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**DIRECTORS' FIDUCIARY DUTIES
IN TAKEOVERS AND MERGERS**

By Arthur Fleischer, Jr. and Alexander R. Sussman*

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* Arthur Fleischer, Jr. is the Senior Partner of Fried, Frank, Harris, Shriver & Jacobson and Alexander R. Sussman is a partner of the firm.

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§ 3.01 GENERAL PRINCIPLES*

[A] Directors' Fiduciary Duties in Takeovers and Mergers

Directors' responsibilities in Delaware and most jurisdictions are measured primarily by the business judgment rule, a principle that essentially defers to the decision-making process of the directors themselves and that, absent special circumstances such as personal gain, presumes the propriety of the directors' actions.⁴ The Delaware Supreme Court has observed that, in order to rebut the business judgment rule presumption, a shareholder plaintiff must effectively provide evidence that the "board of directors, in reaching its challenged decision, breached any *one* of its 'triad of fiduciary duties, loyalty, good faith, due care.'"⁵

As explained by prominent Delaware jurists in a 2001 article,⁶ "[i]n the cases, a standard formulation of the business judgment rule in Delaware is that it creates a presumption that (i) a decision was made by directors who (ii) were disinterested and independent, (iii) acted in subjective good faith, and (iv) employed a reasonable decision making process. Under those circumstances, the directors' decision is reviewed not for reasonableness but for rationality."⁷ Furthermore, "[w]here the business judgment standard applies, a director will not be held liable for a decision—even one that is unreasonable—that results in a loss to the corporation, so long as the decision is rational."⁸

In a 1996 ruling, Delaware Chancellor Allen commented on the traditional business judgment rule that generally applies to board decisions as follows:

[C]ompliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is,

* The authors acknowledge the research assistance of Oren Bechor and Mark Feldhamer for the update of Section 3.01 of the 2002 Supplement.

⁴ In cases against directors arising out of completed actions involving operational issues, "the business judgment rule shields directors from personal liability if, upon review, the court concludes the directors' decision can be attributed to any rational business purpose." *See Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. Supr. 1971). *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1373 (Del. 1995).

⁵ *McMullin v. Beran*, 765 A.2d 910, 917 (Del. 2000) (emphasis in original) (quoting *Emerald Partners v. Berlin*, 726 A.2d 1215, 1221 (Del. 1999); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162-63 (Del. 1995); *In re Tri-Star Pictures, Inc. Litig.*, 634 A.2d 319, 333 (Del. 1993)).

⁶ *See* William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 Bus. Law. 1287 (Aug. 2001) (hereinafter *Function Over Form*). The authors are former Delaware Chancellor Allen, then Vice Chancellor and later Delaware Supreme Court Justice Jacobs, and Vice Chancellor Strine.

⁷ *Id.* at 1298 (footnotes omitted). In that article, the authors also question whether good faith should be treated as a separate one of a triad of directors' fiduciary duties, suggesting that "it is a subset or 'subsidiary requirement' that is subsumed within the duty of loyalty, as distinguished from being a compartmentally distinct fiduciary duty of equal dignity with the two bedrock fiduciary duties of loyalty and due care." *Id.* at 1305 n.69 (quoting *Emerald Partners v. Berlin*, C.A. No. 9700, 2001 Del. Ch. LEXIS 20, at *87 n.63 (Del. Ch. Feb. 7, 2001) (citations omitted).

⁸ *Id.* at 1296.

whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through “stupid” or “egregious” or “irrational,” provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests. . . . Thus, the business judgment rule is process oriented and informed by a deep respect for all good faith board decisions.⁹

The traditional business judgment rule has been modified in Delaware and some other jurisdictions as it applies to defensive actions by a target board to resist an unsolicited offer and to board actions in the environment of a sale of control of the company. Because of the nature of contested takeovers and mergers and the very substantial financial stakes involved, target board actions in those contexts are frequently challenged in the courts. Thus, numerous cases have adjudicated the nature of a board’s fiduciary responsibilities in evaluating and reacting to an unsolicited offer and in entering into a merger or sale of control and a sizeable body of law has developed.

We here summarize the key principles, focusing primarily on Delaware law. Some state legislatures have amended their corporate laws,¹⁰ and other states’ laws have been interpreted expressly, to reject Delaware principles and to apply the ordinary business judgment rule, or rules even more protective of target boards. We describe some of the court cases in other states as they appear pertinent.

[1] Duties in Evaluating Takeover Attempts

In general, the fiduciary obligation of target management and directors in a change of control context is to act in good faith, with due care and loyalty, in what they believe to be the best interests of the corporation and its constituents.

Duty of Care: The board will not lose its business judgment rule protection for lack of due care, unless the board’s conduct amounts to gross negligence.¹¹ As the Delaware Supreme Court has emphasized, “the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one.”¹² Moreover, the directors will not be personally liable in damages even for gross negligence if the shareholders of the company have adopted a charter provision, as authorized by DGCL

⁹ *In re Caremark Int’l Inc. Derivative Lit.*, 698 A.2d 959, 1996 Del. Ch. LEXIS 125 at *26-*27 (Sept. 25, 1996) (footnotes omitted).

¹⁰ *See Takeover Defense* §4.07.

¹¹ *See Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985). In *Function Over Form*, the jurists complain that *Van Gorkom* and the later *Cede II* ruling improperly diluted the gross negligence standard. *See* 56 Bus. Law. at 1299-1301. They contend that the alleged failures of process in *Van Gorkom* “may have amounted to ordinary negligence, but it is difficult to argue that they constituted gross negligence, which involves a devil-may-care attitude or indifference to duty amounting to recklessness.” *Id.* at 1300.

¹² *Id.* *See Aronson v. Lewis*, 473 A.2d 805, 812 (Del.1984) (“[U]nder the business judgment rule director liability is predicated upon concepts of gross negligence.”). *Accord, Citron v. Fairchild Camera and Instrument Corp.*, 569 A.2d 53, 66-67 (Del. 1989); *Grobow v. Perot*, 539 A.2d 180, 190-91 (Del. 1988) (dismissing stockholder derivative claim of gross negligence for failure to make pre-suit demand).

§ 102(b)(7), limiting liability to acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law.¹³

In many cases, the Delaware Supreme Court has ruled that “director liability for breaching the duty of care ‘is predicated upon concepts of gross negligence,’”¹⁴ but it has not specifically defined those “concepts of gross negligence.” In *McMillan v. Intercargo Corp.*,¹⁵ Vice Chancellor Strine gave content to the term in observing that, “[s]econd-guessing about whether a board’s strategy was ‘reasonable’ or ‘appropriate’” is not sufficient to show gross negligence; rather a plaintiff must “set forth facts from which one could infer that the defendants’ lack of care was so egregious as to meet Delaware’s onerous gross negligence standard.”¹⁶

Duty of Loyalty: The duty of loyalty requires that a director may not act solely or primarily for a personal or non-corporate purpose, such as to preserve a position as a director or officer. However, the type of self-interest that precludes reliance on the business judgment rule does not include the alleged self-interest with which every director in a takeover situation is faced. A board’s decision will not be set aside solely because it has the collateral effect of enhancing the power of incumbent management.

The Delaware Supreme Court has held that a claim that a director is self-interested, standing alone without evidence of disloyalty, does not rebut the business judgment rule presumption.¹⁷ The self-interest of a single director does not taint the business judgment protection for the board’s action, unless it “would have affected the collective decision of the board.”¹⁸ A subjective “actual person” standard applies in determining whether any self-interest was material to the allegedly conflicted director’s decision.¹⁹ In *Technicolor*, the Delaware Supreme Court affirmed the Chancery Court’s conclusions that under the subjective test only one of nine

¹³ See *Takeover Defense* § 3.06[A].

¹⁴ *Malpiede v. Townson*, 780 A.2d 1075, 1097 n. 76 (Del. 2001) (quoting *McMullin*, 765 A.2d at 921 (quoting *Aronson*, 473 A.2d at 812)).

¹⁵ 768 A.2d 492 (Del. Ch. 2000).

¹⁶ *Id.* at 505 n.56 (citing *Kahn v. Roberts*, Del. Ch., C.A. No. 12324, 1995 Del. Ch. LEXIS 151, *11. Steele, V.C. (Dec. 6, 1995) (“gross negligence means ‘reckless indifference to or a deliberate disregard of the whole body of stockholders’ or actions which are ‘without the bounds of reason’”) (quoting *Tomczak v. Morton Thiokol, Inc.*, Del. Ch., C.A. No. 7861, 1990 Del. Ch. LEXIS 47, *35, Hartnett, V.C. (Apr. 5, 1990)), *aff’d*, 679 A.2d 460 (Del. 1996)). See also *Function Over Form*, *supra*, defining “gross negligence” as involving “a devil-may-care attitude or indifference to duty amounting to recklessness.” 56 Bus. Law. at 1300.

¹⁷ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362, 365 (Del. 1993) (“*Cede II*”), *after remand*, *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995). See § 3.03[A][3] (Independence of the Board), *infra*.

¹⁸ *Cede II*, 634 A.2d at 363-64.

¹⁹ *Technicolor*, 663 A.2d at 1167; *accord*, *Orman v. Cullman*, 794 A.2d 5, 24, 29-31 (Del. Ch. 2002) (in shareholder derivative suit challenging a cash-out merger, court found pleading sufficient to overcome the business judgment rule presumptions, when a majority of the Board allegedly lacked independence, four directors being affiliated with the interested controlling shareholder and two directors being interested because they were receiving, respectively, consulting fees and an investment banking fee if the merger were completed); see also *H-M Wexford LLC v. Encorp, Inc.*, C.A. No. 19849, 2003 Del. Ch. LEXIS 54 (Del. Ch. May 27, 2003) (“the alleged benefit must be significant enough as to make it improbable that the director could perform his fiduciary duties to the shareholders”) (quoting *Orman*, 794 A.2d at 23).

directors had a material conflict of interest and, notwithstanding this self-interest, the board as a whole remained a “neutral decision-making body.”²⁰

In *Parnes v. Bally Entertainment Corp.*,²¹ plaintiff challenged the merger of Bally with Hilton Hotels. The court observed that, to overcome the presumption of the business judgment rule, plaintiff had to prove that “a majority of the directors ‘will receive a personal benefit from a transaction that is not equally shared by the stockholders . . . [or] where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders’ or ‘that a majority of the directors were ‘beholden’ to an interested party or so under the influence of an interested party that the directors’ discretion would be sterilized.’”²² Following a trial, the court found that the outside board members were “completely disinterested and independent” and dismissed the claims.²³

Duty of “Good Faith”: Historically, challenges to a director’s good faith were subsumed in a court’s inquiry into the director’s satisfaction of her duties of care and loyalty. Where a violation of either of those duties was found, there was no particular significance to determining whether there was a separate violation of the director’s duty of good faith; and where there was no breach of those duties, it was uncommon to have an issue of the director’s good faith. As noted above, however, DGCL § 102(b)(7) removes the exculpatory protection of that statute for violations of the duty of care for “acts or omissions not in good faith.” Recent cases have therefore inquired into whether directors’ alleged due care or loyalty violations also constituted bad faith conduct and have raised the question whether directors should be separately concerned with meeting their duty of good faith.

Notably, in two opinions issued in derivative suits in 2003, *In re The Walt Disney Co. Derivative Litig.*²⁴ and *In re Abbott Labs. Derivative Shareholders Litig.*,²⁵ the courts found that plaintiffs sufficiently pleaded allegations of breaches of the duty of good faith, not only to survive defendants’ motions to dismiss, but also to preclude the protection of Section 102(b)(7).²⁶ Those cases offer sharp warnings that the protections afforded by the business judgment rule and exculpatory charter provisions will not extend to instances in which directors “consciously and intentionally disregarded their responsibilities, adopting a ‘we don’t care about the risks’ attitude concerning a material corporate decision.”²⁷ For further discussion of those cases, see Appendix II, *Directors’ Conscious Disregard of Known Risk Is Not Protected by Business Judgment Rule or Exculpatory Clauses*; and Appendix III, *Is There a Duty of Good Faith Separate from the Duty of Care and the Duty of Loyalty?* See also Appendix IV, *Pertinent Excerpts from Treatises Defining “Good Faith”*.

Business Judgment Rule Applicability to Takeover Bids: The business judgment rule applies to the decision to accept or reject an offer. The board is not obligated to negotiate with third parties, or to sell the corporation, just because a premium price is offered, if the board makes a good faith, informed decision that it would be in the corporation’s best interests to reject the

²⁰ *Id.* at 1168-70.

²¹ No. 15192, 2001 Del. Ch. LEXIS 34 (Del. Ch. Feb. 20, 2001).

²² *Id.* at *30 (quoting *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993)).

²³ *Id.* at *33.

²⁴ C.A. No. 15452 2003 Del Ch. LEXIS 52 (Del. Ch. May 28, 2003).

²⁵ 325 F.3d 79 (7th Cir. Mar. 28, 2003).

²⁶ See *Disney*, 2003 Del. Ch. LEXIS 52, at *4, *39; *Abbott*, 325 F.3d at 809-11.

²⁷ *Disney*, 2003 Del. Ch. LEXIS 52, at *37-*38 (emphasis in the original); accord *Abbott*, 325 F.3d at 809.

offer.²⁸ An invitation to negotiate a premium merger does not suspend the business judgment rule or the directors' authority to accept or reject the invitation in good faith and on an informed basis.

These principles were applied by the Delaware Chancery Court in its 1998 opinion in *Kahn v. MSB Bancorp, Inc.*, a ruling that was affirmed without opinion by the Delaware Supreme Court.²⁹ The target in *MSB* received two unsolicited offers to merge with a bidder. The first letter contained no proposed price, but simply invited the target to enter into merger discussions, while the second letter suggested a price for the target's stock, but contained no other specific terms.³⁰ The target's board, after having considered its investment banker's analysis of the offer, rejected the bid.³¹ Shareholders of the target sued, claiming that the target's board breached its fiduciary duties of loyalty and care by having rejected those offers and by failing to disclose them to the shareholders.

The court granted the defendant directors summary judgment dismissing the complaint, holding that since the target "merely voted not to negotiate the merger offer," no enhanced standard of judicial review applies to that decision, because "there was no defensive action [by the target's board of directors]."³² Therefore, the court held, the board's decisions were protected by the business judgment rule, and the plaintiff failed to present a triable issue that the board breached its fiduciary duties because it was "self-interested, because the directors were motivated to entrench themselves in office" or because the board's "behavior amounted to gross negligence."³³

In *Minzer v. Keegan*,³⁴ a federal district court interpreting New York law held that the ordinary business judgment rule applies when a target determines whether to pursue a merger

²⁸ See, e.g., *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1383 (Del. 1995) (recognizing "prerogative of a board of directors to resist a third party's unsolicited acquisition proposal or offer") (quoting *Paramount v. QVC Network, Inc.*, 637 A.2d 34, 43 n.13 (Del. 1994)); *Paramount Communications, Inc. v. Time, Inc.* ("Time-Warner") 571 A.2d 1140, 1152, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,938 (Del. 1990) ("We have repeatedly stated that the refusal [of directors] to entertain an offer may comport with the valid exercise of a board's business judgment."); *Gagliardi v. Trifoods Int'l, Inc.*, 683 A.2d 1049, 1055 (Del. Ch. 1996) (holding directors may "refuse" to negotiate or entertain sale of company to potential acquirer absent bad faith); *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278 (Del. Ch. 1989).
²⁹ No. 14712-NC, 1998 WL 409355 (Del. Ch. July 16, 1998), *aff'd without publ'd op.*, 734 A.2d 158 (Del. 1999).

³⁰ *Id.* at *2.

³¹ The bidder modified its offer price subsequently, and the target's board once again rejected it. The target's board then received yet another bidder's unsolicited offer to merge with the target. The target's board rejected that offer as well. *Id.* at *2.

³² *Id.* at *3. *MSB* therefore held explicitly that the stricter standard of review of a board's actions embodied in *Unocal v. Mesa Petroleum*, 493 A.2d 946 (1985), was "irrelevant where, as here, no defensive action was taken." *MSB* at *3.

³³ *Id.* The court refused expressly to accept the shareholder plaintiffs' invitation to create "a new rule that a board should be required to persuade the court that it has acted in good faith and with due care when it rejects a merger offer." Such a rule, *MSB* held, "would depart from precedent." *Id.*

³⁴ No. CV-97-4077 (CPS), 1997 U.S. Dist. LEXIS 16445 (E.D.N.Y. Sept. 22, 1997), *aff'd*, 218 F.3d 144 (2d Cir. 2000), *cert. denied*, 531 U.S. 1192 (2001).

proposal.³⁵ On appeal, in affirming on other grounds, the Second Circuit commented that “there is no statutory or case law requiring the [target] board to consider merger offers or, in the presence of such offers, to conduct a fair auction. Indeed, there are New York statutes that allow management considerable leeway in defending against hostile takeovers, . . . and there is no case law that would enable shareholders to compel [the target] Greater New York’s board to negotiate with [the hostile bidder] North Fork.”³⁶

Once the board determines to reject an unsolicited bid, it may authorize management to oppose the offer. A complaining shareholder has the burden of rebutting the business judgment rule presumption³⁷ and of proving that the directors acted other than in good faith.³⁸ Indeed, it is now settled that, as fiduciaries, the directors are required to oppose offers that in their judgment are not in the best interests of the corporation and its constituents. In *Gilbert v. The El Paso Co.*,³⁹ for example, the Delaware Supreme Court pointedly observed:

Supported by the opinion of their advisors, the directors found that the bid threatened the corporate enterprise. Their prompt adoption of defensive measures in an attempt to meet this imminent threat was hardly improvident. Given the injunction of *Unocal* that the duties of care and loyalty prevent a board from being a passive instrumentality in the face of a perceived threat to corporate control, one would have expected nothing less from the directors under the circumstances.⁴⁰

³⁵ *Id.*, 1997 U.S. Dist. LEXIS 16445 at *32-*34.

³⁶ 218 F.3d at 150 (citations omitted). *Accord Dynamics Corp. of America v. WHX Corp.*, 967 F. Supp. 59 (S.D.N.Y. 1997) (denying preliminary injunction to competing bidder; holding that, under New York law, there is no heightened scrutiny for an independent target board’s antitakeover actions, and, alternatively, ruling that even under Delaware standards there was no fiduciary breach because the target board had approved the superior offer and had exercised due care in making its decision); *see also Winters v. First Union Corp.*, No. 01-CVS-5362 (Forsyth County Super. Ct. July 12, 2001) (applying North Carolina law, court held that “the decision to enter into a merger agreement is a decision for the board of directors that is subject to review under the business judgment rule”) (citing *Paramount Communications Inc. v. Time, Inc.*, 571 A.2d 1140, 1142 (1989)).

³⁷ *See, e.g., Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984) (failure of board to negotiate with third party that made premium offer is not prima facie breach of fiduciary duty; derivative suit dismissed for failure to make demand); *Lewis v. Straetz*, No. 7859 (Del. Ch. Feb. 12, 1986) (motion to dismiss derivative suit granted because “[t]he fact that a hostile tender offer was rejected, standing alone, does not state a breach of fiduciary duty”).

³⁸ *See Technicolor*, 663 A.2d at 1162. Bad faith is “not simply bad judgment or negligence, but . . . the conscious doing of a wrong because of dishonest purpose or moral obliquity. . . . [I]t contemplates a state of mind affirmatively operating with furtive design or ill will.” *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund II, L.P.*, 624 A.2d 1199, 1208 n.16 (Del. 1993) (citation omitted).

³⁹ 575 A.2d 1131 (Del. 1990).

⁴⁰ *Id.* at 1146 (citing *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334 (Del. 1987); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); and other cases). *See Unitrin v. American General Corp.* 651 A.2d 1361, 1383 (Del. 1995). *See also Heit v. Baird*, 567 F.2d 1157 (1st Cir. 1977); *Panter v. Marshall Field & Co.*, 486 F. Supp. 1168, 1194 (N.D. Ill. 1980), *aff’d*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Treadway Cos. v. Care Corp.*, 490 F. Supp. 660, 684 (S.D.N.Y.), *aff’d in part and rev’d in part*, 638 F.2d 357 (2d Cir. 1980); *GM Sub Corp. v. Liggett Group, Inc.*, No. 6155 (Del. Ch. Apr. 24, 1980); *Northwest Indus. v. B.F. Goodrich Co.*, 301 F. Supp. 706, 712 (N.D. Ill. 1969).

[2] *Unocal* Principles for Defensive Measures

One of the most critical developments in business judgment rule jurisprudence has been the gradual evolution of more rigorous judicial scrutiny of board decisions involving defensive actions taken to block hostile takeover attempts. A heightened standard of business judgment review was first formally articulated in Delaware in the 1985 decision in *Unocal Corp. v. Mesa Petroleum Co.* Under *Unocal* and its progeny, the invocation of defensive tactics imposes a special burden on directors prior to their enjoying the benefits of the business judgment rule. First, the board must inform itself fully, and any decision to take defensive action must be the result of a careful evaluation of the hostile bid and of the various alternative courses of action available. As suggested by the Delaware Supreme Court's interpretation of the *Unocal* test in *El Paso, Time-Warner* and later cases, however, the board, particularly a board with a majority of disinterested directors, will be afforded considerable latitude in determining whether an unsolicited bid may be deemed to constitute a threat to corporate policy and effectiveness, the first prong of the *Unocal* test.⁴¹

Second, the board must justify the reasonableness of specific defensive tactics employed in relation to the nature of the particular hostile threat to shareholder and corporate interests. In general, a defensive measure will be found improper or "disproportionate" if it is either "draconian" (coercive or preclusive) or falls outside a range of reasonable responses. Again, however, the case law suggests that the board enjoys latitude with respect to the satisfaction of this aspect of the *Unocal* standard as well. As the Delaware Supreme Court explained in *El Paso*, in responding to the directors' apparent fear that board conduct "might somehow wither under enhanced judicial scrutiny,"

Like the traditional business judgment analysis, however, *Unocal* also implicitly acknowledges that courts should not impose their own business judgment upon independent directors who reasonably respond to a threat to the corporate enterprise in good faith and on an informed basis.⁴²

Where the board is taking action to protect stockholders from potentially detrimental activities of a raider,⁴³ courts have generally been supportive of reasonable defensive actions taken by the board after adequate investigation and due deliberation.⁴⁴ For example, in *Unitrin*, where the board was taking defensive actions in response to a bona fide bid, the Delaware

⁴¹ In *Function Over Form*, the authors suggest that the "two-step test" be considered "as part of a broader, unitary inquiry into whether the board-adopted defensive measures taken as a whole, were reasonable in light of the objective circumstances facing the board." *Function Over Form* at 1320-21.

⁴² 575 A.2d at 1145 n.29 (Del. 1990).

⁴³ Where a board consisting of a majority of outside directors is enacting defensive measures in reaction to the "traditional threats posed by over-the-transom acquisition offers," and the measures "present no insuperable barrier to a hostile acquisition offer," they "cannot, as a matter of law, be deemed unreasonable." *In re Gaylord Container Corp. Sh. Litig.*, 753 A.2d 462, 464, 478 n.51 (Del. Ch. 2000) (holding that panoply of defensive measures satisfied *Unocal/Unitrin* standards).

⁴⁴ See, e.g., *Katz v. Chevron Corp.*, 22 Cal. App. 4th 1352, 27 Cal. Rptr. 2d 681 (1st Dist. 1994) (affirming summary judgment on behalf of Chevron's directors, upholding various defensive actions they had taken in response to Pennzoil's 8.8%, \$2.1 billion secret acquisition of Chevron stock applying Delaware law).

Supreme Court re-emphasized the need for judicial restraint in reviewing defensive responses under a “range of reasonableness” standard:

The *ratio decidendi* for the “range of reasonableness” standard is a need of the board of directors for latitude in discharging its fiduciary duties to the corporation and its shareholders when defending against perceived threats. The concomitant requirement is for judicial restraint. Consequently, if the board of directors’ defensive response is not draconian (preclusive or coercive) and is within a “range of reasonableness,” a court must not substitute its judgment for the board’s.⁴⁵

If the board satisfies the *Unocal* reasonableness standard, its defensive actions are subject to review under the business judgment standard. However, if the board’s actions fail to pass muster under *Unocal*, the defensive measures will be invalidated unless the board can demonstrate that its actions were entirely fair. The authors of *Function Over Form* argue that, for a variety of reasons, these linkages are inappropriate. In their view, the only test should be whether the defensive actions make sense under *Unocal* in which case any further judicial review “is analytically and functionally unnecessary.”⁴⁶

[3] *Revlon* Principles for a Sale of Control

If a sale of control is in question, at least in Delaware, *Revlon* principles will apply.⁴⁷ Courts will more closely scrutinize the board’s process and actions in order to ensure that the sole objective of maximizing shareholder value is sought to be achieved. In those circumstances, a Delaware court may not defer as readily to the board’s business decisions as might be suggested by the *El Paso*, *Unitrin*, and *Time-Warner* rulings. Accordingly, determining what constitutes a “sale of control” is a significant part of a court’s analysis. In *Paramount Communications Inc. v. QVC Network, Inc.*,⁴⁸ for example, the Delaware Supreme Court held that, because the merger transaction approved by the Paramount board resulted in a transfer of voting control from the Paramount public shareholders to the individual controlling shareholder of Viacom, the transaction was a sale of control and triggered the duty under *Revlon* to obtain the best value reasonably available.⁴⁹ The court found that the Paramount directors had failed to satisfy that duty in favoring Viacom over the competing bidder, QVC.

Significantly, the court specified the obligation that the directors had under the circumstances of a sale of control as follows:

⁴⁵ *Unitrin*, 651 A.2d at 1388 (citing *Paramount*, 637 A.2d at 45-46). But if the primary purpose of the board’s defensive actions are meant to interfere with a stockholder vote, the *Blasius* “compelling justification” standard will be applied within the *Unocal* standard of review. *MM Companies, Inc., v. Liquid Audio, Inc.*, 813 A.2d 1118, 1123 (Del. 2003) (citing *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 661 (Del. Ch. 1988)). See §3.01[A][5] *infra*.

⁴⁶ *Function Over Form* at 1311. Prior to 2003, there had been considerable debate over whether deal protections in a merger agreement should be considered defensive measures subject to the *Unocal* standard.- See generally *Takeover Defense* § 15.05[D]. That debate was resolved by the Delaware Supreme Court in its *Omnicare* opinion, in which the court ruled that they are. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003). See generally §15.05 *infra*.

⁴⁷ See *Takeover Defense* Chapter 15 sections below.

⁴⁸ 637 A.2d 34 (Del. 1994).

⁴⁹ *Id.* at 43-48.

Under the facts of this case, the Paramount directors had the obligation: (a) to be diligent and vigilant in examining critically the Paramount-Viacom transaction and the QVC tender offers; (b) to act in good faith; (c) to obtain, and act with due care on, all material information necessary to compare the two offers to determine which of these transactions, or an alternative course of action, would provide the best value reasonably available to the stockholders; and (d) to negotiate actively and in good faith with both Viacom and QVC to that end.⁵⁰

The Delaware Supreme Court observed that

a court applying enhanced judicial scrutiny should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.⁵¹

The Delaware Supreme Court reviewed the record and concluded that "the Paramount directors' process was not reasonable, and the result achieved for the stockholders was not reasonable under the circumstances."⁵²

Similarly, in *Cede & Co. v. Technicolor, Inc.*,⁵³ the Delaware Supreme Court held that the Technicolor board's decision to sell the company was not entitled to the presumptions of the business judgment rule because it found that the decision was uninformed, even though it also found that the board had obtained a fair price. On remand, the Chancery Court held that the sale transaction was entirely fair to the Technicolor stockholders and dismissed the claim against Technicolor's board, a ruling that was affirmed by the Delaware Supreme Court.⁵⁴

[4] Entire Fairness Defense If Duty Is Breached

In general, as has been discussed, the Delaware cases subject defensive decisions to a preliminary judicial examination to determine if the standards discussed above have been met.⁵⁵ If the directors' defensive actions satisfy these basic standards and if the directors' decisions are based upon their evaluation of business considerations, it will be protected by the business judgment rule and will not be second-guessed by the courts. However, if the board breaches one of the triad of its fiduciary duties (good faith, loyalty, or due care) or fails to meet the *Unocal* or

⁵⁰ *Id.* at 48.

⁵¹ *Id.* at 45. *Accord, In re Pennaco Energy, Inc. Sh. Litig.*, No. 18606, 2001 Del. Ch. LEXIS 19 (Del. Ch. Feb. 5, 2001) (quoting above passage from *QVC*) (denying motion for preliminary injunction against sale of company to third party).

⁵² *Id.* at 49.

⁵³ 634 A.2d 345 [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶97,811 (Del. 1993), *after remand sub nom., Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995) ("*Technicolor*").

⁵⁴ *Technicolor*, 663 A.2d at 1172-80. *See* discussion of the series of *Technicolor* decisions in *Takeover Defense* § 3.05[H].

⁵⁵ The Delaware Supreme Court has ruled that target directors generally must justify defensive measures that favor one suitor over others before they can obtain dismissal of a suit challenging their conduct. *See In re Santa Fe Pacific Corp. Sh. Lit.*, 669 A.2d 59, 72 (Del. 1995), discussed in *Takeover Defense* §§ 3.01[C] and 5.08[E].

Revlon standards, business judgment rule protection is lost; the board's actions are not, therefore, *ipso facto*, invalid. Rather the directors then have the burden of proving the "entire fairness" of the challenged actions, which will be upheld if they are found to be fair to stockholders.⁵⁶

Function Over Form criticizes this doctrine as appearing to treat due care violations as seriously as loyalty breaches in requiring directors to prove entire fairness regardless of whether plaintiffs have shown any injury:

Under *Cede II*, all the plaintiff need show now is a breach of the duty [of care], irrespective of whether any harm resulted, to trigger a far more liability-threatening procedural consequence—a change of the review standard to the more exacting entire fairness scrutiny, with the directors having the burden to negate the presumption of unfairness [footnote omitted]. Nothing in *Cede II* explains why directors accused of due care violations should be subjected to that far greater liability risk.⁵⁷

[5] Consideration of Stockholder Voting Rights

When directors take actions that affect stockholders' exercise of their right to vote, the courts will examine the purpose and effect of those actions. In *Schnell v. Chris-Craft Indus., Inc.*,⁵⁸ the Delaware Supreme Court in 1971 held a board's rescheduling of an annual meeting to be unlawful, because:

Management has attempted to utilize the corporate machinery and the Delaware Law for the purpose of perpetuating itself in office; and, to that end, for the purpose of obstructing the legitimate efforts of dissident stockholders in the exercise of their rights to undertake a proxy contest against management. These are inequitable purposes, contrary to established principles of corporate democracy.⁵⁹

Later cases have placed the burden on directors to justify a "manipulation" of the corporate machinery.⁶⁰ In *Blasius Indus., Inc. v. Atlas Corp.*, the board was required to demonstrate a "compelling justification" because its actions were found to have the "the primary purpose of impeding the exercise of stockholder voting power."⁶¹ The *Blasius* principle stems from the

⁵⁶ See *Emerald Partners v. Berlin*, 726 A.2d 1215, 1221 (Del. 1999); *Williams v. Geier*, 671 A.2d 1368, 1378 & n.20, 1384 (Del. 1996); *Technicolor*, 663 A.2d at 1162-64; *Unitrin*, 651 A.2d at 1377 n.18 (citing authorities). The "entire fairness" test also applies to transactions between the corporation and controlling stockholders. See *Takeover Defense* Chapter 14.

⁵⁷ *Function Over Form* at 1303-04. The authors also question the apparent abandonment of "traditional tort burden allocation principles," requiring plaintiffs to prove that a due care "violation caused harm to the corporation or the shareholders. . . ." *Id.* at 1301 & n.57. They propose that the standard of review governing due care breaches should be: "did the plaintiff prove that the board's conduct was grossly negligent *and* caused injury?" *Id.* at 1318-19 (emphasis in original; citation omitted).

⁵⁸ 285 A.2d 437 (Del. 1971).

⁵⁹ *Id.* at 439, quoted with approval in *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003), and *Unitrin*, 651 A.2d at 1378., both discussed below. Other cases have precluded similar board actions that affected corporate governance and were taken for the primary purpose of entrenchment. See, e.g., *Lerman v. Diagnostic Data, Inc.*, 421 A.2d 906, 914 (Del. Ch. 1980), and discussion of that case and others in *Takeover Defense* § 6.06[C].

⁶⁰ See, e.g., *Aprahamian v. HBO & Co.*, 531 A.2d 1204 (Del. Ch. 1987).

⁶¹ *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 661 (Del. Ch. 1988).

corporate governance policy rationale that regards stockholder enfranchisement “as the ‘ideological underpinning’ upon which the legitimacy of the directors managerial powers rest.”⁶² According to Chancellor Allen in *Blasius*, because of the fundamental nature of this agency governance principle, the deferential business judgment rule and *Unocal* standard are not satisfactory when examining board actions that affect shareholder voting rights.⁶³ The Delaware Supreme Court noted in *Unitrin* that “we accept the basic legal tenets” set forth in *Blasius*.⁶⁴

In its 2003 opinion in *MM Companies v. Liquid Audio, Inc.*,⁶⁵ the Delaware Supreme Court endorsed the use of the *Blasius* standard in both takeover and non-takeover situations, stating that:

[T]he same circumstances must be extant before the *Blasius* compelling justification enhanced standard of judicial review is required to sustain a board’s action either independently, in the absence of a hostile contest for control, or within the *Unocal* standard of review when the board’s action is taken as a defensive measure. The “compelling justification” standard set forth in *Blasius* is applied independently or within the *Unocal* standard only where “the primary purpose of the board’s action is to interfere with or impede exercise of the shareholder franchise and the shareholders are not given a full and fair opportunity to vote” effectively.⁶⁶

The court then noted that “the non-deferential *Blasius* standard of enhanced judicial review . . . is rarely applied either independently or within the *Unocal* standard of review.”⁶⁷

⁶² *Blasius*, 564 A.2d at 659.

⁶³ *Id.* at 660. Chancellor Allen stated that: “Action designed principally to interfere with the effectiveness of a vote inevitably involves a conflict between the board and a shareholder majority. Judicial review of such action involves a determination of the legal and equitable obligations of an agent towards his principal. This is not, in my opinion, a question that a court may leave to the agent finally to decide so long as he does so competently; that is, it may not be left to the agent’s business judgment.”

⁶⁴ *Unitrin*, 651 A.2d at 1378-79 (Del. 1995) (quoting *Stroud v. Grace*, 606 A.2d 75, 91 (Del. 1992)). The authors of *Function Over Form* contend that the *Blasius* standard should be eliminated and *Unocal* used as the tool. Noting that *Stroud* and *Unitrin* “began gradually to ‘fold’ the *Blasius* standard into *Unocal*,” the jurists explained their reasoning:

The fine analytical distinctions required by having parallel, coexisting standards of review that are similar in operation and result strike us as functionally unhelpful and unnecessary. The post-*Blasius* experience has shown that the *Unocal/Unitrin* analytical framework is fully adequate to capture the voting franchise concerns that animated *Blasius*, so long as the court applies *Unocal* “with a gimlet eye out for inequitably motivated electoral manipulations or for subjectively well-intentioned board action that has preclusive or coercive effects.”

Function Over Form at 1316 (quoting *Chesapeake Corp. v. Shore*, 771 A.2d 293, 323 (Del. Ch. 2000)).

⁶⁵ 813 A.2d 1118 (Del. 2003).

⁶⁶ *Id.* at 1130, quoting *Williams v. Geier*, 671 A.2d 1368, 1376 (Del. 1996) (quoting *Stroud*, 606 A.2d 75, 92 (Del. 1992)). *Liquid Audio* implicitly rejects the criticism of *Blasius* in *Function Over Form*, discussed in the next preceding footnote.

⁶⁷ *Id.*

In *Liquid Audio*, the court reversed a Chancery Court ruling that had upheld defensive board actions under *Unocal* and *Blasius*. MM Companies had sought to acquire Liquid Audio, but the board entered into a merger agreement with a third party.⁶⁸ MM then sought to elect two directors at the next annual meeting, which could have led, as a practical matter, to MM's gaining control of the board because of the concern that two of the other three incumbent directors would resign if MM's nominees were elected.⁶⁹ In response, the Liquid Audio board expanded the size of the board from five to seven directors and appointed directors to fill the two new board positions.⁷⁰ The Delaware Supreme Court noted that the Chancery Court concluded after an expedited trial that the director defendants timed their actions "for the *primary purpose* of diminishing the influence of MM's nominees, if they were elected at the annual meeting."⁷¹

Based on that finding, the Delaware Supreme Court applied *Blasius* "within an application of the *Unocal* standard of review,"⁷² stating:

When the *primary purpose* of a board of directors' defensive measure is to interfere with or impede the effective exercise of the shareholder franchise in a contested election for directors, the board must first demonstrate a compelling justification for such action as a condition precedent to any judicial consideration of reasonableness and proportionality.⁷³

Since the director defendants did not demonstrate a compelling justification for their action in expanding the board, the court ruled that the board expansion should have been invalidated by the Court of Chancery.⁷⁴

In contrast, in the earlier *Stroud* and *Unitrin* cases, the *Blasius* analysis was held inapplicable. In *Stroud*, the Delaware Supreme Court upheld a director nomination bylaw because it could not be said "that the 'primary purpose' of the board's action was to interfere with or impede exercise of the shareholder franchise" and because the shareholders had a "full and fair opportunity to vote."⁷⁵ In *Unitrin* and *Stroud*, the Delaware Supreme Court specifically noted that "boards of directors often interfere with the exercise of shareholder voting when an acquirer launches both a proxy fight and a tender offer."⁷⁶

The *Unitrin* court also observed that it was "mindful of the special import of protecting the shareholder's franchise within *Unocal*'s requirement that a defensive response be reasonable and proportionate."⁷⁷ The court found that the shareholders' franchise was not impeded by the *Unitrin* board's repurchase program, because "a proxy contest remained a viable (if more problematic) alternative for American General even if the Repurchase Program were to be completed in its entirety."⁷⁸ Nevertheless, the court instructed the Chancery Court on remand to

⁶⁸ *Id.* at 1124.

⁶⁹ *Id.* at 1125-26.

⁷⁰ *Id.* at 1124.

⁷¹ *Id.* at 1126 (emphasis in the original).

⁷² *Id.* at 1132 (emphasis in the original).

⁷³ *Id.* (emphasis in the original).

⁷⁴ *Id.*

⁷⁵ *Stroud*, 606 A.2d at 92, as quoted in *Unitrin*, 651 A.2d at 1379.

⁷⁶ *Unitrin*, 651 A.2d at 1379 (citing *Stroud*, 606 A.2d at 92 n.3).

⁷⁷ *Unitrin*, 651 A.2d at 1379.

⁷⁸ *Id.* at 1388.

apply *Unocal* to “determine whether Unitrin’s Repurchase Program would only inhibit American General’s ability to wage a proxy fight and institute a merger or whether it was, in fact, preclusive because American General’s success would either be mathematically impossible or realistically unattainable.”⁷⁹

In *Aquila, Inc. v. Quanta Servs.*,⁸⁰ the Quanta board faced a proxy contest by Aquila, an insurgent shareholder. The board created a stock employee trust (“SECT”), to which it sold 10% of its shares, under terms which provided that certain non-director employees of Quanta would vote those shares.⁸¹ Aquila claimed that the board’s motivation in creating the SECT was to dilute Aquila’s voting power.⁸² Defending its action, the board argued that the main purpose of the SECT was to benefit company employees and that its voting provisions were normal and incidental to its business purpose.⁸³

In an opinion issued before *Liquid Audio*, the court declined to apply *Blasius*’s “compelling justification” standard,⁸⁴ but held that the stock issuance was likely to fail the *Unocal* test. The court noted that, in applying *Unocal*, it was “obliged to show special vigilance for protecting the shareholder franchise. That special vigilance requires that the voting feature of the SECT be analyzed and justified on its own terms, as a distinct defensive measure.”⁸⁵

The court observed that the board’s “decision to have those shares voted by persons who do not own them necessarily raises substantial questions about the propriety of the Special Committee’s purpose in doing so” and concluded that “the defendants will not be able to meet their initial burden under *Unocal* of showing that their actions were reasonable in relation to the threat posed by Aquila’s activities.”⁸⁶ Nevertheless, the court denied the requested preliminary injunction for lack of irreparable harm finding that, given Aquila’s 34% voting power, it was unlikely the SECT shares would be decisive in the proxy contest, and, if necessary, following the election, the court could provide relief after a prompt final hearing on the merits.⁸⁷

In The Learning Company’s (TLC’s) defense of its merger plan with Broderbund against a hostile bid by SoftKey, the Delaware Chancery Court permitted a bylaw amendment that ensured that shareholders could vote on the pending merger agreement 25 days before SoftKey could call a stockholder-initiated meeting.⁸⁸ The court interpreted *Unitrin* to establish that board action to allow stockholders to vote on a proposed transaction and to give the board “a reasonable time to explore and develop other options” as a defensive measure against a hostile tender offer coupled with a proxy contest “does not implicate the *Blasius* standard of review.”⁸⁹ The *TLC* court found

⁷⁹ *Id.* at 1388-89.

⁸⁰ 805 A.2d 196 (Del. Ch. 2002).

⁸¹ *Id.* at 198.

⁸² *Id.* at 205.

⁸³ *Id.* at 201, 205-06.

⁸⁴ *Id.* at 205.

⁸⁵ *Id.* at 207 (citing *Unitrin*, 651 A.2d at 1386-87).

⁸⁶ *Id.* at 207-08 & n.32 (noting that this result was consistent with prior precedents “enjoining the voting of shares issued for entrenchment purposes”).

⁸⁷ *Id.* at 208-09.

⁸⁸ See *Kidsco, Inc. v. Dinsmore* (“*TLC*”), 674 A.2d 483 (Del. Ch.), *aff’d*, 670 A.2d 1338 (Del. 1995) (Order affirming on opinion below), discussed further in *Takeover Defense* § 6.06[A].

⁸⁹ *TLC*, 674 A.2d at 496 (denying preliminary injunction against bylaw amendment giving board 25 additional days to call a special meeting and noting the *Stahl* case was “functionally indistinguishable”).

that the *Blasius* compelling justification standard had been limited to cases where inequitable conduct relating to a shareholder vote had the effect of either “(i) precluding effective shareholder action . . . or, of (ii) ‘snatch[ing] victory from an insurgent slate on the eve of the noticed meeting.’ . . .”⁹⁰

In *Hilton Hotels Corp. v. ITT Corp.*,⁹¹ as a defense to Hilton’s hostile bid, the ITT board had approved a reorganization that placed most of ITT’s operations in a new corporation with a staggered board, thereby preventing ITT shareholders from voting on Hilton’s effort to oust the ITT board at ITT’s upcoming annual meeting to facilitate its takeover bid. The federal court enjoined the classified board provision and other elements of the board’s plan as a violation of both *Unocal* and *Blasius* principles.⁹² With respect to the *Blasius* claim, the court specifically found that the primary purpose of the reorganization plan was to interfere with the shareholder franchise and that no compelling justification existed for that interference.⁹³

Certainly, *Liquid Audio* sends a clear signal that the Delaware courts will rigorously review board action that could affect an election contest. The directors, in this context, should evaluate the reasons for the proposed action and its probable impact on the shareholder franchise.

[6] Effect of Stockholder Approval

One way to significantly reduce the risk of potential breach of fiduciary duty claims is for the board to obtain shareholder approval of a proposed transaction, when this is a feasible course to follow. While a board may have no legal duty to subject proposed transactions to a shareholder vote absent an express requirement pursuant to a statute or a corporation’s certificate of incorporation or bylaws,⁹⁴ shareholder approval of a proposed merger (required for a target under Delaware law) or other transaction may shield the board from most breach of fiduciary duty claims.⁹⁵

⁹⁰ *TLC*, 674 A.2d at 495-96 (quoting *Stahl*, 579 A.2d at 1123, and citing other precedents).

⁹¹ 978 F. Supp. 1342 (D.Nev. 1997).

⁹² *Id.* at 1347-50. The Nevada federal court applied Delaware law. *See id.* at 1346 (“Where, as here, there is no Nevada statutory or case law on point for an issue of corporate law, this Court finds persuasive authority in Delaware case law” [citation omitted]).

⁹³ *Id.* at 1348-50. *See also Simon Prop. Group v. Taubman Ctrs.*, 2003 U.S. Dist. LEXIS 7435 (E.D. Mich. May 1, 2003) (holding that actions taken by the board to amend the corporation’s bylaws to preclude shareholders from calling a special meeting without board approval, thereby thwarting the efforts of a shareholder to unilaterally call a special shareholder meeting and have an eventual vote, warranted review under the *Blasius* “compelling justification” standard).

⁹⁴ *See Lennane v. Ask Computer Sys. Inc.*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,674, 1990 WL 154150 (Del. Ch. Oct. 11, 1990) (holding that (i) NASD requirement of shareholder vote for issuance of new stock did not obligate board to put transaction to shareholder vote; and (ii) directors are bound to hold a vote only when required by state law or a corporation’s certificate or bylaws), *appeal refused*, 588 A.2d 660 (Del. Oct. 19, 1990) (decision without published opinion), *aff’d on reconsideration*, 1990 WL 161094 (Del. Ch. Oct. 19, 1990).

⁹⁵ *See generally Solomon v. Armstrong*, 747 A.2d 1098, 1113-17 (Del. Ch. 1999), *aff’d on opinion below*, 746 A.2d 277 (Del. 2000) (granting motion to dismiss claims challenging the General Motors board decision to split off its Electronic Data Systems subsidiary); *In re Wheelabrator Technologies Inc. Sh. Lit.*, 663 A.2d 1198, 1201-05 (Del. Ch. 1995) (“*Wheelabrator II*”). *See also Weiss v. Rockwell Int’l Corp.*, C.A. No. 8811, 1989 Del. Ch. LEXIS 94, at *8-*10 (Del. Ch. July 19, 1989) (citing *Smith v. Van Gorkom*, 488 A.2d at 890, for well-settled rule that shareholder approval with full disclosure precludes breach of fiduciary duty claims, except where

Under Delaware law, a merger also extinguishes any derivative claims against the directors if the corporation becomes a subsidiary of the acquiror, in which case the acquiring corporation, as the new sole stockholder, succeeds to control all derivative claims.⁹⁶ However, a challenge to the merger's fairness is an individual claim, not a derivative claim, and is not extinguished.⁹⁷

It is unclear whether a duty-of-loyalty claim against directors may be eliminated by stockholder ratification on less than a unanimous vote.⁹⁸ In *Solomon v. Armstrong, supra*, Chancellor Chandler observed that the legal principles on this question "may be one of the most tortured areas of Delaware law."⁹⁹ In that case, the court held that, in addressing duty of loyalty claims, "where there is no controlling shareholder, control group or dominating force that can compel a particular result," shareholder approval of a merger or other challenged transaction "provides an independent reason to maintain business judgment protection for the board's acts."¹⁰⁰

In *Lewis v. Austen*,¹⁰¹ the stockholder plaintiff challenged the treatment of stock options in a spinoff transaction. The court held that stockholder approval of the option modifications did not extinguish a duty of loyalty claim; however, ratification put the burden on the plaintiff to plead either insufficient proxy disclosures or a claim of corporate waste¹⁰² in order to overcome the business judgment rule presumption. Since the plaintiff's pleadings were inadequate, the claim was dismissed.¹⁰³

approved transaction involves "gift or waste of assets, fraud, or ultra vires"), *aff'd mem.*, 574 A.2d 264 (Del. 1990).

⁹⁶ See *Takeover Defense* § 3.01[C].

⁹⁷ See *Parnes v. Bally Entertainment*, 722 A.2d 1243 (Del. 1999) (*en banc*), discussed in *Takeover Defense* § 3.01[C].

⁹⁸ In *Williams v. Geier*, 671 A.2d 1368, 1378 (Del. 1996), the Delaware Supreme Court, after noting circumstances under which "interested transactions" may be ratified and citing cases, stated: "We express no opinion on the question whether a 'duty of loyalty claim' may or may not be ratified." *Id.* at 1379 (citing *Wheelabrator II*, 663 A.2d at 1202, for "noting some such circumstances [under which interested transactions may be ratified] and concluding that stockholder ratification may not extinguish a 'duty of loyalty claim'").

⁹⁹ 747 A.2d at 1114; see *id.* at 1117 n.59 ("The Delaware Supreme Court has not squarely addressed the issue of whether fully-informed shareholder ratification may legally bar approving shareholders from subsequently asserting duty of loyalty claims," citing *Williams v. Geier*, 671 A.2d at 1379 n.23, but noting that in *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 848 (Del. 1987), the Delaware Supreme Court stated that "[w]hen an informed minority shareholder either votes in favor [of a transaction or] . . . accepts the benefits of the transaction, he or she cannot thereafter attack its fairness").

¹⁰⁰ *Id.* at 1117; see *id.* at 1127 (holding fully informed, non-coerced shareholder vote required rejection of duty of loyalty challenge to General Motors' split-off of its EDS subsidiary). See also *Wittman v. Crooke*, 120 Md. App. 369, 377-378, 707 A.2d 422 (Md. Ct. Sp. App. 1998) (holding that shareholder ratification extinguishes duty of loyalty claim under Maryland law).

¹⁰¹ C.A. No. 12937, 1999 WL 378725 (Del. Ch. June 2, 1999).

¹⁰² Function Over Form criticizes the waste exception: "When fully informed, disinterested stockholders have approved a transaction, on what principled basis could a court determine that the transaction is wasteful?" Function Over Form at 1318; see *id.* at 1317 n.119, 1318 n.120. (citing cases). That criticism appears to answer the theoretical quandary that waste is considered a void act, which therefore can not be ratified except by a unanimous shareholder vote. See *Solomon*, 747 A.2d at 1114.

¹⁰³ See *Lewis v. Austen*, 1999 WL 378725 at *6 n.24 (citing cases).

However, when defensive measures are employed after a hostile bid has been made or *Revlon* duties are at issue, shareholder ratification of a transaction will not shield the board's decision to erect the defenses, or possibly the board's fulfillment of *Revlon* requirements, from enhanced judicial review, unless the shareholders specifically ratify the defensive measures or the auction process, and not just the transaction.¹⁰⁴ Furthermore, the burden rests on the party relying on shareholder approval to establish that the shareholders were fully informed and disinterested.¹⁰⁵ Nonetheless, as to any transaction specifically voted upon, the general rule remains that, "in most circumstances, 'where a majority of fully informed stockholders ratify action even of interested directors, an attack on the ratified transaction normally must fail.'"¹⁰⁶

[7] Duties of Directors of an Acquiring Corporation

In the mergers and acquisitions arena, the law of directors' fiduciary duties has generally evolved in relation to the actions of the target company's board. Delaware and other courts have had fewer opportunities to review the actions of an acquiring company's directors. However, in *Ash v. McCall*,¹⁰⁷ the Delaware Court of Chancery recently applied traditional business judgment principles in evaluating the approval of a merger by an acquiror's board.¹⁰⁸ Rejecting a breach of duty-of-care claim, the court held that the board was "entitled to the presumption that it exercised proper business judgment."¹⁰⁹ Additionally, *Ash* sets forth legal standards for determining the circumstances when the directors of an acquiring company would not be entitled to the classic business judgment presumption. These standards are consistent with the business judgment rule as applied by Delaware and other courts in other contexts.

The plaintiffs' claims in *Ash* stemmed from the stock merger of McKesson Corporation and HBOC & Co. in January 1999. After the completion of that merger, in April 1999, management of the combined company, McKesson HBOC, discovered various irregularities in HBOC's accounting for sales, revenues, and earnings from 1996 to April 1999. This discovery resulted in McKesson HBOC disallowing \$327.4 million of revenue and \$191.5 million of operating income and an approximate 50% reduction in the company's market capitalization. Plaintiffs claimed

¹⁰⁴ See *Santa Fe Pacific*, 669 A.2d at 67-68 ("Since the stockholders . . . merely voted in favor of the merger and not the defensive measures, we decline to find ratification"). The application of this non-ratification principle to *Revlon* claims is less clear as the court in *Santa Fe* held that plaintiffs had failed to plead a valid *Revlon* claim. *Id.* at 71. See *Solomon*, 747 A.2d at 1117 n.59 (describing *Santa Fe Pacific* as "holding that majority approval after full disclosure of a merger did not extinguish shareholders' claims . . . challenging *the merger* and defensive measures taken by the board in light of a hostile bidder's efforts to acquire the railroad corporation" (emphasis added)).

¹⁰⁵ See *Geier*, 671 A.2d at 1378. See generally § 15.03[F] *infra*.

¹⁰⁶ *Santa Fe*, 669 A.2d at 68 (quoting *Technicolor*, 663 A.2d at 1176; *Van Gorkom*, 488 A.2d at 890). In *Technicolor*, where the Technicolor directors had the burden of proving the entire fairness of the sale of the company in a two-stage tender offer/merger transaction, the Delaware Supreme Court noted that "the Court of Chancery properly found the tender by an overwhelming majority of Technicolor's stockholders [i.e., over 75% of the outstanding stock was tendered] to be tacit approval and, therefore, constituted substantial evidence of fairness." 663 A.2d at 1176 (citations omitted).

¹⁰⁷ 2000 Del. Ch. LEXIS 144 (Sept. 15, 2000).

¹⁰⁸ See § 3.01[A][1] *supra* for a general discussion of the business judgment rule in Delaware.

¹⁰⁹ *Id.* at *31.

that the McKesson directors breached their duty of due care by failing to discover these accounting irregularities during the course of their pre-merger due diligence investigation of HBOC. Additionally, plaintiffs alleged that the McKesson board's disregard of several "clear warnings" of these irregularities, including some well-publicized reports of HBOC's accounting practices, was further evidence of this breach of the duty of care.

Although the court disposed of most of the plaintiffs' claims on procedural grounds for failure to demonstrate demand futility,¹¹⁰ Chancellor Chandler also addressed several of the substantive claims in ways that provide helpful guidance to directors of a company planning an acquisition. In dismissing the plaintiffs' duty of care claims, the court held that, in challenging a transaction approved by a board composed of a majority of independent, disinterested directors, plaintiffs bear a heavy burden to create reasonable doubt that the directors fulfilled their duty of care.¹¹¹ To determine whether reasonable doubt exists courts examine the decision-making process rather than the business result of a decision and

whether the directors (i) informed themselves of available critical information before approving the transaction; (ii) considered expert opinion; (iii) provided all Board members with adequate and timely notice of the [transaction] before the full Board meeting and of its purpose; or (iv) inquired adequately into the reasons for or the terms of [the transaction].¹¹²

Since the McKesson board satisfied these process requirements, in particular the consideration of expert advice, the plaintiffs failed to bear this burden and the court dismissed their claims.

As McKesson engaged expert accounting and financial advisors to perform due diligence and those advisors gave HBOC a "clean bill of health," the court focused the duty of care inquiry as a question of whether the acquiror's directors may properly rely on qualified experts. In answering this question, the court applied longstanding principles of Delaware law and wrote "[d]irectors of Delaware corporations quite properly delegate responsibility to qualified experts in a host of circumstances. One circumstance is surely due diligence review of a target company's books and records."¹¹³ Furthermore, to overcome the presumption that a board may rely on experts, the court held that plaintiffs must allege particularized facts that, if proved, would show that (1) the directors in fact did not rely on the expert, or (2) that their reliance was not in good faith, or (3) that they did not reasonably believe that the experts' advice was within the experts' professional competence, or (4) that the directors were at fault for not selected experts with reasonable care, or (5) that the issue . . . was so obvious that the board's failure to detect it was grossly negligent regardless of the experts' advice, or (6) that the board's decision was so unconscionable as to constitute waste or fraud.¹¹⁴

Since nothing in the pleadings demonstrated that the McKesson directors lacked good faith in relying on their accountants and financial advisors, the court dismissed the due care claim.

The plaintiffs in *Ash* also asserted that the decision to enter into and recommend the merger to McKesson's shareholders constituted an act of corporate waste by the McKesson board. Under Delaware law, to establish a corporate waste claim, "plaintiffs must show that the merger in question either served no corporate purpose or was so completely bereft of consideration that it

¹¹⁰ See *Takeover Defense* § 3.01[C] for a discussion of derivative claims.

¹¹¹ *Id.* at *33.

¹¹² *Id.* at *34.

¹¹³ *Id.* at *30 (citing 8 Del. C. § 141(e)).

¹¹⁴ *Id.* at *32 (citing *Brehm v. Eisner*, Del. Supr., 746 A.2d 244, 262 (2000)).

effectively constituted a gift.”¹¹⁵ However, the court stated that “the relevant time to measure whether [a board] committed ‘waste’ is at the time they entered into and approved the transaction.”¹¹⁶ Finding that at the time the McKesson board approved the transaction the merger did not appear wasteful, the court held that the McKesson directors did not commit an act of waste.

* * *

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¹¹⁵ *Id.* at *23.

¹¹⁶ *Id.* at *26.

§15.02 BOARD FIDUCIARY DUTIES IN SALES AND MERGERS*

[A] No Fiduciary Duty to Sell the Company or Negotiate

A board of directors, as a general rule, has no fiduciary obligation to negotiate with a hostile bidder or to sell the company just because it has received a premium offer for all the company's shares.¹¹⁷ In Delaware, its special “*Revlon* duty” to seek the best available transaction arises only if the board has put the company up for sale or is proposing a transaction or business reorganization that would clearly break up the company.¹¹⁸ In essence, this duty is imposed if a company is sold for cash, for a non-voting security, or to a company controlled by one or more persons (but generally not in a combination for voting securities, except to a controlled company). Outside of those situations, it is now settled, at least in Delaware, that a target board has “the prerogative . . . to resist a third party’s unsolicited acquisition proposal or offer.”¹¹⁹

However, while the target board has the prerogative to resist unsolicited bids under Delaware law, the *Unocal* and *Revlon* doctrines may constrain the board’s defensive actions.¹²⁰ In a number of other states, state legislatures have amended their corporate laws expressly to reject those Delaware doctrines, giving target boards in those states more flexibility and discretion in protecting the company’s independence.¹²¹ Furthermore, common law rules in certain states have been interpreted to apply the ordinary business judgment rule, rather than some heightened standard, to board decisions in the merger and takeover context.¹²²

Finally, the fact that a director of the target approves a merger in which he or she will have the opportunity to serve as a director of the surviving corporation in itself does not ordinarily make the director self-interested in the merger transaction or raise a duty of loyalty issue.¹²³ As

* The authors acknowledge the assistance of Fried, Frank partner Phil Richter, associate Neil Rifkind and summer associate Shalini Aggarwal for the update of sections of Chapter 15 of the 2002 Supplement.

¹¹⁷ See generally §3.01[A][1] *supra* and *Takeover Defense* §3.02.

¹¹⁸ See §15.03 *infra*.

¹¹⁹ *Unitrin*, 651 A.2d at 1383 (Del. 1995), quoting *Paramount*, 637 A.2d at 43 n.13. See generally §3.01[A][1] *supra*. See also *Garland Inc.’s Profit Sharing Plan v. The Pillsbury Co.*, No. 88-17834 (4th Dist. Minn. Nov. 10, 1988) (court denied plaintiff’s motion to compel Pillsbury to negotiate with hostile bidder).

¹²⁰ See §3.01[A][1]-[3] *supra*.

¹²¹ For example, Pennsylvania (15 Pa. Cons. Stats. §511(e)), Maryland (Ann. Code of Md. Corps & Assns §2-405.1(f)) and Indiana (Ind. Code Ann. §23-1-35-1).

¹²² See, e.g., *Dynamics Corp. of America v. WHX Corp.*, 967 F. Supp. 59 (S.D.N.Y. 1997) (denying preliminary injunction to competing bidder, holding that under New York law, there is no heightened scrutiny for an independent target board’s antitakeover actions, and, alternatively, ruling that even under Delaware standards there was no fiduciary breach because the target board had approved the superior offer and had exercised due care in making its decision); *Minzer v. Keegan*, CV-97-4077 (CPS), 1997 U.S. Dist. LEXIS 16445, *32 (E.D.N.Y. Sept. 22, 1997) (ordinary business judgment rule applies to merger decision absent some showing of “fraud, illegality or self-dealing” under New York law), *aff’d*, 218 F.3d 144 (2d Cir. 2000), *cert. denied*, 531 U.S. 1192, 2001 U.S. LEXIS 1728 (Feb. 26, 2001).

¹²³ See, e.g., *Wittman v. Crooke*, 120 Md. App. at 375. Compare *Minzer*, 1997 U.S. Dist. LEXIS 16445, *30-34 (target board members’ 3-year appointment to \$24,000-per-year advisory board

the Delaware Chancery Court commented in one of the *Technicolor* decisions, under the language of the Delaware interested-director statute, “it is clear . . . that the alleged hope of better employment opportunities does not constitute the kind of interest covered.”¹²⁴

[B] Consideration of Merger Alternative to Hostile Bid

Just as a target board may maintain a policy of independence in the face of a premium bid, it may also properly pursue a strategic merger knowing a hostile suitor is in the wings or even after an uninvited bid has been proposed. Two questions often arise in this context. First, the board should consider whether to communicate with the interloper before agreeing to an alternative merger proposal. A related second question is whether the board can agree to negotiate exclusively with the prospective strategic merger partner.

1. Communications with Hostile Bidder

No Delaware precedent directly addresses whether there is a duty to communicate with an unsolicited suitor prior to signing a merger agreement with a strategic partner. However, the duty of care requires directors to gather all necessary information and to take adequate time to review that information in connection with any proposed transaction.¹²⁵ Furthermore, several cases suggest that the duty to be informed may include consideration of available alternatives.¹²⁶

On the other hand, Delaware law also recognizes that, where the alternatives are competing business combination transactions, there may be risks in exploring alternatives, and that boards, not courts, should decide whether the benefits of seeking information about alternatives outweigh the risks.¹²⁷ A decision whether to engage in further contacts with a hostile suitor is a matter of business judgment and should not, if the directors properly inform themselves in reaching their decision, be second-guessed by a court. The board’s exercise of its business

position in merger transaction made them self-interested for demand excusal purposes under New York law, but did not establish self-dealing in their approving merger necessary to overcome business judgment rule presumption).

¹²⁴ *Cinerama v. Technicolor, Inc.*, 663 A.2d 1134, 1154 (Del. Ch. 1994). See §3.01[A][1] *supra*.

¹²⁵ See generally *Takeover Defense* §3.03[A].

¹²⁶ See, e.g., *Phelps Dodge Corp. v. Cyprus Amax Minerals Corp.*, C.A. No. 17398, transcript at 4 (Del. Ch. Sept. 27, 1999) (a “target can refuse to negotiate” under the business judgment rule, but must “be informed when making such refusal”); *Braunschweiger v. American Home Shield Corp.*, C.A. No. 10755, slip op. at 17 (Del. Ch. Oct. 26, 1989) (directors must “take reasonable steps designed to assure that they have probed for alternatives and have a reasonable basis to conclude that the choice that they make is the best available alternative”); *City Capital Assocs. v. Interco, Inc.*, 551 A.2d 787, 802 (Del. Ch. 1988) (“The essence of rational choice is an assessment of costs and benefits and the consideration of alternatives.”).

¹²⁷ See, e.g., *Phelps Dodge*, Tr. at 6-7 (holding that the benefit of entering an injunction to permit gathering of more information was outweighed by the “risk to the transaction already on the table”); *In re RJR Nabisco, Inc.*, C.A. No. 10389, slip op. at 51-52 (Del. Ch. Jan. 31, 1989); accord, *TW Services Inc. v. SWT Acquisition Corp.*, No. 10427, slip op. at 33 (Del. Ch. Mar. 2, 1989) (upholding Board’s decision not to negotiate with the potential acquiror where the Board “has reason to believe it understands the range of prices [the acquiror] is talking about and to commence such talks in order to get more information would involve a heavy price in terms of the risks to its present strategy”).

judgment in determining whether to communicate with a hostile suitor will depend on the facts and circumstances as they appear at the time of the board's decision.

In this context, the board should evaluate whether the benefits of communicating with the bidder outweigh the risks. In assessing possible benefits, consideration may be given to the likelihood of the hostile bidder's increasing its bid in an amount that might affect the board's consideration of a proposed strategic merger or otherwise presenting information that would affect the choice of alternatives. As to possible risks, the board might consider whether communications with the hostile bidder may be kept confidential and cause other potential transaction partners to either cease discussions with the target or seek terms less favorable to the target. Other possible benefits and risks, as well as other possible factors in evaluating this question, may also be relevant for the board's consideration.

If the target board authorizes communications with the hostile bidder, the goal of any communication should be to gain the most helpful information possible while minimizing any risks that may result from the communication process. Various approaches are possible. At one end, the target's mission could be just to listen to the interloper. At the other end, the target might advise the unsolicited bidder that the target is considering its alternatives and request that the bidder advise the company, based on available public information, of the top price that it is willing to pay. That request would be designed to determine the bidder's best current price but avoid a request by the bidder for due diligence or negotiation, either of which could lead to further public disclosure and delay, jeopardizing the target's ability to pursue a strategic business combination.

2. Exclusive Negotiating Agreement with a Potential Merger Partner

A potential merger partner's request that the company negotiate exclusively with that suitor raises many of the same considerations as deciding whether to communicate with a hostile bidder. The benefits must be weighed against the risks. The board's determination should be upheld if the board satisfies its duty of care in approving the arrangement. The courts are likely to view the arrangement much like "no-shop" clauses, which are quite common in merger agreements and have been recognized as appropriate by the Delaware courts. *See* §15.05[A] *infra*.

[C] The *Revlon* Doctrine: Duties in a Sale or Breakup of the Company

In *Revlon*, the *Delaware* Supreme Court held that the company's board had breached its duty of loyalty to shareholders by taking measures to benefit one of two competing bidders who sought control of the target. The favored bidder was a leveraged buyout group, which initially included *Revlon*'s management. In its opinion, the court stated that, once the board determined to sell the company, the duty of the board changed from preserving the corporate entity to maximizing stockholder value. In short, according to the court, "the directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."¹²⁸ Commentators often refer to the shift of the board's role as entering the "*Revlon* mode" and the corresponding duties as the "*Revlon* duties."

The court enjoined both the lock-up and break-up fee provisions of a merger agreement between *Revlon* and a white knight (*Forstmann Little*), based on the court's finding that the

¹²⁸ *Revlon*, 506 A.2d at 182.

directors had impermissibly sacrificed the interests of shareholders for the benefit of the holders of Revlon notes issued in connection with a defensive self-tender, motivated in part by the directors' fear of legal liability to the noteholders for a steep decline in their market value. In addition, the court placed much emphasis on the fact that, unlike options that "draw bidders into battle," the option granted by Revlon ended an active auction, thereby foreclosing further bidding and not maximizing shareholder value.¹²⁹

Revlon alters the *Unocal* standard by which the actions of a target board in response to a hostile takeover attempt are judged. According to the Delaware Supreme Court, once the company is determined to be for sale, there is no threat to corporate policy and effectiveness resulting from a potential change of control and, consequently, "[t]he whole question of corporate defensive measures [becomes] moot."¹³⁰ Once the company is in a *Revlon* mode, the test of any defensive actions becomes whether they are a reasonable response designed to maximize shareholder value under the enhanced *Unocal* standard of review.¹³¹

As noted, the *Revlon* opinion involved a takeover context and a hostile suitor, where loyalty issues are more likely and give rise to heightened scrutiny. Nevertheless, the *Revlon* value-maximization principle applies whenever a company is sold. The board must exercise its fiduciary duties to obtain the best available transaction for the stockholders.

* * *

§15.03 WHEN DOES "REVLON MODE" GENERALLY OCCUR?

Where the target is facing a bid from an unsolicited third party, *Revlon* duties attach only when the company is "for sale." Thus, as long as the target is considering other alternatives, the *Revlon* duties do not come into play.

[A] When Is a Company "For Sale"?

In *Time-Warner*,¹³² the Supreme Court upheld the Chancellor's finding that the merger between Time and Warner Communications did not trigger *Revlon* duties because control of the company remained in the market after the transaction,¹³³ and explained the *Revlon* doctrine as follows:

Under Delaware law there are, generally speaking and *without excluding other possibilities*, two circumstances which may implicate *Revlon* duties. The first, and clear one, is when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear breakup of the company. . . . However, *Revlon* duties may also be triggered where in response to

¹²⁹ *Id.* at 182-84. See further discussion of lock-ups and other deal protection devices in §15.05 *infra*.

¹³⁰ *Id.* at 182.

¹³¹ See, e.g., *Gilbert v. The El Paso Co.*, 575 A.2d 1131 (Del. 1990) (once it was apparent that breakup of the company was inevitable, it was incumbent upon the El Paso board to seek the best transaction and maximum value reasonably attainable under the circumstances, subject to the board's continued duties of care and loyalty under *Unocal*). See also *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1989) ("*Macmillan III*").

¹³² *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1990) ("*Time-Warner*").

¹³³ *Paramount Communications Inc. v. Time Inc.*, Fed. Sec. L. Rep. (CCH) ¶94,514 (Del. Ch. 1989).

a bidder's offer, a target abandons its long term strategy and seeks an alternative transaction also involving the breakup of the company.¹³⁴

But *Time-Warner* left two important questions unanswered. First, did *Revlon* duties hinge on an abandonment of the corporation's continued existence? The Delaware Supreme Court seemed to suggest that a "clear breakup" of the company was required to invoke *Revlon*. And second, did the court abandon the Chancellor's change-of-control test, since it was not included in the above explanation?

In *Paramount Communications Inc. v. QVC Network Inc.* ("*Paramount*"),¹³⁵ the Delaware Supreme Court resolved both of these questions in the negative. More specifically, the court held:

[W]hen a corporation undertakes a transaction which will cause: (a) a change in corporate control; or (b) a breakup of the corporate entity, the director's obligation is to seek the best value reasonably available to the stockholders. . . . Neither *Time-Warner* nor any other decision of this Court holds that a "break-up" of the company is essential to give rise to this obligation where there is a sale of control.¹³⁶

Consequently, *Paramount* clarified the circumstances that trigger *Revlon*. *Revlon* obligations will adhere to any transaction in which corporate control passes to a third party, including (i) a sale or merger for cash or debt securities,¹³⁷ or (ii) a merger for securities—even a strategic merger—that transfers control to a private company or to a public company with a majority shareholder. *Revlon* obligations will also apply when a company determines to sell itself for cash through an active bidding process, or a transaction or business reorganization will cause a clear break-up of the company.

Conversely, *Revlon* duties should not apply to (i) the process of evaluating whether to accept an acquisition proposal; (ii) a situation in which a company with a strategic plan rejects an unsolicited offer; or (iii) a transaction that does not result in a transfer of control, such as a merger of equals or a common stock merger with a widely held public company.¹³⁸ Moreover, a target should be able to execute an agreement of sale without having shopped the company so long as (i) the agreement does not effectively preclude competition through "unreasonable" break-up fees or other contractual limitations, and (ii) the board determines, on the basis of an informed decision-making process, that it can maximize shareholder value without shopping the company.¹³⁹

¹³⁴ 571 A.2d at 1150 (emphasis added).

¹³⁵ 637 A.2d 34 (Del. 1994).

¹³⁶ *Id.* at 48 (emphasis in the original).

¹³⁷ The percentage of cash consideration that may be offered in a merger involving part stock and part cash before triggering *Revlon* duties has not been precisely defined. *See* §15.03[C][1] *infra*.

¹³⁸ *See* §15.03[C] *infra*.

¹³⁹ As the Delaware Supreme Court stated, "We express no opinion whether, certain aspects of the No-Shop Provision here could be valid in another context. Whether or not it could validly have operated here at an early stage solely to prevent Paramount from actively 'shopping' the

In *Wells Fargo*, Chancellor Allen observed that “board discussions with a number of other possible transaction partners” did not give rise to *Revlon* duties.¹⁴⁰ According to the then Chancellor, most courts would be slow to impose *Revlon* duties “except in limited circumstances.”¹⁴¹

However, a number of questions still remain. First, what constitutes a change of control? In *Paramount*, the Delaware Supreme Court held that a merger that divested Paramount’s public stockholders of their control over the surviving entity triggered the board’s *Revlon* duties.¹⁴² In that case, Sumner Redstone, the Chairman of Viacom, the acquiring company, would have obtained control of the surviving entity as a result of the proposed merger. Accordingly, the assumption should be that a transaction will implicate *Revlon* if one shareholder with say 40% or more of the voting stock, or a group of shareholders with 50% who have agreed to act in concert, have effective control of the surviving company.¹⁴³

In a merger providing both stock and cash consideration, how much cash may be offered before *Revlon* duties are triggered? As discussed in §15.03[C][1], in *Santa Fe* the Delaware Supreme Court allowed 33% cash without implicating *Revlon*, while, in *Lukens*, the Delaware Chancery Court expressed the view that over 60% cash consideration triggers *Revlon*.

Second, can structural devices designed to secure minority shareholder power and to limit majority shareholder power avoid the imposition of *Revlon* duties? And what sort of structural devices? In *Paramount*, the court seemed to suggest that protective devices such as supermajority voting provisions and majority-of-the-minority requirements could provide minority shareholders with adequate protection in a change-of-control transaction.¹⁴⁴ In addition, the court noted that it had already upheld the reasonableness of a standstill agreement that limited a 49.9% stockholder to 40% board representation in *Newmont Mining*.¹⁴⁵ Accordingly, a court might conclude that, under some circumstances, the use of protective devices that allow minority shareholders to retain control of the surviving company or protect the “back-end” would relieve the board of its *Revlon* obligations.

In *Newmont Mining*,¹⁴⁶ an open market purchase program by an existing 26% stockholder, Consolidated Gold Fields, conducted with the concurrence of the target that raised its ownership from 26% to 49.7%, was not held to constitute a change-in-control transaction that triggered *Revlon* duties. The amended standstill agreement restructured Gold Fields’ control of Newmont by (i) limiting Gold Fields’ representation on Newmont’s board to 40%; (ii) requiring Gold Fields to support the board’s slate of nominees for the remaining board positions; and (iii)

company, it could not prevent the Paramount directors from carrying out their duties in considering unsolicited bids or in negotiating for the best value reasonably available to the stockholders.” *Paramount*, 637 A.2d at 49 n.20.

¹⁴⁰ *Wells Fargo & Co. v. First Interstate Bancorp*, 1996 WL 32169, *4 (Del. Ch. 1996).

¹⁴¹ *Id.* at *4 n.3.

¹⁴² *Paramount* 637 A.2d at 42-43.

¹⁴³ See also *Endervelt v. The Nostalgia Network, Inc.*, C.A. No. 11415 (Del. Ch. 1991) (a pre-*Paramount* case holding that *Revlon*’s analytical framework did not apply to the acceptance by two director/shareholders of an offer in which they sold a block of stock that, in conjunction with stock purchased from a third party shareholder, gave a suitor control of the company).

¹⁴⁴ *Paramount*, 637 A.2d at 43 (“Paramount stockholders are entitled to receive, and should receive, a control premium and/or protective devices of significant value.”).

¹⁴⁵ *Id.* at 42, n.12, citing *Newmont Mining*, 535 A.2d 1334, 1343 (Del. 1987).

¹⁴⁶ *Ivanhoe Partners Newmont Mining Corp.*, 535 A.2d 1334 (Del. 1987), also discussed in §15.02[A] *supra* and *Takeover Defense* §3.02[C].

prohibiting Gold Fields from transferring its interest to any third party who refused to be bound by the standstill. The Delaware Supreme Court found that the Newmont board consistently demonstrated its intent to keep the company independent and that there was neither a bidding contest nor a sale. The fact that Newmont's declaration of the dividend facilitated Gold Fields' purchases was not deemed to constitute a "sale" of the company. Accordingly, the court found that the sale of Newmont was not "inevitable" so as to put Newmont into *Revlon* mode.

In *Tomczak v. Morton Thiokol, Inc.*,¹⁴⁷ the Delaware Chancery Court rejected a claim that Morton Thiokol's sale of a division triggered *Revlon* duties. The court observed that the sale did not constitute a sale of the company, or even most of the company, nor did it effect a business reorganization involving a clear break-up of the company. In fact, the court found, it was a profitable sale of a single division that was consistent with the company's long-term plans.

In *Buckhorn, Inc. v. Ropak Corp.*,¹⁴⁸ a federal court held that preliminary negotiations concerning the sale of the company or its crown jewel did not trigger *Revlon* duties. The court noted that the directors never authorized the sale of the company; had authorized the exploration of a variety of alternatives intended to enhance profitability including a sale of securities, self-tender, sale of assets, spin-off, business combination, or acquisition by Buckhorn of another company; and had never indicated any inevitable commitment to sell the company to anyone.

* * *

[C] Stock-for-Stock Mergers

[1] *Time-Warner* and Progeny: No *Revlon* Duties If No Sale of Control

In *Time-Warner*, the Delaware Supreme Court refused to block Time from completing its tender offer for Warner Communications and thereby defeat Paramount Communication's hostile bid for Time.¹⁴⁹ Originally, Time and Warner were to combine through a stock-for-stock merger that would have required Time stockholder approval. However, when Paramount launched its own unsolicited tender offer for Time, the transaction with Warner was restructured into a leveraged cash bid by Time for Warner shares, not requiring the approval of Time's shareholders.¹⁵⁰

Paramount argued that, by entering into the original merger agreement with Warner, Time's board had put the company up for sale and triggered the *Revlon* mode. In particular, Paramount pointed out that 62% of the shares of the combined entity that would have been outstanding immediately after the merger would have been held by former Warner shareholders.

¹⁴⁷ C.A. No. 7861 (Del. Ch. Apr. 5, 1990).

¹⁴⁸ 656 F. Supp. 209 (S.D. Ohio 1987), *aff'd by sum. ord.*, 815 F.2d 76 (8th Cir. 1987).

¹⁴⁹ *Time-Warner*, 571 A.2d 1140 (Del. 1990). For more detailed discussions of certain aspects of this case, see *Takeover Defense* §3.04[H].

¹⁵⁰ In contrast, in *Kansas City Power & Light Co. v. Western Resources, Inc.*, No. 96-0552-CV-W-5 Order (D. Kan. Aug. 2, 1986), as reported in *Corporate Control Alert*, Sept. 1996, at 8, a Kansas federal judge held that a restructured merger transaction required a two-thirds stockholder vote under Missouri law. The judge rejected the "doctrine of independent legal significance," as applied in Delaware, and, noting the importance of protecting shareholder rights, ruled that under Missouri law a revised merger agreement using a two-step transaction did not avoid Missouri's requirement that two-thirds of the outstanding shares approve a merger. *Id.*, Order at 8-16.

As discussed above in this section, the Delaware Supreme Court, in rejecting this argument, ruled that there were two instances, generally speaking, in which *Revlon* is implicated: first, “when a corporation initiates an active bidding process seeking to sell itself,” and second, when “in response to a bidder’s offer, a target abandons its long-term strategy and seeks an alternative transaction also involving a break-up of the company.” The court concluded that there was no *Revlon* issue created by the Time-Warner merger agreement, since no self-initiated bidding process or break-up was involved.¹⁵¹

In *In re Santa Fe Pacific Corporation Shareholder Litigation*,¹⁵² the Delaware Supreme Court rejected the stockholder plaintiffs’ argument that Santa Fe Corporation’s board had triggered *Revlon* by initiating an active bidding process. The ruling cleared up some confusion from the court’s earlier *Arnold v. Society for Savings Bancorp*,¹⁵³ which implied to some that an active bidding process in itself might trigger *Revlon*.

In *Santa Fe*, Santa Fe Corporation and Burlington had agreed to a friendly stock merger when Union Pacific commenced a hostile tender offer for Santa Fe. In the course of the ensuing “bidding” contest, Santa Fe adopted a host of defensive devices. Santa Fe’s stockholders eventually approved the merger between Santa Fe and Burlington, but a group of Santa Fe shareholders sued, alleging that the board breached its *Revlon* duties. The court noted that those duties were triggered by a board’s initiation of an “active bidding process only if the board seeks to sell itself [*i.e.*, to sell control] or to effect a business reorganization involving a clear break-up of the company.”¹⁵⁴ Since the stockholder plaintiffs’ complaint omitted any description of Burlington’s stock ownership structure, the court dismissed the *Revlon* claim because, without the description, the pleaded facts did not show that control of Burlington and Santa Fe after the merger would not remain “in a large, fluid, changeable and changing market.”¹⁵⁵

In *Santa Fe*, as part of the defense to Union Pacific’s hostile tender offer, the Santa Fe-Burlington merger agreement was amended to provide for a joint cash tender offer to purchase

¹⁵¹ The Delaware Chancery Court had rejected Paramount’s argument on narrower grounds, ruling that there had been no change of control triggering *Revlon* duties because Time’s board had not resolved to sell the company and was not disposing of anything, and, further, control both before and after the contemplated merger remained in a large and fluid market. *Paramount Communications Inc. v. Time Inc.*, Fed. Sec. L. Rep. (CCH) ¶94,514 (Del. Ch. July 17, 1989). The Supreme Court, while reaching the same conclusion, affirmed on broader grounds. Prior to the Delaware Supreme Court’s opinion in *Time-Warner*, a federal district court had reached a similar result in *Newell Co. v. Vermont American Corporation*, 725 F. Supp. 351 (N.D. Ill. 1989). The court held that, absent the “exceptional case” where the corporation is in a “*Revlon* mode,” directors of a target company “may in good faith and on an informed basis pursue long-term interests at the expense of immediate value maximization.” Here, in response to a partial offer for 10% of the shares of Vermont by Newell (which already owned 11%), Vermont engaged in a restructuring that included a stock repurchase program, restructuring of a current acquisition to ensure greater voting control and lowering the trigger on its poison pill for 120 days while a possible sale of the company was explored. Ultimately, Vermont agreed to be acquired by a third party. The court emphasized that Vermont’s basic business philosophy was sufficiently threatened by Newell that, under *Unocal*, its defensive response was justified. For a more detailed discussion, see *Takeover Defense* §3.02[E].

¹⁵² 669 A.2d 59 (1995).

¹⁵³ 650 A.2d 1270 (1994).

¹⁵⁴ *Santa Fe*, 669 A.2d at 71, quoting *Time-Warner*, 571 A.2d at 1150.

¹⁵⁵ *Id.* at 71, quoting *Society for Savings Bancorp*, 650 A.2d at 1290.

33% of Santa Fe’s outstanding shares for cash. Without commenting on this fact, the court observed that: “Plaintiffs do not allege that the [Santa Fe] Board at any point decided to pursue a transaction which would result in a sale of control. . . . Rather, the complaint portrays the Board as firmly committed to a stock-for-stock merger with Burlington.”¹⁵⁶ Following *Santa Fe*, in *Wells Fargo & Co. v. First Interstate Bancorp*,¹⁵⁷ the Delaware Chancery Court reiterated that a stock-for-stock merger without the sale of control does not trigger *Revlon*.

In the earlier *Society for Savings Bancorp* case, the Delaware Supreme Court affirmed the Chancery Court’s holding that “enhanced duties” under *Revlon* were not implicated by the stock-for-stock merger at issue, noting that there is no sale or change in control when control of the merged companies remains in a “large, fluid, changeable and changing market.”¹⁵⁸ The court rejected plaintiff’s argument that Society for Savings Bancorp was “seeking to sell itself,” because there was no change in control, as there had been in *Paramount*, and Bancorp had not “initiate[d] an active bidding process.”¹⁵⁹

In *In re Lukens Inc. Shareholders Litigation*,¹⁶⁰ the Delaware Chancery Court dismissed a complaint alleging fiduciary breaches by Lukens’ directors in the sale of the company to Bethlehem Steel. In the merger, Lukens shareholders could elect to receive cash for up to 62% of the total merger consideration and the balance in Bethlehem stock. The director defendants argued that, because over 30% of the merger consideration constituted common stock, *Revlon* did not apply. The court held that the complaint was subject to dismissal, even assuming *Revlon* applied, but disagreed with defendants’ inapplicability argument. The court noted that “for a substantial majority of the current shareholders, ‘there is no long run.’”¹⁶¹ The court found *Santa Fe* to be distinguishable because, although the Delaware Supreme Court “has not set out a black-line rule,” *Santa Fe* does not control “a situation in which over 60% of the consideration is cash.”¹⁶²

[2] *QVC v. Paramount*: Control Shift Triggers *Revlon* in Strategic Merger

In *Paramount*, QVC sought an order enjoining the use of defensive measures—including a no-shop provision, a termination fee, and a stock purchase option—approved by the Paramount board and designed to facilitate a merger between Viacom and Paramount.¹⁶³ The Paramount board argued that a strategic merger in which Paramount shares were exchanged largely for stock in an ongoing enterprise did not trigger the *Revlon* mode. Accordingly, the directors contended that (i) they were not required to abandon their long-term merger strategy in order to attempt to

¹⁵⁶ *Santa Fe*, 669 A.2d at 64, 71. The Chancery Court had declined to apply *Revlon* duties on these facts. See *In re Santa Fe Pacific Corp.*, C.A. No. 13587 (Del. Ch. May 31, 1995).

¹⁵⁷ 1996 Del. Ch. Lexis 3 (Del. Ch. 1996).

¹⁵⁸ *Arnold*, 650 A.2d at 1290, quoting *Paramount*, 637 A.2d at 47.

¹⁵⁹ *Id.* at 1290, quoting *Time-Warner*, 571 A.2d at 1150. In 1994, American Oil & Gas (AOG) accepted a stock-for-stock merger offer from KN Energy that facially provided less value than a competing stock-for-stock proposal by Parker & Parsley Petroleum. The AOG proxy statement explained the AOG board’s rationale, which was supported by its largest shareholder, which held 35% of its stock, and its legal counsel’s advice that it did not have to sell to the highest bidder if it merged with a strategic partner and there was no change of control.

¹⁶⁰ 757 A.2d 720 (Del. Ch. 1999).

¹⁶¹ *Id.* at 732 n. 25 (quoting *TW Servs., Inc. v. SWT Acquisition Corp.*, No. 10427, 1989 Del. Ch. LEXIS 19, *22 (Del. Ch. Mar. 2, 1989)).

¹⁶² *Id.*

¹⁶³ *QVC Network, Inc. v. Paramount Communications Inc.*, 635 A.2d 1245, 1246 (Del. Ch. 1993).

maximize short-term shareholder value, and (ii) their decisions to recommend the Viacom merger and to retain the defensive measures constituted protected exercises of business judgment.

The Delaware Supreme Court affirmed the Chancery Court decision preliminarily enjoining the defensive measures. As noted above, the court held that a transaction that causes “a change in corporate control or a breakup of the corporate entity” triggers the director’s obligation to seek the best value reasonably available to stockholders.¹⁶⁴ Applying the enhanced judicial scrutiny of *Unocal*, *Revlon*, and their progeny, the court concluded that “the Paramount’s directors’ process was not reasonable, and the result achieved for the stockholders was not reasonable under the circumstances.”¹⁶⁵

* * *

[F] Effect of Shareholder Approval of a Merger on *Revlon* and *Unocal* Claims

There was reason to infer from certain Delaware court rulings that a fully informed shareholder vote in favor of a merger or a sale of control might operate as a complete defense to claims under *Revlon*. Those rulings cited the general principle that, except in cases where a challenged transaction allegedly involves a waste of assets or fraud or is *ultra vires*, valid shareholder approval ratifies the board’s actions in recommending the transaction and obviates a claim that the transaction was the product of gross negligence.¹⁶⁶

However, in *Santa Fe*, which involved the stock-for-stock merger of Santa Fe and Burlington Northern discussed above, the Delaware Supreme Court held that *Revlon* claims challenging unilateral board action were not extinguished by a fully informed stockholder vote approving the challenged merger: “Permitting the vote of a majority on a merger to remove from judicial scrutiny unilateral Board action in a contest for corporate control would frustrate the purposes underlying *Revlon*. . . .”¹⁶⁷ The ramifications of that ruling remain unclear. The court in *Santa Fe* never assessed the alleged *Revlon* claims, holding that the stockholder plaintiffs had failed to allege a sale of control and, therefore, no *Revlon* claim had been properly pleaded.¹⁶⁸

Santa Fe also held that shareholder approval of an alternative transaction to a hostile bid does not ratify a board’s use of defensive measures in response to the hostile bid, unless the shareholders specifically ratify the defenses.¹⁶⁹ The court reversed the Chancery Court and applied enhanced scrutiny to the Santa Fe board’s decision to employ defensive measures, even though Santa Fe’s shareholders had approved the merger.

¹⁶⁴ *Paramount*, 637 A.2d at 48; see also the general discussion at the beginning of this section.

¹⁶⁵ *Paramount*, 637 A.2d at 49.

¹⁶⁶ See *Geier*, 371 A.2d at 1380 (expressly not deciding whether a duty of loyalty claim may be extinguished by a stockholder vote, *id.* at 1378); *Wheelabrator II*, 663 A.2d 1200-02 and the cases cited therein. See generally §3.01[A][4] *supra*.

¹⁶⁷ See *In re Santa Fe Pacific Corp. Sh. Lit.*, 669 A.2d 59, 68 (Del. 1995).

¹⁶⁸ *Id.* at 71.

¹⁶⁹ *Id.* at 68.

Of course, valid shareholder ratification requires dissemination of a proxy statement that affords full and fair disclosure of all material information pertinent to the transaction.¹⁷⁰ In *Santa Fe*, the Delaware Supreme Court affirmed dismissal of the plaintiff shareholders' disclosure claims. The court held that Santa Fe's proxy statement adequately disclosed the likelihood of regulatory approval of a proposed merger, the substance of the merger negotiations, and earlier efforts by Santa Fe to merge with or acquire another company.¹⁷¹

In *Solomon v. Armstrong*, relating to GM's split-off of EDS, Chancellor Chandler analyzed the effect of shareholder ratification on duty of loyalty claims in various contexts. In the course of that analysis, the court observed that "shareholder ratification can have a penetrating legal effect . . . [in] situations where shareholder approval is sought (e.g., approval of a merger) and where there is *no* controlling shareholder, control group, or dominating force that can compel a particular result. Absent any other allegations that might cast doubt on the board's disinterest vis-à-vis the merits of the transaction, an informed and uncoerced shareholder vote on the matter provides an independent reason to maintain business judgment protection for the board's acts."¹⁷²

In *Wheelabrator II*, the plaintiff shareholders challenged the completed merger between Wheelabrator and Waste Management.¹⁷³ The court again rejected their disclosure claim, finding that "the proxy disclosures are fully consistent with the record facts."¹⁷⁴ However, the Chancery Court determined that plaintiffs' duty of loyalty claim was not extinguished by the fully informed stockholder vote on the merger.¹⁷⁵ The effect of that vote, the court held, "is to invoke the business judgment standard, which limits review to issues of gift or waste with the burden of proof resting upon the plaintiffs," a question which had not yet been addressed by the parties.¹⁷⁶

¹⁷⁰ As the Delaware Supreme Court stated in *Santa Fe*, the materiality standard requires that directors disclose all facts that, "under all the circumstances, . . . would have assumed actual significance in the deliberations of the reasonable shareholder." See, e.g., *id.* at 66, quoting *Arnold v. Society for Savings Bancorp, Inc.*, 650 A.2d 1270, 1277 (Del. 1994) (holding that, in view of the extensive background description of the proposed merger, proxy statement's failure to disclose prior conditional higher bid was material, but declining to decide whether or not there was a remedy against corporate defendants, the merger having been consummated); see *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. Supr. 1985) (holding that directors have a fiduciary duty to shareholders to disclose all material facts pertaining to stockholder votes on proposed mergers).

¹⁷¹ See *Santa Fe*, 669 A.2d at 66-67; see also *Rand v. Western AirLines, Inc.*, C.A. No. 8632-NC (Del. Ch. Feb. 25, 1994) (rejecting disclosure claims that board failed to disclose earlier higher "offer" and alleged investment banker "valuation" that exceeded merger price).

¹⁷² *Solomon v. Armstrong*, 747 A.2d 1098, 1117 (Del. Ch. 1999) (holding fully informed, non-coerced shareholder vote required rejection of duty of loyalty challenge to General Motors' split-off of its EDS subsidiary), *aff'd on opinion below*, 746 A.2d 277 (Del. 2000). See also *Wittman v. Crooke*, 120 Md. App. 369, 377-378, 707 A.2d 422 (Md. Ct. Sp. App. 1998) (holding that shareholder ratification extinguishes duty of loyalty claim under Maryland law). See generally §3.01[A][6] *supra*.

¹⁷³ 663 A.2d 1194 (Del. Ch. 1995).

¹⁷⁴ *Id.* at 1199.

¹⁷⁵ *Id.* at 1200-05.

¹⁷⁶ *Id.* at 1200. See also *Lewis v. Austen*, C.A. No. 12937 (Del. Ch. June 2, 1999).

§15.04 CONSEQUENCES OF THE “REVLON MODE”

[A] Overview of the “Revlon Duties”

Once a company has entered the “Revlon” mode, the board’s “bedrock” fiduciary duty is to maximize current share value through pursuit of the best transaction reasonably available for the shareholders.¹⁷⁷ At the same time, the Delaware Supreme Court has observed that “Revlon neither creates a new type of fiduciary duty in the sale-of-control context nor alters the nature of the fiduciary duties that generally apply. Rather, *Revlon* emphasizes that the board must perform its fiduciary duties in the service of a specific objective: maximizing the sale price of the enterprise.”¹⁷⁸ The case law discussed below in this section clearly establishes three important general principles in relation to the fulfillment of the board’s “Revlon duties.”

- Although there is “no single blueprint” for carrying out those duties,¹⁷⁹ some meaningful market check procedure, which may be responsive, is generally advisable to assure that the sale price represents the highest value reasonably obtainable under the circumstances. While the Delaware Supreme Court, in *Revlon*, used the “auctioneer” analogy, the court subsequently ruled, in *Macmillan III*, that the board still has the right and obligation to exercise its best business judgment in deciding from among a “panoply of devices” how to maximize immediate stockholder value.¹⁸⁰ An auction in the conventional (or “Sotheby’s”) sense—with all interested bidders being given an equal one-time opportunity to submit their highest bids—is one method but it is not the required method.¹⁸¹

¹⁷⁷ See *Macmillan III*, 559 A.2d at 1288, discussed in *Takeover Defense* §3.05[E]; *Revlon*, 506 A.2d at 182. Many states have rejected or at least modified Delaware’s imposition of this *Revlon* duty. More than half the states now have statutes which permit, or, in a few instances, require, a board to consider non-stockholder interests, either in connection with all actions taken by the board or specifically in connection with actions taken in a change-of-control context. In Delaware, which has not enacted such a statute, stockholder-approved charter provisions may give a board an equivalent mandate, but the relationship between such a provision and the board’s *Revlon* duties has not been passed upon by the courts.

¹⁷⁸ *Malpiede v. Townson*, 780 A.2d 1075 (Del. Aug. 27, 2001) (*en banc*) (affirming dismissal of complaint challenging merger of Frederick’s of Hollywood into Knightsbridge Capital Corporation).

¹⁷⁹ *Paramount*, 637 A.2d at 44 (citing cases).

¹⁸⁰ *Macmillan III*, 559 A.2d at 1288.

¹⁸¹ See also *Glenn Freedman v. Restaurant Associates Indus., Inc.*, C.A. No. 9212 (Del. Ch. 1990) (“Although a board of directors may fulfill its obligation to make an informed and reasonable business judgment in a sale context by conducting an auction sale, . . . an auction is not always

- The board’s obligation is not to seek out the hypothetically ideal transaction but, rather, the best price and other terms reasonably available under the circumstances. *Macmillan III* made it clear that, in the exercise of its business judgment, the board is entitled and required to evaluate all aspects of a bid, including its likelihood of consummation and anticipated timetable, in deciding whether it satisfies this test.¹⁸² Moreover, *Technicolor* underscores the primacy of the board’s obligation to ensure that its decision-making process is informed by all material information reasonably available.¹⁸³
- Within the realm of business judgment, there may be circumstances where the goal of achieving the best available transaction can most effectively be achieved by favoring one bidder over another rather than permitting all bidders a one-time opportunity to put their best offer on the table. However, if disparate treatment is afforded in a context where the *Unocal* tests have been triggered—*i.e.*, where the company has entered the *Revlon* mode in response to a hostile takeover attempt—then, under *Paramount* and *Macmillan III*, a modified version of *Unocal*’s proportionality test will require the company’s board to bear the burden of establishing that the nature and extent of the disparate treatment was proportional to the benefit reasonably expected to flow to the stockholders in terms of the “bedrock” goal of maximizing the immediate value of their shares.¹⁸⁴

In *Amsted*,¹⁸⁵ the Delaware Supreme Court commented on the *Revlon* duties as follows:

[T]here is no single blueprint that a board must follow to fulfill its duties. A stereotypical approach to the sale and acquisition of corporate control is not to be expected in the face of the evolving techniques and financing devices employed

necessary.”); *Herd v. Major Realty Corp.*, C.A. No. 10707 (Del. Ch. 1990) (“*Revlon* certainly does not . . . require that every change of control of a Delaware corporation be preceded by a heated bidding contest, some type of market check or any other prescribed format.”).

¹⁸² *Macmillan III*, 559 A.2d at 1288.

¹⁸³ *Cede & Co. v. Technicolor, Inc.*, Fed. Sec. L. Rep. (CCH) ¶97,811 (Del. 1993), *rev’g* C.A. No. 8358 (Del. Ch. 1991).

¹⁸⁴ *See Paramount*, 637 A.2d at 45; *Macmillan III*, 559 A.2d at 1288. *See also, e.g., Golden Cycle, LLC v. Allan*, C.A. No. 16301 (Del. Ch. Dec. 10, 1998) (opinion denying preliminary injunction), and the cases cited therein.

¹⁸⁵ *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279 (Del. 1989).

in today's corporate environment. . . . Rather, a board's actions must be evaluated in light of relevant circumstances to determine if they were undertaken with due diligence and in good faith. If no breach of duty is found, the board's actions are entitled to the protections of the business judgment rule. . . .

. . . . When it becomes clear that the auction will result in a change of corporate control, the board must act in a neutral manner to encourage the highest possible price for shareholders. . . . However, *Revlon* does not demand that every change in control of a Delaware corporation be preceded by a heated bidding contest. . . . When multiple bidders are competing for control, this concern for fairness forbids directors from using defensive mechanisms to thwart an auction or to favor one bidder over another. . . . When the board is considering a single offer and has no reliable grounds upon which to judge its adequacy, this concern for fairness demands a canvas of the market to determine if higher bids may be elicited. . . . When, however, the directors possess a body of reliable evidence with which to evaluate the fairness of a transaction, they may approve that transaction without conducting an active survey of the market. As the Chancellor recognized, the circumstances in which this passive approach is acceptable are limited. "A decent respect for reality forces one to admit that . . . advice [of an investment banker] is frequently a pale substitute for the dependable information that a canvas of the relevant market can provide." . . . The need for adequate information is central to the enlightened evaluation of a transaction that a board must make. Nevertheless, there is no single method that a board must employ to acquire such information. Here, the Chancellor found that the advice of the Special Committee's investment bankers, when coupled with the special circumstances surrounding the negotiation and consummation of the MBO, supported a finding that Amsted's directors had acted in good faith to arrange the best possible transaction for shareholders. Our own review of the record leads us to rule that the Chancellor's finding was well within the scope of his discretion.¹⁸⁶

In *Paramount*, the Delaware Supreme Court gave *Revlon* duties the following gloss:

[A] court applying enhanced judicial scrutiny should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.¹⁸⁷

In summarizing the nature of the enhanced judicial review contemplated by *Paramount*, Vice Chancellor Strine has explained:

¹⁸⁶ *Id.* at 16-17. *Accord, Golden Cycle, LLC v. Allan*, C.A. No. 16301, slip op. at 25 (Del. Ch. May 20, 1998) ("no single blueprint," quoting *Amsted*).

¹⁸⁷ *Paramount*, 637 A.2d at 45.

The sale of control context also invokes a specific form of enhanced judicial review that involves two “key features”:

- “(a) a judicial determination regarding the adequacy of the decision making process employed by the directors, including the information on which the directors based their decision; and
- (b) a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing. The directors have the burden of proving that they were adequately informed and acted reasonably.”¹⁸⁸

[B] No Duty to Shop

In *Fairchild Camera*,¹⁸⁹ plaintiffs’ basic allegation was that the directors violated their fiduciary duties of good faith and due care in failing to conduct an auction of the company and to maximize the price to be received by shareholders. In response to a proposed tender offer by Gould, Fairchild, through its financial advisors, contacted potential third party bidders. Ultimately, only one of the numerous companies contacted, Schlumberger, made a competing bid. Fairchild and Schlumberger thereafter entered into a merger agreement, and Gould subsequently withdrew its proposal.

The Delaware Supreme Court affirmed the finding of the Delaware Chancery Court that the board acted disinterestedly, independently, and in good faith throughout the negotiations.¹⁹⁰ The Chancery Court had looked beyond the conventional indicia to an *ad hoc* determination of the board’s motives. To this effect, the Chancery Court stated that “[a]s in other contexts, however, this inquiry into a subjective state of mind necessarily will require inferences to be drawn from overt conduct—the quality of the decision made being one notable possible source of such an influence.”¹⁹¹

Under a conventional analysis of the board’s good faith, the Chancery Court concluded that the board was properly motivated and that it acted in good faith. The board was structurally independent, having no personal financial interest in whether one

¹⁸⁸ *In re Pennaco Energy, Inc. Sh. Litig.*, 2001 WL 115341, *11, 2001 Del. Ch. LEXIS 19 (Del. Ch. Feb. 5, 2001) (quoting *Paramount*, 637 A.2d at 45). See also *Malpiede*, 780 A.2d at 1090-96 (affirming grant of motion to dismiss *Revlon* claim for failure to plead bad faith or disloyalty, because allegations only raised a due care claim that was subject to the target corporation’s §102(b)(7) exculpatory charter provision); accord *In re Lukens Inc. Sh. Litig.*, 757 A.2d 720, 732-34 (Del. Ch. 1999), *aff’d sub nom.*, *Walker v. Lukens, Inc.*, 757 A.2d 1278 (Del. 2000)(Order). On 8 Del. Code §102(b)(7), see *Takeover Defense* §3.06[A][1].

¹⁸⁹ *Citron v. Fairchild Camera and Instrument Corp.*, 569 A.2d 53 (Del. 1989).

¹⁹⁰ In *Kahn v. Caporella*, C.A. No. 13248 (Del. Ch. Mar. 10, 1994), the court, citing *Fairchild Camera*, criticized the defendant directors for failing to take an “active and direct role” in the sale process, but denied a requested preliminary injunction on the ground that the challenged merger would likely be upheld as entirely fair and the injunction, which might cause withdrawal of the merger partner, could harm the shareholders.

¹⁹¹ *Citron v. Fairchild Camera and Instrument Corp.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,915 at 90,102 (Del. Ch. 1988).

or the other bidder prevailed. Yet, to complete its analysis, the Chancery Court conceded that, “[t]here may be instances in which an apparently disinterested board makes a judgment that is essentially inexplicable on the basis of an otherwise unproven inappropriate motive—such as personal favoritism or antipathy.”¹⁹²

The Chancery Court further stated that “the plaintiff is certainly incorrect to assert that the case recognized a duty on the part of directors when a corporation is “For Sale,” to get the highest available price. Rather, the duty can only be to try in good faith, in such a setting, to get the best available transaction for the shareholders. Directors are not insurers.”¹⁹³

In *Federated*,¹⁹⁴ a federal district court held that the board had an obligation to conduct an auction in a manner that would maximize the benefit to the shareholders once the corporation became the target of competing takeover bids and the board determined that the corporation was to be sold. *Federated* was clearly in a *Revlon* mode, having responded to CRTF’s unsolicited bid by entering into a definitive merger agreement with Macy’s providing for a transaction it considered superior.

The court outlined the directors’ basic fiduciary duties of loyalty and of due care under Delaware law, citing *Revlon*. The court noted that, in an auction situation, the directors’ duties are changed only in the respect that they are charged with the duty of selling the company at the highest price obtainable for the stockholders’ benefit, and that *Revlon* “must be read to emphasize the goal of the ‘best price available’ rather than the means of ‘market forces’” used to achieve that price.¹⁹⁵

* * *

§15.05 DEAL PROTECTION

The need to “protect” a deal, driven by the desire for certainty of consummation, is an important consideration when negotiating a transaction. Buyers do not want to serve as “stalking horses” for a better deal, nor do they want to expend time and effort without an assured outcome, while sellers’ motivations may be somewhat more complex.¹⁹⁶ Sellers may want to preserve the maximum amount of flexibility to consider alternative

¹⁹² *Id.*

¹⁹³ *Id.* at 90,102-90,103, fn. 17. The Delaware Chancery Court has also recognized in other cases that the highest bid is not necessarily the best bid. *See, e.g., Caruana v. Seligman*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,889 (Del. Ch. 1990) (Board did not commit corporate waste by selecting 7% lower bid, especially since non-monetary factors such as timing, structure, and certainty of financing could have accounted for the board’s acceptance of the lower offer.).

¹⁹⁴ *CRTF Corp. v. Federated Department Stores, Inc.*, 683 F. Supp. 422 (S.D.N.Y. 1988).

¹⁹⁵ *Id.* at 441.

¹⁹⁶ *See Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 942 (Del. 2003) (“NCS”) (dissenting opinion) (lockups permit exchange of certainties that may lead to higher price and avoid perception that target of failed transaction is damaged goods) (citing *Rand v. Western Air Lines*, 1994 WL 89006 at *6 (Del. Ch.), *aff’d* 659 A.2d 228 (Del. 1995)).

transactions, in order to satisfy *Revlon* duties or preserve their ability to obtain a more favorable deal, or they may want to avoid being put “in play” and forced into an unwanted transaction. A company’s ability to enter into a transaction, particularly a strategic transaction, and not be put “in play,” has been recognized by the courts as one of the primary bases for deal protections.¹⁹⁷

This need for deal protection has resulted in the development of a number of features intended to deter third parties from disrupting a deal and, in the event disruption occurs, to compensate the jilted party. Among the most common deal protection alternatives are: (i) a no-shop clause, which limits the ability of a seller to solicit competing bids—an almost universal feature of merger agreements; (ii) a no-talk provision, which restricts the target’s ability to discuss a bid with, or provide information to, a third party; (iii) break-up fees, which provide that, if a transaction is terminated and the target enters into a combination agreement with a third party, the seller will pay a fee to the initial buyer, usually in the range of 1 to 4 percent of the equity value of the transaction, depending upon the size of the transaction, the circumstances under which the agreement is executed—whether at the beginning or end of a process, the nature of the consideration (cash or stock), and the terms and conditions of the agreement, including how committed the buyer is; (iv) stock options, which provide that either the seller, or in some instances, both parties, grant an option to the acquiror or the other party to purchase, a specified percentage of grantor’s common stock, an alternative that has become increasingly rare with the demise of pooling of interests accounting treatment; (v) a requirement that the transaction be presented for target stockholder approval, regardless of whether the board of the target has changed its recommendation; and (vi) clauses designed to “lock-out” competitive bidders, precluding the target from entering into or agreeing to another transaction for a specified period of time.¹⁹⁸ These alternatives, which themselves come with almost infinite variation, do not exhaust the possibilities. The variations are potentially boundless, limited, in the first instance, by the creativity of M&A lawyers and investment bankers and, in the second and, ultimately, determinative instance, by the courts and state legislatures.

¹⁹⁷ See *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1151 (Del. 1990) (holding that board’s desire not to be put “in play” as both reasonable and capable of being protected by enforceable contract terms). The basic facts of *Time-Warner*, the announcement of a transaction between parties intent on a strategic combination that triggers the attentions of unwanted suitor(s), are repeated with seemingly increasing frequency. See generally Robert Spatt, “The Four Ring Circus—Round Five; a Further Updated View of the Mating Dance Among Announced Merger Partners and an Unsolicited Second or Third Bidder,” Thirteenth Tulane Corporate Law Institute, March 2001 (providing a sophisticated catalogue of topping bids and deal jumping).

¹⁹⁸ “Crown jewel” lock-ups granting the acquiror an option on “key” target assets have fallen out of favor in recent years for various reasons, including valuation difficulties. See John C. Coates IV and Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 *Stan. L. Rev.* 307, 315-96 (2000) (concluding, based upon review of M&A lockups over the preceding twelve years, that “[a]sset lockups never popular in the period [1988-2000], fell from the picture by the mid-1990’s”).

The case law governing deal protection is in an important state of evolution and key perceived distinctions, such as between cash and stock-for-stock transactions, for example, are narrowing. Originally, *Revlon* and its progeny set the guidelines on acceptable contractual restraints and the law outside *Revlon* was murky and, in the view of certain practitioners, substantially more permissive. This distinction is eroding in key respects in Delaware, which is undergoing an intensive self-examination process.¹⁹⁹

It is clear that in a *Revlon* transaction a board cannot accede to deal protection measures that would lock up a deal (even a deal with great long-term potential) if these measures would make it impossible to accept a higher current value bid from another party. A lock-up in this sense would encompass the issuance by the target of over 50% of its voting securities to the acquiror or an undertaking by the target not to consider any other merger proposals for an extended period, say, eighteen months.

After the decision in *Omnicare, Inc. v. NCS Healthcare, Inc.* (“NCS”), it is also clear that a strategic, stock-for-stock transaction not subject to *Revlon* may not be **completely** protected by the actions of the target board itself,²⁰⁰ but it remains unclear what degree of protection it may be given.²⁰¹ However, we believe that the views of Vice Chancellor Strine, expressed prior to NCS, continue to have force: “[A] well-informed board may give significant and enforceable bidding advantage to its preferred merger partners in a non-*Revlon* stock-for-stock merger agreement.”²⁰² At the same time, under NCS, directors have a continuing obligation to discharge their fiduciary duties as future circumstances develop and cannot contract away their exercise of fiduciary obligations in the future.²⁰³ In addition, board approval of deal protection devices will be evaluated under the stricter *Unocal* standard rather than an ordinary business judgment analysis.²⁰⁴ It should be

¹⁹⁹ See *Function Over Form*, 56 Bus. Law. 1287 (2001); Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 Bus. Law. 919 (2001).

²⁰⁰ See NCS, 818 A.2d at 938 (“The directors of a Delaware corporation have a continuing obligation to discharge their fiduciary responsibilities, as future circumstances develop, after a merger agreement is announced. Genesis anticipated the likelihood of a superior offer after its merger agreement was announced and demanded defensive measures from the NCS board that *completely* protected its transaction. [Footnote omitted.] Instead of agreeing to the absolute defense of the Genesis merger from a superior offer, however, the NCS board was required to negotiate a fiduciary out clause to protect the NCS stockholders if the Genesis transaction became an inferior offer.” (emphasis in original)).

²⁰¹ NCS, 818 A.2d at 946 (dissenting opinion) (dissent expressing hope that majority opinion will be interpreted narrowly and its holding limited to unique facts).

²⁰² Strine, *supra* note 83, at 940. See also NCS, 818 A.2d at 938 (“Any board has authority to give the proponent of a recommended merger agreement reasonable structural and economic defenses, incentives, and fair compensation if the transaction is not completed. To the extent that defensive measures are economic and reasonable, they may become an increased cost to the proponent of any subsequent transaction. Just as defensive measures cannot be draconian, however, they cannot limit or circumscribe the directors’ fiduciary duties.”).

²⁰³ NCS, 818 A.2d at 938.

²⁰⁴ NCS, 818 A.2d at 933 (holding that board’s decision to protect its decision to enter a merger agreement that will not result in a change in control with defensive devices against uninvited

emphasized that other states have deviated from the Delaware pattern, and the law of the governing state must be consulted.

As discussed in Section 15.05[A][3][b] *infra*, in the case of a corporation having a controlling stockholder or group, a buyer can assure itself of the acquisition of control by purchasing more than a 50% interest from that person or group. The lock-up issues in that situation arise in connection with dealing with the target's board, such as the negotiation of the related merger agreement.

Most critically, each deal protection feature cannot be analyzed in a vacuum and must be considered as part of the mix of the totality of the circumstances surrounding a transaction: What is the impact of the overall package of deal protection features?²⁰⁵ Has the company been shopped, or is it just beginning negotiations; *viz.*, is it at the beginning or end of a process? Does the transaction involve cash, stock, or a mixture of the two? What are the business reasons for the transaction?

A combination of factors has led to increased scrutiny of these deal protection features. Moreover, and as noted, the surrounding jurisprudence has moved into a stage of rapid evolution. Accordingly—as with all facets of the acquisition process—careful attention must be paid so that any agreement that restricts or limits a seller from entertaining a competing transaction is the product of fully informed and well reasoned board deliberations.²⁰⁶ Indeed, fashions change in response to case law and other developments. Thus, in the late 1990s, numerous deals had no fiduciary termination rights, and several had no fiduciary exception to the general no-talk prohibitions. The former continues to be the case with a trend towards the right to terminate; the latter is a decided exception.

[A] No-Shop/No-Talk Clauses

No-shop/no-talk clauses are contractual forbearances which provide that (i) the target will not “shop” for, or solicit, alternative transactions; and (ii) the target will not engage in discussions with, negotiate with, or provide confidential information to, potential

competing transactions that may emerge is subject to *Unocal's* enhanced judicial scrutiny standard).

²⁰⁵ See *NCS*, 818 A.2d at 939 (“In this case, the NCS board combined those two otherwise valid actions and caused them to operate in concert as an absolute lock up, in the absence of an effective fiduciary out clause in the Genesis merger agreement.”).

²⁰⁶ In the views of a recent commentary, the process followed by a target's board in approving a particular deal protection profile may determine whether deal protection features are upheld. See generally Gregory V. Varallo & Srinivas M. Raju, *A Process Based Model for Analyzing Deal Protection Measures*, 55 *Bus. Law.* 1609 (2000) (noting that in recent decisions “[t]he deal protections that had been adopted after a careful and thorough process by directors fared quite differently than when the process followed had been less than rigorous”). “Bidders, too, must understand the need for process: a lock-up shoved down the throats of an unwilling target board will certainly mean ugly depositions in an expensive shareholder lawsuit, and may well mean that the lock-up will be enjoined—and thus worth exactly what the bidder paid for it.” Coates and Subramanian, *supra* note 82, at 388.

interlopers. No-shop provisions are fundamental and unqualified; their appearance in acquisition or combination agreements is almost universal. In rare instances, a target may insist on reserving the right to seek out other bidders, usually for a limited period of time after the execution of the agreement. This latitude is generally allowed in transactions subject to *Revlon* where the target had not been shopped prior to execution of the acquisition agreement and either the acquiror wants to induce the target to sign up promptly or the target is not prepared to rely on “passive” shopping. In those circumstances, the announcement of a deal, often in tandem with the efforts of the target’s and others’ investment bankers, will act as a catalyst for any interested party to focus on whether to pursue a bid for the target—such is the power of the press and the market for corporate control.²⁰⁷ On the other hand, the no-talk component of a no-shop/no-talk provision has in the past often been, and after *NCS* will continue generally to be, subject to a “fiduciary out” exception, which permits the target, under certain conditions, to negotiate with and provide confidential information to a third party in response to an unsolicited proposal. Furthermore, fiduciary outs will typically allow a target’s board to withdraw, or modify, its recommendation of a merger agreement. In its most expansive form, the fiduciary out will allow a target to terminate a transaction to pursue an alternative deal, usually contingent upon the payment of a break-up fee.

[1] No-Shop Provisions

No-shop provisions limit a company’s ability to *solicit* alternative transactions and have been recognized as appropriate by the Delaware courts. For example, in *ACE Ltd. v. Capital Re Corp.*, Vice Chancellor Strine recognized that restricting the ability of the target’s board to “play footsie with other potential bidders or stir up an auction” is “perfectly understandable, if not necessary, if good faith business transactions are to be encouraged.”²⁰⁸ So long as some provision is made to allow the target to respond to unsolicited proposals, no-shop provisions are acceptable and should be upheld. In *McMillan v. Intercargo Corp.*,²⁰⁹ Vice Chancellor Strine observed that a no-shop provision that allowed the target to respond to unsolicited proposals subject to certain conditions and restrictions “is hardly indicative of a *Revlon* (or *Unocal*) breach”²¹⁰ and, along with termination fee provisions, as long as they are “non-preclusive, non-coercive,

²⁰⁷ *Cf. In re Pennaco*, 2001 WL 115341, *11, 2001 Del. Ch. LEXIS 19 (noting that filing of Form 8-K with merger agreement attached as exhibit “gave the marketplace knowledge of [the target’s] ability to speak with rival bidders and the standard nature of the termination fee”).

²⁰⁸ 747 A.2d 95, 106 (Del. Ch. 1999). *See also Matador Capital Mgmt. Corp. v. BRC Holdings Inc.*, 729 A.2d 280, 291 (Del. Ch. 1998) (noting that deal protections discussed, particularly no-shop provision, “do not foreclose other offers, but operate merely to afford some protection to prevent disruption of the [merger agreement] by proposals from third parties that are neither bona fide nor likely to result in a higher transaction”).

²⁰⁹ 768 A.2d 492 (Del. Ch. 2000).

²¹⁰ *Id.* at 506 (footnote omitted), citing *Matador Capital Mgmt. Corp. v. BRC Holdings, Inc.*, 729 A.2d 280, 291 (Del. Ch. 1998) and *ACE*.

and otherwise within the boundaries of reason, Delaware law generally recognizes them as valid.”²¹¹

[2] “No-Talk” Provisions

While a strict no-shop that completely bars a seller from soliciting competing transactions will be upheld, Delaware Chancery Court decisions suggest that it is unlikely that an absolute (*i.e.*, without a fiduciary out exception) no-talk that imposes a complete bar on a seller’s ability to furnish information to, or negotiate with, unsolicited suitors will be upheld except in certain limited circumstances.²¹²

In *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*,²¹³ Chancellor Chandler considered the validity of a strict no-talk provision in the context of a third party bidder’s motion to enjoin the vote on the merger between Cyprus Amax and ASARCO, a stock-for-stock combination and, thus, outside the scope of *Revlon*. In this instance, the no-talk provision contained no fiduciary out and had the effect of completely foreclosing any discussions with third parties prior to the stockholders’ vote. While declining to enjoin the vote,²¹⁴ Chancellor Chandler stated:

No-talk provisions . . . are troubling precisely because they prevent a board from meeting its duty to make an informed decision with respect to even considering whether to negotiate with a third party.²¹⁵

The Chancellor affirmed the Delaware concept that parties to a stock-for-stock combination not involving a change of control have no duty to negotiate with third parties. However, a decision not to negotiate must be an informed one. Furthermore, Chancellor Chandler further characterized strict no-talk provisions as “the legal

²¹¹ *McMillan v. Intercargo Corp.*, 768 A.2d at 506.

²¹² These circumstances could include the end of a competitive auction process. *See ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 107 n.36 (Del. Ch. 1999) (“One legitimate circumstance may be where a board has actively canvassed the market, negotiated with various bidders in a competitive environment and believes that the necessity to close a transaction requires that the sales contest end.”).

²¹³ No. 17398, 1999 Del. Ch. LEXIS 202 (Sept. 27, 1999).

²¹⁴ The court held there was no irreparable injury because (i) Phelps, which had made a bid to acquire both Cyprus Amax and ASARCO, could continue to pursue a merger with both even if a merger of those two companies were completed and (ii) the shareholders could vote the merger down. The court also acknowledged that, if the Cyprus Amax board pursued the Phelps bid, it risked losing the merger with ASARCO. In the end, the court held that the harm of losing the merger with ASARCO outweighed the *de minimis* harm to Phelps and the shareholders. *Phelps Dodge*, 1999 Del. Ch. LEXIS 202, at *6.

²¹⁵ *Phelps Dodge*, 1999 Del. Ch. LEXIS 202, at *3.

equivalent of legal blindness, a blindness that may constitute a breach of a board's duty of care."²¹⁶

In *ACE*, a putative buyer sought to enjoin a target from terminating its merger agreement in accepting a financially superior all-cash bid by a third party, alleging that the termination was necessarily the result of the target's violation of the merger agreement's no-talk provision. The no-talk at issue contained a fiduciary out that allowed the target to provide information to a third party, but conditioned on the receipt of an opinion of counsel that this action was "required in order to prevent the Board of Directors of [target] from breaching its fiduciary duties." However, instead of obtaining the specific opinion required by the terms of the no-talk prior to providing information to a competing bidder, the target's board instead received an opinion of counsel that entering into discussions with a third party was "consistent with" their fiduciary duties. Because of this deviation from the procedure mandated by the merger agreement, the buyer sought to enjoin termination of the merger agreement on the grounds that the target had not complied with the terms of the contract. Vice Chancellor Strine found that, as construed by the acquiror, the fiduciary out exception to the no-talk clause would "[involve] an abdication by the board of its duty to determine what its own fiduciary obligations require at precisely the time in the life of the [target] when the board's own judgment is most important."²¹⁷ Given the import of this construction, the court instead construed the fiduciary out clause to permit the target to negotiate with the third party.²¹⁸ Since 46% of the stockholder vote had been locked up,²¹⁹ the court found that a literal reading would have virtually guaranteed the original transaction, resulting in a preclusive

²¹⁶ *Id.* at *4. Phelps Dodge had also argued that the "no-talk" provision prevented the board from deciding in an informed way whether to withdraw their recommendation to the merger. In addition, it claimed that the board of Cyprus Amax did not fully understand its reasons for prohibiting conversations with other bidders and had not considered whether a less restrictive "no-shop" clause could have been adopted. The court's opinion did not address either of these claims. Gregory P. Williams, "Phelps Dodge, ACE Ltd., and IXC: Protecting Stock-for-Stock Mergers," *The Corporate Governance Advisor*, Nov./Dec. 1999, at 9.

²¹⁷ One commentator recommends that a seller should condition the exception to a no-talk clause on the existence of a "superior offer" rather than linking any such exception to a board's "fiduciary duties." *See generally* John F. Johnston, "A Rubeophobic Defense Counsel Marks Up Fiduciary Out Forms: Part II," *Insights* (Feb. 2000). *See* §15.05[A][3] *supra*.

²¹⁸ The court noted that, without the ability to terminate the merger agreement, which they could not do without first complying with the terms of the no-talk, "the [seller] board knew *ACE* would have the voting power to consummate the merger even if the merger was no longer in the best interests of [seller's] other stockholders." *ACE*, 747 A.2d at 102. In that context, the court noted: "It is especially important that the board negotiate with care and retain sufficient flexibility to ensure that the stockholders are not unfairly coerced into accepting a less than optimal exchange for their shares."

²¹⁹ The buyer held 12.3% of seller's stock and had obtained voting agreements with respect to an additional 33.5%. *Id.* at 97.

and coercive obstacle within the meaning of *Unocal*²²⁰ or, alternatively (and dispositively), would constitute a breach of the target board's duty of care. In the context of a guaranteed transaction (a transaction where the acquiror has locked up any necessary stockholder vote), the Vice Chancellor's opinion suggests that the target board must reserve to itself a fiduciary termination out.

On the other hand, the court in *ACE* suggested that restrictive no-talk provisions in a merger agreement with no fiduciary out might well be permissible in different circumstances. The court noted, for example, that: "It may well be a different matter for a board to agree to put a merger agreement [with restrictive deal protections] to a vote if there are no other provisions tied to the agreement that operate to preclude the stockholders from freely voting down the merger and accepting another deal or opting for no deal at all."²²¹ The opinion did not directly address the propriety of strict no-talk provisions where a board is pursuing only a strategic merger and would otherwise pursue solely a policy of independence if the strategic merger were not consummated.

Shortly after the *ACE* decision was handed down, Vice Chancellor Steele (now a Delaware Supreme Court Justice) refused to enjoin a stockholders' vote on a proposed merger agreement that had originally contained a strict (*i.e.*, without a fiduciary out) no-talk provision. The merger agreement and transaction at issue were the result of six months of exploring possible transactions with several parties following public notification that the seller was interested in a merger or sale. Subsequent to its execution, the merger agreement was amended to permit the seller to consider "superior proposals," though the record reflected that no superior proposals, nor any other unsolicited interest, had emerged. Based on the record before him, then Vice Chancellor Steele stated:

The assertion that the board "willfully blinded" itself by applying the now defunct "no-talk" provision in the Merger Agreement is unpersuasive, particularly considering how late in the process this provision came. Provisions like this are common in merger agreements and do not imply some automatic breach of fiduciary duty.²²²

²²⁰ The court described the *ACE* transaction as being in "the less than precise corporate law context of a merger agreement that does not implicate *Revlon* but may preclude other transactions in a manner that raises eyebrows under *Unocal*." *Id.* at 106.

²²¹ *Id.* at 106 n.34. The court added: "In this regard, see the recent amendment to 8 Del. C. §251(c) [renumbered §146, eff. Aug. 1, 2003] enabling a board to agree to put a merger to a vote even where its recommendation about the merger has changed." *Id.* The court also gave an example of a legitimate circumstance where "a board could prudently place itself in the position of not being able to entertain and consider a superior proposal to a transaction dependent on a stockholder vote," namely, "where a board has actively canvassed the market, negotiated with various bidders in a competitive environment, and believes that the necessity to close a transaction requires that the sales contest end." *Id.* at 107 & n.36.

²²² *In re IXC Communications, Inc. Sh. Litig.*, 1999 WL 1009174 (Del. Ch.) See also *State of Wisconsin Inv. Bd. v. Bartlett*, No. 17727, 2000 Del. Ch. LEXIS 42, *30 (Del. Ch. Feb. 24, 2000) (noting that "Delaware law permits lock-ups and related agreements, 'where their adoption is untainted by director interest or other breaches of fiduciary duty'" (quoting *Revlon*, 506 A.2d at 176), *aff'd*, 808 A.2d 1205 (Del. 2002).

While a significant portion of the vote had been locked up,²²³ as in *ACE*, other facts distinguish *IXC* from *ACE* and may serve to reconcile the two decisions and offer guidance to the practitioner. First, the record in *IXC* reflected that the seller had engaged in discussions regarding a possible transaction with a number of parties and had publicly announced that it had retained an investment bank to explore merger or sale opportunities, the combination of which should be viewed as “exploring the marketplace with confidence.”²²⁴ Second, and perhaps dispositively, though not much help analytically, no other bidders appeared. It remains to be seen, though, whether a court will determine that a seller has sufficiently “explored the marketplace with confidence” and uphold a strict no-talk, in the face of a bona fide competing bid.²²⁵

223 In *IXC*, an approximately 40% stockholder had sold half of its stock to buyer and agreed to vote the remaining half in favor of the transaction. The plaintiffs in *IXC* conceded that the transaction was only “almost locked up,” which Vice Chancellor Steele noted “does not mean ‘locked up.’” *Id.* at *8. In addition, Vice Chancellor Steele also took notice of the fact that 169 institutional investors constituted more than 60% of shareholders of record eligible to vote on the merger. *Id.* Neither opinion reflects that any evidence of voter turnout in prior stockholder votes was presented. See *Chesapeake Corp. v. Shore* 771 A.2d 293 (Del. Ch. 2000) (finding provision requiring supermajority to approve bylaw amendment preclusive in light of historical voter turnout and percentage of shares held by management).

224 See *ACE*, 747 A.2d at 107 n.36 (intimating where a board has “explored the marketplace with confidence,” a board’s decision “to preclude itself—and therefore the stockholders—from entertaining other offers” may be justifiable).

225 In *Renaissance Communications Corp. v. National Broadcasting Co., Inc.*, C.A. No. 14446, 1995 WL 1798510 (Del. Ch. Aug. 1, 1995) (oral ruling), Chancellor Allen explained, in the context of an auction setting, that directors need flexibility in negotiating mergers if they are to maximize stockholder value, and that a “fiduciary overlay” prohibiting restrictive merger covenants will actually harm stockholders’ interests by causing bidders to reserve their highest price:

. . . I think it is different if the board negotiates highly particular protections in order to get the highest price in the auction, because *if the fiduciary duty always overrides an auction, you have just made auctions less valuable*, because people obviously won’t have the incentive to issue the best price. *So it is self-defeating for the fiduciary law to say in all events a higher and later price gives rise to a fiduciary obligation to breach the contract. . . .*

. . . Now, that gets you into this doctrinal problem, because people tend to think of fiduciary duties as supervening. But unless you say that these fiduciary duties are afunctional—that is, they operate without regard to the impact they have—then *there must be circumstances in which the contracts can essentially—in this auction context essentially remove from the board the later discretion. They can remove it from themselves if they do it in the right way. And they have to be able to do that.*

Otherwise, the auctions won’t work.

Id. at *14-15 (emphasis added). This argument is further extended to a strategic non-*Revlon* context by a leading practitioner in arguing that preventing a buyer in that context from fully protecting a deal will cause partners to announce deals with lower exchange ratios in order to keep some economic ammunition in reserve in the event of a topping bid. See Paul K. Rowe, “The Future of the ‘Friendly Deal’ in Delaware,” 18th Annual Institute Mergers & Acquisitions (Glasser Legal Works 2001) 192, at 31. This type of gamesmanship, however, may create exactly

[3] Fiduciary Outs

As Chancellor Allen has stated: “Fiduciary outs are anomalous contract provisions that generally provide an escape hatch to a target corporation from performing some contractual undertaking meant to advance the closing of an acquisition agreement.”²²⁶ Under various circumstances -- and certainly in connection with the sale of control -- fiduciary outs, or exceptions to deal protections, are all but required in order to fulfill *Revlon* or similar emerging duties in the context of stock-for-stock deals.²²⁷ In other instances, they are often the product of negotiation and/or the surrounding circumstances.²²⁸ In its various forms, a fiduciary out provides an exception to a no-talk provision and a requirement that a target board recommend a transaction to stockholders. In their most robust form, fiduciary outs allow a seller to terminate an acquisition agreement in order to accept a competing superior proposal.

(a) No-Talk Provisions

In the context of no-talk provisions, which are generally the initial hurdle to entertaining a competing transaction,²²⁹ fiduciary outs operate as an exception to a

the type of circumstances that invite topping bids. Similarly, Vice Chancellor Jacobs implicitly endorsed this approach in *Malpiede v. Townsend*, C.A. No. 15943 (Del. Ch. Sept. 29, 1997) (oral ruling), where he explained that the court’s role in enforcing fiduciary duties should be to assess process, not result, and that in some cases, even where a board meets its duties, the stockholders may not be able to take a later, but higher, price. *See generally*, A. Gilchrist Sparks, III and Kenneth J. Nachbar, “Corporate Deal Protection—The Lay of the Land in Delaware” (Nov. 18, 2000) at 16-17; John F. Johnston, “Putting *ACE*, *Phelps Dodge* and *IXC Communications* in Context,” Insights (Feb. 2000).

²²⁶ William T. Allen, *Understanding Fiduciary Outs: The What and Why of an Anomalous Concept*, 55 Bus. Law. 653 (2000). In Delaware, there is no implied right to take a better offer without risking dangers for breach of contract. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). Thus, the fiduciary out must be contractual. *See Rowe, supra* note 109.

²²⁷ As discussed below, the Delaware Supreme Court in *NCS* held that the combination of a force-the-vote provision in a merger agreement, as permitted by DGCL Section 146 (formerly §251(c)), together with majority stockholder voting agreements ensuring stockholder approval of the merger and the absence of a fiduciary out clause, was unenforceable. *NCS*, 818 A.2d at 938.

²²⁸ Sellers in stock-for-stock mergers not implicating *Revlon* may, as a business matter, bargain for the ability to terminate a merger agreement prior to a stockholder vote in order to pursue an alternative superior transaction. Recent examples include: Hewlett-Packard/Compaq, Phillips/Conoco, Cardinal Health/Boron, Lepore & Associates, Citigroup/Associates, Pfizer/Warner-Lambert, General Electric/Honeywell, and El Paso/Coastal.

²²⁹ *See ACE*, 747 A.2d at 99 (noting that the fiduciary out exception to no-talk “is the logical gateway through which the [seller’s] board must pass” in order to terminate the merger agreement pursuant to a fiduciary out). The reasons are clear. As Vice Chancellor Strine stated in *ACE*, “that

covenant not to provide information to, or negotiate with, third parties in response to an unsolicited bid.²³⁰ This type of fiduciary out usually follows various forms. The common formulation allows the target to furnish information to or negotiate with an unsolicited bidder if the board of directors believes, after consulting with counsel, that this action “is consistent with” or “is required by” the target board’s “fiduciary duties” or a failure to negotiate may, or will, result in a breach of the directors’ fiduciary duties. Occasionally, this formulation will also require that the target board obtain an opinion of counsel that negotiation with an unsolicited bidder is necessary to prevent a breach of fiduciary duty, though this requirement has become significantly less common in light of *ACE*.²³¹ Moreover, the fiduciary out may be conditioned on the receipt of a “superior offer.”²³²

What does the more “typical” formulation of the fiduciary out mean? Presumably, in the context of the particular facts and circumstances -- i.e. whether a cash versus stock-for-stock combination or, at the beginning or end of a process and in light of the terms and conditions of the alternative proposal -- directors will determine whether they believe themselves obligated, as a matter of fiduciary duty and/or the applicable law, to negotiate with a bidder, after consultation with counsel. In a stock-for-stock transaction not otherwise falling in the orbit of *Revlon*, a good faith determination by disinterested directors in exercising their business judgment to negotiate or not should be dispositive. In a *Revlon* context, however, directors should measure their steps against the objective of maximizing shareholder value. *Revlon*’s dictate, however, does not deprive directors of the ability to exercise discretion; even in the context of *Revlon*’s heightened scrutiny, the issue will be whether the board’s decision was, on balance, within the range of reasonableness.²³³

A leading Delaware practitioner has taken exception to the “typical” fiduciary out formulation, arguing that the target board’s fiduciary duties are implicated primarily at the time of contracting. In this view, the exercise of fiduciary duties requires a board to preserve, under the terms of the contract, the flexibility to consider potential future offers and that after execution, contract law, not fiduciary duty law, governs.²³⁴ The alternative

a third party would consummate a superior proposal . . . without negotiation or with material information from a [seller] strikes me as highly implausible.” *Id.* at 99 n.8.

230 The likelihood that a strict no-talk will be upheld other than in limited circumstances is slim. *See* Coates & Subramanian, *supra* note 82, at 319 n.19 (noting that no-talk provisions “are generally thought to be subject to the board’s fiduciary duties to shareholder regardless of whether a formal ‘fiduciary out’ is contained in the agreement”); *see also* *NCS*, 818 A.2d at 937 *citing* *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 39, 51 (Del. 1994) (holding that “a contract [that] purports to require a board to act or not act [so] as to limit the exercise of fiduciary duties . . . is invalid and unenforceable”). As a result, the focus of negotiation usually revolves around the wording, rather than the inclusion, of the fiduciary out.

231 *See supra* note 101 and accompanying text.

232 *See infra* note 120.

233 *See supra* §15.04[A].

234 *See generally* John F. Johnston, “A Rubeophobic Defense Counsel Marks Up Fiduciary Out Forms: Part I,” *Insights*, November 1999, at 2 (attempting to reconcile wording of common

formulation permits discussions with third parties upon receipt of an “acquisition proposal,” without reference to fiduciary duties, if the target board determines that the acquisition proposal is reasonably likely to lead to a “superior proposal,” generally defined as a proposal that would, if consummated, be more favorable from a financial point of view to the target stockholders.

As noted, the superior offer concept is often a predicate for exercising a fiduciary out. In evaluating what constitutes a superior offer, the board should, and is often contractually obligated to, take into account all relevant factors, including the terms and conditions of the proposal; any legal or regulatory issues; the potential timing of execution and closing; if a cash transaction, the financing of the deal, or if stock, the outlook and prospects for the bidder’s business and operations, the volatility of the bidder’s stock price and whether the value consideration will be fixed by a collar or similar mechanism. As with all contractual provisions, the specific language of this formulation can be altered to provide more or less flexibility to the target’s board. Common examples include requiring the target board to conclude that an acquisition proposal “constitutes” a superior proposal rather than allowing the target’s board to determine that an acquisition proposal is “reasonably likely” or “could reasonably be expected to lead to” a superior proposal. It is also not unusual to include conditions to a definition of a superior proposal. These could include requirements that: the competing bid not be subject to a financing condition or that the target’s investment banker determine that the competing bid is more favorable;²³⁵ the initial bidder be apprised of the amount and form of consideration of the competing bid and the status of the negotiations; and the initial bidder be allowed the opportunity to match the second bid before turning over information to the interloping bidder. Historically, fiduciary outs that offer more flexibility to a board to enter into discussions with a third party have been seen as more appropriate in the context of a sale of control²³⁶ (other than at the conclusion of an

fiduciary out provisions with the drafter’s intent); *see also* NCS, 818 A.2d at 939 (“board had no authority to execute a merger agreement that subsequently prevented it from discharging its ongoing fiduciary responsibilities”); *Phelps Dodge* at *2 (noting in dicta that agreeing to strict no-talk “is the legal equivalent of willful blindness, a blindness that may constitute a breach of a board’s duty of care”); *Smith v. Van Gorkom*, 488 A.2d 858, 888 (Del. 1985) (holding that corporate directors have no fiduciary right to breach a contract).

235 *See Kontrabecki Group Inc. v. Triad Park LLC*, C.A. No. 16256, 1998 Del. Ch. LEXIS 246 (Del. Ch. Mar. 18, 1998) (Temporary Restraining Order) (holding that plaintiff “had demonstrated a colorable claim that [a competing merger proposal] did not constitute a ‘Superior Proposal’ under the Merger Agreement” and restraining target from terminating the merger agreement and from postponing the shareholders’ meeting to vote on the merger).

236 For an example of a “loose” fiduciary out that has withstood judicial scrutiny in a *Revlon* transaction, *see In re Pennaco*, 2001 WL 115341, at *14, 2001 Del. Ch. LEXIS 19. After describing the provisions of the fiduciary out, the court noted approvingly that “the board . . . retained significant flexibility to deal with any later emerging bidder.” There, the target was allowed to furnish information to, and participate in discussions and negotiations with, a third party making an unsolicited bid “if, and only to the extent that, a majority of the entire [target

auction) while clauses that offer less flexibility have been more likely in strategic mergers, although that distinction appears to be eroding.²³⁷

One condition common to either formulation of the no-talk fiduciary out is that the target enter into a confidentiality agreement containing substantially the same terms as with the initial bidder with the unsolicited suitor prior to furnishing any information. Thus, if the confidentiality agreement has a standstill, the initial bidder will generally insist that any interloper be subject to the same restrictions. Accordingly, the relative bargaining power and position of the parties at the time the initial confidentiality agreement is executed will have an impact on the target board's flexibility to negotiate with third parties.²³⁸

(b) Commitments to Recommend: Submission to Stockholder Votes; Termination Outs

Merger agreements commonly contain covenants requiring the target board of directors (and in a transaction requiring a vote of the shareholders of the acquiror, the board of the acquiror) to recommend that stockholders approve a transaction. Any contractual obligation to recommend a transaction that does not allow a board to withdraw its recommendation if the board no longer believes the transaction is in the best interests of its stockholders may well be invalid.²³⁹ Furthermore, as a practical matter, a board would not want to continue to recommend a transaction that it no longer believed in. In any case, the target must disclose (and in the merger agreement, must retain the right to disclose) any material developments that would influence a shareholder's voting

board] determines in good faith that such Company takeover proposal could reasonably result in a Superior Company Proposal." Under the agreement,

"Superior Company Proposal" means any bona fide written Company Takeover Proposal made by a third party . . . to acquire directly or indirectly (i) all the equity securities or (ii) the assets of the Company substantially as an entirety, which *the Company Board determines in good faith* (based on, among other things, the advice of its independent financial advisors and outside counsel), taking into account all legal, financial, regulatory and other aspects of the proposal and the person making such proposal, (x) *would, if consummated, be more favorable, from a financial point of view, to the holders of Company Common Stock than the Transactions and* (y) *is reasonably likely to be consummated without undue delay.*

(Emphasis added.)

²³⁷ On a few occasions, the target's right to negotiate or turn over information has been conditioned on either the bidder's right to terminate the agreement or to receive a break-up fee or both. A target board should obviously carefully consider this type of request. Specific considerations include: the basis for the request; the impact of these provisions; the amount of the break up fee; and whether the target has been shopped.

²³⁸ See Spatt, *supra* note 81 (surveying impact of confidentiality agreement provisions on seller's negotiations with competing bidders).

²³⁹ Cf. *Malone v. Brincat*, 722 A.2d 5 (Del. 1998) (holding that "when directors communicate publicly or directly with shareholders about corporate matters, the *sine qua non* of directors' fiduciary duty to shareholders is honesty").

decision, such as the existence of a higher offer. Given such a choice, why would shareholders then accept a lower offer in the face of an equally certain, higher offer? In the context of commitments to recommend a merger, how should the change of recommendation exception be drafted? The narrowest standard would limit the board's ability to change its recommendation only in the event of a superior proposal. A broader standard would contemplate a possible change if the board determines that its fiduciary duty so requires or a failure to change is likely not to be consistent with its fiduciary duties.²⁴⁰

In addition to covenants to recommend that stockholders approve a transaction, merger agreements will always require the board to submit the transaction to a stockholder vote. Pursuant to the 1998 amendment adding a clause to sub-section (c) of §251 of the Delaware General Corporate Law (the "1998 Amendment," that clause now contained in new §146, effective August 1, 2003), a merger agreement can be submitted to the vote of stockholders even if the board has withdrawn its recommendation that stockholders adopt the agreement.²⁴¹ Prior to this amendment, a significant issue arose as to whether a merger agreement could be submitted for stockholder approval in those circumstances.²⁴²

Primarily as a result of the 1998 Amendment, merger agreements may be drafted so as not to provide a target board with any ability to terminate a merger agreement in order to accept a superior offer prior to a stockholder vote.²⁴³ This inability to terminate means,

240 Practitioners may attempt to define or limit the other factors that might cause a target board to withdraw or modify its recommendation. Such an attempt was made in the Warner-Lambert/American Home Products merger agreement:

the Board of Directors of Warner-Lambert may make a Change in the Warner-Lambert Recommendation (x) pursuant to [fiduciary out provision] or (y) prior to the Warner-Lambert Stockholders Meeting if (i) after the date of this Agreement, Warner-Lambert acquires knowledge of facts or circumstances that the Board of Directors of Warner-Lambert determines in good faith, after taking into account those facts and circumstances concerning AHP that are disclosed in the AHP SEC Reports filed prior to the date of this Agreement (or that Warner-Lambert otherwise has knowledge of as of the date of this Agreement), constitute a material adverse development with respect to AHP and (ii) the Board of Directors of Warner-Lambert determined in good faith that, by reason of its determination in clause (i) and based upon the advice of outside counsel to Warner-Lambert, the failure to effect such Change in the Warner-Lambert Recommendation would create a substantial probability of violating the fiduciary duties of the Warner-Lambert Board of Directors under applicable law.

241 The board, however, must make a recommendation prior to authorizing entering into the merger agreement. *See* 8 Del. Code §146 (effective August 1, 2003) (permitting terms of any agreement, including a merger agreement, to require that it be submitted to stockholders "whether or not the board of directors determines at any time subsequent to declaring its advisability that the agreement is no longer advisable and that the stockholders reject it.").

242 *See Smith v. Van Gorkom*, 488 A.2d 858, 888 (Del. 1985).

243 Transactions consummated pursuant to merger agreements with no termination right include: Conexant/Alpha Industries, AT&T Wireless/Telecorp, U.S. Bancorp/Firststar, AIG/American

effectively, that a competing bidder cannot execute a merger agreement with the target until the merger agreement is terminated according to its terms, usually following stockholder action, often 90 to 120 days following execution. At a minimum, the absence of the ability to terminate erects a roadblock to the interloper and gives negotiating leverage to the initial bidder. As a practical matter, however, the initial bidder may well negotiate a settlement with a likely successful interloper before the stockholder meeting is actually held.

Whether a merger agreement should contain a termination right for a superior offer will depend upon the facts and circumstances of that transaction and the demands of the law. First, does the target board want to be in the position of submitting a proposal to shareholders that it no longer recommends? Second, is the transaction subject to *Revlon* or not? If the transaction is subject to *Revlon*, any justification for agreeing to a merger agreement that does not contain a termination right must be justified as a reasonable step in maximizing shareholder value.²⁴⁴ Considerations in making this determination include the following: when the meeting will be held; whether the value of the transaction is at the high end of a range of expected values; the bargaining position of the bidder; whether the agreement is being entered into at the end of the process; and whether the requirement to hold a meeting inhibits or enhances the board's ability to maximize shareholder value (in that the bidder "pays" for this commitment). Finally, in the context of a strategic merger based on the board's informed and reasoned views about the long-term value of a particular combination, a merger agreement that contains no termination right may be viewed as furthering a rational corporate good.²⁴⁵ However, under *NCS*, that position may be sustained only if stockholders are able to reject the transaction in the event a superior proposal has been made, that is, the requisite majority of stockholders' vote has not been contractually predetermined?²⁴⁶

General, Fifth Third Bancorp/Old Kent Financial Corporation, JP Morgan/Chase, and UBS/PaineWebber.

244 *Cf.* Allen, *supra* note 110, at 659 ("If a lawyer representing a target or its directors concludes that no fiduciary outs are required in a *Revlon* transaction at any point other than the end point of a public auction, the experience of the last fifteen years would suggest that he is accepting a non-de minimis risk.")

245 As discussed below, under *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 942 (Del. 2003) ("*NCS*"), depending upon the overall circumstances, a board decision not to provide a termination right prior to the meeting of stockholders will likely be viewed as a deal protection measure, rather than as an attempt to ensure a stockholder vote on the proposed transaction, and will be assessed under *Unocal* standards. *See* §15.05[A][3] *infra*. Where a thorough auction has preceded execution of the merger agreement, a board should certainly be able to agree to an agreement that does not contain a fiduciary termination out if "the directors felt high confidence that the board has carefully considered all reasonably available alternatives and believe this to be the best available transaction." *Function Over Form* at 658.

246 As discussed below, a broad reading of *NCS* (and an inappropriate one in our view) would require that every merger agreement must contain a fiduciary out permitting the target company to terminate the agreement if a superior proposal emerges. A narrow reading of *NCS* would require a termination right only where the stockholders are not free to reject the original merger

In this regard, recent Delaware cases, involving transactions subsequent to the 1998 Amendment, suggest certain of the possible parameters of no termination right provisions. In the *Phelps Dodge* decision, Chancellor Chandler, while labeling a strict no-talk provision the “legal equivalent of willful blindness,” and without directly addressing the fact that the merger agreement contained no fiduciary termination right, expressed little concern about the ramifications of such a provision, *viz.* that the target would not be able to explore an alternate transaction and thus would not be in a position to accept an alternate bid. There, in response to a request for injunctive relief, the court stated:

I need not rescue the shareholders from losing out on a premium bid, as they can simply vote down the Cyprus/ASARCO transaction which is scheduled to be voted on this Thursday. When such self help measures are available, and when the arsenals of all parties have been unleashed so as to fully and completely educate the shareholders of their choices, it is not for this court to ride to their rescue.²⁴⁷

In this situation the shareholders of the target had the clear right to approve or reject the transaction.

Following *Phelps Dodge*, the *ACE* court provided, in *dicta*, that an agreement that did not provide for a fiduciary termination right would be acceptable in certain circumstances.²⁴⁸ At the same time, in instances where the stockholder vote is a foregone conclusion, the Supreme Court in *NCS* ruled that the target board must retain the right to terminate the merger agreement to provide an “escape clause” even in a non-*Revlon*, stock-for-stock transaction.²⁴⁹

In *NCS*, in order to “lock up” the merger with NCS, Genesis had insisted that two NCS stockholders (who were also directors) collectively owning 65% of the voting power of NCS, but only 20% of the equity,²⁵⁰ enter into agreements to vote in favor of the merger. The merger

agreement even if a superior proposal emerges (e.g. because of contractual voting agreements with the holder or holders of the minimum votes necessary for approval of the transaction).

247 *Phelps Dodge*, 1999 WL 1054255, at *2. While the issue there was lack of a fiduciary out to the no-talk clause (which, as noted in note 113 *supra*, any fiduciary termination right would follow), the reasoning expressed by the court would support a merger agreement with no termination right that could be rejected by stockholders.

248 *See, ACE*, 747 A.2d at 106, n.24 (stating that it may be permissible for a board to agree to put a merger agreement to a vote if there are no other provisions tied to the agreement that operate to preclude the stockholders from freely voting down the merger and accepting another deal or opting for no deal at all).

249 *See NCS*, 818 A.2d at 940 (holding board required to contract for an effective fiduciary out to discharge fiduciary duties where voting agreements predetermined stockholder vote).

250 818 A.2d at 918-19. NCS Stock consisted of two classes, one with 10 votes per share, giving the two majority stockholders greater voting power than their percentage equity ownership due to their holdings of super-voting Class B stock. Although not specifically relied upon in its legal analysis, the fact that the majority stockholders owned only 20% of NCS’s equity may have influenced the majority ruling, as it noted that the Chancery Court “did find as a fact, however, that NCS’s public stockholders (*who owned 80% of NCS and overwhelmingly supported*

agreement also included a provision requiring that the merger be presented to stockholders of NCS, notwithstanding a withdrawal of the recommendation of the NCS board in favor of the merger. The two shareholders were to receive the same price per share as all other stockholders and would not receive a control premium or other special treatment.

For more than two years, NCS had been seeking to find a buyer. During this period, NCS had teetered on the brink of bankruptcy, before showing a resurgence in the months leading up to execution of the merger agreement.²⁵¹ Before that resurgence, NCS had a series of discussions with Omnicare, all of which contemplated an acquisition of the business of NCS in bankruptcy, with no payment to NCS stockholders. In early 2002, when the business of NCS was improving, Genesis surfaced as a possible buyer, and, in March 2000, NCS formed a special committee to consider and negotiate possible transactions for NCS.²⁵² After receiving a stock-for-stock merger offer from Genesis at approximately \$1.00 per share, in early July 2002, NCS signed an exclusivity agreement to negotiate exclusively with Genesis.²⁵³

Omnicare continued to demonstrate a lack of interest until late in Genesis's negotiations with NCS. At that time, Omnicare, sensing that Genesis might be on the verge of a deal with NCS, submitted an alternative, conditional proposal for \$3.00 cash per share.²⁵⁴ NCS sought to use this proposal to obtain an improved bid from Genesis and succeeded in obtaining a revised proposal, coupled with an ultimatum by Genesis to execute the agreement within 24 hours or Genesis would walk away from the deal. The NCS board subsequently approved a stock-for-stock merger with Genesis valued at about \$1.80 per share, and the stockholder lock-ups and merger agreement were executed.

Following the execution of these agreements, Omnicare brought litigation to enjoin consummation of the Genesis merger and commenced a tender offer for all NCS shares at \$3.50 cash per share.²⁵⁵ Two months later, Omnicare sent NCS an offer letter in which Omnicare irrevocably committed itself to a transaction with NCS at \$3.50 cash per share. As a result of this irrevocable offer, the NCS board withdrew its recommendation of the Genesis merger and NCS's financial adviser withdrew its fairness opinion on the NCS/Genesis merger agreement.²⁵⁶

The Chancery Court found that, at the time the board of directors of NCS entered into the Genesis merger agreement, the board reasonably believed that the Genesis offer was "the only game in town" and that the failure to accept Genesis' offer could result in Genesis withdrawing

Omnicare's offer) will be forced to accept the Genesis merger because of the structural defenses approved by the NCS board." *Id.* at 935-36 (emphasis added).

²⁵¹ The Chancery Court concluded that NCS's shopping of the company and subsequent decision to merge with Genesis did not trigger *Revlon* duties because NCS did not initiate an active auction process and the stock-for-stock merger with Genesis would not result in a change of control. *See NCS*, 818 A.2d at 930 (discussing decision below, *In re NCS Healthcare Inc., Sh. Litig.*, C.A. 19786 Del. Ch. Nov. 22, 2002, Slip op. at 26-31). The Supreme Court held that the Court of Chancery's decision to review the board's decision under the business judgment rule rather than *Revlon* was not outcome determinative on appeal.

²⁵² *NCS*, 818 A.2d at 922.

²⁵³ *Id.* at 923. The court hints that the board did not effectively shop the company. *See id.* at 938 n.84. ("The marked improvements in NCS's financial situation during the negotiations with Genesis strongly suggests that the NCS board should have been alert to the prospect of competing offers or, as eventually occurred, a bidding contest.").

²⁵⁴ *Id.* at 924.

²⁵⁵ *Id.* at 926.

²⁵⁶ *Id.* at 927.

its offer. Since Omnicare could not be relied upon to follow through with its conditional offer, NCS stockholders might be left with nothing. Under these facts, the Chancery Court found no breach of duty by the directors in approving the stockholder lock-ups required by Genesis and in not insisting upon reserving a right to terminate the merger agreement for a higher offer.

In a rare 3-2 split decision,²⁵⁷ the Supreme Court enjoined the consummation of the merger between NCS and Genesis. The majority held that the NCS directors' defensive devices were not within a reasonable range of responses to the perceived threat of losing the Genesis offer, because they were preclusive and coercive; and, alternatively, that the defensive measures that protected the merger transaction were unenforceable because they were invalid as they operated in the circumstances. According to the majority, directors of a Delaware corporation have a continuing obligation to discharge their fiduciary duties, as future circumstances develop, and accordingly a board of directors cannot disable itself from exercising its fiduciary obligations in the event of a subsequent superior offer. Specifically, the court held:

Although the minority stockholders were not forced to vote for the Genesis merger, they were required to accept it because it was *a fait accompli*. The record reflects that the defensive devices employed by the NCS board are preclusive and coercive in the sense that they accomplished *a fait accompli*. In this case, despite the fact that the NCS board has withdrawn its recommendation for the Genesis transaction and recommended its rejection by the stockholders, the deal protection devices approved by the NCS board operated in concert to have a preclusive and coercive effect. Those tripartite defensive measures — the Section 251(c) [now §146] provision, the voting agreements, and the absence of an effective fiduciary out clause — made it “mathematically impossible” and “realistically unattainable” for the Omnicare transaction or any other proposal to succeed, no matter how superior the proposal. [Citations omitted] The deal protection devices adopted by the NCS board were designed to coerce the consummation of the Genesis merger and preclude the consideration of any superior transaction. The NCS directors' defensive devices are not within a reasonable range of responses to the perceived threat of losing the Genesis offer because they are preclusive and coercive. [Footnote omitted] Accordingly, we hold that those deal protection devices are unenforceable.²⁵⁸

The court also clarified that even in a non-*Revlon* transaction, deal protection devices will be evaluated under the *Unocal* standard, not under a traditional business judgment analysis. The court said:

A board's decision to protect its decision to enter a merger agreement with defensive devices against uninvited competing transactions that may emerge is

²⁵⁷ Chief Justice Veasey noted in his dissenting opinion that “this is a rare 3-2 split decision of the [Delaware] Supreme Court.” *Id.* at 939 n.90. According to the dissenters: “Because we believe this Court must respect the reasoned judgment of the board of directors and give effect to the wishes of the controlling stockholders, we respectfully disagree with the Majority's reasoning that results in a holding that the confluence of board and stockholder action constitutes a breach of fiduciary duty.” *Id.* at 940.

²⁵⁸ *NCS*, 818 A.2d at 937.

analogous to a board's decision to protect against dangers to corporate policy and effectiveness when it adopts defensive measures in a hostile takeover contest. In applying *Unocal's* enhanced judicial scrutiny in assessing a challenge to defensive actions taken by a target corporation's board of directors in a takeover context, this Court held that the board "does not have unbridled discretion to defeat perceived threats by any Draconian means available". [Citation omitted.] Similarly, just as a board's statutory power with regard to a merger decision is not absolute, a board does not have unbridled discretion to defeat any perceived threat to a merger by protecting it with any draconian means available ... Therefore, in applying enhanced judicial scrutiny to defensive devices designed to protect a merger agreement, a court must first determine that those measures are not preclusive or coercive *before* its focus shifts to the "range of reasonableness" in making a proportionality determination. [Footnote omitted] If the trial court determines that the defensive devices protecting a merger are not preclusive or coercive, the proportionality paradigm of *Unocal* is applicable. The board must demonstrate that it has reasonable grounds for believing that a danger to the corporation and its stockholders exists if the merger transaction is not consummated.²⁵⁹

In a dissenting opinion with which Justice Steele joined, Chief Justice Veasey expressed strong disagreement both with the majority's application of a *Unocal* analysis to defensive measures imposed not by the board, but by a potential acquiror, and with the majority's holding that an absolute lock-up constitutes a per se breach of fiduciary duty. The dissenting opinion stated:

The Majority invalidates the NCS board's action by announcing a new rule that represents an extension of our jurisprudence. That new rule can be narrowly stated as follows: A merger agreement entered into after a market search, before any prospect of a topping bid has emerged, which locks up stockholder approval and does not contain a "fiduciary out" provision, is per se invalid when a later significant topping bid emerges. As we have noted, this brightline, per se rule would apply regardless of (1) the circumstances leading up to the agreement and (2) the fact that stockholders who control voting power had irrevocably committed themselves, *as stockholders*, to vote for the merger. Narrowly stated, this new rule is a judicially-created "third rail" that now becomes one of the given "rules of the game," to be taken into account by the negotiators and drafters of merger agreements. In our view, this new rule is an unwise extension of existing precedent.²⁶⁰

In addition, Justice Steele authored a separate dissenting opinion in which he expressed the hope that the majority did not intend to apply a mandatory, bright line, *per se* breach analysis *ex-post* to all challenged merger agreements.

In our view, the decision should be read narrowly – in accordance with its facts. That is, in a transaction involving the sale of a control block and a merger of the acquiror and the target,

²⁵⁹ NCS, 818 A.2d at 933.

²⁶⁰ NCS, 818 A.2d at 943.

the target board must – at least in Delaware – negotiate for a fiduciary out in the merger agreement if the control block has agreed to support the transaction.

A broader view of *NCS* to the effect that all acquisition agreements must contain a fiduciary termination right is not an appropriate interpretation of the case, in our opinion, because it is not supported by the factual context of the case; would be inconsistent with Section 251(c) of the DGCL, which contemplates submission for a shareholder vote even if the board has withdrawn its recommendation and, therefore, must be given content in some circumstances; and would be contrary to the tradition of Delaware law to evaluate lock-ups in their factual circumstances.

What does this mean? What are the limits? Typically, the acquiror wants to control the majority block to lock-up the target and as the first step to effecting a merger. In this context, the acquiror must interact with the target board on two levels. First, the board must approve any merger agreement.²⁶¹ Second, since most states have anti-takeover business combination statutes and companies typically have not opted out of their coverage, the target board must approve in advance the block purchase or voting lock-up of the significant shareholder or else the acquiror cannot complete a second-step merger for a statutorily specified period or without the approval of disinterested shareholders.²⁶²

The need for interaction by the acquiror with the target board suggests that the target board has *some* negotiating leverage which it must utilize to protect the minority shareholders.²⁶³ As noted, *NCS* dictates that, if the acquiror has a voting agreement with the control shareholder of the target, any merger agreement must contain a fiduciary termination right for the target. What else is required is unclear; the possible alternatives include:

- Assume that the agreement with the dominant shareholder requires that the shareholder vote against any other deal for, say, eighteen months, accompanied by restrictions on sale during this period. The control shareholder can do as it desires with its block, as a shareholder, and *NCS* expressly confirms that principle.²⁶⁴ However, can the target board accept this “tail” in approving the merger agreement and exempting the stock purchase from Delaware Section 203? The negative position would contend that the restriction is a practical limitation on the board’s fiduciary responsibilities (since no other bidder will likely appear) and, therefore, interdicted by *NCS*. Moreover, in *Quickturn Design Sys., Inc. v. Shapiro*,²⁶⁵ the Delaware Supreme Court struck down a “dead-hand” provision in a rights plan that barred a newly elected board from redeeming the rights for six months after taking office. The effect of the redemption would be to facilitate a transaction with a party that supported the election of the new board. The court

²⁶¹ See, e.g., 8 Del. Code § 251(b); NYBCL § 902.

²⁶² See, e.g., 8 Del. Code § 203; NYBCL § 912. For a discussion of these and other business combination statutes, see generally *Takeover Defense* § 4.05.

²⁶³ See *In re Digex, Inc. Sh. Litig.*, C.A. No. 18336, 2000 WL 1847679 (Del. Ch. Dec. 13, 2000), discussed in *Takeover Defense* § 15.07[C].

²⁶⁴ *NCS*, 818 A.2d at 938 (“The stockholders with majority voting power, Shaw and Outcalt, had an absolute right to sell or exchange their shares with a third party at any price.”); see generally *Takeover Defense* § 15.03[B].

²⁶⁵ 721 A.2d 1281 (Del. 1998).

ruled that this limitation was an impermissible abrogation of the board's power to negotiate a sale of the company.²⁶⁶ Accordingly, in the context of the sale of a control block, the contention would be that implicit board approval of a shareholder agreement that had the effect of taking the company off the market would be improper. The contrary, and affirmative position, will underscore that a transfer of control can occur without board involvement and the board's negotiating status should be viewed in that light. Moreover, the board will have a termination right as demanded by *NCS*. The fact that the control stockholder cannot sell its block in an acquisition for a period is not an injury cognizable by the minority since the minority has no right to compel the majority to sell, or if the majority sells, to take the minority along. Finally, those advocating the affirmative position will point out that *NCS* was a 3-2 decision and the Delaware Supreme Court has a new Justice (former Vice-Chancellor Jack Jacobs), who has replaced retiring Justice Walsh, one of the three Justices in the *NCS* majority.

- Certainly no objection can be raised if the merger agreement has a termination right and the voting agreement ends if the merger agreement ends. In these circumstances, how should the § 203 exemption be structured by the target board given that the acquiror may complete the purchase of the block even if the merger is not consummated? Should the approval be granted only if the acquiror agrees to certain procedural protections in these circumstances (such as any future merger proposal must be reviewed by a committee of target independent directors advised by its own investment bankers)?
- One alternative is for the acquiror to purchase the control block and not simultaneously seek a merger. Subsequently, at least in states like Delaware where a non-exempt purchase does not result in an absolute bar to a merger for a specified period, the acquiror could negotiate a merger with a committee of independent directors of the target.²⁶⁷ Under Delaware law, that transaction would be subject to a two-third vote of “disinterested shareholders.”²⁶⁸
- Another possibility is for the acquiror, after purchasing (or agreeing to purchase) the control block, to make a tender offer for target shares or buy those shares in the market. Section 203 does not restrict a partial tender offer by an “interested shareholder.”²⁶⁹ If the acquiror -- interested shareholder -- achieves ownership of more than 90% of the target's outstanding voting securities, would a “short-

²⁶⁶ *Id.* at 1291-92; *see generally Takeover Defense* § 5.05[G][1].

²⁶⁷ For a discussion of the use of a Special Committee in this context, *see generally Takeover Defense* § 14.03.

²⁶⁸ 8 Del. Code § 203(a).

²⁶⁹ *See In re Home Shopping Network, Inc. Sh. Litig.*, C.A. No. 12868, 1993 WL 172371 (Del. Ch. May 19, 1993) (Chandler, V.C).

form” merger of target and acquiror be a transaction prohibited by the anti-merger statute?²⁷⁰

- Finally, the acquiror could secure voting control over, say, 30-35% of the outstanding stock through agreement with the control person. If this arrangement did not involve “effective control”, arguably the NCS standard would not apply and the acquiror would have a “leg-up”, if not a totally secure transaction.

We also believe that NCS made three other significant points of note:

- Protective restrictions in an acquisition or merger agreement must be evaluated by the target board under *Unocal*.

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Section 203, Delaware’s anti-takeover statute, which provides that “a corporation shall not engage in a business combination with any interested stockholder” (emphasis added), could be read to restrict only business combinations that require an affirmative act of the target corporation, but not those implemented unilaterally by the interested stockholder. Under this interpretation, Section 203 would not apply to a short-form merger between an interested stockholder and a target because the transaction requires “only a unilateral act -- a decision by the [interested stockholder] parent company” and no action by the target. *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242, 247 (Del. 2001). The anti-takeover statutes of other states contain language similar to the Delaware statute. *See, e.g.*, NYBCL §912(B) (providing that “no domestic corporation shall engage in any business combination with any interested shareholder”); Va. Stock Corp. Act, §13.1-725.1 (providing that “no corporation shall engage in any affiliated transaction with any interested shareholder”); Ga. Corp. Law, § (providing that “a resident corporation shall not engage in any business combination with an interested shareholder”); Md. General Corp. Law, §3-602(a) (providing that “a corporation may not engage in any business combination with an interested stockholder”); Ohio General Corp. Law, §1704.02 (providing that “An issuing public corporation shall not engage in any Chapter 1704 transaction”). Interestingly, in 1990, Ohio amended its short-form merger provisions (as well as its long-form merger law) to explicitly provide that those mergers are subject to the restrictions of the Ohio anti-takeover law. *See id.*, §§ 1701.80(A), 1701.801(A) and 1701.78(A).

Note, however, that according to at least one commentator, an exemption from Section 203 for short-form mergers was rejected “because it would be an illusory exemption.” Craig B. Smith, *The Takeover Law of Delaware*, 78 C.P.S. A-30, fn. 9, The Bureau of National Affairs, Inc. (2002).

A consequence of excluding short-form mergers from the purview of Section 203 could be that minority stockholders may be coerced into accepting an inadequate tender offer out of fear that the interested stockholder will reach the 90% ownership level required to effect a short-form merger in which the remaining shareholders could be squeezed out at an even lower price. However, the possibility of harm to minority stockholders from a tender offer by an interested stockholder is mitigated by the fact that, under Delaware law, a coercive tender offer by a controlling stockholder is subject to the heightened fiduciary requirements of entire fairness. An offer taking the controlling shareholder to about 90% of the target (without a back-end commitment at the same price and a majority-of-the-minority condition to the offer) could well be viewed as coercive. *See, e.g., In re Pure Resources, Inc. Sh. Litig.*, 808 A.2d 421 (Del. Ch. 2002), *In re Aquila Inc. Sh. Litig.*, 805 A.2d 184 (Del. Ch.2002); *In re Siliconix Inc. Sh. Litig.*, C.A. No. 18700, 2001 WL 716787, 2001 Del. Ch. LEXIS 83 (Del. Ch. June 19, 2001).

- Generally, these restrictions will be reviewed with uniform standards, whether or not the transaction is under, or outside of, *Revlon*, -- that is, whether the deal is a change of control or a strategic merger.
- In a change of control context, a board cannot unilaterally place control in the hands of a preferred buyer, as, for example, by issuing a block (or option on) 51% of the target's voting stock to that buyer. This step would be "preclusive" and unenforceable; the conclusion is readily inferred from earlier Delaware cases, including *Revlon*.

[B] Lock-Outs

One of the most aggressive deal protection devices is the lock-out, which effectively precludes any third party from entering into a merger agreement with the target for a specified period, generally from one to two years. This result is achieved by omitting any right to terminate the merger agreement as a result of a negative stockholder vote and providing that the no-shop/no-talk clauses and interim covenants of the merger agreement remain in effect for a specified period even if the target shareholders reject the deal. Obviously, the ability to forestall any third party from pursuing its bid for a significant period of time may serve as a meaningful deterrent to any potential interloper.

A lock-out provision (keeping the merger agreement alive for two years) was challenged under Pennsylvania law in connection with Norfolk Southern's bid to break up the Conrail/CSX merger agreement. There, the federal district court denied relief and allowed the lock-out to stand, but noted that:

If by reason something occurs in the future by which it could be determined that there was a fiduciary duty upon the board of directors to go ahead and take some action by reason of some offer that had been made, if the fiduciary duty so required it, I see no reason why that should make any difference that it is not specifically set forth in the contract.²⁷¹

More recently, a North Carolina Supreme Court Judge ruled that the lock-out feature of the First Union/Wachovia merger agreement was invalid.²⁷² Relying on the Delaware Supreme Court's reasoning in *Quickturn Design Systems, Inc. v. Shapiro*,²⁷³ the North Carolina Supreme Court held the lock-out represented an impermissible abrogation of the target board's duties and

²⁷¹ *Norfolk Southern Corp. v. Conrail, Inc.*, No. 96-7167, 1997 U.S. Dist. LEXIS 978, *5-6 (E.D. Pa. Jan. 9, 1997). The ruling was affirmed for lack of showing of irreparable harm. *Id.*, No. 96-2025 (3d Cir. Mar. 7, 1997).

²⁷² *First Union Corp. v. SunTrust Banks, Inc.*, C.A. No. 01-CVS-10075 (Superior Ct. Mecklenburg Cty. July 20, 2001). The terms of the merger agreement provided that the agreement would terminate only upon the arrival of the "drop dead date" eighteen months from execution. The agreement contained no fiduciary termination right, nor could it be terminated if either party did not obtain the required stockholder approval of the transaction.

²⁷³ 721 A.2d 1281 (Del. 1998).

was “the equivalent of a contractual *Quickturn*” and was impermissibly coercive. As noted by the court in *First Union*, no court has specifically upheld a lock-out provision, and its validity has not been addressed by the Delaware courts.²⁷⁴ However, Vice Chancellor Strine has stated his view that a lock-out would be inconsistent with the reasoning in *Quickturn*.²⁷⁵

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²⁷⁴ The court in *Corwin v. DeTrey*, 1989 WL 146231 (Del. Ch.), rejected a stockholder claim that failure to terminate a merger agreement with a lock-out feature in response to changed economic conditions constituted a breach of the target directors’ fiduciary duties. There, the merger agreement contained no fiduciary termination right and no right to termination upon the target’s stockholders rejecting the deal. In that case, however, there was no competing bid, and the operation of the lock-out feature was not specifically at issue. Similarly, mergers have been consummated pursuant to merger agreements containing a lock-out feature, such as the Fleet Financial/Bank of Boston transaction, without having the lock-out feature challenged. The companies involved in that transaction were incorporated in Rhode Island and Massachusetts, respectively, and the merger agreement provided that it was governed by Rhode Island law.

²⁷⁵ Strine, *supra* note 83, at 937-38.

APPENDIX I

Deal Protection Provisions in Mergers: A Discussion of *Omnicare v. NCS*

By Barry G. Sher and Israel David (June 23, 2003)*

Consider the following scenario: The board of directors of a financially troubled company determines that it is necessary to begin exploring strategic alternatives. The company is in default on several hundred million dollars in debt and its stock has fallen to almost nothing. The board hires financial advisors who canvass the market, contacting more than fifty potential transaction partners. An independent committee consisting of directors who are neither officers nor major stockholders of the company is formed. At the end of a careful and thorough process lasting more than two years, the independent committee and the full board approve a merger with the one party willing to pay more than the face value of the company's debt, making it the only transaction that would provide for a recovery by the company's stockholders. At the insistence of its merger partner, the company also agrees to deal protection provisions that — together with voting agreements entered into by the majority stockholders — "lock up the deal," and provide certainty that the transaction will close.

Will Delaware courts uphold the deal protection provisions agreed to in connection with the merger? Until recently the answer would seemingly have been yes. The board's process fully satisfied the board's duty of care. Without the merger transaction, the company would have been forced into bankruptcy and the stockholders would have been wiped out. The "lock up" provisions appear to have been a small price to pay in order to induce the only viable merger partner to do the deal. The Delaware courts historically have given great deference to a board's decision in such circumstances. But the Delaware Supreme Court's April 4, 2003 ruling in *Omnicare v. NCS*,¹ a rare 3-2 split decision, creates uncertainty in this area, particularly when a superior offer emerges and there is no "fiduciary out" allowing the board to pursue that offer.

Omnicare Background Facts. NCS Healthcare, Inc. ("NCS") fell on hard times beginning in 1999 due to changes in the health care industry. The succeeding years were no better, and by early 2001 NCS had defaulted on over \$200 million in senior bank debt and more than \$100 million in subordinated notes. Its stock had fallen from over \$20 to less than \$0.50 per share.

In February 2000, the company retained financial advisors to identify potential acquirers or equity investors. By October, after contacting over fifty entities, NCS had only received one non-binding expression of interest — which was valued at \$190 million, less than the face value of NCS's senior debt. This proposal, which provided no recovery for NCS's stockholders, was later reduced by 20% after the offeror conducted due diligence. NCS also held discussions with various investor groups regarding a restructuring in a pre-packaged bankruptcy, but any recovery for the NCS stockholders seemed impossible.

* Barry G. Sher is a partner and Israel David is an associate in the New York office of Fried, Frank, Harris, Shriver & Jacobson. The views expressed in this article are those of the authors and should not be attributed to their firm or its clients.

In the second half of 2001 and again in February 2002, Omnicare, Inc. ("Omnicare") made several proposals to acquire NCS, but only as part of an asset sale in bankruptcy. NCS urged Omnicare to increase its offer and to consider a transaction outside the bankruptcy context, but Omnicare refused. Instead, Omnicare began secret negotiations directly with NCS's noteholders, which resulted in an increased offer but one that remained structured as an asset sale in bankruptcy and still provided no recovery for NCS's stockholders.

In March 2002, NCS's financial performance began to improve. NCS formed an independent committee (the "Independent Committee") consisting of two outside directors of NCS. (NCS's two other directors — one the company's Chairman, the other its CEO — together held a majority of the voting power of the NCS common stock (the "Majority Stockholders")). In the summer of 2002, the Independent Committee began negotiations with a new player, Genesis Health Ventures, Inc. ("Genesis"), a competitor of Omnicare's in the health care industry. These discussions were far more promising. Genesis made several acquisition proposals, each of which provided for a recovery by NCS's stockholders. As negotiations continued, the terms of a potential transaction with Genesis improved, resulting in a proposal that called for full repayment of NCS's senior bank debt, payment of par value for NCS's subordinated notes, and \$24 million in Genesis stock for NCS's stockholders (around \$1 in value for each share of NCS stock).

On July 26, 2002, Omnicare — which had gotten wind of the negotiations between NCS and Genesis — abruptly changed course and submitted a non-binding proposal that did not require bankruptcy for NCS and that would include a payment of \$3 cash for each share of NCS common stock. Omnicare's proposal, however, contained a due diligence condition that essentially gave Omnicare the ability to unilaterally walk away from its proposal. NCS tried to persuade Omnicare to drop its due diligence condition, but Omnicare refused to do so. After deliberation, the Independent Committee determined that further discussions with Omnicare presented a "substantial" and "unacceptable risk" that Genesis would abandon its merger discussions with NCS.

NCS did, however, put Omnicare's proposal to good use as a negotiating tool in its discussions with Genesis, and successfully coaxed Genesis to substantially improve the terms of its offer. Thus, Genesis increased the consideration to be paid to NCS's stockholders by 80%, and agreed to pay all accrued interest to NCS's noteholders. In return, Genesis informed NCS that its proposed transaction would have to be approved by midnight the next day, July 28, 2002, or else Genesis would terminate all discussions and withdraw its offer.

The Independent Committee met on July 28, followed by the full board later that day. Each received reports and advice from its legal and financial advisors. After concluding that Genesis's ultimatum was sincere, the Independent Committee voted unanimously to recommend the transaction to the full board. The NCS board similarly determined that "balancing the potential loss of the Genesis deal against the uncertainty of Omnicare's [proposal], results in the conclusion that the only reasonable alternative for the Board of Directors is to approve the Genesis transaction." The NCS board approved the transaction and the definitive merger agreement, which was executed later that day.

Protecting the NCS/Genesis Merger Agreement. Throughout the negotiations, Genesis had made it clear that it was not interested in becoming a "stalking horse" bidder for NCS, and that it required certainty that it "would be able to consummate the transaction it negotiated and executed." Thus, at the insistence of Genesis, the NCS/Genesis merger agreement contained a provision authorized by Section 251(c) of Delaware's corporation law,

requiring NCS to submit the merger agreement to NCS's stockholders for a vote regardless of whether the NCS board continued to recommend the merger (the "Mandatory Vote Provision").ⁱⁱ Genesis also insisted that the Majority Stockholders enter into voting agreements requiring the Majority Stockholders to vote all of their shares in favor of the NCS/Genesis merger agreement. The NCS/Genesis merger agreement did not contain a so-called "fiduciary out" that would have allowed NCS to terminate the transaction in favor of a subsequent superior proposal.

Genesis told NCS that all of these provisions were absolute requirements of Genesis, and that without them there would be no deal between NCS and Genesis.

Challenges to the NCS/Genesis Merger Agreement. After the announcement of the NCS/Genesis merger agreement, Omnicare continued to press on with its conditional proposal, and filed a lawsuit on August 1, 2002 attempting to enjoin the NCS/Genesis merger. At the same time, several stockholder plaintiffs filed class action complaints alleging that the NCS directors breached their fiduciary duties by allegedly failing to establish a process designed to obtain the transaction affording the highest value for the NCS stockholders.ⁱⁱⁱ

In October 2002, Omnicare increased its offer to \$3.50 per NCS share, and – for the first time – dropped its due diligence condition. As a result of Omnicare's improved and unconditional offer, the NCS board withdrew its recommendation that the stockholders vote in favor of the NCS/Genesis merger agreement. Nonetheless, the merger agreement's Mandatory Vote Provision combined with the voting agreements ensured NCS stockholder approval of the NCS/Genesis merger.

Delaware Chancery Court Ruling; Reversal by Supreme Court. The Delaware Court of Chancery rejected Omnicare's and the shareholders' challenge to the NCS/Genesis merger. In essence, the Chancery Court (i) concluded that so-called "*Revlon* duties"^{iv} had not been triggered because the stock-for-stock merger between NCS and Genesis would not result in a change of control, and (ii) upheld the NCS/Genesis deal protection measures after applying the heightened judicial scrutiny prescribed by *Unocal v. Mesa Petroleum Co.*^v As a result, the Chancery Court denied the plaintiffs' request to enjoin the NCS/Genesis merger.

The Delaware Supreme Court reversed in a sharply divided opinion. Although the Court assumed *arguendo* that no *Revlon* duties applied, the Court held that the NCS/Genesis merger agreement's deal protection measures — the tripartite combination of the Mandatory Voting Provision, the voting agreements, and the absence of an effective fiduciary out — could not withstand scrutiny under *Unocal* and were therefore invalid and unenforceable.

Under the familiar two-stage analysis set forth in *Unocal*, the Court first examined whether the board had reasonable grounds for believing that a threat to corporate policy existed. Apparently concluding that it did, the Court noted that the threat identified by the NCS board was the possibility of losing the Genesis offer and being left with no comparable alternative transaction. The second stage of the *Unocal* analysis involves a two-step process: the board must first establish that the defensive measures (*i.e.*, deal protection devices) adopted in response to the threat were not "coercive or preclusive," and then demonstrate that its response was within a "range of reasonable responses" to the perceived threat.^{vi} The Court concluded that the NCS/Genesis defensive measures were, in combination, coercive and preclusive in that they were designed to "coerce the consummation of the Genesis merger and preclude the consideration of any superior transaction."

The Delaware Supreme Court also held that the provisions were unenforceable on the alternative ground that they operated to limit the fiduciary duties of the NCS board following the execution of the NCS/Genesis merger agreement. According to the Court, instead of agreeing to

the absolute lock up of the NCS/Genesis merger, the NCS board was required to negotiate a fiduciary out to protect the NCS stockholders in the event the Genesis offer subsequently became an inferior offer.

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The Delaware Supreme Court's approach to the NCS/Genesis merger agreement and the analysis employed in both of its alternative holdings raises a number of questions regarding the use of deal protection measures in merger agreements.

Can a Board Ever Offer Certainty to a Potential Merger Partner? *Omnicare* presents the first instance in which the Delaware Supreme Court has ruled that, in negotiating a merger agreement in a non-change of control context, a board must always leave the door open for a potential superior offer even where there has been a lengthy process and a thorough market check, at least where the stockholder vote has been locked up through voting agreements.^{vii}

One point of view is that the *Omnicare* decision should be narrowly confined to its particular facts and not affect most deals. That is the hope expressed by the dissenting justices in *Omnicare*. Another view is that, without the certainty that a negotiated agreement will close, potential merger partners in a non-change of control context may hesitate to present their best and final offers in merger negotiations as they will want to keep some powder dry in case a topping bidder seeks to break up an existing merger agreement. Likewise, potential bidders who for various business purposes may require certainty that an announced merger agreement will not be disturbed by a topping bid might decline to enter into negotiated merger agreements. This would have the effect of depriving stockholders of the opportunity for value enhancing deals.

The plight of NCS would seem to be an example of why, at least in certain circumstances, a board should be able to offer certainty to a potential merger partner. At the time the NCS board agreed to the Genesis merger — after over two years of searching for a transaction partner — the Genesis offer was the only non-conditional offer received by NCS that provided for any recovery for the NCS stockholders. Further, NCS had previously held discussions about a potential transaction with Omnicare, but all of NCS's efforts to negotiate a deal had been unsuccessful because Omnicare had consistently insisted that it was only interested in an asset sale in bankruptcy and had never offered anything for NCS's stockholders. Even when Omnicare later relented on the structure of a potential deal, it refused to propose a binding offer until two months after filing its lawsuit challenging the NCS/Genesis merger agreement. Against that backdrop, and in the face of Genesis's ultimatum and threat that it would withdraw its offer, the NCS board determined that approving the Genesis merger was the "only reasonable alternative" for the NCS board. This is the type of board determination that deserves maximum judicial deference. In that regard, it is noteworthy that fully informed stockholders holding a majority of the voting power of NCS voluntarily agreed to be bound to the NCS/Genesis merger agreement, strongly supporting the board's determination that the NCS/Genesis merger was the best transaction reasonably available.

Departure from Time-Warner? In the Delaware Supreme Court's well-known *Time-Warner*^{viii} decision, Time and Warner had entered into a merger agreement that would have required the approval of Time's stockholders. After the announcement of the Time/Warner merger agreement, Paramount made a premium bid for Time. Concerned that Time's stockholders would vote down the Time/Warner merger agreement in favor of Paramount's bid, Time and Warner restructured their merger agreement to a leveraged transaction that did not require a vote of the Time stockholders, thus defeating Paramount's bid for Time.

Applying a *Unocal* analysis, the Delaware Supreme Court held that the Time board satisfied the first prong of *Unocal* because the board reasonably perceived a threat to Time's corporate policy, namely the threat posed by Paramount to Time's editorial and journalistic culture. Turning to the second prong of *Unocal*, the Court then held that Time's response — which absolutely precluded Time's stockholders from accepting Paramount's bid — was reasonable and proportionate to the perceived threat from Paramount. The Court noted that Time's response was not aimed at "cramming down" upon stockholders management's proposal, but instead had as its goal the carrying forward of a pre-existing transaction. The Court also noted that Paramount was still able to bid for the merged Time-Warner entity.

In several respects, the facts in *Omnicare* provide an even more compelling basis for finding that the NCS/Genesis merger agreement passes muster under *Unocal*. First, the threat perceived by the NCS board (*i.e.*, that Genesis would withdraw its offer and that NCS would be left with no alternative transaction) was a threat to the very existence of the corporation as there was evidence that the NCS stockholder's equity would be completely wiped out without a business combination transaction. The threat to Time's culture and editorial integrity pales in comparison to the threat NCS faced.^{ix} Second, the restructured merger agreement in *Time-Warner* absolutely prevented any stockholder vote and any opportunity for the Time stockholders to vote down the Time/Warner merger agreement in favor of the Paramount bid. In other words, instead of "coercing" the vote, the Time board restructured the Time/Warner merger agreement to simply "preclude" any vote in the first place. Conversely, the NCS/Genesis merger agreement not only provided for a stockholder vote, it actually mandated such a vote. The fact that the outcome of the vote was determined when the Majority Stockholders voluntarily committed to vote for the merger (and forego a potential topping bid) simply reflects corporate democracy at work in light of the magnitude of the threat that NCS faced. Finally, there is no reason that *Omnicare* could not have made a bid for the combined NCS/Genesis entity, just as Paramount was free to bid for Time/Warner.

What is the Role of Majority Stockholders? In finding that the defensive provisions in the NCS/Genesis merger agreement were unenforceable on the alternative ground that they operated to limit the fiduciary duties of the NCS board following the execution of the NCS/Genesis merger agreement, the Delaware Supreme Court held that the NCS board was required to negotiate a fiduciary out to protect NCS's minority stockholders in the event the Genesis offer subsequently became an inferior offer. The Court explained that, given the Mandatory Vote Provision and voting agreements, only a fiduciary out would have protected the minority stockholders in the event a superior offer materialized.

This analysis appears to elevate the role and power of minority stockholders. In practice, minority stockholders never have an "unfettered" vote, as the vote of the majority stockholder will always carry the day. For example, had there been no voting agreement in *Omnicare*, the stockholder vote would have operated to protect the minority stockholders only in the sense that the Majority Stockholders would have almost certainly voted for the belated, superior offer from *Omnicare*. But the minority stockholders had no power in and of themselves to dictate, or even affect, the outcome of the vote. Consequently, it is unclear why the Majority Stockholders were unable to cast an early vote and accept the "bird in a hand" by agreeing to vote for the Genesis merger and forego a conditional superior offer.

The Court relies heavily on its decision in *Paramount v. QVC*.^x In *QVC*, Paramount's public stockholders would have been relegated to minority status as a result of the proposed transaction between Paramount and Viacom, because Sumner Redstone would have owned a

majority of the combined entity. It therefore made sense that the vote by the shareholders on whether to become minority shareholders, and accept a concomitant diminution in their voting power, was entitled to special protection to ensure that the vote was uncoerced and free of preclusive factors. But *Omnicare* extends this protection to a situation where the minority already exists and is subject to the will of the majority. The NCS/Genesis merger itself would have caused no diminution in the public stockholders' voting power, and the defensive measures certainly were not coercive or preclusive for the Majority Stockholders – in essence, they had already voted pursuant to the voting agreements.

Moreover, voting agreements are entitled to more deference than other defensive measures because they are fundamentally stockholder action, not board actions. It is board action in the face of a contest for control — and the associated “omnipresent specter” that a board will act for purposes of entrenching itself to the detriment of the stockholders — that justifies the “heightened scrutiny” of *Unocal* in the first place. But stockholders are free to vote as they please. The *Omnicare* Court explained that the voting agreements should be subject to *Unocal* analysis because they were “inextricably intertwined” with the merger agreement. An example may be where a board agrees to waive Section 203 of the Delaware corporation law (the so-called anti-takeover statute) in connection with a voting agreement. But it is unclear that a board's approval of a stockholder's voting agreement, or the fact that the stockholder also serves on the board, should transform a voluntary voting decision as a stockholder into board action.

Would a *Revlon* Analysis Have Yielded A Different Result? As noted, the Delaware Supreme Court in *Omnicare* assumed *arguendo* that *Revlon* did not apply, implying that the Court was applying a less stringent standard of judicial scrutiny. Curiously, an application of *Revlon* may have yielded a different result. Under a *Revlon* analysis, the primary focus would have been on whether the NCS board employed a process designed to obtain the highest value reasonably available for the NCS stockholders. Here, there was no question raised as to whether NCS engaged in a full and robust process. The market check lasted approximately two years and, by all accounts, included every logical bidder.^{xi} Having satisfied their duty to conduct a full and robust process, the only potential areas of attack on the NCS board would have been (i) whether the board concluded the process too early — *i.e.*, by deciding to crown Genesis as the winner and declining to extend *Omnicare* an opportunity to continue its due diligence, and (ii) whether the board appropriately locked up the winning bid.

On the first issue, Delaware courts have granted directors wide discretion in conducting auctions or other sales processes under *Revlon*.^{xii} In particular, the courts have recognized that at some point the directors are entitled to close the auction.^{xiii} Indeed, the courts have noted that it is the directors' ability to set the rules for the auction (including auction deadlines) that provides bidders with the comfort to come forward with their highest and final offers.^{xiv} Thus, it is unlikely that a court would have second-guessed the NCS board's decision to end the process when it did. Likewise, on the second issue, if the defensive measures in the NCS/Genesis merger agreement are viewed as locking up the winner of an auction or sales process, any argument that the board must still leave the door open for further bidding would find itself competing with the accepted doctrine that the auctioneers (*i.e.*, the directors) are entitled to set the rules for the auction in order to conduct a successful sales process. Consequently, the NCS/Genesis merger agreement may well have satisfied scrutiny under a *Revlon* analysis.

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The impact of the *Omnicare* decision remains to be seen. The dissent suggests it should be interpreted narrowly and confined to its facts. It is likely that parties seeking to challenge

future merger agreements will take a more expansive approach. The courts will decide which interpretation is correct.

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APPENDIX II

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Directors' Conscious Disregard of Known Risk Is Not Protected by Business Judgment Rule or Exculpatory Clauses*

Two recent decisions regarding alleged duty of care violations, In Re The Walt Disney Company Derivative Litigation, C.A. No. 15452 (Del. Ch. May 28, 2003) and In Re Abbott Laboratories Derivative Shareholders Litigation, 325 F.3d 795 (7th Cir. March 28, 2003), offer sharp warnings that the protections afforded by the business judgment rule and charter provisions permitted by state law eliminating or limiting the liability of directors for breaches of their duty of due care (which generally have exceptions for acts or omissions not in good faith), referred to as exculpatory clauses, will not extend to instances in which directors “consciously and intentionally disregard [] their responsibilities, adopting a ‘we don't care about the risks’ attitude concerning a material corporate decision.”

In these cases, the courts held that directors can be held personally liable if they fail affirmatively to consider troubling corporate developments -- even when management elects not to put such matters on the agenda for consideration by the directors -- and this failure constitutes a “conscious disregard of a known risk.” Significantly, the courts held that the allegations of conscious disregard of known risks called into question whether directors acted in good faith and, as a result, were entitled to the protections offered by exculpatory clauses. The courts concluded that boards of directors are not solely reactive parts of the corporate machinery. Rather, good corporate governance mandates that directors proactively inform themselves about corporate developments and aggressively intervene to understand reported troublesome corporate behavior that is not voluntarily brought before the board by management. Accordingly, directors who knowingly put their heads in the sand to avoid taking action on corporate issues may offer plaintiffs a tempting anatomical target at which to kick.

In Disney, stockholder derivative plaintiffs alleged that Disney directors breached their duty of care in connection with the hiring and subsequent termination of Michael Ovitz, both of which were negotiated almost exclusively by Disney's chief executive officer (and Ovitz's close personal friend) Michael Eisner, and which resulted in a \$140 million severance payment. Specifically, plaintiffs alleged that the directors breached their fiduciary duties when they “blindly approved an employment agreement with [] Michael Ovitz and then, again without any review or deliberation, ignored Michael Eisner's dealings with Ovitz regarding his [] termination.” Reviewing the actions of the Disney Board in connection with Ovitz's termination, the court observed:

* By Fried, Frank partners Arthur Fleischer, Jr., Warren de Wied, Stuart Katz, Sanford Krieger, William McGuinness, Robert Schwenkel and Abbott Cooper.

The [] Board apparently never sought to negotiate with Ovitz regarding his departure. Nor, apparently, did it consider whether to seek a termination based on fault. . . . [T]he [] Board allegedly chose to remain invisible in the process. The new complaint alleges that the [] Board: (1) failed to ask why it had not been informed; (2) failed to inquire about the conditions and terms of the agreement; and (3) failed even to attempt to stop or delay the termination until more information could be collected. If the Board had taken the time or effort to review these or other options, perhaps with the assistance of expert legal advisors, the business judgment rule might well protect its decision. In this case, however, the new complaint asserts that the [] directors refused to explore any alternatives, and refused to even attempt to evaluate the implications of the non-fault termination

While the court acknowledged its reluctance to second guess the decisions of independent directors, it held that the facts alleged “believe any assertion that [the Disney directors] exercised any business judgment or made any good faith attempt to fulfill the fiduciary duties they owed to Disney and its shareholders.”

In addition to the claims against the Disney directors, the court also considered the plaintiffs’ claims that Ovitz breached his fiduciary duties to Disney during the negotiation of his employment agreement and termination. Although the court acknowledged Ovitz’s right to seek the best employment agreement possible for himself, it found that, since Ovitz became president of Disney while still negotiating his employment agreement, he “had a duty to negotiate honestly and in good faith so as not to advantage himself at the expense of Disney shareholders.” The court further found that the alleged facts, if true, supported an inference that Ovitz breached that duty, with respect to both his employment agreement and his termination.

In considering shareholder derivative plaintiffs’ claims that directors failed, over a period of six years, to inquire into, much less interrogate management about, FDA violations of which the directors were aware (reported in the press and in the Company’s own public filings) and which ultimately resulted in Abbott paying a fine of \$100 million to the FDA, the Abbott court noted plaintiffs’ allegation that “directors were aware of the six year history of noncompliance problems with the FDA and . . . had a duty to take necessary action to correct these problems.” Similar to the holding in Disney, the court concluded that these allegations, if true,

support a reasonable assumption that there was “a sustained and systematic failure of the board to exercise oversight,” in this case intentional in that the directors knew of the violations of law, took no steps in an effort to prevent or remedy the situation, and that failure to take any action for such an inordinate amount of time resulted in substantial corporate losses

In both Disney and Abbott, the courts held that, assuming the truth of the facts alleged, the directors’ failures were so egregious as to “establish a lack of good faith” and were contrary to the best interests of the corporation; consequently (i) the plaintiffs in each case were excused from making demand upon the corporation, and (ii) neither board was

entitled to the protections offered by the exculpatory clauses permitted by DGCL § 102(b)(7) and its Illinois equivalent. Additionally, although not raised by either court, the holding in each case raises the spectre not only that the protections afforded by the business judgment rule and exculpatory clauses will not attach in instances of conscious disregard of known risks, but that directors' and officers' insurance carriers may disclaim coverage in such instances, relying on the exclusions for willful or intentional misconduct and wrongful acts commonly found in recent policies.

While both opinions make clear that exculpatory clauses do not protect directors from liability in cases where directors have consciously disregarded their duties, the following caveats should be kept in mind. First, because of the procedural posture of each case, the court was required to accept as true all well pled facts in the plaintiffs' complaint. The ruling in each case was that the plaintiffs' complaint stated a claim, not that the directors were liable for the alleged breaches. Second, the facts alleged in each case depict sustained failures in board oversight by directors who failed to "act in good faith and meet minimal proceduralist standards of attention." Both cases concerned troublesome breakdowns in the board process -- the inactions complained of were not isolated incidents or "honest errors," but rather "egregious process failures that implicate[d] the foundational directoral obligation to act honestly and in good faith to advance corporate interests." Third, the complained of inaction in each case involved issues of which the directors were aware. Neither ruling applies where directors would not reasonably be aware of facts or circumstances that result in corporate losses.

Notwithstanding these decisions, independent directors who exercise skepticism, diligence and a willingness to ask tough questions, to insist that management present to the board (or an appropriate committee) matters of potential materiality to the corporation, who fully inform themselves with respect to matters presented to the board (including decisions not to act), and who seek the advice of independent experts (including executive compensation experts) when it is appropriate to do so, should continue to enjoy all the protections afforded by the business judgment rule and exculpatory clauses.

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APPENDIX III

Is There a Duty of Good Faith Separate from the Duty of Loyalty and the Duty of Care?

By Arthur Fleischer, Jr. and Alex Sussman* (August 1, 2003)

The business judgment rule, “is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”²⁷⁶ To rebut the presumption of the business judgment rule, a plaintiff may show, “a breach of any one of the board of directors’ triad of fiduciary duties, loyalty, good faith, or due care. . . .”²⁷⁷

Historically, challenges to a director’s good faith were subsumed in a court’s inquiry into the director’s satisfaction of her duties of care and loyalty. Where a violation of either of those duties was found, there was no particular significance to determining whether there was a separate violation of the director’s duty of good faith; and where there was no breach of those duties, it was uncommon to have an issue of the director’s good faith. However, Section 102(b)(7) of the Delaware General Corporation Law removes the exculpatory protection of that statutory section for violations of the duty of care where there are “acts or omissions not in good faith.”²⁷⁸ Recent cases have therefore inquired into whether directors’ alleged due care or loyalty violations also constituted bad faith conduct and have raised the question whether directors should be separately concerned with meeting their duty of good faith.

In particular, in two recent derivative suits, *In re The Walt Disney Co. Derivative Litig.*²⁷⁹ and *In re Abbott Labs. Derivative Shareholders Litig.*,²⁸⁰ the courts found that plaintiffs sufficiently pleaded allegations of breaches of the duty of good faith, not only to survive defendants’ motions to dismiss, but also to preclude the protection of Section 102(b)(7).²⁸¹

The corporation’s ability to limit or extinguish director liability stems from § 102(b)(7) of the Delaware General Corporation Law or the statutory equivalent of

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²⁷⁶ *McMullin v. Beran*, 765 A.2d 910, 916 (Del. 1999) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

²⁷⁷ *Emerald Partners v. Berlin*, 726 A.2d 1215, 1221 (Del. 1999); see *Cede & Co v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993); see also *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162-64 (Del. 1995); *In Re Tri-Star Pictures, Inc. Litig.*, 634 A.2d 319, 333 (1993).

²⁷⁸ 8 Del. C. § 102(b)(7)(ii).

²⁷⁹ C.A. No. 15452 2003 Del Ch. LEXIS 52 (Del. Ch. May 28, 2003).

²⁸⁰ 325 F.3d 79 (7th Cir. Mar. 28, 2003).

²⁸¹ See *Disney*, 2003 Del. Ch. LEXIS 52, at *4, *39; *Abbott*, 325 F.3d at 809-11.

another state.²⁸² Section 102(b)(7) provides that:

§ 102. Contents of certificate of incorporation.

* * *

(b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) *for acts or omissions not in good faith* or which involve intentional misconduct or a knowing violation of law;²⁸³

The essence of § 102(b)(7) is that corporations may eliminate or limit director liability for breaches of the duty of care.²⁸⁴ In keeping with the business judgment rule, Delaware courts have consistently held that directors may be liable for breaching their duty of care only when they have acted in a grossly negligent manner, well beyond ordinary negligence.²⁸⁵ Indeed, gross negligence, for this purpose, has been described as involving, “a devil-may-care attitude or indifference to a duty amounting to recklessness.”²⁸⁶

The *Disney* and *Abbott* opinions focus attention on the imprecise, subjective distinction between “gross negligence amounting to recklessness,” only a due care violation for which directors will have § 102(b)(7) protection, and recklessness showing “conscious disregard” or “knowing and deliberate indifference” of the director’s duties or “conscious disregard of known risks,” for which, according to those opinions, § 102(b)(7) protection is not available. In both *Disney* and *Abbott* the courts found that the plaintiffs

²⁸² For similar director exculpation provisions in other states, see *Takeover Defense* § 3.06[A][2].

²⁸³ 8 Del. C. § 102(b)(7) (emphasis added).

²⁸⁴ See Rodman Ward, Jr., Edward P. Welch & Andrew J. Turezyn, Esquire, *Folk on the Delaware General Corporation Law* (4th ed. 1998, Supp. 2003) (“...[T]he Delaware legislature decided that Delaware corporations should be authorized to include provisions in their certificate of incorporation limiting or eliminating the personal liability of directors for breach of the duty of due care.”); *Abbott*, 325 F.3d at 809-10.

²⁸⁵ See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985).

²⁸⁶ William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 Bus. Law. 1287, 1300 (Aug. 2001) (citing *Solash v. Telex Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P93, 608 at 97,722 (Del. Ch. Jan. 19, 1988) (gross negligence is a “high standard” requiring proof of “reckless indifference” or “gross abuse of discretion”); see also *Tomczak v. Morton Thiokol, Inc.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P95,327, at 96, 577 (Del. Ch. Apr. 5, 1990) (citing *Allaun v. Consolidated Oil Co.*, 147 A. 257, 261 (Del. Ch. 1929)); *Gimbel v. Signal Cos., Inc.*, 316 A.2d 599, 615 (Del. Ch. 1974), *aff’d*, 316 A.2d 619 (Del. 1974)).

sufficiently pleaded violations of the duty of good faith and, therefore, director liability notwithstanding the corporations' § 102(b)(7) charter provisions, based on alleged director recklessness amounting to conscious or intentional misconduct.²⁸⁷

For example, in *Disney*, the board of directors allegedly allowed Michael Eisner to unilaterally hire Michael Ovitz, his close friend of over twenty-five years, as president of the Walt Disney Company.²⁸⁸ Neither the board of directors nor the compensation committee received a draft of the employment agreement to review prior to their meetings on September 26, 1995. The compensation committee's meeting, on September 26, 1995, lasted for less than an hour. At their meeting the committee members spent most of their time discussing two topics other than the Ovitz employment agreement, one of which was the compensation of director Irwin Russell for helping to obtain Ovitz's employment. In the brief time spent discussing the employment agreement itself, the committee received only a summary of its terms and conditions. Only a few questions were asked about the agreement, and none of the committee members took the time to review the employment agreement. Additionally, there was no presentation by an expert to the committee. Before the conclusion of the meeting the committee approved Ovitz's hiring and granted Eisner the power to approve the final terms of the agreement.²⁸⁹

The board of directors met the next day. Of the fifteen pages of board minutes generated from that meeting less than one and one-half pages involve discussion of Ovitz's hiring. From the minutes, most of the time spent discussing Ovitz's hiring appeared to focus on the compensation to be paid to Mr. Russell. No presentations were made to the board with regard to the terms of the draft agreement. If any questions were asked with regard to the agreement, they were not reflected in the minutes. There was no expert presentation to the board. At the end of the meeting, the board approved Ovitz's hiring. The board, like the compensation committee, left it up to Eisner to hammer out the final terms of the employment agreement.²⁹⁰

Eisner and Ovitz reached a final agreement on December 12, 1995. The final agreement varied from the original draft, but neither the committee nor the board ever reviewed it. The final version of the agreement was signed without further board involvement beyond the meeting on September 26, 1995.²⁹¹

Ovitz performed badly as Disney's president. Eisner and Ovitz agreed to end Ovitz's employment with a non-fault termination. Disney's board was never consulted. Ovitz's non-fault termination agreement was finalized on December 11, 1996. The Disney board did not question the arrangement of the non-fault termination. On December 27, 1996, Eisner and another Disney executive and director accelerated the effective date of the non-fault termination. Again the Disney board took no action.²⁹²

²⁸⁷ See *Disney*, 2003 Del. Ch. LEXIS 52, at *37-39; *Abbott*, 325 F.3d at 809-811.

²⁸⁸ See *Disney*, 2003 Del. Ch. LEXIS 52, at *30-31

²⁸⁹ See *id*

²⁹⁰ See *id*.

²⁹¹ See *id*. at *33.

²⁹² See *id*. at *33-34.

Based on the above facts, the Delaware Court of Chancery held that the plaintiffs had pleaded sufficient allegations of breach of fiduciary duty to survive the defendants' motion to dismiss.²⁹³ Specifically, the court found that the plaintiffs had sufficiently pleaded allegations of breach of the duty of good faith.²⁹⁴ In determining that the plaintiffs had adequately alleged a breach of the duty of good faith the court stated:

These facts, if true, do more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of material importance to their corporation. Instead, the facts alleged in the new complaint suggest that the defendant directors *consciously and intentionally disregarded their responsibilities*, adopting a “we don't care about the risks” attitude concerning a material corporate decision. Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct, in my opinion, that may not have been taken honestly and in good faith to advance the best interests of the company. Put differently, all of the alleged facts, if true, imply that the defendant directors *knew* that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss. Viewed in this light, plaintiffs' new complaint sufficiently alleges a breach of the directors' obligation to act honestly and in good faith in the corporation's best interests for a Court to conclude, if the facts are true, that the defendant directors' conduct fell outside the protection of the business judgment rule.²⁹⁵

The court also found that the plaintiffs' claims, if proven, would be outside of the protection of the Disney Company's liability waiver pursuant to §102(b)(7).²⁹⁶ In making this determination, the court stated, “[w]here a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the directors' actions are either ‘not in good faith’ or ‘involve intentional misconduct.’”²⁹⁷ Thus the court determined that directors would lose liability protection because their conduct fell within §102(b)(7)(ii).²⁹⁸

In *Abbott*, the Seventh Circuit dealt with allegations that Abbott's board of directors violated their fiduciary duties through inaction.²⁹⁹ During a six year period,

²⁹³ *See id.* at *37-38.

²⁹⁴ *See id.*

²⁹⁵ *Id.* (emphasis in the original).

²⁹⁶ *See id.* at *39.

²⁹⁷ *Id.*

²⁹⁸ *See id.*

²⁹⁹ *See Abbott*, 325 F.3d at 802.

from 1993 until 1999, the FDA conducted thirteen inspections of Abbott's Abbott Park and North Chicago facilities and repeatedly sent notices to Abbott of safety violations.³⁰⁰ Plaintiffs alleged facts showing that Abbott's directors were well aware of the continuing problems.³⁰¹ These FDA violations, eventually, "...resulted in the largest civil fine ever imposed by the FDA and the destruction and suspension of products which accounted for approximately \$ 250 million in corporate assets...."³⁰²

The Seventh Circuit reversed the district court's dismissal of the case.³⁰³ It held that the plaintiffs sufficiently pleaded allegations that, if true, could lead to the finding that the defendants had knowledge of Abbott's violations and that their inaction violated the duty of good faith.³⁰⁴ In assessing the possible violations of fiduciary duty by the directors, the Seventh Circuit stated:

Given the extensive paper trail in *Abbott* concerning the violations and the inferred awareness of the problems, the facts support a reasonable assumption that there was a "sustained and systematic failure of the board to exercise oversight," in this case intentional in that the directors knew of the violations of law, took no steps in an effort to prevent or remedy the situation, and that failure to take any action for such an inordinate amount of time resulted in substantial corporate losses, establishing a lack of good faith. We find that six years of noncompliance, inspections, 483s, Warning Letters, and notice in the press, all of which then resulted in the largest civil fine ever imposed by the FDA and the destruction and suspension of products which accounted for approximately \$ 250 million in corporate assets, indicate that the directors' decision to not act was not made in good faith and was contrary to the best interests of the company.³⁰⁵

The Seventh Circuit also considered whether the defendants would be protected from liability under Abbott's § 102(b)(7) waiver provision.³⁰⁶ The court determined that the plaintiffs' claims were not precluded by Abbott's § 102(b)(7) provision, because the plaintiffs had sufficiently alleged violations of the duty of good faith.³⁰⁷ Following the reasoning of the Sixth Circuit in *McCall v. Scott*, 250 F.3d 997 (6th Cir. 2001), the Seventh Circuit explained:

³⁰⁰ *See id.* at 799-800.

³⁰¹ *See id.* at 799-801.

³⁰² *Id.* at 809.

³⁰³ *See id.* at 811.

³⁰⁴ *See id.* at 809.

³⁰⁵ *Id.*

³⁰⁶ *See id.* at 809-11.

³⁰⁷ *See id.* at 811.

The Sixth Circuit followed Delaware law in *McCall* in finding that the directors' fiduciary duties include not only the duty of care but also the duties of loyalty and good faith, stating that although "duty of care claims alleging only grossly negligent conduct are precluded by § 102(b)(7) waiver provision, it appears that duty of care claims based on reckless or intentional misconduct are not." The *McCall* court noted, "To the extent that recklessness involves a *conscious disregard of a known risk*, it could be argued that such an approach is not one taken in good faith and thus could not be liability exempted under the statute." The court further stated, "Under Delaware law, the duty of good faith may be breached where a *director consciously disregards his duties to the corporation*, thereby causing its stockholders to suffer." Plaintiffs in *Abbott* accused the directors not only of gross negligence, but of intentional conduct in failing to address the federal violation problems, alleging "a conscious disregard of known risks, which conduct, if proven, cannot have been undertaken in good faith."

In *McCall*, where the duty of care claims arose from the board's unconscious [sic] failure to act, the Sixth Circuit held that with a Certificate of Incorporation which exempts the directors from personal liability (with language identical to the *Abbott* provision), "a conscious disregard of known risks, which conduct, if proven, cannot have been undertaken in good faith. Thus, . . . plaintiffs' claims are not precluded by [the company]'s § 102(b)(7) waiver provision." [sic]³⁰⁸

In conclusion, the *Disney* and *Abbott* opinions endorse the principle that directors may be held liable for a lack of good faith only where they consciously or intentionally disregard their duties -- and not for gross negligence or even recklessness where their wrongdoing is unwitting or unintentional. The potential difficulty for directors is in the manner in which judges and juries may evaluate their conduct given the imprecise and subjective boundary between good faith and bad faith applying that principle.

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³⁰⁸ *Id.* (citations omitted) (emphasis added).

APPENDIX IV

Pertinent Excerpts from Treatises Relating to Good Faith

- David A. Drexler, Lewis S. Black, Jr., A. Gilchrist Sparks, III, DELAWARE CORPORATION LAW AND PRACTICE (1988) (Supp. 2002) (Matthew Bender).
- p. 15-4 “In its recent discussions of the subject of fiduciary duty, the Delaware Supreme Court has expanded its definition of the fiduciary duty of directors into a ‘triad,’ encompassing not only the duty of loyalty and the duty of care, but a third, independent duty of good faith. Good faith as a separate aspect of the performance of a director’s fiduciary duty is also suggested by a 1986 amendment to the General Corporation Law. However, it is difficult to see how good faith as a concept is not encompassed within the other legs of the ‘triad’ -*i.e.*, how a director might be found to have breached his duty of good faith without being either disloyal or insufficiently careful. (See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995); 8 Del. C. §102(b)(7)).”
- Rodman Ward, Jr., Edward P. Welch & Andrew J. Turezyn, Esquire, FOLK ON THE DELAWARE GENERAL CORPORATION LAW (4th ed. 1998) (Supp. 2003) (Aspen Publishers).
- p. GCL-IV-21 “The director’s fiduciary duty to both the corporation and its shareholders has been characterized by the Delaware Supreme Court as a triad comprising good faith, due care, and loyalty. (*Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (citing *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 64 (Del. 1989), *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985), and *Aronson v. Lewis*, 473 A.2d 803, 805 (Del. 1984)). *See also* *Kahn v. Dairy Mart Convenience Stores, C.A. No. 12489*, slip op. at 3 (Del. Ch. Mar. 1, 1994); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1164 (Del. 1995); *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998); *Emerald Partners v. Berlin*, 726 A.2d 1215, 1221 (Del. 1999); *Jackson Nat’ Life Ins. Co. v. Kennedy*, 741 A.2d 377, 386 (Del. Ch. 1999). *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001) (“The directors of Delaware corporations have a triad of primary fiduciary duties; due care, loyalty, and good faith.”)).”
- p. GCL-IV-22 “In *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, the Delaware Supreme Court stated that bad faith relates to state of mind, and that a claim of bad faith ‘hinges on a party’s

tortious state of mind.’ (624 A.2d 1199, 1208 (Del. 1993), citing *Black’s Law Dictionary* 72 (5th ed. 1983) (“‘bad faith’ is not simply bad judgment or negligence, but . . . implies the conscious doing of a wrong because of dishonest purpose or moral obliquity; it is different from the negative idea of negligence in that it contemplates a state of mind affirmatively operating with furtive design or ill will”).”

- R. Franklin Balotti & Jesse A. Finkelstein, *THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS* (3d ed. 1998) (Supp. 2003) (Aspen Publishers).

p. 4-151 “When a director acts with ‘reckless indifference to or [with] a deliberate disregard to the interests of the whole body of stockholders,’ some cases suggest that he cannot be said to be acting in good faith. (See *In re J.P. Stevens & Co., Inc. S’holders Litig.*, 542 A.2d 770, 780 (Del. Ch. 1988) (“[a] court may, however, review the substance of a business decision made by an *apparently* well-motivated board for the limited purpose of assessing whether that decision is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith”).”

- Dennis J. Block, Nancy E. Barton & Stephen A. Radin, *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* (5th ed. 1998) (Aspen Publishers).

p. 26-7 “[T]o rebut the presumption, a shareholder plaintiff assumes the burden of providing evidence that the board of directors, in reaching its challenged decision, breached any one of its triad of fiduciary duties: good faith, loyalty or due care.’ (*Technicolor III*, 663 A.2d at 1164 (emphasis deleted and citing *Technicolor II*, 634 A.2d at 361); see also *Williams*, 671 A.2d at 1378 (“[o]nly by demonstrating that the Board breached its fiduciary duties may the presumption of the business judgment rule be rebutted”); *Technicolor III*, 663 A.2d at 1164 (“the breach of any one of the board’s fiduciary duties” overcomes the business judgment rule presumption) (emphasis deleted); *Parnes*, 1997 Del. Ch. LEXIS 70, at *5, 1997 WL 257435, at *2; *Potter*, 560 N.W.2d at 392).”

p. 80 “The term ‘bad faith’ has been defined as ‘not simply bad judgment or negligence. . . [R]ather it implies the conscious doing of a wrong because of dishonest purpose or moral obliquity; it is different from the negative idea of negligence in that it contemplates a state of

mind affirmatively operating with furtive design or ill will.’ (*Desert Equities, Inc., v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, 624 A.2d 1199, 1208 n. 16 (Del. 1993), *quoted in Potter v. Pohlad*, No. 95-3016, slip op. at 7 (Minn. Dist. Ct. Aug. 19, 1996), *aff’d*, 560 N.W.2d 389 (Minn. Ct. App. 1997), *review denied*, 1997 Minn. LEXIS 459 (Minn. June 11, 1997)).”

p. 82 “Bad faith may be inferred where ‘the decision is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.’ (*In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770, 780-81 (Del. Ch. 1988), *appeal refused*, 540 A.2d 1088 (unpublished opinion, text available at 1988 Del. LEXIS 102 and 1988 WL 35145) (Del. Apr. 12, 1988, *quoted in In re Rexene Corp. Shareholders Litig.*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,010 at 90,058 (Del. Ch. May 8, 1991), *aff’d sub nom. Eichorn v. Rexene Corp.*, 604 A.2d 416 (unpublished opinion, text available at 1991 Del. LEXIS 333 and 1991 WL 210962) (Del. Oct. 10, 1991)).”

- Dennis J. Block, Nancy E. Barton & Stephen A. Radin, *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* (5th ed. 2002 Supp.) (Aspen Publishers).

p. 102 “[T]he duty of good faith may be breached where a director consciously disregards his duties to the corporation, thereby causing its stockholders to suffer.’ (*McCall v. Scott*, 250 F.3d 997, 1001 (6th Cir. 2001)).”

p. 102-03 “The Court of Chancery has suggested that ‘[i]f it is useful at all as an independent concept, the good faith iteration’s utility may rest in its constant reminder (1) that a fiduciary may act disloyally for a variety of reasons other than personal pecuniary interest; and (2) that, regardless of motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes.’ (*Nagy v. Bistricher*, 770 A.2d 43, 49 n.2 (Del. Ch. 2000)).”

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ⁱ *Omnicare, Inc. v. NCS Healthcare, Inc.*, 2003 Del. LEXIS 195 (Del. April 4, 2003). fny03\fleisar\523082.1

ⁱⁱ Section 251(c) was amended in 1998. Case law prior to the adoption of the current Section 251(c) interpreted the Delaware corporation law as precluding a stockholder vote if the board of

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- directors, after approving a merger agreement, decided to no longer recommend it. *See Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).
- iii Although Omnicare also alleged breaches of fiduciary duty in its complaint, because the Delaware Chancery Court determined that Omnicare did not have standing to bring those claims, it was the fiduciary duty claims brought by the stockholder plaintiffs that were ultimately heard and decided by the Delaware Supreme Court in *Omnicare*.
- iv *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986). Where *Revlon* applies, the board has a duty to obtain the highest value reasonably available for the stockholders under the circumstances. *Id.*
- v *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).
- vi *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1387-88 (Del. 1995).
- vii Previously, a number of decisions by the Delaware Chancery Court have discussed whether there are circumstances in which a board may lock up a negotiated merger agreement. *See, e.g., Ace Ltd. v. Capital Re Corp.*, 747 A.2d 95, 107 & n.36 (Del. Ch. 1999) (suggesting, in dicta, that "where a board has actively canvassed the market, negotiated with various bidders in a competitive environment, and believes that the necessity to close a transaction requires that the sales contest end" may present a circumstance where "a board could prudently place itself in the position of not being able to entertain and consider a superior proposal to a transaction dependent on a stockholder vote"), *IXC Communications, Inc. Shareholder Litig.*, 1999 WL 1009174 (Del. Ch. Oct. 27, 1999) (declining to enjoin a merger agreement that had originally contained a no-talk provision, no fiduciary out clause, and where 40% of the target's stock was "locked up" — the Court noted that the target had publicly shopped itself for nearly six months); *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, 1999 Del. Ch. LEXIS 202 (Del. Ch. Sept. 27, 1999) (suggesting that a board can never absolutely contract away its right to talk to potential topping bidders for the entire period from the execution of a merger agreement until the stockholder vote, and characterizing such strict provisions as "the legal equivalent of legal blindness, a blindness that may constitute a breach of a board's duty of care").
- viii *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1990).
- ix In *Time-Warner*, the Delaware Supreme Court endorsed the principle that the magnitude of the perceived threat informs the distance the board may go in protecting against the threat. 571 A.2d at 1154.
- x *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1993).
- xi In that regard, although the Delaware Chancery Court held that *Revlon* was completely inapplicable to the NCS/Genesis merger agreement, that Court nonetheless noted that, even applying the *Revlon* standard, the NCS board acted in conformity with their duty in seeking to achieve the highest and best transaction reasonably available to the NCS stockholders. *In re NCS Healthcare, Inc. Shareholder Litig.*, 2002 Del. Ch. LEXIS 133, at *50 (Del. Ch. Nov. 25, 2002).
- xii *See, e.g., Doskocil Cos. v. Griggy*, 1988 Del. Ch. LEXIS 132 (Del. Ch. Oct. 7, 1988) (board may use the company's rights plan as a gavel for conducting auction until the highest price reasonably available is obtained and may, for example, refuse to redeem rights plan for higher offeror even

where board has already redeemed plan as to lower competing offer so long as the auction is still in process).

xiii *See, e.g., TCG Securities, Inc. v. Southern Union Co.*, 1990 Del. Ch. LEXIS 12 (Del. Ch. Jan. 31, 1990).

xiv *See, e.g., Renaissance Communications Corp. v. National Broadcasting Co.*, C.A. No. 14446, 1995 WL 1798510 (Del. Ch. Aug 1, 1995) (oral ruling) ("if the fiduciary duty always overrides an auction, you have just made auctions less valuable, because people obviously won't have the incentive to issue the best price...., [therefore] there must be circumstances in which the contracts can essentially — in this auction context essentially remove from the board the later discretion" to consider a higher bid).