").

175. For an analysis of the Delaware Supreme Court's application of the *Unocal* standard in *Time*, see BAINBRIDGE, *supra* note 1, at 397–400.

176. The description and analysis of these cases in this section borrows from *id.* at 399–400.

target managers or the target's employee stock ownership plan effectively received the dividend in the form of target common stock at an exchange rate based on the stock's post-dividend value.[177] Alternatively, the target might conduct a tender offer in which public shareholders exchange their stock for cash and debt.[178] In either case, management's equity interest in the corporation increased substantially relative to that of the public shareholders, creating a formidable barrier for any post-transaction hostile bidder.

In contrast, as Chancellor Allen emphasized, nothing Time's board of directors did created any obstacle for a post-transaction bidder defensive action other than the postmerger combined Time-Warner entity's great size.[179] So long as a hostile bidder had sufficiently deep pockets and a large enough debt capacity, nothing precluded such a bidder from buying the combined Time-Warner corporation and, if so desired, spinning or selling off unwanted divisions.[180] Accordingly, the Time-Warner transaction was more akin to a repeat game than a final period one and, as such, the target board's conflict of interest was constrained by the market for corporate control in ways that had not been true of the defensive restructuring cases.

Another important distinction between *Time* and the earlier cases was that Time's board was motivated throughout by a desire to advance legitimate corporate interests. In effect, Paramount was asking the Delaware courts to block Time's board from continuing to operate the corporation's business and affairs during the pendency of the takeover bid. The Delaware courts were properly reluctant to do so, as a hostile bidder has no right to expect the incumbent board of directors to stop an ongoing business strategy in midstream.

In sum, *Time* presented a highly unusual set of facts, which rebutted the inference that the board acted from improper motives and rendered the result—if not the reasoning—in that particular case relatively unobjectionable. Many fruitful avenues for limiting *Time*'s reasoning thus presented themselves. The question was whether the Delaware Supreme Court would avail itself of those options or would continue down the road of retreat *Time*'s reasoning appeared to mark out.

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177. *E.g.*, Black & Decker Corp. v. Am. Standard, Inc., 682 F. Supp. 772, 776–77 (D. Del. 1988); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1345 (Del. 1987); Robert M. Bass Grp., Inc. v. Evans, 552 A.2d 1227, 1236–37 (Del. Ch. 1988).

178. *E.g.*, AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986).

179. *See* Paramount Commc'ns, Inc. v. Time Inc., 1989 WL 79880, at *22 (Del. Ch. July 14, 1989) ("The merged Time-Warner company would be large, it is true . . . , but recent history has shown that huge transactions can be done.").

180. *See id.* (noting that, "if a leveraged acquisition of both participants was feasible before the merger, one cannot say that a stock for stock consolidation of such firms would necessarily preclude an acquisition of it thereafter, or so defendants contend").

2. *QVC*

Some five years later, the Delaware Supreme Court revisited the issues posed in its *Time* opinion in a major decision that, oddly enough, also involved Paramount Communications.[181] Paramount agreed to merge with Viacom, a major media conglomerate whose CEO and controlling shareholder was Sumner Redstone. In order to discourage competitive bids, the companies included a number of exclusivity provisions in the agreement and plan of merger. A no-shop clause precluded Paramount's board from discussing a potential business combination with a third party unless the third party could show that its proposal was not subject to financial contingencies, and the Paramount board determined that its fiduciary duties obliged it to enter negotiations with the third party.[182] A termination fee obligated Paramount to pay Viacom $100 million if "(a) Paramount terminated the Original Merger Agreement because of a competing transaction; (b) Paramount's stockholders did not approve the merger; or (c) the Paramount Board recommended a competing transaction."[183] In addition to the agreement and plan of merger, Viacom and Paramount also entered into a stock lockup option, under which, if the Viacom deal fell through for any reason that triggered the termination fee, Viacom would be able to purchase shares representing approximately 20 percent of Paramount's outstanding common stock.[184] As the court explained, the agreement also "contained two provisions that were both unusual and highly beneficial to Viacom."[185] First, Viacom could pay for the shares using a senior subordinated note of questionable marketability instead of cash. Second, in lieu of exercising the option, Viacom could elect to require Paramount to pay Viacom in cash a sum equal to the difference

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181. Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994). The analysis in this section borrows in part from BAINBRIDGE, *supra* note 1, at 400–03.

182. *See QVC*, 637 A.2d at 39 (describing the no-shop clause).

183. *Id.* Provisions for monetary compensation of the favored bidder in the event the transaction fails to go forward long have been common in negotiated acquisitions. *E.g.*, Cottle v. Storer Commc'n, Inc., 849 F.2d 570, 578 (11th Cir. 1988); Beebe v. Pac. Realty Trust, 578 F. Supp. 1128, 1150 n.7 (D. Or. 1984). Termination fees, such as those at issue in *QVC*, are essentially liquidated damages payable if the acquirer fails to receive the expected benefits of its agreement. The fee ordinarily falls in a range of 1 to 5 percent of the proposed acquisition price. *See* St. Jude Med., Inc. v. Medtronic, Inc., 536 N.W.2d 24, 27 (Minn. Ct. App. 1995) (citing Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239, 246 (1991)). Payment of the fee is commonly triggered by the acquisition of a specified amount of target stock by a third party. *E.g.*, Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264, 269 (2d Cir. 1986); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 178 (Del. 1986). Variants include termination of the merger agreement by the target or shareholder rejection of the acquisition proposal. *E.g.*, *Cottle*, 849 F.2d at 572; *Beebe*, 578 F. Supp. at 1150. White knights proposing a leveraged buyout of the target in response to a hostile takeover bid may also require an engagement fee, requiring the target to pay a relatively small fee as consideration for the white knight's preparation and submission of its bid. *E.g.*, *Cottle*, 849 F.2d at 572; *Hanson Trust PLC*, 781 F.2d at 269.

184. *See QVC*, 637 A.2d at 39 (describing the agreement).

185. *Id.*

between the strike price in the option and the market price of Paramount's stock.[186] The potential value of the option to Viacom was uncapped and eventually "increased to nearly $500 million."[187]

Despite the obstacles created by these defenses, QVC made a competing offer for Paramount.[188] Going forward from this point, the takeover fight was further complicated by the intrusion of Hollywood egos. Paramount CEO Davis Martin had once fired QVC's CEO and major shareholder, Barry Diller, and the two apparently hated each other.[189]

Following several rounds of bidding, Paramount's board announced that it would recommend acceptance of the Viacom proposal and would continue to resist QVC's offer.[190] In response, QVC brought suit seeking to enjoin Paramount's defensive efforts to protect the Viacom deal.

Paramount relied on *Time* to argue that its defensive actions had not triggered *Revlon*. Because Paramount had neither initiated an active bidding process nor approved a breakup of the company, this was not an implausible argument.[191] The facts of *QVC* thus highlighted the potential doctrinal mischief done by *Time*. Assuming that *Revlon* had not been triggered, the issue would be whether Paramount's defensive actions could be sustained under a *Unocal*-style analysis. A successful Paramount-Viacom merger would not have legally precluded QVC from attempting to purchase the combined Viacom-Paramount entity. Accordingly, there was a strong argument that Paramount's actions should pass muster under *Time*'s reading of *Unocal*.[192] But while nothing Paramount had done created a legal obstacle to a QVC bid for the postmerger combined Viacom-

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186. *Id.*

187. *Id.* at 40 n.5.

188. *See id.* at 39–40 (discussing QVC's initial competing bid).

189. *See* John Greenwald, *The Deal That Forced Diller To Fold*, TIME, Feb. 28, 1994, at 50, 51 (describing the Diller-Davis feud). Edward Rock points out that the ego clash meant that QVC implicated accountability concerns in a way that Time had not:

> In *Time-Warner*, fully informed directors acted deliberately pursuant to a well-thought-out long-term plan. Along comes Paramount, which tries to stop the Time board. In response, the directors reject Paramount's efforts and determine to continue their long-term plan. In *Viacom*, a strong-willed CEO misleads the board, keeps crucial information from them, prevents them from discussing the terms of the bid with Barry Diller, and structures the transaction so that QVC is at a serious disadvantage because of personal antipathy for Diller. From this perspective, the cases are completely consistent with Delaware norms. Strong-willed CEOs who dominate directors are disfavored. Allowing personal antipathy for a bidder to interfere with the board's serious consideration of the bid is wrong. Tilting the playing field towards management's preferred bidder immediately raises questions.

Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1081 (1997) (footnotes omitted). As he aptly summarizes, "The principal difference between the two cases is that the managers and board behaved well in *Time-Warner* and badly in *QVC*." *Id.* at 1086.

190. *See QVC*, 637 A.2d at 40–41 (describing the bidding process).

191. *See supra* note 172 and accompanying text (quoting *Time*'s discussion of *Revlon* triggers).

192. *See supra* notes 179–80 and accompanying text (discussing the importance of how, in *Time*, a bid for the combined entity was not precluded).

Paramount entity, QVC—and any other bidder—would face an insurmountable practical barrier in the form of Sumner Redstone. As controlling shareholder of Viacom, Redstone would have controlled the combined Paramount-Viacom entity.[193]

The presence of a controlling shareholder substantially changes the conflict of interest mix. In an acquisition of one publicly held corporation by another public corporation, diversified shareholders should be indifferent as to the allocations of gains between the two corporate entities. To understand why that is the case, begin by assuming that the typical acquisition generates gains equal to 50 percent of the target's pre-offer market price. Fully diversified investors are as likely to own acquiring company shares as target shares; indeed, they may own shares in both corporate entities.[194] Because increasing the target's share of the gains by increasing the premium the acquirer pays to obtain control necessarily reduces the acquirer's share, the diversified investor will view such a shift as simply robbing Peter to pay Paul.[195] Indeed, if changing the gain allocation between the two raises total transaction costs, such changes leave fully diversified investors worse off, because expenditures devoted to shifting the gain allocation between the parties amount to a tax on investors in favor of outsider advisors such as lawyers, investment bankers, and others.[196]

If the acquiring entity is privately held, however, even a fully diversified investor can never be on both sides of the transaction. If the intermediate case in which the acquiring entity is publicly held, but is controlled by a single shareholder, as in *QVC*, a fully diversified investor likely will not share pro rata in the gains reaped by the acquiring company because the large shareholder's control enables it to reap a non–pro rata share of any such gains.[197] Accordingly, in the *QVC* situation, diversified investors

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193. *See QVC*, 637 A.2d at 43 (noting that after the merger "there will be a controlling stockholder," referring to Redstone).

194. *See* Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 154 (2009) ("When the shareholder census consists of diversified investors such as institutional shareholders, these investors may well own shares in companies on both sides of the deal . . . .").

195. *See In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1021 (Del. Ch. 2005) ("For diversified investors as likely to own the shares of an acquiror as a target, it is often the case that the premium paid in an M & A deal goes from one pocket to another."); *cf.* William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1077 (2002) (arguing that, for investors holding diversified portfolios, gains from holding target company stock are likely to be offset by losses from holding acquirer stock).

196. Professor Bernard Black argues that "apart from transaction costs, overpayment [by takeover acquirers] does not cause losses to diversified investors because such investors are indifferent to whether the bidder pays excess cash to its own or to the target's shareholders," thereby simultaneously acknowledging and downplaying the role of transaction costs. Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 649 (1989).

197. *Cf.* Nina A. Mendelson, *A Control-Based Approach to Shareholder Liability for Corporate Torts*, 102 COLUM. L. REV. 1203, 1207 (2002) (noting that a controlling shareholder's "general ability to reap a share of corporate benefits in excess of a pro rata share").

should not be indifferent to how the gain is allocated between target and acquirer. Instead, such investors should prefer that as much of the gain as possible be allocated to the target.[198]

Unfortunately, there is good reason to suspect that target directors and managers will favor the privately held acquirer's interests over those of the target shareholders. The controlling shareholder's ability to reap a disproportionate share of post-transaction gains, for example, gives it an unusually high incentive to cause the acquiring entity to offer side payments to target directors and managers in order to obtain their cooperation. In turn, the controlling shareholder's de facto ability to block acquisition proposals for the postmerger combined entity insulates that conflict of interest from the constraining influence of the market for corporate control.[199] As a result, the conflict of interest inherent in any corporate control auction is substantially magnified in the *QVC* situation. In addition, of course, the facts of that case presented a unique conflict due to the clashing Hollywood egos at play.[200]

The *QVC* court demonstrated its sensitivity to this concern by holding that the Paramount board's conduct was subject to enhanced judicial scrutiny:

> Such scrutiny is mandated by: (a) the threatened diminution of the current stockholders' voting power; (b) the fact that an *asset belonging to public stockholders (a control premium)* is being sold and may never be available again; and (c) the traditional concern of Delaware courts for actions which impair or impede stockholder voting rights.[201]

As Dooley observes, the factors the court identified seem incongruous, because they have little to do with the conflicted interest focus of *Unocal* and *Revlon*.[202] As applied to the specific facts of *QVC*, however, references to the shareholders' interest in the control premium presumably reflect the possibility that conflicted interests on the part of Paramount's directors would lead them to take actions that transferred gains from their shareholders to Viacom and Redstone.[203]

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198. *Cf.* DOOLEY, *supra* note 25, at 577 (noting that the *QVC* court expressed concern that "voting control is generally achieved only at the price of paying a 'premium' to the minority shareholders for the loss of their voting influence (fluid and dispersed though it is), and that public shareholders lose the expectation of receiving any such premium once control has been transferred to and consolidated in a majority shareholder").

199. *Cf.* Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 844–45 (Del. 1987) (holding that a target company's controlling shareholder has no duty to sell his shares to a prospective acquirer, even if an acquisition would benefit the minority shareholders).

200. *See supra* note 189 (discussing the clash of egos).

201. *QVC*, 637 A.2d at 45 (emphasis added).

202. DOOLEY, *supra* note 25, at 577.

203. The same concern seems to underlie then-Vice Chancellor Jacobs's observation that

> the shareholders' continuing equity interest is far from secure, because once the Viacom transaction is complete Mr. Redstone will have absolute control of the merged entity and will have the power to use his control at any time to eliminate the shareholders' interest by a "cash out" merger. In this case the board did not obtain, or even bargain for, structural protections that would ensure the continuity

In *QVC*, the Delaware Supreme Court did not overrule *Time*, but did limit *Time* to its unique facts, thereby seemingly recognizing—albeit sub silentio—the doctrinal limitations *Time* imposed on the Delaware courts' ability to police target directors' and managers' conflicted interests. Recall that the critical passage in *Time* was the claim that, "[u]nder Delaware law there are, generally speaking and *without excluding other possibilities*, two circumstances which may implicate *Revlon* duties," which were initiation of an active bidding process and approval of a breakup of the company.[204] In *QVC*, the court seized upon the qualifying phrase "without excluding other possibilities."[205] In this case, the court opined, one of the other possibilities was present—namely, a change of control.[206] Accordingly, *Revlon* was triggered.[207]

By thus rehabilitating Chancellor Allen's *Time* opinion, which the court went out of its way to describe as "well-reasoned,"[208] and by resurrecting the change of control test, *QVC* specifically addressed the potential for conflicted interests on the part of directors in transactions like the one at hand. In addition to rewriting *Time*'s narrow interpretation of *Revlon*, the *QVC* decision introduced a subtle but highly significant doctrinal shift. While *Time* had treated *Unocal* and *Revlon* as separate standards of review, *QVC* restored the pre-*Time* view that they are part of a single line of cases in which the significant conflict of interest found in certain control transactions justified enhanced judicial scrutiny.[209]

Likewise, while *Time* had emphasized the formal tests announced in *Unocal* and *Revlon*, the *QVC* court struck out in a less rigid direction. As described by *QVC*, the enhanced scrutiny test is basically a reasonableness inquiry to be applied on a case-by-case basis. This inquiry has two key features. First, the court must determine whether the directors had followed an adequate decision-making process in gathering information and

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> of Paramount's current shareholders (or their successors) in any merged enterprise. Absent such protection, these shareholders can have no assurance that they will receive the long-run benefits claimed to justify the board's decision to prefer Viacom over QVC. This is the only opportunity that Paramount's shareholders will ever have to receive the highest available premium-conferring transaction. For this reason as well, fairness requires that the shareholders be afforded the fiduciary protections mandated by *Revlon* and *Unocal*.

QVC Network, Inc. v. Paramount Commc'ns Inc., 635 A.2d 1245, 1266–67 (Del. Ch. 1993) (footnote omitted), *aff'd*, 637 A.2d 34 (Del. 1994).

204. Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989) (emphasis added).

205. Paramount Commc'ns, Inc. v. QVC Network Inc., 637 A.2d 34, 46–48 (Del. 1994).

206. *Id.* at 48.

207. *Id.*

208. *Id.* at 47.

209. See *id.* at 46 (quoting Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989), for the proposition that "the general principles announced in *Revlon*, in *Unocal Corp. v. Mesa Petroleum Co.*, and in *Moran v. Household International, Inc.* govern this case and every case in which a fundamental change of corporate control occurs or is contemplated" (emphasis removed) (citations omitted).

evaluating the need for takeover defenses.[210] Second, the court must determine that the directors' decisions were reasonable under the circumstances.[211] The directors have the burden of proof on both aspects of the inquiry, although the directors need not prove that they made the right decision, but merely that their decision fell within the range of reasonableness.[212]

The reasonableness standard was the logical culmination of the case law evolution toward using the *Unocal* and *Revlon* standards as a sieve for conflicted interests. Notice that the reasonableness test parallels the definition of fairness used in the former Model Business Corporation Act provisions governing interested director transactions, namely, whether the transaction in question falls "within the range that might have been entered into at arms-length by disinterested persons."[213] Both standards ferret out board actions motivated by conflicted interests by contrasting the decision at hand to some objective standard. The assumption seems to be that a reasonable decision is unlikely to be motivated by conflicted interest or, at least, that improper motives are irrelevant so long as the resulting decision falls within a range of reasonable outcomes. Put another way, the animating principle behind both standards seems to be "no harm, no foul," which seems sensible enough.

D. Summation

In sum, the search for conflicted interests reflects the Delaware courts' solution to the irreconcilable tension between authority and accountability. Concern for accountability drives the courts' expectation that the board will function as a separate institution independent from and superior to the firm's managers. The court will inquire closely into the role actually played by the board, especially the outside directors, the extent to which they were supplied with all relevant information and independent advisors, and the extent to which they were insulated from management influence. Only if the directors had the ultimate decision-making authority, rather than incumbent management, will the board's conduct pass muster. But if it does, respect-for-authority values will require the court to defer to the board's substantive decisions. The board has legitimate authority in the takeover context, just as it has in proxy contests and a host of other decisions that nominally appear to belong to the shareholders. Nor can the board's authority be restricted in this context without impinging on the board's authority elsewhere. Authority thus cannot be avoided any more

210. *QVC*, 637 A.2d at 45.

211. *Id.*

212. *See id.* (holding that "a court applying enhanced judicial scrutiny should be deciding whether the directors made *a reasonable* decision, not a *perfect* decision"). QVC also strongly indicated that a court should not second-guess a board decision that falls within the range of reasonableness, "even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination." *Id.*

213. MODEL BUS. CORP. ACT ANN. § 8.31 cmt. 4 (1984).

than can accountability; the task is to come up with a reasonable balance. Properly interpreted, that is precisely what the Delaware cases have done.

III. A MAP OF *REVLON*-LAND POST-*QVC*

Any effort to map *Revlon*-land requires resolution of two critical questions. First, when do directors stop being "defenders of the corporate bastion" and become "auctioneers"? Second, what are the directors' obligations once their role shifts?

A. Revlon*-Land's Borders*

Shortly after deciding *QVC*, the Delaware Supreme Court settled on a three-pronged standard for determining whether *Revlon* had come into play:

> The directors of a corporation have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders in at least the following three scenarios: (1) 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; (2) where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company; or (3) when approval of a transaction results in a sale or change of control. In the latter situation, there is no sale or change in control when [c]ontrol of both [companies] remain[s] in a large, fluid, changeable and changing market.[214]

Outside those three situations, which do not even encompass all corporate control auctions, *Unocal* remains the defining standard, as the court elsewhere emphasized by flipping the *Revlon* metaphor around to hold that "[w]hen a corporation is not for sale, the board of directors is the defender of the metaphorical medieval corporate bastion and the protector of the corporation's shareholders."[215] Accordingly, outside *Revlon*-land, a target board may respond defensively to a bidder "at the corporate bastion's gate."[216]

B. Directors' Duties in Revlon*-land*

Although the court continued to identify a limited class of cases in which *Revlon* was the controlling precedent, it also continued to confirm *QVC*'s holding that *Revlon* is properly understood as a mere variant of *Unocal*

214. Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270, 1289–90 (Del. 1994) (footnotes omitted) (citations omitted) (internal quotation marks omitted).

215. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1388 (Del. 1995). In *Unitrin*, the target's board had adopted a poison pill, amended the bylaws to add additional defenses, and initiated a defensive stock repurchase. The chancery court found the latter "unnecessary" in light of the poison pill, but the Supreme Court reversed. *Id.* at 1367. The Supreme Court held that "draconian" defenses (i.e., those that are "coercive or preclusive") are invalid per se. *Id.* at 1387. Defenses that are not preclusive or coercive, however, are to be reviewed under *QVC*'s "range of reasonableness" standard. *Id.* at 1387–88.

216. *Id.* at 1388.

rather than as a separate doctrine.[217] Having said that, however, application of the reasonableness standard does differ somewhat in cases falling within the borders of *Revlon*-land than in those governed by *Unocal*. As the Delaware Chancery Court has observed, this is so because in the former a court must assess "a director's performance of his or her duties of care, good faith and loyalty in the unique factual circumstance of a sale of control over the corporate enterprise."[218] Accordingly, what is reasonable under *Unocal* may not be reasonable in *Revlon*-land.

1. Consideration of Nonshareholder Interests

The clearest example of how *Revlon* duties differ from those imposed by *Unocal* is the proper role, if any, of director concerns for corporate stakeholders other than shareholders. In *Unocal* settings, the target's board may consider "the impact [of the bid] on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)" in whether the bid posed a cognizable threat.[219] In *Revlon*-land, by contrast, directors may not consider any interest other than shareholder wealth maximization.[220]

2. Discrimination and Favoritism

Many takeover defenses that pass muster under the *Unocal* standard involve discrimination between the bidder and other shareholders. The stock repurchase at issue in *Unocal* itself excluded Mesa from participation.[221] In contrast, once *Revlon* triggers, the target's board of directors loses most of its power to discriminate between bidders and to favor one outcome of the takeover fight over another. To be sure, while it is true that the board must take an "active and direct role in the sale process,"[222] "there is no single blueprint that a board must follow to fulfill its [*Revlon*] duties."[223] Even so, however, the board's goal must be "to secure the highest value reasonably attainable for the stockholders."[224]

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217. QVC Network, Inc. v. Paramount Commc'ns Inc., 635 A.2d 1245, 1267 (Del. Ch. 1993) ("The basic teaching of *Revlon* and *Unocal* 'is simply that the directors must act in accordance with their fundamental duties of care and loyalty.'"), *aff'd*, 637 A.2d 34 (Del. 1994).

218. *In re* Lukens Inc. S'holders Litig., 757 A.2d 720, 731 (Del. Ch. 1999).

219. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

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

221. *See Unocal*, 493 A.2d at 953–54 (holding that "a Delaware corporation may deal selectively with its stockholders, provided the directors have not acted out of a sole or primary purpose to entrench themselves in office").

222. Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 66 (Del. 1989).

223. Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989).

224. McMillan v. Intercargo Corp., 768 A.2d 492, 502 (Del. Ch. 2000). But "[n]o court can tell directors exactly how to accomplish that goal, because they will be facing a unique combination of circumstances, many of which will be outside their control." Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 242 (Del. 2009).

Favoritism toward one bidder over the other therefore has been treated as highly suspect. Although "[f]avoritism for a white knight to the total exclusion of a hostile bidder might be justifiable when the latter's offer adversely affects shareholder interests," the Delaware courts have made clear that "the directors cannot fulfill their enhanced *Unocal* duties by playing favorites with the contending factions."[225]

What does this mean for the use of lockup options and other exclusivity provisions in *Revlon*-land? In *Macmillan*, the Delaware Supreme Court distinguished between lockups that draw an otherwise unwilling bidder into the contest and those that end an active auction by effectively foreclosing further bidding.[226] While neither type is per se unlawful, the latter is subject to exacting judicial scrutiny.[227] Where the target obtains only a minimal increase in the final bid in return for an auction-ending lockup, the agreement is unlikely to pass muster.[228]

Of course, this distinction makes no practical sense. Suppose a prospective white knight tells the target's board that it will not bid unless the board grants the bidder a lockup amounting to 10 percent of the target's outstanding shares. In response, the initial bidder says that it will walk if the lockup is granted. If both parties are credible, the lockup will simultaneously induce an unwilling bid and end the auction process. Accordingly, while the inducement versus end dichotomy

> has the virtue of appearing to encourage a desirable end—competitive bidding in acquisition transactions—it is not particularly helpful in determining the validity of any particular option because all lock-up options, by their nature, encourage the bid of the person receiving the lock-up and discourage the bids of all other persons.[229]

The Eleventh Circuit cut through the confusion in *Cottle v. Storer Communication, Inc.*[230] As we saw above, the court there recognized that all control "auctions must end sometime."[231] The court further acknowledged that the distinction between lockups that draw in a bidder

225. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1288 (Del. 1988) (citations omitted).

226. *See id.* at 1286 (quoting *Revlon* to distinguish between lockups that "draw bidders into a battle" and those that "end an active auction and foreclose further bidding").

227. *See id.* (distinguishing "the potentially valid uses of a lockup from those that are impermissible").

228. *See id.* ("When one compares what KKR [the favored bidder] received for the lockup, in contrast to its inconsiderable offer, the invalidity of the agreement becomes patent.").

229. Kenneth J. Nachbar, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.—*The Requirement of a Level Playing Field in Contested Mergers, and Its Effect on Lock-ups and Other Bidding Deterrents*, 12 DEL. J. CORP. L. 473, 488 (1987) (footnote omitted). Accordingly, "classifying a lockup as a permissible type that promotes bidding, or a harmful strain that discourages bidding, appears to be no more than conclusory judicial labels that are affixed by hindsight after the lockup has been scrutinized by the courts." Leo Herzel, *Misunderstanding Lockups*, 14 SEC. REG. L.J. 150, 177 (1986).

230. 849 F.2d 570 (11th Cir. 1988).

231. *Id.* at 576 (quoting Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964)).

and those that end an auction is fatuous because all "lock-ups by definition must discourage other bidders."[232] Accordingly, the question is not whether a lockup ended the auction, but whether the target's decision to grant the lockup was a reasonable one.

Delaware courts likely would agree. After all, if the analysis in the preceding part was correct in positing that motive is what matters, a board that conducts a fair auction is a board whose motives will withstand scrutiny.

3. No Liability for Mere Negligence

The emphasis on analyzing the target board's motives in determining whether their conduct satisfied *Revlon* is further exemplified by the chancery court's *Lukens* decision.[233] Vice Chancellor Lamb emphasized that *Revlon*, "like *Unocal* before it," comes into play because "of 'the omnipresent specter that a board may be acting primarily in its own interest, rather than those of the corporation and its shareholders.'"[234] Accordingly, where "a complaint merely alleges that the directors were grossly negligent in performing their duties in selling the corporation, without some factual basis to suspect their motivations, any subsequent finding of liability will, necessarily, depend on finding breaches of the duty of care,"[235] which in turn means that "judicial scrutiny will not often result in a greater likelihood of liability than if the business judgment presumption applied from the outset."[236] As a result, mere negligence in carrying out a sale of control should not result in liability under *Revlon*.

4. Liability for Bad Faith?

While the precise geography of *Revlon*-land remains somewhat obscure, the decisions in *Ryan v. Lyondell Chemical Co.*[237] offered important clarification by defining the relationship between *Revlon* and the emerging case law on the obligation of directors to act in good faith.[238] In turn, that

232. *Id.* (citing Nachbar, *supra* note 229, at 488).

233. *In re* Lukens Inc. S'holders Litig., 757 A.2d 720 (Del. Ch. 1999). We revisit *Lukens* below in connection with the opinion's treatment of when *Revlon* duties apply. *See infra* Part IV.

234. *Lukens*, 757 A.2d at 731 (quoting Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989)).

235. *Id.* at 731–32.

236. *Id.* at 732 n.26.

237. C.A. No. 3176, 2008 WL 2923427 (Del. Ch. July 29, 2008), *rev'd*, 970 A.2d 235 (Del. 2009).

238. The developing good faith obligation grew out of the Delaware Supreme Court's 1993 assertion that Delaware corporate law recognized a triad of fiduciary duties consisting of care, loyalty, and good faith. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993). Oddly, however, it was not until 2006 that the court began clarifying the triad formulation by defining good faith as encompassing

> all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders. A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than

guidance provided clarification of the extent to which an exculpatory provision in the target corporation's certificate of incorporation can insulate the target's directors from risk of monetary liability in *Revlon* cases.[239]

The board of directors of Lyondell Chemical Co. was approached in April 2006 by Basell AF, which expressed an interest in acquiring Lyondell.[240] The board thought the offered price was inadequate and expressed a lack of interest in selling.[241] In May 2007, Access Industries, Basell's parent corporation, filed a Schedule 13D announcing that it had the right to acquire an 8.3 percent stake in Lyondell.[242] Lyondell's board recognized that the Schedule 13D put it into play, but decided to take a wait-and-see approach to potential offers.[243]

On July 9, 2007, Access owner Leonard Blavatnik met with Lyondell CEO Dan Smith to propose a $40 per share acquisition of Lyondell.[244] After negotiations, Blavatnik raised his offer to $48 per share, conditioned on a demand for a $400 million break-up fee and a merger agreement to be signed not later than July 16.[245] Negotiations and due diligence followed for several days.[246] On July 16, following a presentation by Lyondell's financial advisors, who stated that $48 was "an absolute home run" and that

> that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating conscious disregard for his duties.

In re The Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006) (quoting the chancery court decision below).

In *Stone v. Ritter*, 911 A.2d 362 (Del. 2006), the court provided further clarification by explaining "the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty." *Id.* at 370. Instead, the obligation to act in good faith is now subsumed wholly within the duty of loyalty. *See id.* (holding that "the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith.").

For criticism of the Delaware cases on this duty of good faith, see BAINBRIDGE, *supra* note 1, at 160–63.

239. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2011) (authorizing corporations to include a provision in the certificate of incorporation that exculpates directors from monetary liability, but forbidding such exculpation, inter alia, "for acts or omissions not in good faith").

240. Ryan v. Lyondell Chem. Co., C.A. No. 3176, 2008 WL 2923427, at *4 (Del. Ch. July 29, 2008), *rev'd*, 970 A.2d 235 (Del. 2009).

241. *Id.*

242. *Id.* at *4 n.17, *5.

243. *Id.* at *5.

244. *Id.* at *6.

245. *Id.* There was a certain amount of time pressure from Balavatnik's perspective. At the same time he was negotiating with Lyondell, he was also negotiating with an alternative target (Huntsman). Blavatnik had a deadline of July 11 to raise his offer for Huntsman if he wanted to go forward with that acquisition, so he asked Smith for Lyondell to provide a firm indication of interest by the end of the day on the 11th. Lyondell's board decided to provide the requested indication. Blavatnik announced he would not be raising his offer for Huntsman, and Huntsman terminated its negotiations with Blavatnik. *See id.* at 6–7 (describing the Huntsman bid).

246. Ryan v. Lyondell Chem. Co., 970 A.2d 235, 238 (Del. 2009).

no other bidder was likely to pay more, Lyondell's board approved the deal.[247]

The chancery court conceded that Lyondell's board "was active, sophisticated and generally aware of the value of the Company and the conditions of the markets in which the Company operated."[248] The board long had been kept up to date on the company's financial outlook and plans. The board had been kept fully abreast of the negotiations with Access and another potential bidder. The board had been briefed on Access' proposal by Lyondell's financial advisor.

Despite all this, however, the chancery court found the board's conduct deficient in a number of respects. First, the "entire deal was negotiated, considered, and agreed to in less than seven days."[249] This gave the court "pause as to how hard the Board really thought about this transaction and how carefully it sifted through the available market evidence."[250] The court's concern was consistent with an earlier Delaware Supreme Court caution that "boards 'that have failed to exercise due care are frequently boards that have been rushed.'"[251] Having said that, however, boards often must act quickly. If courts insist that boards beat the bushes in search of the proverbial two birds, they force boards to risk losing the equally proverbial bird in the hand.

Second, the court criticized the board for failing to conduct a "formal market check" by proactively seeking out competing bidders.[252] The chancery court's concern in this regard, however, overlooked clear Delaware Supreme Court teaching that no such formal test was mandatory even in *Revlon*-land.[253]

Third, the court likewise criticized the board for not actively involving itself in the negotiation and sale processes.[254] Here again, however, the chancery court overlooked clear Delaware Supreme Court teaching. Recall that there is no single roadmap directors must follow through *Revlon*-land.[255]

Despite the dubious nature of its expressed concerns, the chancery court denied the defendant's motion for summary judgment, holding that there was significant doubt that the board had satisfied its *Revlon* duties.[256] Note that the chancery court thus not only exposed the board to the possibility

247. *Id.* at 239.

248. *Lyondell*, 2008 WL 2923427, at *13.

249. *Id.* at *14.

250. *Id.*

251. McMullin v. Beran, 765 A.2d 910, 922 (Del. 2000) (quoting Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 67 (Del. 1989)).

252. *Lyondell*, 2008 WL 2923427, at *14.

253. *See generally* Barkan v. Amsted Indus., Inc., 567 A.2d 1279 (Del. 1989).

254. *Lyondell*, 2008 WL 2923427, at *14.

255. *See supra* note 223 and accompanying text.

256. *Lyondell*, 2008 WL 2923427, at *19 ("The record, as it presently stands, does not, as a matter of undisputed material fact, demonstrate the Lyondell directors' good faith discharge of their *Revlon* duties—a known set of 'duties' requiring certain conduct or impeccable knowledge of the market in the face of Basell's offer to acquire the Company.").

that its decisions would be enjoined, the usual remedy in the *Unocal*/*Revlon* context,[257] but also the very serious risk of nonexculpable monetary liability. In reversing, the Delaware Supreme Court emphasized that an "extreme set of facts" is required to sustain a bad faith claim.[258] Only where the target's board of directors "knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty."[259] Put another way, liability would follow only where the "directors utterly failed to attempt to obtain the best sale price."[260] Although motive did not figure explicitly in that analysis, the Delaware Supreme Court's *Lyondell* decision in fact is fully consistent with the argument in the preceding part that motive is what matters. After all, why would a board consciously disregard known duties if not for some improper motive?

Importantly, the Delaware Supreme Court emphasized that the emergent doctrine of good faith did not change the longstanding principle that there is no single roadmap boards must follow in *Revlon*-land. The chancery court had held that *Revlon* duties required that "directors must 'engage actively in the sale process,' and they must confirm that they have obtained the best available price either by conducting an auction, by conducting a market check, or by demonstrating 'an impeccable knowledge of the market.'"[261] In reversing, the Delaware Supreme Court held that "bad faith will be found if a 'fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.'"[262] Because there are "no legally prescribed steps that directors must follow to satisfy their *Revlon* duties," however, "the directors' failure to take any specific steps during the sale process could not have demonstrated a conscious disregard of their duties."[263]

IV. CHANCERY REDRAWS THE BORDERS OF *REVLON*-LAND

Recall that post-*QVC* a transaction entered *Revlon*-land via three checkpoints.[264] Checkpoint 1 requires the target corporation to initiate "an active bidding process seeking to sell itself or to effect a business reorganization involving a clear breakup of the company," with it being unclear whether the reference to a "breakup" modifies both halves of this checkpoint or only the latter.[265] Checkpoint 2 requires that, "in response to a bidder's offer, a target abandons its long-term strategy and seeks an

257. *Cf.* Paul Regan, *Judicial Standards of Review of Corporate Fiduciary Action*, 26 DEL. J. CORP. L. 995, 1021 (2001) ("Most applications of *Unocal* result in injunction denied.").

258. *Lyondell*, 970 A.2d at 243.

259. *Id.* at 243–44.

260. *Id.* at 244.

261. *See id.* at 243 (summarizing the chancery court holding).

262. *Id.* (citing the chancery court opinion).

263. *Id.*

264. *See supra* note 214 and accompanying text.

265. *See* Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270, 1289–90 (Del. 1994) (footnotes omitted) (citations omitted) (internal quotation marks omitted).

alternative transaction involving the break-up of the company."[266] Checkpoint 3 requires "a sale or change of control" of the target.[267] In recent years, however, a number of chancery court decisions have disregarded this settled law and thus redrawn *Revlon*-land's boundaries in ways that are inconsistent both with the policy framework developed above and Delaware Supreme Court precedents.

A. Hypotheticals

This section offers some simplified hypotheticals designed to illustrate how *Revlon* ought to be applied in various settings, so as to set the stage for analyzing the ways in which the chancery court has departed from both precedent and sound policy in applying *Revlon*.

1. A Stock for Stock Merger of Equals

Acme and Ajax are both public corporations listed on the New York Stock Exchange (NYSE). Acme offers to acquire Ajax in a merger of equals in which Acme shareholders would receive Ajax stock for their Acme shares. This is an easy case. Recall that in *Time*, Chancellor Allen had said that *Revlon* was not triggered because there was no change of control. This was so, he explained, because control of the combined entity after the merger remained "in a large, fluid, changeable and changing market."[268] The same is true here.[269] Accordingly, because the merger does not involve a sale or other change of control, the Acme "board's decision . . . is entitled to judicial deference pursuant to the procedural and substantive operation of the business judgment rule."[270] In contrast, if the acquiring firm has a controlling shareholder, the merger would result in the requisite change of control and *Revlon* would trigger.[271]

2. A Triangular Merger

Start with the same facts as in the preceding hypothetical, but now assume Acme proposes a triangular merger in which Ajax would be merged into a wholly owned Acme subsidiary. Despite the change in form, the substantive effect of this transaction is precisely the same. The combined entity ends up being owned by dispersed shareholders "in a large, fluid, changeable and changing market." Only by elevating form over substance could *Revlon* apply here.

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266. *Id.*

267. *Id.*

268. *See supra* note 170 and accompanying text.

269. *See* Krim v. ProNet, Inc., 744 A.2d 523, 527 (Del. Ch. 1999) (noting that *Revlon* "does not apply to stock-for-stock strategic mergers of publicly traded companies, a majority of the stock of which is dispersed in the market.").

270. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 928 (Del. 2003).

271. *See* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 47–48 (Del. 1994) (holding that *Revlon* was triggered because Viacom's controlling shareholder Sumner Redstone would control the combined entity following the transaction).

3. An Asset Sale

This time, vary the hypothetical by assuming that Acme proposes to acquire substantially all of Ajax's assets in exchange for Acme stock, after which Ajax will liquidate itself and, after paying off all creditors, distribute the remaining Acme shares to its shareholders as a liquidating final dividend. Although the form of this transaction obviously involves a sale of Ajax's assets and the disappearance of Ajax, the substance of the transaction is the same as in our first two hypotheticals. Acme ends up owning Ajax, but control of the post-transaction entity ends up being owned by dispersed shareholders in the requisite "large, fluid, changeable and changing market."

4. Transactions in Which Part or All of the Consideration Consists of Cash

In this hypothetical, change the facts by changing the form of consideration. Version A entails a merger between Acme and Ajax in which Ajax shareholders get cash for their stock. Version B entails a triangular merger between Ajax and a wholly owned Acme subsidiary in which the Ajax shareholders get cash. Version C is a tender offer for any and all Ajax shares for cash to be followed by a freeze-out merger in which any remaining Ajax shareholders will be squeezed out in return for cash.

Checkpoint 1 is not triggered on the bare facts of any of these versions of the hypothetical. Ajax did not initiate an active bidding process seeking to sell itself. Likewise, none of the transactions will result in a business reorganization involving a clear break-up of the company.

Checkpoint 2 is not triggered, inter alia, because none of Ajax's actions were responsive to an unwanted offer.

As for Checkpoint 3, the key issue is whether a cash sale constitutes "a sale or change of control." A going private transaction in which the target is acquired for cash by a private equity firm obviously would enter *Revlon*-land via this third portal,[272] but what if the acquirer is publicly held and has no controlling shareholder? To answer that question, one must know whether control modifies both "sale" and "change" or only modifies "change." If the former, cash sales do not trigger *Revlon* duties if the acquirer is publicly held.

272. Indeed, such a transaction was the one at issue in *Revlon* itself. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (discussing the Forstmann Little leveraged buyout firm's attempt to acquire Revlon).

B. Chancery Precedents on Cash Sales

A number of chancery court decisions have found *Revlon* duties to be triggered by transactions in which all or part of the acquisition consideration consisted of cash.[273]

1. *Lukens Inc.*

In 1998, Lukens, Inc. and Bethlehem Steel Corp. agreed to a merger in which the latter would exchange a combination of its stock and cash valued at $30 per share for each share of Lukens common stock. The merger agreement provided that each Lukens shareholder would have the right to elect how much cash to receive, "subject to a maximum total cash payout equal to 62% of the total consideration."[274] If all Lukens shareholders opted for cash, the split thus would be 62–38 cash and stock.

In dictum,[275] Vice Chancellor Lamb observed:

> [A]lthough there is no case directly on point, I cannot understand how the Director Defendants were *not* obliged, in the circumstances, to seek out the best price reasonably available. The defendants argue that because over 30% of the merger consideration was shares of Bethlehem common stock, a widely held company without any controlling shareholder, *Revlon* and *QVC* do not apply. I disagree. Whether 62% or 100% of the consideration was to be in cash, the directors were obliged to take reasonable steps to ensure that the shareholders received the best price

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273. Not all chancery court decisions have fallen into this error, however. For example, in *In re Synthes, Inc. Shareholder Litigation*, 50 A.3d 1022 (Del. Ch. 2012), Chancellor Strine observed:

> [P]laintiffs are also wrong on the merits of their argument that *Revlon* applies. Their sole basis for claiming that *Revlon* applies is that the Synthes stockholders are receiving mixed consideration of 65% J&J stock and 35% cash for their Synthes stock, and that this blended consideration represents the last chance they have to get a premium for their Synthes shares. But under binding authority of our Supreme Court as set forth in *QVC* and its progeny, *Revlon* duties only apply when a corporation undertakes a transaction that results in the sale or change of control. . . . [T]he mixed consideration Merger does not qualify as a change of control under our Supreme Court's precedent. A change of control "does not occur for purposes of *Revlon* where control of the corporation remains, post-merger, in a large, fluid market." Here, the Merger consideration consists of a mix of 65% stock and 35% cash, with the stock portion being stock in a company whose shares are held in large, fluid market.

Id. at 1047 (footnotes omitted). Chancellor Strine's holding is fully consistent with the understanding of *Revlon* and its progeny advanced herein. Curiously, however, Chancellor Strine fails to discuss any of the contrary chancery court precedents critiqued in the following sections.

274. *In re* Lukens Inc. S'holders Litig., 757 A.2d 720, 725 (Del. Ch. 1999).

275. The discussion of whether *Revlon* duties had triggered was mere dicta, because Vice Chancellor Lamb had concluded that, even "assuming that *Revlon* is implicated, the Complaint must still be dismissed." *Id.* at 732 n.25. This was so because plaintiff's claims sounded solely under the duty of care and therefore were not cognizable in light of the target corporation's exculpatory charter provision under section 102(b)(7). *See id.* at 732–34 (discussing the effect of Lukens's exculpatory charter provision).

> available because, in any event, for a substantial majority of the then-current shareholders, "there is no long run."[276]

Vice Chancellor Lamb cited no authority directly supporting his understanding of the change of control test. The phrase, "there is no long run," was quoted from an unpublished opinion by Chancellor Allen, in which the latter had indeed stated:

> In the setting of a sale of a company for cash, the board's duty to shareholders is inconsistent with acts not designed to maximize present share value, acts which in other circumstances might be accounted for or justified by reference to the long run interest of shareholders. In such a setting, for the present shareholders, there is no long run.[277]

Even so, however, Allen's *TW Services* opinion provides little support for Lamb's dicta. First, Allen's comment itself is also dictum. The issue in *TW Services* was whether the target's board of directors had properly decided to turn down a proposed merger. Whether *Revlon* ever applied to such a decision was, Allen explained, an issue that did not then "need . . . [to] be decided."[278]

Second, Allen's comment clearly is directed to sales of control in which 100 percent of the consideration takes the form of cash. This is shown, for example, by his description of the relevant transaction as one in which "all of the current shareholders will be removed from the field."[279] If even a small fraction of the consideration is in acquiring company stock or debt, however, not all of the current target shareholders will be removed from the field. Some will remain as shareholders or creditors of the post-transaction combined entity (assuming that entity to be the field to which Allen referred).

Third, the would-be acquirer in *TW Services* was a subsidiary of a limited partnership controlled by Coniston Partners, a private equity fund, through various affiliates.[280] As such, although Allen did not highlight the issue in the relevant passage, this was not a case in which control of the post-transaction combined entity was "in a large, fluid, changeable and changing market." To the contrary, if the transaction succeeded, the target would be taken private by Coniston and its affiliates who would thereafter exclusively control it. In contrast, if the acquirer had been publicly held and lacked a controlling shareholder, the pre-transaction TW Services shareholders could use the cash they received in the acquisition to buy stock in the post-transaction combined entity. Any removal from the field they might experience as a result of the transaction thus would be transitory. Put another way, for them there is at least the potential for a long run.

276. *Id.* at 732 n.25.
277. TW Servs., Inc. v. SWT Acquisition Corp., Civ. A. Nos. 10427, 10298, 1989 WL 20290, at *7 (Del. Ch. Mar. 2, 1989) (footnotes omitted).
278. *Id.* at *8.
279. *Id.* at *7.
280. *See id.* at *2 (describing the ownership structure of the proposed acquisition vehicle).

Taken together, these considerations show that *TW Services* at most stands for the proposition that a 100 percent cash sale of control triggers *Revlon*. More likely, moreover, the case probably stands for the even more limited proposition that a 100 percent cash sale in the context of a going private transaction triggers *Revlon*. In addition, as already noted, the passage on which Vice Chancellor Lamb relied was obvious dictum. Finally, although Delaware gives precedential value to unpublished opinions,[281] surely that factor should be taken into account in assessing how much weight to give such opinions.

The only other authority cited by Vice Chancellor Lamb in the relevant passage of *Lukens* was the Delaware Supreme Court's decision in *In re Santa Fe Pacific Corp. Shareholder Litigation*.[282] Because *Santa Fe* contradicts all of the relevant chancery court decisions to be discussed in this section, analysis of the conflict between it and *Lukens* is deferred until the other cases have been discussed.[283] Suffice it for now to say that Vice Chancellor Lamb ducked *Santa Fe* by dismissing it out of hand.[284]

2. *NYMEX*

The *Lukens* dicta seemingly went unnoticed for almost a decade, when it resurfaced in another chancery court decision.[285] In 2007, the board of directors of NYMEX Holdings, Inc., set up a special committee to consider possible sales or acquisitions.[286] Shortly thereafter, NYMEX Chairman of the Board Richard Schaeffer met with then–NYSE CEO John Thain.[287] In their discussions, the latter "spoke of purchasing NYMEX for $142 per share," but the NYSE ultimately failed to make a formal acquisition proposal.[288]

Even before the abortive negotiations with the NYSE, Schaeffer and NYMEX CEO James Newsome had begun negotiations with representatives of CME Group, Inc., which eventually resulted in CME making an offer to acquire NYMEX. CME offered a mix of cash and CME stock in exchange for the NYMEX stockholders' shares, which represented a mix of "56% CME stock and 44% cash."[289]

In *NYMEX*, Vice Chancellor Noble raised, but ultimately did not resolve, the question of whether *Revlon* applied on those facts.[290] As with *Lukens*,

281. *See* DEL. SUP. CT. R. 14(b)(vi)B(2) (2013).
282. 669 A.2d 59 (Del. 1995).
283. *See infra* Part IV.C.
284. *See infra* text accompanying note 333 (discussing *Lukens*'s analysis of *Santa Fe*).
285. A Westlaw search in the DE-CS database using the search term "Lukens /s Revlon" found no Delaware cases discussing the relevant dicta prior to the *NYMEX* decision.
286. *In re* NYMEX S'holder Litig., C.A. Nos. 3621-VCN, 3835-VCN, 2009 WL 3206051 at *1 (Del. Ch. Sept. 30, 2009). At that time, NYMEX "was the largest commodity futures exchange in the world." *Id.*
287. *Id.*
288. *Id.*
289. *Id.*
290. *Id.* at *5–6.

the target corporation's certificate of incorporation included a section 102(b)(7) exculpatory provision, which required dismissal of the complaint because the plaintiffs had failed adequately to plead a breach of the duty of loyalty or lack of good faith. Accordingly, as with *Lukens*, *NYMEX*'s precedential value is reduced because we again are dealing with dicta.[291]

In that dicta, Vice Chancellor Noble opined:

> *Revlon* scrutiny applies only to transactions "'in which a fundamental change of corporate control occurs or is contemplated.'" [Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 46 (Del. 1994) (quoting Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del.1989)).] They dispute what constitutes a fundamental change of control sufficient to trigger *Revlon* scrutiny. A fundamental change of control does not occur for purposes of *Revlon* where control of the corporation remains, post-merger, in a large, fluid market. [*See id.* at 47.] Thus, for example, in a transaction where cash is the exclusive consideration paid to the acquired corporation's shareholders, a fundamental change of corporate control occurs—thereby triggering *Revlon*—because control of the corporation does not continue in a large, fluid market. In transactions, such as the present one, that involve merger consideration that is a mix of cash and stock—the stock portion being stock of an acquirer whose shares are held in a large, fluid market—"[t]he [Delaware] Supreme Court has not set out a black line rule explaining what percentage of the consideration can be cash without triggering *Revlon*." [*In re* Lukens Inc. S'holders Litig., 757 A.2d 720, 732 n.25 (Del. Ch. 1999).][292]

The block quotation includes the footnotes from the opinion to draw the reader's attention to how carefully Vice Chancellor Noble included citations of support for three of the four sentences in the passage. Crucially, however, he omitted a citation of support for the critical proposition that "a fundamental change of corporate control occurs" "in a transaction where cash is the exclusive consideration." If this passage constituted a holding rather than dicta, that statement would be the holding. Of the four sentences in the passage, accordingly, it is this passage that most demands validation by precedent. In light of the thorough job the Vice Chancellor did in providing support for his other assertions, this glaring omission is quite telling.

The final sentence of the passage, with its quotation from *Lukens*, does not provide the missing support. Even setting aside the argument above that *Lukens* should be given little precedential weight,[293] the *Lukens* quotation does not tell the whole story. True, the Delaware Supreme Court had not set out a bright-line rule defining what percentage of cash triggered

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291. *Cf.* ONTI, Inc. v. Integra Bank, Civ. A. 14514, 1999 WL 160131, at *1 (Del. Ch. Mar. 2, 1999) (declining to find that "*obiter dictum*" held "any precedential value for my decision here").

292. *NYMEX*, 2009 WL 3206051, at *5 (footnotes included in brackets).

293. *See supra* text accompanying note 291 (noting that the relevant passage from *Lukens* was mere dicta).

Revlon. It was (and remains) equally true, however, that the Delaware Supreme Court has never held that the form and allocation of the consideration is even relevant to the question of whether *Revlon* has been triggered. To the contrary, as discussed below, the better reading of the relevant Delaware Supreme Court precedents is that the form of the consideration is wholly irrelevant to that question.[294]

Finally, notice that the passage also errs in asserting that "in a transaction where cash is the exclusive consideration paid to the acquired corporation's shareholders . . . control of the corporation does not continue in a large, fluid market."[295] Obviously, this is a reference to Chancellor Allen's holding in *Time* that the Time-Warner merger agreement would not result in a transfer of control because control remained "in a large, fluid, changeable and changing market."[296] In *Time*, Chancellor Allen obviously was referring to control not of the target corporation but to control of the post-transaction combined entity. A fluid market controlled the target and there was no change of control because control of the combined entity would remain in such a market after the transaction was completed. In an all-cash deal—let alone a partial-cash deal like the one at issue in *NYMEX*—so long as the acquirer is publicly held, control of the combined post-transaction entity will rest in the hands of "a large, fluid, changeable and changing market." Accordingly, it is not the form of the consideration that matters under *Time*, but whether the acquirer has a controlling shareholder.

3. *Smurfit-Stone Container Corp.*

Although both *Lukens* and *NYMEX* had limited precedential value on this point because the relevant passages were mere dicta, in *Smurfit-Stone Container Corp. Shareholder Litigation*,[297] Vice Chancellor Parsons relied principally on those cases to hold—for the first time—that all- or partial-cash transactions trigger *Revlon*.[298] The case involved a triangular merger in which publicly held target Smurfit was to merge into a wholly owned subsidiary of publicly held acquirer Rock-Tenn Co. In the merger, the shareholders of Smurfit got $35 per share, with 50 percent of the consideration paid in cash and 50 percent paid in Rock-Tenn stock. Accordingly, as the Vice Chancellor observed that, "this case provides cause . . . to address a question that has not yet been squarely addressed in Delaware law; namely, whether and in what circumstances *Revlon* applies when merger consideration is split roughly evenly between cash and stock."[299]

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294. *See infra* Part IV.C (discussing the relevant precedents).
295. *NYMEX*, 2009 WL 3206051, at *5.
296. *See supra* text accompanying note 170 (quoting the relevant passage from the *Time* opinion).
297. 2011 WL 2028076 (Del. Ch. 2011).
298. *See id.* at *12–14 (discussing when *Revlon* applies).
299. *Id.* at *1.

There was no dispute that Checkpoints 1 and 2 were not implicated on these facts. There was no claim that the target's board had initiated an active bidding process to sell itself or had sought to effect a reorganization involving a breakup of Smurfit.[300] There was no claim that the board had abandoned its long-term strategy in response to a bidder's offer or sought an alternative transaction involving a breakup of the target.[301]

As such, only Checkpoint 3's reference to "a sale or change of control" was at issue.[302] Vice Chancellor Parsons began his analysis by observing that one entered *Revlon*-land via this checkpoint in all-cash transactions.[303] As support for that proposition, he cited *Lukens*, *Topps*, and *TW Services*. As we have seen, however, the latter is a very weak reed on which to rest that claim. As for *Topps*,[304] then–Vice Chancellor Strine opined therein that "[w]hen directors propose to sell a company for cash or engage in a change of control transaction, they must take reasonable measures to ensure that the stockholders receive the highest value reasonably attainable."[305] Crucially, however, *Topps* involved a going private transaction in which the target would be acquired by "a private equity firm . . . , The Tornante Company, LLC, in an alliance with another private equity group, Madison Dearborn Capital Partners, LLC."[306] Accordingly, like *TW Services*, *Topps* does not stand for the proposition that a cash transaction by a publicly held acquirer triggers *Revlon*. Finally, of course, *Lukens* was mere dicta on this point.[307]

Unlike *Lukens* and *NYMEX*, both of which had failed to engage the key passage from Chancellor Allen's *Time* opinion, in *Smurfit* Vice Chancellor Parsons expressly held that *Revlon* applied even though "control of Rock-Tenn after closing will remain in a large, fluid, changing, and changeable market" and the "Smurfit-Stone stockholders will retain the right to obtain a control premium in the future."[308] Although he acknowledged that the defendants' argument to the contrary was "cogent,"[309] he dismissed it by observing that "[e]ven if Rock-Tenn has no controlling stockholder and Smurfit-Stone's stockholders will not be relegated to a minority status in

300. *See id.* at *12 ("Plaintiffs do not allege that the Board initiated an active bidding process to sell itself or effected a reorganization involving the break-up of Smurfit-Stone.").

301. *See id.* (noting that plaintiffs had not claimed "that the Board abandoned its long-term strategy in response to a bidder's offer and sought an alternative transaction involving the break-up of the Company").

302. *See id.* (explaining that plaintiffs alleged that "*Revlon* should apply to this case because the Merger Consideration was comprised of 50% cash and 50% stock at the time the parties entered into the Agreement, which qualifies the Proposed Transaction as a 'change of control' transaction").

303. *See id.* at *13 ("*Revlon* will govern a board's decision to sell a corporation where stockholders will receive cash for their shares.").

304. *In re* Topps Co. S'holders Litig., 926 A.2d 58 (Del. Ch. 2007).

305. *Id.* at 64.

306. *Id.* at 65.

307. *See supra* note 275 and accompanying text (explaining why the relevant statement in *Lukens* was dicta rather than a holding).

308. *Smurfit*, 2011 WL 2028076, at *15.

309. *Id.*

the postmerger entity, half of their investment will be liquidated."[310] Accordingly, the Vice Chancellor asserted that "the fact that control of Rock-Tenn after consummation will remain in a large pool of unaffiliated stockholders, while important, neither addresses nor affords protection to the portion of the stockholders' investment that will be converted to cash and thereby be deprived of its long-run potential."[311]

But that concern is misplaced. First, the locus of control of the post-transaction combined entity is not merely important, but rather is dispositive. In *Time*, Chancellor Allen did not treat the locus as a factor to be considered. Instead, he dismissed the *Revlon* claim solely because control of the combined entity remained "in a large, fluid, changeable and changing market."[312] Second, as we have now seen repeatedly, the argument about whether target shareholders get to participate in the long-run potential of the combined entity is not a relevant—let alone dispositive—consideration.[313]

In sum, by embracing Vice Chancellor Lamb's reasoning, Vice Chancellor Parsons embraced error. The precedents on which he relied provide weak reeds on which to rest such an important holding. The policy arguments on which he relied likewise are unavailing. The borders of *Revlon*-land thus have suffered a significant distortion.

4. *Steinhardt*

Also in 2011, Vice Chancellor Laster issued a bench ruling possibly portending an even greater erosion of the borders of *Revlon*-land.[314] In *Steinhardt v. Howard-Anderson*,[315] Occam Networks proposed to acquire Calix in a merger in which the latter's shareholders would receive a package of 50 percent cash and 50 percent stock valued at $7.75 per share.[316] If the transaction went through, the former target shareholders would own between 15 percent and 19 percent of the post-transaction combined entity's voting stock.[317]

Vice Chancellor Laster held that the transaction should be reviewed using an "enhanced scrutiny" standard, which in context appears to be a

310. *Id.*
311. *Id.*
312. Paramount Commc'ns, Inc. v. Time, Inc., Nos. 10866, 10670, and 10935, 1989 WL 79880, at *739 (Del. Ch. July 14, 1989), *aff'd on other grounds*, 571 A.2d 1140 (Del. 1989).
313. *See supra* notes 294–96 and accompanying text (explaining why the form of consideration is not relevant).
314. I am indebted to Steven M. Haas, Esq., of Hunton & Williams for calling this case to my attention and providing a very helpful research memorandum about the case. *See* Memorandum from Steven M. Haas, Delaware Court Questions Application of Business Judgment Rule to Stock-for-Stock Mergers (February 8, 2011) (on file with the author).
315. Transcript of Ruling of the Court on Plaintiffs' Motion for a Preliminary Injunction, Steinhardt v. Howard-Anderson, No. 5878-VCL (Del. Ch. Jan. 24, 2011) [hereinafter Transcript of Ruling], *available at* http://www.alston.com/files/docs/Occam_Ruling.pdf.
316. Haas, *supra* note 314.
317. *Id.*

reference to the *QVC* formulation of the unified standard of review applicable to both *Unocal* and *Revlon* cases.[318] If the Vice Chancellor had hung his holding on *Lukens*, the case could be dismissed as simply moving the trigger at which *Revlon* comes into play from 60 percent cash down to 50 percent cash.[319] In fact, however, Vice Chancellor Laster focused on the fact that after the merger the former target shareholders would own only approximately 15 percent of the stock of the combined entity. As a result, he worried, this was the last opportunity the target directors and managers would have to maximize the target shareholders' share of a control premium.[320] If the combined entity someday were to be sold, Laster opined, the Occam Network shareholders would "only get 15 percent" of any control premium paid in that later transaction.[321]

As discussed below, Vice Chancellor Laster's analysis is problematic in the first instance because the controlling Delaware Supreme Court precedents do not premise *Revlon*'s applicability on the ability of target shareholders to participate in future takeover premia.[322] Second, the Vice Chancellor's analysis overlooks many key facts. If Calix were to be acquired in the future, any former target shareholders would now get the benefit of Calix's directors' and officers' fiduciary duties. By the time Calix was acquired in the future, moreover, many of the former target shareholders presumably long since would have sold their Calix shares. If those shareholders are unlikely to be around when future takeover premia are divided, why should the prospect of such premia determine the fiduciary duties of the target's board and management?

Third, why rest the analysis on the possibility that the acquirer might be acquired in the future? Many companies are never subjected to a takeover offer, let alone actually acquired. In addition, assuming the companies least likely to be acquired in the future are those with a controlling shareholder, Vice Chancellor Laster's analysis would imply that there is no reason to apply *Revlon*. Yet, of course, that is precisely the context in which *Revlon* most clearly applies.[323]

Finally, and most disturbingly, because Vice Chancellor Laster's analysis does not depend on the percentage of the consideration paid in cash, that analysis would apply equally well to a stock-for-stock merger. Yet, both Chancellor Allen and the Delaware Supreme Court's opinions in *Time*

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318. Transcript of Ruling, *supra* note 315, at 7.

319. Haas, *supra* note 314.

320. Transcript of Ruling, *supra* note 315, at 4–6 ("This is a situation where the target stockholders are in the end stage in terms of their interest in Occam. This is the only chance they have to have their fiduciaries bargain for a premium for their shares as the holders of equity interests in that entity.").

321. *Id.*

322. *See infra* notes 344–46 and accompanying text (discussing *QVC*'s discussion of the relevance of control premia).

323. *See supra* text accompanying note 271 (explaining that *Revlon* is triggered when the acquiring firm has a controlling shareholder).

made clear that *Revlon* does not apply to such mergers.[324] This doctrinal conflict suggests that Vice Chancellor Laster's approach should be rejected.

C. Lukens *and Its Progeny Are Inconsistent with Controlling Delaware Supreme Court Precedents*

The most directly relevant Delaware Supreme Court precedent is *In re Santa Fe Pacific Corp. Shareholder Litigation*.[325] Santa Fe and Burlington were both publicly held Delaware corporations.[326] After negotiations, they agreed to a complicated deal in which the two companies would make a joint tender offer for up to 33 percent of Santa Fe's shares at $20 per share in cash.[327] If successful, the offer would give Burlington 16 percent of Santa Fe's remaining outstanding shares.[328] If the offer succeeded, a freeze-out merger in which remaining Santa Fe shareholders would get Burlington shares in exchange for their Santa Fe stock would follow it.[329] All the while, Santa Fe's board of directors was fending off an unsolicited takeover bid by Union Pacific.[330]

The Delaware Supreme Court rejected the plaintiffs' argument that the deal triggered *Revlon* duties for Santa Fe's directors on grounds that the plaintiffs "failed to allege that control of Burlington and Santa Fe after the merger would not remain 'in a large, fluid, changeable and changing market.'"[331] The clear implication is that the form of consideration was not the relevant issue. Instead, the issue was whether the Burlington shareholders would remain dispersed "in a large, fluid, changeable and changing market."

Yet, in *NYMEX*, the chancery court characterized *Santa Fe* as simply setting a floor—33 percent cash—below which one did not enter *Revlon*-land.[332] As for higher ratios, the chancery court relied on *Lukens* for the proposition that the Delaware "Supreme Court has not set out a black line rule explaining what percentage of the consideration can be cash without triggering *Revlon*."[333]

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324. *See supra* Part IV.A.1 (discussing rules governing stock-for-stock mergers).
325. 669 A.2d 59 (Del. 1995).
326. *Id.* at 63.
327. *See id.* at 63–64 (describing the negotiations and deal terms).
328. *Id.* at 64.
329. *Id.*
330. *See id.* at 63–64 (describing the Union Pacific offer).
331. *Id.* at 71.
332. *In re* NYMEX S'holder Litig., C.A. Nos. 3621-VCN, 3835-VCN, 2009 WL 3206051, at *5 (Del. Ch. Sept. 30, 2009).
333. *Id.* In sharp contrast, Chancellor Strine recently observed:

> Here, the Merger consideration consists of a mix of 65% stock and 35% cash, with the stock portion being stock in a company whose shares are held in large, fluid market. In the case of *In re Santa Fe Pacific Corp. Shareholder Litigation*, the Supreme Court held that a merger transaction involving nearly equivalent consideration of 33% cash and 67% stock did not trigger *Revlon* review when there was no basis to infer that the stock portion of that consideration was stock in a controlled company. That decision is binding precedent.

In re Synthes, Inc. S'holder Litig., 50 A.3d 1022, 1048 (Del. Ch. 2012) (footnote omitted).

This characterization of *Santa Fe* is hard to square with the Delaware Supreme Court's analysis in the case, which makes no reference to floors or ceilings, but rather to the postdeal "stock ownership structure of Burlington."[334] It is even more difficult to square with the three checkpoints established by *Arnold v. Society for Saving Bancorp, Inc*.[335]

The *Smurfit* court finessed *Arnold* in the first instance by selective quotation of the key passage setting out the three checkpoints. The *Smurfit* court quoted it as follows:

> The Delaware Supreme Court has determined that a board might find itself faced with such a duty in at least three scenarios: "(1) 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[ ]; (2) where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company; or (3) when approval of a transaction results in a sale or change of control[.]"[336]

The observant reader will note that the chancery court thereby omitted the critical qualifier *Arnold* adds to Checkpoint 3. To emphasize the point, let us quote the pertinent part of *Arnold* again in full: "(3) when approval of a transaction results in a sale or change of control. In the latter situation, *there is no sale or change in control when [c]ontrol of both [companies] remain[s] in a large, fluid, changeable and changing market*."[337]

Arnold's clear implication is that an acquisition by a publicly held corporation with no controlling shareholder that results in the combined corporate entity being owned by dispersed shareholders in the proverbial "large, fluid, changeable and changing market" does not trigger *Revlon* whether the deal is structured as all stock, all cash, or somewhere in the middle. The form of consideration is simply irrelevant.

The Delaware Supreme Court's more recent opinion in *Lyondell* confirms this reading of both *Santa Fe* and *Arnold*. In addition to the substantive errors made by the chancery court in *Lyondell*,[338] the chancery court also took too expansive an approach to when *Revlon* duties are triggered by holding that the target board enters *Revlon*-land when it "undertakes a sale of the company for cash."[339]

Checkpoint 1 was inapplicable on *Lyondell*'s facts, because the target board had not initiated "an active bidding process," let alone one that would involve a breakup of the company. Checkpoint 2 was inapplicable because

334. *In re* Santa Fe Pac. Corp. S'holder Litig., 669 A.2d 59, 71 (Del 1995).
335. 650 A.2d 1270 (Del. 1994).
336. Smurfit-Stone Container Corp. S'holder Litig., 2011 WL 2028076, at *12 (Del. Ch. May 24, 2011) (alterations in original) (quoting *Arnold*, 650 A.2d at 1290).
337. *Arnold*, 650 A.2d at 1290 (alterations in original) (emphasis added) (footnotes omitted) (citations omitted) (internal quotation marks omitted).
338. *See supra* Part III.B.3 (discussing the chancery court's errors in defining *Revlon* duties).
339. Ryan v. Lyondell Chem. Co., C.A. No. 3176-VCN, 2008 WL 2923427, at *12 (Del. Ch. July 29, 2008), *rev'd*, 970 A.2d 235 (Del. 2009).

the transaction did not involve a hostile offer or an abandonment of the target's long-term strategy or a breakup of the company.

Checkpoint 3, however, was triggered once the target board decided to sell the company to Access because Access was a privately held corporation. The transaction therefore would have involved a change of control from disperse public shareholders in "a large, fluid, changeable and changing market" to a single controlling shareholder. Although the Delaware Supreme Court did not quote that now proverbial standard, it did hold that one does not enter *Revlon*-land simply because a prospective target company is "in play."[340] Instead, one does so "only when a company embarks on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control."[341]

Fairly read, this confirms that in the phrase "sale or change of control," as used in Checkpoint 3, control must be understood to modify both the words "sale" and "change." Accordingly, *Lyondell* confirms that the interpretation of *Arnold* and *Santa Fe* set out above is the correct one rather than that offered by the chancery court.

D. Lukens *and Its Progeny Are Inconsistent with the Policies Underlying* Revlon

The logic of the chancery court decisions rests on the policy that target shareholders who get cash have no opportunity to participate in the potential postacquisition gains that may accrue to shareholders of the combined company:

> Defendants emphasize that no Smurfit-Stone stockholder involuntarily or voluntarily can be cashed out completely and, after consummation of the Proposed Transaction, the stockholders will own slightly less than half of Rock-Tenn. . . . Defendants lose sight of the fact that while no Smurfit-Stone stockholder will be cashed out 100%, 100% of its stockholders who elect to participate in the merger will see approximately 50% of their Smurfit-Stone investment cashed out. As such, like Vice Chancellor Lamb's concern that potentially there was no "tomorrow" for a substantial majority of Lukens stockholders, the concern here is that there is no "tomorrow" for approximately 50% of each stockholder's investment in Smurfit-Stone. That each stockholder may retain a portion of her investment after the merger is insufficient to distinguish the reasoning of *Lukens*, which concerns the need for the Court to scrutinize under *Revlon* a transaction that constitutes an end-game for all or a substantial part of a stockholder's investment in a Delaware corporation.[342]

340. *Lyondell*, 970 A.2d at 242.
341. *Id.*
342. Smurfit-Stone Container Corp. S'holder Litig., 2011 WL 2028076, at *14 (Del. Ch. May 24, 2011).

As we have seen, however, this concern makes no sense.[343] As long as the acquirer is publicly held, shareholders who get cash could simply turn around and buy stock in the postacquisition company. They would then participate in any post-transaction gains, including any future takeover premium. Only if there has been a change of control is that option foreclosed.

In any event, as the discussion in Part II.C makes clear, the relevant policy concern is not whether there is a future. To be sure, *QVC* spoke of "an asset belonging to public shareholders" (i.e., "a control premium").[344] As we saw above, although he did not cite *QVC*, Vice Chancellor Laster implicated this concern by holding that *Revlon* was triggered because the transaction at issue was the "only chance [the target shareholders would] have to have their fiduciaries bargain for a premium for their shares."[345]

If *QVC* is properly understood, however, the Delaware Supreme Court was not showing concern for whether there will be a tomorrow for the shareholders. Instead, as discussed above, the court was concerned in *QVC* with the division of gains between target and acquirer shareholders because the post-transaction company would have a dominating controlling shareholder.[346]

As the analysis of *QVC* in Part II.C.2 explained, the relevant concern thus is the potential that conflicted interests will affect the target's board of directors' decisions.[347] Indeed, as we have seen, even Vice Chancellor Lamb's opinion in *Lukens* recognized that the motivating concern underlying *Revlon* is "the omnipresent specter that a board may be acting primarily in its own interest, rather than those of the corporation and its shareholders."[348] Curiously, however, Vice Chancellor Lamb brought that policy concern into play only with respect to whether the directors had satisfied their *Revlon* duties, while ignoring it when deciding whether those duties have triggered. But nothing in *Revlon* or *QVC* suggests that that policy is limited to the former issue rather than both inquiries.

Because the conflict of interest policy concern is the underlying driver of both aspects of *Revlon*, the chancery court in *Lukens* and its progeny should

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343. *See supra* text accompanying notes 279–80 (discussing *Lukens* last period argument).

344. *See supra* note 201 and accompanying text (quoting *QVC*).

345. *See supra* note 320 and accompanying text (quoting Transcript of Ruling, *supra* note 315). In *In re Synthes, Inc. Shareholder Litigation*, 50 A.3d 1022 (Del. Ch. 2012), the plaintiffs argued that *Revlon* was triggered by a deal "represent[ing] the last chance they have to get a premium for their [target company] shares." *Id.* at 1047. Chancellor Strine rejected that argument, holding that the plaintiffs were "wrong on the merits." *Id.* At least implicitly, Chancellor Strine thus rejected the focus in *Steinhardt* on the final period aspect of the transactions at bar.

346. *See supra* notes 202–03 and accompanying text (discussing the proper interpretation of *QVC*).

347. *See supra* notes 199–200 and accompanying text (discussing the conflicts of interest on the part of target managers and directors when the postmerger entity has a controlling shareholder).

348. *See supra* note 234 and accompanying text (quoting *Lukens*).

have considered whether the all- or partial-cash transactions necessarily implicate conflicts of interest akin to those at issue in *Revlon* and *QVC*. If the various Vice Chancellors had done so, they would have recognized that, so long as acquisitions of publicly held corporations are conducted by other publicly held corporations, diversified shareholders will be indifferent as to the allocations of gains between the parties.[349] In turn, those shareholders also will be indifferent as to the form of consideration.

In contrast, if the transaction results in a privately held entity, a diversified shareholder cannot be on both sides of the transaction. If the post-transaction entity remains publicly held, but will be dominated by a controlling shareholder, there is a substantial risk that the control shareholder will be able to extract non–pro rata benefits in the future and get a sweetheart deal from target directors in the initial acquisition. In either situation, the division of gains matters a lot. As such, investors would prefer to see gains in such transactions allocated to the target.[350] It is in these situations that *Revlon* should come into play.

E. Should Revlon *Be Extended to All Corporate Acquisitions?*

A proponent of *Lukens* and its progeny might respond to the arguments made above by arguing that Delaware law is not static, which is certainly true.[351] "It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs," to quote *Unocal* itself.[352] Perhaps the chancery court is groping toward a new understanding of *Revlon*, which would necessitate a broader application to a wider array of transactions.[353]

In particular, the emphasis on allocation of the control premia in Vice Chancellor Laster's bench ruling in *Steinhardt* suggests a concern that target managers may have sold too cheaply. Put another way, "Vice Chancellor Laster was concerned that the target stockholders' interest in the

349. *See supra* notes 194–96 and accompanying text (discussing investor preferences with respect to the allocation of gains when the postmerger entity does not have a controlling shareholder).

350. *See supra* notes 197–98 and accompanying text (discussing investor preferences with respect to the allocation of gains when the postmerger entity has a controlling shareholder).

351. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 957 (Del. 1985) (noting that Delaware "corporate law is not static").

352. *Id.*

353. Of course, even if the chancery court is correct in this regard, the evolution properly should take place only once the Delaware Supreme Court has given its imprimatur to *Lukens* and its progeny. In *In re Synthes, Inc. Shareholder Litigation*, 50 A.3d 1022 (Del. Ch. 2012), the plaintiffs argued that *Revlon* was triggered by a deal in which they would receive "mixed consideration of 65% J&J stock and 35% cash for their Synthes stock," because "this blended consideration represents the last chance they have to get a premium for their Synthes shares." *Id.* at 1047. Chancellor Strine squarely rejected this argument, holding that the plaintiffs were "wrong on the merits." *Id.* The Chancellor based that holding on the "binding authority of our Supreme Court as set forth in *QVC* and its progeny," pursuant to which "*Revlon* duties only apply when a corporation undertakes a transaction that results in the sale or change of control." *Id.* As suggested by his use of the word "binding," trial courts are supposed to follow higher court precedents even when they disagree with them.

target's assets could be diluted and value improperly transferred to the buyer's stockholders if the target board failed to secure an adequate price in the merger."[354] By invoking *Revlon* and its associated reasonableness standard, the Vice Chancellor gave himself far greater latitude to evaluate the merits of the sale than would be allowed under the business judgment rule.

If this is the direction in which the chancery court is seeking to evolve *Revlon*, however, there are a number of reasons to abort that effort. First, although *Steinhardt* could be understood as a logical extension of the repeated concerns expressed in *Lukens* and its progeny with final period transactions, the concern manifests itself in the former via a much different legal rule. Instead of focusing on what percentage of the consideration takes the form of cash, Vice Chancellor Laster focused on what percentage of the combined entity will be held by former target shareholders.[355] This doctrinal shift is essential to effectuating the new policy goal because the percentage of the consideration taking the form of cash is wholly irrelevant to determining whether the target board obtained an adequate price (or, for that matter, whether the target board had a conflict of interest). Indeed, if nothing else, Vice Chancellor Laster's holding in *Steinhardt* at least exposed, albeit sub silentio, the inherent flaw in the reasoning of *Lukens* and its progeny. Simply put, the percentage of the consideration paid in cash advances no cognizable policy concern.

Second, if the new standard is to be that *Revlon* is triggered when the target shareholders will end up with a small percentage of the stock of the post-transaction combined entity, that standard is both unworkable and illogical. Any point at which one draws the line will necessarily be arbitrary. Whether the target shareholders end up with 1 percent or 99 percent of the stock of the post-transaction corporation, there will still be a risk that the target board may have failed to obtain an adequate price.

These observations demonstrate that neither the form of the consideration nor the percentage of the combined entity ultimately owned by former target shareholders adequately responds to Vice Chancellor Laster's concern. Indeed, no trigger could satisfactorily address that concern, because it is inevitably present in all corporate acquisitions. As noted above, sometimes side payments from the favored bidder may induce the target board to accept a lower price than the maximum attainable.[356] Other times, however, the target board may simply have made mistakes. Addressing the Vice Chancellor's concern thus requires extending the *QVC* reasonableness standard to all corporate acquisitions, so that the court can determine whether the target board got an adequate price and, if not, why not.

354. Haas, *supra* note 314.
355. *See supra* notes 319–20 and accompanying text (discussing the *Steinhardt* holding).
356. *See supra* notes 73–74 (discussing the impact of side payments).

This is a step the Delaware courts have been unwilling to take. The reason they have declined to do so is probably captured by Chancellor Allen's warning that, unless *Unocal* was carefully applied, "courts—in exercising some element of substantive judgment—will too readily seek to assert the primacy of their own view on a question upon which reasonable, completely disinterested minds might differ."[357] This is true even with respect to the adequacy of the price received by the target, as the Delaware Supreme Court explained in *Time*, by stating that courts should not substitute their "judgment as to what is a 'better' deal for that of a corporation's board of directors."[358]

This is so, the Court explained, because "Delaware law confers the management of the corporate enterprise to the stockholders' duly elected board representatives. . . . That duty may not be delegated to the stockholders."[359] Prior to *Lukens* and its progeny, the Delaware courts thus seemed to recognize the tension between authority and accountability that was discussed in Part I.C above. Indeed, it is striking how precisely Chancellor Allen's warning echoes the argument above that one cannot make an actor more accountable without simultaneously transferring some aliquot of his decision-making authority to the entity empowered to hold him to account. As we saw in that part, there are strong policy reasons not to do so even in the context of corporate acquisitions. Accordingly, the Delaware courts should not go further down the road toward applying a substantive reasonableness analysis to all corporate acquisitions.[360]

CONCLUSION

Revlon should be understood as a special case of the *Unocal* heightened scrutiny standard of review. The target board of directors' sole *Revlon* duty is to obtain the best deal for their shareholders. In so doing, any favoritism of one bidder over another must be motivated by a concern for immediate shareholder value and not by any improper motives.

One enters *Revlon*-land through any one of three checkpoints: (1) the target's board initiates an active bidding process to sell the corporation or to effect a business reorganization involving a clear breakup of the company; (2) in response to an initial offer, the target's board causes the corporation to abandon the corporation's long-term strategy and seeks an alternative

357. City Capital Assocs. L.P. v. Interco Inc., 551 A.2d 787, 796 (Del. Ch. 1988).

358. Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1990).

359. *Id.* at 1154.

360. Taken to its logical extreme, Vice Chancellor Laster's concern that an acquisition is a final period transaction representing the last occasion on which the target's board and management can maximize the value of the target's shares suggests that even a substantive reasonableness standard would not suffice as a standard of review. After all, if that is the concern, the reason the target board failed to obtain an adequate price would be irrelevant. The sole inquiry would be whether the price was adequate. Such a rule, however, would substitute the court's judgment for that of the board in all cases. This observation thus further confirms the extent to which *Steinhardt* is an outlier in Delaware jurisprudence.

transaction involving the breakup of the company; (3) the transaction results in a sale or change of control of the corporation.

Contrary to recent chancery court opinions, Checkpoint 3 is not dependent on the form of the consideration paid by the acquirer. If dispersed shareholders own the post-transaction combined entity in "a large, fluid, changeable and changing market," *Revlon* does not apply. If the post-transaction entity has a controlling shareholder, however, regardless of whether the corporation goes private or remains listed on a stock market, *Revlon* does apply. In other words, there must be a change of control, whether by sale or otherwise.