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

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NOTES

Corporate Law—CORPORATIONS MAY EXCLUDE RAIDERS FROM DEFENSIVE SELF-TENDER OFFERS IN WARDING OFF HOSTILE TAKEOVERS—*Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985)

I. INTRODUCTION

Corporate takeovers have increased significantly in the last decade, subjecting many companies to hostile tender offers. In response, incumbent managements have devised a variety of defenses to fend off these unwelcome offers. Delineating the proper role of management faced with a hostile tender offer is a difficult task. While management should have the discretion to protect the corporation from raiders that intend to injure shareholders by inducing them to accept inadequate tender offers, officers should not be allowed to reject lucrative offers in an attempt to entrench themselves in office, contrary to the shareholders' best interests. In *Unocal Corp. v. Mesa Petroleum Co.*,[1] the Delaware Supreme Court established the scope of judicial review for management action opposing a takeover.

One means by which incumbent management can oppose a hostile takeover attempt is by purchasing the company's shares on the market, thereby precluding acquisition of those shares by the control-seeking group or company. In *Unocal*, the defensive tactic at issue was such a self-tender by Unocal, which excluded the hostile tender offeror, Mesa, from tendering its shares of Unocal stock.

Mesa challenged the discriminatory tender offer in the Delaware Court of Chancery. Unocal defended by asserting the Business Judgment Rule,[2] through which courts generally refuse to subject managers' decisions to review on the merits.[3] However, the court held that the rule did not apply to a selective purchase of the company's stock and issued a temporary restraining order prohibiting

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1. 493 A.2d 946 (Del. 1985).

2. The Business Judgment Rule provides that "absent bad faith or some other corrupt motive, directors are not normally liable for mistakes of judgment, whether those mistakes are classified as mistakes of fact or mistakes of law." Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 274 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

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

Unocal from proceeding with the tender offer unless Mesa could tender its shares on the same terms as other shareholders.[4] On appeal, the Delaware Supreme Court addressed the issue: "Did the Unocal board have the power and duty to oppose a takeover threat it reasonably perceived to be harmful to the corporate enterprise, and if so, [was] its action . . . entitled to the protection of the business judgment rule?"[5]

In this Note, the author reviews Delaware cases delineating the role of corporate management facing a takeover attempt, analyzes the Delaware Supreme Court's decision in *Unocal Corp. v. Mesa Petroleum Co.*, discusses possible ramifications for future takeover attempts, and examines the federal court action filed by Mesa as well as the Securities and Exchange Commission's response.

II. The Role of Incumbent Management Faced With a Takeover

Delaware courts have applied various standards of judicial review to corporate board action in hostile takeover situations, including the corporate interest standard, the fairness standard, and the Business Judgment Rule. Additionally, some academicians advocate court-imposed managerial passivity in the takeover context; others contend that while management should be able to respond to tender offers, that response should be limited by requiring board actions to be subject to close judicial scrutiny.

A. *Delaware Case Law*

In *Bennett v. Propp*,[6] the corporate Chairman purchased a substantial number of company shares on the open market after learning that another company intended to acquire a majority of the company's stock. It was unclear initially whether the Chairman's purchases were made on his own behalf or on behalf of the corporation.[7] Shareholders brought a derivative suit against the Board of Directors, alleging that corporate assets were wasted in order to retain managerial control.[8] Because the Chairman's purchases were

4. *Unocal*, 493 A.2d at 951. The temporary restraining order was changed to a preliminary injunction by the Vice Chancellor after the interlocutory appeal was granted. The Delaware Supreme Court allowed the Vice Chancellor to proceed with a hearing to enlarge the record on various issues. *Id.* at 952.

5. *Id.* at 953.

6. 187 A.2d 405 (Del. 1962).

7. *Id.* at 407

8. *Id.* at 408.

later ratified by the Board, the lower court determined that the purchases were made in the corporation's behalf.[9] The Delaware Supreme Court upheld the Court of Chancery's finding that the purchases were made in order to preserve incumbent management's control and found such use of corporate funds improper[10] because the Board had failed to identify an immediate threat to the corporation or any genuine business reason for the purchase.[11]

The Delaware Supreme Court noted that incumbent management might use corporate funds to preserve its control, and recognized that "directors are of necessity confronted with a conflict of interest and an objective decision is difficult."[12] Thus, directors using corporate funds to combat threats to corporate policy must "justify such a purchase as one primarily in the corporate interest."[13] Applying this standard, the court held both the Chairman and the President of the corporation liable for the improper purchases made for the purpose of perpetuating their control. The President was held liable because he knew of the Chairman's purchases but did nothing to remedy the situation.[14] The other Directors were not held liable because their ratification of the purchases was aimed at protecting the corporation from potential litigation.[15]

Cheff v. Mathes[16] was the next major Delaware case to delineate management's proper role when facing a takeover. In *Cheff*, a known corporate raider purchased a large block of the target company's stock, creating employee unrest at the prospect of company

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9. *Id.* at 407. The timing of the ratification ran counter to the court's finding that the purchases were made on behalf of the corporation. Having a board adopt a ratification resolution prior to the purchases would be a better procedure for demonstrating that they were made on behalf of the corporation.

10. *Id.* at 408. In Yasik v. Wachtel, 17 A.2d 309 (Del. Ch. 1941), the court approved the general principle that directors cannot use their powers to preserve their control of the corporation.

11. *Bennett*, 187 A.2d at 409. The absence of a valid business purpose distinguished the Chairman's purchases from those made by Directors in Kors v. Carey, 158 A.2d 136 (Del. Ch. 1960). In *Kors*, the Directors repurchased the corporation's shares from a company attempting to change the target corporation's established method of selling cosmetics.

12. *Bennett*, 187 A.2d at 409.

13. *Id.*

14. *Id.* The court examined the following factors in holding the President, along with the Chairman, jointly and severally liable: "his knowledge of the purchases, his silence and failure to act, coupled with his vote on the resolution." *Id.*

15. *Id.* However, the court made clear that directors would be exonerated from liability only when there was an immediate emergency, of which the directors previously had been unaware. *Id.*

16. 199 A.2d 548 (Del. 1964).

liquidation.[17] In response, the target company's Board adopted a resolution to repurchase the stock from the raider at a price above that of the prevailing market,[18] a practice commonly known as "greenmail."[19]

Shareholders brought a derivative suit against the Board, alleging that it had purchased stock for the purpose of retaining its control. The Delaware Supreme Court reversed the lower court's decision, which had held four Directors liable on that ground.[20] The supreme court cited *Bennett*, which placed the initial burden upon directors to justify a repurchase of shares "as one primarily in the corporate interest,"[21] but noted that directors who lacked personal pecuniary interests did not have the "same 'self-dealing interest' as is present . . . when a director sells property to the corporation."[22] Thus, the fairness standard[23]—which requires that all board actions be fair to corporate shareholders—while appropriate when directors have personal pecuniary interests, was held inapplicable.[24]

The supreme court, without labeling it as such, applied the Business Judgment Rule in analyzing the repurchase of shares. Under this rule, directors must satisfy their burden of demonstrating reasonable grounds to believe a danger to the corporation existed by showing that they acted in good faith, after reasonable investigation of the tender offer. Thus, they "will not be penalized for an honest mistake in judgment, if the judgment appeared reasonable at the time the decision was made."[25] The *Cheff* court determined that the Business Judgment Rule was satisfied because the Board conducted an investigation of the threat, received professional advice, and determined that the actions of the raider were inconsis-

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17. *Id.* at 551-52. The incumbent Directors refused the raider's demand to be placed on the Board. The raider also opposed the company's retail sales organization, believing it to be obsolete. *Id.* at 552.

18. *Id.* at 553.

19. *Id.* The Delaware Supreme Court described the practice of "greenmail" as "buying out a takeover bidder's stock at a premium that is not available to other stockholders in order to prevent the takeover." Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 956 n.13 (Del. 1985).

20. *Cheff*, 199 A.2d at 553.

21. *Id.* at 554.

22. *Id.*

23. The fairness standard would require a court to "review [the action] and subject it to rigid and careful scrutiny, and would invalidate [the action] if it was found to be unfair to the corporation." Marsh, *Are Directors Trustees?*, 22 Bus. Law 35, 43 (1966).

24. *Cheff*, 199 A.2d at 554; *see* Smith v. Good Music Station, Inc., 129 A.2d 242 (Del. Ch. 1957).

25. *Cheff*, 199 A.2d at 555.

tent with its purported corporate purpose. Further, the Directors were entitled to use their personal funds to oppose the raider, once they made a good faith decision serving corporate interests. The court held that the Board's method of financing stock repurchases was a matter of business judgment.[26]

In *Pogostin v. Rice*,[27] the Delaware Supreme Court again applied the Business Judgment Rule to the Directors' rejection of a tender offer. The issue was whether shareholders could sue the Board of Directors without first demanding that the Board bring suit against themselves for wrongful refusal to negotiate with the corporate raider. The shareholders alleged that the defendant Directors improperly refused a tender offer solely because they wished to retain corporate control. The shareholders argued that the Board's refusal to negotiate or accept the raider's tender offer, which included a premium over market price, was a prima facie breach of fiduciary duty.[28]

The court recognized that "the availability, function, and operation of the business judgment rule" is applicable in the takeover context.[29] Thus, the shareholders had to show that the sole or primary motive for rejecting the tender offer was improper. The court found that the shareholders had failed to plead facts supporting their claim, and it rejected the argument that the Board's desire to retain control was shown by the mere fact that it opposed the tender offer. If refusal of an offer or failure to negotiate proved a prima facie breach of a fiduciary duty then corporate boards would be robbed "of all discretion, forcing them to choose between accepting any tender offer or merger proposal above market, or facing the likelihood of personal liability if they reject it."[30]

Giving target company management the opportunity to oppose inadequate tender offers without fear of being held personally liable should not be judicially discouraged because directors are privy to information vital to an informed evaluation of tender offers. Directors can disclose this information to shareholders and allow them to decide whether they should tender. However, courts

26. *Id.* at 556.
27. 480 A.2d 619 (Del. 1984).
28. *Id.* at 622.
29. *Id.* at 627. The court cited a number of cases in reaching this conclusion, including two federal appeals court decisions applying Delaware law. *See* Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981).
30. *Pogostin*, 480 A.2d at 627.

should not afford directors absolute freedom to reject lucrative tender offers in order to entrench themselves in office.

B. Other Alternatives

Several commentators have argued that target company directors should play a limited role in dealing with hostile tender offers[31] because there is an inherent conflict of interest between incumbent management and shareholders.[32] The conflict exists because current management probably will be ousted when the corporate raider takes control. This is especially apparent when management has a "substantial interest in the control of the corporation extending beyond the directorship itself."[33]

Gelfond and Sebastian criticize the motive-based primary purpose judicial standard, which was applied in *Cheff* and *Bennett*, as "difficult to apply, . . . and generally ill-suited to the hostile tender offer situation."[34] Under this standard, courts are to determine whether directors took action for the primary purpose of maintaining control[35] or whether their actions were taken primarily in the corporate interest.[36] One difficulty in utilizing this test lies in defining "primary" and applying that definition to a corporate board's collective action.[37] However, the main problem is that the primary purpose test is subjective; thus, it may be difficult to prove that the board's primary purpose in acting was to maintain its control. Gelfond and Sebastian note that by using clever tactics, "management will . . . color its actions as being in the best interests of the shareholders,"[38] thereby insulating itself from judicial review.

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31. Easterbrook & Fischel, *supra* note 3; Gelfond & Sebastian, *Reevaluating the Duties of Target Management in a Hostile Tender Offer*, 60 B.U.L. REV. 403 (1980); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981).

32. Easterbrook & Fischel, *supra* note 3, at 1198; Gelfond & Sebastian, *supra* note 31, at 436; Gilson, *supra* note 31, at 825.

33. Gelfond & Sebastian, *supra* note 31, at 436.

34. *Id.* at 437.

35. *Id.* at 415.

36. Bennett v. Propp, 187 A.2d 405, 409 (Del. 1962).

37. Gelfond & Sebastian, *supra* note 31, at 438. It is unclear whether "primary" means a motive stronger than any other individual motive or whether it refers to a motive stronger than all other motives, collectively. Difficulties also arise in ascertaining primary purpose when directors have acted collectively. It is not clear whether a court should look to the motive of the board as a collective entity, or whether primary purpose is derived from a sum of the directors' individual motives. *Id.*

38. *Id.* at 415-16.

The application of the Business Judgment Rule also has been criticized as inappropriate in the takeover context.[39] Professor Gilson aptly states that "the business judgment rule does not express the measure by which a court determines whether management has discharged its duty of care; rather its application reflects a conclusion that the management action in question will not be reviewed at all."[40] Courts traditionally have not applied the Business Judgment Rule to cases in which directors have conflicts of interest.[41] However, in the takeover context, courts have found that directors do not have conflicts of interest[42] and have held the Business Judgment Rule applicable to management action. In effect, this means that board actions will not be judicially scrutinized unless fraud or gross overreaching is shown. Gelfond and Sebastian note that such a deferential approach seems inappropriate, given that management may act in order to maintain its control.[43]

Professor Gilson contends that management should play a completely passive role when faced with a tender offer, because the shareholders should ultimately decide whether to accept the offer. Gilson's approach focuses on whether management acted, and on the type of action taken, not on the wisdom or good faith behind the particular action.[44]

Gelfond and Sebastian maintain that self-serving managerial action could be thwarted by subjecting that action to a fairness test by which courts would consider objective factors, case by case, to determine whether management acted fairly toward shareholders.[45] This test should be easier to apply than the primary purpose doc-

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39. *Id.* at 436-37; Gilson, *supra* note 31, at 822.

40. Gilson, *supra* note 31, at 822.

41. Gelfond & Sebastian, *supra* note 31, at 435-36.

42. *Id.* at 434.

43. *Id.* at 435.

44. Gilson proposed the following rule to govern the role of management in responding to a tender offer:

> During the period commencing with the date on which target management has reason to believe that a tender offer may be made for part or all of a target company's equity securities and ending at such time thereafter that the offeror shall have had a reasonable period in which to present the offer to target shareholders, no action shall be taken by the target company which could interfere with the success of the offer or result in the shareholders of the target company being denied the opportunity to tender their shares *except* that the target company (1) may disclose to the public or its shareholders information bearing on the value or the attractiveness of the offer, and (2) may seek out alternative transactions which it believes may be more favorable to target shareholders.

Gilson, *supra* note 31, at 878-79.

45. *See* Gelfond & Sebastian, *supra* note 31, at 470-72.

trine and would provide shareholders assurance that management was not acting primarily out of self-interest in rejecting tender offers.

One case in which a higher scope of judicial review was applied to incumbent management action is *Klaus v. Hi-Shear Co.*[46] In *Klaus*, the court of appeals interpreted California law to require a "compelling business purpose" to justify management action which perpetuated incumbent control.[47] The court noted that the term " 'compelling business purpose' suggests a balancing of the good to the corporation against the disproportionate advantage to the majority shareholders and incumbent management."[48] This standard is attractive because it would permit incumbent management to reject hostile tender offers for "compelling business purposes," yet deter management from acting primarily to retain its control. However, this standard does not placate critics who contend that management should play a completely passive role when facing a tender offer.

III. THE DELAWARE SUPREME COURT DECISION IN *Unocal Corp. v. Mesa Petroleum Co.*

In *Unocal*, the Delaware Supreme Court applied the Business Judgment Rule in analyzing Unocal's response to Mesa's hostile tender offer, but the court introduced a balancing test requiring corporate boards to weigh various objective factors before acting on a tender offer. This balancing test provides an avenue for judicial scrutiny which may help ensure that corporate boards act primarily in the corporate interest. However, this check may not be stringent enough. Other court-imposed standards, such as the fairness test or the requirement of total management passivity, may be necessary to ensure that tender offers are handled for shareholders' best interests.

A. *The Court's Analysis in* Unocal

Unocal's discriminatory tender offer was adopted in response to a tender offer by T. Boone Pickens, Jr., and the Mesa group.[49]

46. 528 F.2d 225 (9th Cir. 1975).

47. *Id.* at 233-34. The court rejected the defendants' argument that their actions were protected by the Business Judgment Rule.

48. *Id.* at 234.

49. *Unocal*, 493 A.2d at 949. The members of the Mesa group included Mesa Petroleum Co., Mesa Asset Co., Mesa Partners II, and Mesa Eastern, Inc.

Mesa acquired approximately 13% of Unocal's stock before it commenced a two-tiered "front loaded" cash tender offer for approximately 37% of Unocal's outstanding stock. The price offered to stockholders tendering at the "front end" was $54 in cash. Those tendering at the "back end" would exchange their shares for securities purportedly worth $54.[50] This second-tier offer was designed to eliminate the remaining publicly held shares. Mesa admitted in a supplemental proxy statement that the securities offered at the "back end" of the merger would be subordinated to 2.4 billion dollars of Mesa debt securities.[51]

Unocal's Board met for over nine hours to consider Mesa's tender offer.[52] Financial advisors and legal counsel made presentations evaluating the offer and discussed the Board's obligations and available defense strategies, including a self-tender of Unocal's shares. The eight outside Directors, with advisors, determined that the offer was inadequate and should be rejected; this decision was approved by the five present inside Directors. The Board ultimately agreed to a self-tender of shares which would involve repurchase of 49% of Unocal's outstanding stock in exchange for debt securities worth $72 per share, if Mesa purchased 64 million shares of Unocal stock.[53] The key feature of the self-tender offer was that it excluded Mesa shareholders from tendering. The Board noted that under the proration aspect of the exchange offer, every Mesa share exchanged would displace one held by another shareholder, defeating efforts to compensate adequately shareholders at the "back end" of Mesa's proposal. Further, the Board determined that the exclusion was necessary to prevent the exchange offer from financing what it deemed to be Mesa's inadequate proposal.[54]

The Delaware Supreme Court initially found that the Board had the inherent power to manage corporate affairs and deal in its own

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50. *Id.* Two-tiered tender offers have been described as follows:

> The two-tiered tender offer is an attempt to purchase one hundred percent of the target company that maximizes the coercion inherent in the tender offer process. Instead of offering to buy all the target shares at a price X, the bidder offers to buy fifty-one percent of the shares at price X + Y and announces its desire to acquire the remainder in a second-step merger at price X-Y. Thus, the target's shareholders are induced to tender both by carrot (premium offered in the first stage) and by stick (the lower price offered in the second).

Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The Poison Pill Preferred*, 97 HARV. L. REV. 1964, 1966 (1984).

51. *Unocal*, 493 A.2d at 950 n.3.

52. *Id.* at 950.

53. *Id.* at 951.

54. *Id.*

stock, and thus could repurchase its shares.[55] By virtue of this authority, Delaware corporate directors may deal selectively with stockholders if their sole or primary purpose is not merely to remain in office.[56] Further, the Board had the duty to protect the corporation "from harm reasonably perceived, irrespective of its source."[57] These considerations convinced the court that the Board was not merely a passive instrumentality, and that it had the authority to adopt the defensive self-tender.[58]

Citing *Pogostin*, the Delaware Supreme Court reiterated the principle that the Business Judgment Rule is applicable in the takeover context, and noted that the rule presumes that directors make business decisions in the best interests of the company.[59] Thus, "a court will not substitute its judgment for that of the board if the latter's decision can be attributed to any rational business purpose,"[60] and courts will not interfere with a board's decision unless it was not based on any rational business purpose.[61] However, the court recognized that a board might act primarily in self-interest. Therefore, it imposed an "enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."[62] Directors may meet this burden "by showing good faith and reasonable investigation."[63] Because Unocal's eight outside Directors agreed to oppose Mesa's tender offer and to pursue the self-tender, the court held that the Board had acted in good faith. Reasonable investigation was shown by the Board's detailed analysis of the Mesa offer.[64]

The *Unocal* court introduced a balancing element in evaluating defensive measures adopted by a board of directors. The court noted that for defensive measures to fall within the ambit of the Business Judgment Rule, they must "be reasonable in relation to the threat posed."[65] Thus, a board must inquire into the nature of

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55. *Id.* at 953. DEL. CODE ANN. tit. 8 § 14(a) (1983) provides that the business affairs of all corporations shall be managed by the board of directors, while DEL. CODE ANN. tit. 8, § 160(a) (1983) allows a corporation extensively to buy, sell, or trade its own stock.

56. *Id.; see* Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964); Bennett v. Propp, 187 A.2d 405, 408 (Del. 1962).

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

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.* at 955.

64. *Id.*

65. *Id.*

the takeover threat and its effect on the corporation. Relevant factors a board may consider include the price offered, timing of the offer, the impact on "constituencies" other than shareholders (such as employees and creditors), and the quality of securities offered in exchange for the corporation's stock.[66] A board may also consider whether stockholders who are short-term speculators fueled the coercive tender offer at the expense of long term investors.[67]

Unocal's Board viewed the threat to the corporation as an inadequate two-tiered tender offer combined with the possibility of greenmail.[68] The Board had determined that the company's shares were worth more than the $54 offered at the front end of the merger and also had concluded that the bonds offered at the back end were "junk bonds" worth far less than $54. The supreme court recognized this type of two-tiered tender offer as a classic method of coercing stockholders into tendering their shares for fear of what they will receive at the back end of the merger. Also, "the threat was posed by a corporate raider with a national reputation as a 'greenmailer,'" which compounded the coerciveness of Mesa's offer.[69]

Thus, the Delaware Supreme Court found valid the Board's objective either to defeat Mesa's inadequate offer or, if Mesa were to prevail, provide the 49% of its stockholders, who would otherwise have to accept "junk bonds," with $72 worth of senior debt. The court held that Mesa shareholders should be excluded from the exchange offer because allowing Mesa to tender its shares would subsidize Mesa's efforts to acquire the company, and because Mesa could not fit within the class of shareholders being protected from its own coercive tender offer.[70]

Mesa argued that Unocal's discriminatory exchange offer was unlawful. The court concurred with Mesa's position that no case had ever sanctioned devices precluding a raider from sharing in

66. *Id.*

67. Legal scholars do not agree on whether shareholders benefit when a hostile tender offer is defeated. Martin Lipton takes the position that shareholders do benefit from the defeat of a hostile tender offer. He supports his view with the fact that 95% of the cases in which companies resisted tender offers have resulted in shareholders receiving a higher price than the original offer. Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 106-09 (1979). Easterbrook & Fischel, *supra* note 3, at 1188-90, take the position that shareholders do not benefit when a hostile tender offer is rejected. They contend the most likely reason a tender offer defeat results in a higher price is that it becomes the first round in an extended auction for the company.

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

69. *Id.*

70. *Id.*

benefits available to all other shareholders. However, this case differed from cases approving selective stock repurchases only in "that heretofore the approved transaction was the payment of 'greenmail' to a raider or dissident posing a threat to the corporate enterprises."[71] Thus, the court implied that raiders should not complain if they are excluded from obtaining benefits available to other shareholders because greenmail allows them to obtain benefits unavailable to those shareholders. The court found Mesa's claim ironic, given its history of greenmail.[72]

The court also rejected Mesa's claim that Unocal's Board was not disinterested since it received benefits from the tender of its own shares which, because of the Mesa exclusion, did not devolve upon all shareholders equally. Mesa's argument that the Board had abdicated its fiduciary duties and punished Mesa for exercising its right of corporate democracy were similarly unpersuasive. The court noted that Unocal's Board had reasonably found Mesa to have exercised its rights contrary to the best interests of the corporate enterprise, including Unocal's other stockholders,[73] and that Delaware law does not require a corporation to guarantee benefits to stockholders deliberately provoking the threats to which the Board's actions were addressed.[74]

B. *Implications of* Unocal *for Judicial Review of Corporate Board Action*

The Delaware Supreme Court noted in *Unocal* that a board must fulfill an enhanced duty before the Business Judgment Rule is invoked. This burden is satisfied by showing a board's good faith and reasonable investigation. Earlier, in *Aronson v. Lewis*,[75] the Delaware Supreme Court had interpreted the Business Judgment Rule as creating "a presumption that in making a business decision the directors of a corporation acted on an *informed basis*, in *good faith* and in the honest belief that the action taken was in the best interest of the company."[76] To the extent that the standards of board conduct delineated in *Unocal* and *Aronson* both require that directors have acted in good faith, after reasonable investigation, the enhanced duty requirement set forth in *Unocal* seems to pro-

71. *Id.* at 957.
72. *Id.*
73. *Id.* at 958.
74. *Id.*
75. 473 A.2d 805 (Del. 1984).
76. *Id.* at 812 (emphasis added).

vide shareholders with no protection beyond that of the Business Judgment Rule as interpreted in *Aronson*.[77]

However, *Unocal* added a balancing test to the court's arsenal of review standards by requiring that a board's defensive measures "be reasonable in relation to the threat posed" to the corporation.[78] This balancing requirement provides an avenue of judicial review through which a court may find that the defensive measures were not reasonably related to the threat, and may preclude directors from adopting defensive measures when no threat exists, or when the motives underlying the tactics are improper.

Finally, in upholding Unocal's discriminatory tender offer, the court specifically referred to Mesa's reputation as a greenmailing corporate raider.[79] This raises the question whether the court would have upheld Unocal's defensive measure had a less well-known corporate raider been excluded. The court might have considered less threatening a raider lacking Mesa's greenmailer reputation and afforded Unocal's Board less discretion in adopting the defensive measures.

After *Unocal*, Delaware corporate boards have substantial discretion in devising methods to defeat hostile tender offers. If the measures satisfy the requirements of both the Business Judgment Rule and the balancing element established in *Unocal*, they should be upheld. The *Unocal* court, in effect, maintained a narrow scope of judicial review of management's response to tender offers, decreasing Delaware corporate shareholders' chances of deciding whether future tender offers should be accepted.

Courts should seriously consider Professor Gilson's suggestion that shareholders be permitted to make the ultimate decisions re-

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77. There may be a subtle distinction between the courts' approaches in *Unocal* and *Aronson*. The *Aronson* approach requires that the presumption that directors acted on an informed basis, in good faith, be rebutted by the party challenging the board's acts. The *Unocal* approach seems to require directors to produce some evidence showing that they acted in good faith after reasonable investigation. However, this distinction appears to be minor and does not alter the conclusion that both approaches apply essentially the same standard. The American Law Institute project also would require directors to act in good faith on an informed basis before their actions are protected by the Business Judgment Rule. It provides in pertinent part: "A director or officer who makes a business judgment in good faith fulfills his duty under the Section if . . . (2) he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances." PRINCIPALS OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 4.01 (Tent. Draft No. 4, 1985).

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

79. *Id.* at 956.

garding tender offers.[80] Gilson views tender offers as the most viable method of displacing incumbent management. He considers mergers and sales of assets less effective because both require board approval. Similarly, proxy challenges are not attractive because boards can use corporate funds to resist ouster. Thus, Gilson advocates a court-imposed passive role for corporate management in the takeover context; this approach would eliminate the problem of determining the proper scope of judicial review.[81] However, given that courts previously have upheld a variety of defensive tactics, they may be reluctant to adopt this rather stringent standard.

Another way to ensure that shareholders make the ultimate decisions involving tender offers is to require that the judiciary assume a more active role in reviewing board-adopted defensive measures. Thus, the Business Judgment Rule should be replaced by the fairness test, which would necessitate close judicial scrutiny of management action. This standard would enable directors to oppose inadequate tender offers yet ensure that they acted in shareholders' best interests.

IV. Federal Issues

Federal issues regarding Unocal's discriminatory self-tender were raised when Mesa filed suit in federal district court. Mesa claimed that Unocal had violated federal securities law.

A. *Federal District Court Decision in* Unocal Corp. v. Pickens

Mesa challenged Unocal's discriminatory self-tender offer in the United States District Court for the Central District of California, claiming the discriminatory offer violated sections 13(e) and 14(e) of the Williams Act.[82] In *Unocal Corp. v. Pickens*,[83] the court re-

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80. Gilson, *supra* note 31, at 845-48.

81. *Id.* at 842-45; *see* Easterbrook & Fischel, *supra* note 3, at 1199-1201.

82. Williams Act, Pub. L. No. 90-439, §§ 2, 3, 82 Stat. 454-55, 457 (amending 15 U.S.C. § 78m-n (1964)) (codified as amended at 15 U.S.C. § 78m(e), n(e) (1982)). The Williams Act provides for:

> full disclosure in cash tender offers and in stock acquisitions of more than 10 percent of a corporation's equity shares. . . . [A]ll pertinent facts concerning the identity and background of the person or group making the tender offer or acquisition must be disclosed. Stockholders must also be informed as to—[t]he size of the holdings of the person or group involved[,] [t]he source of the funds to be used to acquire the shares . . .[,] [a]ny financing arrangements made for these funds . . .[,] [t]he purpose of the tender offer[,] [t]he plans of the offeror . . . whether to liquidate [the company], sell its assets, merge it with another company, or to make major changes in its business or corporate structure.

113 Cong. Rec. 24,664 (1967).

83. 608 F. Supp. 1081 (C.D. Cal. 1985).

jected this argument and denied Mesa's motion for a preliminary injunction. In determining whether the Williams Act prohibits discriminatory tender offers, the court recognized that the only stockholder excluded in this case was the "competing, hostile tenderor."[84] The court then examined both the plain language and the legislative history of the statute, and found nothing to support Mesa's "implicitly sweeping reading of the [Williams] Act."[85]

The court stated that the Securities and Exchange Commission's (SEC) proposing but not adopting rules compelling tender offers to be "open to all" was indicative of either their lack of authority to so adopt, or nonadoption was a policy decision.[86] Subsequent to this case, the SEC has adopted such rules[87] dispelling the court's presumptions although not eliminating possible court challenge.

The court's finding in *Unocal* that the Williams Act lacks a substantive "open to all" requirement is consistent with the United States Supreme Court's interpretation of the Act in *Schreiber v. Burlington Northern, Inc.*[88] The Court in *Schreiber* construed section 14(e) of the Williams Act to require fraudulent misrepresentation or nondisclosure for its violation. It refused to read the term "manipulative" into section 14(e) for fear of extending to federal courts an invitation "to oversee the substantive fairness of tender offers."[89] In light of *Schreiber*, the *Unocal* decision correctly places on state courts the burden of ensuring tender offer fairness.[90]

B. *The SEC's Response to the* Unocal *Decisions*

The SEC responded to the *Unocal* decisions by proposing rules which would require tender offers to be open to all shareholders of the class of securities subject to the tender offer.[91] These rules, recently adopted, make explicit the SEC's position that the Williams Act contains "an implicit requirement for equal treatment of all

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84. *Id.* at 1082.
85. *Id.*
86. *Id.*; *see* 44 Fed. Reg. 70,349 (1979) (proposed Rule 14e-4) (Dec. 11, 1979); 42 Fed. Reg. 63,066 (proposed Rule 13e-4) (Dec. 7, 1977).
87. 17 C.F.R. § 240.13e-4 (1986); 17 C.F.R. § 240.14d-10 (1986).
88. 105 S. Ct. 2458 (1985).
89. *Id.* at 2464.
90. *Unocal*, 608 F. Supp. at 1082.
91. 17 C.F.R. § 240.13e-4 (1986) (requiring issuer tender offers to be open to all security holders of the class of securities subject to the offer); 17 C.F.R. § 240.14d-10 (1986) (requiring third-party tender offers to be open to all security holders of the class of security holders of the class of securities subject to the offer).

security holders."[92] Whether the SEC has the authority to adopt these substantive positions is uncertain and probably will be challenged. In light of the Court's reluctance in *Schreiber* to impose fairness standards on tender offers, the Court might strike these measures as beyond the scope of the SEC's statutory authority and as a substantial departure from the general full and adequate disclosure goals of the federal securities laws.[93]

The purpose of the Williams Act was "to require full and fair disclosure for the benefit of investors."[94] Where Congress chose to go beyond requiring mere disclosure, it explicity so provided in the Act.[95] Thus, absent clear statutory authority, the SEC should either leave the fairness issue to state courts or obtain explicit congressional approval of its position.

V. Conclusion

Delaware Supreme Court cases have generated a dynamic standard of judicial review for corporate board action in the takeover context. Initially, corporate directors were required to justify their purchases as primarily in the corporate interest. Later cases applied the Business Judgment Rule to board action, with the court deferring to corporate judgment after an initial showing of the board's good faith and reasonable investigation of the tender offer; shareholders were required to demonstrate that directors' motives in rejecting a tender offer were improper.

In *Unocal*, the court's initial requirement that directors show good faith and reasonable investigation before the Business Judgment Rule may be invoked appears to afford no additional assurance that board actions will not be motivated by the desire to retain corporate control. However, *Unocal* added a balancing element which lays down objective factors that boards must consider in adopting measures opposing tender offers. This examination could enable boards to adopt defensive measures reasonably

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92. 51 Fed. Reg. 25873, 25877 (1986).

93. The Supreme Court noted this concern in Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 478 (1977), describing the "fundamental purpose" of the Securities Exchange Act as implementing a "philosophy of full disclosure"; "once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute."

94. 113 Cong. Rec. 24,664 (1967) (remarks of Sen. Williams).

95. Williams Act, Pub. L. No. 90-439, §§ 2, 3, 82 Stat. 454-55, 457 (amending 15 U.S.C. § 78m-n (1964)) (codified as amended at 15 U.S.C. § 78m(d)-(e), n(d)-(f) (1982)). According to 15 U.S.C. § 78n(d)(6) (1982), shares must be accepted pro rata when there is an oversubscription; 15 U.S.C. § 78n(d)(7) (1982) requires increased consideration to be paid for all shares if it is paid for any prior to expiration of the terms of the offer.

related to the threat posed and provide a means by which courts can scrutinize board action for propriety.

Given the inherent conflict of interest that directors face in hostile tender offers, the balancing requirement developed in *Unocal* may not guarantee that shareholders' interests will be considered. Thus, more stringent standards of judicial review may be necessary. The fairness standard would enable courts to analyze board decisions for basic fairness to corporate shareholders.

The SEC rules requiring that tender offers be open to all dictate different results than those reached in the *Unocal* decisions. However, whether the SEC has the authority to adopt these substantive rules, and whether such requirements exceed the general disclosure policy in federal securities markets is a justiciable matter.

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