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Frank Cara

Peter F. Lane

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THE BUSINESS JUDGMENT RULE AND *UNOCAL*: TWIN BARRIERS TO SHAREHOLDER WELFARE

“An evil soul, producing holy witness,
Is like a villain with a smiling cheek,
A goodly apple rotten at the heart.
O, what a goodly outside falsehood hath.”

Antonio, in Shakespeare’s *The Merchant of Venice*, Act 1:3, ll. 99-102.

Antonio, a modern merchant of Venice, is a shareholder in a Delaware corporation. The board has recently implemented a defensive measure in response to a hostile takeover attempt.¹ A disappointed Antonio sues, confident that the Delaware courts will uphold his claim. After all, these magistrates have smiled graciously upon shareholders by adding the requirement that directors satisfy the *Unocal* test² before business judgment rule protec-

¹ See Hogg, *Hostile Takeovers And Other War Games* in THE PREDATOR AND THE PREDATEE 1 n.1 (1988). When “acquisitions are sought over the obligation of the target’s management . . . the acquisition is ‘hostile’. . . . The acquisition, which may be of control (frequently 51% of the outstanding common stock), or more than control, or total, is commonly referred to as a ‘takeover’ —the target being ‘taken’ and not ‘given by consent.’” *Id.* See, e.g., *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1339 (Del. 1987) (predator owning 9.95 percent of targets stock commenced hostile offer for 42 percent of target’s outstanding shares); *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 178 (Del. 1986) (hostile offer made to target for \$56.25 conditioned on nullification of rights plan, waiver of notes covenants and “election of three Pantry Pride directors to the Revlon board.”); *AC Acquisitions v. Anderson, Clayton & Co.*, 519 A.2d 103, 109 (Del. 1986) (predator corporation made tender offer for any and all shares of target for \$56 per share cash); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 949 (Del. 1985) (owning 13 percent of target’s stock, shareholder made hostile tender offer for 37 percent of target’s outstanding stock); *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227, 1237 (Del. Ch. 1988) (hostile acquiror made \$73 per share cash offer for any and all shares of target). See also 1 M. LIPTON & E. STEINBERGER, TAKEOVERS & FREEZEOUTS 6.1 - 6.3.3 (1987) (discussing various defensive tactics available to directors when faced with takeover threat).

² *Unocal*, 493 A.2d at 955. Directors are not afforded business judgment protection until they prove a “good faith and reasonable investigation” of the threat, and that these responses were “reasonable in relation to the threat posed.” *Id.* See *infra* notes 10, 25-32 and accompanying text.

tion³ is afforded. Antonio is glad he is not a shareholder in a New York corporation. New York courts would not require directors to bear the initial burden of proving business judgment rule protection under a standard like *Unocal*. Is Antonio correct in his assumption that Delaware courts will use the "goodly" *Unocal* test to carefully scrutinize board decision-making, before invoking business judgment rule protection?

Delaware courts, like most jurisdictions, have traditionally held that directors owe fiduciary duties of care and loyalty to shareholders.⁴ However, with the increase in mergers and acquisitions

³ See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). The business judgment rule is a presumption that "in making a business decision directors have 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." *Id.* See *infra* notes 7, 18-24 and accompanying text (additional application of business judgment rule).

⁴ See *Loftland v. Cahill*, 118 A. 1, 3 (Del. 1922) ("directors of a corporation are trustees for the stockholders, and their acts are governed by the rules applicable to such a relation, which exact of them the utmost good faith and fair dealing, especially where their individual interests are concerned"); *Loft, Inc. v. Guth*, 2 A.2d 225, 238-39 (Del. Ch. 1938) (it is accepted that fiduciary duties and obligations of an officer and director of corporation are such that "if a business opportunity comes to him which is in the line of his corporation's activities and of advantage to it, and especially if really intended for it, the law will not allow him to divert the opportunity from the corporation and embrace it as his own."), *aff'd*, 5 A.2d 503 (Del. 1939). See also *Norlin Corp. v. Rooney Pace, Inc.*, 744 F.2d 255, 264 (2d Cir. 1984) (directors owe duties of care and loyalty to corporation and shareholders); *Revlon*, 506 A.2d at 182 (directors breached their fiduciary duty of loyalty to shareholders when actions taken by Revlon were self-serving and at expense of shareholders); *Unocal*, 493 A.2d at 955 (reviewing corporations attempt at takeover bid, court starts analysis with "basic principle that corporate directors have a fiduciary duty to act in the best interests of the corporation's stockholders"); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) ("director must execute duties with recognition that he acts on behalf of others"); *Grand Metro.*, 558 A.2d at 1055 (corporate directors have fiduciary duty to act in best interests of corporate shareholders); Harrington, *If It Ain't Broke, Don't Fix It: The Legal Propriety of Defenses Against Hostile Takeover Bids*, 34 SYRACUSE L. REV. 977, 987-90 (1983) (discussion of duty of care and duty of loyalty owed to company by management). See generally HENN & ALEXANDER, *LAW OF CORPORATIONS*, 621-25 (1983) (discussing directors' duty of care).

Many states have adopted a statutory duty of care based on the Revised Model Business Corporation Act, which states in pertinent part:

A director shall discharge his duties as a director, including his duties as a member of a committee:

- (1) in good faith;
- (2) with the care an ordinary prudent person in a like position would exercise under similar circumstances; and
- (3) in a manner he reasonably believes to be in the best interests of the corporation.

REVISED MODEL BUSINESS CORP. ACT § 8.30(a) (1984). See, e.g., N.Y. BUS. CORP. LAW § 717 (McKinney 1987) (based on REVISED MODEL BUSINESS CORP. ACT). See also Harrington, *supra*, at 987 n.47 ("[s]even states have statutorily adopted the Model Act wording, an additional nine have judicially adopted its ordinary negligence standard . . .").

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in recent years,⁵ Delaware courts have grappled with defining the legal duties directors owe to shareholders in the hostile takeover setting.⁶ In their struggle the Delaware courts have looked to the business judgment rule⁷ and to the test articulated in *Unocal Corp.*

⁵ Bartlett & Andrews, *The Standstill Agreement: Legal and Business Considerations Underlying Corporate Peace Treaty*, 62 B.U.L. REV. 143, 143 (1982) (competition has increased number of mergers and acquisitions); N.Y.L.J., Sept. 14, 1989 at 5 (great increase in mergers and acquisitions over past twenty five years). See Sommer, *Hostile Tender Offers: Time for a Review of Fundamentals*, in TENDER OFFERS 256 (M. Steinberg ed. 1985) ("disquiet has mounted as the size of takeovers has steadily mounted . . ."); Note, *The Business Judgment Rule in a Hostile Tender Offer: Tearing at the Seams of a Confusing Doctrine - Norlin v. Rooney Pace, Inc.*, 17 RUTGERS L.J. 321, 321 (1986) (discussing substantial growth, both in number and ferocity, of struggles for corporate control in recent years). See also A. KRAMER & J. MCCORD, MERGERS AND ACQUISITIONS 1-24 (1969) (providing early surveys explaining increased number of mergers and acquisitions).

⁶ See, e.g., *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1354 (Del. 1985) (court decided that in takeover attempt when tender offer is made directors owe fiduciary duty to stockholders); *Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.*, 506 A.2d 173, 179 (Del. 1985); (court must determine whether, in takeover setting, concessions made by directors "out of concern for their liability to noteholders rather than maximizing the sale price of the company for the stockholders' benefit breached a fiduciary duty directors have to stockholders"); *Grand Metro. Public Ltd. v. Pillsbury Co.*, 558 A.2d 1049, 1055 (Del. Ch. 1988) (court decided that "in discharging their managerial function, the directors owe fiduciary duties of care and loyalty to the corporation and its shareholders and those principles apply with equal force to a corporate merger and to corporate takeover issues.") (citing *Revlon*, 506 A.2d at 179). See also *supra* note 4 (discussing directors' duties of care and loyalty).

⁷ See *infra* notes 19-25 and accompanying text (description of business judgment rule). See also *Revlon*, 506 A.2d at 180 (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)) (business judgment rule applies to director actions if fiduciary duties of care and loyalty are satisfied); *Aronson*, 473 A.2d at 812. "[B]usiness judgment rule is an acknowledgement of the managerial prerogatives" of directors. *Id.* There is a presumption that directors' action was in best interest of corporation. *Id.* (citing *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971)); *Kaplan*, 284 A.2d at 124 (business judgment rule determines if directors have breached their fiduciary duties).

Because directors of a corporation are charged with strong fiduciary duties to both the corporation and its shareholders, the business judgment rule "exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors." *Smith*, 488 A.2d at 872 (citing *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981)). "The rule itself 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' it was in the company's best interest. *Smith*, 488 A.2d at 872 (quoting *Aronson*, 473 A.2d at 811). Consequently, Delaware directors acting in conformance with their power to manage the business affairs of the corporation under title 8, § 141 (a) of the Delaware Code, are generally entitled to business judgment protection. See *Smith*, 488 A.2d at 872 (Del. 1985) (benefit of business judgment rule given to corporate directors); C. SMITH & C. FURLOW, GUIDE TO THE TAKEOVER LAW OF DELAWARE 21 (1988). The statute provides in pertinent part: "(a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." DEL. CODE ANN. tit. 8, § 141(a) (Supp. 1988).

*v. Mesa Petroleum*⁸ for guidance.⁹ Because of Delaware's prominent role in this area of the law, this Note will focus on the Delaware courts.¹⁰

In the hostile takeover context, the business judgment rule is generally accepted as the standard of judicial review for gauging the defensive measures of directors.¹¹ This rule places the initial burden of proof on the shareholders to overcome the presumption that board decisions are proper.¹² However, Delaware courts

⁸ 493 A.2d 946 (Del. 1985).

⁹ *Unocal*, 493 A.2d at 955. The court used five criteria as guidance to determine the permissibility of defensive acts before it afforded the directors protection under the business judgment rule. *Id.* First, the board must show that it had reasonable grounds to take the action. *Id.* (citing *Cheff v. Mathes*, 199 A.2d 548, 554-55 (Del. 1964)). Second, the board must act in good faith. *Id.* Third, proof of reasonable grounds and good faith is enhanced if the board is composed of disinterested directors. *Id.* Fourth, the board must make a reasonable investigation of the tender offer. *Id.* Fifth, the defensive tactic must be reasonable in relation to the threat posed. *Id.* See, e.g., *Grand Metro. Public Ltd. v. Pillsbury Co.*, 558 A.2d 1049, 1056 (Del. 1988) (explaining criteria listed in *Unocal*; business judgment protection not granted when board decision to keep poison pill in place failed *Unocal*); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1343-44 (Del. 1987) (court upheld street sweep under *Unocal* and business judgment rule); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985) (court used business judgment rule and *Unocal* standard to uphold purchase rights plan); *City Capital Assocs. Ltd. v. Interco Inc.*, 551 A.2d 787, 801 (Del. Ch. 1988) (proposed sale of corporate division was acceptable defensive maneuver under *Unocal* test), *appeal dismissed*, 556 A.2d 1070 (Del. 1988). *Cf.* *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 182 (Del. 1986). Delaware courts have also charged directors with the fiduciary duty of "getting the best price for the stockholders at a sale of the company" where the board has recognized "the company was up for sale." *Id.* Generally, the company is "up for sale" when the board entertains various offers for the company's sale, or "the dissolution of the company becomes inevitable." *Id.* at 184. *But see, e.g.*, *Paramount Communications Inc. v. Time, Inc.*, Fed. Sec. L. Rep. ¶ 94514, Nos. 10866, 10670, 10935 at 69-73 (Del. Ch. July 17, 1989) (LEXIS, States library, Del file) (when board negotiates friendly merger transaction and hostile acquiror intervenes, company is not "up for sale" within meaning of *Revlon*), *aff'd*, 565 A.2d 280 (Del. 1989).

¹⁰ See *Johnson & Millon, Misreading the Williams Act*, 87 MICH. L. REV. 1862, 1862 (1989) (Delaware law governs one half of all New York Stock Exchange listed corporations); *Romano, The State Competition Debate in Corporation Law*, 8 CARDOZO L. REV. 709, 714 (1987) ("slightly more than one-half of the largest U.S. firms are incorporated in Delaware"); *N.Y. Times*, Feb. 1, 1988, at D1, col.1 ("Delaware is the state of incorporation for about 180,000 corporations and is the legal home to many of the nations best-known corporations."); *Black, Legal Times*, Nov. 25, 1985, at 6, col. 1 (national law of takeovers evolves in Delaware); *Wall Street Journal*, May 10, 1984, § 2, at 33(w) (Delaware Chancery Court is major corporate battleground).

¹¹ See *Greene, Recent Tender Offer Developments: On the Edge or Deep In?*, 45 OHIO ST. L. J. 721, 729 (1984) (due to reluctance to get involved and complicated nature of actions, courts chose business judgment rule as easy solution); *infra* notes 18-24 and accompanying text.

¹² See *infra* notes 20-25 and accompanying text (discussing shareholder burden of proof

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have recognized that directors, through their defensive measures, sometimes act for the primary purpose of retaining control.¹³ Therefore, first in *Bennett v. Propp*¹⁴ and then within the context of the formal test in *Unocal*,¹⁵ the Delaware courts have shifted the initial burden of proof to directors. Under the *Unocal* test, directors must first justify their defensive action before receiving the benefit of business judgement rule protection.¹⁶

This Note will examine the relationship between the business judgment rule and the *Unocal* test in the hostile takeover setting. In addition, it will discuss the complications arising from the broad deference Delaware courts have granted to director decisions under these standards. This Note will propose that the business judgment rule and the *Unocal* test are substantively equal as a result of the excessive judicial deference given to director rationale under the directors' burden of proof. By requiring directors to prove only that which is presumed under the business judgment rule, Delaware courts have slowly reduced prominent judicial standards to vacuous principles that are insufficient to protect shareholder interests.¹⁷ It is suggested that unless Delaware courts are willing to adopt a more critical analysis of reviewing director decisions, shareholder interests will not be sufficiently protected. Finally, this Note will propose that a truly enhanced burden will

under business judgment rule).

¹³ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985).

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

¹⁵ 493 A.2d 946 (Del. 1985).

¹⁶ See *Unocal*, 493 A.2d at 955 (in control situation initial burden of proof automatically shifts to directors); *Bennett v. Propp*, 187 A.2d 405, 409 (Del. 1962) (director has initial burden to show action is in corporate interest). See also Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1198 (1981).

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.

Id.

¹⁷ See Johnson & Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 375-76 (1987) (although it was surmised that courts' reluctance to second guess directors' decisions may lead to inconsistent standards, it was concluded that courts are generally not qualified to undertake more thorough review); Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CALIF. L. REV. 1671, 1683 (1985) (courts have limited or eliminated shareholder authority over structural decisions through expansion of business judgment rule).

result if shareholder plaintiffs were to bear the initial burden of proof without having to overcome the presumption of the business judgment rule. Once the burden has shifted, the directors would be permitted to demonstrate the degree to which their business judgment should be protected by proving the *Unocal* factors.

I. THE RELATIONSHIP BETWEEN THE BUSINESS JUDGMENT RULE AND *UNOCAL*

The business judgment rule functions to protect directors from shareholder actions brought in response to the implementation of takeover defense tactics.¹⁸ The rule is a general presumption that board decisions have been made on an informed basis, in good faith and in the honest belief that board action was taken in the best interests of the corporation.¹⁹ If directors satisfy the rule's presumptive elements then, absent any abuse of discretion²⁰ or

¹⁸ See *Jewel Cos. v. Pay Less Drug Stores N.W., Inc.*, 741 F.2d 1555, 1564 (9th Cir. 1984) (directors protected under business judgment rule when court approved no-shop provision which foreclosed competing offers); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1342 (Del. 1987) (court recognized that business judgment rule protected directors in corporation's self-tender offer that excluded minority shareholder from making bid for corporation); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1357 (Del. 1985) (flip-over rights plan held valid under business judgment rule therefore directors obtained judicial protection). *But see* Note, *Dual Class Recapitalization and Shareholder Voting Rights*, 87 COLUM. L. REV. 106, 108 (1987) (fiduciary obligations prohibit directors from resisting takeover that offers fair price and will not harm corporation).

¹⁹ See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)); *Unocal*, 493 A.2d at 954 (quoting *Aronson*, 473 A.2d at 812); *Aronson*, 473 A.2d at 812; *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971); *Bodell v. General Gas & Elec. Corp.*, 15 Del. Ch. 420, 140 A. 264, 268 (1927). See *Johnson & Siegel*, *supra* note 17, at 323 n.27. The business judgment rule serves a twofold purpose: first, directors should not be exposed to liability for decisions they made in good faith and in what they perceived to be the best interests of the corporation. *Id.* Second, since shareholders entrusted directors to make decisions, they must also give them "latitude to take risks" without being held liable for failure. *Id.* *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1980) (business judgment rule applies to takeover contexts). See generally E. FOLK, *THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS* 75-81 (1972) (discussing principles and applicability of business judgment rule).

The business judgment rule should be applied in accordance with state corporate law. See *Burks v. Lasker*, 441 U.S. 471, 478 (1979) (application of business judgment rule is state corporate law question); Note, *Corporate Auction and Directors' Fiduciary Duties: A Third-Generation Business Judgment Rule*, 87 MICH. L. REV. 276, 280 (1988) (directors' business judgment will be evaluated by "standards of conduct required by state law").

²⁰ *Cottle v. Storer Communications, Inc.*, 849 F.2d 570, 575 (11th Cir. 1988) (defendant directors entitled to business judgment protection unless plaintiff shows abuse of discretion); *Aronson*, 473 A.2d at 812 (absent abuse of discretion, directors decision respected by

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gross negligence,²¹ the directors' decisions will not be questioned by most courts.²² This rule has only placed "the rudiments of limits"²³ on the discretion of directors in pursuing plans of action they feel are necessary for the future of the corporation.²⁴

courts).

²¹ *Smith v. Van Gorkom*, 488 A.2d 858, 874 (Del. 1985). The court found that directors were grossly negligent in failing to act with "informed reasonable deliberation." *Id.* at 881. The directors approved the "sale" by relying on a two hour oral presentation without prior knowledge of the matter, and the premium was accepted without prior appraisal of the subsidiary. *Id.* at 876. The court held that in the aggregate this constituted gross negligence. *Id.* at 881. See *Moran*, 500 A.2d at 1356-57 (since directors had reasonable belief that company was vulnerable to threat posed by potential acquiror, their judgment did not amount to "gross negligence."). See also *Penn Mart Realty Co. v. Becker*, 298 A.2d 349, 351 (Del. Ch. 1972) (gross negligence is breach of fiduciary duty). Cf. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 722 (Del. 1971) (absent gross overreaching, business judgment rule applicable). See generally Kreider, *Corporate Takeovers and the Business Judgment Rule: An Update*, 11 J. CORP. L. 633 (1986) (development of gross negligence as standard for reviewing boards' business judgment), reprinted in 30 CORP. PRAC. COMMENTATOR 117, 123-125 (1989).

²² See *Aronson*, 473 A.2d at 812. If the decision was made on informed basis, in good faith and in the honest belief that it was in best interests of company, it will be respected by the court. *Id.* See also *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) ("Court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.'") (quoting *Sinclair*, 280 A.2d at 720). See generally Buxbaum, *supra* note 17, at 1677 ("court pays exaggerated respect to the black box of managerial function"); S. Lorne, *Acquisitions and Mergers: Negotiated and Contested Transactions* §4.05 (3)(a), at 4-101 (1985) (courts acquiesce to director decisions because they are unqualified to second guess these decisions). But see *Conoco Inc. v. Seagram Co.*, 517 F. Supp. 1299, 1303-4 (S.D.N.Y. 1981) (stockholders should not be denied opportunity to tender shares in reliance on equity principles); *Schnell v. Chris-Craft Indus. Inc.*, 285 A.2d 437, 439 (Del. 1971) ("[I]nequitable action does not become permissible simply because it is legally possible.").

²³ Note, *Panter v. Marshall Field & Co.: Unbridled Discretion of Management to Resist Hostile Tender Offers*, 33 MERCER L. REV. 647, 650 (1982).

²⁴ Note, *supra* note 23, at 650. But cf. Note, *False Halo: The Business Judgment Rule in Corporate Control Contests*, 66 TEX. L. REV. 843, 844 (1988) (rule remains presumption, not a standard of conduct; "instead of applying the business judgment rule mechanically, [in takeover cases] courts have begun to analyze carefully the directors' faithfulness to their fiduciary duties to the corporation").

See *Smith*, 488 A.2d at 872. The elements making up the business judgment rule, such as making an informed decision, acting in good faith and with the honest belief that it is in the best interests of the corporation, focus on the individual director's knowledge of material information at the time just prior to the decision. *Id.* The courts must rely on the directors' interpretations of the surrounding circumstances in order to determine if they have met the criteria of the business judgment rule. *Id.* See also *Harrington*, *supra* note 4, at 1001. Referring to the court's unwillingness to analyze such important issues as the fairness of a transaction or an obvious conflict of interest, *Harrington* notes that "[t]he natural instinct of the courts [is] to avoid such thorny thickets of review" *Id.* "[T]he reluctance of the courts to face these issues has all too often resulted in a total distortion of the business judgment rule and a misapplication of the rule to cases in which it should never have been applied." *Id.*

However, because of the increased likelihood that directors will forsake the interests of shareholders in the hostile takeover setting, Delaware courts require directors to satisfy the "enhanced" burden of the *Unocal* test before they are afforded business judgment rule protection.²⁵ In *Unocal*, a minority shareholder made a two-tier front loaded tender offer²⁶ for 37 percent of the corporation's outstanding stock at a price of \$54 per share.²⁷ After determining that the offer was coercive and that the price was inadequate, the *Unocal* board of directors implemented a selective exchange agreement²⁸ as a defense against the tender offer.²⁹ Recognizing the risk of self-interested motives, the Delaware Supreme Court placed a dual burden of proof on the directors: first, they were required to prove that there were reasonable grounds for believing that corporate policy and effectiveness was in danger;

See supra note 17; *infra* notes 35-47 and accompanying text (discussing inadequacy of business judgment rule in protecting shareholder interests).

²⁵ *Unocal*, 493 A.2d at 954. In the hostile takeover context, directors have the initial burden of proof. *Id.* at 955. This burden is satisfied upon a showing of "good faith and reasonable investigation," and a reasonable response. *Id.* *See* *Paramount Communications, Inc. v. Time, Inc.*, Fed. Sec. L. Rep. ¶ 94514, Nos. 10866, 10670, 10935 at 79 (Del. Ch. July 17, 1989) (LEXIS, States library, Del file) (in hostile takeover setting directors must overcome *Unocal* standard before obtaining business judgment protection), *aff'd*, 565 A.2d 280 (Del. 1989); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987) (same); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986). "This potential for conflict places upon the directors the burden of proving that they had reasonable grounds for believing there was a danger to corporate policy and effectiveness, a burden satisfied by a showing of good faith and reasonable investigation." *Id.*

²⁶ *See* Steinberg, *Some Thoughts on Regulation of Trade Offers*, in *TENDER OFFERS* 273 (M. Steinberg ed. 1985). A two-tier front loaded tender offer is:

[a] two step acquisition technique in which the first step (front end) is a cash tender offer and the second step (back end) is a merger in which remaining shareholders of the subject company typically receive securities of the bidder valued below the cash consideration offered in the first step tender offer.

Id. at 274 n.1.

²⁷ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 949 (Del. 1985).

²⁸ *Id.* at 951. A selective exchange agreement occurs when a company implements a "self-tender for its own shares which excludes from participation a stockholder making a hostile tender offer for the company's stock." *Id.* at 949.

²⁹ *Id.* at 956. The court stated:

[T]he *Unocal* directors had concluded that the value of *Unocal* was substantially above the \$54 per share offered [T]he board stated that its objective was either to defeat the inadequate *Mesa* offer or, should the offer still succeed, provide the 49% of its stockholders, who would otherwise be forced to accept "junk bonds," with \$72 worth of senior debt.

Id.

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and second, they had to show that the defensive measures taken were reasonable in response to the threat posed.³⁰ If the directors sustained this burden, it became the plaintiff's task to establish director fraud, bad faith or self dealing by a preponderance of the evidence.³¹ The *Unocal* court held that the defensive measure in question was reasonable under the circumstances, and thus invoked business judgment protection.³²

II. THE BUSINESS JUDGMENT RULE IN THE TAKEOVER CONTEXT: COMPLETE PROTECTION FOR DIRECTORS

The business judgment rule is most frequently applied when decisions of directors are challenged in the takeover context.³³ When directors reject a bidder's tender offer they often base their decision on "the inadequacy of the bid, the nature and timing of the offer, questions of illegality, the impact on constituencies other than shareholders, the risk of nonconsummation, and the basic stockholder interests at stake, including the past actions of

³⁰ See *Id.* at 955, 958. See *Ivanhoe Partners v. Newmont Mining Corp.*, 533 A.2d 585, 606 (Del. Ch.) (two prong *Unocal* test applied when board resists takeover bid), *aff'd*, 535 A.2d 1334, 1341 (Del. 1987); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986) (same). See *Johnson & Siegel*, *supra* note 17, at 329 (general discussion and expansion of *Unocal* requirements).

³¹ See *Unocal*, 493 A.2d at 958. Once the burden shifts to the plaintiff, "unless it is shown by a preponderance of the evidence that the directors' decisions were primarily based . . . on some . . . breach of fiduciary duty such as fraud, overreaching, lack of good faith, or being uninformed, a [c]ourt will not substitute its judgment for that of the board." *Id.* See also *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985) (burden of going forward with evidence shifts back to plaintiff after directors satisfy *Unocal* standard). *But see Cottle v. Storer Communication, Inc.*, 849 F.2d 570, 575 (11th Cir. 1988) (defendant entitled to summary judgment unless plaintiff first shows genuine issue of fraud, bad faith or abuse of discretion); *Wolf v. Fried*, 473 Pa. 26, 373 A.2d 734, 735 (1977) (even absent proof of fraud or self dealing, "directors of a corporation may be held personally liable where they have been imprudent, wasteful, careless and negligent and such actions have resulted in corporate losses.") (stating holding in *Selheimer v. Manganese Corp.*, 423 Pa. 563, 224 A.2d 634 (1966)).

³² *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 949, 959 (Del. 1985).

³³ See *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984). See also *Johnson v. Trueblood*, 629 F.2d 287, 292-93 (3d Cir. 1980) (business judgment rule applicable in takeover context); *Unocal*, 493 A.2d 954 (same); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) ("The function of the business judgment rule is of paramount significance in the context of a derivative action."); *Kaplan v. Centex Corp.* 284 A.2d 119, 124 (Del. 1971). Business judgment rule applies to takeovers. *Id.* See generally *Kreider*, *supra* note 21, at 636-37 (explains circumstances in which business judgment rule applies).

the bidder and its affiliates in other takeover contexts."³⁴ The Delaware courts have granted deference to board decision-making because of the extensive number of factors it involves and the recognition that the board has more experience in corporate matters and is privileged to pertinent information concerning its own affairs.³⁵ The shareholders, by contrast, are viewed as unable to make informed decisions.³⁶

Directors in Delaware corporations enjoy a wide latitude of discretion because the courts consider themselves unqualified to second-guess director decisions.³⁷ If directors can demonstrate any rational business purpose, in spite of other concerns, their decisions will prevail.³⁸ Consequently, directors have almost absolute

³⁴ *Ivanhoe*, 535 A.2d at 1341-42; *Unocal*, 493 A.2d at 955-56 (board must balance various factors when deciding reasonable course of action); Paramount Communications, Inc. v. Time, Inc., Fed. Sec. L. Rep. ¶ 94514, Nos. 10866, 10670, 10935 (Del. Ch. July 17, 1989) (LEXIS, States library, Del file), *aff'd*, 565 A.2d 280 (Del. 1989). See generally Lipton & Brownstein, *Takeover Responses and Directors' Responsibilities: An Update*, ABA NATIONAL INSTITUTE ON THE DYNAMICS OF CORPORATE CONTROL 7 (December 8, 1983). But see Easterbrook & Fischel, *Takeover Bids, Defense Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733, 1746-50 (1981) (authors argue for "managerial passivity" which would require directors to acquiesce when confronted with a tender offer). But cf. Herzelt, Schmidt & Davis, *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 CORP. L. REV. 107, 110 (1980) (requiring "passivity" would, "in effect, put the company up for sale to the highest bidder at all times").

³⁵ *Smith v. Van Gorkom*, 488 A.2d 858, 876 (Del. 1985) (board in better position to gather relevant information, therefore court defers to their "informed" decision). See Bother & Prussin, *The Business Judgment Rule & Shareholder Derivative Actions: Viva Zapata?*, 37 BUS. LAW. 27, 32-33 (1981) (court's refusal to second guess director decisions is major rationale under business judgment rule); *supra* notes 17 and 22. Cf. *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 286 (2d Cir. 1986) (Kearse, J., dissenting) (courts are ill-equipped to evaluate business judgment).

³⁶ See Easterbrook & Fischel, *supra* note 16, at 1196 (plaintiff/shareholders, just like courts, lack experience and information necessary to intelligently challenge managerial decisions); Herzelt, Schmidt & Davis, *supra* note 34, at 111 (shareholders unable to make decisions that will best serve their collective self-interest); *supra* notes 17 & 22.

³⁷ See *supra* notes 17, 22 & 36 (discussing Delaware courts' unwillingness to second guess director decisions).

³⁸ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (court will not substitute its judgment for board's if "latter's decision can be 'attributed to any rational business purpose'") (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)) (emphasis added). See *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987) ("directors' decisions are *presumed* to have been made on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company") (emphasis added); *Cheff v. Mathes*, 199 A.2d 548, 555 (Del. 1964) (directors not "penalized" if decision seemed reasonable at time made). See generally Easterbrook & Fischel, *supra* note 34 at 1748-49 (debating whether rational business purpose can be formed when board action forecloses shareholder premium and depletes corporate treasury with litigation expenses).

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discretion in deciding what is in the best interest of both the corporation and its shareholders.³⁹ Unfortunately for shareholders in the hostile takeover context, the exercise of director discretion often precludes shareholders from obtaining a guaranteed capital gain on their investment, usually in the form of a premium over the current market price of the stock.⁴⁰

See Grand Metro. Pub. Ltd. v. Pillsbury Co., 558 A.2d 1049, 1055 (Del. Ch. 1988) (“Delaware court will not substitute its judgment for that of board, provided that the answer the Board gave can be attributed to any rational business purpose and . . . that the standards required by *Unocal* have been met.”) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 726 (Del. 1971)). *See also Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (court will not second guess board decision); *Sinclair Oil Corp.*, 280 A.2d at 720 (Del. 1971) (court “will not substitute its notion of what is or is not sound business judgment”).

Several policy reasons have been put forth to justify defensive measures as sound business judgment. For instance, the board may claim that they are able “to obtain greater value for the shareholders.” Gilson, *Delaware’s Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality*, 44 BUS. LAW. 247, 260 (1989). The board can also justify its defensive measures by claiming it could achieve a better price “by preserving the target’s independence and generating value internally.” *Id.* at 262. *See, e.g., Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1340 (Del. 1987) (standstill agreement limited hostile offeror’s control of target, “thereby assuring the latter’s continued independence”); *Paramount Communications, Inc. v. Time, Inc.*, Fed. Sec. L. Rep. ¶ 94514, Nos. 10866, 10670, 10935 (Del. Ch. July 17, 1989) (LEXIS, States library, Del file) (Time board entered merger agreement that precluded hostile offer to preserve “Time Culture,” and to promote policy decision to manage for “long term” value of company), *aff’d*, 565 A.2d 280 (Del. 1989). However, Easterbrook and Fischel have argued that board policies of resisting tender offers or maintaining company independence operate to the shareholders detriment, and should therefore be restricted. *See Easterbrook & Fischel, supra* note 34, at 1737 (stockholders worse off when defensive tactics preserve independence); Easterbrook & Fischel, *supra* note 16, at 1174-75 (“If the company adopts a policy of intransigent resistance and succeeds in maintaining its independence, the shareholders lose whatever premium over market value the bidder offered or would have offered but for the resistance . . .”).

In cases of self-perpetuation, the courts have invalidated a board’s decision only when it was the sole or primary motive for their actions, not merely an underlying motive. *Cheff*, 199 A.2d at 554. *See Frantz Mfg. Co. v. EAC Indus., Inc.*, 501 A.2d 401, 408 (Del. 1985) (improper motive of self-perpetuation overrides protection of business judgment rule); *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971) (court enjoined management’s acts which attempted to perpetuate themselves in office by obstructing legitimate efforts of dissenting stockholders to undertake proxy contest).

³⁹ *See, e.g., Panter v. Marshall Field & Co.*, 646 F.2d 271, 297 (7th Cir.) (court upheld “defensive” acquisitions used to thwart takeover due to antitrust law), *cert. denied*, 454 U.S. 1092 (1981); *Moran v. Household Int’l, Inc.*, 500 A.2d 1346, 1357 (Del. 1985) (court deemed purchase of rights plan that diluted acquirer’s holding in target corporation to be reasonable in relation to threat posed); *Unocal*, 493 A.2d at 955 (court upheld self-tender offer excluding certain shareholder participation where directors reasonably believed certain shareholders presented danger to corporate policy and effectiveness); *Harrington, supra* note 4, at 1005 (“board can take, with impunity, virtually any action it wishes to frustrate” a tender offer); *supra* notes 17 & 35.

⁴⁰ *See Bradley, Interfirm Tender Offers and the Market for Corporate Control*, in *MERGERS*

By straining to insulate directors from liability at the expense of shareholders, Delaware courts have reduced the business judgment rule to a mere token standard, enabling a court to sanction virtually any business decision.⁴¹ This effectively clothes directors with an "almost irrebuttable presumption of sound business judgment, prevailing over everything but the elusive hobgoblins of fraud, bad faith or abuse of discretion."⁴² The approach taken by the Delaware courts effectively insulates directors from liability because the directors are obliged to merely present post hoc rationales to justify their defensive policies.⁴³ This post hoc protection undermines the very purpose of the business judgment rule⁴⁴

AND ACQUISITIONS 267 (M. Keenan ed. 1982) ("[B]idding firms paid target stockholders an average premium of 49 percent for the shares they purchased."). See, e.g., *Panter*, 646 F.2d at 280 (shareholders lost premium when defensive measures were upheld); *Whittaker Corp. v. Edgar*, 535 F. Supp. 933, 951 (N.D. Ill. 1982) (directors of target corporation sold "crown jewel" asset thereby lowering value of company to detriment of shareholders), *aff'd*, Nos. 82-1305, 82-1307 (7th Cir. Mar. 5, 1982); *Paramount Communications, Inc. v. Time, Inc.*, Fed. Sec. L. Rep. ¶ 94514, Nos. 10866, 10670, 10935 at 73 (Del. Ch. July 17, 1989) (LEXIS, States library, Del file) (Time shareholders precluded from realizing Paramount's \$200 per share offer in return for higher speculated returns in future), *aff'd*, 565 A.2d 280 (Del. 1989); Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621, 655 (1983) ("stringent application of the business judgment rule creates an almost insurmountable barrier to relief for shareholders who have been denied the opportunity to sell their shares at a substantial premium"). Cf. *Jewel Cos. v. Pay Less Drug Stores N.W., Inc.*, 741 F.2d 1555, 1564 (9th Cir. 1984) (merger agreement with no-shop clause provision precluding acceptance of competing offers could be valid before approval by shareholders which might preclude them from possible capital gain).

⁴¹ See *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 286 (2d Cir. 1986) (Kearse, J., dissenting) (policy underlying business judgment rule is twofold: courts are ill-equipped to evaluate business judgments, and there is no available objective standard to judge correctness of board decisions); *Panter*, 646 F.2d at 299. (Chudahy, J., dissenting) (courts' use of business judgment rule is moving closer "to shredding whatever constraints still remain upon the . . . corporate directors . . ."); Buxbaum, *supra* note 18, at 1683. The courts have limited or eliminated shareholders' ultimate authority over structural decisions via an expanded definition of "business judgment," therefore there are few checks upon the directors. *Id.* See also Harrington, *supra* note 4, at 1001 (courts' reluctance to review substance or motivation of board action has "often resulted in total distortion of the business judgment rule"). See generally *Johnson v. Trueblood*, 629 F.2d 287, 300 (3d Cir. 1980) (court upheld "scorched earth" and "lock up option" defense where friendly bidder was given option on target's securities), *cert. denied*, 450 U.S. 999 (1981).

⁴² *Panter v. Marshall & Co.*, 646 F.2d 271, 299 (7th Cir.) (Cudahy, J., dissenting), *cert. denied*, 454 U.S. 1092 (1981).

⁴³ *Panter*, 646 F.2d at 299 (Cudahy, J., dissenting). See *supra* note 38.

⁴⁴ See Steinberg, *Some Thoughts on Regulation of Tender Offers*, in TENDER OFFERS 273, 285 n.44 (M. Steinberg ed. 1985). "First, if management were liable for mere good faith errors in judgment, few capable individuals would be willing to incur the financial and emotional risks of serving in such roles. Second, courts are generally ill-equipped to evaluate business judgments. Finally, management has the expertise to . . . mak[e] such determinations." *Id.*

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because it allows protection not granted upon the true rationale of a decision, but rather upon some convenient justification.⁴⁵ Criticizing this “hands off” approach to the conflict, the dissent in *Panter v. Marshall Field & Co.* accurately warned of directors channeling their expertise to their personal advantage and to the detriment of the corporation and its shareholders.⁴⁶ The minimal standards used to evaluate defensive director action taken without shareholder approval, and the Delaware courts’ implicit trust of those actions, are no longer justifiable in light of the certain conflict of interest between directors and shareholders in the hostile takeover situation.⁴⁷

III. *Unocal*: LIMITED PROTECTION FOR SHAREHOLDERS IN HOSTILE TAKEOVERS

The Delaware courts have applied the *Unocal* test to defensive measures in a hostile takeover setting,⁴⁸ recognizing that directors

Note, *supra* note 40, at 651 (policy of business judgment rule is to “allow directors the discretion to formulate effective company policy [.]. . . encourage[] competent people to become directors without fear of personal liability [and]. . . relieve[] the courts of the burden of second guessing complex corporate decisions”).

⁴⁵ See *supra* notes 17, 22, 38, 43 and accompanying text. See generally Easterbrook & Fischel, *supra* note 34, at 1745-47 (business judgment rule should not be applied to directors who are resisting tender offer due to inherent conflicts of interests between shareholders and managers and courts’ unwillingness to second-guess business decisions).

⁴⁶ *Panter v. Marshall Field & Co.*, 646 F.2d 271, 300 (7th Cir.) (Cudahy, J., dissenting), cert. denied, 454 U.S. 1092 (1981). See Gelfond & Sebastian, *Reevaluating the Duties of Target Management in a Hostile Tender Offer*, 60 B.U.L. REV. 403, 435-37 (1980). Hostile tender offers create unavoidable conflict of interest. *Id.* at 436. The directors are interested in protecting their position and holdings; therefore, their decisions might not truly reflect what is in the best interest of the corporation or its shareholders. *Id.*

⁴⁷ See Block & Miller, *The Responsibilities and Obligations of Corporate Directors in Takeover Contests*, 11 SEC. REG. L. J. 44, 69-70 (1983) (discussing danger of business judgment rule when board actions are not in best interest of shareholders); Buxbaum, *supra* note 17, at 1727-32 (recognizing inability of Delaware courts to properly address management defensive strategies, and concurrent need for checks on board authority); Easterbrook & Fischel, *supra* note 16, at 1198 (courts should not grant deference to managerial decisions resisting tender offer because of “unavoidable conflict of interest that inheres in any decision on one’s own ouster”); Kreider, *supra* note 21, at 648-50 (discussing trend of courts to second-guess “business judgment of the directors by imposing their own judgment in the interest of fairness to shareholders”); Note, *Discrimination Against Shareholders in Opposing a Hostile Takeover*, 59 S. CAL. L. REV. 1319, 1322 (1986) (discussing arguments in favor of prohibiting defensive measures by board). But see Herzog, Schmidt & Davis, *supra* note 34, at 109 (managerial resistance to tender offers creates bargaining process which ultimately benefits shareholders).

⁴⁸ E.g., *Paramount Communications, Inc., v. Time, Inc.*, Fed. Sec. L. Rep. ¶ 94514, Nos.

“[do] not have unbridled discretion to defeat any perceived threat by any Draconian means available.”⁴⁹ The courts look to the additional burden of satisfying the *Unocal* criteria as a means of guarding against “the omnipresent specter that a board may be acting primarily in its own interests rather than those of the corporation and its shareholders.”⁵⁰ Although it may appear that a requirement of reasonableness is an additional burden upon directors, it is submitted that the *Unocal* requirements have in fact provided shareholders with insufficient protection. The *Unocal* standard is substantively equal to the business judgment rule as a result of the expansive judicial deference⁵¹ given to board rationale under the board’s burden of proof. Unless the Delaware courts are willing to critically examine these rationales, the purpose of *Unocal*⁵² is undermined and the requirement of proof serves little purpose.

The first prong of the *Unocal* test requires directors to prove that they conducted a “good faith and reasonable investigation” of both the perceived threat and the corporation’s possible defenses.⁵³ The directors can satisfy this burden by demonstrating

10866, 10670, 10935 (Del. Ch. July 17, 1989) (LEXIS, States library, Del file) (court reviews defensive measures to hostile takeovers under *Unocal* test), *aff’d*, 565 A.2d 280 (Del. 1989). See *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341-44 (Del. 1987) (probability of success of claim must be analyzed under well-established standard of *Unocal*); *Moran v. Household Int’l Inc.*, 500 A.2d 1346, 1350 (Del. 1985) (same); *City Capital Assocs. Ltd. v. Interco Inc.*, 551 A.2d 787, 790 (Del. Ch.) (court applied *Unocal* test to defensive measures implemented to thwart takeover), *appeal dismissed*, 556 A.2d 1070 (Del. 1988); *Grand Metro. Pub. Ltd. v. Pillsbury Co.*, 558 A.2d 1049, 1055 (Del. Ch. 1988) (same); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986) (same). See *supra* note 1 (definition of hostile takeover).

⁴⁹ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

⁵⁰ *Unocal*, 493 A.2d at 954. See *Ivanhoe*, 535 A.2d at 1341 (explaining *Unocal* policy); *Johnson & Siegel*, *supra* note 17, at 329 (explains application of enhanced burden of *Unocal*).

⁵¹ See *supra* notes 17, 38 and accompanying text (discussing Delaware courts’ unwillingness to substitute its judgment for that of board).

⁵² See *supra* notes 11-16 and accompanying text (discussing purpose of *Unocal* test).

⁵³ *Unocal*, 493 A.2d at 955. See *Grand Metro. Pub.*, 558 A.2d at 1055 (first element satisfied by good faith and reasonable investigation); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987) (same).

In a similar case, a tender offer was made that was noncoercive and contained no threat of injury to the shareholders or the corporation. *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 112 (Del. 1986). As a defense, the board implemented a self-tender of a higher amount for “65 percent of its outstanding stock at \$60 per share cash.” *Id.* at 104. The court held that this competitive “alternative,” based on economic considerations, satisfies the first prong of *Unocal* because it serves a valid corporate purpose. *Id.* at 112. It has been recognized that the ease of meeting this threshold requirement is that

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that they were not grossly negligent in reaching an “informed decision.”⁶⁴ The Delaware courts have granted deference to board rationales for “informed decisions” in all but extreme circumstances; so, realistically, the burden under *Unocal’s* first prong can be easily satisfied.⁶⁵ Informed decision-making, for example, has been shown simply by proof of an extended discussion of a proposed defensive measure with legal consultants⁶⁶ or a board’s recognition of the tender offeror’s past actions in other takeover contexts.⁶⁷ One Delaware court has gone as far as presuming that an informed decision existed where a board of directors simply determined the company value.⁶⁸ Thus, the “informed decision” prong

directors do not have to prove “a danger existed to corporate policy and effectiveness . . . [and] directors can almost always cite a conflict in policy between the corporation and the bidder.” Johnson & Siegel, *supra* note 17, at 330. See also Note, *Corporate Auctions and Directors’ Fiduciary Duties: A Third-Generation Business Judgment Rule*, 87 MICH. L. REV. 276, 286 (1988). “A reasonably cautious board that is aware of its obligations under the duty of care will have little difficulty satisfying this threshold, procedural inquiry.” *Id.* The first prong is simply meant to identify some rational business purpose behind the board’s actions. . . .” *Id.* But see *Robert M. Bass Group, Inc. v. Evans*, Fed. Sec. L. Rep. (CCH) ¶ 93,924 at 90,197-98 (Del. Ch. 1989) (single meeting with offeror’s representatives was rejected as reasonable investigation because it was “little more than a charade”).

⁶⁴ See *Moran v. Household Int’l Inc.*, 500 A.2d 1346, 1356 (Del. 1985) (board satisfied first prong of *Unocal* by presenting proof that decision was informed and not grossly negligent); *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985). Directors must act in an informed and deliberate manner. *Id.* Duty of care in Delaware prescribes that “informed” decision-making be evaluated on a gross negligence standard. *Id.* Johnson & Siegel, *supra* note 17, at 332 (duty of care requires informed decision); DEL. CODE ANN. tit. 8, § 251(b) (1974) (Delaware’s statute requires informed decision making by directors).

⁶⁵ See *infra* note 73 and accompanying text (only three cases exist in which directors did not meet *Unocal* standard).

⁶⁶ See, e.g., *Moran*, 500 A.2d at 1356. The court stated:

The Directors were given beforehand a notebook which included a three-page summary of the Plan along with articles on the current takeover environment. The extended discussion between the board and representatives of Wachtell, Lipton and Goldman, Sachs, before approval of the Plan reflected a full and candid evaluation of the Plan.

Id. The court concluded that the board made an informed decision since it was not grossly negligent in its review under these circumstances. *Id.*

⁶⁷ See, e.g., *Ivanhoe*, 535 A.2d at 1342. The court stated: “[t]he series of Ivanhoe maneuvers, including the secret acquisition of shares, the ‘bear hug’ letter, the coercive partial tender offer and inadequate bid were all viewed by the defendants as classic elements of Mr. Pickens’ typical *modus operandi*.” *Id.* Furthermore, he had a reputation of acquiring and breaking up corporations. *Id.* From these facts the board could conclude the offer was not in the best interest of the shareholders. *Id.* See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955-56 (Del. 1985). Board can properly consider the past actions of the bidder and its affiliates, in other takeover contexts, when determining what is best for the corporation. *Id.*

⁶⁸ See, e.g., *City Capital Assocs. Ltd. v. Interco Inc.*, 551 A.2d 787, 795, 798 (Del. Ch.)

of the *Unocal* test places no significant burden on directors because it requires them to satisfy only that which is presumed under the business judgment rule: that a decision was made on "an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."⁶⁰

The second prong of the *Unocal* test requires that director response be reasonable in relation to the threat posed.⁶⁰ In determining the reasonableness of the response, the focus is on "the nature of the takeover bid and its effect on the corporate enterprise."⁶¹ An appropriate response is illustrated by Delaware's policy of upholding board decisions when the board demonstrates the existence of either a conflict between the hostile offer and their corporate policy, or a valid business purpose underlying the board's decisions.⁶² In an example of the former situation, the court has found board activity reasonable when the board effectively rejected a hostile offer by revising a merger agreement in order to carry out long term corporate policy.⁶³ In an instance of the latter situation, the Delaware court has recognized as a rea-

(board made informed decision based on good faith belief that corporate restructuring would produce higher share value than that of offer tendered), *appeal dismissed*, 556 A.2d 1070 (Del. 1988). *But see* *Smith v. Van Gorkom*, 488 A.2d 858, 874 (Del. 1985) (*Unocal* analysis is not applied where decision based on twenty minute oral presentation of proposal and unsupported valuation of company's worth was not considered informed.)

⁶⁰ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). Many courts have reaffirmed *Aronson's* definition of the business judgment rule. *See, e.g.*, *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987) (quoting *Aronson* definition of business judgment rule); *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 180 (Del. 1986) (same); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (same).

⁶¹ *Unocal*, 493 A.2d at 955. *See generally* *Johnson & Siegel*, *supra* note 17, at 330-39 (1987) (discussing simplicity of overcoming relatively reasonable response standard established under *Unocal*).

⁶² *Ivanhoe*, 535 A.2d at 1341-42. *See Unocal*, 493 A.2d at 955.

⁶³ *See Unocal*, 493 A.2d at 957 (selective exchange offer motivated by valid business purpose held reasonable); *Paramount Communications, Inc. v. Time, Inc.*, Fed. Sec. L. Rep. ¶ 94514, Nos. 10866, 10670, 10935 (Del. Ch. July 17, 1989) (LEXIS, States library, Del file) (board's restructuring merger transaction motivated by valid strategic business concerns held reasonable), *aff'd*, 565 A.2d 280 (Del. 1989). *But cf.* *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 112-13 (Del. Ch. 1986) (board's creation of alternatives to outside company's offer motivated by valid business concern, but options held unreasonably defensive).

⁶⁴ *Paramount Communications, Inc. v. Time, Inc.*, Fed. Sec. L. Rep. ¶ 94514, Nos. 10866, 10670, 10935 (Del. Ch. July 17, 1989) (LEXIS, States library, Del file) (corporate policy of preserving Time's "culture" justified board's defensive actions), *aff'd*, 565 A.2d 280 (Del. 1989).

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sonable response a “comprehensive defensive strategy”⁶⁴ employed to “maintain the company’s independence.”⁶⁵ In *City Capital Assocs. v. Interco, Inc.*,⁶⁶ the Delaware Chancery Court stretched the concept of “reasonable response” to include prophylactic board decisions made prior to the actualization of any threat.⁶⁷

In determining reasonableness, Delaware courts have recognized that they must “employ[] the *Unocal* precedent cautiously,”⁶⁸ because if “inartfully applied, the *Unocal* form of analysis could permit an unraveling of the well-made fabric of the business judgment rule”⁶⁹ It is proposed that such an unraveling has in fact occurred. Delaware’s unjustifiably cautious and deferential application of the second prong of the *Unocal* test sterilizes the test and renders it substantively equivalent to the business judgment rule.

Given the comparative standards of the *Unocal* test and the business judgment rule,⁷⁰ the only difference between the two is that *Unocal* places the burden of proof upon the directors while the business judgment rule presumes this burden in their favor.⁷¹ It is submitted that this difference is not a distinguishable factor in

⁶⁴ *Ivanhoe*, 535 A.2d at 1345. A comprehensive, defensive strategy included a standstill agreement, a declarations of dividends, and a street sweep. *Id.* at 1336-37. The court stated that, “Newmont’s actions . . . are so inextricably related, the principles of *Unocal* require that they be scrutinized collectively as a unitary response to the perceived threats.” *Id.* at 1343.

⁶⁵ *Id.* at 1345. “Newmont’s directors had both the duty and responsibility to oppose the threats presented by Ivanhoe and Gold Fields.” *Id.* The board determined that the offer was inadequate and coercive. *Id.* at 1342. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (directors have duty to protect corporation “from harm reasonably perceived, irrespective of its source”).

⁶⁶ 551 A.2d 787 (Del. Ch. 1988).

⁶⁷ See *Johnson & Siegel*, *supra* note 17, at 330-31 (1987) (*Unocal* applied where no threat to corporate policy existed).

⁶⁸ *City Capital Assocs. Ltd v. Interco Inc.*, 551 A.2d 787, 796 (Del. Ch.), *appeal dismissed*, 556 A.2d 1070 (Del. 1988). This caution is evidenced by the fact that only two cases have ruled that boards used disproportionate defense measures relative to the takeover threat. *Id.* at 796 n.9. See *Paramount Communications v. Time, Inc.*, Fed. Sec. L. Rep. ¶ 94514, Nos. 10866, 10670, 10935, at 85-86 (Del. Ch. July 17, 1989) (LEXIS, States library, Del file) (“it is prudent to keep in mind that the innovative and constructive rule of *Unocal* must be cautiously applied”), *aff’d*, 565 A.2d 280 (Del. 1989).

⁶⁹ *City Capital Assocs.*, 551 A.2d at 796.

⁷⁰ See *supra* note 59, 69 and accompanying text (discussing relationship between and comparison of business judgment rule and *Unocal*).

⁷¹ See *supra* notes 12, 16, 25 and accompanying text (discussing placement of burden of proof under *Unocal* and business judgment rule).

light of the judicial deference given to board decisions.⁷² The burden of proof distinction serves little purpose because the courts willingly defer to virtually any showing put forth by directors. This deference is evidenced by the infrequency in which the board has failed to sustain its burden of proof in attaining business judgment protection under *Unocal*.⁷³

Most states have recognized that a more effective review of board activity is achieved when the shareholder plaintiff is required to sustain the initial burden of presenting evidence of director fraud, bad faith or self-dealing in the hostile takeover setting.⁷⁴ Following the lead of these other states, the Delaware courts should require shareholders to sustain the initial burden of proof and should not grant directors the business judgment rule presumption. The Delaware courts could then incorporate the

⁷² See Note, *supra* note 53, at 288 (in applying second prong of *Unocal* Delaware courts "show great deference toward a target board's reasonable determination that an offer poses a threat to the corporate enterprise."); Johnson & Siegel, *supra* note 17, at 338-39 (discussing superficiality of *Unocal* in relation to directors duty of loyalty and courts deferential treatment to board decisions).

⁷³ See *Grand Metro. Pub. Ltd. v. Pillsbury Co.*, 588 A.2d 1049, 1060 (Del. 1988) (defensive threat insufficient to warrant board's responsive action); *Robert M. Bass Group, & Co. v. Evans*, Fed. Sec. L. Rep. (CCH) ¶ 93,924 (Del. Ch. July 14, 1989) (same); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 112-15 (Del. Ch. 1986) (minimal "threat" more like probable non-preference for remedy of coercive shareholders). Since *Unocal*, only three cases exist in which the defensive steps were found disproportionate to the threat posed. See *City Capital Assocs. Ltd. v. Interco Inc.*, 551 A.2d 787, 796 n.9 (Del. 1988).

⁷⁴ See *Priddy v. Edelman*, 883 F.2d 438, 443 (6th Cir. 1989) (burden of proof on plaintiff under Michigan law); *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 273 (2d Cir. 1986) (plaintiff in New York bears initial burden of proving directors breach of fiduciary duty resulting from defensive tactics to takeovers); *Treadway Cos., Inc. v. Care Corp.*, 638 F.2d 357, 382 (2nd Cir. 1980) (burden of proof on plaintiff; applying New Jersey rule); *Treco, Inc. v. Land of Lincoln Sav. & Loan*, 749 F.2d 374, 378 (7th Cir. 1984) (under Illinois law burden of proof on plaintiff); *Keyser v. Commonwealth Nat'l Fin. Corp.*, 675 F. Supp. 238, 256 (M.D. Pa. 1987) (plaintiff in Pennsylvania bears initial burden of proof). See generally Note, *supra* note 40, at 656. "[P]laintiff should be required to show that there is a substantial likelihood that the directors will be replaced upon successful completion of the tender offer . . . the burden should [then] shift to the directors to show that their conduct was fair and reasonable." *Id.* See also Note, *Target Directors' Fiduciary Duties: An Initial Reasonableness Burden*, 61 NOTRE DAME L. REV. 722, 726 (1986).

The majority of courts accordingly do not place an initial burden on a board of directors before they can enjoy the presumption of the business judgment rule. These courts require the plaintiff to first present evidence that the directors acted on an uninformed basis, in bad faith, or primarily or solely for the purpose of preventing a change in control to keep themselves in office.

Id.

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Unocal factors as guidelines for determining if directors have met their burden of proof.⁷⁵ Thus, rather than being dispositive on the question of the legitimacy of board action, the *Unocal* factors would be available to directors as an aid toward establishing the proper degree of protection due under the business judgment rule. As it now stands, Delaware's practice of placing the initial burden of proof on the directors⁷⁶ under the *Unocal* standard critically hampers the proper scrutiny of board action because directors have merely been required to sustain the relatively easy burden of establishing the elements of the business judgment rule.⁷⁷ This requirement, in conjunction with the Delaware courts' unwillingness to second-guess board action,⁷⁸ leaves Delaware unable to adequately protect its shareholders in the hostile takeover setting.

CONCLUSION

The Delaware courts have failed to adequately protect shareholder interests through the application of the business judgment rule and the *Unocal* test. Under the business judgment rule, the Delaware courts have strained to grant deference to the expertise of directors and have been unwilling to second-guess their decisions. As a result, virtually any business decision can be shown to have been made in good faith and in the honest belief that it was in the corporation's best interests.

⁷⁵ See *supra* notes 9, 34 and accompanying text (factors considered by board in implementing defensive measure and factors reviewed by court in determining permissibility of board action).

⁷⁶ See *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987) (citing *Unocal*, 493 A.2d at 954). "[T]he directors [have] the burden of proving that they have not acted solely or primarily out of a desire to perpetuate themselves in office, that the threatened takeover posed a danger to corporate policy and effectiveness, and that the defensive measures adopted are reasonable in relation to the threat posed." *Id.* See also *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985) (explaining policy reasons for requiring board to bear initial burden of proof); *Moran v. Household Int'l, Inc.* 500 A.2d 1346, 1350 (Del. 1985) (recognizing need for placing initial burden of proof on directors because judiciary has increased concern over drastic actions taken by directors to remove unwarranted takeover threats). See generally Kreider, *supra* note 21, at 636-38 (1989) (describes burden of proof in takeover offers); Note, *supra* note 74, at 727-28 (discussing why initial burden is on directors).

⁷⁷ See *supra* notes 59, 68-71 and accompanying text (rational decisions upheld).

⁷⁸ See *supra* notes 17, 22, 35, 38 and accompanying text (discussing courts' unwillingness to second-guess board).

In order to effectively protect shareholder interests, Delaware should adopt a more critical analysis of the rationales underlying board decisions. This had been attempted in the hostile takeover setting, in which the *Unocal* test has been purportedly erected as a barrier to business judgment protection. The *Unocal* test, however, is limited as a means of reviewing board decisions and is insufficient to protect shareholders from improper board activity. Board decisions could be more effectively reviewed by requiring the shareholder to sustain the initial burden of proof without having to overcome the presumption of the business judgment rule. If the burden were shifted to the shareholders, directors would be permitted to establish the necessary degree of protection accorded their business judgment using the *Unocal* factors, instead of initially benefiting from the rule. This form of analysis would better allow board activity to be viewed with a critical eye, and therefore diminish the initial deference the Delaware courts have been willing to grant directors.

Frank Cara & Peter F. Lane