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## Assessing the Wisdom of the Business Judgment Rule in Corporate Control Contests: Is It Time to Make Shareholders' Interests Paramount

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**ASSESSING THE WISDOM OF THE BUSINESS  
JUDGMENT RULE IN CORPORATE CONTROL  
CONTESTS: IS IT *TIME* TO MAKE  
SHAREHOLDERS' INTERESTS  
*PARAMOUNT*?**

**I. INTRODUCTION**

*In 1961, you were elected to the board of directors of HealthCo, a multi-million dollar pharmaceutical company. The president of HealthCo was your college roommate. Despite increased competition in the industry and long delays in obtaining FDA approval to sell new products, you remain confident in HealthCo's management and in its future. Rather than focusing on short-term earnings per share and paying a large portion of HealthCo's earnings to the shareholders as dividends, the company has reinvested HealthCo's earnings into long-term research and development (R&D) efforts seeking to ensure the company's growth and success into the next century. The history of marginal earnings and modest dividends has caused the company's stock price to languish between \$30 and \$35 per share over the last two years.*

*Today, the company received an unsolicited offer from a well-known corporate takeover artist to purchase all of the company's shares for \$55 cash per share. Your investment banker has advised defending against this unsolicited offer because the takeover offer will saddle HealthCo with massive debt—payment of which could threaten the company's ongoing R&D efforts. You like the defense plan proposed by the bankers, but are concerned that the cost of the plan is expected to exceed ten million dollars. In addition, HealthCo has exhausted its credit opportunities and will be forced to finance the proposed defense plan with junk bonds. Without the defense plan, the company will be "taken over" and the current management and the board of directors will be ousted.*

*As a director, you owe fiduciary duties to the company's shareholders and have an obligation to maximize the value of their investment. However, you are concerned with retaining your position on the board and with the future of the company's current management and employees. Moreover, if you defend*

*against the takeover, the company's shareholders may sue you for denying them the \$55 per share price. What do you do?*

Legislatures and courts entrust directors with substantial deference premised on the belief that directors are experts in business management and are therefore better suited than judges to make corporate decisions.<sup>1</sup> In spite of their expertise, directors do not always make the best decisions for the corporation or its shareholders. Directors may have a financial or other interest in the outcome of their decision which conflicts with the best interests of the corporation or its shareholders.<sup>2</sup> A conflict between director and shareholder interests is most likely to arise when a corporation is faced with an unwanted takeover.<sup>3</sup> On one hand, directors have fiduciary duties to the company's shareholders,<sup>4</sup> who have a short-term interest in maximizing the value of their shares.<sup>5</sup> On the other hand, directors may have a duty to consider the long-term interests of the company.<sup>6</sup> Directors may also have social and professional relationships with the corporation's management,<sup>7</sup> and may be tempted to thwart a

1. *See, e.g.*, *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 888 (6th Cir. 1986) (corporate directors "know more about running their businesses than courts do"); *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252, 1259 (S.D.N.Y. 1985) ("Courts have no place substituting their judgments for that of the directors."); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (When board of directors uses sound business judgment, "[a] court . . . will not substitute its own notions of what is or is not sound business judgment."); *Solash v. Telex Corp.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608, at 97,727 (Del. Ch. Jan. 19, 1988) ("Because businessmen and women are correctly perceived as possessing skills, information and judgment not possessed by reviewing courts[,] . . . courts have long been reluctant to second-guess such decisions when they appear to have been made in good faith."). *See also infra* notes 39-54 and accompanying text for a discussion of the rationale behind the business judgment rule.

2. *See, e.g.*, *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 184 (Del. 1986) (business judgment rule protection not afforded where "[t]he principle benefit [of the board decision] went to directors, who avoided personal liability").

3. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985). When faced with a takeover bid, there is an "omnipresent specter that a board may be acting primarily in its own interests." *Id.* *See also infra* notes 418-40 and accompanying text for a discussion of why business judgment rule protection, therefore, may be inappropriate in control contexts.

4. *See, e.g.*, *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). *See also infra* notes 22-37 and accompanying text for a discussion of directors' fiduciary duties.

5. *Revlon*, 506 A.2d at 182.

6. *See Paramount Communications, Inc. v. Time Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,281-82 (Del. Ch. July 14, 1989), *aff'd*, No. 284, 1989 (Del. Feb. 26, 1990). *See also infra* notes 382-417 and accompanying text.

7. Although corporate law grants shareholders the power to elect corporate directors, in practice, management nominates directors and shareholders ratify management's selections. W. KNEPPER & D. BAILEY, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* 4 (1988). Besides maintaining social and professional relationships with management, directors may be part of the company's inside management. H. HENN & J. ALEXANDER, *LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* 553 (1983).

takeover in order to entrench current management and themselves.<sup>8</sup>

The business judgment rule is a convenient doctrine to keep corporate decision making out of the courtroom.<sup>9</sup> In general, the business judgment rule provides that courts will not second guess informed decisions made by boards of directors absent a showing of "gross and palpable overreaching."<sup>10</sup> Besides protecting board decisions from judicial review, the business judgment rule also insulates directors from personal liability.<sup>11</sup> The rule recognizes the directors' important role in overseeing company operations and protects and promotes the full and free exercise of directors' managerial power<sup>12</sup> despite the existence of these conflicting interests.<sup>13</sup>

This Comment considers the nature of director responsibilities in corporate management and the fiduciary duties which attend these responsibilities. Next, the Comment analyzes the theory and development of the business judgment rule as applied to contests for corporate control. The Comment then discusses some problems with allowing the business judgment rule to protect directors' corporate control decisions. Finally, the author concludes that increased director accountability is needed to protect shareholders, and proposes a legislative solution which transfers the power to make corporate control decisions to shareholders.

## II. BACKGROUND OF DIRECTORS' FIDUCIARY DUTIES AND THE BUSINESS JUDGMENT RULE

### A. Corporate Control and Fiduciary Duties

The fundamental structure of corporate governance divides manage-

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8. See, e.g., *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227, 1244 (Del. Ch. 1988) (directors' plan unreasonable because it "tend[ed] to entrench the management group and virtually eliminate the public shareholders' opportunity to realize a 'takeover premium' for their shares"). See also *infra* notes 418-40 and accompanying text.

9. See *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984).

10. See, e.g., *Sinclair*, 280 A.2d at 720; *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883, 887 (Del. 1970). See also *Responsibilities of Corporate Officers and Directors Under Federal Securities Laws*, Fed. Sec. L. Rep. (CCH) No. 1291, at 78 (June 22, 1988).

11. Some commentators distinguish the business judgment rule from the business judgment doctrine, the former protecting directors from personal liability and the latter protecting decisions made by directors. Courts, at least in the takeover context, do not. See, e.g., *Revlon*, 506 A.2d at 180 n.10 ("In the transactional justification cases, where the doctrine is said to apply, our decisions have not observed the distinction in such terminology" between the business judgment rule and the business judgment doctrine). Further consideration of this distinction is outside the scope of this Comment. For additional discussion of the distinction, see Hinsey, *Duty of Care: Business Judgment Rule and ALI Corporate Governance*, 52 GEO. WASH. L. REV. 609, 611-13 (1984).

12. *Van Gorkom*, 488 A.2d at 872; *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

13. *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984).

ment powers between shareholders, company officers and a board of directors.<sup>14</sup> State corporate law defines the respective rights and responsibilities of shareholders, officers and directors.<sup>15</sup> Shareholders own the corporation.<sup>16</sup> However, their power to participate in corporate management and control is limited to decisions affecting the corporation's "ultimate destiny."<sup>17</sup> These types of decisions include the power to (1) approve or remove directors,<sup>18</sup> (2) make amendments to articles of incorporation or corporate bylaws, and (3) approve or disapprove fundamental corporate changes not in the regular course of business.<sup>19</sup>

Directors, not shareholders, are responsible for managing the business and affairs of a corporation.<sup>20</sup> Although directors delegate daily operating responsibility to company officers, the board of directors monitors the performance of company management and establishes broad company policies.<sup>21</sup> Accompanying their powers of management, directors have fiduciary obligations to the corporation and its shareholders under both common law and state statutes.<sup>22</sup> These fiduciary duties include the duty of care and the duty of loyalty.<sup>23</sup>

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14. *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 258 (2d Cir. 1984). See also generally H. HENN & J. ALEXANDER, *supra* note 7, at 466-67.

15. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 304 (1971) (law of incorporating state determines administration of corporation). See also *Norlin*, 744 F.2d at 264 n.5. This Comment focuses primarily on common law and Delaware statutory law because a significant portion of publicly-traded companies are incorporated in Delaware. H. HENN & J. ALEXANDER, *supra* note 7, at 185 (approximately 40% of companies listed on the New York Stock Exchange are incorporated in Delaware).

16. H. HENN & J. ALEXANDER, *supra* note 7, at 486.

17. *Norlin*, 744 F.2d at 258 ("[D]ecisions affecting a corporation's ultimate destiny are for the shareholders to make in accordance with democratic procedures.")

18. H. HENN & J. ALEXANDER, *supra* note 7, at 491. By removing directors, shareholders can completely change the management and control of the corporation. D. BLOCK & H. PITT, PROXY CONTESTS 15 (1982).

19. H. HENN & J. ALEXANDER, *supra* note 7, at 491.

20. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (1983) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . ."); see also REVISED MODEL BUSINESS CORP. ACT § 8.01(b) (1982) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation shall be managed under the direction of, its board of directors.")

21. W. KNEPPER & D. BAILEY, *supra* note 7, at 5-7.

22. See *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939); Warden, *The Boardroom as a War Room: The Real World Applications of the Duty of Care and the Duty of Loyalty*, 40 BUS. LAW. 1431, 1431 (1985). See also generally D. BLOCK, N. BARTON & S. RADIN, THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS AND OFFICERS 1 (1988). In addition to common-law fiduciary duties, approximately 35 states have codified mandatory directorial conduct. *Id.* at 2.

23. D. BLOCK, N. BARTON & S. RADIN, *supra* note 22, at 1. See also *infra* notes 24-37 for a discussion of these duties.

## 1. Duty of care

The duty of care requires that a director "exercise, in the performance of his [or her] tasks, the care that a reasonably prudent [director] in a similar position would use under similar circumstances."<sup>24</sup> When acting within this standard of care, a director is shielded from personal liability, and his or her decision is protected from judicial scrutiny.<sup>25</sup> However, the converse is not always true. A director's failure to act reasonably does not necessarily invoke judicial review or impose personal liability.<sup>26</sup> State legislatures disagree over whether the standard for director liability is one of gross negligence or ordinary negligence.<sup>27</sup> Regardless of what standard applies, courts struggle in imposing it consistently due to the broad and often anomalous protection afforded by the business judgment rule.<sup>28</sup>

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24. *Norlin*, 744 F.2d at 264. See also *Briggs v. Spaulding*, 141 U.S. 132, 147 (1981) ("The degree of care required . . . has to be determined in view of all the circumstances."). For further consideration of possible future trends in directors' responsibilities, see Frankel, *Corporate Director's Duty of Care: The American Law Institute's Project on Corporate Governance*, 52 GEO. WASH. L. REV. 705 (1984).

25. D. BLOCK, N. BARTON & S. RADIN, *supra* note 22, at 28.

26. *Id.* This is because "the degree of culpability required for the imposition of liability may be higher than the standard of care." *Id.*

27. Delaware state law is the most advantageous to directors because liability requires gross negligence. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985) ("gross negligence is . . . the proper standard for determining whether [directors exercised proper] business judgment"); *Aronson v. Lewis*, 473 A.2d 805, 812 n.6 (Del. 1984) ("director liability is predicated on a standard which is less exacting than simple negligence"). Similarly, Indiana's law imposes director liability only where "breach or failure to perform constitutes willful misconduct or recklessness." IND. CODE ANN. § 23-1-35-11e(2) (Burns 1986). California's standard for director conduct, on the other hand, is framed in more rigorous terms than Delaware's or Indiana's because director liability may be based on a showing of ordinary negligence. CAL. CORP. CODE § 309(a) (West 1977) ("A director shall perform the duties of a director . . . in good faith . . . as an ordinarily prudent person in a like position would use under similar circumstances."). Furthermore, directors must demonstrate a "compelling business purpose" for their actions whenever a conflict of interest is shown. *Klaus v. Hi-Shear Corp.*, 528 F.2d 225, 233-34 (9th Cir. 1975) (interpreting California law). Similar to California, New York law employs an ordinary negligence standard. N.Y. BUS. CORP. LAW § 717(a) (McKinney Supp. 1989) ("A director shall perform his duties as a director . . . in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances."). See also *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 274 (2d Cir. 1986) (applying New York law).

28. The inconsistency in judicial decisions can be readily seen in cases involving the validity of poison pills, a popular defense mechanism implemented to thwart unwanted takeovers. See *infra* note 76 for a description of poison pills and other common defense mechanisms. Compare *Black & Decker Corp. v. American Standard, Inc.*, 682 F. Supp. 772, 788 (D. Del. 1988) (applying Delaware law) (directors' decision to implement poison pill not protected by business judgment rule); *Grand Metro. PLC v. Pillsbury Co.*, 558 A.2d 1049, 1060 (Del. Ch. 1988) (same); with *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1357 (Del. 1985) (business judgment rule protected directors' decision to implement poison pill plan).

## 2. Duty of loyalty

The duty of loyalty imposes on directors an affirmative duty to protect the economic interests of shareholders.<sup>29</sup> This duty also prohibits self-dealing by directors in the course of their relationship with the corporation and its shareholders.<sup>30</sup> Directors' duty of loyalty is breached when a director uses his or her fiduciary position "to promote, advance or effectuate a transaction . . . in which the [director] has a substantial economic interest."<sup>31</sup> For example, a director who buys a valuable corporate subsidiary at a discount from its fair market value and re-sells it for personal profit has violated the duty of loyalty.<sup>32</sup> Additionally, a director may breach the duty by advancing his or her individual non-economic interests.<sup>33</sup> This could occur, for example, when a director "manipulate[s] the internal corporate machinery" to perpetuate his or her own control over the corporation.<sup>34</sup>

The underlying purpose of the duty of loyalty is to ensure that the corporation and its shareholders are treated fairly.<sup>35</sup> When a conflict-laden transaction is unfair, directors may be held personally liable.<sup>36</sup>

29. See *Norlin*, 744 F.2d at 264; *Van Gorkom*, 488 A.2d at 872.

30. *Norlin*, 744 F.2d at 264.

31. *Solash v. Telex Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608, at 97,727 (Del. Ch. Jan. 19, 1988). Under *Solash*, it is irrelevant whether the economic interest is direct or indirect. *Id.*

32. W. KNEPPER & D. BAILEY, *supra* note 7, at 122. Note however, that transactions such as this could be upheld if the interested director adequately disclosed his or her interest to all concerned parties. *Id.* at 83-84. See also *Van Gorkom*, 488 A.2d at 889 (board action sustained, notwithstanding board's violation of its duty of care, "if its approval by majority vote of the shareholders is found to have been based on an informed electorate").

33. W. KNEPPER & D. BAILEY, *supra* note 7, at 87.

34. *Id.*

35. The Delaware court in *Guth v. Loft, Inc.* first articulated the underlying rationale of the duty of loyalty:

A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty . . . . The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.

5 A.2d 503, 510 (Del. 1939).

Later, the Delaware court elaborated on the requirements of this duty:

There is no "safe harbor" for such divided loyalties in Delaware. When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness. The requirement of fairness is unflinching in its demand that where one stands on both sides of the transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.

Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (citations omitted). See also *Norlin*, 744 F.2d at 265 ("Once self-dealing or bad faith is demonstrated . . . the burden shifts to the directors to 'prove that the transaction was fair' . . .") (citation omitted).

36. Cf. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 724 (Del. 1971). In *Sinclair*, the parent

When a director violates his or her duty of loyalty, but the decision nonetheless is "fair" to the company and its shareholders, courts generally will not invalidate the transaction or impose personal liability on the directors.<sup>37</sup>

### B. *The Business Judgment Rule*

This section discusses the underlying rationale of the business judgment rule and its application to changes in corporate control.<sup>38</sup>

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company was held responsible for breaching its duty of loyalty to minority shareholders of one of its subsidiaries. *Id.*

37. See REVISED MODEL BUSINESS CORP. ACT § 8.31(a)(3) (1982) (a conflict-laden transaction "is not voidable by the corporation solely because of the director's interest in the transaction if . . . the transaction was fair to the corporation"). The Revised Model Business Corporation Act (RMBCA) "reject[ed] the common law view that all conflict of interest transactions entered into by directors are automatically voidable at the option of the corporation . . ." *Id.* at § 8.31 comment 1. Under the RMBCA, conflict of interest transactions may arise if a director has a direct or indirect financial or managerial interest. *Id.* at § 8.31(b).

See also *Burton v. Exxon Corp.*, 583 F. Supp. 405, 415 (S.D.N.Y. 1984) (applying Delaware law) (When "directors, who control the making of a transaction and its terms, are on both sides, then the presumption and deference to sound business judgment are no longer present[.] . . . [i]ntrinsic fairness is then the [standard of review]."); *Sinclair*, 280 A.2d at 723 (once self-dealing was found, court applied "intrinsic fairness standard" and found that parent corporation failed to prove it acted fairly); *In re RJR Nabisco, Inc. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,709 (Del. Ch. July 17) ("[I]f the board is financially interested in the transaction, the appropriate form of judicial review is to place upon the board the burden to establish the entire fairness of the transaction."), *appeal refused mem.*, 556 A.2d 1070 (Del. 1989); *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227, 1239 (Del. Ch. 1988) ("[I]f the corporate fiduciaries [stand] on both sides of the transaction . . . those fiduciaries must establish the transaction's 'entire fairness' . . ."); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986) (when board had financial interest in its decision, "there is no alternative to a judicial evaluation of the fairness of the terms of the terms of the transaction").

38. Changes in corporate control generally occur in three types of transactions: (1) a negotiated merger between two companies; (2) a proxy contest, in which shareholders vote between an outsider and current management in an election; or (3) a tender offer by an outsider to buy a majority share. 11 S. LORNE, SECURITIES LAW SERIES, ACQUISITIONS AND MERGERS: NEGOTIATED AND CONTESTED TRANSACTIONS §§ 2.09, 3.01, 4.01 (1988). Negotiated mergers and some tender offers occur in a friendly environment, whereas proxy contests and most tender offers occur in a hostile environment. *Id.* at §§ 3.01, 4.01. The business judgment rule may apply to protect director decisions made in both hostile and friendly environments. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 (Del. 1985) (court protected management decision to fight hostile tender offer); *Paramount Communications, Inc. v. Time Inc.*, No. 284, 1989 (Del. Feb. 26, 1990) (court protected management decision to complete friendly transaction).

A friendly transaction may be preferred to a hostile transaction for reasons including seller cooperation, minimization of economic and emotional disadvantages characteristic of hostile transactions, and tax and accounting benefits. S. LORNE, *supra*, at § 2.01. This Comment focuses on transactions arising in a hostile environment because conflicts between shareholder and director interests are most apparent when management opposes a proposed takeover.



### 1. The rationale of the business judgment rule

The business judgment rule was initially recognized nearly a century ago by the Supreme Court of the United States in *Briggs v. Spaulding*.<sup>39</sup> A three-fold policy rationale underlies director protection under the business judgment rule.<sup>40</sup> First, the business judgment rule recognizes human fallibility.<sup>41</sup> Business opportunities often require quick decisions,<sup>42</sup> and the business judgment rule prevents "Monday-morning quarterbacking."<sup>43</sup> Courts appreciate the part-time nature of directorships<sup>44</sup> and the necessary reliance directors place on corporate officers and outside professionals in making efficient and effective board decisions.<sup>45</sup>

Second, the rule allows directors to engage in a certain amount of risk-taking.<sup>46</sup> Shareholders generally accept that directors will assume certain risks on their behalf because anticipated risk is often commensurate with anticipated return on investment.<sup>47</sup> Absent the protection afforded by the business judgment rule, competent individuals might refuse to serve as directors,<sup>48</sup> and those individuals who do agree to serve as

39. 141 U.S. 132 (1891). In *Briggs*, the Court ruled to protect directors from personal liability because the directors acted without bad faith or corrupt motive. *Id.* at 159.

40. D. BLOCK, N. BARTON & S. RADIN, *supra* note 22, at 5-11.

41. *Id.* at 5.

42. W. KNEPPER & D. BAILEY, *supra* note 7, at 183 ("Business imperatives often call for quick decisions, inevitably based on less than perfect information.").

43. *Id.* (quoting *Panter v. Marshall Field & Co.*, 646 F.2d 271, 297 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981)).

44. Many directors serve on a part-time basis, and therefore, "generally cannot [completely] know . . . the true condition of the affairs of the company." *Briggs*, 141 U.S. at 162-63. See also D. BLOCK, N. BARTON & S. RADIN, *supra* note 22, at 36 (citing a study which concluded that outside directors spend an average of two hours per week conducting their directorial duties); Greene, *Recent Tender Offer Developments: On the Edge or Deep In?*, 45 OHIO ST. L.J. 721, 729 (1984).

45. Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1492-98 (1984). See also DEL. CODE ANN. tit. 8, § 141(e) (1983) (board members are "fully protected in relying in good faith upon the books of account or reports made to the corporation by any of its officers, or by an independent certified public accountant, or by an appraiser . . ."). This reliance on third parties, however, will not excuse a director's failure to reasonably obtain and disseminate relevant information. Manning, *supra*, at 1492. See also *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

46. W. KNEPPER & D. BAILEY, *supra* note 7, at 183 ("Corporate directors perform an entrepreneur's function, which involves encountering risks . . .").

47. *Joy v. North*, 692 F.2d 880, 885-86 (2d Cir. 1982) ("[I]t is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions."), *cert. denied*, 660 U.S. 1051 (1983).

48. Arsh, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 97 (1979) ("The business judgment rule grew principally from the judicial concern that persons of reason, intellect, and integrity would not [otherwise] serve as directors . . .").

directors might be overly cautious.<sup>49</sup> Because overly cautious decision making limits the return shareholders ultimately realize, shareholders accept and expect risk-taking by company directors.<sup>50</sup>

Finally, courts admit they are ill-equipped to evaluate the wisdom of complex corporate decisions made in the uncertain and competitive business environment in which directors are peculiarly qualified.<sup>51</sup> As a consequence, courts are reluctant to impose their hindsight on decisions made by well-informed business professionals.<sup>52</sup> Although initially applied to protect decisions such as "should we install lights at Wrigley Field?,"<sup>53</sup> the business judgment rule has been expanded to protect almost all types of board decisions—including decisions affecting corporate control.<sup>54</sup>

## 2. Protection under the business judgment rule

For the business judgment rule to shield directors from liability and protect directors' decisions from judicial second-guessing, five elements must be satisfied.<sup>55</sup> These elements embody specific requirements of directors' fiduciary obligations.<sup>56</sup> First, directors must affirmatively act<sup>57</sup> or make a conscious decision not to act.<sup>58</sup> No protection is afforded director inaction resulting from ignorance<sup>59</sup> or abdication of duties.<sup>60</sup> This requirement stems from the policy that directors, by virtue of their

49. *Joy*, 692 F.2d at 886.

50. *Id.* ("A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally.")

51. See *Solash v. Telex Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608, at 97,727 (Del. Ch. Jan. 19, 1988).

52. *Id.*

53. *Shlensky v. Wrigley*, 95 Ill. App. 2d 173, 180, 237 N.E.2d 776, 781 (1968) (business judgment rule protected decision by directors of Chicago Cubs not to install lights at Wrigley Field because "directors[, not judges, were] elected for their business capabilities and judgment.")

54. *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984). *But see* *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252, 1259 (S.D.N.Y. 1985). The court noted that the business judgment rule was designed to protect decisions such as "should we buy a new truck today?" and "should we give Joe a raise?" *Id.* The court cautioned that defensive tactics "raise a wholly different set of considerations [because] by their very nature, [defensive tactics] act as a restraint on business purposes." *Id.*

55. D. BLOCK, N. BARTON & S. RADIN, *supra* note 22, at 12.

56. See *supra* notes 22-37 and accompanying text for a discussion of directors' fiduciary duties.

57. D. BLOCK, N. BARTON & S. RADIN, *supra* note 22, at 12.

58. *Id.* (directorial *action* is protected, whereas *inaction* is not protected "unless it is the result of a conscious decision not to act"). See also *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984).

59. *Rabkin v. Philip A. Hunt Chem. Corp.*, 547 A.2d 963, 972 (Del. 1986).

60. *Aronson*, 473 A.2d at 813 & n.7.

unique expertise, are better suited than judges to make corporate decisions.<sup>61</sup> Directors who fail to act are not satisfying their directorial responsibilities, and if directors fail to utilize their superior expertise, then the grounds for judicial deference disappear.

Second, directors must act without any conflict of interest.<sup>62</sup> This element embodies the directors' general duty of loyalty.<sup>63</sup> Also, in refusing to second-guess a directorial decision, courts necessarily assume that the decision resulted from an objective evaluation of all available alternatives. When the outcome of a decision affects personal interests of the decision maker, the ability of that decision maker to objectively evaluate alternatives is impaired.<sup>64</sup> Business judgment rule deference, therefore, is inappropriate when any personal interest affects the director's ability to exercise his or her business judgment.<sup>65</sup>

Third, directors must satisfy their duty of care which requires that directors obtain all reasonably available information necessary for effective deliberation.<sup>66</sup> Directors' efforts to obtain and consider relevant information have come under increasing judicial scrutiny in cases involving corporate control contests.<sup>67</sup>

Fourth, directors must act in good faith.<sup>68</sup> Good faith requires a genuine belief on the part of directors that actions taken are in the best

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61. *Solash*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608, at 97,727.

62. D. BLOCK, N. BARTON & S. RADIN, *supra* note 22, at 13-16. See also *Drobbin v. Nicolet Instrument Corp.*, 631 F. Supp. 860, 881 (S.D.N.Y. 1986) (applying Nevada law) (business judgment rule protection may be defeated without finding of pecuniary interest if indirect "entanglements and alliances" impair independence).

63. *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984) (applying Delaware law). See also *supra* notes 29-37 and accompanying text for a discussion of directors' duty of loyalty.

64. D. BLOCK, N. BARTON & S. RADIN, *supra* note 22, at 14 (citing *Arsht, The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 115 (1979)).

65. See *infra* notes 418-40 and accompanying text for a discussion of how control decisions affecting corporate control may impair a director's business judgment.

66. See *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985) ("[A] director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty."). See *supra* notes 24-28 and accompanying text for a discussion of directors' duty of care.

67. See, e.g., *Van Gorkom*, 488 A.2d at 872 (business judgment rule protects only informed decisions); *City Capital Assocs. Ltd. Partnership v. Interco Inc.*, 551 A.2d 787, 803 (Del. Ch.) ("[A] board may not proceed, consistently with its duty to be informed, without appropriately considering relevant information relating to alternatives."), *appeal dismissed*, 556 A.2d 1070 (Del. 1988); *In re Fort Howard Corp. Shareholders Litig.*, No. 9991 (Del. Ch. Aug. 8, 1988) (LEXIS, States library, Del file) ("It is essential for valid director action that it be taken on an informed basis. . . . [T]he gravity of [a corporate control] transaction places a special burden upon the directors to make sure that they have a basis for an informed view.").

68. D. BLOCK, N. BARTON & S. RADIN, *supra* note 22, at 19.

interests of the corporation and its shareholders.<sup>69</sup> The good faith requirement, like the absence of conflicting interests embodies the directors' general duty of loyalty.<sup>70</sup> Some courts have expanded the application of this duty to include director responsibility to non-shareholder constituencies.<sup>71</sup>

Finally, directors must respect the wide discretion entrusted to them and not abuse it.<sup>72</sup> This overriding element is sometimes referred to as the courts' "escape hatch."<sup>73</sup> The escape hatch allows courts to protect shareholders from truly egregious actions taken in good faith, such as a conspicuous waste of corporate assets.<sup>74</sup>

### C. Takeover Threats

To allow business judgment rule protection of board decisions, the board must satisfy each of the five elements discussed above.<sup>75</sup> The business judgment rule may apply to protect director decisions to implement "defensive tactics"<sup>76</sup> designed to thwart unwanted takeover

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69. *Id.* at 19.

70. W. KNEPPER & D. BAILEY, *supra* note 7, at 184.

71. *See, e.g.*, *Herald Co. v. Seawell*, 472 F.2d 1081, 1095 (10th Cir. 1972) (Denver Post is "quasi-public institution" and therefore has obligations to its employees and to public); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (directors may consider non-shareholder constituencies such as "creditors, customers, employees, and perhaps even the community generally"). *See also infra* notes 463-500 and accompanying text for an analysis of the legitimacy of consideration of non-shareholder constituencies.

72. D. BLOCK, N. BARTON & S. RADIN, *supra* note 22, at 19-22. This element reflects the principle underlying the business judgment rule, which allows for errors of judgment but not for unconscionable and unreasonable acts. *Arsht, supra* note 48, at 122.

73. *West Point-Pepperell, Inc. v. J.P. Stevens & Co.*, 542 A.2d 770, 781 n.5 (Del. Ch. 1988).

74. *Growbow v. Perot*, 539 A.2d 180, 189-92 (Del. 1988) (repurchase of company's stock at premium over market from dissident shareholder was not "so egregious" as to eliminate presumption of business judgment protection); *but see Gimbel v. Signal Cos.*, 316 A.2d 599, 610 (court invalidated sale of company subsidiary for inadequate price, noting "[t]here are limits on the business judgment rule which fall short of intentional or inferred fraudulent misconduct and which are based simply on gross inadequacy of price.") (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974).

75. D. BLOCK, N. BARTON & S. RADIN, *supra* note 22, at 12.

76. "Defensive tactics" is the term given to a wide variety of corporate actions which individually or in combination with others can hinder or effectively preclude a change in management control. These tactics can be implemented either during "peacetime," when no live threat is pending, or after a hostile bidder has announced its intentions. GUIDELINES FOR DIRECTORS: PLANNING FOR AND RESPONDING TO UNSOLICITED TENDER OFFERS 4 (ABA Comm. on Corp. Laws 1985).

Defensive tactics, labelled with colorful names, have become increasingly inventive in recent years. Some of these tactics require shareholder approval. *Id.* at 5-8. Others can be implemented through the unilateral action of boards of directors. *Id.* at 8. Generally, a share-

holder vote is required to issue new securities or to change articles of incorporation provisions regarding voting requirements and terms of directors' service. *See id.* at 5-8.

Below is a limited list of common defensive measures which are referred to throughout the remainder of this Comment. For a thorough discussion of defensive tactics, see 1 A. FLEISCHER, *TENDER OFFERS: DEFENSES, RESPONSES, AND PLANNING* (1983).

#### *Defensive Tactics Requiring Shareholder Vote*

##### (1) Classified Boards of Directors:

A "classified" board is one on which directors serve for a specified term of years. S. LORNE, *supra* note 38, § 3.08[1][a]. The terms of service are staggered so that a bidder seeking control through a proxy election will not be able to oust the entire board in one election. *Id.* Availability of a classified board is subject to state statute. *See, e.g.,* DEL. CODE ANN. tit. 8, § 141(d) (Supp. 1988) (permitting classified boards).

##### (2) Cumulative Voting Provisions:

Cumulative voting provisions, like classified boards, are subject to corporate charter and statutory authority. *See, e.g.,* DEL. CODE ANN. tit. 8, § 214 (Supp. 1988) (allows cumulative voting). Under cumulative voting provisions, each shareholder is entitled to one vote per share multiplied by the number of directors on the ballot. S. LORNE, *supra* note 38, at § 3.08[1][b] n.6. Cumulative voting provisions are said to assure representation of minority shareholders on the board. *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 86 n.11 (1987). Cumulative voting inhibits takeovers because target shareholders have the ability to concentrate their shares in voting for directors. S. LORNE, *supra* note 38, at § 3.08[1][b] n.6. This allows shareholders to retain some directors, thereby denying insurgents speedy ouster of all opposing directors.

##### (3) Shark Repellents:

Among other techniques, shark repellent devices include "supermajority" voting provisions that increase the percentage of shareholders' votes required to approve a merger, and "fair price" provisions which require a bidder to pay the same price to all shareholders. *Responsibilities of Corporate Officers & Directors Under Federal Securities Laws, supra* note 10, at 72-73. Supermajority provisions decrease the likelihood of a takeover because the bidder must attain a greater percentage of support in order to acquire control. *Id.* at 73.

Fair-price provisions require a bidder to pay the same price to all shareholders. A. FLEISCHER, *supra*, at 33-34. Absent a fair-price provision, bidders can use a two-tier "front-loaded" bid which typically pays a large cash premium to a majority of shareholders in order to gain control. *Id.* at 388.141-152 (Supp. 1987). Once control is secured, the bidder buys out "back-end" minority shareholders with a "package" consisting of debt or equity that is typically high risk. *Id.* at 388.141-143. *See also infra* notes 86-98 and accompanying text for further explanation and discussion of the coercive nature of two tier bids.

#### *Defensive Tactics Not Requiring Shareholder Vote*

##### (1) Golden Parachutes:

This term refers to employment agreements with high-level corporate officers which guarantee large lump-sum payments, continued employment, or generous severance packages in the event of a change in control. *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 3 n.2 (1985). Golden parachutes act as a defensive tactic because a bidder may think twice before pursuing a target which forces it to retain current management employees or pay substantial amounts of money to get rid of them. In *Minstar Acquiring Corp. v. AMF Inc.*, a federal district court in New York found that severance benefits triggered only by changes in control "raise a strong inference that [the target's] board acted only to entrench itself." 621 F. Supp. 1252, 1261 (S.D.N.Y. 1985). *But see* S. LORNE, *supra* note 38, at § 4.05[1][e] (aggregate size of contracts often not large enough to deter hostile bidder).

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(2) Greenmail:

This term refers to a company's repurchase of its shares from a hostile bidder at a price significantly in excess of the current market price. *Responsibilities of Corporate Officers & Directors Under Federal Securities Laws*, *supra* note 10, at 72. Greenmail acts as a defense measure because the threat of an unwanted bidder is eliminated by the payoff. *See generally* Note, *Greenmail: Targeted Stock Repurchases and the Management Entrenchment Hypothesis*, 98 HARV. L. REV. 1045 (1985).

(3) Poison Pill:

This defense measure deters bidders by making the cost of a takeover prohibitively expensive. *Responsibilities of Corporate Officers & Directors Under Federal Securities Laws*, *supra* note 10, at 72. Under a poison-pill plan, a special class of stock is issued upon some triggering event, such as the acquisition of a stated percentage of the company's stock. *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 254 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987). These newly issued shares are available to existing shareholders at a bargain price. *Id.* at 254-55. Such share issuances reduce the target's desirability by decreasing the bidder's percentage ownership upon triggering of the poison pill provisions. Because the bidder's ownership percentage is reduced, the bidder must purchase more shares in order to attain control. *Id.* at 255. In *CTS*, the Seventh Circuit noted that the validity of poison-pill plans depends on whether stockholder wealth is maximized. *Id.* at 256.

(4) Use of a White Knight:

A "white knight" is a "friendly" bidder which acquires control of the target company in order to prevent a hostile bidder from taking control. *Responsibilities of Corporate Officers & Directors Under Federal Securities Laws*, *supra* note 10, at 73. Even though a change in control occurs, a white knight is considered "friendly" because the white knight often will agree to retain current management and current operating policies. *See, e.g.*, *West Point-Pepperell, Inc. v. J.P. Stevens & Co.*, 542 A.2d 770, 779 (Del. Ch. 1988) (white knight offer greatly preferred because white knight "had indicated it wanted the current management to stay on").

(5) Sale of Crown Jewels:

This term refers to the corporation's "most prized asset" which, when sold, has the dual effect of reducing the target's attractiveness and giving the corporation cash to defend against a pending takeover. *Responsibilities of Corporate Officers & Directors Under Federal Securities Laws*, *supra* note 10, at 72.

(6) Lock-ups:

A "lock-up" refers to an agreement giving a "friendly" bidder an advantage over all others. *Id.* For a thorough discussion of lock-up arrangements, see A. FLEISCHER, *supra*, at 388.88-.111 (1987). *See also infra* notes 174-89 and accompanying text for a discussion of *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986). In *Revlon*, the court enjoined a lock-up arrangement because it discriminated against a competing bidder offering greater consideration to Revlon shareholders. *Id.* at 184-85.

(7) Management Leveraged Buyout (LBO) and Sales of Shares to an Employee Stock Ownership Plan (ESOP):

If enacted in good faith, management can effectively retain control by purchasing company shares either directly or indirectly. In these cases, however, courts scrutinize management's motivations more closely. For example, in *Edelman v. Fruehauf Corp.*, a management plan to directly purchase company shares in an LBO transaction was struck down because company directors favored management and failed to act in good faith. 798 F.2d 882, 885 (6th Cir. 1986).

Similarly, the Delaware Chancery court struck down the defensive use of an ESOP finding a breach of directors' duty of loyalty where the "effect of the [defensive measure] . . . cannot be justified as reasonable." *A.C. Acquisitions Corp. v. Anderson, Clayton & Co.*, 519

attempts.<sup>77</sup> However, such decisions are subject to additional safeguards designed to guard against potential conflicts of interest.<sup>78</sup>

Directors of a corporation have an obligation to protect the corporation and its shareholders from harm.<sup>79</sup> Some legal scholars argue that directors should be given broad discretion to defend against takeovers because all takeovers are harmful.<sup>80</sup> Other legal scholars argue that directors faced with an unwanted takeover proposal should be passive because takeovers serve as an important check on management efficiency.<sup>81</sup> The Supreme Court,<sup>82</sup> Congress,<sup>83</sup> and the Securities and Exchange Commission (SEC)<sup>84</sup> all recognize that, in reality, some takeovers are harmful, while others are useful. Ideally, the business judgment rule

A.2d 103, 114 (Del. Ch. 1986) (emphasis in original). *But see* Polaroid Corp. v. Disney, 862 F.2d 987, 1000 (3rd Cir. 1988) (upholding defensive use of ESOP, finding that "[t]he mere presence of a conflict of interest does not, of course, prove that management's hostile reaction to a tender offer is not in the best interest of shareholders").

(8) Creation of an Antitrust Problem:

Once a bidder is known, an antitrust problem can be created by the target's acquisition of a business that competes in the same industry as the bidder. A. FLEISCHER, *supra*, at 111-13. The purpose of a defensive acquisition such as this is to either delay an acquisition pending determination of compliance with federal antitrust statutes, or to preclude the acquisition altogether. *Id.*

77. Pogostin v. Rice, 480 A.2d 619, 627 (Del. 1984).

78. See generally Note, *Outside Directors and the Modified Business Judgment Rule in Hostile Takeovers: A New Test for Director Liability*, 62 S. CAL. L. REV. 645 (1989). See also *infra* notes 116-89 and accompanying text for a discussion of additional requirements necessary for business judgment rule protection of takeover prevention decisions.

79. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) ("[T]he board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm . . .").

80. See, e.g., Trevor, *Hostile Takeovers: Wrong on the Facts and Wrong on the Law*, CONTROLLERS Q., Fall 1989, at 2. Trevor, a partner in the international law firm, Jones, Day, Reavis & Pogue, proposes an abolition of all tender offers. *Id.* at 6.

81. Easterbrook & Fischel, *The Proper Role of Target Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1169 (1981).

82. See *CTS*, 481 U.S. at 92 n.13 (1987) ("No one doubts that some successful tender offers will provide more effective management . . ."); *Piper v. Chris-Craft*, 430 U.S. 1, 34 (1977) (recognizing the "plight of takeover bidders faced with 'unfair tactics by entrenched management'").

83. See H.R. REP. NO. 1711, 90th Cong., 2d Sess. 2, reprinted in 1968 U.S. CODE CONG. & ADMIN. NEWS 2811, 2813 ("[T]akeover bids . . . serve a useful purpose in providing a check on entrenched but inefficient management."). See also *infra* notes 526-33 and accompanying text for a discussion of the legislative history and purpose of the Williams' Act, 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1988).

84. Concept Release on Takeovers and Contests for Corporate Control: Advance Notice of Possible Commission Actions, Exchange Act Release No. 23,486, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,018, at 88,204 (July 31, 1986) ("Tender offers can benefit shareholders by offering them an opportunity to sell their shares at a premium and by guarding against management entrenchment.").

should only protect directors' decisions to defend against harmful takeovers.

A proposed takeover may be harmful if it is either procedurally coercive or substantively unfair.<sup>85</sup> This section analyzes what procedural and substantive aspects of takeovers may be undesirable.

### 1. Procedural coercion

Procedural coercion typically results from two-tier front-loaded bids.<sup>86</sup> In a two-tier front-loaded tender offer, the bidder offers to pay a significant cash premium to a majority of, but not all, target shareholders in order to gain control.<sup>87</sup> The remaining "back-end" shareholders are then bought out with a lower valued, and usually lower grade, securities "package" or with "junk bonds."<sup>88</sup> The difference between the price or quality of consideration offered in the "front end" compared with the "back end" may coerce target shareholders.<sup>89</sup> Shareholders may be "coerced because they must act independently to assess whether the tender offer will be successful."<sup>90</sup> Shareholders thinking the bidder will be suc-

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85. *City Capital Assocs. Ltd. Partnership v. Interco Inc.*, 551 A.2d 787, 797 (Del. Ch.), *appeal dismissed*, 556 A.2d 1070 (Del. 1988). The Delaware Supreme Court has recently refused to limit threats directors are empowered to defend against to just procedural and substantive threats. *Paramount Communications, Inc. v. Time Inc.*, No. 284, 1989, slip op. at 34-35 (Del. Feb. 26, 1990). The court noted "that directors may consider, when evaluating the threat posed by a takeover bid, the 'inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on contingencies other than shareholders, the risk of nonconsummation and the quality of securities being offered in the exchange.'" *Id.* at 35-36 (quotation omitted). See *infra* notes 382-417 and accompanying text for a discussion of the *Time* court's analysis.

86. *City Capital*, 551 A.2d at 797.

87. Two-Tier Tender Offer Pricing and Non-Tender Offer Purchase Programs—Advance Notice of Possible Commission Action, Exchange Act Release No. 21,079, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,637, at 86,915 n.1 (June 21, 1984).

88. *Id.* See also *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 (Del. 1985) (two-tier bid planned to "squeeze out of the [minority] shareholders in the 'back-end' merger [with] 'junk bonds' worth far less than [their face value]" found coercive). Junk bonds are high-yield securities which are considered higher risk than investment-grade debt. Buffett, Dingman, Gray & Lowenstein, *Hostile Takeovers and Junk Bond Financing: A Panel Discussion*, in *KNIGHTS, RAIDERS, AND TARGETS* 11, 11 (1988). See also *infra* note 102 for a general discussion of junk bonds.

89. Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 19 (1987) [hereinafter Lipton I].

90. Herzel, Schmidt & Davis, *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 CORP. L. REV. 111 (1980). This situation is sometimes called the "prisoner's dilemma" because like a prisoner, a shareholder can optimize his or her strategy only if he or she knows and can control what the other shareholders will do. *Id.* See also *Minstar*, 621 F. Supp. at 1255 ("Under the 'prisoner's dilemma,' individual dispersed shareholders are forced to tender their shares into a partial offer regardless of whether they think the offer being proposed gives them full and fair value. They act out of fear . . .").



cessful will tender their shares at the front end.<sup>91</sup> By tendering immediately, shareholders eliminate the risk of losing their chance to obtain the premium offered, but those shareholders also sacrifice the possibility of receiving a higher premium from a subsequent bidder.<sup>92</sup> Shareholders anticipating that the tender offeror will not be successful will not tender their shares. Those shareholders will hold out hoping for a subsequent higher offer.<sup>93</sup>

One court observed that two-tier bids are "classic coercive measure[s] designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will [or will not] receive at the back end of the transaction."<sup>94</sup> By contrast, the "all-cash, all-shares" offer is not procedurally coercive.<sup>95</sup> As the descriptive title indicates, "all-cash, all-shares" bids do not offer shareholders low grade debt or equity securities.<sup>96</sup> In addition, because the same cash consideration is offered for all shares, this type of offer does not coerce uninformed shareholders into tendering for fear of "losing out" on the premium offered.<sup>97</sup> A shareholder can decide individually whether to tender, and that decision is not dependent on the decisions of all other shareholders.<sup>98</sup>

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91. Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?*, 28 J.L. & ECON. 151, 156 (1985).

92. *Id.* An individual shareholder is assured some tender premium, which otherwise may be sacrificed if other shareholders tender their shares first. *Id.*

93. *Id.*

94. *Unocal*, 493 A.2d at 956.

95. *See, e.g., Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227, 1240 (Del. Ch. 1988) (unsolicited "offers proposed the same price to all stockholders, were not 'front-end loaded,' and their financing did not depend upon a 'break-up' of the [c]ompany"). *See also* cases cited *infra* note 97.

96. "Equity securities generally create or contemplate a shareholder (or stockholder) relationship, with the shareholders being, in a broad sense, 'insiders' who 'own' the corporation (as compared to the holders of debt securities who are 'outsiders' 'owned' by the corporation)." H. HENN & J. ALEXANDER, *supra* note 7, at 383.

97. Some courts have found that an all-cash, all-share offer does not pose a threat great enough to justify business judgment rule protection of a board decision to defend against it. *See, e.g., Robert M. Bass Group*, 552 A.2d at 1240 (No "selling or nonselling shareholder was coerced [by all shares cash offer] or otherwise harmed in the process."); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 112 (Del. Ch. 1986) (all shares cash offer not unfair). *But see Amanda Acquisition Corp. v. Universal Foods Corp.*, 708 F. Supp. 984, 1013 (E.D. Wis.) (court upheld management's defense against proposed all-cash, all-shares tender offer, noting "[t]here is an element of coercion or risk even in an all cash, all shares offer"), *aff'd*, 877 F.2d 496 (7th Cir.), *cert. denied*, 110 S. Ct. 367 (1989); *Paramount Communications, Inc. v. Time Inc.*, No. 284, 1989, slip op. at 34-35 (Del. Feb. 26, 1990) (rejecting plaintiffs' argument that all-cash, all-shares offer cannot be procedurally coercive).

98. *Robert M. Bass Group*, 552 A.2d at 1243 (shareholders able to make own choice and, therefore, directors "not free to 'cram down' [economically inferior] transaction").

## 2. Substantive unfairness

Substantive unfairness to shareholders can result from inadequate bids, which are not procedurally coercive.<sup>99</sup> Bids may be inadequate either because the price itself is too low<sup>100</sup> or because the quality of the consideration offered is inadequate.<sup>101</sup> A low quality bid may, for example, consist of equity securities or junk bonds.<sup>102</sup> Such bids are arguably less valuable to tendering shareholders than all-cash offers.<sup>103</sup> Moreover, shareholders who tender in a non-cash tender offer do not receive immediate value for their shares as do shareholders who tender in a cash bid. The value of the debt or equity consideration accepted in response to a non-cash offer is dependent on the future operation of the now highly leveraged company, managed by the successful bidder.<sup>104</sup>

Unsolicited offers consisting of either low price or poor quality can justify defensive action by corporate directors.<sup>105</sup> Directors' affirmative duty to protect shareholders from harm includes the potential harm arising from a substantively unfair bid.<sup>106</sup> Additionally, some commentators argue that even all-cash tender offers can be substantively unfair when

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99. *City Capital*, 551 A.2d at 797.

100. *Id.* (threat might be posed if price inadequate).

101. *See, e.g., Unocal*, 493 A.2d at 956 ("junk bonds" worth far less than face value of \$54 consideration offered); *West Point-Pepperell*, 542 A.2d at 781 n.6 (directors may consider "form of consideration, timing of the transaction [and] risk of non-consummation," as well as price).

102. The term "junk bonds" refers to high-yield debt which typically pays interest at three to four percentage points more than investment-grade debt. Buffett, Dingman, Gray & Lowenstein, *supra* note 88, at 11. The higher interest rate compensates for the increased risk of default borne by junk-bond holders. *Id.* Junk-bond financing of takeovers might involve abuse if it puts the target company in a "precarious financial position." *Id.* *But see* Noninvestment Grade Debt as a Source of Tender Offer Financing, Securities and Exchange Commission, Office of the Chief Economist, Study in Full Text, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,011, at 88,170 (June 20, 1986) ("[J]unk bond financing should be regarded as an innovative reaction by financial markets to specialized financing needs.").

103. *Cf. Unocal*, 493 A.2d at 956 (allowing directors to consider type of consideration offered in deciding whether to accept or reject bid).

104. Many commentators have argued that junk bonds are less risky than the media has portrayed. *See, e.g., M. Jensen, The Takeover Controversy: Analysis and Evidence in KNIGHTS, TARGETS, AND RAIDERS* 314, 339 (1988). One author notes that the degree of risk of particular junk bonds is difficult to predict because the widespread use of junk bonds is a relatively recent phenomenon. *Id.* *But see* Smith & Sesit, *UAL Clouds Banks' Bigger Buy-Out Role*, *Wall St. J.*, Oct. 20, 1989, at C1, col. 3 ("In the wake of Campeau's problems, prices of junk bonds tumbled, throwing into doubt the ability of corporate acquirors to finance large takeovers with the help of junk bond sales.").

105. *See, e.g., Unocal*, 493 A.2d at 956 (quality inadequate); *Paramount Communications, Inc. v. Time Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,272 (Del. Ch. July 14, 1989) (price inadequate), *aff'd*, No. 284, 1989 (Del. Feb. 26, 1990).

106. *Unocal*, 493 A.2d at 954.

financed with high-yield debt.<sup>107</sup> In this scenerio, the unfairness is not to the shareholders, who receive their cash premium and are no longer concerned with the company operations.<sup>108</sup> Rather, the risk that the high-yield debt will eventually require a "bust up" of company operations is passed on to the corporation itself,<sup>109</sup> harming other groups who continue their relationship with the company, such as employees, creditors and consumers.<sup>110</sup>

Typically in a junk bond-financed "bust up" takeover, the successful bidder will replace management, sell assets, lay off employees and reduce research and development projects in order to maximize the company's short-term liquidity necessary to finance debt costs.<sup>111</sup> In some states, local legislators, fearful of plant closures and worker layoffs resulting from junk bond-financed takeovers, have codified directors' right to consider non-shareholder effects of takeovers.<sup>112</sup> Legal scholars widely debate whether potential effects on *non-shareholders* arising from bids which do not threaten *shareholders* can ever justify defensive action.<sup>113</sup> On the one hand, directors may have a social responsibility to their local

107. See, e.g., Lipton I, *supra* note 89, at 11. "High-yield debt" is used synonymously with "junk bonds" in this Comment. See *supra* note 102 for a general discussion of junk bonds.

108. See TW Servs., Inc. v. SWT Acquisition Corp., [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,179 (Del. Ch. Mar. 2, 1989) (When sale of company for cash is imminent, no "long run" shareholder interest exists because "shareholders will be removed from the field by the contemplated transaction.").

109. Lipton I, *supra* note 89, at 11.

110. See *Unocal*, 493 A.2d at 955 (directors may consider effects of proposed takeover on non-shareholder constituencies); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 115 (1979) (hereinafter Lipton II) ("[N]ational policy requires that directors also consider the long-term interests of the shareholders and the company as a business enterprise with all of its constituencies . . .").

111. Lipton I, *supra* note 89, at 11, 23 & n.103. "Bust up" takeovers also potentially harm target company's pre-existing creditors because outstanding debt becomes riskier and consequently less valuable. *Id.* at 27.

112. See, e.g., MINN. STAT. ANN. § 302A.251(5) (West Supp. 1990) ("[A] director may, in considering the best interests of the corporation, consider the interests of the corporation's employees, customers, suppliers, and creditors, the economy of the state and nation, community and societal considerations . . ."); MO. ANN. STAT. § 351.347(4) (Vernon Supp. 1990) ("In exercising its business judgment concerning any acquisition proposal . . . the board of directors . . . may consider the . . . social, legal and economic effects on employees, suppliers, customers, and others . . ."); 42 PA. CONS. STAT. ANN. § 8363(b) (Purdon Supp. 1989) ("directors may . . . consider the effects of any action upon employees, upon suppliers and customers of the corporation and upon communities in which offices or other establishments of the corporation are located . . .").

113. Compare Easterbrook & Fischel, *supra* note 81, at 1164 (directors should consider shareholders only) with Lipton I, *supra* note 89, at 37-41 (non-shareholder considerations appropriate). See also *infra* notes 463-500 and accompanying text for further discussion of non-shareholder considerations.

communities;<sup>114</sup> but on the other hand, in a takeover situation, directors owe their primary fiduciary duties to the company's shareholders.<sup>115</sup> In general, the priority of directors' duties when faced with a potentially coercive offer is to consider the shareholders first, the company second, and if state statutes expressly permit, non-shareholder constituencies last.

*D. The Business Judgment Rule Applied to  
Contests for Corporate Control*

Directors possess the power and discretion to hinder or effectively preclude an attempted takeover.<sup>116</sup> Additionally, directors have an affirmative duty to defend against genuine threats to the company and its shareholders.<sup>117</sup> However, directors who act to entrench themselves or current management may be subject to personal liability, and the decision they authorized may be enjoined.<sup>118</sup> The difficulty in determining when a genuine threat to the company or its shareholders exists, and in assessing the purity of directors' motivations, creates a unique and controversial setting in which to apply the business judgment rule.<sup>119</sup> Although courts are aware that a takeover bid may threaten shareholders or the corporation itself, courts are also concerned with the potential for directors to abuse their power or discretion.<sup>120</sup> Therefore, courts have

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114. *Edgar v. MITE Corp.*, 457 U.S. 624, 646 n.\* (Powell, J., concurring in part).

115. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

116. *See, e.g., Paramount Communications, Inc. v. Time Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,284 (Del. Ch. July 14, 1989), *aff'd*, No. 284, 1989 (Del. Feb. 26, 1990). *See supra* note 76 for a discussion of common defensive measures target companies implement to defend against unwanted takeovers.

117. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985). *See supra* notes 75-115 and accompanying text for a discussion of how takeover threats may harm a corporation and its shareholders. However, all challenges to corporate control do not harm corporations or their shareholders, and in fact, control challenges may be a useful check on inefficient management. *See supra* notes 81-84 and accompanying text.

118. *See Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 184 (Del. 1986) (directors' decision enjoined because its "principal benefit went to directors").

119. *See H.R. REP. NO. 1028*, 98th Cong., 2d Sess. 1, 15.

The business judgment rule has a long history and for decades has served a legitimate purpose in shielding directors from liability for their conduct in running the day-to-day business of a corporation for the benefit of its shareholders. However, the application of the rule may be inappropriate in the context of contested takeover attempts or other situations involving a threatened change in control of a corporation. In such situations, corporate managers often have a clear interest in maintaining their jobs, and this interest may conflict with both the long-term interests of the company and the interests of shareholders in selling their shares to the highest bidder or in gaining new management for the corporation.

*Id.*

120. *See, e.g., Unocal*, 493 A.2d at 954 (in contests for corporate control, "omnipresent specter" of directorial self-interest exists). *See infra* notes 418-40 and accompanying text for an analysis of directors' motivations and potential abuse of power.

struggled in analyzing the validity of defensive actions<sup>121</sup> authorized by directors opposed to an attempted takeover, and in deciding whether the business judgment rule should apply.<sup>122</sup>

In order to determine whether directors have acted in response to a genuine threat to the corporation or its shareholders, courts first conduct a threshold inquiry into the financial independence of the target's board.<sup>123</sup> If the board's independence is confirmed, courts then require satisfaction of the board's fiduciary obligations of good faith and due care.<sup>124</sup> Once these threshold requirements are met, the burden of proof shifts to the party challenging the board action.<sup>125</sup> The business judgment rule will protect directors and their decisions as long as the board reasonably perceived a threat to the corporation or its shareholders and the response taken was reasonable in relation to that threat.<sup>126</sup>

Courts allow the business judgment rule to protect board decisions to defend against both *immediately* threatened takeovers<sup>127</sup> and potential *future* takeovers.<sup>128</sup> In either instance, the test for determining whether a challenged defense is valid turns on whether the board's action was reasonably related to a viable threat.<sup>129</sup>

A different analysis, however, applies when a change in control is inevitable.<sup>130</sup> Under these circumstances, directors are no longer permitted to defend against unwanted suitors.<sup>131</sup> Instead, directors are obligated to conduct an "auction" and to maximize current value for

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121. See *supra* note 76 for a discussion of common defensive measures.

122. *Compare* *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252, 1259 (S.D.N.Y. 1985) (defensive tactics different from other decisions afforded protection of business judgment rule) with *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984) (business judgment rule equally applicable in defensive contexts).

123. *In re* *RJR Nabisco, Inc. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,709 (Del. Ch. Jan. 31), *appeal denied mem.*, 556 A.2d 1070 (Del. 1989). See also *infra* notes 418-40 and accompanying text for a discussion of whether a board can ever be truly independent.

124. *RJR Nabisco*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,709.

125. *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984).

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

127. *Id.*

128. See *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1350 (Del. 1985) ("[T]he distinguishing factor [of a general future threat, as opposed to a specific and immediate threat] does not result in the [d]irectors losing the protection of the business judgment rule.").

129. *Id.* at 1350 (*Unocal* applies despite distinguishing factor of future, as opposed to immediate, threat).

130. *Revlon*, 506 A.2d at 182. See *infra* notes 309-81 and accompanying text for a discussion of limitations of *Revlon's* "change in control" triggering point, as enunciated by the Delaware Supreme Court in *Time*.

131. *Revlon*, 506 A.2d at 182 ("the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder").

shareholders.<sup>132</sup> The following cases establish the framework for applying the business judgment rule to decisions involving corporate control defensive measures.

1. *Unocal Corp. v. Mesa Petroleum Co.*

In *Unocal Corp. v. Mesa Petroleum Co.*,<sup>133</sup> Mesa Petroleum, an entity controlled by T. Boone Pickens,<sup>134</sup> owned thirteen percent of Unocal stock.<sup>135</sup> Mesa made a hostile tender offer<sup>136</sup> for sixty-four million shares, or approximately thirty-seven percent of Unocal's outstanding shares at a cash price of \$54 per share.<sup>137</sup> Mesa planned to complete its two-tier "front-loaded" cash offer<sup>138</sup> with "junk bonds" purportedly worth \$54 per share.<sup>139</sup>

Unocal's thirteen board members, including eight outside directors,<sup>140</sup> consulted with two reputable investment bankers regarding the merits of Mesa's offer.<sup>141</sup> Based on these consultations, Unocal's board

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132. *Id.*

133. 493 A.2d 946 (Del. 1985).

134. T. Boone Pickens is a well-known corporate raider who is also chairman of United Shareholders Association, a shareholder advocacy group. See Saiwen, *Ruling by SEC May Threaten Parachute Plans*, Wall St. J., Jan. 18, 1990, at A3, col. 4.

135. *Unocal*, 493 A.2d at 949.

136. *Id.* In a tender offer, the bidder typically offers shareholders of a target company a significant premium over the existing market price for a majority or all of the target's outstanding shares. *Tender Offer Update: 1989*, MERGERS & ACQUISITIONS, May-June 1989, at 27. In 1988, 61% of tender offer premiums exceeded 50% of the stock market prices one month prior to the announcement of the initial bid. *Id.* Although not specifically defined, a tender offer generally requires: (1) an active solicitation; (2) of shareholders; (3) of a substantial percentage of outstanding shares; (4) at a premium; (5) under fixed terms; (6) for a limited period of time; (7) with pressure placed on offerees. H. HENN & J. ALEXANDER, *supra* note 7, at 821 n.39 (citing *Wellman v. Dickenson*, 475 F. Supp. 783 (S.D.N.Y. 1979)).

Shareholders of target companies have three options when faced with a tender proposal: retain their shares, tender shares if the offer becomes effective, or dispose of shares in the open market, which usually rises on the tender announcement. *Responsibilities of Corporate Officers & Directors Under Federal Securities Laws*, *supra* note 10, at 75. If management of the target company believes the proposed tender offer is not in the best interests of the corporation and its shareholders, it may implement "defensive" measures to eliminate or impede the takeover threat. See *supra* note 76 for a discussion of common defensive measures.

137. *Unocal*, 493 A.2d at 949.

138. See *supra* notes 86-98 and accompanying text for a discussion of the potentially coercive nature of two-tier bids.

139. *Unocal*, 493 A.2d at 949.

140. An outside director is one who is not also employed within the corporation as are, for example, the chief financial officer or chief executive officer. See generally Simpson, *The Emerging Role of the Special Committee—Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest*, 43 BUS. LAW. 665 (1988) for a discussion of how outside directors enhance the procedural integrity of the corporate decision-making process.

141. *Unocal*, 493 A.2d at 950.

unanimously adopted a resolution to reject Mesa's "grossly inadequate" offer.<sup>142</sup> To defend against Mesa's takeover threat, Unocal made a competing discriminatory self-tender offer which consisted of debt securities valued at \$72 per share.<sup>143</sup> This offer was open to all Unocal shareholders, *except Mesa*.<sup>144</sup>

Mesa filed suit to enjoin its exclusion from Unocal's self-tender offer.<sup>145</sup> Unocal's directors argued that their decision was justified and resulted from their reasonable belief that the self-tender served a valid corporate purpose.<sup>146</sup> In upholding Unocal's action, the Supreme Court of Delaware accepted the board's conclusion that Mesa's bid was inadequate.<sup>147</sup> The court was concerned, however, with an "omnipresent specter" of director self-interest in takeover contests,<sup>148</sup> and cautioned that directors did "not have unbridled discretion to defeat any perceived threat by any Draconian means available."<sup>149</sup>

The *Unocal* court fashioned a two-part "proportionality" test to govern whether the business judgment rule protects takeover defense decisions.<sup>150</sup> First, directors must show that they "reasonably" believed that a danger to corporate policy and effectiveness existed.<sup>151</sup> To satisfy this burden, directors must show that they exercised good faith and performed a reasonable investigation.<sup>152</sup> This showing, the court stated, would be "materially enhanced" when outside directors support board decisions.<sup>153</sup> Presumably, decisions approved by outside directors would

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142. *Id.*

143. *Id.* at 951.

144. *Id.* Subsequent to this case, the SEC enacted the "all-holders rule" which proscribes exclusionary offers. 17 C.F.R. § 240.14d-10(a)(1) (1987). The all-holders rule provides that a bidder's tender offer must be open to "all security holders of the class of securities subject to the tender offer." *Id.* See also *Polaroid Corp. v. Disney*, 862 F.2d 987, 991-95 (3rd Cir. 1988) for a discussion of the purpose of the all-holders rule and the SEC's enactment authority. See Amendments to Tender Offer Rules—All-Holders and Best-Price, Securities Act Release No. 6653 [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,016 (Sept. 4, 1986) for a general discussion of the legislative history and congressional intent of the all-holders rule.

145. *Unocal*, 493 A.2d at 951.

146. *Id.* at 953. Unocal argued that its directors acted properly to protect the company and its shareholders from harm. *Id.*

147. *Id.* at 956 (acknowledging coercive effect of offer by nationally known greenmailer).

148. *Id.* at 954.

149. *Id.* at 955.

150. *Id.*

151. *Id.* (citing *Cheff v. Mathes*, 199 A.2d 548, 554-55 (Del. 1964)).

152. *Id.* A reasonable investigation assumes that it commences on a timely basis. See *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) ("determination of whether a business judgment is an informed one turns on whether the directors have informed themselves 'prior to making a business decision' . . .") (emphasis added) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

153. *Unocal*, 493 A.2d at 955. Courts upholding defensive measures are increasingly focus-

not be tainted with the same conflict of interest facing inside directors. *Unocal's* second prong requires that any defensive measure implemented "be reasonable in relation to the threat posed."<sup>154</sup> Under this prong, directors may consider the nature and timing of the takeover offer, the quality of the securities offered and the predicted effect of a change of control on the corporate enterprise.<sup>155</sup> Directors may also consider the predicted effect of a takeover on non-shareholder constituencies including employees, creditors, customers "and perhaps even the community generally."<sup>156</sup>

In applying this test, the *Unocal* court concluded that T. Boone Pickens, a nationally known "greenmailer,"<sup>157</sup> reasonably posed a threat to company policy.<sup>158</sup> The court also concluded that *Unocal's* discriminatory self-tender offer was commensurate with the threat posed by Pickens.<sup>159</sup>

The court in *Unocal* also recognized that due to the potential conflict of interest which may influence a board decision to defend against an immediately threatened takeover, traditional business judgment rule protection may be inappropriate.<sup>160</sup> *Unocal's* two-pronged test was designed to provide a safeguard against abuses potentially arising from this conflict.<sup>161</sup> After *Unocal*, courts were left to decide whether *Unocal* or some other standard of review should apply under different factual situations involving corporate control contests.

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ing on whether the outside directors of the target company supported the board decision. *See, e.g., Grobow v. Perot*, 539 A.2d 180, 190 (Del. 1988); *West Point-Pepperell, Inc. v. J.P. Stevens & Co.*, 542 A.2d 770, 782 (Del. Ch. 1988). See also *infra* notes 429-30 and accompanying text for a discussion of the role of outside directors and special committees.

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

155. *Id.* The Delaware Supreme Court later clarified these considerations, noting that "[a] board may have regard for various [non-shareholder] constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders." *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 182 (Del. 1986).

156. *Unocal*, 493 A.2d at 955. Cases subsequent to *Unocal* have expanded the scope of non-shareholder considerations. *See, e.g., Paramount Communications, Inc. v. Time Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,283 (Del. Ch. July 14, 1989), *aff'd*, No. 284, 1989 (Del. Feb. 26, 1990) (considering target company's long-term strategic plan). *See also infra* notes 382-417 and accompanying text.

157. *Unocal*, 493 A.2d at 956. *See supra* note 76 for a discussion of greenmail payments and other mechanisms directors utilize to defend against hostile bidders.

158. *Unocal*, 493 A.2d at 956.

159. *Id.*

160. *Id.* at 954.

161. *Id.* at 954-55.



## 2. *Moran v. Household International, Inc.*

In *Moran v. Household International, Inc.*,<sup>162</sup> decided shortly after *Unocal*, the Delaware Supreme Court was faced with a different factual scenario and concluded that *Unocal's* proportionality analysis again was appropriate.<sup>163</sup> The defensive plan upheld in *Moran* involved a poison pill, a popular defensive strategy.<sup>164</sup> Household, the target company, did not adopt this defensive measure in reaction to a specific and immediate threat, as did the target company in *Unocal*, but rather "as a preventative mechanism to ward off [possible] future advances."<sup>165</sup>

Financial studies showed Household's common shares to be significantly undervalued,<sup>166</sup> and therefore an unwanted takeover was a legitimate threat. Because of this potential threat, Household adopted a plan which provided for the issuance of stock rights<sup>167</sup> upon certain "triggering" conditions.<sup>168</sup> The plan provided that should a majority of Household's shares be acquired, any unexercised rights entitled rightholders to purchase \$200 of Household's common stock for \$100.<sup>169</sup> Allowing Household shareholders to purchase shares at a bargain price would increase the number of shares outstanding, and accordingly, increase the cost and reduce the likelihood of a takeover.

The court applied the same analysis as in *Unocal* to determine the validity of Household's defensive rights plan.<sup>170</sup> The court found that Household's directors reasonably believed that a threat to the corporation existed and agreed that the board decision to implement the stock-rights plan was proportional to that threat.<sup>171</sup> In making its ruling, the

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162. 500 A.2d 1346 (Del. 1985).

163. *Id.* at 1356.

164. See *supra* note 76 for an explanation and discussion of poison pills and other takeover defenses.

165. *Moran*, 500 A.2d at 1349 (emphasis added).

166. *Id.*

167. Stock rights entitle the holder of the right to purchase common or participating preferred stock at a substantial discount. A. FLEISCHER, *supra* note 76, at 55. The defensive use of a stock rights plan, such as a "poison pill," inhibits the substantial accumulation of stock by an unwanted bidder and strengthens the target's bargaining power by increasing the cost and uncertainty of a hostile takeover. *Id.* See also *supra* note 76 for a discussion of poison pills and other takeover defenses.

168. *Moran*, 500 A.2d at 1348. Under the plan, stock rights were to be issued upon: (1) announcement of a tender offer for 30% of Household's shares; and (2) acquisition of 20% of Household's shares by any entity or group. *Id.*

169. *Id.* at 1349.

170. *Id.* at 1356. See also *supra* notes 150-56 and accompanying text for a discussion of *Unocal's* proportionality test.

171. *Moran*, 500 A.2d at 1356-57. The court, however, left open the possibility of further scrutiny if the poison pill is later activated. *Id.* at 1357.

court suggested that more deference to a company's board may be appropriate when the board acts while under no immediate threat, as opposed to when it acts in response to a specific threat.<sup>172</sup> The court reasoned that when directors have more time to deliberate, their business expertise is more likely to be utilized.<sup>173</sup>

### 3. *Revlon, Inc. v. MacAndrews & Forbes Holdings*

*Unocal*'s two-pronged analysis applies whenever directors are acting to prevent a change in control, whether that action is in response to an immediate threat or a future threat.<sup>174</sup> When, however, a change in control becomes inevitable, a different analysis applies. In *Revlon, Inc. v. MacAndrews & Forbes Holdings*,<sup>175</sup> the Delaware court limited the *Unocal* proportionality test to circumstances where a target company had undertaken measures to preserve the company's independence and avoid a change in management control.<sup>176</sup> The *Revlon* court announced that a stricter test would be applied when a change in control became inevitable.<sup>177</sup>

In this case, control of Revlon was pursued by two bidders—MacAndrews & Forbes, an unwanted tender offeror, and Forstmann, Little, a “white knight.”<sup>178</sup> Revlon entered into an agreement with Forstmann committing itself to: (1) a lock-up option,<sup>179</sup> (2) a no-shop provision,<sup>180</sup> and, (3) a \$25 million cancellation fee payable to Forstmann if another buyer were to purchase more than 19.9% of Revlon stock.<sup>181</sup> Besides committing to this agreement, Revlon favored Forstmann by providing it with confidential financial data unavailable to MacAndrews

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172. *Id.* at 1350.

173. *Id.* Arguably, just the opposite is true. When directors have more time to deliberate and plan a defensive strategy, abrogation of shareholders' rights should be less justifiable. Under these circumstances, directors have time to consider both shareholders' desires and potential alternatives. Therefore, a higher level of scrutiny seems appropriate.

174. *Id.*

175. 506 A.2d 173 (Del. 1986).

176. *Id.* at 182.

177. *Id.* (“[R]ecognition that the company was for sale . . . significantly altered the board's responsibilities under the *Unocal* standards.”).

178. *Id.* at 184. See also *supra* note 76 for a discussion of the defensive use of a “white knight.”

179. *Revlon*, 506 A.2d at 178. The option allowed Forstmann to purchase certain Revlon subsidiaries at a significant discount from their fair market values in the event that another bidder purchased 40% of Revlon shares. *Id.*

180. *Id.* A no-shop provision precludes the target company from negotiating with any other suitors. *Id.* at 184.

181. *Id.* at 178.

& Forbes.<sup>182</sup> Revlon shareholders and MacAndrews & Forbes sought to enjoin the Revlon-Forstmann agreement and to require "a level playing field" in which Revlon could not favor one bidder over another.<sup>183</sup> Revlon directors asserted that their actions satisfied the *Unocal* proportionality test and were protected by the business judgment rule.<sup>184</sup>

The *Revlon* court disagreed with Revlon's directors, and rejected the proposed application of *Unocal*'s proportionality test.<sup>185</sup> The court distinguished the circumstances of this case from those in *Unocal* and found that once a sale of the target company became inevitable, "[t]he directors' role changed from defenders of the corporate bastion to auctioneers."<sup>186</sup> The court designed this new "auction" standard to focus director attention on shareholder wealth maximization<sup>187</sup> and to preclude directors from "playing favorites" when sale of a target company was inevitable.<sup>188</sup> In *Revlon*, the target directors clearly favored Forstmann at the expense of shareholder wealth maximization; therefore, the court denied the directors business judgment rule protection and enjoined Revlon's anti-takeover measures.<sup>189</sup>

#### 4. *Paramount Communications, Inc. v. Time Inc.*

In *Paramount Communications, Inc. v. Time Inc.*,<sup>190</sup> the Delaware Supreme Court faced a new factual scenario to determine whether *Unocal*, *Revlon*, or some other analysis applied. In this case, the court was asked to decide whether a target company must abandon a preexisting strategic plan and consider the potential shareholder wealth maximization of a proposed non-coercive cash tender offer.<sup>191</sup> In *Time*, the Delaware court did not create a new standard of judicial review, but it did significantly restrict the application of *Revlon*<sup>192</sup> and added a new facet

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182. *Id.* at 184.

183. *Id.* at 175.

184. *Id.* at 182.

185. *Id.* ("there are fundamental limitations upon [*Unocal*'s] prerogative" permitting non-shareholder considerations).

186. *Id.*

187. *Id.* The court held that as auctioneers, directors are "charged with getting the best price for stockholders." *Id.*

188. *Id.* at 184. When "dissolution of the company becomes inevitable, the directors cannot fulfill their enhanced *Unocal* duties by playing favorites with the contending factions." *Id.* See *infra* notes 262-381 and accompanying text for a discussion of whether courts may be retreating from *Revlon*'s level-playing field and shareholder wealth maximization requirements.

189. *Revlon*, 506 A.2d at 185.

190. No. 284, 1989 (Del. Feb. 26, 1990).

191. *Id.* at 25.

192. *Id.* at 27-31. *Revlon* was not triggered by Time's initial merger agreement with Warner, despite a 62% dilution in Time shareholders' ownership. *Id.* at 24. The court limited

to the *Unocal* proportionality test.<sup>193</sup>

The sequence of events giving rise to the *Time* litigation began in 1983, when the directors of Time Inc. began considering several opportunities to enhance Time's competitive advantage in the entertainment industry.<sup>194</sup> Time's goal was to become a world-wide media and entertainment company,<sup>195</sup> but the company was also concerned with preserving the "distinctive and important 'Time culture'" and Time's "journalistic integrity."<sup>196</sup> On March 3, 1989, after months of negotiations, Time and Warner Communications Inc. entered into a merger agreement.<sup>197</sup> This agreement was unanimously approved by the boards of both Time and Warner.<sup>198</sup> The merger agreement provided that: (1) Warner shareholders would own sixty-two percent of previously outstanding Time common shares;<sup>199</sup> and (2) management of the combined company would be shared equally between the previously separate Time and Warner management teams.<sup>200</sup> Part of the reason for structuring a merger, as opposed to another transactional form, was to take advantage of various tax and accounting benefits.<sup>201</sup>

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application of *Revlon* to circumstances of an auction sale or an abandonment of a company's long-term plan and pursuit of a "break up" of the corporate enterprise. *Id.* at 28. See *infra* notes 262-381 and accompanying text for a discussion of cases, including *Time*, which limit *Revlon's* applicability.

193. See *infra* notes 382-417 and accompanying text for a discussion of how *Time* altered *Unocal*.

194. *Time*, No. 284, 1989, slip op. at 8.

195. TIME INC. AND WARNER COMMUNICATIONS INC., JOINT PROXY STATEMENT, TIME INC., PROSPECTUS 33 (May 22, 1980) [hereinafter JOINT PROXY AND PROSPECTUS].

196. *Time*, No. 284, 1989, slip op. at 8 n.4. The court noted that Time's board "made a studious effort to refrain from involvement in Time's editorial policy." *Id.* The independence of Time's editorial policies and Time's board purportedly enhanced Time's "journalistic integrity" and its culture. *Id.*

197. *Id.* at 15. Delaware law required approval of the merger by the boards of directors of both Time and Warner. See DEL. CODE ANN. tit. 8, § 251(b) (Supp. 1988) ("The board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation.").

198. *Time*, No. 284, 1989, slip op. at 15 (approval was unanimous, with all but one Time director in attendance).

199. *Id.* at 24.

200. *Id.* at 16. The shared management agreement required that board representation be evenly divided between Time and Warner's previously separate boards and provided also for co-chief executive officers. *Id.* The estimated cost to Time Warner of retaining co-chief executive officers was approximated at up to \$200 million over ten years. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,275.

201. JOINT PROXY AND PROSPECTUS, *supra* note 195, at 22. For Time and Warner, the proposed merger would have been a non-taxable transaction. *Id.* at 46. In addition, the merged company would have benefitted from application of the "pooling-of-interests" method of accounting for business combinations. *Id.*

For certain qualifying equity mergers, pooling-of-interests accounting allows each com-

Time realized that the planned merger might put Time "in play," and accordingly, the directors obtained "confidence letters" from several banks, which provided that those banks would not finance a tender offer for Time.<sup>202</sup> Time also entered into a "no-shop" agreement with Warner, which restricted the board's ability to negotiate a takeover of Time prior to the planned merger with Warner.<sup>203</sup> Once the terms of the merger were settled, Time's board scheduled the required shareholder vote for June 23, 1989 and mailed proxy solicitations recommending the merger to the Time shareholders.<sup>204</sup>

On June 7, 1989, with Time's stock trading at \$126 per share,<sup>205</sup> Paramount Communications, Inc. launched an unsolicited all-cash, all-shares<sup>206</sup> tender offer of \$175 per share for Time.<sup>207</sup> As a result, Time's

pany's assets and liabilities to be carried forward at their pre-merger recorded book values. BUSINESS COMBINATIONS, Accounting Principles Board Opinion No. 16, ¶ 12 (Accounting Principles Bd. 1970). Alternatively, "purchase accounting," which is used for non-qualifying mergers, and acquisitions for cash or debt, requires the assets of the acquired company to be added to the acquiring company's balance sheet at the current fair market values. *Id.* at ¶ 11. In purchase accounting, the excess between the current fair market value of assets and liabilities and the price paid for the acquired company is capitalized as "goodwill" on the consolidated balance sheet. *Id.* This "goodwill" is then amortized as an expense that reduces net income. INTANGIBLE ASSETS, Accounting Principles Board Opinion No. 17, ¶ 27 (Accounting Principles Bd. 1970). Unlike the proposed merger, the revised Time-Warner transaction did not qualify for the favorable "pooling" method; therefore, Time will report goodwill approximating \$9 billion. *Time*, No. 284, 1989, slip op. at 22.

For a general discussion of purchase and pooling accounting, see PRACTICING LAW INSTITUTE, FINANCIAL REPORTING FOR BUSINESS COMBINATIONS, ACCOUNTING FOR LAWYERS 1989 313-19 (1989); Fiflis, *Accounting for Mergers, Acquisitions and Investments, in a Nutshell: The Interrelationships of, and Criteria for, Purchase or Pooling, the Equity Method, and Parent-Company-Only and Consolidated Statements*, 37 BUS. LAW. 89 (1981).

One of the reasons Time and Warner initially agreed to merge was to take advantage of the anticipated favorable tax and accounting treatment. *Time*, No. 284, 1989, slip op. at 10. Although "pooling" accounting treatment was not a condition of merger, prevention of pooling-of-interests accounting was grounds for termination of the merger agreement. JOINT PROXY AND PROSPECTUS, *supra* note 195, at 46.

202. *Time*, 284, 1989, slip op. at 17.

203. *Id.*

204. *Id.* at 8. Approval by a majority of Warner shareholders was required by Delaware statutory law. *Id.* at 15-16. See DEL. CODE ANN. tit. 8, § 251(c) (Supp. 1988) (the merger agreement "shall be submitted to the stockholders of each constituent corporation . . . for the purpose of acting on the agreement."). However, approval by Time shareholders was required by New York Stock Exchange rules only. *Time*, No. 284, 1989, slip op. at 15. Delaware law did not require approval by Time's shareholders because Time's stock would not have been affected by the merger, and additional shares were not required to be authorized. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,270.

205. *Time*, No. 284, 1989, slip op. at 18.

206. See *supra* notes 95-98 and accompanying text for a discussion of the advantages which all-cash, all-shares bids offer shareholders.

207. *Time*, No. 284, 1989, slip op. at 18. Paramount later increased its offer to \$200 per share, and this, too, was rejected as inadequate. *Id.* at 23.

stock price jumped to \$182 per share.<sup>208</sup> Time directors dampened the market's enthusiasm, announcing that Time was "not for sale."<sup>209</sup>

Time directors recognized that with Paramount's bid outstanding, securing shareholder approval to merge with Warner would be "problematic."<sup>210</sup> Therefore, they abandoned the merger plan and instead pursued a \$14 billion acquisition of Warner.<sup>211</sup> This revised Warner transaction, financed with \$12 billion in high-yield debt,<sup>212</sup> was completed quickly and without a shareholder vote.<sup>213</sup> Time's directors were confident that the \$30 billion<sup>214</sup> market value of the combined Time-Warner company would eliminate any reasonable possibility of Paramount tendering for Time Warner.<sup>215</sup>

Time shareholders and Paramount sought an injunction to stop Time's acquisition of Warner,<sup>216</sup> asserting that Time's directors failed to maximize shareholder wealth as required by *Revlon*.<sup>217</sup> Under two different theories, the plaintiffs argued that the Delaware court should apply the *Revlon* analysis<sup>218</sup> and not the more lenient *Unocal* standard of review.<sup>219</sup>

First, the plaintiffs argued that the original Time-Warner merger agreement demonstrated a decision by Time's board to transfer control to the Warner shareholders.<sup>220</sup> The plaintiffs reasoned that transferring sixty-two percent of voting ownership and sacrificing fifty percent of

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208. *Id.* at 21.

209. *Id.* at 22.

210. *Id.* at 20. The court noted in its opinion that "Paramount's cash premium would be a tempting prospect to [Time's shareholders]." *Id.*

211. Hidler & Landro, *Paramount Withdraws its Hostile Offer as Time Begins its Purchase of Warner*, Wall St. J., July 25, 1989, at A3, col. 1. See also Joint Time and Warner Press Release, Aug. 23, 1989 (describing consideration for Warner acquisition, which consisted of 38% preferred stock convertible into Time common shares).

212. Richter, *Time Warner Details Plans to Pay for Takeover*, L.A. Times, Aug. 24, 1989, Part IV, at 1, col. 5.

213. *Time*, No. 284, 1989, slip op. at 23; Answering Brief of Time Appellees at 25, *Paramount Communications, Inc. v. Time Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. July 26, 1989) (No. 10,866, consolidated 10,670 and 19,835), *aff'd*, No. 284, 1989 (Del. Feb. 26, 1990). For a general discussion of the differences between tender offer and merger requirements, including shareholder voting requirements, see S. LORNE, *supra* note 38, at §§ 3.11-12.

214. *Time*, No. 284, 1989, slip op. at 30.

215. Hidler & Landro, *Paramount Withdraws its Hostile Offer as Time Begins its Purchase of Warner*, Wall St. J., July 25, 1989, at A3, col. 1.

216. *Time*, No. 284, 1989, slip op. at 3.

217. *Id.* at 4-5.

218. See *supra* notes 185-88 and accompanying text for a discussion of the *Revlon* analysis.

219. *Time*, No. 284, 1989, slip op. at 24. See *supra* notes 150-56 and accompanying text for a discussion of the *Unocal* test.

220. *Time*, No. 284, 1989, slip op. at 24.

management control constituted a "change in control" triggering *Revlon* duties.<sup>221</sup> The Delaware Supreme Court, however, rejected this argument, noting that Time never *intended* to be sold.<sup>222</sup>

Second, the plaintiffs argued that *Revlon* should apply because the \$30 billion market value of Time Warner prevented shareholders from ever obtaining a future control premium.<sup>223</sup> The plaintiffs asserted that directors may not foreclose the possibility of a future takeover, and therefore, the Time-Warner merger obligated the directors to maximize the shareholders' current value.<sup>224</sup> The Delaware Supreme Court, and the chancery court before it, however, were not convinced that the combined Time-Warner company would "*legally* preclude or impede a later sale" and concluded that *Revlon* did not apply.<sup>225</sup>

Having rejected application of *Revlon*, the supreme court considered plaintiffs' alternative argument under *Unocal*.<sup>226</sup> Plaintiffs alleged that even if *Unocal* applied, rather than *Revlon*, Paramount's "fully-negotiable" and fairly-priced bid did not reasonably pose a threat to Time or its shareholders.<sup>227</sup> Paramount's bid offered cash for all of Time's outstanding shares, and the bid was bank financed.<sup>228</sup> The plaintiffs reasoned that

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221. *Id.*

222. *Id.* at 27-28. The court restricted application of *Revlon* to circumstances in which a board puts the company on the "auction block" or when the company "abandons its long-term strategy and seeks an alternative transaction also involving the breakup of the company." *Id.* at 28. See *infra* notes 277-81 and accompanying text for a discussion of the *Time* court's restriction of circumstances triggering *Revlon*. In restricting *Revlon*, the Delaware Supreme Court rejected not only the plaintiffs' argument, but also the narrower rationale of the chancery court. The Delaware Chancery Court had concluded that a *Revlon* "change in control" did not result because in a stock for stock merger, control remains "in a fluid aggregation of unaffiliated shareholders representing a voting majority." *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,279. The chancery court likened the dilution of voting control suffered by Time shareholders under the proposed merger agreement to the dilution suffered in any public distribution of new securities. *Id.* The chancery court distinguished the circumstances in *Time* from those in which control changes from *private* hands to the *public* market, noting that in the latter circumstances, *Revlon* would "plainly apply." *Id.* at 93,279.

223. *Time*, No. 284, 1989, slip op. at 24.

224. *Id.* The Delaware Supreme Court did not conduct a separate inquiry into the plaintiffs' two separate *Revlon* arguments, but relied on the findings of the chancery court. *Id.* at 29. See *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,280 (plaintiffs argued that Time board "enter[ed] into a number of agreements that were intended to preclude or impede the emergence of current value maximizing alternatives.").

225. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,281 (emphasis added). See also *Time*, No. 284, 1989, slip op. at 29-30 (accepting the chancery court's conclusion that the mere size of the combined Time-Warner company is not sufficient to trigger *Revlon*).

226. *Time*, No. 284, 1989, slip op. at 31-41.

227. *Id.* at 4.

228. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,282-83. The plaintiffs cited authority for the proposition that when faced with an all-cash, all-shares offer,

under these circumstances, a board could not justify defensive action that was totally unrelated to a threat to the corporation or its shareholders.<sup>229</sup>

The Delaware Supreme Court vehemently rejected any "misconceptions" that all-cash, all-shares offers are non-coercive,<sup>230</sup> and refused to limit application of the business judgment rule under *Unocal* to circumstances where an identifiable substantive or procedural threat exists.<sup>231</sup> The court praised *Unocal* as a flexible analytical tool which was "not intended [to be] an abstract standard [or] a structured and mechanistic procedure."<sup>232</sup> The court concluded that Time's directors had reasonably perceived threats to: (1) Time's strategic plan of global expansion to be effected through a combination with Warner;<sup>233</sup> and (2) "company policy and effectiveness."<sup>234</sup>

The court acknowledged that the Paramount bid might offer a greater immediate return to Time's shareholders.<sup>235</sup> However, the court reasoned that directors have the duty to manage the company and are, therefore, "obligated to charter a course for the corporation which is in [the corporation's] best interests without regard to a fixed investment ho-

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the only potential threat was to the price offered shareholders. *Id.* at 93,283 (citing *City Capital Assocs. v. Interco Inc.*, 551 A.2d 787, 796 (Del. Ch.), *appeal dismissed*, 556 A.2d 1070 (Del. 1988)).

229. *Time*, No. 284, 1989, slip op. at 34. Courts prior to *Time* had consistently rejected the "just say no" defense. *See, e.g.*, *Grand Metro. PLC v. Pillsbury Co.*, 558 A.2d 1049, 1060 (Del. Ch. 1988) (no business judgment rule protection for implementation of poison pill which precluded shareholder acceptance of fully financed "all-shares" cash offer); *City Capital Assocs. Ltd. Partnership v. Interco Inc.*, 551 A.2d 787, 797 (Del. Ch.) (board "is not authorized to take preclusive action . . . [which,] as a practical matter, withdraws from the shareholders the option to choose between the offer and the status quo or some other board sponsored alternative"), *appeal dismissed*, 556 A.2d 1070 (Del. 1988). *But see* *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 508-09 (7th Cir.) (if tender offer threatens corporation's long-term plan, managers may "just say no"), *cert. denied*, 110 S. Ct. 367 (1989). *See also generally* Yablon, *Poison Pills and Litigation Uncertainty*, 1989 DUKE L.J. 54; Note, *Shareholder Rights Plans: Saying No to Inadequate Tender Offers*, 57 FORDHAM L. REV. 803 (1989).

230. *Time*, No. 284, 1989, slip op. at 34-35.

231. *Id.* at 34-36. Before *Time*, courts allowing the business judgment rule to protect board decisions under *Unocal* required a reasonably perceived substantive or procedural threat to the company or its shareholders. *See, e.g.*, *City Capital*, 551 A.2d at 797.

232. *Time*, No. 284, 1989, slip op. at 35.

233. *Id.* at 21. The court acknowledged that Time's "board's prevailing belief was that Paramount's [initial \$175 per share cash] bid presented a threat to Time's control of its own destiny and retention of the 'Time Culture.'" *Id.* The court also accepted the board's conclusion that Paramount's increased offer of \$200 per share "was still inadequate and that the Warner transaction offered a greater long-term value for the stockholders . . ." *Id.* at 23.

234. *Id.* at 37.

235. *Id.* at 20.



rizon."<sup>236</sup> The court stressed that Time's dual goals of global expansion and preservation of the "Time culture" exemplified such management planning.<sup>237</sup> The court viewed Time's plan to combine with Warner as a rational means of pursuing these goals.<sup>238</sup>

The supreme court also recognized as a defensible threat the potential for shareholder ignorance.<sup>239</sup> Time directors allegedly were concerned that shareholders would improvidently tender their shares to Paramount rather than support the Time-Warner merger out of "ignorance or a mistaken belief of the strategic benefit which a business combination with Warner might produce."<sup>240</sup>

Recognizing that Time's strategic plan to combine with Warner was a legally cognizable interest, and that Paramount's bid threatened that interest, the court held that Time's decision to recast the Time-Warner agreement was reasonable.<sup>241</sup> The court concluded that the Time directors had satisfied the requirements of *Unocal* and that the business judgment rule protected the directors from personal liability and protected their decision from judicial second-guessing.<sup>242</sup> Although the court pur-

236. *Id.* See also *id.* at 39 (directors' "fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals").

237. *Id.* at 8 n.4. The court stated that the Time directors "believed that Time had become recognized in this country as an institution built upon a foundation of journalistic integrity." *Id.* In addition, the court noted that some of Time's "directors feared that a merger with an entertainment company would divert Time's focus from news journalism and threaten the Time Culture." *Id.* Presumably, Time selected Warner as a vehicle to pursue its strategy of global expansion because Warner would enhance Time's distribution capacities without sacrificing the "Time culture." *Id.* at 11-12. The initial merger agreement provided that the board of directors of the combined company would be equally divided between the then-existing Time and Warner directors. *Id.* at 16. A separate "editorial committee," with a majority of its members representing Time was planned to ensure continuance of Time's journalistic integrity and culture. *Id.*

238. *Id.* at 8.

239. *Id.* at 36-37. The court noted that:

[C]ertain Time directors expressed their concern that their stockholders would not comprehend the long-term benefits of the Warner merger. Large quantities of Time shares were held by institutional investors. The board feared that even though there appeared to be wide support for the Warner transaction, Paramount's cash premium would be a tempting prospect to these investors.

*Id.* at 20.

240. *Id.* at 36. The legitimacy of this concern of Time's directors is highly questionable. Clearly, informing shareholders of a proposed merger transaction endorsed by the board of directors is the directors' responsibility. See *infra* notes 393-417 and accompanying text for a discussion and criticism of the court's allowing directors to "defend" against threats caused by their own abdication of duties.

241. *Time*, No. 284, 1989, slip op. at 38-39.

242. *Id.* The chancery court had noted in its opinion that "[i]t is not part of the function of the court to evaluate whether the Time-Warner deal is a good one for Time shareholders or a poor one." *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,284. The chancery court also noted that "the innovative and constructive rule of *Unocal* must be cau-

ported to apply the *two-pronged* test of *Unocal*,<sup>243</sup> it focused solely on the process of the board's decision,<sup>244</sup> and failed to consider whether any reasonably perceived threat to Time or its shareholders was actually posed. Had the court applied even a minimal level of scrutiny, it would have realized that the board was "protecting" the shareholders from the board's abdication of its own duties.<sup>245</sup>

Without expressly overruling or precisely redefining the requirements of *Unocal* and *Revlon*, the *Time* court significantly broadened director discretion in takeover situations. The extent of this broadened discretion, however, is unclear. The language of the supreme court's opinion left open several important questions. For example, can a company avoid *Revlon* duties simply by professing a goal to remain independent? If so, can a company avoid *Revlon* duties even if that company plans a fundamental change in the company's capital and its ownership structure?<sup>246</sup> Second, is a threat to a company's strategic plan a sufficiently reasonable basis under *Unocal* for defending against a non-coercive tender offer?<sup>247</sup> Finally, what non-shareholder constituencies may directors consider, and when may directors consider these constituencies at the expense of shareholder desires?<sup>248</sup>

### III. PROBLEMS WITH BUSINESS JUDGMENT RULE PROTECTION OF CONTROL DECISIONS

The *Unocal Corp. v. Mesa Petroleum Co.*<sup>249</sup> proportionality test<sup>250</sup> and the *Revlon, Inc. v. MacAndrews & Forbes Holdings*<sup>251</sup> auction duties

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tiously applied lest the important benefits of the business judgment rule . . . be eroded or lost by slow degrees." *Id.* at 93,284-85.

243. *Time*, No. 284, 1989, slip op. at 38 ("It is not until both parts of the *Unocal* inquiry have been satisfied that the business judgment rule attaches to defensive actions of a board of directors.")

244. The court noted that the directors were "adequately informed of the potential benefits of a transaction with Paramount." *Id.* at 37. The court also found that the legitimacy of the board's failure to negotiate with Paramount was "materially enhanced by the fact that twelve of Time's sixteen board members were outside independent directors." *Id.* at 38.

245. The court recognized as legitimate the purported concern of Time's board that "Time shareholders might elect to tender into Paramount's cash offer in ignorance or a mistaken belief of the strategic benefit which a business combination *with Warner* might produce." *Id.* at 36. (emphasis added). The court failed, however, to recognize that the Time-Warner merger was the transaction endorsed by Time's directors, and that it was the directors' responsibility to convince the shareholders of the merits of that transaction.

246. See *infra* notes 277-381 and accompanying text.

247. See *infra* notes 382-417 and accompanying text.

248. See *infra* notes 463-500 and accompanying text.

249. 493 A.2d 946 (Del. 1985).

250. See *supra* notes 150-56 and accompanying text for a discussion of this test.

251. 506 A.2d 173 (Del. 1986).

test<sup>252</sup> are the two primary tests applied to determine whether the business judgment rule will protect corporate control decisions. A court's decision to apply one of these tests rather than the other may be outcome determinative because *Revlon* calls for a greater degree of judicial scrutiny than *Unocal*.<sup>253</sup> Protection of the business judgment rule under *Revlon* requires directors to focus exclusively on shareholder wealth maximization,<sup>254</sup> whereas the more lenient *Unocal* test allows a broad range of director considerations and requires only that directors act reasonably and in good faith.<sup>255</sup>

Problems resulting from business judgment rule protection of corporate control decisions made by directors fall into two broad categories—practical considerations and theoretical considerations.<sup>256</sup> Courts have been unable to practicably and consistently define director responsibilities in takeover contexts<sup>257</sup> partly because of an inability to define what *Revlon* and *Unocal* require, and when either of these levels of responsibility is required.<sup>258</sup> As a result, courts have significantly deferred to the business judgment of directors, virtually eliminating any meaningful judicial scrutiny.<sup>259</sup> Besides practical difficulties in applying *Revlon* and *Unocal*, in theory, the business judgment rule should not apply in control contests because directors' objectivity is unavoidably impaired.<sup>260</sup> Under these circumstances, deference to target directors is inappropriate.<sup>261</sup>

#### A. *What Does Revlon, Inc. v. MacAndrews & Forbes Holdings Require?*

In *In re RJR Nabisco Shareholders Litigation*,<sup>262</sup> the RJR board put

252. See *supra* notes 185-88 and accompanying text for a discussion of this test.

253. *AC Acquisitions Corp. v. Anderson, Clayton & Co.* 519 A.2d 103, 111 (Del. Ch. 1986) ("determination of the appropriate standard of judicial review frequently is [outcome-]determinative"); see also *Revlon*, 506 A.2d at 182 ("[R]ecognition that [a target] company [is] for sale . . . significantly alter[s] the board's responsibilities under the *Unocal* standards.").

254. *Revlon*, 506 A.2d at 182.

255. *Unocal*, 493 A.2d at 955. See also *supra* notes 150-56 and accompanying text.

256. See *infra* notes 262-440 and accompanying text.

257. See *infra* notes 262-417 and accompanying text for a discussion and analysis of this problem.

258. See S. LORNE, *supra* note 38, at § 1A.05[1]-[4].

259. See *Paramount Communications, Inc. v. Time Inc.*, No. 284, 1989 (Del. Feb. 26, 1990). See *infra* notes 320-81 and accompanying text for a discussion of the limited judicial scrutiny applied in *Time*.

260. *Unocal*, 493 A.2d at 954.

261. See *infra* notes 418-46 and accompanying text for a discussion and analysis of this problem.

262. [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194 (Del. Ch. Jan. 31), *appeal denied mem.*, 556 A.2d 1070 (Del. 1989).

RJR on the auction block.<sup>263</sup> All parties conceded that *Revlon, Inc. v. MacAndrews & Forbes Holdings*<sup>264</sup> applied,<sup>265</sup> but the Delaware Chancery Court was left to decide what *Revlon* “auction duties” required.<sup>266</sup> Ultimately, the duties required were significantly less than what *Revlon* seems to mandate. *Revlon* explicitly states that “when bidders make relatively similar offers, or dissolution of the company becomes inevitable, the directors cannot . . . play[] favorites.”<sup>267</sup> In *RJR Nabisco*, however, the Delaware court retreated from *Revlon*, stating a “level playing field” is not required as long as directors act in good faith.<sup>268</sup>

The RJR directors were faced with two substantially equivalent bids—one offered by RJR management and the other by the investment firm, Kohlberg Kravis Roberts & Co. (KKR).<sup>269</sup> The management bid offered more cash than KKR’s, yet RJR’s board rejected that bid in favor of KKR’s bid.<sup>270</sup> According to the court, RJR’s directors were not required to accept management’s equivalent bid which included a greater cash component than KKR’s opposing bid, nor were they required to enhance the bidding process by trying to “break the tie.”<sup>271</sup> Yet *Revlon*’s focus on shareholder wealth maximization would seem to require that at least one of these actions be taken.<sup>272</sup>

Besides rejecting plaintiffs’ *Revlon* arguments, the court also disregarded allegations of improper board motivation,<sup>273</sup> finding instead that

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263. *Id.* at 91,714.

264. 506 A.2d 173 (Del. 1986).

265. *RJR Nabisco*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,714.

266. *Id.* at 91,714-15.

267. *Revlon*, 506 A.2d at 184. The court noted that favoritism is justifiable only when: (1) similar bids are not offered and dissolution of the company is not inevitable, and (2) “the [hostile bidder’s] offer adversely affects shareholder interests . . . .” *Id.*

268. *RJR Nabisco*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,714. See also *In re Fort Howard Corp. Shareholders Litig.*, No. 9991, at 40 (Del. Ch. Aug. 8, 1988) (LEXIS, States library, Del file) (board “may favor one [bidder] over another if in good faith and advisedly it believes shareholder interests would be thereby advanced”); *West Point-Pepperell, Inc. v. J.P. Stevens & Co.*, 542 A.2d 770, 782 (Del. Ch. 1988) (“[T]he board may tilt the playing field if, but only if, it is in the shareholders’ interests to do so.”). But see *In re Holly Farms Corp. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,181, at 91,644 (Del. Ch. Dec. 30, 1988) (“Even if the [b]oard thought it was acting in good faith, the [auction] process itself was so substantially flawed that the [b]oard’s actions . . . cannot be viewed as rational.”).

269. *RJR Nabisco*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,701.

270. *Id.* at 91,713.

271. *Id.*

272. *Revlon*, 506 A.2d at 182. See also *supra* notes 185-88 and accompanying text for a discussion of the wealth-maximization focus of *Revlon*.

273. *RJR Nabisco*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at

the RJR board did not act "grossly negligent."<sup>274</sup> In assessing the reasonableness of the board's decision, the court appears to have applied the more lenient *Unocal* standard, rather than the stricter shareholder-wealth-maximization test of *Revlon*.<sup>275</sup> Other recent cases have similarly retreated from the shareholder-wealth-maximization test, focusing instead on the absence of directors' bad faith.<sup>276</sup>

*B. Avoiding Revlon, Inc. v. MacAndrews & Forbes Holdings Duties by Maintaining a "Goal" of Corporate Independence*

The triggering point for application of the strict requirements of *Revlon, Inc. v. MacAndrews & Forbes Holdings*<sup>277</sup> hinges on the "inevitability of a change in control,"<sup>278</sup> a phrase not defined by the *Revlon* court. The *Revlon* court noted, however, that an inevitable change in control is not limited to circumstances of an active auction resulting from directors putting the company up for sale.<sup>279</sup> Courts subsequent to *Revlon* have placed great weight on a corporation's goal of "remaining independent,"<sup>280</sup> but generally, mere articulation of a goal to remain independent has not been sufficient to avoid *Revlon* auction duties.<sup>281</sup> Courts, prior to *Paramount Communications, Inc. v. Time Inc.*,<sup>282</sup> seemed to require a company desiring independence to ensure that a majority of ownership control remains with existing shareholders.<sup>283</sup> Thus,

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91,701-02. The RJR directors were allegedly motivated by a desire to disassociate themselves from the management plan because of the "harsh [public] criticism [it] engendered." *Id.* at 91,702. For example, *Time* magazine trumpeted the management proposal as "A Game of Greed." *Id.* at 91,711 n.14.

274. *Id.* at 91,703.

275. *Id.* at 91,714-15 (court interpreted *Revlon* as not applicable where directors act in good faith, and therefore, found no basis in *Revlon* to overturn board's decision).

276. See, e.g., *West Point-Pepperell*, 542 A.2d at 782 ("level playing field" not required in auction if directors act with due care); *In re Fort Howard*, No. 9991 (Del. Ch. Aug. 8, 1988) (LEXIS, States library, Del file) (board "may favor one [bidder] over another if in good faith and advisedly it believes shareholder interests would be thereby advanced"); *Citron v. Fairchild Camera & Instrument Corp.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,915, at 90,103 n.17 (Del. Ch. May 19, 1988) (*Revlon* duty not to get best price but to strive in good faith to get best available transaction).

277. 506 A.2d 173 (Del. 1986).

278. *Id.* at 182. See also *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1345 (Del. 1987) (*Revlon* applies only if sale "inevitable").

279. *Revlon*, 506 A.2d at 181-82. A change in control may also occur where there is a "merger or buyout with a third party." *Id.* at 182.

280. See, e.g., *Black & Decker Corp. v. American Standard, Inc.*, 682 F. Supp. 772 (D. Del. 1988); *Ivanhoe*, 535 A.2d 1334.

281. See *Black & Decker*, 682 F. Supp. at 784.

282. No. 284, 1989 (Del. Feb. 26, 1990).

283. See *Ivanhoe*, 535 A.2d at 1345.

a fifty-percent cut-off test<sup>284</sup> was applied to determine whether a change in majority ownership occurred in *Ivanhoe Partners v. Newmont Mining Corp.*<sup>285</sup> and *Black & Decker Corp. v. American Standard, Inc.*<sup>286</sup> This fifty-percent test, however, may have been limited or abandoned in *Time*, in which the court suggested that a company cannot involuntarily enter the "Revlon mode."<sup>287</sup>

In *Ivanhoe*, the Newmont board faced an unwanted takeover threat and articulated its goal to remain "independent."<sup>288</sup> To further this goal, Newmont declared a \$33 per share cash dividend.<sup>289</sup> Payment of this dividend allowed Gold Fields, a favored Newmont shareholder, to engage in a "street sweep"<sup>290</sup> of Newmont stock and increase its ownership from twenty-six percent to just under fifty percent.<sup>291</sup> Newmont facilitated the street sweep, but assured its independence by entering into an agreement limiting Gold Fields' equity ownership of Newmont to just under fifty percent and its board representation to forty percent.<sup>292</sup>

*Ivanhoe*, a hostile bidder, sued to enjoin or rescind Newmont's plan, arguing that the Newmont directors failed to fulfill their *Revlon* auction duties.<sup>293</sup> The Delaware Supreme Court, however, agreed with Newmont in its conclusion that limiting Gold Fields' equity ownership and board representation to under fifty percent ensured that a change in

284. A 50% cut-off test assumes a change in control when over half of the company's shares outstanding change hands. This 50% cut-off is somewhat artificial because a shareholder owning significantly less than 50% of voting shares can still effectively maintain working control over company operations through executive officer or board representation. See Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 705 (1982). See also Rule 405 accompanying the Securities Act of 1933, which defines "control" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies . . . through ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405 (1989) (emphasis added).

285. 535 A.2d 1334 (Del. 1987).

286. 682 F. Supp. 772 (D. Del. 1988).

287. See *Time*, No. 284, 1989, slip op. at 27-28. See also *infra* notes 309-42 and accompanying text.

288. *Ivanhoe*, 535 A.2d at 1336-37.

289. *Id.* at 1337.

290. "'Street sweep' refers to the rapid acquisition of securities on the open market during and shortly after the pendency of a tender offer for the same class of securities." *Id.* at 1337 n.3. The dividend paid by Newmont provided cash which enabled Gold Fields to purchase Newmont shares at a premium and allowed Newmont to keep its shares in "friendly" hands. *Id.* at 1344. In addition to facilitating Gold Field's street sweep, the cash dividend, financed through asset sales, reduced Newmont's attractiveness to potential bidders by reducing its asset base and its liquidity. *Id.* at 1339-40.

291. *Id.* at 1337.

292. *Id.* at 1340.

293. *Id.*

control would not occur,<sup>294</sup> and therefore *Revlon* did not apply.<sup>295</sup> The court limited its review of Newmont's defensive cash dividend to *Unocal*'s proportionality analysis<sup>296</sup> and allowed business judgment rule protection of the board's plan.<sup>297</sup> In applying *Unocal*, the *Ivanhoe* court found that Ivanhoe's bid was inadequate and coercive, and therefore, presented a reasonably perceived threat to Newmont shareholders.<sup>298</sup> The court also found that Newmont's actions in facilitating the street sweep were reasonable and in the shareholders' best interests.<sup>299</sup>

The target company in *Black & Decker*, similar to the target company in *Ivanhoe*, articulated a goal to remain independent; however, the court in this case applied *Revlon* rather than *Unocal*.<sup>300</sup> In *Black & Decker*, American Standard was the target of a hostile offer by Black & Decker.<sup>301</sup> In pursuit of the goal of maintaining independence,<sup>302</sup> American Standard's directors approved implementation of a recapitalization plan which involved exchanging outstanding equity shares for cash plus a small equity stub.<sup>303</sup> As part of this plan, equity shares owned by American Standard's management were to be purchased by an employee stock ownership plan (ESOP) controlled by American Standard management.<sup>304</sup> Upon consummation of the recapitalization plan, the combined ownership of American Standard management and the ESOP would total 54.5% of American Standard's outstanding equity shares, and public ownership would be reduced to 45.5%.<sup>305</sup> As in *Ivanhoe*, the Delaware court considered the target company's intent in light of the percentage of voting shares transferred.<sup>306</sup> American Standard's management controlled the ESOP; therefore, the court found that the ultimate effect of

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294. *Id.* at 1345.

295. *Id.* See also *supra* notes 185-88 and accompanying text for a discussion of *Revlon*-level scrutiny.

296. *Ivanhoe*, 535 A.2d at 1342-43. See *supra* notes 150-56 and accompanying text for explanation of the *Unocal* analysis.

297. *Ivanhoe*, 535 A.2d at 1345.

298. *Id.* at 1342.

299. *Id.* at 1343.

300. *Black & Decker*, 682 F. Supp. at 782. The court distinguished the facts in *Ivanhoe Partners* from those in *Black & Decker*, noting that while the management of both target companies articulated goals of maintaining independence, the target company in *Black & Decker* sought to maintain its independence "only through a change in control." *Id.*

301. *Id.* at 774.

302. *Id.* at 780.

303. *Id.* at 782. An equity "stub" represents a fractional ownership share, that combined with the cash and debt offered in this case, constituted the "package" of consideration offered. *Id.*

304. *Id.*

305. *Id.*

306. *Id.* The court noted that under the proposed arrangement, "public shareholders

the plan was to transfer ownership of American Standard from the public's hands to those of its management.<sup>307</sup> The court concluded that a "change in control" had occurred and accordingly required imposition of *Revlon* auction duties to maximize shareholder wealth.<sup>308</sup>

In *Time*, the Delaware Supreme Court may have abandoned, or at least redefined, the fifty-percent cut-off test applied in *Ivanhoe* and *Black & Decker*. Similar to *Ivanhoe* and *Black & Decker*, the *Time* court considered the target's desire to remain independent.<sup>309</sup> The *Time* directors had articulated a goal to remain independent and preserve *Time*'s "role in American life."<sup>310</sup> Unlike *Ivanhoe Partners* and *Black & Decker*, however, the court did not focus exclusively on the *percentage* of shares changing hands, but rather focused on the subjective intent of the *Time* directors.<sup>311</sup>

Under the initial *Time*-Warner merger agreement,<sup>312</sup> a change in both voting and management control seemed inevitable. Warner shareholders would have owned sixty-two percent of previously outstanding *Time* common shares,<sup>313</sup> and management of the combined company would have been shared equally between the previously independent management teams of *Time* and Warner.<sup>314</sup> Nevertheless, the *Time* court held that *Revlon* did not apply.<sup>315</sup>

In *Time*, the Delaware Supreme Court refocused the issue of whether *Revlon* applies, from, "Is a fundamental change in the company's ownership or capital structure inevitable?" to, "Is giving the

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would own 45.5% of the outstanding common stock, management would own 23.9% and . . . [the] ESOP would control 30.6% [effectively giving management 54.5% ownership]." *Id.*

307. *Id.* at 783.

308. *Id.* at 784.

309. *Time*, No. 284, 1989, slip op. at 14. See also the chancery court's opinion which stated:

Neither the goal of establishing a vertically integrated entertainment organization, nor the goal of becoming a more global enterprise, was a transcendent aim of *Time* management or its board. More important to both, apparently, has been a desire to maintain an independent *Time* incorporated that reflected a continuation of what management and the board regarded as distinctive and important "Time culture."

Paramount Communications, Inc. v. *Time* Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,267 (Del. Ch. July 14, 1989), *aff'd*, No. 284, 1989 (Del. Feb. 26, 1990).

310. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,267.

311. See *Time*, No. 284, 1989, slip op. at 27. The court concluded that there was insufficient "evidence to conclude that *Time*'s board, in negotiating with Warner, made dissolution or break up of the corporate entity inevitable . . ." *Id.*

312. See *supra* notes 190-245 and accompanying text for a discussion of the initial *Time*-Warner merger agreement and the sequence of events giving rise to this litigation.

313. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,270.

314. *Id.* at 93,269.

315. *Time*, No. 284, 1989, slip op. at 29.



shareholders the option to accept an all-cash tender offer inconsistent with the company's strategic plan?"<sup>316</sup> In so doing, the Delaware Supreme Court has rendered *Revlon* useless. Under the *Revlon* rule, as previously applied in *Revlon* and in cases prior to *Time*, courts focused on whether the directors planned a change in the fundamental structure of the company.<sup>317</sup> This reasoning is consistent with the statutory provisions dividing corporate powers between directors and shareholders,<sup>318</sup> directors are charged with managing the business and affairs of the company<sup>319</sup> and the shareholders are responsible for decisions affecting the corporation's ultimate destiny.<sup>320</sup>

The intended focus of *Revlon* was to ensure shareholder protection once a change in the fundamental structure of a corporation became inevitable.<sup>321</sup> Assuming that corporate decision-making powers lie on a continuum between those delegated to directors and those delegated to shareholders, a decision which changes the fundamental structure of a corporation lies closer to the shareholders' powers of "ultimate destiny" than to the director's powers. The *Revlon* court recognized that when a change in corporate structure is pending, the company is "no longer faced [with] threats to [existing] corporate policy or effectiveness"<sup>322</sup> and that under such circumstances, the potential for abuse by the directors increases. Therefore, when a change in the corporation's fundamental structure is inevitable, directors should be required to pay greater attention to shareholder desires than what is required under *Unocal*.

In *Revlon*, the Delaware Supreme Court focused on whether a fundamental structure of the company was inevitable. The court defined the circumstances which change the fundamental structure of a company as those involving either an inevitable "break-up [or dissolution] of the company"<sup>323</sup> or a "board[] authoriz[ation] . . . to negotiate a merger or

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316. *Id.* at 25.

317. See, e.g., *Revlon*, 506 A.2d at 181 (shareholder-wealth maximization duties may arise in corporate restructurings where fundamental change in the capital structure of the target company occurs); *Ivanhoe*, 535 A.2d at 1345 (fundamental change in the ownership structure).

318. See *supra* notes 14-19 and accompanying text.

319. DEL. STAT. ANN. tit. 8, § 141(a) (1983).

320. *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 258 (2d Cir. 1984). For examples of such "ultimate destiny" decisions requiring shareholder vote see DEL. STAT. ANN. tit. 8, § 211 (shareholder vote required for election of directors); *id.* § 241(b) (shareholder vote required to amend articles of incorporation); *id.* § 251(c) (shareholder vote required for merger or consolidation) (Supp. 1988).

321. The *Revlon* court stated that the duty of a board is "maximization of the company's value at a sale for the *stockholders'* benefit." 506 A.2d at 187 (emphasis added).

322. *Id.* at 182.

323. *Id.*

buyout with a third party”<sup>324</sup> *Revlon*’s definitions of when a fundamental change in company structure occurs were applied in *Ivanhoe* and *Black & Decker*. In *Ivanhoe*, the directors ensured that a fundamental change in corporate structure would not occur, and the court, therefore, held that *Revlon* did not apply.<sup>325</sup> In *Black & Decker*, a fundamental change in the corporate structure did occur when ownership control shifted from investors in the open market to management.<sup>326</sup> In this situation, *Revlon* was applied.<sup>327</sup>

These same *Revlon* triggering points, however, were ignored in *Time*. In *Time*, the board gave management the “go-ahead” to discuss the possibility of a merger with Warner,<sup>328</sup> and *Revlon* was not triggered.<sup>329</sup> When the boards of *Time* and Warner signed the merger agreement, which transferred a majority of *Time*’s voting control to Warner shareholders and half of *Time*’s management control to Warner management, *Revlon* scrutiny again was not triggered.<sup>330</sup> Even after Paramount launched its tender offer and *Time* directors further considered alternative merger and buyout opportunities,<sup>331</sup> the *Time* court again held that *Revlon* did not apply.<sup>332</sup>

Contrary to courts’ focus on objective criteria, such as changes in the corporate structure and ownership control, the *Time* court focused on the subjective intent of the *Time* directors.<sup>333</sup> Prior to *Time*, courts had questioned whether it was possible for “a board to thrust itself involuntarily into a *Revlon* [mode].”<sup>334</sup> The Delaware Supreme Court in *Time* answered “no.” The court restricted application of *Revlon* duties

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324. *Id.*

325. *Ivanhoe*, 535 A.2d at 1345.

326. In *Black & Decker*, the target company’s recapitalization plan provided that all outstanding shares were to be exchanged for a \$59.00 cash distribution and a debt and securities package. *Black & Decker*, 682 F. Supp. at 787. The reduction of equity and increase in debt fundamentally changed the capital structure of American Standard. In addition, transfer of shares to management through the ESOP changed the ownership control structure of American Standard. *Id.*

327. *Id.* at 784. The *Black & Decker* court distinguished *Ivanhoe* from the facts of this case, noting that “management ha[d] said it want[ed] to remain independent, yet its actions reveal[ed] that the company [was] for sale.” *Id.*

328. *Time*, No. 284, 1989, slip op. at 10.

329. *Id.* at 29.

330. *Id.*

331. *Id.* at 30 n.16.

332. *Id.* at 30.

333. *Id.* at 14. The court noted that “*Time* steadfastly maintained it was not placing itself up for sale.” *Id.*

334. *TW Servs., Inc. v. SWT Acquisition Corp.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,179-80 (Del. Ch. Mar. 2, 1989).

to two narrow circumstances:<sup>335</sup> (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;"<sup>336</sup> and (2) "where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction also involving the break up of the company."<sup>337</sup>

Each of the two "*Revlon* circumstances," as defined by the Delaware Supreme Court in *Time*, requires either directors' subjective intent or an actual plan to sell or dismantle the company. The first *Revlon* circumstance requires the board to initiate an active bidding contest and the second requires abandonment of the company's long-term strategy and a management plan to break up the company.<sup>338</sup> If subjective intent or knowledge is required, the companies cannot "involuntarily" fall into the *Revlon* mode. Therefore, the circumstances in which *Revlon* is most likely to benefit shareholders—the cases in which management adopts a plan which perpetuates its own control at the expense of shareholders—will not invoke *Revlon*.

For example, if, after *Time*, circumstances identical to *Black & Decker* arise, a result opposite from that in *Black & Decker* will be reached. In *Black & Decker*, the target directors wanted to maintain the company's independence.<sup>339</sup> In fact, the ESOP transaction was structured to ensure the company's independence by providing for target management to achieve voting control of the company.<sup>340</sup> The transaction planned by the target company, American Standard, did not involve an active bidding contest, nor did it involve an abandonment of the company's desire to remain independent and a break up of the company. Yet, these appear to be the only two circumstances which will give rise to *Revlon* after *Time*.

Target management in *Black & Decker* was, however, clearly per-

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335. *Time*, No. 284, 1989, slip op. at 28-29. The court noted, however, that other possibilities for triggering *Revlon* were not foreclosed. *Id.* at 27. Given the narrow focus adopted by the *Time* court, such possibilities are difficult to imagine.

336. *Id.* at 23.

337. *Id.*

338. *Id.* at 28. The court further clarified its restrictions on application of *Revlon*, noting that if a "board's reaction to a hostile tender offer is found to constitute only a defensive response and not abandonment of the corporation's continued existence, *Revlon* duties are not triggered . . ." *Id.*

339. *Black & Decker*, 682 F. Supp. at 780.

340. *Id.* at 784. The court noted that "the shareholders [were] acceding control in the corporation . . . [and] management [was] availing [itself] of the takeover threat to increase their . . . ownership in the company." *Id.*

petuating its own self-interest at the expense of the shareholders.<sup>341</sup> Yet after *Time*, if the same circumstances were to arise, *Revlon* would not be triggered because the directors of American Standard did not have a subjective intent to put the company up for sale. Given the low level of scrutiny called for under *Unocal*, directors who approve a defensive plan, need only show that they acted reasonably to reduce or eliminate some threat.<sup>342</sup> Under *Unocal*, the ESOP transaction approved by American Standard's directors would have been upheld. The utility of *Revlon*'s shareholder wealth-maximization requirement is demonstrated in *Black & Decker*, where the target directors were forced to maximize the shareholders' wealth, rather than their own wealth. *Revlon*'s usefulness can also be seen through analysis of what a court applying *Revlon* to the facts of *Time* should have concluded.

Had *Revlon* been applied, *Time* directors would have been obligated to maximize shareholder wealth.<sup>343</sup> Presumably, this would require choosing between two alternative transactions:<sup>344</sup> (1) Paramount's all-cash, all-shares acquisition of *Time*, under which *Time* shareholders would receive \$200 cash per share,<sup>345</sup> or (2) *Time*'s junk-bond-financed acquisition of Warner, under which *Time* shareholders would own shares in the combined *Time-Warner* company.<sup>346</sup> *Revlon*'s shareholder-wealth-maximization requirement<sup>347</sup> would have obligated the *Time* directors to consider which deal would have been best for the *Time* shareholders.<sup>348</sup> In determining the "best deal," *Time*'s directors would have

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341. American Standard's management gave itself control rather than allowing the shareholders to realize the significant cash premium offered by the outside bidder. *Black & Decker*, 682 F. Supp. at 784.

342. See *Time*, No. 284, 1989, slip op. at 41. See *supra* notes 272-381 and accompanying text for a discussion of how *Time* limits *Unocal*, and how the Delaware Supreme Court applied *Unocal* to the circumstances in *Time*.

343. *Revlon*, 493 A.2d at 182. See *supra* notes 185-88 and accompanying text for a discussion of *Revlon*'s focus on shareholder wealth maximization.

344. Although choosing between the two transactions was not a *legal* necessity, it was a *practical* and economic necessity. See *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,280.

345. *Time*, No. 284, 1989, slip op. at 23.

346. *Id.* at 22. The court noted that recasting *Time*'s transaction with Warner caused *Time* to "assume 7-10 billion dollars worth of debt, thus eliminating one of the principal transaction-related benefits of the original merger agreement." *Id.* *Time*'s directors would have to choose one over the other because implementation of both deals would not be economically feasible. *Id.* at 30. The court noted, however, that acquisition of a combined *Time-Warner* company would not be impossible. *Id.*

347. See *supra* notes 262-76 and accompanying text for a discussion of what *Revlon* may (or may not) require.

348. This analysis is speculative, however, because it is performed in hindsight and the actual long-term benefit (or detriment) of *Time*'s decision will not be recognized for years to

had to assess, among other things, the relative degree of coercion imposed by each transaction.<sup>349</sup>

A takeover bid may involve procedural or substantive coercion.<sup>350</sup> Moreover, at least according to the Delaware Supreme Court in *Time*, an otherwise non-coercive takeover bid may nonetheless threaten a company's strategic plan.<sup>351</sup> Paramount avoided procedural coercion by offering the same cash price to all Time shareholders.<sup>352</sup> On the other hand, Time's transaction with Warner arguably may have procedurally coerced Time shareholders if it was designed to manipulate the corporate machinery and avoid a shareholder vote.<sup>353</sup> Time directors initially planned a merger with Warner, which would have required a shareholder vote.<sup>354</sup> Time's board of directors had unanimously approved the merger agreement, which it trumpeted because it did not follow the trend towards greater leverage,<sup>355</sup> and it had scheduled a shareholder vote.<sup>356</sup> The board later withdrew its approval when Paramount's offer was re-

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come. See *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,284 ("the Time board may be proven in time to have been brilliantly prescient or dismayingly wrong").

349. Usually under *Revlon*, directors choose between competing offers each of which provides an immediate return to shareholders. See, e.g., *Revlon*, 506 A.2d at 177-78 (hostile tender offer or buyout by white knight); *In re RJR Nabisco Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,701 (Del. Ch. Jan. 31) (management bid or outside bid), *appeal denied mem.*, 556 A.2d 1070 (1989). In these cases, consideration of future threats posed is not relevant because shareholder wealth maximization involves a short-term, immediate result. See *supra* notes 262-76 and accompanying text for a discussion of *RJR*. Contrary to these cases, however, *Time* involved two competing proposals, one offering an immediate return to shareholders and the other offering the future value of a combined Time-Warner company. *Time*, No. 284, 1989, slip op. at 25-26. Therefore, consideration of future threats posed is necessary to evaluate the ultimate value to Time shareholders of the Time-Warner combination. See *supra* notes 75-115 and accompanying text for a discussion of threats that takeovers pose to target corporations.

350. See *City Capital Assocs. Ltd. Partnership v. Interco Inc.*, 551 A.2d 787, 797 (Del. Ch.), *appeal dismissed*, 556 A.2d 1070 (Del. 1989). See also *supra* notes 75-115 and accompanying text.

351. *Time*, slip op. at 36-37. See *infra* notes 382-417 for a discussion of the court's consideration of Time's strategic plan.

352. *Time*, slip op. at 5.

353. This argument was not specifically addressed by the supreme court, however, the chancery court dismissed the argument on an allocation-of-powers theory. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,281. The chancery court reasoned that because a shareholder vote on the initial merger agreement was required by the New York Stock Exchange rules only, and not by federal or state statutes, Time shareholders had no legal grounds to complain that their rights had been infringed. *Id.* at 93,381 n.18.

354. *Time*, No. 284, 1989, slip op. at 15.

355. *Id.* at 22 (one of the principal benefits of the merger was the lack of debt). The court also noted that "Time representatives lauded the lack of debt to the United States Senate and to the President of the United States. Public reaction to the announcement of the merger was positive. Time-Warner would be a media colossus with international scope." *Id.* at 17-18.

356. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,271.

ceived.<sup>357</sup> Time directors admitted that they revised the transaction with Warner only because the needed shareholder vote became “problematic.”<sup>358</sup>

The Delaware Supreme Court rejected the plaintiffs’ argument that “Time’s board . . . by entering into its initial merger agreement with Warner [came] under a *Revlon* duty either to auction the company or to maximize shareholder value . . . .”<sup>359</sup> The lower court had, in its opinion, clarified the reasoning behind permitting Time’s directors to withdraw the merger proposal from shareholder consideration.<sup>360</sup> The plaintiffs had argued that the original Time-Warner merger required both director and shareholder approval and that once solicitation of shareholder vote had commenced, the ultimate decision rested in the hands of the shareholders.<sup>361</sup> Therefore, they argued, directors could not withdraw their approval simply because a “shareholder vote seemed destined to go against management.”<sup>362</sup> In rejecting this argument, the lower court looked at the directors’ role, rather than the shareholders’ role, and found that a merger could not be accomplished without *director* approval.<sup>363</sup> Because directors’ approval was a condition precedent to the merger transaction, the court reasoned that Time’s board could legitimately withdraw its approval, regardless of shareholder desires.<sup>364</sup>

Substantive coercion typically involves an inadequate amount or quality of consideration.<sup>365</sup> In *Time*, Paramount offered cash consideration, not low-grade securities.<sup>366</sup> Moreover, the plaintiffs seeking to enjoin the Warner transaction and pursue the Paramount deal included

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357. *Id.* at 93,272.

358. *Id.*

359. *Time*, No. 284, 1989, slip op. at 5. The chancery court, in its opinion, had also noted that “commitment of the original Warner transaction to a shareholder vote [did not give] rise to a fiduciary obligation [on the part of Time’s directors] to permit shareholders to decide the matter.” *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,278. The chancery court distinguished *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988) from *Time*, commenting that “a board resolution rescinding approval of an agreement of merger and removing the matter from the agenda [as in *Time*] . . . is altogether different from a resolution designed to interfere with the statutory power to act through consent [as in *Blasius*].” *Id.*

360. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,281.

361. *Id.*

362. *Id.* This argument was not specifically addressed by the Delaware Supreme Court.

363. *Id.* at 93,281.

364. *Id.*

365. *City Capital*, 551 A.2d at 797. See *supra* notes 99-115 and accompanying text for a discussion of substantive coercion.

366. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,271. Subsequent to its initial offer for \$175 per share, Paramount made a \$200 per share cash offer. *Id.* at 93,275.

Time shareholders.<sup>367</sup> Therefore, it would be difficult to argue that Paramount's offer was substantively unfair. On the other hand, Time's acquisition of Warner, though considered "friendly,"<sup>368</sup> resulted in many of the harmful aspects of debt-financed hostile takeovers upon which directors often justify their defensive actions.<sup>369</sup> The Time-Warner deal, therefore, could be considered substantively unfair.

Time's acquisition of Warner was achieved through junk-bond financing,<sup>370</sup> which is considered riskier and less valuable than bank or other financing.<sup>371</sup> The typical fears arising from junk-bond financing include: (1) increased risk of default;<sup>372</sup> (2) a threat that a "bust-up" of company operations may be necessary to pay debt costs;<sup>373</sup> and, (3) an expectation that restrictive debt covenants and increased interest expenses will limit the company's ability to operate competitively in the future.<sup>374</sup> Each of these fears came to light as a result of Time's acquisition of Warner.

First, Time's debt has been downgraded by Standard & Poor's,<sup>375</sup> resulting in Time being labeled a "junk bond company."<sup>376</sup> In addition, Time's future business activities have been severely confined by restrictive covenants accompanying its acquisition-debt agreements.<sup>377</sup> Finally, Time has identified over \$1.3 billion of assets that it might sell to support debt costs associated with its acquisition of Warner.<sup>378</sup> Not only was Paramount's transaction better from an immediate profit-maximization

367. *Id.* at 93,265.

368. *Id.* at 93,270 (directors of both Time and Warner unanimously approved the transaction).

369. See *infra* notes 370-81 and accompanying text.

370. See *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,274.

371. Buffett, Dingman, Gray & Lowenstein, *supra* note 88, at 11.

372. *Id.*

373. *Id.* at 12 (Junk-bond financed takeovers are abusive because they "break apart companies as opposed to putting them together . . . [T]he entire junk bond issue is based upon what, in a predetermined manner will result from selling off pieces. . . . [T]he junk bond takeover restricts the ability of the affected business to grow or to provide increased productivity and employment."); see also Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, in KNIGHTS, RAIDERS AND TARGETS 77, 116 n.3 (1988) ("[P]lans to dismantle the target and sell its assets in piecemeal fashion to third parties are often in place even before the takeover has succeeded.").

374. Buffett, Dingman, Gray & Lowenstein, *supra* note 88, at 12.

375. *Time Warner Inc.'s Senior Debt Rating is Lowered by S&P*, Wall St. J., Oct. 2, 1989, at C9, col. 4.

376. *Id.*

377. Time's debt agreements have limited Time's ability to pay future dividends, borrow additional funds and expand through future investments. TIME WARNER INC., QUARTERLY REPORT ON FORM 10-Q 8 (June 30, 1989) [hereinafter TIME WARNER 10-Q].

378. Richter, *Time Warner Details Plans to Pay for Takeover*, L.A. Times, Aug. 24, 1989, Part IV, at 1, col. 1.

viewpoint, the Time-Warner deal will undoubtedly restrict Time Warner's future ability to operate competitively and realize its long-term profit potential.<sup>379</sup> Although the Time directors claimed to put forth the best deal for Time and its shareholders, it is difficult to understand their decision on purely economic terms.<sup>380</sup>

Had the *Time* court applied *Revlon's* shareholder-wealth-maximization analysis, rather than the more lenient *Unocal* analysis, it would have likely reached a different result.<sup>381</sup>

### C. *Is Pursuit of a Strategic Plan an Interest Protectable Under Unocal?*

After rejecting application of *Revlon, Inc. v. MacAndrews & Forbes Holdings*,<sup>382</sup> which application may or may not have resulted in a different outcome, the *Paramount Communications, Inc. v. Time Inc.*<sup>383</sup> court performed a *Unocal Corp. v. Mesa Petroleum Co.*<sup>384</sup> analysis.<sup>385</sup>

The Delaware Chancery Court found that the first prong of *Unocal* was satisfied by the Time directors reasonably perceiving that Paramount's tender offer posed a threat to Time's long-term strategic plan.<sup>386</sup> The court reasoned that if Paramount's tender offer was successful, Time would be precluded from consummating a transaction with Warner, and

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379. See Kneale, *Time Warner Had 4th-Period Loss of \$222 Million; Debt Costs Cited*, Wall St. J., Feb. 13, 1990, at B6, col. 1 (Time Warner has been unable to generate adequate cash to pay acquisition debt costs and Wall Street had not increased its value assessment of Time Warner); Sandler, *Time Warner's Mega-Issues Receive Miniscule Reviews*, Wall St. J., Jan. 3, 1990, at C2, col. 4 (reason Time Warner's stock value may never achieve its full potential is because "Time Warner now has a post-merger stock with a ton of debt on top of it, and not much immediate prospect of being taken over"). But see Marcial, *Two-for-one Plums Ripe for the Picking*, BUS. WEEK, Feb. 26, 1990, at 92 (citing investment banker's report concluding that Time Warner's underlying value is expected to grow 20% annually, and its underlying assets may be worth \$330 per share in 1993).

380. See *infra* notes 382-417 and accompanying text for a discussion of non-economic interests considered by Time's board.

381. Keep in mind, however, that this analysis is speculative only. See *supra* note 349. The Delaware Chancery Court justified its deference to Time's board by noting that "[n]o one . . . has access to more information concerning the corporation's present and future condition" than the company's board. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,277. The court referred to the triumph of The Walt Disney Co. which, in 1984, rejected a \$72.50 per share hostile tender offer, and now trades at an equivalent per share value of \$380. *Id.*

382. 506 A.2d 173 (Del. 1986).

383. No. 284, 1989 (Del. Feb. 26, 1990).

384. 493 A.2d 946 (Del. 1985).

385. *Time*, No. 284, 1989, slip op. at 31.

386. *Paramount Communications, Inc. v. Time Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,282 (Del. Ch. July 14, 1989), *aff'd*, No. 284, 1989 (Del. Feb. 26, 1990).



that the revised Warner transaction, "even though 'reactive' in important respects, had its origin and central purpose in *bona fide* strategic business planning . . . ." <sup>387</sup> The chancery court had concluded that "achievement of the long-term strategic plan of the Time-Warner consolidation [was] plainly a most important corporate policy" <sup>388</sup> and that this corporate policy was a "legally cognizable interest." <sup>389</sup>

The Delaware Supreme Court, however, refused to limit director discretion to protect only *long-term* plans. <sup>390</sup> This court stressed the flexibility of *Unocal*, <sup>391</sup> noting that the "precepts underlying the business judgment rule mitigate against a court's engaging in the process of attempting to appraise and evaluate the relative merits of a long-term versus a short-term investment goal for shareholders." <sup>392</sup> The supreme court then attempted to articulate the precise threat posed by Paramount's offer. <sup>393</sup> The court recognized one concern of Time's board—that "shareholders might elect to tender into Paramount's cash offer in ignorance or a mistaken belief of the strategic benefit which a business combination *with Warner* might produce." <sup>394</sup>

This "threat" is far from real. The board of directors was responsible for adequately informing Time's shareholders about the merits of its planned merger with Warner. <sup>395</sup> Before Paramount announced its offer, Time directors had mailed proxy solicitations requesting Time's share-

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387. *Id.* at 93,283.

388. *Id.*

389. *Id.*

390. *Time*, No. 284, 1989, slip op. at 26. The court commented that:

While we affirm the result reached by the Chancellor, we think it unwise to place undue emphasis upon long-term versus short-term corporate strategy. Two key predicates underpin our analysis. First, Delaware law imposes on a board of directors the duty to manage the business and affairs of the corporation. This broad mandate includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability. Thus, the question of "long-term" versus "short-term" values is largely irrelevant because directors, generally, are obliged to charter course for a corporation which is in its best interest without regard to a fixed investment horizon.

*Id.* (citation and footnote omitted).

391. *Id.* at 35.

392. *Id.* at 36.

393. *Id.*

394. *Id.* (emphasis added).

395. The rules governing proxy solicitations require that "[n]o [proxy] statement shall contain any statement which . . . is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading . . ." 17 C.F.R. § 240.14c-6 (1989) (emphasis added). Presumably the benefits of the proposed Time-Warner merger would have been considered a material fact, and therefore, would have required disclosure in order to not mislead Time's shareholders.

holders to vote for the Time-Warner merger.<sup>396</sup> Under federal securities laws, Time's directors had a duty to provide full and fair disclosure in those proxy solicitations so that the shareholders could make an intelligent decision.<sup>397</sup> If the directors failed in this regard, and that failure threatened Time's shareholders, there is no reason why those same directors should be permitted to eliminate the perceived "threat" by pursuing the same course of action which caused the threat.

The other "legitimate concerns" recognized by the supreme court are equally unconvincing. The court noted that "Time viewed the conditions attached to Paramount's offer as introducing a degree of uncertainty. . . ."<sup>398</sup> The court also accepted the assertion by Time's directors that the "timing of Paramount's offer . . . [was] arguably designed to upset, if not confuse, the Time stockholders' vote."<sup>399</sup> Despite the fact that Time refused to discuss Paramount's negotiable offer with Paramount, the court concluded that the Time directors were "adequately informed of the potential benefits of a transaction with Paramount."<sup>400</sup>

If Time's directors actually met with Paramount, these "threats" could have been eliminated. A meeting could have resolved, or at least concretely identified, the uncertainty surrounding Paramount's offer. Time's directors could have become sufficiently informed and notified the shareholders of any legitimate concern or uncertainty. The shareholders then could have considered these issues in making their decision whether to tender to Paramount or support the merger with Warner.

These trumped up threats to Time's "strategic plan" were found adequate to satisfy the first prong of *Unocal*.<sup>401</sup> This is the first time a court has allowed a threat to a "strategic plan" to satisfy *Unocal*'s first prong. Directors' consideration of a strategic plan is not, however, an entirely new concept.

*Unocal* allowed such consideration,<sup>402</sup> but under *Unocal*, this consideration took place in the second prong of the analysis *after* a viable

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396. *Time*, No. 284, 1989, slip op. at 18.

397. *J.I. Case Co. v. Borak*, 337 U.S. 426, 431 (1964) (The purpose of the federal proxy regulations "is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation."). In *Borak*, the Supreme Court quoted the legislative history of section 14(a), noting that "[t]oo often proxies are solicited without explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought." *Id.* (quotation omitted).

398. *Time*, No. 284, 1989, slip op. at 36.

399. *Id.* at 36-37.

400. *Id.* at 37.

401. *Id.*

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

threat to the corporation or its shareholders satisfied the first prong.<sup>403</sup> Under *Unocal*, protection of directors' decisions by the business judgment rule, required a viable threat to the corporation or its shareholders.<sup>404</sup> In *Unocal*, the directors had already established that Pickens' two-tier offer posed a legitimate threat to the corporation and its shareholders.<sup>405</sup> In *Time*, the threat recognized by the Delaware Supreme Court was to the company's strategic plan and to the integrity of the shareholders' decision-making process.<sup>406</sup>

Allowing a threat to a strategic plan to satisfy *Unocal*'s first prong greatly expands director discretion to fight a proposed takeover. Without first requiring an identifiable threat to the company or its shareholders, any creative board can claim that its company's plan is threatened. Limiting consideration of a long-term plan to *Unocal*'s second prong makes more sense. If a reasonably perceived coercive offer is outstanding, directors' fiduciary duties require them to consider all possibilities.<sup>407</sup> If, on the other hand, an outstanding offer is not coercive in an identifiable respect, directors should evaluate whether its strategic plan will ever maximize shareholder interests.<sup>408</sup>

The likely impact of recognizing that a strategic plan can satisfy *Unocal*'s first prong is illustrated through further analysis of the *Time* court's reasoning. In its decision, the Delaware Supreme Court considered *Time*'s plan to become a world-wide media giant and its intention to merge with Warner in furtherance of this plan.<sup>409</sup> The court then recognized this plan as an interest worthy of protection by *Time*'s directors.<sup>410</sup> The court, did not, however, apply its reasoning consistently. The "strategic plan" that the *Time* court recognized involved a merger transaction

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403. *Id.*

404. *Id.* See *supra* notes 75-115 and accompanying text for a discussion of how takeovers may threaten a corporation or its shareholders.

405. *Unocal*, 493 A.2d at 956.

406. *Time*, No. 284, 1989, slip op. at 36-37.

407. *Cf. Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) ("director's duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders").

408. Easterbrook and Fischel assert that bidders propose takeovers because they think they can make a profit in excess of the premium offered shareholders. Easterbrook & Fischel, *supra* note 81, at 1174. Easterbrook and Fischel suggest that if management's plan is truly more valuable than the bidder's offer, management should publicly disclose its plan. *Id.* at 1168. The stock market will then reflect the new information and the future value of the company under management's plan. *Id.* Assuming market efficiency, there will then be no room for a bidder to pay a premium, take over the target company and make a profit. *Id.*

409. *Time*, No. 284, 1989, slip op. at 25-26.

410. *Id.* at 22.

with Warner, and that plan was abandoned.<sup>411</sup> The ultimate plan that the court protected was Time's substituted plan to acquire Warner, and this plan was created *after* announcement of Paramount's bid.<sup>412</sup>

By refusing to enjoin Time's defensive acquisition of Warner, the *Time* court has invited companies to devise a *plan* and should an unwanted bidder seek control, just revise that plan to suit their needs.<sup>413</sup> As long as a strategic goal exists, directors may revise the company's plan and need not consider the desires of its shareholders<sup>414</sup> or the effect on the company.<sup>415</sup> *Time* suggests that as long as a revised plan does not arise from an "egregious" abuse of discretion, a court will uphold director action and protect it under the business judgment rule.<sup>416</sup> In future

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411. *Id.* at 22-23.

412. *Id.* at 23. The supreme court affirmed the chancery court's finding that "the initial Time-Warner transaction [was] negotiated at arms length and the restructured Time-Warner transaction . . . resulted from Paramount's offer and its expected effect on a Time shareholder vote." *Id.*

413. In *Time*, the Delaware Chancery Court acknowledged that that the revised acquisition transaction was "reactive" in important aspects, but focused on the its finding that the revised transaction had its "origin and central purpose in *bona fide* strategic business planning." *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,283. The Delaware Supreme Court also emphasized the value of strategic planning and did not seem concerned that the fundamental structure of the deal changed. The court noted that "Time representatives lauded the lack of debt [under the initially-planned transaction] to the United States Senate and to the President of the United States." *Time*, No. 284, 1989, slip op. at 17. The court also acknowledged that the revised transaction caused Time to incur seven to ten billion dollars worth of debt, "thus eliminating one of the principal transaction-related benefits of the original merger agreement." *Id.* at 22. The court disregarded the significant differences in the two Time-Warner transactions, and instead focused on the broader company "strategy." *Id.* at 40. The supreme court affirmed the chancery court's conclusion that the revised deal with Warner "had as its goal the carrying forward of a pre-existing transaction in an altered form." *Id.* The broad discretion entrusted to Time directors to revise their transaction in order to further a pre-existing corporate strategy indicates that a broadly-conceived "corporate strategy" may permit directors wide discretion in defending against any potential "threat" to that strategy.

414. *Id.* at 41. The supreme court noted that "although Time was required, as a result of Paramount's hostile offer, to incur a heavy debt to finance its acquisition of Warner, that fact alone does not render the board's decision unreasonable so long as the directors could reasonably perceive the debt load not to be so injurious to the corporation as to jeopardize its well-being." *Id.* The court may have appeared to have imposed some limitation to director discretion; however, based on its approval of Time's acquisition of Warner despite the adverse effects suffered by Time, that limitation is probably artificial.

The chancery court, in its opinion, also reinforced broad director discretion despite the effect on the company or the desires of the shareholders. See *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,266. The chancery court noted that even though a majority of shareholders may disagree with the wisdom of a board decision, directors have no obligation "to take another, more popular course of action." *Id.*

415. See *supra* notes 343-81 and accompanying text for a discussion of the effects of the revised Time-Warner agreement on Time.

416. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,284 ("[T]here is

cases, courts may have to consider whether all strategic plans will constitute a legally cognizable interest, protectable under *Unocal*, and if so, to what extent directors can evade shareholder desires under the guise of furthering that plan.<sup>417</sup>

#### D. Unavoidable Conflicts of Interest

Besides the practical difficulties in applying *Revlon, Inc. v. MacAndrews & Forbes Holdings*<sup>418</sup> and *Unocal Corp. v. Mesa Petroleum Co.*,<sup>419</sup> business judgment rule protection of corporate control decisions is theoretically troublesome. Corporate control decisions are unlike other decisions protected by the business judgment rule.<sup>420</sup> Control contests inevitably place directors in a dilemma.<sup>421</sup> The conflict facing directors arises in part from their professional and social relationships with company officers.<sup>422</sup> Shareholders formally cast votes for directors; but generally, executive management writes the ballot.<sup>423</sup> Directors and company officers function jointly as a management team, and depend on each other for effective decision making.<sup>424</sup> This makes it difficult for directors to objectively evaluate a proposed takeover bid designed to displace current management and themselves.<sup>425</sup> Besides losing the per-

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no persuasive evidence that the board of Time ha[d] a corrupt or venal motivation . . . even in the face of the cost that that course will no doubt entail for the company's shareholders in the short run.").

417. See *supra* notes 386-417 and accompanying text for additional non-shareholder interests affected by Time's long-term plan.

418. 506 A.2d 173 (Del. 1986).

419. 493 A.2d 946 (Del. 1985).

420. *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252, 1259 (S.D.N.Y. 1985). *But see Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984) (business judgment rule equally applicable "in the context of a takeover").

421. *Unocal*, 493 A.2d at 955 (in this situation, "'directors are of necessity confronted with a conflict of interest' ") (quoting *Bennett v. Propp*, 187 A.2d 405, 409 (Del. 1962)).

422. Although typically, directors are more likely to side with management than with a hostile bidder, this is not always the case. See *In re RJR Nabisco Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194 (Del. Ch. Jan. 31), *appeal denied mem.*, 556 A.2d 1070 (Del. 1989). In *RJR*, the plaintiffs accused the target directors of being biased *against* management. *Id.* at 91,702-03. The plaintiffs in this case alleged the target directors were motivated by a desire to disassociate themselves from the management plan because of the "harsh [public] criticism [management's LBO proposal] engendered." *Id.* at 91,702. For example, *Time* magazine trumpeted the management proposal as "A Game of Greed." *Id.* at 91,711 n.14. The court, however, rejected this assertion, and found that the directors acted reasonably and were protected under the business judgment rule. *Id.* at 91,703.

423. W. KNEPPER & D. BAILEY, *supra* note 7, at 4.

424. *Id.* at 2 ("[D]irectors [have] limited time to devote to their directorial duties and [are] dependent upon management for access to administration, [therefore, they are able to] do little to guide or direct corporate policies in many instances.").

425. *Herzel, Schmidt & Davis, supra* note 90, at 113 (Management's desire to retain control

sonal satisfaction derived from serving a public corporation, a change in control may cause directors to lose the prestige, power and compensation accompanying directorships.<sup>426</sup>

Courts recognize that a conflict may impair a director's independence;<sup>427</sup> however, courts are reluctant to disallow business judgment rule protection absent a direct financial interest.<sup>428</sup> Instead, courts rely on the independence of "special committees"<sup>429</sup> and outside directors to show that boards, at least *seek* objectivity.<sup>430</sup> In reality, though, as long as management selects directors, the title "independent director" remains an oxymoron, and management and shareholder interests may never be completely reconciled.<sup>431</sup>

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is due in part to "a belief (usually held in good faith and often quite justifiable) in the high quality of [its] own management of the company." See also *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 254 (7th Cir. 1986) ("It is only human for [the target] officers and directors to doubt that [a successful bidder displacing current management will] . . . actually do a better job of running [the] company."), *rev'd on other grounds*, 481 U.S. 69 (1987).

426. See generally *Easterbrook & Fischel*, *supra* note 81, at 1194-1204; *Greene*, *supra* note 44, at 730; but see *Manning*, *The Business Judgment Rule: An Overview*, 45 OHIO ST. L.J. 615, 618 (1984).

427. See, e.g., *Grobow v. Perot*, 539 A.2d 180, 188 (Del. 1988) (plaintiffs must demonstrate "either a financial interest or entrenchment on the part of the [target] directors").

428. See, e.g., *RJR Nabisco*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,710 (court dismissed plaintiffs' allegations that special committee was motivated by fear of personal liability, noting that "[t]he sort of 'interest' that qualifies to disarm a board . . . is a financial interest in the transaction adverse to that of the corporation or its shareholders").

429. A "special committee" is an ad hoc committee created in situations where a board as a whole is not completely objective. *Simpson*, *supra* note 140, at 666.

430. *Id.* at 673-74. See also *Grobow*, 539 A.2d at 190 ("[A]pproval of a transaction by a majority of independent, disinterested directors almost always bolsters a presumption that the business judgment rule attaches to transactions approved by a board of directors."); *Unocal*, 493 A.2d at 955 (showing of good faith "is materially enhanced . . . by the approval of a board comprised of a majority of outside independent directors"); *West Point-Pepperell, Inc. v. J.P. Stevens & Co.*, 542 A.2d 770, 779-80 (Del. Ch. 1988) (although facts indicated likelihood that special committee may have favored management's preferred bidder, court upheld special committee's decision because there was no direct evidence of bad faith). But see *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 256 (7th Cir. 1986) (in "takeover situations, directors 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 . . . No one likes to be fired, whether he is just a director or also an officer."), *rev'd on other grounds*, 481 U.S. 69 (1987); *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227, 1243 (Del. Ch. 1988) (special committee not free to "cram down" management restructuring "in order to 'protect' their shareholders from a non-coercive, economically superior one").

431. *Coffee*, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 724 (1984) (interests of management and shareholders can never be perfectly aligned). See also *RJR Nabisco*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,701-02 (upholding special committee's selection of outside bid over equivalent bid by RJR Nabisco's management despite "imaginative" argument that special committee acted in its self-interest by publicly repudiating RJR management's competing, but self-entrenching, bid).

Even absent a conflict of interest, directors may act contrary to the shareholders' best interests. Bidders profit by utilizing a target's assets more efficiently,<sup>432</sup> and, therefore, are attracted to inefficient companies.<sup>433</sup> Inefficient management that is arguably not working to maximize company wealth prior to a takeover threat is not in a position to decide whether a tender offer serves the shareholders' best interests.<sup>434</sup> Besides this, shareholders have a "right" to management which will maximize the value of their shares.<sup>435</sup> Although directors enjoy broad powers to fight a threatening takeover,<sup>436</sup> "shareholders are the real targets of a takeover bid, [and] they[, therefore,] should dictate the nature and degree of management's response."<sup>437</sup> In control contests, the bidder asks shareholders to make a decision.<sup>438</sup> Yet this decision can be effectively thwarted by a management team opposing the bid.<sup>439</sup> One federal court recognized this problem, noting that "a board of director's assertion of a unilateral right . . . to act as a surrogate for shareholders' in-

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432. Easterbrook & Fischel, *supra* note 81, at 1178.

433. *Id.* This presumption, however, is highly debated. For views contrary to Easterbrook and Fischel's, see Herman & Lowenstein, *The Efficiency Effects of Hostile Takeovers*, in *KNIGHTS, RAIDERS, AND TARGETS* 211, 227 (1988) (recent studies show target companies are well-managed, financially healthy companies); A. Fleischer, Jr., *Responses to Takeover Bids: Corporate, SEC, Tactical, and Fiduciary Considerations* (BNA) No. 6-2nd, at A-1 (1985) (citing Merrill Lynch study concluding that target companies generally experienced above average earning growth and cash flow).

434. Cohn, *Tender Offers and the Sale of Control: An Analogue to Determine the Validity of Target Management Defensive Measures*, 66 *IOWA L. REV.* 475, 508 (1981). It is "ironic" for current management to pose as shareholder protector when the undervalued market price of the target's stock reflects the "market's collective judgment of the inefficiency of current management." *Id.*

435. Easterbrook & Fischel, *supra* note 81, at 1191. *But see* Moran v. Household Int'l, Inc., 490 A.2d 1059, 1070 (Del. Ch.) ("[S]hareholders 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 . . ."), *aff'd*, 500 A.2d 1346 (Del. 1985).

436. *Unocal*, 493 A.2d at 954 ("board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise . . . from harm"). See *supra* notes 75-115 and accompanying text for a discussion of how takeovers threaten the corporate enterprise.

437. Andre, *Tender Offers for Corporate Control: A Critical Analysis and Proposals for Reform*, 12 *DEL. J. CORP. L.* 865, 902 (1987). See also *Grand Metro. PLC v. Pillsbury Co.*, 558 A.2d 1049, 1060 n.10 (Del. Ch. 1988) (quoting *Conoco Inc. v. Seagram Co.*, 517 F. Supp. 1299 (S.D.N.Y. 1981)).

What is sometimes lost sight of in these tender offer controversies is that the shareholders, not the directors, have the right to franchise with respect to the shares owned by them; "stockholders, once informed of the facts, have a right to make their own decisions in matters pertaining to their economic self-interest."

*Conoco Inc. v. Seagram Co.*, 517 F. Supp. 1299, 1303 (S.D.N.Y. 1981) (citation omitted).

438. A. FLEISCHER, *supra* note 76, at 343.

439. *Id.*

dependent right of alienation of stock is troublesome."<sup>440</sup>

#### IV. THE PROPRIETY OF BUSINESS JUDGMENT RULE PROTECTION IN CORPORATE CONTROL CONTEXTS

Courts are unable to define and consistently apply standards of director responsibilities in control contexts.<sup>441</sup> The standards for determining when and how *Revlon, Inc. v. MacAndrews & Forbes Holdings*<sup>442</sup> and *Unocal Corp. v. Mesa Petroleum Co.*<sup>443</sup> interact to judge applicability of the business judgment rule continue to be malleable and unpredictable.<sup>444</sup> The ease with which courts apply the business judgment rule fails to fully recognize that corporate control decisions are different from other decisions for which the business judgment rule was devised.<sup>445</sup> The business judgment rule as presently applied ignores the real and unavoidable conflicts of interest that arise in all corporate control decisions,<sup>446</sup> and the rights of shareholders as owners of the corporation.<sup>447</sup> As a result, application of the business judgment rule precludes judicial scrutiny of board decisions, even those which may result in harm to shareholders or to the corporation.<sup>448</sup> To remedy business judgment rule problems, the business judgment rule could either be modified or abandoned, or the

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440. *Minstar*, 621 F. Supp. at 1260 n.6; see also Cohn, *supra* note 434, at 501.

441. See *supra* notes 262-417 and accompanying text.

442. 506 A.2d 173 (Del. 1986).

443. 493 A.2d 946 (Del. 1985).

444. See *supra* notes 262-417 and accompanying text.

445. *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252, 1259 (S.D.N.Y. 1985) ("The [business judgment] rule was developed to protect directors' judgments on questions of corporate governance. . . . Defensive tactics, however, raise a wholly different set of considerations. The problem is that defensive tactics often, by their very nature, act as a restraint on business purposes."). See also *Panter v. Marshall Fields & Co.*, 646 F.2d 271, 299-300 (7th Cir.) (Cudahy, J., concurring in part and dissenting in part) (distinguishing between corporate activities in managing business enterprise where judicial interference would be undesirable, from those activities involving capital investment and distribution, which involve corporation-shareholder relationship, and therefore justify judicial intervention to ensure equitable behavior), *cert. denied*, 454 U.S. 1092 (1981).

446. See *supra* notes 418-40 and accompanying text. Some commentators note that a conflict of interest alone is not enough to preclude application of the business judgment rule because a conflict is present in many decisions properly delegated to boards. See, e.g., *Easterbrook & Fischel*, *supra* note 81, at 1198 n.106.

447. *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 258 (2d Cir. 1984) (court's role "is to protect fundamental structure of corporate governance[; w]hile the day-to-day affairs of a company are to be managed by its officers under the supervision of directors, decisions affecting a corporation's ultimate destiny are for the shareholders to make in accordance with democratic procedures.").

448. See *supra* notes 349-81 and accompanying text for a discussion of the harmful effects of the *Time* decision.



decision-making process could be given to shareholders, rather than the directors.

### A. *Abandoning Business Judgment Protection in Control Contexts*

Wholesale abandonment of the business judgment rule in corporate control contexts is not the answer.<sup>449</sup> Without business judgment rule protection, directors would be held to an ordinary negligence standard.<sup>450</sup> Directorial decisions would be compared with what an "ordinarily careful and prudent director" under similar circumstances would have decided.<sup>451</sup> This proposal, though initially appealing, is not without problems.

The business judgment rule exists to encourage directorial service and to enhance the integrity of corporate governance.<sup>452</sup> Without protection of the business judgment rule, the potential for personal liability would likely deter knowledgeable businesspeople from serving as directors,<sup>453</sup> despite statutes enacted in virtually all states allowing corporations to provide insurance against directors' negligence<sup>454</sup> and to indemnify directors against personal liability.<sup>455</sup> Even if statutes allow for insurance or indemnity, directors may consider whether adequate financial protection is afforded. Director and officer liability insurance has

449. See Manning, *supra* note 426, at 619-21. But see Note, *False Halo: The Business Judgment Rule in Corporate Control Contexts*, 66 TEX. L. REV. 843 (1988) (proposing abolition of the business judgment rule in hostile takeover cases).

450. W. KNEPPER & D. BAILEY, *supra* note 7, at 43-44.

451. *Id.* at 43.

452. See *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

453. Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 1987 DEL. J. CORP. L. 25, 28. See also W. KNEPPER & D. BAILEY, *supra* note 7, at 183. See also *supra* notes 39-54 and accompanying text for a general discussion of the business judgment rule rationale.

454. W. KNEPPER & D. BAILEY, *supra* note 7, at 688 ("[C]orporations are expressly authorized to purchase and maintain [directors and officers] insurance by statutes of all states except Vermont.").

455. *Id.* at 654 (indemnification has been legislated in all 50 states); see, e.g., DEL. CODE ANN. tit. 8, § 145 (1983), which provides in pertinent part:

(a) A corporation may indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action . . . by reason of the fact that he is or was a director . . . if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation . . . .

(g) A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director . . . against any liability asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not the corporation would have the power to indemnify him against such liability under this section.

*Id.*

become prohibitively expensive in recent years and, therefore, is often not practicably available.<sup>456</sup> Even if insurance is available, many insurance companies exclude takeover fights from policy coverage.<sup>457</sup> Such exclusions exist regardless of whether a takeover attempt is "alleged or actual, successful or unsuccessful."<sup>458</sup>

Insurance and indemnity statutes may or may not offer financial protection to directors, but many directors serve for the prestige, power and camaraderie accompanying their positions, as well as for monetary compensation. Directors fearful of losing their jobs or suffering personal embarrassment may be unwilling to risk exposure to public judgment despite protection from financial liability.

### B. Giving Shareholders the Right to Vote

Inadequacies in current law governing responsibilities of boards of directors faced with takeover threats have been identified.<sup>459</sup> The business judgment rule serves to protect board decisions; yet, where corporate control is involved, concerns with the potential for conflicts of interest and abrogation of shareholder rights outweigh the policy rationale underlying the business judgment rule. In part due to the complexity of control contests, and in part due to courts' decision to defer to boards of directors, courts do not consistently apply standards of review for evaluating board decisions in control contexts.<sup>460</sup> Even if courts were willing and able to consistently apply a heightened standard of review appropriate to scrutinize corporate control decisions in which conflicts of interest are unavoidable, the potential for personal financial liability and professional embarrassment would deter otherwise qualified businesspeople from serving as directors.<sup>461</sup>

Giving the ultimate decision-making authority for such decisions to shareholders avoids problems arising under current law from director conflicts of interest and avoids director liability problems which would arise if a higher level of judicial scrutiny was required. In addition, shareholder vote in control situations does not usurp director power to manage the corporation.<sup>462</sup> Corporate control decisions involve *who* will run the company, not *how* it is run. Directors will retain full discretion

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456. W. KNEPPER & D. BAILEY, *supra* note 7, at 685.

457. *Id.* at 724.

458. *Id.*

459. See *supra* notes 249-440 and accompanying text.

460. See *supra* notes 262-417 and accompanying text.

461. See *supra* notes 418-40 and accompanying text.

462. In fact, the shareholders' "right to elect and alter management [is] perhaps the last and most fundamental vestiges of shareholder authority." Cohn, *supra* note 434, at 501.

to manage the company's business and affairs as long as they are the desired leaders.

Those opposed to giving shareholders the right to vote argue that directors have a duty to protect non-shareholder interests, which would not be adequately protected by voting shareholders.<sup>463</sup> Opponents might also argue that directors, rather than courts or shareholders, are best suited to make a unified and informed decision because of their special knowledge of the company and the business environment.<sup>464</sup>

Under current fiduciary concepts, when faced with a situation adverse to shareholders' interests, such as a coercive takeover threat, directors have the right, and even the duty, to oppose it.<sup>465</sup> This principle is implicit in directors' fiduciary duties to shareholders.<sup>466</sup> Directors also have fiduciary duties to the corporations that they serve.<sup>467</sup> Some courts, therefore, hold that directors should consider the impact a takeover may have on a corporation's non-shareholder interests including employees, creditors and the local community.<sup>468</sup>

Legal scholars widely debate whether and to what extent non-shareholder interests can eclipse those of the shareholders, but courts generally agree that directors may not completely and permanently foreclose shareholder choice.<sup>469</sup> At one extreme, Professors Easterbrook (now

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463. *Id.* at 506. Cohn commented that directors possess greater ability and objectivity to consider the long-range concerns raised by a tender offer, including the interests of employees, suppliers, and other groups that may be materially affected. Shareholders, on the other hand, are seen as having a narrower interest . . . [and may] disregard long-term consequences to the corporation, non-tendering shareholders, and other interests.

*Id.*

464. *Paramount Communications, Inc. v. Time Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,277 (Del. Ch. July 14, 1989), *aff'd*, No. 284, 1989 (Del. Feb. 26, 1990). *See also* Herzelt, Schmidt & Davis, *supra* note 90, at 111.

465. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (1985) ("[T]he board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise . . . from harm.").

466. *Lipton I*, *supra* note 89, at 35 ("It would seem beyond question that [directors] must govern on behalf of shareholders by whom they are elected and to whom the fiduciary duties of care and loyalty are said to run.").

467. *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939).

468. *See, e.g.*, *GAF Corp. v. Union Carbide Corp.*, 624 F. Supp. 1016, 1019-20 (S.D.N.Y. 1985) ("A corporation with a perceived threat of dismemberment of large divisions of the enterprise, employing thousands of employees, owes [those employees] substantial regard . . ."). Some states have provided by statute for such considerations. *See, e.g.*, MINN. STAT. ANN. § 302A.251(5) (West Supp. 1990); MO. ANN. STAT. § 351.347(4) (Vernon Supp. 1990). *See also supra* note 112. The rationale for allowing non-shareholder considerations is based in part, on social responsibility concerns, and in part on a belief that non-shareholder constituencies "share the risk and are vital to the success of corporate activity." *Lipton I*, *supra* note 89, at 37.

469. *See, e.g.*, *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 259 (7th Cir. 1986)

Judge Easterbrook of the Court of Appeals for the Seventh Circuit) and Fischel urge complete managerial passivity.<sup>470</sup> Under this theory, market forces, without director interference, will ensure the highest and best use of economic assets,<sup>471</sup> and this use will benefit society as a whole.<sup>472</sup> At the other extreme, Professor Lipton argues that directors have a responsibility to consider the effect a takeover may have on non-shareholder interests.<sup>473</sup> The non-shareholder interests theory recognizes that corporations have a social responsibility to serve community interests as well as shareholder interests.<sup>474</sup>

In the middle of these two extremes, Professor Coffee reasons that some non-shareholder constituencies can protect themselves.<sup>475</sup> For example, banks and other substantial creditors can protect themselves through restrictive debt covenants; upper management can negotiate stock options or employment contracts; and, lower level employees can bargain collectively through a union.<sup>476</sup> Coffee recognizes, however, that smaller creditors and lower level management employees may not be able to adequately protect themselves.<sup>477</sup> Coffee agrees that management owes its primary fiduciary duties to shareholders, but should also be concerned with corporate social responsibility.<sup>478</sup> Coffee challenges directors to "ask what strategies for increasing shareholder wealth at the expense of [non-shareholder constituencies] it wishes to encourage."<sup>479</sup> As a solution, Coffee urges a "policy of encouraging greater employee

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(poison-pill plan allegedly to prevent "bust up" takeover held invalid because it "effectively preclude[d] a hostile takeover, and thus allow[ed] management to take the shareholders hostage"), *rev'd on other grounds*, 481 U.S. 69 (1987); *Grand Metro. PLC v. Pillsbury Co.*, 558 A.2d 1049, 1060 (Del. Ch. 1988); *City Capital Assocs. Ltd. Partnership v. Interco Inc.*, 551 A.2d 787, 799-800 (Del. Ch.), *appeal dismissed*, 556 A.2d 1070 (Del. 1988). *But see Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,284 (Time's defensive merger with Warner did not "legally preclude the successful prosecution of a hostile tender offer . . . [although it may have] practically impact[ed] the likelihood of a successful takeover offer.") (emphasis added).

470. Easterbrook & Fischel, *supra* note 81, at 1164.

471. *Id.* at 1169 ("[t]ender bidding process polices managers . . . and disciplines or replaces them if they stray too far from the services of the shareholders").

472. *Id.* at 1190 ("Takeovers improve efficiency, and that improvement usually enhances the position of those who deal with the firm."). *See also* Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1269 (1982).

473. Lipton II, *supra* note 110, at 105-06.

474. Note, *Stakeholder Versus Stockholders: The Director's Proper Constituency in a Contest for Corporate Control*, 15 WM. MITCHELL L. REV. 475, 488 n.109 (1989).

475. Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1146, 1247-48 (1984).

476. *Id.* at 1247.

477. *Id.* at 1248.

478. *Id.* at 1248-49.

479. *Id.* at 1248.

ownership in the corporation."<sup>480</sup> Greater employee stock ownership, presumably, will bridge the gap between management and control and encourage long-term profit maximization.<sup>481</sup>

Non-shareholder interests involve important social policy concerns that corporations cannot responsibly ignore, but these interests should not become paramount to shareholder interests.<sup>482</sup> In *Revlon, Inc. v. MacAndrews & Forbes Holdings*,<sup>483</sup> the Delaware Supreme Court noted that "while concern for various corporate constituencies is proper when addressing a takeover threat, that principle is limited by the requirement that there be some rationally related benefit accruing to the stockholders."<sup>484</sup> Therefore, allowing directors to justify their corporate control decisions based on non-shareholder interests may be undesirable because the business judgment rule precludes any real inquiry into directors' motivations.

In *Time*, both the Supreme and the Chancery Courts of Delaware accepted Time's claim that its distinctive corporate culture was a protectable non-shareholder interest.<sup>485</sup> The supreme court did not specifically address the limitations of non-shareholder considerations, however, the chancery court warned that preserving corporate culture may not always suffice as a legally protectable interest under *Unocal*,<sup>486</sup> "recogniz[ing] the risk of cheap deception that would be entailed in a broad and indiscriminate recognition of 'corporate culture.'"<sup>487</sup> In deciding that Time's plan was not a "cheap deception," the chancery court explored the potential effect Paramount's proposed takeover of Time might have on non-shareholder interests, including *Time* magazine employees and society as a whole.<sup>488</sup> At Time, the senior writers report directly to a special committee of Time's board.<sup>489</sup> Time argued that this management structure helps preserve its editorial independence.<sup>490</sup>

480. *Id.* at 1251.

481. *Id.*

482. *Cf. Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 183 (Del. 1986). The court stated that a board may consider non-shareholder constituencies only if those considerations "are rationally related to benefits accruing to the stockholders . . . [and may not be considered at all] when an auction among active bidders is in progress . . . ." *Id.*

483. 506 A.2d 173 (Del. 1986).

484. *Id.* at 176.

485. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,283. *See also, Paramount Communications, Inc. v. Time Inc.*, No. 284, 1989, slip op. at 35-36 (Del. Feb. 26, 1990).

486. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,267.

487. *Id.*

488. *Id.* at 93,269.

489. *Id.*

490. *Id.* at 93,268.

The chancery court also accepted Time's concern with the effect a Paramount takeover might have had on society as a whole.<sup>491</sup> One of Time's directors testified that Time's editorial freedom was "absolutely essential if members of our society are to be enlightened enough to form wise judgments and fulfill their responsibilities as citizens."<sup>492</sup> The court accepted the validity of these concerns without any indication that Paramount intended to interfere with Time's editorial independence.<sup>493</sup> The chancery court did not dispute the importance of Time's management structure.<sup>494</sup>

Both the supreme and the chancery courts in *Time* appear willing to defer corporate control decisions to directors whether the threat perceived by the directors is a concrete threat to the company's shareholders or an ambiguous threat to the company's "culture." Neither court articulated what is needed for directors to substantiate a protectable interest in the company's culture. The chancery court acclaimed Time's stated concern for its employees and society as a whole.<sup>495</sup> However, if all a company has to do is express a concern for employees, it would not be difficult for a company to write a strategic plan articulating any number of concerns, and thereby avoid judicial scrutiny. For example, an airline company has a non-shareholder interest in public safety; a hospital company has a non-shareholder interest in its patients and in the health of society at large; and, a restaurant has a non-shareholder interest in the quality of the food served to its customers. Each of these non-shareholder interests is clearly an important social interest, but assigning to directors the responsibility of furthering these interests in a takeover context is troublesome for at least two reasons.

First, directors are protected by the business judgment rule because they are experts in *business*.<sup>496</sup> "Expanding corporate governance to encompass society as a whole benefits neither corporations nor society."<sup>497</sup> The legislature provides a better forum than corporate boardrooms for

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491. *Id.* at 93,269.

492. *Id.* (testimony of Director Matina S. Horner, then president of Radcliffe College and Time director since 1975).

493. In fact, Paramount tried to negotiate a deal with Time, and may have been willing to commit to preserving Time's editorial independence, but Time refused to even talk with Paramount. *Id.* at 93,271.

494. *Id.* This is true despite the fact that Time magazine contributes 20% of Time-Warner's revenues. *Id.*

495. *Id.* at 93,269.

496. *Solash v. Telex Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608, at 97,727 (Del. Ch. Jan. 19, 1988).

497. *Lipton I*, *supra* note 89, at 42.

considering broad social and political issues.<sup>498</sup> Directors, therefore, should manage "on behalf of shareholders by whom they are elected and to whom the fiduciary duties of care and loyalty are said to run."<sup>499</sup>

Second, although social policy concerns may be an important part of corporate governance, these considerations are not appropriate in take-over situations.<sup>500</sup> The business judgment rule gives directors broad discretion and limits judicial scrutiny. Expanding the list of interests directors can consider opens the door to self-entrenchment decisions rationalized with insincere articulations of non-shareholder concerns.<sup>501</sup> Therefore, a shareholder vote is a more appropriate mechanism for making corporate control decisions.

In addition to concerns with non-shareholder interests, opponents of a shareholder vote may argue that the administrative difficulties in coordinating an informed shareholder vote outweigh the benefits gained.<sup>502</sup> Opponents may also argue that a coercive tender offer may unfairly force inadequately informed shareholders into making a decision.<sup>503</sup> These arguments are not persuasive for two reasons. First, shareholders can and do make unified decisions. In proxy elections, shareholders have both the right and the ability to oust current management.<sup>504</sup> Under current proxy rules, Congress has given shareholders of reporting companies<sup>505</sup> the right to determine company control.<sup>506</sup> The SEC, under Congressional authority, has provided strict regulations governing proxy solicitations.<sup>507</sup> These regulations are designed to ensure full and fair disclosure to shareholders which enhances shareholder ability to vote in their best interests.<sup>508</sup> Besides their disclosure orientation, proxy rules also protect

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498. *Id.* at 43.

499. *Id.* at 35. Lipton recognizes that unhappy shareholders can sell out, but those who choose to invest for the long-term deserve directors' attention. *Id.* at 35-36.

500. *Cf. Revlon*, 506 A.2d at 182.

501. See *supra* notes 418-40 and accompanying text for a discussion of conflicts of interest which may taint director decisions.

502. Booth, *Is There Any Valid Reason Why Target Managers Oppose Tender Offers?*, 14 SEC. REG. L.J. 43, 56-57 (1986).

503. See *supra* notes 86-98 and accompanying text for a discussion of the coercive nature of two-tier bids.

504. Lipton II, *supra* note 110, at 116.

505. Reporting companies are companies which are required to register their stock under section 12 of the Securities Exchange Act of 1934. 15 U.S.C. § 78(l) (Supp. 1989). In general, reporting companies include all corporations with securities that are registered on a national exchange, or with assets in excess of \$5 million and a class of equity securities held by 500 or more persons. *Id.*

506. *Id.* § 78(n); 17 C.F.R. § 240.14a (1989).

507. 17 C.F.R. § 240.14a (1989).

508. Schultz, *The Boards of Directors: Composition, Duties and Liabilities, Meetings and Procedures* (BNA) No. 3-2nd, at A-2 to 3 (Apr. 26, 1983).

shareholders from fraud and promote the free exercise of voting rights by shareholders.<sup>509</sup>

Second, as long as shareholders are adequately informed, the risk of coercion by a hostile bidder is mitigated.<sup>510</sup> An informed shareholder vote will require additional time and money, but such costs would not be excessive when compared with the benefits to be gained.<sup>511</sup> In particular, additional time would be useful in allowing shareholders an opportunity to disseminate relevant information in order to cast an educated and uncoerced vote.

## V. A PROPOSED LEGISLATIVE SOLUTION

Absent the opportunity for shareholders to vote in control decisions, the business judgment rule as applied to corporate takeovers may not adequately protect shareholders from director's conflicts.<sup>512</sup> Yet abandonment of the rule would create new problems.<sup>513</sup> This author, therefore, proposes a legislative solution which will transfer the ultimate decision-making authority to corporate shareholders. The proposal is designed to protect shareholders from self-serving management and to ensure availability of all significant information so that shareholders can make a knowledgeable decision. This section discusses competing federal and state interests in implementing takeover legislation and proposes a federal statute to be amended to existing federal takeover law.

### A. Federal and State Interests in Takeover Legislation

A publicly traded corporation is governed by both federal<sup>514</sup> and

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509. *Perelman v. Pennsylvania Real Estate Inv. Trust*, 432 F. Supp. 1298, 1300 (E.D. Pa. 1977). See also *J.I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964) (remedial purpose of proxy rules stems from Congress' belief that "fair corporate suffrage is important shareholder right") (citation omitted); *Klaus v. Hi-Shear Corp.*, 528 F.2d 225, 232 (9th Cir. 1975) ("Congress intended to guarantee the integrity of the processes of corporate democracy.").

510. See *Smith v. Van Gorkom*, 488 A.2d 858, 890 (Del. 1985) (board "required to disclose 'all germane facts' which a reasonable shareholder would have considered important in deciding whether to approve the merger").

511. See H.R. REP. NO. 181, 99th Cong., 1st Sess. 1, 2 ("Informed shareholders are critical to the effective functioning of U.S. corporations and to confidence in the capital markets as a whole. When an investor purchases common stock in a corporation, that individual also obtains the ability to participate in making certain major decisions affecting that corporation.").

512. See *supra* notes 418-40 and accompanying text.

513. See *supra* notes 450-58 and accompanying text.

514. Federal regulation, including legislation with regard to tax, antitrust, price discrimination, and unfair or deceptive acts, controls all United States business enterprises. H. HENN & J. ALEXANDER, *supra* note 7, at 36-41. In addition the Securities Act of 1933 and the Securities Exchange Act of 1934 govern all listed securities and their issuers. *Id.* at 796-813.



state law.<sup>515</sup> The Commerce Clause of the United States Constitution,<sup>516</sup> authorizes Congress to enact federal legislation regulating corporations because corporate activity affects interstate commerce.<sup>517</sup> States also possess power to govern activities of corporations incorporated within its borders, and in fact, provide most corporate legislation.<sup>518</sup> State regulation, however, is constrained by the Commerce<sup>519</sup> and Supremacy<sup>520</sup> Clauses of the United States Constitution.

A state maintains an interest in ensuring the integrity of the corporate governance system it has enacted and in "promoting stable relationships among parties involved in the corporations it charters."<sup>521</sup> In addition, states are concerned that the takeover of a local company might result in harm to residents<sup>522</sup> and to the state itself.<sup>523</sup> States fear that a takeover may result in the firing of resident employees or the moving of corporate headquarters and significant business operations to another state.<sup>524</sup> As a result, states are not necessarily motivated to protect shareholders, and may be more concerned with non-shareholder interests than with shareholder interests. State legislation to date has been ineffective in ensuring shareholder protection and, often, has been invalidated as violative of the Commerce or Supremacy Clauses.<sup>525</sup>

515. State law governs the formation and general activities of a corporation incorporated within that state. *Id.* at 176-85.

516. U.S. CONST. art. I, § 8, cl. 3. "The Congress shall have Power . . . To regulate Commerce among the several States . . ." *Id.*

517. *Id.* See also *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935) (holding that commerce power authorizes Congress to regulate all activities which *utilize means of* interstate commerce or *effect* interstate commerce).

518. H. HENN & J. ALEXANDER, *supra* note 7, at 176-85 (list of incorporation considerations which indicates extent of state control over company operation).

519. The Commerce Clause acts both as a grant of federal power and a limit of state power. *Kassel v. Consolidated Freightways Corp.*, 450 U.S. 662, 669 (1981) (Powell, J., plurality opinion).

520. U.S. CONST. art. VI. cl. 2. "The laws of the United States . . . shall be the Supreme Law of the Land." *Id.*

521. *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 91 (1987).

522. See, e.g., *GAF Corp. v. Union Carbide Corp.*, 624 F. Supp. 1016, 1019-20 (S.D.N.Y. 1985).

523. *Edgar v. MITE Corp.*, 457 U.S. 624, 646 n.\* (1982) (Powell, J., concurring in part); *BNS Inc. v. Koppers Co.*, 683 F. Supp. 458, 473 (D. Del. 1988).

524. *MITE*, 457 U.S. at 646 n.\* (Powell, J., concurring in part) ("When corporate headquarters (or significant operating facilities) are transferred out of a city and [s]tate into [another], the [s]tate and locality from which the transfer is made inevitably suffer significantly.").

525. See, e.g., *MITE*, 457 U.S. at 646 (striking down Illinois statute which required approval by local enforcement body because of its undue burden on interstate commerce); *Tyson Foods, Inc. v. McReynolds*, 865 F.2d 99, 101 (6th Cir. 1989) (Tennessee act violated Commerce Clause to extent that it applied to target companies incorporated outside Tennessee); *Campeau Corp. v. Federated Dep't Stores*, 679 F. Supp. 735, 739 (S.D. Ohio 1988) (Ohio act which affected corporations incorporated outside Ohio with substantial interests in Ohio vio-

Federal takeover legislation, on the other hand, specifically addresses shareholder interests and protects shareholders from fraud by requiring full and fair disclosure.<sup>526</sup> In regulating takeovers, Congress seeks to favor neither target management nor bidder.<sup>527</sup> Congress has recognized that tender offers serve a "useful purpose in providing a check on entrenched but inefficient management."<sup>528</sup> In enacting legislation to promote investor protection, Congress has acknowledged that such legislation may impede some takeovers, but noted that this is "a small price to pay" for investor protection.<sup>529</sup>

The Williams Act<sup>530</sup> is the most important federal takeover legislation. The Williams Act requires specified disclosures by any person either acquiring five-percent equity ownership of a publicly traded company<sup>531</sup> or planning a tender offer.<sup>532</sup> These disclosures include background information concerning the acquiror; the source, amount and type of consideration used or to be used in acquiring shares; the purpose of the purchases; and any major plans or proposals to change the target

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lated Commerce Clause by creating impermissible risk of inconsistent regulation among states); *Batus, Inc. v. McKay*, 684 F. Supp. 637, 640 (D. Nev. 1988) (Nevada takeover act violated Commerce Clause because it substantially affected free flow of commerce); *TLX Acquisition Corp. v. Telex Corp.*, 679 F. Supp. 1022, 1029 (W.D. Okla. 1987) (Oklahoma act violated Commerce Clause by creating impermissible risk of inconsistent regulation of tender offers and excessive burden on interstate commerce). *But see CTS Corp.*, 481 U.S. at 94 (Indiana takeover statute which requires vote of majority of disinterested target shareholders before voting rights granted to a potential bidder held valid); *Amanda Acquisition Corp. v. Universal Foods Corp.*, 708 F. Supp. 984, 1003 (E.D. Wis. 1989) (Wisconsin act did not violate Commerce Clause because it did not impose any greater burden on out-of-state tender offerors than on similarly situated Wisconsin tender offerors), *aff'd*, 877 F.2d 496 (7th Cir.), *cert. denied*, 110 S. Ct. 367 (1989); *BNS Inc.*, 683 F. Supp. at 473 (Delaware act extends to constitutional limits). *See generally* Note, *Sword or Shield: The Impact of Third-Generation State Takeover Statutes on Shareholder Wealth*, 57 GEO. WASH. L. REV. 958 (1989); Note, *State Regulation of Corporate Takeovers: Legislation After CTS Corp. v. Dynamics Corp. of America*, 18 SW. U.L. REV. 155 (1988); Note, *The Constitutionality of State Takeover Legislation Revisited: The Effect of CTS Corp. v. Dynamics Corp. of America*, 1988 UTAH L. REV. 675.

526. H.R. REP. NO. 1711, 90th Cong., 2nd Sess. 2-4, *reprinted in* 1968 U.S. CODE CONG. & ADMIN. NEWS 2811, 2813. *See also* *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 26-28 (1977).

527. *Piper*, 430 U.S. at 29 ("Congress was indeed committed to a policy of neutrality in contests for control").

528. H.R. REP., *supra* note 526, at 2813.

529. *Id.*

530. Act of July 29, 1968, Pub. L. No. 90-439, 83 Stat. 454 (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1988)). The Williams Act, amending the Securities Exchange Act of 1934, was enacted in response to the increasing use of tender offers to acquire control. H.R. REP., *supra* note 526, at 2811-12. Prior to enactment of the Williams Act, proxy contest disclosures were strictly regulated, and a bidder could seek control through a tender offer in "almost complete secrecy." *Id.* at 2812.

531. 15 U.S.C. §§ 78m(d), 78n(d) (1988); 17 C.F.R. § 240.13d (1989).

532. 17 C.F.R. § 240.14d (1989).

company's business or corporate structure.<sup>533</sup>

More recently, the SEC, pursuant to a congressional grant of authority,<sup>534</sup> enacted the "All-Holders"<sup>535</sup> and "Best-Price"<sup>536</sup> rules. The "All-Holders" rule requires that all tender offers be "open to all security holders of the class of securities subject to the tender offer."<sup>537</sup> The best price rule requires that "[t]he consideration paid to any security holder . . . [be] the highest consideration paid to any other security holder . . . ."<sup>538</sup> The SEC clearly states that these rules are designed not to prohibit tender offers, but to protect shareholders faced with an option to tender.<sup>539</sup> The proposed legislation is consistent with federal regulation and is proposed to fill a gap in shareholder protection that is not adequately secured through state statutes or common law. Therefore, the legislation will be more effective at the federal rather than the state level.

### B. Proposed Legislation

The author proposes the following amendment to the Williams Act in order to protect shareholders in publicly traded companies. This legislation is designed to preempt state regulation of takeovers to the extent state law conflicts with the shareholder protection purposes of this amendment but it is not otherwise designed to interfere with state corporate law.

#### SECTION 1:

Upon receipt of an unwanted all-shares offer, the board of directors shall delegate to a "special committee"<sup>540</sup> the responsibility of determining the validity of the offer.

#### A. BIDDER'S RESPONSIBILITIES

533. *Id.* §§ 240.13d-101 Schedule 13D, 240.14d-100 Schedule 14 D-1.

534. *See* 15 U.S.C. §§ 78c(b), 78m(e), 78n(d), 78n(e), 78n(a) (1989). *See also* Amendments to Tender Offer Rules—All-Holders & Best-Price, Securities Act Release No. 6653, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,016, at 88,189 (Sept. 4, 1986) ("[t]he all-holders and best-price rules are 'necessary or appropriate' to implement the Williams Act").

535. 17 C.F.R. §§ 240.14d-10(a), 240.13e-4(f) (1989).

536. *Id.* §§ 240.13e-4(f)(8)(ii), 240.14d-10(a)(2).

537. *Id.* §§ 240.14d-10(a)(1), 13e-4(f). Under this rule, Unocal's exclusion of Mesa from its self tender offer would have been invalid. *See supra* notes 133-61 and accompanying text for a discussion of Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

538. 17 C.F.R. §§ 240.13e-4(f)(8)(ii), 14d-10(a)(2) (1988).

539. Securities Act Release No. 6653, *supra* note 534, at 88,189 (the purpose is to "ensur[e] that all [shareholders] of the class subject to the tender offer receive information necessary to make an informed decision").

540. *See supra* notes 429-30 and accompanying text for a discussion of the use of special committees to alleviate board conflict problems.

1. Bidder shall submit to the special committee all material information regarding the Bidder's identity, purpose, means of financing, and other material information.
2. Until the special committee has determined that adequate financing is reasonably secured by Bidder, Bidder shall not publicly solicit shareholders.<sup>541</sup>
3. If the special committee has determined that adequate financing is reasonably secured, Bidder shall prepare a proposed plan reflecting the anticipated managerial and financial changes in the target's business.
  - a. In the case of a *partial* tender offer, Bidder's proposed plan must disclose the pro rata consideration and its composition assuming all shareholders desire to tender.<sup>542</sup>
4. Any information given to shareholders from Bidder or from target shall be subject to the anti-fraud provisions prescribed by the SEC.<sup>543</sup>

#### B. TARGET MANAGEMENT'S RESPONSIBILITIES

1. If the special committee concludes that adequate financing is secured by Bidder, target management shall prepare and submit the following to the special committee:
  - a. Its proposed plan to defend against the unwanted Bidder.
    - (1) This plan shall be designed for the benefit of shareholders and shall not serve as a management-entrenchment device.
  - b. A reasonably supportable strategic plan demonstrating the likelihood of current management's ability to provide an equivalent or superior return to shareholders within a reasonable time period.
    - (1) A "reasonably supportable plan" is one based on assumptions which are objectively verifiable by independent experts, such as accountants, investment bankers or appraisers.
    - (2) A "reasonable time period" shall not exceed three years.
    - (3) Management's plan shall include the cost and financing restrictions of its proposed defense plan.<sup>544</sup>

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541. In order for financing to be reasonably secured, the Bidder should receive financial commitments from banks or other sources.

542. This requirement may reduce the desirability of Bidder's offer because the cash premium would be less per share. But it will also eliminate potential coercion by assuring equal consideration to all shareholders. See *supra* notes 86-98 and accompanying text for a discussion of the procedural coercion present in some bids.

543. See 15 U.S.C. § 78(l) (1982).

544. "Financing restrictions" includes debt covenants, such as limitations on dividends, future indebtedness or future investment. See, for example, TIME WARNER 10-Q, *supra* note 377, at 8. This provision is designed to demonstrate the effect on the target company of financ-

(4) Management's projections shall include a discount factor which takes into account:

- a. the likelihood that projected returns will not be realized, and
- b. the time value of money.

2. Any information given to shareholders from Bidder or from target shall be subject to the anti-fraud provisions prescribed by the SEC.

#### C. SPECIAL COMMITTEE'S RESPONSIBILITIES

1. The special committee is initially responsible for determining whether Bidder has reasonably secured adequate financing.

2. If Bidder has reasonably secured adequate financing, the special committee shall review the plans submitted by both Bidder and management.

a. The special committee shall then consult with independent experts to verify assumptions and conclusions in management's and Bidder's plans.<sup>545</sup>

b. Any expert consulted shall have access to all material information concerning target and Bidder, which is reasonably required to make an objective evaluation.

3. Target and Bidder proposals, expert opinions and a recommendation by the special committee, shall then be submitted to target shareholders.

a. The special committee recommendation shall include: (1) a summary of the rationale for its conclusion; (2) its evaluation of the degree of threat posed by each competing offer; and (3) the potential financial benefit inuring to current management, if any, under management's proposed plan.

#### D. SHAREHOLDER VOTE

1. Shareholders shall then have a reasonable time to evaluate information submitted and vote.<sup>546</sup>

a. Each share shall count as one vote.<sup>547</sup>

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ing a defense plan either by depleting existing cash earmarked for other purposes or by selling debt. See Lipton I, *supra* note 89, at 23-24.

545. This provision avoids the temptation of directors' "rubber stamping" management's proposal. Such "rubber stamping" was invalidated in *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 885-86 (6th Cir. 1986).

546. Variations of shareholder voting rights have been proposed. See, e.g., *Bebchuck, Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695, 1752-64 (1985); Lipton I, *supra* note 89, at 62-63.

547. The author considered the exclusion of shares held by management and Bidder, as in the case with the Indiana "control share" statute upheld by the Supreme Court of the United

- b. The plan receiving the greatest number of shareholder votes shall be implemented by the Board of Directors under the guidance of the special committee.

## SECTION 2:

Boards of directors shall not adopt plans to deter or prevent an unwanted takeover when no takeover threat is posed unless so decided by a shareholder majority vote.

1. Plans designed to deter or prevent an unwanted takeover threat include, but are not limited to the following:
  - a. poison pills,<sup>548</sup> and
  - b. golden parachutes.<sup>549</sup>
2. For purposes of such shareholder vote, each share shall count as one vote.

## VI. CONCLUSION

Corporate takeovers can be beneficial to individual shareholders and to the national economy. However, takeovers may also be coercive attempts to force shareholders to tender their shares or to harm the corporate enterprise. Corporate directors, though serving an important function in managing the business and affairs of companies, may not adequately serve shareholder interests. Directors faced with corporate control decisions should not enjoy the same deference afforded them in other business judgment decisions because the outcome of a control decision will unavoidably affect the directors personally.

Regulation of corporate control decisions is necessary to protect shareholders from coercive bids and to ensure efficient utilization of economic assets. Attempts by states to regulate tender offers have been ineffective in ensuring shareholder protection and may not be constitutionally permissible because of the significant effect takeovers

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States in *CTS v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987), but concluded that a bidder should be able to vote in its best interest.

548. *See supra* note 76. Although poison pills can serve as a useful negotiating tool when a truly coercive offer is proposed, they may preclude valuable shareholder opportunities that may arise in the future. Therefore, implementation of a poison pill may result in improper management entrenchment. *See also* *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 254-55 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987).

549. *See supra* note 76. This provision is not meant to proscribe fair and reasonable severance contracts with loyal and long-standing employees awarded to commend outstanding service to the company. The propriety of golden parachute plans has recently come under increasing scrutiny. *See* Salwen, *Ruling by SEC May Threaten Parachute Plans*, *Wall St. J.*, Jan. 18, 1990, at A3, col. 4 (SEC required Transamerica Corp. to submit its proposed golden parachute plan to shareholder vote).

have on dispersed shareholders.<sup>550</sup> Federal legislation has sought to provide shareholder protection and to ensure fairness in the takeover market; however, as currently applied, it is inadequate. The proposed federal legislation is designed to protect shareholders from truly coercive offers, while allowing shareholders to exercise their full voting power. Amending the Williams Act with such legislation will balance director discretion and shareholder protection and will further the Williams Act shareholder protection purposes.<sup>551</sup>

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550. *See, e.g.*, *Edgar v. MITE Corp.*, 457 U.S. 624 (1982); *Tyson Foods, Inc. v. McReynolds*, 865 F.2d 99 (6th Cir. 1989); *Campeau Corp. v. Federated Dep't Stores*, 679 F. Supp. 735 (S.D. Ohio 1988). *See also supra* notes 521-25 and accompanying text.

551. *See supra* notes 526-33 and accompanying text.

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