

The Presumptions and Burdens of the Duty of Loyalty Regarding Target Company Defensive Tactics

I. INTRODUCTION

Within the past decade, the proliferation of hostile takeover activity has spawned many innovative defensive strategies by target companies.¹ However, corporate directors do not have unlimited discretion to fend off hostile tender offers. They are limited by their fiduciary obligations to the corporation and its shareholders.² The business judgment rule is the generally accepted standard of judicial review regarding the adoption of defensive measures by directors in a hostile takeover situation.³ Courts differ on the allocation⁴ and degree⁵ of the burden of proof in applying the business judgment rule to a situation involving corporate control. Judicial interpretation of the rules governing fiduciary conduct must adequately scrutinize a target company's defensive tactics to ensure that the directors have fulfilled their fiduciary duties and have remained responsive to the corporation and the shareholders. Two recent Supreme Court of Delaware decisions, *Unocal Corp. v. Mesa Petroleum Co.*⁶ and *Moran v. Household International, Inc.*,⁷ considered the allocation of the burden of proof in a hostile takeover situation under the business judgment rule. In both cases, the court held that the burden of proof was appropriately shifted to the directors to show that reasonable grounds for believing that a danger to corporate policy and effectiveness existed and that the defensive mechanism adopted was reasonable in relation to the threat posed.⁸

This Note considers the judicial perspective of the duty of loyalty on corporate management in a hostile takeover situation. Part I will examine both the business judgment rule and the duty of loyalty and the relationship of each to a target company's defensive maneuvers. Part II will detail the variations in judicial allocation of the burden of proof under business judgment rule analyses of defensive tactics. Part III will scrutinize the different standards that courts have imposed on directors to justify their defensive tactics. Part IV will examine the decisions in *Unocal* and *Moran*. Part V will analyze the implications of these cases for the

1. Specific takeover defensive strategies are discussed in E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 193-202 (1977); M. LIPTON & E. STEINBERGER, 1 TAKEOVERS AND FREEZEOUTS § 6.05 (1986).

2. Fiduciaries must act in the best interests of the corporation and its shareholders. In addition, fiduciaries' actions may not exceed their authority or the powers of the corporation. For example, if a target company's defensive tactics were designed to bankrupt the company, the fiduciaries' actions arguably breached their obligations to the company. For a general discussion of corporate directors' fiduciary duties, see H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS §§ 231-42 (3d ed. 1983).

3. See *infra* note 27 and accompanying text.

4. See *infra* notes 28-99 and accompanying text.

5. See *infra* notes 100-20 and accompanying text.

6. 493 A.2d 946 (Del. 1985).

7. 500 A.2d 1346 (Del. 1985).

8. See *infra* text accompanying notes 134-45 (regarding the *Unocal* decision) and 172-79 (regarding the *Moran* decision).

application of the business judgment rule in future actions challenging a target company's defensive tactics.

II. THE BUSINESS JUDGMENT RULE AND THE DUTY OF LOYALTY

The business judgment rule is a principle of judicial review for corporate conduct.⁹ Generally stated:

[A] court will not interfere with the judgment of the board of directors unless there is a showing of gross and palpable overreaching. A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.¹⁰

Many compelling reasons underlie the rule. Primarily, courts and commentators firmly believe that directors are more competent to make business decisions than are the courts.¹¹ Furthermore, such business decisions mandate that directors be afforded substantial discretion to establish effective corporate policies.¹² Moreover, given the nature of the business world, many decisions are made on information markedly less substantial than the rigid evidentiary standards demanded in a court of law. Corporate directors should not be held responsible for higher standards in a court than are demanded by the open market. In addition, market forces effectively monitor corporate policy, weeding out inefficient management.¹³ The business judgment rule relieves the courts from reviewing the merits of business decisions that the courts often feel inadequate to second-guess.¹⁴ The rule's immunity—the privilege of human error—“encourages competent people to become directors without fear of personal liability for honest errors in judgment.”¹⁵

The business judgment rule is a presumption embracing two tenets of fiduciary responsibility: the duty of care and the duty of loyalty. The duty of care requires the fiduciary to exercise the care that a reasonably prudent person in a similar position would use under similar circumstances.¹⁶ Such care must be exercised *before* a

9. See, e.g., *Moran v. Household Int'l, Inc.*, 490 A.2d 1059 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985), in which the court explained:

The business judgment rule has evolved as a corollary to the principle that a board of directors stands in a fiduciary relationship to the shareholders it represents. Because the role of a fiduciary ordinarily does not admit of any conflicting interests or conduct the business judgment rule seeks to accommodate that status to the realities of the business world.

490 A.2d 1059, 1074.

10. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (citation omitted).

11. See Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1195-96 (1981).

12. See Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621, 650-51 (1983).

13. See Easterbrook & Fischel, *supra* note 11, at 1196.

14. See Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964, 1969 (1984); Note, *supra* note 12, at 651.

15. Note, *supra* note 12, at 651. See also Comment, *The Misapplication of the Business Judgment Rule in Contests for Corporate Control*, 76 NW. U.L. REV. 980, 983-84 (1982) (“Without such protection, few qualified people would be willing to serve as directors, and those that could be coerced to serve would be reluctant to undertake business risks.”).

16. See *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984); *Enterra Corp. v. SGS Associates*, 600 F. Supp. 678, 684 (E.D. Pa. 1985).

fiduciary renders a business decision; "a judgment reached without . . . [due care] is not entitled to the presumptive protection which otherwise would be provided by the business judgment rule."¹⁷

The duty of loyalty, or good faith, is derived from the prohibition against self-dealing inherent in the fiduciary relationship.¹⁸ The presumptions of the business judgment rule are inapplicable to a situation in which a fiduciary faces a conflict of interest.¹⁹ Once a fiduciary is proven to have engaged in "self-dealing" or to have a "material personal interest" in a corporate transaction, the decision is tainted and the business judgment rule will not apply.²⁰ The burden then "shifts to the officer or director, who must demonstrate by a preponderance of the evidence that the transaction was 'intrinsically fair' to the corporation and its stockholders."²¹

This theoretical distinction between a director's duty of loyalty to the corporation and the proscription against self-dealing is less rigid in actual practice. A director often cannot avoid some taint of self-interest in order to act effectively as a director:

It is frequently said that directors are fiduciaries. Although this statement is true in some senses, it is also obvious that if directors were held to the same standard as ordinary fiduciaries the corporation could not conduct business. For example, an ordinary fiduciary may not have the slightest conflict of interest in any transaction he undertakes on behalf of the trust. Yet by the very nature of corporate life a director has a certain amount of self-interest in everything he does. The very fact that the director wants to enhance corporate profits is in part attributable to his desire to keep shareholders satisfied so that they will not oust him.²²

The self-interest of corporate directors is especially apparent in the takeover context. Some commentators view the directors' actions regarding a takeover attempt as no different from other business decisions: their duty is to act in the best interests of the corporation and its shareholders and, as such, their decisions should be accorded the same presumptions as any other business decision.²³ Others question the application of the business judgment rule to a takeover situation:

Given the serious and unavoidable conflict of interest that inheres in any decision on one's own ouster, courts ought not to make available to a manager resisting a tender offer—and, in effect, fighting against his own replacement—the same deference accorded to the decisions of a manager in good standing.²⁴

17. Comment, *supra* note 15, at 985. See also *Smith v. Van Gorkom*, 488 A.2d 858, 872-74 (Del. 1985) (there is no protection under the business judgment rule for directors who have made unintelligent or unadvised decisions).

18. See *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939); *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984); *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (Del. 1939).

19. See Note, *supra* note 14, at 1969.

20. See Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PA. L. REV. 647, 714 (1984).

21. *Id.* at 714-15. See also Note, *supra* note 14, at 1969 ("[T]he burden of showing the 'intrinsic fairness' of their actions . . . entails a demonstration of the substantive fairness of the challenged transaction."). See generally *Arsht, The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 115-16 (1979) (describing the intrinsic fairness rule).

22. *Johnson v. Trueblood*, 629 F.2d 287, 292 (3d Cir.), *vacated on other grounds*, 629 F.2d 302 (3d Cir. 1980) (*per curiam*), *cert. denied*, 450 U.S. 999 (1981).

23. See *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1350 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

24. *Easterbrook & Fischel, supra* note 11, at 1198. Professors Easterbrook and Fischel argue that directors of

Assuming that it is proper for a board of directors to be actively involved in a takeover situation²⁵—and there has been no indication that the courts feel otherwise²⁶—the doubt raised regarding their presumption of loyalty to the corporation should preclude the application of the business judgment rule and shift the burden to the directors to prove the intrinsic fairness of their actions. However, the courts have declined to place such a burden on the directors and have applied a business judgment rule analysis to takeover situations.²⁷

III. THE BURDEN OF GOING FORWARD REGARDING CHALLENGED DEFENSIVE TACTICS

In an action by a target company's shareholders challenging the defensive tactics of that company's board of directors, the threshold issue for the court is whether the challengers should bear the burden of attacking the disputed action or whether the defendant directors must bear the burden of justification. Under the business judgment rule, the presumptions of due care and good faith underlying the directors' business decisions place the initial burden of proof on the challengers.²⁸ In evaluating a target company's defensive tactics, the uncertainties inherent in the application of the good faith presumption have caused courts and commentators to differ regarding the allocation of the initial burden and, if the burden is placed on the challenging party, the standard required to shift the burden to the defendant directors.

A. Automatic Shift of Burden to the Directors

Several decisions, most notably in the Delaware state courts, have shifted the burden of proof automatically to the directors when retention of control was implicated. In *Bennett v. Propp*,²⁹ one of the first cases to address this topic, Noma

target companies should be proscribed completely from efforts to resist a takeover because the decision whether or not to accept the takeover bid is properly and competently within the province of the shareholders. *Id.* But see Lipton, *Takeover Bids in the Target's Boardroom; An Update After One Year*, 36 BUS. LAW. 1017 (1981) and Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979), which support the participation of target management in a hostile takeover situation.

25. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) ("[I]n the broad context of corporate governance, including issues of fundamental corporate change, a board of directors is not a passive instrumentality."); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 299 (7th Cir.), cert. denied, 454 U.S. 1092 (1981) ("duty of directors to evaluate proposed business combinations on their merits and oppose those detrimental to the well-being of the corporation even if that is at the expense of the short term interests of individual shareholders").

26. But see Easterbrook & Fischel, *supra* note 11, at 1194-1204; and Gilson, *A Structural Approach to Corporations; The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 831-48 (1981), in which commentators argue that directors of target companies should be passive in a takeover attempt.

27. See Greene, *Recent Tender Offer Developments: On the Edge or Deep In?*, 45 OHIO ST. L.J. 721 (1984): [T]he first courts to review a board's decision to fight a tender offer were being asked to decide, as a threshold matter, whether or not they should even attempt to second-guess the board's decision. At that time the legal arena had reached no consensus as to what should be the proper response of directors in a takeover situation. Without a consensus as to what was right, it was hard to judge whether the directors had acted improperly. The courts also realized that if they chose the path of second-guessing, it could lead to their having to impose tremendous damages on individual directors. Because the majority of directors often were not full-time employees and thus appeared to be disinterested, and because of the intense judicial reluctance to get involved, the courts uniformly chose an easier solution—the business judgment rule.

Id. at 729.

28. See *supra* note 9 and accompanying text.

29. 41 Del. Ch. 14, 187 A.2d 405 (Del. 1962).

Lites was faced with a potential takeover offer by Textron. In response, Noma's chairman of the board purchased on the open market more than twenty-five percent of his company's outstanding shares on behalf of the corporation.³⁰ This action was not authorized by the board of directors; in fact, the board of directors did not know of the chairman's purchases until two days before payment was due.³¹ At that time, the chairman presented the situation to the directors and asked that his actions be ratified.³² The directors approved his actions and effected a loan of nearly three million dollars to pay for the stock.³³ In a shareholders' suit for account against the directors for ratifying the purchase, the Supreme Court of Delaware stated:

We must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult. . . . Hence, in our opinion, the burden should be on the directors to justify such a purchase as one primarily in the corporate interest.³⁴

The control ramifications of the directors' actions caused the court to shift the initial burden of proof to the directors as a matter of law. Thus, the plaintiffs were not required to make an initial showing regarding the directors' motivations.

Similarly, in *Cheff v. Mathes*,³⁵ shareholders of the Holland Furnace Company brought a derivative suit to hold certain corporate directors liable for the loss caused by the allegedly improper use of corporate funds to buy out a dissident stockholder.³⁶ The defendant directors claimed that their actions were necessary to maintain the company's sales program policies and to quell employee unrest caused by the prospect of the dissident stockholder's potential control of the company.³⁷ The plaintiffs maintained that the defendants' actual purpose was to insure the perpetuation of control through the purchase of the dissident shareholder's stock.³⁸ The Supreme Court of Delaware reasoned:

[I]f the actions of the board were motivated by a sincere belief that the buying out of the dissident stockholder was necessary to maintain what the board believed to be proper business practices, the board will not be held liable for such decision, even though hindsight indicates that the decision was not the wisest course. On the other hand, if the board has acted *solely or primarily* because of the desire to perpetuate themselves in office, the use of corporate funds for such purposes is improper.³⁹

In this context, judicial consideration of whether the directors acted "solely or primarily" out of self-interest is directed toward the question of ultimate liability for the alleged violation of the directors' fiduciary duty of loyalty and not toward the initial

30. *Id.* at 17, 187 A.2d at 407.

31. *Id.* at 17-18, 187 A.2d at 407.

32. *Id.* at 18, 187 A.2d at 407.

33. *Id.* at 18-19, 187 A.2d at 407.

34. *Id.* at 22, 187 A.2d at 409. The court found that this burden was not sustained by the defendant directors. *Id.*

35. 41 Del. Ch. 494, 199 A.2d 548 (Del. 1964).

36. *Id.* at 496-97, 199 A.2d at 549-50.

37. *Id.* at 507, 199 A.2d at 556.

38. *Id.* at 502, 199 A.2d at 553.

39. *Id.* at 504, 199 A.2d at 554 (citations omitted) (emphasis added).

allocation of the burden of proof. However, the court did not actually address the issue of whether the directors had breached their duty of loyalty, which would have abrogated the business judgment rule presumption. Rather, the court addressed the allocation of the burden of proof between the challenging shareholders and the defendant directors in light of the business judgment rule. The court specifically stated, "Initially, the decision of the board of directors in authorizing a purchase was presumed to be in good faith and could be overturned only by a conclusive showing by plaintiffs of fraud or other misconduct."⁴⁰ However, the court cited with approval the language in *Bennett* that placed the initial burden of proof on the directors when a threat to control was involved⁴¹ and automatically shifted the burden to the directors.⁴²

B. Burden on Plaintiff to Demonstrate that the Directors' Sole or Primary Motive was to Retain Control

Unlike the *Bennett* and *Cheff* decisions, the courts in *Johnson v. Trueblood*⁴³ and *Panter v. Marshall Field & Co.*⁴⁴ placed a relatively high initial burden of proof on challengers to a target corporation's defensive tactics. In *Johnson v. Trueblood*, the plaintiffs owned forty-seven percent and the defendant directors owned fifty-three percent of Penn Eastern, a real estate development company.⁴⁵ When the corporation experienced financial difficulties, the defendants proposed to raise additional capital by selling twenty-one new shares of stock to Arnold Trueblood, one of the majority directors, at seven hundred fifty dollars per share.⁴⁶ The plaintiffs countered with an offer to purchase twenty new shares at one thousand dollars per share, an offer that would have shifted corporate control to the plaintiffs.⁴⁷ The defendant directors subsequently rejected the plaintiffs' offer and approved the sale of stock to Arnold Trueblood.⁴⁸ In a derivative suit challenging the directors' actions under Delaware law, the plaintiffs contended that they only needed to prove that control was *a* motive for the defendants' actions in order to rebut the business judgment rule presumptions, and thereby shift the burden to the defendant directors.⁴⁹ In a two to one decision, the Court of Appeals for the Third Circuit found this standard to be insufficient, stating that while control is arguably *a* motive in any action taken by a director, it is not, of itself, proof of bad faith.⁵⁰ The court saw the business judgment rule as "postulating that if actions are arguably taken for the benefit of the corporation, then the directors are presumed

40. *Id.*

41. See *supra* note 34 and accompanying text.

42. *Cheff v. Mathes*, 41 Del. Ch. 494, 504-05, 199 A.2d 548, 554 (Del. 1964).

43. 629 F.2d 287 (3d Cir.), *vacated on other grounds*, 629 F.2d 302 (3d Cir. 1980) (*per curiam*), *cert. denied*, 450 U.S. 999 (1981).

44. 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

45. *Johnson v. Trueblood*, 629 F.2d 287, 288 (3d Cir.), *vacated on other grounds*, 629 F.2d 302 (3d Cir. 1980) (*per curiam*), *cert. denied*, 450 U.S. 999 (1981).

46. *Id.* at 289.

47. *Id.*

48. *Id.*

49. *Id.* at 292.

50. *Id.* at 292-93. See text accompanying note 22 for the *Johnson* court's rationale regarding a director's self-interest in control.

to have been exercising their sound business judgment rather than responding to any personal motivations.”⁵¹ As *Johnson* illustrates, this formulation effectively precludes a challenger’s attack on the good faith of the target company’s directors’ defensive tactics⁵² by substituting an analysis of corporate benefits for any consideration of directorial motives. Furthermore, the *Johnson* court held that to overcome the presumption of the business judgment rule and thereby shift this lesser burden to the defendant directors, the plaintiff must “tender evidence from which a factfinder might conclude that the defendant’s *sole or primary* motive was to retain control.”⁵³

In his dissent, Judge Rosenn espoused the plaintiffs’ position and contended that the plaintiffs need only show that control was *a* motive in order to negate the presumptions of the business judgment rule.⁵⁴ Interpreting *Bennett*, he found that when a transaction involving control of a corporation raises a conflict of interest on the part of the board of directors, the burden of justification shifts to the defendant directors.⁵⁵ Judge Rosenn correctly noted that the “sole or primary motive” language in *Cheff v. Mathes*, relied upon by the majority in *Johnson* to establish a burden of proof for the plaintiff, referred to establishing liability and *not* to the burden of proof required to overcome the presumptions of the business judgment rule.⁵⁶ He advocated shifting the burden of proof to the directors once a conflict of interest is established, as was done in *Cheff* and *Bennett*.⁵⁷

In *Panter v. Marshall Field & Co.*,⁵⁸ Marshall Field was faced with a hostile takeover attempt by Carter Hawley Hale (CHH).⁵⁹ In response, Marshall Field’s directors resolved to oppose CHH.⁶⁰ Marshall Field implemented an expansion program designed to raise an insurmountable antitrust barrier against CHH that successfully deterred CHH from pursuing its bid.⁶¹ In a suit by shareholders of Marshall Field against the company and its directors, the plaintiffs contended that the directors resisted any takeover, regardless of possible benefits to the shareholders or the corporation, because they sought to retain control of the company, thereby breaching their fiduciary duty to the corporation.⁶² In a two to one decision, the Court of Appeals for the Seventh Circuit, applying Delaware law, rejected the plaintiffs’ claim under a business judgment rule analysis. The court’s evaluation of Marshall Fields’ policy toward proposed acquisitions rested on the presumption of good faith afforded by the business judgment rule.⁶³ The court found that the plaintiffs “presented no evidence of self-dealing, fraud, overreaching or other bad conduct

51. *Id.* at 292.

52. See *Greene & Junewicz*, *supra* note 20, at 715–16.

53. *Johnson v. Trueblood*, 629 F.2d 287, 293 (3d Cir.), *vacated on other grounds*, 629 F.2d 302 (3d Cir. 1980) (*per curiam*), *cert. denied*, 450 U.S. 999 (1981) (*emphasis added*).

54. 629 F.2d 287, 299–300 (3d Cir. 1980) (Rosenn, J., concurring and dissenting).

55. *Id.* at 300.

56. *Id.* See *supra* notes 39–42 and accompanying text.

57. *Johnson v. Trueblood*, 629 F.2d 287, 301 (3d Cir.), *vacated on other grounds*, 629 F.2d 302 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981).

58. 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

59. *Id.* at 279.

60. *Id.* at 280.

61. *Id.* at 280–81.

62. *Id.* at 293.

63. *Id.* at 296.

sufficient to give rise to any reasonable inference that impermissible motives predominated in the board's consideration of the approaches."⁶⁴ Furthermore, when discussing the expansion program that fended off CHH, the court stated:

[E]ven if the desire to fend off CHH was among the motives of the board in entering the transactions, because the plaintiffs have failed to establish that such a motive was the *sole or primary* purpose, as has been required by Delaware law since the leading case of *Cheff v. Mathes*, the mere allegation, or even some proof, that a given transaction was made on "unfavorable" terms does not meet the fairly stringent burden the business judgment rule imposes on plaintiffs.⁶⁵

The court's rationale mirrored that used by the *Johnson* court and imposed a difficult burden for the plaintiffs to overcome.

In his dissent, Judge Cudahy argued that "the majority has adopted an approach which would virtually immunize a target company's board of directors against liability to shareholders."⁶⁶ He viewed issues dealing with the corporation-shareholder relationship, such as corporate control, as those in which the courts may actively promote equitable concerns.⁶⁷

C. Burden on Plaintiff to Demonstrate that a Motive of the Directors was to Retain Control

The Court of Appeals for the Second Circuit seems to have espoused an intermediate burden for a challenger to a target corporation's defensive tactics. Although the presumptions of the business judgment rule place the initial burden on the plaintiff, the burden will shift to the directors if the plaintiff shows self-interest or bad faith on the part of the directors.⁶⁸ However, this test is quite subjective—it is unclear how much evidence must be produced to shift the burden.⁶⁹

In *Treadway Cos. v. Care Corp.*,⁷⁰ Care acquired almost one-third of Treadway's outstanding common stock and indicated an interest in obtaining control.⁷¹ Treadway's directors then planned to merge with another corporation (Fair Lanes).⁷² The first step of the merger process was a sale to Fair Lanes, for cash, of a large block of Treadway's treasury stock plus authorized but unissued stock.⁷³ This

64. *Id.*

65. *Id.* at 297 (citations omitted) (emphasis added).

66. 646 F.2d 271, 299 (7th Cir. 1981) (Cudahy, J., concurring and dissenting).

67. *Id.* Judge Cudahy states that the majority fails to make the important distinction between the activity of a corporation in managing a business enterprise and its function as a vehicle for collecting and using capital and distributing profits and losses. The former involves corporate functioning in competitive business affairs in which judicial interference may be undesirable. *The latter involves only the corporation-shareholder relationship, in which the courts may more justifiably intervene to insist on equitable behavior.*

Id. at 299-300 (quoting Note, *Protection for Shareholder Interests in Recapitalizations of Publicly Held Companies*, 58 COLUM. L. REV. 1030, 1066 (1958) (emphasis supplied by Judge Cudahy)).

68. See *infra* text accompanying notes 70-99.

69. See *infra* text accompanying notes 187-90.

70. 638 F.2d 357 (2d Cir. 1980).

71. *Id.* at 364-65.

72. *Id.* at 365-66.

73. *Id.* at 366-68.

transaction would dilute Care's holdings and thus prevent Care from blocking the merger.⁷⁴

At trial, Care contended that Treadway's directors caused the shares to be sold to Fair Lanes for the sole or primary purpose of retaining control of the corporation.⁷⁵ The court found that the sale of stock to Fair Lanes should be analyzed under the New Jersey business judgment rule because the target company was a New Jersey corporation.⁷⁶ Therefore, if Treadway's board of directors had determined that a Care takeover would be detrimental to the corporation and its shareholders, they would be justified in taking actions against it.⁷⁷ The business judgment rule's presumption of good faith would protect their actions.⁷⁸

Although the court framed the business judgment rule based on the line of Delaware cases represented by *Bennett* and *Cheff*, it declined to automatically shift the initial burden to the directors, even though the issue of control was present.

The court stated that the initial burden of proving the director's interest or bad faith always rests with the plaintiff.⁷⁹ The plaintiff must demonstrate the directors' self-interest in order to shift the burden to the directors. The court noted, "In nearly all of the cases treating stock transactions intended to affect control, the directors who approved the transaction have had a real and obvious interest in it: their interest in retaining or strengthening their control of the corporation."⁸⁰

The court concluded that Care did not satisfy that burden.⁸¹ Evidence was presented that Fair Lanes had been interested in merging with Treadway for some years, that the merger negotiations were not a sham, and that all but one of Treadway's directors expected to lose their positions as Treadway directors after a Fair Lane merger.⁸² The court found that the Treadway directors were not acting to maintain control over the corporation, but rather were endeavoring to consummate a merger with Fair Lanes.⁸³ The court ultimately held that "Care has not demonstrated an interest on the part of Treadway's directors . . . such as would shift onto the directors the burden of proving fairness."⁸⁴

The burden on the plaintiff was clarified and probably eased in *Norlin Corp. v. Rooney, Pace Inc.*⁸⁵ In *Norlin*, Piezo Electric Products purchased thirty-two percent of Norlin's common stock.⁸⁶ In response, Norlin conveyed to a wholly-owned subsidiary 800,000 shares of authorized but unissued preferred stock, which would vote on a share-for-share basis with Norlin common stock, in exchange for a twenty

74. *Id.*

75. *Id.* at 380.

76. *Id.* at 381.

77. *Id.*

78. *Id.* at 382.

79. *Id.*

80. *Id.*

81. *Id.* at 383.

82. *Id.*

83. *Id.*

84. *Id.*

85. 744 F.2d 255 (2d Cir. 1984).

86. *Id.* at 259.

million dollar interest-bearing note.⁸⁷ At the same time, Norlin established an Employee Stock Option Plan (ESOP) by transferring 185,000 common shares to the ESOP in exchange for a promissory note.⁸⁸ Norlin was the beneficial owner of all the transferred shares.⁸⁹ Together with the shares already under their control and as a result of these transactions, the Norlin directors controlled forty-nine percent of the corporation's voting stock, which was sufficient to block a hostile takeover bid by Piezo Electric Products.⁹⁰

The Court of Appeals for the Second Circuit, construing the New York business judgment rule, upheld a preliminary injunction enjoining the board of directors from voting the contested shares.⁹¹ The court stated that the business judgment rule protects the directors' actions in resisting takeovers only when the directors are not shown to have a self-interest in such actions.⁹² The court inferred that the purpose of the transactions was to perpetuate the directors' control of Norlin⁹³ after considering the evidence presented: that all of the stock transferred by Norlin was to be voted by Norlin directors; that the ESOP was created at the same time that stock was issued to it; and that the timing of such transactions corresponded to Piezo's interest in the company. Such evidence "was more than adequate to constitute a prima facie showing of self-interest on the board's part," thus shifting the burden of proof to the directors.⁹⁴

It seems that *Norlin* required only that retention of control be merely a factor in the contested transaction to shift the burden from the challenger to the defendant directors. Although the court required a demonstration by the plaintiff of the directors' self-interest in the transaction,⁹⁵ it did not require the plaintiff to show retention of control to be a primary motivation of the directors. The court's analysis held that "a prima facie showing of self-interest on the board's part" was sufficient to shift the burden to the directors.⁹⁶ Furthermore, the court cited with approval the dissenting opinions in *Panter v. Marshall Field & Co.*⁹⁷ and *Johnson v. Trueblood*,⁹⁸ both of which expressly promulgated such a standard.⁹⁹

IV. THE BURDEN UPON THE DIRECTORS OF A TARGET COMPANY TO JUSTIFY THEIR DEFENSIVE TACTICS

Assuming that a challenger to a target corporation's defensive tactics can overcome or circumvent the presumptions of the business judgment rule, the burden

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.* at 260, 269.

92. *Id.* at 265.

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.*

97. 646 F.2d 271, 299-312 (7th Cir. 1981) (Cudahy, J., concurring and dissenting).

98. 629 F.2d 287, 295-301 (3d Cir. 1980) (Rosenn, J., concurring and dissenting).

99. See *supra* text accompanying notes 54-57 for a discussion of Judge Rosenn's dissenting opinion in *Johnson v. Trueblood*.

of justification will then fall upon the directors of the target corporation. Under a general business judgment rule analysis, a plaintiff's showing of self-dealing sufficient to negate the presumption of good faith would place a heavy burden on the defendant directors—the burden of showing that the transaction at issue was intrinsically fair to the corporation and its shareholders.¹⁰⁰ However, in transactions involving control, the courts have declined to impose such a stringent burden on the directors.

A. Burden of Showing that the Transaction was Primarily in the Corporate Interest

In *Cheff v. Mathes*,¹⁰¹ the court found that the conflict of interest inherent in a transaction involving control shifted the burden to the directors to justify their action as one primarily in the corporate interest.¹⁰² The court distinguished the directors' interest in corporate control from a personal and pecuniary interest in the transaction, stating that while directors do bear the burden of proof in the former situation, they "will not be held to the same standard of proof required of those directors" implicated in the latter situation.¹⁰³ The court in *Cheff* framed the issue to be whether the directors showed "reasonable grounds to believe a danger to corporate policy and effectiveness existed by the presence of the Maremont stock ownership."¹⁰⁴ Furthermore, the court found that directors satisfy their burden by showing good faith and reasonable investigation.¹⁰⁵ The court held that this burden was met, concluding:

[T]he board of directors, based upon direct investigation, receipt of professional advice, and personal observations of the contradictory action of Maremont and his explanation of corporate purpose, believed, with justification, that there was a reasonable threat to the continued existence of Holland, or at least existence in its present form, by the plan of Maremont to continue building up his stock holdings.¹⁰⁶

In effect, the directors met the burden of the transaction being primarily in the corporate interest "simply by showing that they planned to pursue a different strategy than that proposed by the bidders, and by asserting a belief that their strategy was better."¹⁰⁷ This analysis does not actually consider whether the transaction's business purpose was primarily in the corporate interest. However, it does require sufficient directorial justification of the corporate actions at issue to confirm the directors' presumption of good faith.

100. See *supra* notes 18–21 and accompanying text.

101. 41 Del. Ch. 494, 199 A.2d 548 (Del. 1964).

102. *Id.* at 504–05, 199 A.2d at 554.

103. *Id.* at 505, 199 A.2d at 554–55. See *supra* notes 21 & 100 and accompanying text for the standard of proof required for directors having a personal or pecuniary interest in the transaction.

104. *Cheff v. Mathes*, 41 Del. Ch. 494, 506, 199 A.2d 548, 555 (Del. 1964).

105. *Id.*

106. *Id.* at 508, 199 A.2d at 556.

107. Note, *Greenmail: Targeted Stock Repurchases and the Management—Entrenchment Hypothesis*, 98 HARV. L. REV. 1045, 1057 (1985).

B. Burden of Showing that the Transaction had a Valid Corporate Business Purpose

In *Johnson v. Trueblood*,¹⁰⁸ the Court of Appeals for the Third Circuit found that if the plaintiff rebutted the business judgment presumption of director good faith in a control situation, the burden then would shift to the defendant directors to show that the transaction could be attributed to a "valid corporate business purpose."¹⁰⁹ This is an extremely lax standard. It does not address the concerns of fairness which exist in a traditional business judgment analysis of a director's shifted burden.¹¹⁰ Actually, this standard avoids the question of good faith altogether, because directors who are motivated by concerns of perpetuating their control need only demonstrate a rational business purpose to justify their defensive strategies. This is inconsistent with the business judgment rule, which is premised on the concept of directorial good faith.¹¹¹ Allowing a director who acts in bad faith to justify his actions by rationalizing to some other purpose should not obscure the violation of his fiduciary duty of loyalty to the corporation and its shareholders. A proper business judgment rule analysis must ensure that directors adhere to their fiduciary duties in actions taken against a hostile takeover.

Similarly, in *Treadway Cos. v. Care Corp.*,¹¹² the court stated that once the burden is shifted to the director, the director must prove that the transaction at issue was "fair and reasonable" to the corporation.¹¹³ The court defined "fair" in this context as "entered into for a proper corporate purpose, and not merely for the directors' selfish purposes."¹¹⁴ The court's interpretation of the directors' burden seems to correspond to the "valid corporate business purpose" standard adopted by the *Johnson* decision.¹¹⁵

C. Burden of Showing that the Transaction Was Fair and Reasonable to the Corporation

In *Norlin Corp. v. Rooney, Pace Inc.*,¹¹⁶ the Court of Appeals for the Second Circuit, citing *Treadway*, found that once the burden shifted to the directors, they were required to prove that the transaction in question was fair and reasonable to the corporation.¹¹⁷ However, unlike its holding in *Treadway*, the court did not modify this language by allowing a showing of a valid corporate business purpose to satisfy

108. 629 F.2d 287 (3d Cir.), *vacated on other grounds*, 629 F.2d 302 (3d Cir. 1980) (per curiam), *cert. denied*, 450 U.S. 999 (1981).

109. *Id.* at 293.

110. *See supra* notes 18-21 and accompanying text.

111. *See supra* notes 18-27 and accompanying text.

112. 638 F.2d 357 (2d Cir. 1980).

113. *Id.* at 382. This is dictum, as the plaintiff could not make a showing sufficient to shift the burden to the directors.

114. *Id.* "Courts have held that the directors can make a sufficient showing of fairness by demonstrating that the transaction was entered into for a proper corporate purpose; they need not also prove that the actual terms of the transaction were fair." *Id.* at 382 n.47 (citations omitted).

115. *See supra* text accompanying notes 108-11.

116. 744 F.2d 255 (2d Cir. 1984).

117. *Id.* at 265.

the directors' burden.¹¹⁸ The court rejected the directors' contention that once a board decides "that an actual or anticipated takeover attempt is not in the best interests of the company, a board of directors may take any action necessary to forestall acquisitive moves,"¹¹⁹ although such a test would seem to satisfy the *Treadway* court's standard. Here, however, the court found that the ESOP was created solely as a tool for management self-perpetuation, and thus, it was not fair and reasonable.¹²⁰

V. RECENT DECISIONS: *UNOCAL CORP. v. MESA PETROLEUM CO.* AND *MORAN v. HOUSEHOLD INTERNATIONAL, INC.*

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

In *Unocal Corp. v. Mesa Petroleum Co.*,¹²¹ Mesa, the owner of approximately thirteen percent of Unocal's stock, commenced a two-tier "front-loaded" cash tender offer for sixty-four million shares, or approximately thirty-seven percent of Unocal's outstanding stock, at a price of fifty-four dollars per share.¹²² The "back-end" was designed to eliminate the remaining publicly-held shares by exchanging them for securities purportedly worth fifty-four dollars per share.¹²³ After considering the offer, including presentations by expert financial advisors, Unocal's directors concluded that Mesa's tender offer price was inadequate.¹²⁴ Furthermore, Unocal's directors proposed to initiate a self-tender by Unocal for its own stock. If Mesa acquired sixty-four million shares of Unocal stock through its own offer, the self-tender provided that Unocal would buy the remaining forty-nine percent outstanding shares for an exchange of debt securities having an aggregate par value of seventy-two dollars per share.¹²⁵ Unocal sought either to defeat Mesa's inadequate tender offer or, if the offer succeeded, to adequately compensate shareholders at the "back-end" of Mesa's proposal, which the latter would finance with "junk bonds."¹²⁶ Mesa was excluded from this proposal.¹²⁷

The Supreme Court of Delaware considered whether the Unocal board had both the power and duty to oppose a takeover threat that it reasonably perceived to be

118. See *supra* note 114 and accompanying text.

119. *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 265-66 (2d Cir. 1984).

120. *Id.* at 266-67.

121. 493 A.2d 946 (Del. 1985).

122. *Id.* at 949. A two-tiered tender offer is "a partial tender offer . . . coupled with an announced plan to follow up with a second-step merger at a lower price per share." Mirvis, *Two-Tier Pricing: Some Appraisal and "Entire Fairness" Valuation Issues*, 38 BUS. LAW. 485, 485 (1983). "Front-loaded" means that the first tier is a cash tender offer while the second tier involves an exchange of securities or notes.

123. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 949 (Del. 1985). However, Mesa's supplemental proxy statement disclosed that these securities would be highly subordinated.

124. *Id.* at 950.

125. *Id.* at 950-51.

126. *Id.* at 956.

127. *Id.* at 951. The directors were advised by legal counsel that under Delaware law Mesa could only be excluded for what the directors reasonably believed to be a valid corporate purpose. To include Mesa would defeat the objective of adequately compensating shareholders at the second tier of Mesa's proposal because under the proration aspect of the exchange offer (49%), every Mesa share accepted by Unocal would displace one held by another stockholder. Furthermore, if Mesa were permitted to tender to Unocal, the latter would in effect be financing Mesa's own inadequate proposal.

harmful to the corporate enterprise and, if so, whether the directors' actions should be entitled to the protection of the business judgment rule.¹²⁸ Mesa contended that the business judgment rule should not protect Unocal because the exchange offer was not fair to all shareholders (specifically Mesa); thus, Unocal violated the fiduciary duty it owed to Mesa.¹²⁹ In response, Unocal denied any duty of fairness owed to Mesa because Unocal's board of directors concluded both that Mesa's tender offer was coercive and inadequate, and that Mesa sought selective treatment for itself.¹³⁰ Unocal claimed protection of the business judgment rule because the board's approval of the exchange offer was made in good faith, on an informed basis, and in the exercise of due care.¹³¹

The court concluded that the board had the power to oppose Mesa's takeover bid.¹³² In evaluating whether the board was justified in exercising its power in this situation, the court found that the business judgment rule is applicable in the context of a takeover.¹³³

In determining the placement of the initial burden of proof, the court reasoned:

When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment.¹³⁴

However, the court cited with approval *Bennett v. Propp*,¹³⁵ recognizing that in a situation involving control a board might act primarily in its own interests.¹³⁶ The court placed the initial burden on the directors, automatically shifting the burden to them in a control situation.¹³⁷

The court in *Unocal* placed a two-part burden on the directors. Under the first prong, the "directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership."¹³⁸ This burden was satisfied by showing good faith and reasonable investigation on the part of the directors,¹³⁹ the standard first established in *Cheff v. Mathes*.¹⁴⁰ Noting that the directors may not act solely or primarily out of a desire to perpetuate themselves in office, the court found this standard "designed to ensure that a defensive measure to thwart or impede a takeover is indeed motivated

128. *Id.* at 953.

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.* at 953-54.

133. *Id.* at 954.

134. *Id.*

135. 41 Del. Ch. 14, 187 A.2d 405 (Del. 1962).

136. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985). *See also supra* note 34 and accompanying text.

137. *Id.* at 955.

138. *Id.*

139. *Id.*

140. *See supra* notes 103-05 and accompanying text.

by a good faith concern for the welfare of the corporation and its stockholders, which in all circumstances must be free of any fraud or other misconduct.”¹⁴¹

The second prong of the directors’ burden required the defensive measure at issue to be reasonable in relation to the threat posed.¹⁴² This requirement “entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise.”¹⁴³ The court found that the directors were warranted in their belief that the two-tier tender offer was inadequate, coercive, and linked to possible greenmail.¹⁴⁴ Furthermore, Unocal’s efforts to protect its shareholders reasonably required Mesa’s exclusion from the exchange offer.¹⁴⁵

B. Moran v. Household International, Inc.

In *Moran v. Household International, Inc.*,¹⁴⁶ a shareholder of Household brought suit to invalidate a preferred stock rights dividend plan.¹⁴⁷ The plaintiff was a director of Household, as well as chairman of Dyson-Kissner-Moran Corp. (D-K-M), the largest single shareholder of Household.¹⁴⁸ Household’s board of directors enacted the rights plan as a preventive mechanism to preclude future advances; the board perceived the company as a vulnerable takeover target.¹⁴⁹ The plaintiffs claimed that the rights plan gave Household’s directors an effective right of refusal to any takeover attempt, which entrenched the existing directors and pre-empted the shareholders’ right as owners of the corporate stock to participate in a tender offer.¹⁵⁰ According to the plaintiffs:

[T]he business judgment rule does not apply to actions designed to effect structural changes in the relationship between stockholders and the Board, but if it does, the rule requires the application of special scrutiny, with Household bearing the burden of proving that the Plan is fair and reasonable to the shareholders.¹⁵¹

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

142. *Id.*

143. *Id.*

144. *Id.* at 956.

145. *Id.* at 956-57.

146. 500 A.2d 1346 (Del. 1985).

147. The rights plan worked as follows:

Basically, the Plan provides that Household common stockholders are entitled to the issuance of one Right per common share under certain triggering conditions. There are two triggering events that can activate the Rights. The first is the announcement of a tender offer for 30 percent of Household’s shares (“30% trigger”) and the second is the acquisition of 20 percent of Household’s shares by any single entity or group (“20% trigger”). If an announcement of a tender offer for 30 percent of Household’s shares is made, the Rights are issued and are immediately exercisable to purchase 1/100 share of new preferred stock for \$100 and are redeemable by the Board for \$.50 per Right. If 20 percent of Household’s shares are acquired by anyone, the Rights are issued and become non-redeemable and are exercisable to purchase 1/100 of a share of preferred. If a Right is not exercised for preferred, and thereafter, a merger or consolidation occurs, the Rights holder can exercise each Right to purchase \$200 of the common stock of the tender offeror for \$100.

Id. at 1348-49.

148. *Id.* at 1349.

149. *Id.* At that time, Moran began discussions concerning a possible leveraged buy-out of Household by D-K-M. This never progressed beyond the discussion stage. *Id.*

150. *Moran v. Household Int’l, Inc.*, 490 A.2d 1059, 1074 (Del. Ch.), *aff’d*, 500 A.2d 1346 (Del. 1985).

151. *Id.*

The Court of Chancery of Delaware applied the business judgment rule as the standard of review in this situation, stating “in the absence of fraud or bad faith, directors will not be held liable for mistakes of judgment in actions arguably taken for the benefit of the corporation.”¹⁵² The attendant presumption of good faith placed the initial burden of proof on the challenging party to demonstrate bad faith.¹⁵³ Citing *Panter v. Marshall Field & Co.*,¹⁵⁴ *Crouse-Hinds Co. v. InterNorth, Inc.*,¹⁵⁵ and *Johnson v. Trueblood*,¹⁵⁶ the court noted that “the shifting of the burden of proof in control situations has been expressly rejected by majority decisions in three federal circuits in cases applying Delaware law.”¹⁵⁷ Applying the standard of *Johnson v. Trueblood*,¹⁵⁸ the court stated that a showing of a motive to retain control was not sufficient to overcome the presumption of good faith.¹⁵⁹

The court, however, did shift the burden of proof to the defendant directors by promulgating a theory of inquiry into the directors’ actions other than an improper motive inquiry:

Where, however, the takeover defensive device is itself calculated to alter the structure of the corporation, apart from the question of motive, and results in a fundamental transfer of a power from one constituency (shareholders) to another (the directors) the business judgment rule will not foreclose inquiry into the directors’ action.

Because the Rights Plan permits the Household Board to act as the prime negotiator of partial tender offers through the power of redemption, the resulting allocation of authority affects the structural relationship between the Board and the shareholders. *It is this fundamental result, rather than a mere conflict of interest, which requires the Board to present evidence, the business judgment rule notwithstanding, that its approval of the Plan was not motivated primarily by a desire to retain control but by a reasonable belief that the Plan was necessary to protect the corporation from a perceived threat to corporate policy and effectiveness.*¹⁶⁰

The burden placed on the directors was identical to that used by the court in *Cheff v. Mathes*:¹⁶¹ the directors must demonstrate that their actions were “reasonable at the time.”¹⁶² The *Moran* court characterized this burden as “the burden of going forward on a showing of reasonableness rather than a burden of persuasion,”¹⁶³ because the presumption of good faith continues in effect until the plaintiffs can make

152. *Id.*

153. *Id.*

154. 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

155. 634 F.2d 690 (2d Cir. 1980).

156. 629 F.2d 287 (3d Cir.), *vacated on other grounds*, 629 F.2d 302 (3d Cir. 1980) (*per curiam*), *cert. denied*, 450 U.S. 999 (1981).

157. *Moran v. Household Int’l, Inc.*, 490 A.2d 1059, 1075 (Del. Ch.), *aff’d*, 500 A.2d 1346 (Del. 1985).

158. 629 F.2d 287 (3d Cir.), *vacated on other grounds*, 629 F.2d 302 (3d Cir. 1980) (*per curiam*), *cert. denied*, 450 U.S. 999 (1981).

159. *Moran v. Household Int’l, Inc.*, 490 A.2d 1059, 1076 (Del. Ch.), *aff’d*, 500 A.2d 1346 (Del. 1985). *See supra* text accompanying notes 50–53 for a discussion of the *Johnson* standard for the plaintiffs’ burden of proof.

160. *Moran v. Household Int’l, Inc.*, 490 A.2d 1059, 1076 (Del. Ch.), *aff’d*, 500 A.2d 1346 (Del. 1985) (emphasis added).

161. 41 Del. Ch. 494, 199 A.2d 548 (Del. 1964).

162. *Moran v. Household Int’l, Inc.*, 490 A.2d 1059, 1076 (Del. Ch.), *aff’d*, 500 A.2d 1346 (Del. 1985). *See also* *Cheff v. Mathes*, 41 Del. Ch. 494, 506, 199 A.2d 548, 555 (Del. 1964) (directors must show that their actions were reasonable).

163. *Moran v. Household Int’l, Inc.*, 490 A.2d 1059, 1076 (Del. Ch.), *aff’d*, 500 A.2d 1346 (Del. 1985).

a showing of the directors' bad faith.¹⁶⁴ The Court of Chancery found in favor of the defendants, concluding that the coercive nature of two-tier tender offers justified the adoption of the rights plan to protect Household and its shareholders from such offers.¹⁶⁵

In affirming the Court of Chancery's decision, the Supreme Court of Delaware agreed that the business judgment rule was the proper standard of review for a target company's defensive tactics.¹⁶⁶ The court found that this standard was appropriate whether the directors' actions were directed toward a specific threat or, as in the *Moran* case, the defensive mechanism was adopted to protect against prospective takeover bids.¹⁶⁷

The supreme court, unlike the lower court, rejected the plaintiffs' contention that the rights plan represented an unauthorized "fundamental transfer of power from the stockholders to the directors."¹⁶⁸ The court found that if faced with a tender offer and a request to redeem the rights, even if it were a hostile tender offer, the directors still would "be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism."¹⁶⁹ The board could reject a bid only if their action was within the ambit of the business judgment rule. This reasoning rendered moot the lower court's standard that shifted to the directors a burden of reasonableness for their actions when their defensive tactics effected a "fundamental transfer of power from the stockholders to the directors."¹⁷⁰ Instead, the supreme court in *Moran* followed *Unocal* and reaffirmed the business judgment rule as the applicable standard of judicial review for a target company's defensive tactics.¹⁷¹

Citing to *Unocal*, the *Moran* court placed the initial burden of proof on the defendant directors because their adoption of a defensive mechanism implicated concerns of corporate control.¹⁷² Furthermore, the *Moran* court adopted the two-prong standard promulgated by *Unocal* as the initial burden the directors were required to meet in a control situation:¹⁷³

The directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed. . . . [T]hey satisfy that burden by showing good faith and reasonable investigation. . . . In addition, the directors must show that the defensive mechanism was reasonable in relation to the threat posed.¹⁷⁴

The court found that the directors adopted the rights plan "in the good faith belief that it was necessary to protect Household from coercive acquisition tech-

164. *Id.*

165. *Id.* at 1082-83.

166. *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1350 (Del. 1985).

167. *Id.*

168. *Id.* at 1354. *Cf. Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1076 (Del. Ch. 1985) (lower court found the plan fundamentally altered the corporate structure).

169. *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1354 (Del. 1985).

170. *See supra* text accompanying notes 160-65.

171. *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356-57 (Del. 1985).

172. *Id.* at 1356.

173. *Id.*

174. *Id.* (citations omitted).

niques” and after reasonable investigation of the mechanism of the rights plan.¹⁷⁵ In addition, the defendants demonstrated that the rights plan was reasonable in relation to the threat posed.¹⁷⁶ The directors thereby satisfied their burden of proof and were protected by the business judgment rule.¹⁷⁷ The burden then shifted back to the plaintiffs who now had “the ultimate burden of persuasion to show a breach of the directors’ fiduciary duties.”¹⁷⁸ The court upheld the adoption of the rights plan because the plaintiffs could not make such a showing.¹⁷⁹

VI. IMPLICATIONS OF *UNOCAL* AND *MORAN*

The *Unocal* and *Moran* decisions are authoritative interpretations of the business judgment rule’s application in hostile takeover situations. The Supreme Court of Delaware has sought to reconcile or override the deviations of the federal courts’ interpretations of the Delaware business judgment rule. In doing so, the court has fashioned a workable business judgment rule analysis that balances concerns of directorial fidelity against the need for directorial discretion in a hostile takeover situation.

A. Burden of Going Forward Placed on Directors as a Matter of Law

The Supreme Court of Delaware properly placed the initial burden on the target company’s directors to justify defensive tactics under the business judgment rule. The business judgment rule rests upon the validity of its inherent presumptions, including the presumption of good faith. While it would be unfair to impugn the integrity of corporate management by presuming that directors act in bad faith or self-interest in a control situation, it would be unrealistic to assert that motives of control play no part in their actions. There is sufficient doubt of directorial good faith raised by the nature of a takeover situation¹⁸⁰ to require some form of judicial scrutiny of the target directors’ duty of loyalty before granting the directors the protection of the business judgment rule. In an abstract sense, the factors that justify a presumption of utmost loyalty for business decisions do not counterbalance the obvious direct threat to corporate management in a hostile takeover situation.

From a mechanical perspective, placement of the initial burden on the target company’s directors is the best way to ensure adequate judicial scrutiny of the target company’s defensive tactics and the directors’ adherence to their fiduciary duty. In *Johnson v. Trueblood*¹⁸¹ and *Panter v. Marshall Field & Co.*,¹⁸² the courts required the plaintiffs to demonstrate that the directors’ sole or primary motive was to retain

175. *Id.* at 1357.

176. *Id.*

177. *Id.*

178. *Id.* at 1356.

179. *Id.* at 1357.

180. See *supra* text accompanying notes 22–24.

181. 629 F.2d 287 (3d Cir.), *vacated on other grounds*, 629 F.2d 302 (3d Cir. 1980) (*per curiam*), *cert. denied*, 459 U.S. 999 (1981).

182. 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

control.¹⁸³ By making the plaintiffs' burden so stringent, the courts strengthened the business judgment rule presumption beyond the degree warranted by a control situation. In most cases, the difficulty of shifting the burden to the directors would preclude any substantive consideration of the merits of the directors' actions. In *Panter*, despite various actions on the part of the directors that could have supported an allegation of self-serving management entrenchment,¹⁸⁴ the court declined to examine the directors' actions because the plaintiffs could not meet their burden of demonstrating that the directors' primary purpose for their actions was retention of corporate control.¹⁸⁵ Judge Cudahy's dissenting opinion in *Panter* aptly categorized the standard imposed on the plaintiff by the majority as "an approach which would virtually immunize a target company's board of directors against liability to shareholders"¹⁸⁶ Both the directors' presumed interest in a hostile takeover situation and the shareholders' interest in their investment mandate that the directors justify their actions. The "sole or primary motive" standard does not meet this need.

Furthermore, because courts must resolve legal issues involving directors' motives based on a set of facts largely within the control of the directors, it would be extremely difficult for a plaintiff to meet a stringent test involving motives. Again, the directors would rarely have to answer for their actions. A stringent initial burden on plaintiffs that could rarely be met may tempt directors to employ improperly motivated defensive tactics in light of judicial indifference.

In *Treadway Cos. v. Care Corp.*¹⁸⁷ and *Norlin Corp. v. Rooney, Pace Inc.*,¹⁸⁸ the Court of Appeals for the Second Circuit imposed a lesser burden on the plaintiff: a showing that retention of control be merely a factor in the directors' actions.¹⁸⁹ This standard presents a difficulty in that "a prima facie showing of self-interest on the board's part,"¹⁹⁰ sufficient to shift the burden to the directors, is too subjective. Because motivation of control generally must be inferred from the directors' actions, a court would have great discretion in determining whether control was a motivating factor. This discretion should not shield directors from having to justify their conduct regarding a hostile takeover, just as the business judgment rule itself should not shield directors without reaffirmation of directorial loyalty.

By placing the initial burden on the directors as a matter of law in an action involving a target company's defensive tactics, the Supreme Court of Delaware in *Unocal* and *Moran* has reaffirmed the allocation of the initial burden set forth in *Bennett v. Propp*¹⁹¹ and *Cheff v. Mathes*.¹⁹² This was necessary to ensure adequate

183. See *supra* text accompanying notes 50-53 (discussing the *Johnson* decision) and 64-65 (discussing the *Panter* decision).

184. See *supra* text accompanying note 61.

185. *Panter v. Marshall Field & Co.*, 646 F.2d 271, 296-97 (7th Cir.), cert. denied, 454 U.S. 1092 (1981).

186. *Id.* at 299 (7th Cir. 1981) (Cudahy, J., concurring and dissenting).

187. 638 F.2d 357 (2d Cir. 1980).

188. 744 F.2d 255 (2d Cir. 1984).

189. See *supra* text accompanying notes 79-84 (discussing the *Treadway* decision) and 92-99 (discussing the *Norlin* decision).

190. *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 265 (2d Cir. 1984).

191. 41 Del. Ch. 14, 187 A.2d 405 (Del. 1962).

192. 41 Del. Ch. 494, 199 A.2d 548 (Del. 1964).

judicial scrutiny of a target company's defensive tactics. Such scrutiny could be negated, however, by the federal courts' placement of the initial burden on the challengers to a target company's defensive tactics, thereby placing an excessively stringent burden on the plaintiffs or giving the court too much discretion to avoid a review on the merits of the defensive maneuvers. The Supreme Court of Delaware's decisions should guide the federal courts in future business judgment rule analyses, for they unequivocally shift the initial burden to the target company's directors to justify their defensive tactics against a hostile takeover.

B. The Burden Upon the Directors of a Target Company: An Intermediate Standard

The burden placed on the directors must be sufficient to validate both the courts' presumption of directorial good faith and its subsequent reliance upon the business judgment rule in actions involving corporate control. However, the burden placed on the directors must not be so stringent as to negate the directorial discretion that is integral and necessary to the effective operation of the business judgment rule in the hectic pace of a hostile takeover, lest the courts abandon the business judgment rule altogether. The standard promulgated by the Supreme Court of Delaware in *Unocal* and *Moran* seems to properly strike such a balance.

The courts in *Johnson v. Trueblood*¹⁹³ and *Treadway Cos. v. Care Corp.*¹⁹⁴ imposed a limited burden on the directors to justify their defensive tactics: the directors need only show that the transaction could be attributed to a "valid corporate business purpose."¹⁹⁵ This standard is inadequate to meet the concerns of the business judgment rule. The directors should have the initial burden to justify their defensive tactics to ensure against an unquestioned presumption of good faith in an action directly involving managerial control. A standard requiring only that the directors show a valid corporate business purpose for their actions does not answer such concerns. It is the motives of the directors that are at issue, not their actions. Once their motives are found to be valid, the directors' actions are protected by the business judgment rule.

In *Norlin Corp. v. Rooney, Pace Inc.*,¹⁹⁶ the Court of Appeals for the Second Circuit required the directors to prove that their actions were fair and reasonable to the corporation.¹⁹⁷ Although this standard could be interpreted as meeting the concerns of the business judgment rule regarding directorial loyalty, it is too vague for proper judicial application. A court could interpret this language to allow the directors to justify their actions by meeting a lesser standard. This occurred in *Treadway Cos. v. Care Corp.*, when the court equated "fair and reasonable" to the corporation as "entered into for a proper corporate purpose."¹⁹⁸ Furthermore, the

193. 629 F.2d 287 (3d Cir.), vacated on other grounds, 629 F.2d 302 (3d Cir. 1980) (per curiam), cert. denied, 450 U.S. 999 (1981).

194. 638 F.2d 357 (2d Cir. 1980).

195. See *supra* text accompanying notes 109-15.

196. 744 F.2d 255 (2d Cir. 1984).

197. See *supra* text accompanying notes 116-20.

198. *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980).

Norlin analysis demonstrates that a judicial determination of whether the directors' actions were fair and reasonable is a very subjective factual interpretation. A proper standard should provide more structural guidelines, both for the directors who must meet the standard in their conduct, and for the courts that must interpret the standard.

At the opposite extreme, a court could require the directors to demonstrate the intrinsic fairness of their defensive tactics. In a traditional business judgment rule analysis, this is the burden imposed upon a fiduciary who is shown to have acted in self-interest or bad faith;¹⁹⁹ it is a negation of the business judgment rule. However, it should not be applied as the initial burden on directors to justify their actions in a control situation because the business judgment rule should still be in effect. It is unnecessary to automatically negate the presumption of directorial good faith in a hostile takeover situation; it merely should be confirmed. A stringent requirement on the directors to prove the intrinsic fairness of their actions would be an excessive burden. This burden cannot be justified in a hostile takeover situation absent proof of actual wrongdoing on the part of the directors. This standard, if applied in each instance, would severely curtail the directors' discretion to act in a hostile tender offer situation—discretion which is necessary for the directors to effectively participate in the takeover process, and to uphold their fiduciary obligations to act in the best interests of the company and its shareholders.

The standard espoused by the Supreme Court of Delaware in the *Unocal* and *Moran* decisions strikes the proper balance between judicial scrutiny and directorial discretion in a suit involving a target company's defensive tactics. The first prong of that standard, requiring the directors to demonstrate good faith and reasonable investigation,²⁰⁰ does not eliminate the possibility of improper motives for the directors' use of defensive tactics, nor does it ensure that those tactics are "intrinsically fair." However, it does enable the court to review the directors' conduct in light of their fiduciary obligations by requiring the directors to demonstrate the factors that they considered in their decision and the conclusions to which they purportedly came. The second prong of the test, requiring the directors to show that their actions were reasonable in relation to the threat posed,²⁰¹ is an additional check on the directors' actions. Realistically, judicial review of corporate action can only require an informed decision based on rational premises, which is the outcome of the Supreme Court of Delaware's standard. This standard gives the court enough discretion to find against the directors if their actions are based on arbitrary decisions or contrived motivations. If the directors meet this initial scrutiny, the burden shifts back to the challengers to demonstrate that the directors acted in bad faith.²⁰²

199. See *supra* note 21 and accompanying text.

200. See *supra* text accompanying notes 138–41 (discussing the *Unocal* decision) and 173–75 (discussing the *Moran* decision).

201. See *supra* text accompanying notes 142–45 (discussing the *Unocal* decision) and 174 & 176 (discussing the *Moran* decision).

202. See *supra* text accompanying note 178.

VII. CONCLUSION

This Note has focused on the role of the business judgment rule in judicial evaluations of target company defensive tactics. A court's analysis must balance the need for adequate scrutiny of fiduciary loyalty against the necessity of directorial discretion. Various courts and commentators have promulgated views which tend to be either too lenient toward judicial review, thereby rubber-stamping the directors' actions irrespective of their motives, or too stringent, limiting the directors' ability to wage a legitimate defense against a hostile takeover. This Note concludes that the Supreme Court of Delaware has established an intermediate standard that satisfies these two concerns and suffices to confirm the validity of the directors' good faith in their defensive actions under the business judgment rule presumptions.

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