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Comments

BUSINESS JUDGMENT RULE: A BENCHMARK FOR EVALUATING DEFENSIVE TACTICS IN THE STORM OF HOSTILE TAKEOVERS

I. INTRODUCTION

A wave of corporate takeovers has engulfed the United States with a new intensity in the 1980s.¹ In 1985 alone, 3,165 mergers occurred involving 139.1 billion dollars in assets.² Along with the increase in merg-

1. For a general discussion of the increase in merger activity, see Matheson & Norberg, *Hostile Share Acquisitions and Corporate Governance: A Framework For Evaluating Antitakeover Activities*, 47 U. PITT. L. REV. 407, 411-12 (1986) (presenting statistics on surge in takeover activity from 1975 through 1984); see also *Top 25 Transactions*, appearing in quarterly issues of MERGERS & ACQUISITIONS.

Economists have categorized mergers throughout the years in different time frames. S. OPPENHEIM, G. WESTON & J. MCCARTHY, FEDERAL ANTITRUST LAW 413 (1981). The first wave of mergers occurred between 1895 and 1904, converting a number of enterprises into near monopolies, and so has been characterized as a period of "mergers for monopoly." *Id.* at 410, 413. Mergers during the second period, from 1920 to 1929, have been called "mergers for oligopoly." *Id.* at 413. An oligopoly is a market in which there are few sellers and an increase or decrease in the output of one seller appreciably affects the market price. *Id.* at 277 (citing Wilcox, *Competition and Monopoly in American Industry*, TNEC Monograph No. 21 (1941)). During this period, the monopolistic firms created during the first wave of mergers had declined, and mergers occurred between "second class" or smaller companies, tending to transform industries into oligopolies. *Id.* Following World War II, a third wave of mergers occurred, known as conglomerate mergers, because they involved corporations in different industries. *Id.* at 413 (citing SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 123 (2d ed. 1980)). The next period of intense mergers occurred from 1966 to 1970. *Id.* at 412. Once again, most of these mergers involved corporations from two unrelated industries. *Id.* at 413.

Merger activity has intensified in recent years. From 1979 through 1984, there were 16,285 mergers involving 510.9 billion dollars in assets. *1985 Profile*, MERGERS & ACQUISITIONS, May-June 1986, at 45. The dollar value of takeover transactions from 1983 to 1984 alone increased 139%, from \$61.9 billion to \$142 billion. Matheson & Norberg, *supra*, at 411-12. The number of tender offers for the same period also increased dramatically, from 77 in 1983 to 142 in 1984. *Id.*

2. *1985 Profile*, MERGERS & ACQUISITIONS, May-June 1986, at 45. Corporations attempt to acquire other corporations for many reasons. First, the potential acquiror may believe that it can increase the profits of the target by replacing the target's management. See, e.g., Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1030-31 (1982) (discussing replacement of management as motive for takeover); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1169-73 (1981) (same); E. KINTNER, PRIMER ON THE LAW OF MERGER 18-19 (1983) (discussing shortage of capable management as factor in merger movement). The acquiring corporation often owns a large percentage of the target's stock

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ers has come an increase in the defensive mechanisms employed by corporate directors to prevent their corporations from being the targets of takeovers by undesirable suitors.³

and, therefore, stands to benefit greatly from the increased profits resulting from a change in management. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 870-73 (1981). There are two prevailing reasons why a change in management may increase the profits of the target. As one commentator suggests, a major problem with today's corporations is a dearth of competent management. E. KINTNER, *supra*, at 18-19. The acquiror can replace the target's management with highly-trained, experienced managers who can develop and maintain sound corporate programs that will increase profitability. *Id.* New management may also concentrate more on increasing the viability of the target instead of pursuing interests outside of the corporation. Bebchuk, *supra*, at 1031 & n.18.

A second reason a corporation may seek to acquire another corporation is to reduce its production and marketing costs by enlarging its scale of operation. E. KINTNER, *supra*, at 18. By distributing the acquiring corporation's fixed costs over a broader base, namely the acquiring corporation and its target, the acquiring corporation can reduce the amount of the total cost for each unit sold which is attributable to the fixed costs. *Id.*

Third, management of an acquiring corporation may take over a target corporation in order to diversify and, thus, maintain corporate stability. E. KINTNER, *supra*, at 19. If the profit of the acquiring corporation is cyclical or based on the strength of the economy, it may seek to merge with a corporation whose profits do not fluctuate as frequently. *Id.* The acquiring corporation may also merge in order to avoid going out of business if, for instance, its current product line is no longer marketable. *Id.*

Fourth, managers may seek to expand the size of their corporations because increased income and prestige are customarily associated with large conglomerates. Bebchuk, *supra*, at 1033; *see also* W. BAUMAL, BUSINESS BEHAVIOR, VALUE AND GROWTH 45-52 (rev. ed. 1967); R. MARRIS, THE ECONOMIC THEORY OF MANAGEMENT CAPITALISM 46-109 (1964). Although managers have an incentive to expand their corporate domain, empirical studies have illustrated that the acquiring corporations often lose money as a result of mergers. Nodd & Ruback, *Tender Offers and Stockholders Returns*, 5 J. FIN. ECON. 351, 397-98 (1977). For a discussion of other negative aspects of a takeover and the resulting merger, see *infra* notes 14-15 and accompanying text.

Additionally, corporations may seek to take over another corporation for other reasons. For instance, a corporation may want to assure uninterrupted access to raw materials and market outlets. S. OPPENHEIM, G. WESTON & J. MCCARTHY, *supra* note 1, at 417. A corporation may also want to acquire new technology or research capacity. *Id.* Finally, a corporation may want to expand rapidly through an acquisition, as opposed to the slower growth which generally is associated with internal growth. *Id.* For a discussion of other reasons for allowing and encouraging takeovers, see Morrissey, *Defensive Tactics in Tender Offers—Does Anything Go?*, 53 TENN. L. REV. 103, 111-19 (1985).

3. Note, *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), 14 FLA. ST. U.L. REV. 301, 301 (1986). The defensive strategies employed by directors of targets to discourage hostile tender offers and the participants in the takeover struggle themselves have been dubbed with colorful names. The acquiring corporation that makes the tender offer is referred to as a corporate "raider." "Golden parachute" is the label for termination agreements given by corporations to certain managers and directors which provide substantial bonuses and other benefits to these employees if a raider successfully takes over the target. *See, e.g.*, *Brown v. Ferro Corp.*, 763 F.2d 798, 802-03 (6th Cir.

This comment will discuss and evaluate recent court decisions regarding the legitimacy of three defensive mechanisms employed by corporations to ward off unwanted takeover attempts: discretionary self-tender, poison pill and lock-up option.⁴ A “discretionary self-tender” describes the situation in which the target’s directors offer to purchase the shares of its shareholders, save those of the tender offeror, at a

1985) (rejecting shareholder derivative suit on grounds that corporation incurred no damage from escrow created to fund officers’ severance agreement); see also Profusek, Bober & Johnson, *An Overview of Current Basic Takeover Planning*, 14 SEC. REG. L.J. 195, 228-29 (1986) (noting typical terms of golden parachute agreements). A “white knight” is the friendly corporation with which a target corporation arranges to merge in order to avoid being taken over by a raider. See, e.g., *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 384 (2d Cir. 1980) (raider did not meet burden of proving improper purpose or corporate waste by target when it issued shares to white knight so as to dilute raider’s interest in target). A “lock-up option” is an arrangement under which a target agrees to sell part of its assets to a friendly suitor if the raider obtains control of the target. See, e.g., *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 267 (2d Cir. 1986) (target corporation granted white knight option to purchase two most profitable divisions should raider acquire one-third of target’s shares); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 177 (Del. 1986) (target corporation granted white knight option to purchase its health care divisions should raider acquire 20% of target’s shares). The “Pac-Man” defense describes a situation in which the target corporation takes over the raider to avoid being taken over by the raider. See, e.g., *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623, 625 (D. Md. 1982) (target commenced tender offer for raider’s shares in control battle waged in seven different courts). A “self-tender” is a defensive mechanism whereby the target offers to buy its own shares from shareholders of the corporation at a higher price than that offered by the raider. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 950 (Del. 1985) (target countered raider’s tender offer of \$54 per share with offer to purchase its own shares for \$72 per share). A “poison pill” is a stock, warrant or right which a target issues to its shareholders which has little value until a tender offer or large hostile stock acquisition occurs. Morrissey, *supra* note 2, at 136. The cost of paying off these securities typically will be so high that the would-be bidder would not be able to or would not want to acquire the target. *Id.*; see, e.g., *Moran v. Household Int’l, Inc.*, 500 A.2d 1346, 1349 (Del. 1985) (target’s defensive strategy involved issuance of rights which allowed target’s shareholders to acquire shares of raider at half price in event of successful takeover). “Leveraged buyout” describes the situation by which a target’s directors tender debt securities, with a face value higher than the market value of a target’s shares, to the target’s shareholders in exchange for their shares. Lowenstein, *Pruning Deadwood in Hostile Takeover: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 295 (1983). Directors often obtain capital needed for these transactions from investment groups. *Management Buyouts: Are Public Shareholders Getting a Fair Deal*, FED. SEC. L. REP. (CCH) ¶ 83,436 (Oct. 6, 1983); see also Reiser, *Corporate Takeovers: A Glossary of Terms and Tactics*, CASE & COMMENT, Nov-Dec. 1985, at 35.

4. This comment focuses on three decisions by the Delaware Supreme Court: *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) (lock-up option); *Moran v. Household Int’l, Inc.*, 500 A.2d 1346 (Del. 1985) (poison pill) and *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (discretionary self-tender); and one decision by the United States Court of Appeals for the Second Circuit, *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264 (2d Cir. 1986) (lock-up option).

higher price than that offered by the tender offeror.⁵ This defensive maneuver prevents a takeover since the target purchases all or most of its shares and, therefore, prevents the tender offeror from acquiring enough shares to obtain control of the target.⁶ A "poison pill" defense identifies the scenario wherein the target's directors issue rights to their shareholders which allow the shareholders to purchase shares of the tender offeror at a reduced rate should the tender offeror succeed in a takeover of the target corporation.⁷ This technique discourages takeovers, as a tender offeror may not be willing to sell a large number of its shares to the target's shareholders at a reduced rate.⁸ A "lock-up option" is a technique by which a target arranges to sell some of its attractive assets (the "crown jewels") to a third corporation if the tender offeror acquires a certain percentage of the target's shares.⁹ This mechanism discourages a tender offeror because the assets which the target agrees to sell to the third corporation are usually the same assets which the tender offeror wants to acquire.¹⁰

To aid in the understanding of the decisions which will be discussed, this comment will first discuss the reasons directors defend against a corporate takeover¹¹ and trace the history of the business judgment rule as a gauge for determining whether directors act appropriately when they use defensive mechanisms.¹² This comment concludes with an analysis of the logic in four recent decisions and makes suggestions as to the viable methods a corporation may use in defending against a future takeover attempt.¹³

5. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 950 (Del. 1985) (target countered raider's tender offer of \$54 per share with offer to purchase its own shares at \$72 per share).

6. See Note, *supra* note 3, at 301.

7. See, e.g., *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1349 (Del. 1985) (target issued rights to its shareholders which allowed them to acquire shares of successful tender offeror at half price).

8. See, e.g., Wander & LeCoque, *Boardroom Jitters: Corporate Control Transactions and Today's Business Judgment Rule*, 42 BUS. LAW. 29, 45 (1986) (most common type of poison pill is the shareholder rights plan or "flip-over" pill which allows "stockholders to receive the right to buy shares in the corporation surviving a hostile merger at a substantially discounted price").

9. See, e.g., *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 267 (2d Cir. 1986) (target arranged to sell two most profitable divisions to white knight if tender offer succeeded).

10. See, e.g., *id.* at 279 (target optioned "crown jewels").

11. For a discussion of the reasons for defending against a takeover, see *infra* notes 14-16 and accompanying text.

12. For a historical perspective of the interplay between the business judgment rule and the various defensive mechanisms, see *infra* notes 25-44 and accompanying text.

13. For an analysis of the four opinions, see *infra* notes 201-57 and accompanying text.

II. REASONS FOR DEFENDING AGAINST A TAKEOVER

Empirical evidence indicates that there are many negative aspects to a takeover and the resulting merger of two corporations. The value of the acquiring corporation's stock frequently declines after a merger.¹⁴ In addition, a large number of employees of the acquired corporation may be released because their jobs could be performed effectively by the current employees of the acquiring corporation without additional assistance.¹⁵ Lastly, but most dramatically, the current takeovers may have a severe effect on the national financial markets in the future if corporate raiders and their targets are unable to pay the large debts which they have incurred during a takeover struggle.¹⁶

In light of the disadvantages associated with takeovers and the resulting mergers, courts have found that the business judgment rule allows corporate directors to fend off unwelcome raiders under certain

14. See Asquith, *Merger Bids, Uncertainty, and Stockholder Returns*, 11 J. FIN. ECON. 51, 81, table 9 (1983) (value of successful and unsuccessful bidder's stock often decreased during 240 days after outcome of merger contest determined). But see Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 16-19 (1983) (although there are problems in accurate measurement, evidence indicates minimal increase in value of stock for both successful and unsuccessful bidders); Kummer & Hoffmester, *Valuation Consequences of Cash Tender Offers*, 33 J. FIN. 505 (1978) (takeovers lead to increase in wealth for both bidding firm and target).

Although the results of studies evaluating the effect of a takeover of the stock of the bidding corporation are not uniform, recent studies consistently show that the value of a target's shares increases dramatically as a result of a takeover bid. Asquith, *supra*, at 81 (indicating significant increase in price of target's stock after date tender offer is announced); Jensen & Ruback, *supra*, at 10 (finding that price of target's stock in successful takeover increases approximately 29%); Kummer & Hoffmester, *supra*, at 505 (concluding that takeovers increase wealth of target).

15. See Morrissey, *supra* note 2, at 113-14 (noting argument that hostile tender offers must be restricted to protect workers and communities from severe disruption). Chevron's acquisition of Gulf in 1984 is the largest corporate takeover to date. *Bigger Yes, But Better?*, TIME, Aug. 12, 1985, at 35. As a result of this takeover, officials predict that 16,000 of the acquired company's 79,000 employees will be laid off. *Id.* Mergers have less dramatic, but still notable, effects on the workplace. *Id.* New management or changes in responsibility may have negative effects on employee morale. *Id.*; see also *Edgar v. Mite Corp.*, 457 U.S. 624, 646 (1982) (Powell, J., concurring in part) (noting that relocation of corporate headquarters as a result of acquisition will inevitably have severe effect on locality from which headquarters was moved).

16. See Domenici, *Fools and Their Takeover Bonds*, Wall St. J., May 14, 1985, at 28, col. 4 (Chairman of Senate Budget Committee expressing concern that explosive increase in use of junk bonds could cripple financial markets if not repaid); Rohatyn, *Junk Bonds and Other Securities Swill*, Wall St. J., Apr. 18, 1985, at 30, col. 3 (observing that faith in financial markets could be shaken during recessionary period if corporations are not able to sell enough assets to make payments on debt from issuance of junk bonds); see also Morrissey, *supra* note 2, at 114 (discussing pros and cons of diverting funds from other sources to finance tender offers).

circumstances.¹⁷ Directors can reject a takeover bid on the grounds that the price is inadequate,¹⁸ the offer is illegal,¹⁹ the acquisition is illegal,²⁰ the target corporation desires to grow internally,²¹ or the takeover will have a negative impact on non-investment groups such as employees, customers, creditors and the community.²² A direct effect of the courts'

17. For a discussion of the reasons courts have given for allowing directors to employ defensive tactics, see *infra* notes 18-22 and accompanying text.

18. See, e.g., *Anaconda Co. v. Crane Co.*, 411 F. Supp. 1210, 1215 (S.D.N.Y. 1975) (business judgment rule allows directors to reject tender offer based upon investment banker's report that price was inadequate); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 957 (Del. 1985) (directors have duty to defend against takeover where securities offered in tender offer were "junk bonds"); see also Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 102 (1979) (citing cases which hold that directors can reject tender offer based on inadequate price).

19. See, e.g., *Berman v. Gerber Products Co.*, 454 F. Supp. 1310, 1318-23 (W.D. Mich. 1978) (concern about offer violating securities law is legitimate reason for target's directors to reject tender offer); *Copperweld Corp. v. Imetal*, 403 F. Supp. 579 (W.D. Pa. 1975) (concern about tender offer violating antitrust laws is legitimate reason for target's directors to reject offer); see also Lipton, *supra* note 18, at 102 & n.5 (citing cases in which directors were able to reject tender offer based on illegality of price).

20. See, e.g., *Allis-Chalmers Mfg. Co. v. White Consol. Indus.*, 404 F.2d 506 (3d Cir. 1969) (preliminary injunction granted where merger created probability of antitrust violations), *cert. denied*, 396 U.S. 1009 (1970); *Berman v. Gerber Products Co.*, 454 F. Supp. 1310, 1326 & n.3 (W.D. Mich. 1978) (directors did not breach fiduciary duty by opposing tender offer which they believed to present antitrust problems); *Gulf & Western Indus. v. Great Atl. & Pac. Tea Co.*, 356 F. Supp. 1066 (S.D.N.Y.) (raider prevented from proceeding with tender offer where target alleged potential violations of antitrust laws), *aff'd*, 476 F.2d 687 (2d Cir. 1973); see also Lipton, *supra* note 18, at 102 & n.6 (noting cases in which directors rejected tender offer because acquisition would be illegal).

21. See, e.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271, 296 (7th Cir.) (directors do not breach fiduciary duty by rejecting merger advances because of desire to grow internally), *cert. denied*, 454 U.S. 1092 (1981).

22. See, e.g., *Herald Co. v. Weawell*, 472 F.2d 1081, 1092 (10th Cir. 1972) (recognizing that directors of corporation engaged in publication of large metropolitan newspaper have duty to employees and public, as well as to shareholders and, thus, may reject takeover if any of these constituencies are jeopardized by takeover); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (directors can consider effect of takeover on constituencies other than shareholders, such as creditors, customers, employees and general public, in determining whether to accept tender offer). *But see* *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (board may consider interests of constituencies other than stockholders "provided there are rationally related benefits accruing to the stockholders"). Several commentators agree with the progressive viewpoint of these courts; namely, that the directors of a corporation can consider interests other than those of the shareholders in deciding whether to accept or reject a takeover. See, e.g., Block & Miller, *The Responsibilities and Obligations of Corporate Directors in Takeover Contests*, 11 SEC. REG. L.J. 44, 68-70 (1983) (suggesting that confluence of business judgment rule protections and recognition of expanded constituencies has greatly increased power of directors); Steinbrink, *Management's Response to the Takeover Attempt*, 28 CASE W. RES. L. REV. 882, 902 (1978) (suggesting that non-investor interests such as preservation of locally-controlled businesses may be legitimate considerations in deci-

recognition that there are appropriate reasons for rejecting a tender offer is the development of innovative defensive techniques by directors who have legitimate reasons for fighting a tender offer.²³ The discretionary self-tender, the poison pill and the lock-up option are the newest developments in the expansion of defensive techniques.²⁴

III. BUSINESS JUDGMENT RULE

In the wake of increased takeover activity, the business judgment rule provides a standard by which a court can evaluate the actions of the target's directors in defending against a hostile takeover.²⁵ Stated gen-

tion to resist takeover attempt). Commentators have also suggested other reasons for implementing defensive mechanisms. One commentator has suggested that defensive mechanisms may be used to stall a tender offer. Steinbrink, *supra*, at 896-98. This use is advantageous because the investing public is given time to assess the worth of the target corporation and determine whether they want to submit a higher bid for the target's stock than that offered by the raider. *Id.* at 896.

Another commentator examined the histories of 36 companies that were targets of unwanted tender offers between 1973 and 1979, and found that, in 1979, the shares of more than half of these targets were either selling at a price higher than the rejected offer price, or had subsequently been acquired by a third party at a price higher than that offered by the raider. Lipton, *supra* note 18, at 106-07. The same author cited a study by Goldman Sachs & Co. which demonstrated that in 95% of the cases in which a corporation had been acquired by a third party after successfully defeating an unwelcome tender offer, the shareholders realized a higher price than that offered in the original tender offer. *Id.* at 108. The author also noted that in rejecting a tender offer, it may be important for a corporation to assure employees, suppliers, customers and the communities in which it operates of its intent to remain independent and continue its current policies. *Id.* at 110 (discussing negative reaction by authors and editors to struggle for control between two publishers).

Commentators who support the right of directors to resist a takeover attempt usually suggest that takeovers may have serious, negative, social and economic impacts. For example, one author has suggested that restricting the ability of directors to defend against takeovers would jeopardize the economy by hampering long-term planning. Lipton, *supra* note 18, at 105. Another has referred to the unquantifiable impact on a small community that results from a change in ownership or control of a company that is the dominant employer in the community. Steinbrink, *supra*, at 902; *see also Bigger Yes, But Better?*, *supra* note 15, at 35 (noting that approximately 16,000 of 79,000 employees of target in recent takeover are expected to lose their jobs).

23. Brennan, *New Cases on the Business Judgment Rule: Defending Defensive Tactics Becomes More Difficult*, 14 SEC. REG. L.J. 245 (1986).

24. For a discussion of these latest innovative attempts to ward off takeover attempts, see *infra* notes 55-200 and accompanying text.

25. *See, e.g.,* Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264, 272-83 (2d Cir. 1986) (evaluating lock-up option under business judgment rule); Panter v. Marshall Field & Co., 646 F.2d 271, 295-97 (7th Cir.) (directors' policy of resisting takeovers protected by business judgment rule), *cert. denied*, 454 U.S. 1092 (1981); Asarco Inc. v. A. Court, 611 F. Supp. 468, 480 (D.N.J. 1985) (business judgment rule allows directors to employ defensive tactics if they articulate reasons why defensive tactic is in best interest of shareholders); Horwitz v. Southwest Forest Indus., 604 F. Supp. 1130, 1134 (D. Nev. 1985) (business judgment rule used to evaluate whether directors breached fiduciary duty by

erally, the business judgment rule immunizes a director from liability if he has acted conscientiously in performing his corporate duties, but the corporation or its shareholders, nevertheless, have suffered harm because of his actions.²⁶ In legal terms, a director is protected if he does

implementing poison pill); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179-84 (Del. 1986) (business judgment rule used to evaluate poison pill and lock-up option); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1355-57 (Del. 1985) (directors' action in adopting poison pill evaluated under business judgment rule); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985) (discretionary self-tender analyzed under business judgment rule).

The underpinnings for the business judgment rule began during the industrial revolution when courts sought to protect individuals against liability for ordinary negligence and honest mistakes in judgment made while managing corporate affairs. See, e.g., *Ellerman v. Chicago Junction Rys. & Union Stock-Yards Co.*, 49 N.J. Eq. 217, 232, 23 A. 287, 292 (N.J. Ch. 1891) (shareholders "cannot question in judicial proceedings the corporate acts of directors, if the same are within powers of the corporation and in furtherance of its purposes, are not unlawful or against good morals, and are done in good faith and in the exercise of an honest judgment"); *Hodges v. New England Screw Co.*, 1 R.I. 312 (1850) (directors are not liable for financial losses to corporation when they exercised good faith and acted in corporation's best interest). For a discussion of the historical development of the business judgment rule and its application to takeovers, see Morrissey, *supra* note 2, at 120-36 (concluding that courts should not uncritically accept the business judgment of target company's board); Wander & Le Cogal, *Boardroom Letters: Corporate Control Transactions and Today's Business Judgment Rule*, 42 BUS. LAW. 29, 29-30 (1986) (noting that courts have begun to assume the role of protector of the shareholder by undertaking a more active role in reviewing anti-takeover board decisions); Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621, 657 (1983) (stating that likelihood of director self-interest should be considered but does not require abolition of the business judgment rule); Note, *Panter v. Marshall Field & Co.: The Good Faith Standard for Corporate Directors*, 15 U. RICH. L. REV. 405, 426-27 (1982) (observing that courts scrutinize director decisions more carefully when large amounts of shares are bought or issued in defensive maneuvers to avoid takeover); Note, *Tender Offer Decisions: Effect of the Business Judgment Rule*, 45 ALB. L. REV. 1122, 1128 (1981) (noting that director conflict of interest is basis for rejection of business judgment rule application to tender offer decisions).

26. See, e.g., *Treadway Cos., Inc. v. Care Corp.*, 638 F.2d 357, 381 (2d Cir. 1980) (business judgment rule protects directors who act lawfully and in good faith with purpose of protecting corporation); *Berman v. Gerber Prods. Co.*, 454 F. Supp. 1310, 1319 (W.D. Mich. 1978) ("There can be no doubt that corporate officers and directors have a high fiduciary duty of honesty and fair dealing with shareholders Nevertheless, it is also well established that corporate management may not be held liable for good faith errors in judgment."). See also Johnson, *Anti-Takeover Actions and Defenses: Business Judgment or Breach of Duty?*, 28 VILL. L. REV. 51, 52, n.6 (1983) (since shareholders chose directors, they cannot hold directors liable for decisions made in good faith); Note, *Tender Offer Decisions: Effect of the Business Judgment Rule*, 45 ALB. L. REV. 1122, 1122 (1981) (business judgment rule protects directors from liability for losses when they exercised sound business judgment).

Three purported justifications for the business judgment rule are usually offered. First, the rule provides directors with the flexibility necessary to formulate corporate policy. See *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982) (rule allows directors to make corporate decisions without fear of judicial second-guessing), *cert. denied*, 460 U.S. 1051 (1983); see also Block & Prussia, *The Business*

not act in bad faith,²⁷ in a fraudulent manner²⁸ or in his own self-interest.²⁹

Courts generally recognize two components to the business judgment rule—a duty of care and a duty of loyalty.³⁰ In the context of a tender offer, a target's director satisfies his duty of *care* by making an informed decision about whether the tender offer is in the best interest of the target.³¹ Thus, a director must use reasonable diligence to ac-

Judgment Rule and Shareholder Derivative Actions: Viva Zapata?, 37 BUS. LAW. 27, 32 (1981) (business judgment rule allows directors to make risky but prudent business decisions). Second, the rule allows competent individuals to become members of a corporate board without the fear of personal liability for reasonable decisions made by the board. *Id.* at 32-33. Courts expressed a concern for obtaining quality directors as early as 1847. *Godbold v. Branch Bank*, 11 Ala. 191, 199 (1847) (to require such perfect knowledge that directors cannot err without liability would mean that "no man of ordinary prudence would accept a trust surrounded by such peril"). Third, but perhaps most important, the rule frees the courts from determining the legitimacy of complex corporate decisions. *Block & Prussia*, *supra*, at 32-33 (most important rationale for business judgment rule is to avoid over-burdening courts). Courts do not have the time or facilities to engage in such evaluation. *Auerbach v. Bennett*, 47 N.Y.2d 619, 630, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979) ("courts are ill-equipped and infrequently called on to evaluate what are and must be essential business judgments"); *see also* *Gilson*, *supra* note 2, at 822 (rule "functions less as a standard of management conduct as a statement of judicial restraint").

27. *See* *Treadways Cos. v. Care Corp.*, 638 F.2d 357, 382-83 (2d Cir. 1980) (plaintiff has initial burden of showing that directors had interest in transaction or acted in bad faith or for improper motive); *Johnson v. Trueblood*, 629 F.2d 287, 292 (3d Cir. 1980) (business judgment rule puts burden on plaintiff to show bad faith), *cert. denied*, 450 U.S. 999 (1981).

28. *See* *Panther v. Marshal Field & Co.*, 646 F.2d 271, 296 (7th Cir.) (business judgment rule presumes that directors acted in best interest of corporation unless plaintiffs prove fraud, bad faith or self-dealing), *cert. denied*, 454 U.S. 1092 (1981); *Auerbach v. Bennett*, 47 N.Y.2d 619, 631, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 927 (1979) (plaintiff must prove fraud or bad faith on part of directors); *Kalmanash v. Smith*, 291 N.Y. 142, 155, 51 N.E.2d 681, 687, 45 N.Y.S.2d 142, 155 (1943) ("Nor may judicial process be invoked to challenge the judgment of directors except when fraud is alleged, or conduct is so oppressive as to be its equivalent . . .").

29. *See* *Johnson v. Trueblood*, 629 F.2d 287, 293 (3d Cir. 1980) (business judgment rule protects director whose motive for defending against takeover is not solely to retain control), *cert. denied*, 450 U.S. 999 (1981); *Cheff v. Mathes*, 41 Del. Ch. 494, 504, 199 A.2d 548, 554 (1964) (use of corporate funds to defend against takeover is appropriate if directors' sole or primary motive is not to retain control).

30. *See, e.g.*, *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984) ("board member's obligation to a corporation and its shareholders has two prongs, generally characterized as the duty of care and duty of loyalty"). For a discussion of the directors' duty of care, *see infra* notes 31-34 and accompanying text. For a discussion of the directors' duty of loyalty, *see infra* notes 35-41 and accompanying text.

31. *See* *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (duty of care requires directors to exercise informed business judgment); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (directors must take action only after they analyze all material information reasonably available to them); *see also* *Gearhart Indus. v. Smith Int'l*, 592 F. Supp. 203, 225 (N.D. Tex. 1984) (duty of care requires direc-

quire and to evaluate information about the tender offer.³² A director who fails to consider alternatives to defending against a takeover,³³ or who does not obtain the advice of outside counsel, attorneys or investment analysts, for example, as to the merits of the tender offer, breaches the duty of care.³⁴

A director's duty of *loyalty* evolved from the idea that a director is a fiduciary and, therefore, has a duty to act in the best interests of the

tors to act as reasonably prudent persons in similar situations); Wander & LeCoque, *supra* note 8, at 38 (recent demand by courts that directors make informed decisions reflects increased emphasis on duty of care).

32. See *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984) (duty of care places responsibility on directors to act as reasonably prudent person acting as fiduciary); *Horwitz v. Southwest Forest Indus.*, 604 F. Supp. 1130, 1134 (D. Nev. 1985) (same); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (directors have duty to take steps to inform themselves of all material information reasonably available to them).

33. See *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239, 1249-50 (Del. Ch. 1985) (directors breached fiduciary duty by granting lock-up option to one of two suitors and refusing to entertain bids from other suitor), *aff'd*, 506 A.2d 173 (Del. 1986); *Thomas v. Kempner*, 398 A.2d 320, 323-24 (Del. Ch. 1979) (directors breached duty of care by ignoring bid for assets of target which was significantly higher than selling price).

34. Directors must make intelligent, advised, judgments. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). Directors are able to rely reasonably, and in good faith, on experts chosen with due care. See, e.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271, 297 (7th Cir.) (directors entitled to rely on experts from outside of corporation), *cert. denied*, 454 U.S. 1092 (1981); *Cheff v. Mathes*, 41 Del. Ch. 494, 507, 199 A.2d 548, 556 (1964) (directors properly relied on reports of investment bankers in fending off raider who had "bad reputation" in business community and may have attempted to liquidate target to obtain quick profit); *Kaplan v. Goldsamt*, 380 A.2d 556, 568 (Del. Ch. 1977) (board entitled to rely on reports of investment bankers in setting price for stock repurchase).

Some state corporate laws allow directors to rely on expert opinions. See, e.g., DEL. CODE ANN. tit. 8, § 141(e) (1983) (directors fully protected if they rely on opinion of expert chosen with reasonable care); N.Y. BUS. CORP. L. § 712(2) (Consol. 1963 & Supp. 1986) (directors in performing duty, may rely upon opinions of experts regarding matters in their field of expertise). However, the Second Circuit, interpreting New York law, recently limited the ability of directors to rely on the reports of outside counsel. *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 275 (2d Cir. 1986). The *Hanson* court found that directors must become reasonably familiar with reports before they are allowed to rely on the conclusions of the reports. *Id.* (citing, *inter alia*, A.L.I., *Principles of Corporate Governance: Analysis and Recommendations* § 4.02 at 76-79 (Tent. Draft No. 4, April 12, 1985)). Commentators have agreed that directors should use reasonable diligence in reviewing the opinions and reports of outside counsel. Hawes & Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 VA. L. REV. 1, 48-49 (1976) (management may raise reliance defense when they reasonably relied on advice of counsel relating to questions of law); Longstreth, *Reliance on Advice of Counsel as a Defense to Security Law Violations*, 37 BUS. LAW. 1185, 1190-93 (1982) (defense of reliance rests on good faith and due care in selection of counsel, disclosure of facts to counsel, receipt of advice from counsel and action in accordance with that advice); Small, *The Evolving Rule of the Director in Corporate Governance*, 30 HASTINGS L.J. 1353, 1359-62, 1382-83 (1979) (standard of good faith and due care requires selection of competent counsel, full disclosure, reasonable reliance and action in accordance with advice).

shareholders of the corporation.³⁵ At one time this principle was so strictly enforced that any contract made between a director and the corporation was voidable by the corporation, regardless of the fairness of its terms.³⁶ This standard has been modified by a presumption within the business judgment rule that all actions taken by corporate directors are motivated by sound business judgment rather than personal interest.³⁷ This modification is important in the takeover context, as successful resistance to a tender offer by the target's directors has the collateral effect of perpetuating the directors' self-interest in maintaining control of the target.³⁸ Consequently, courts uniformly revised the standard for determining whether the directors have breached their duty of loyalty so

35. See, e.g., *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984) ("duty of loyalty derives from the prohibition against self-dealing that inheres in the fiduciary relationship"); *Johnson v. Trueblood*, 629 F.2d 287, 292 (3d Cir. 1980) (director is fiduciary but is not held to same standard as ordinary fiduciary because by nature of corporate life, director has certain amount of self-interest in everything he does), *cert. denied*, 450 U.S. 999 (1981).

Corporate directors owe an allegiance to the corporation and all actions taken by directors should be motivated by a consideration for the welfare of the corporation. *Smith v. Van Gorkom*, 488 A.2d 858, 897 (Del. 1985). Typical violations of the duty of loyalty arise when directors compete with the corporation or when directors take advantage of an opportunity which would have been attractive to the corporation. H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS* 625-44 (3d ed. 1983). A potential violation of the duty of loyalty arises when directors participate in financial dealings with the corporation. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (directors must show "intrinsic fairness of arrangement"). In cases alleging a violation of the duty of loyalty, courts will carefully review the directors' actions and the financial arrangements to determine whether the corporation and its shareholders were treated equitably. *Morrissey*, *supra* note 2, at 123.

36. See, e.g., *Wardell v. Union Pacific R.R.*, 103 U.S. 651, 658 (1880) (director cannot obtain valuable contracts from corporation for whom he is director); see also *Marsh, Are Directors Trustees?*, 22 *BUS. LAW.* 35, 36 (1966) (noting that any contract between a corporation and a director was, at one time, voidable). The courts relaxed this inflexible principle over the years, and by 1910, the prevailing rule was that a contract between a director and his corporation which was approved by a majority of disinterested directors would be upheld unless found to be unfair or fraudulent. *Id.* at 39-40.

37. See *Johnson v. Trueblood*, 629 F.2d 287, 292 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981). The *Johnson* court explained that although directors are said to be fiduciaries, they cannot be held to the same standards as a fiduciary of a trust, who may not have the slightest interest in any transaction made on behalf of the trust. *Id.* The court reasoned that a corporate director has a certain amount of self-interest in every corporate action—preservation of his job. *Id.* According to the court, the business judgment rule alleviates this problem by presuming that all actions taken by the directors are for the benefit of the corporation, regardless of whether they have a positive effect on the directors themselves. *Id.* The plaintiff then has the burden of presenting evidence that the directors were, in fact, primarily motivated by their own self-interest and not the interests of the corporation. *Id.*; see also *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (presumption under business judgment rule that directors "acted on an informed basis, in good faith and in honest belief that action taken was in the best interest of the company.").

38. See *Treco, Inc. v. Land of Lincoln Sav. and Loan*, 749 F.2d 374, 378-79

that plaintiffs were required to prove that the directors' "sole or primary" reason for defending against the takeover was self-perpetuation.³⁹ Such a standard places a very heavy burden upon the plaintiffs,⁴⁰

(7th Cir. 1984). The *Treco* court described the dilemma of directors confronted with a takeover threat:

If they determine in good faith that the threatened action is adverse to the corporation's interest, they have a duty to resist the action forcefully (citations omitted). But successful resistance will likely have the collateral effect of perpetuating the incumbent directors' control, so that a director's self-interest in maintaining control may appear to be one of the purposes of resistance.

Id. at 378.

Manuel F. Cohen, a former chairman of the Securities and Exchange Commission stated that "[i]t would be naive to assume that tender offers are not, at times, opposed by managements motivated by their own interests in staving off a change of control." *Full Disclosure of Corporate Equity Ownership in Corporate Takeover Bids: Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 35 (1967); accord, Johnson, *supra* note 26, at 54 & n.14 (takeover defenses tend to preserve management's position and economic advantages); Steinbrink, *supra* note 22, at 902 (observing that management's desire to implement plans and achieve goals which it set for the corporation is a form of self-interest in perpetuating control). Consequently, whenever a target's directors choose to resist a takeover, they may be accused of trying to preserve their jobs at the expense of the company and its shareholders. See *Northwest Indus. v. B.F. Goodrich Co.*, 301 F. Supp. 706, 712 (N.D. Ill. 1969).

Two commentators have taken the position that because of the unavoidable conflicts of interest inherent in the decisions by incumbent management to resist a takeover attempt, courts should not apply the business judgment rule to shield their decisions from judicial review. Easterbrook & Fischel, *Takeover Bids, Defensive Tactics, and Shareholder's Welfare*, 36 BUS. LAW. 1733, 1745-46 (1981).

39. See, e.g., *Treco, Inc. v. Land of Lincoln Sav. and Loan*, 749 F.2d 374 (7th Cir. 1984) (Illinois law); *Crouse-Hinds Co. v. Internorth, Inc.*, 634 F.2d 690, 701-03 (2d Cir. 1980) (New York law); *Schilling v. Belcher*, 582 F.2d 995, 1004 (5th Cir. 1978) (Florida law); *Heit v. Baird*, 567 F.2d 1157, 1161 (1st Cir. 1977) (Massachusetts law); *Horwitz v. Southwest Forest Indus.*, 604 F. Supp. 1130, 1135 (D. Nev. 1985) (Nevada law); *Cummings v. United Artists Theatre Circuit*, 237 Md. 1, 21-22, 204 A.2d 795, 805-06 (1964) (Maryland law). The primary source of the "sole or primary purpose" test is *Cheff v. Mathes*, 41 Del. Ch. 494, 504-05, 199 A.2d 548, 554 (1964). The Delaware Supreme Court, in *Cheff*, derived this test from earlier decisions. *Id.* (citing *Bennett v. Propp*, 41 Del. Ch. 14, 187 A.2d 405 (1962)) (directors may only take actions which are primarily in the interest of corporation); *Yasik v. Wachtel*, 25 Del. Ch. 247, 256, 17 A.2d 309, 313 (1941) (directors may not use issuance of shares to accomplish improper purpose, such as maintaining control of corporation)). The *Cheff* court changed the test slightly from that in *Bennett*, which required directors to show that the action taken was "one primarily in the corporate interest." *Bennett*, 41 Del. Ch. at 14, 22, 187 A.2d at 405, 409 (1962). In *Cheff*, the court required the directors to prove the inverse, namely, that the action taken was not taken solely or primarily to benefit the directors. *Cheff*, 41 Del. Ch. at 504, 199 A.2d at 554.

If a plaintiff proves that the "sole or primary" reason for a director employing a defensive mechanism was to secure his employment, then the burden shifts to the director to prove that his actions were in the best interest of the corporation. See *Treco, Inc. v. Land of Lincoln Sav. and Loan*, 749 F.2d 374, 379 n.8 (7th Cir. 1984); *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 265 (2d Cir. 1984).

The Delaware courts are unique in that they put the initial burden of proof

which has caused some courts to decline to use this standard.⁴¹

If a plaintiff is able to prove that a director breached his duty of care or duty of loyalty, then the burden of proof shifts to the director to prove that the transaction was fair and served the best interests of the

on the defendant directors who use defensive tactics to avoid a takeover which would threaten corporate policy. *See, e.g.,* Crane Co. v. Harsco Corp., 511 F. Supp. 294, 305 (D. Del. 1981); *Cheff v. Mathes*, 41 Del. Ch. 494, 504-05, 199 A.2d 548, 555 (Del. 1964). In *Cheff*, for example, Marymont Automotive Products sought to take over Holland Furniture Co. by purchasing a controlling block of Holland stock. *Cheff*, 41 Del. Ch. at 499-500, 199 A.2d at 551-52. The directors of Holland arranged to purchase the shares, which Marymont had obtained, at an amount in excess of the market value of the shares. *Id.* The court found that the directors had satisfied their initial burden by proving that the shares were purchased in order to continue proper business purposes and not "solely or primarily" to preserve the directors' positions. *Id.* at 508, 199 A.2d at 556.

In its most recent pronouncements, the Delaware Supreme Court has stated that the defendant directors have the initial burden of proof whenever the legitimacy of a defensive mechanism is called into question. *Moran v. Household Int'l*, 500 A.2d 1346, 1356 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985). However, the burden which directors must meet has changed. Now, the directors satisfy their burden by showing that they acted in good faith and after reasonable investigation and that the defensive mechanism employed was reasonable in relation to the threat posed. *Moran*, 500 A.2d at 1356.

Other jurisdictions, however, have not shifted the initial burden to the defendant directors. *See, e.g.,* *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 273 (2d Cir. 1986) (stating that initial burden of proof is on plaintiff under New York law in takeover context, but initial burden is on defendant under Delaware law). For a further discussion of the implications of Delaware's distribution of the burden of proof in the takeover context, see *infra* notes 201-25 and accompanying text.

40. *See generally* Note, *Panter v. Marshall Field & Co.: Unbridled Discretion of Management to Resist Hostile Tender Offer*, 33 MERCER L. REV. 647, 650 (1982) (examination of defensive tactics under business judgment rule is almost non-existent); Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621, 655 (1983) (business judgment rule is "impenetrable shield" for defensive tactics of target's management).

Courts have emphasized that plaintiffs do not meet their burden simply by showing that "one" of the directors' motives was to provide for continued job security. *Johnson v. Trueblood*, 629 F.2d 287, 292-93 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981). Plaintiffs must prove that personal motivations of the directors dominated their actions. *Id.*; *Panter v. Marshall Field & Co.*, 646 F.2d 271, 294 (7th Cir.) ("a" motive to control is insufficient to rebut presumption under business judgment rule), *cert. denied*, 454 U.S. 1092 (1981); *Cummings v. United Artists Theatre Circuit*, 237 Md. 1, 21-22, 204 A.2d 795, 805-06 (1964) (directors liable only if manipulation for control of corporation is principle motivation for action by board).

41. The Delaware Supreme Court, for instance, has declined to use the sole or primary purpose test in its recent opinions and, instead, has chosen simply to apply a new test. *See* *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986); *Moran v. Household Int'l*, 500 A.2d 1346, 1356 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985). For an extensive discussion of the new test applied by the Delaware Supreme Court, see *infra* notes 201-25 and accompanying text.

corporation and the shareholders.⁴² Even though a director may be accused of breaching his duty of care or loyalty by opposing a tender offer,⁴³ courts have found that a director has a responsibility to oppose those offers which he fairly believes will be detrimental to the corporation.⁴⁴

IV. RECENT APPLICATIONS OF THE BUSINESS JUDGMENT RULE TO DEFENSIVE TACTICS

Recently, the Delaware Supreme Court and the United States Court of Appeals for the Second Circuit have decided four cases involving the business judgment rule which provide significant guidance for target directors who are deciding which defensive mechanisms they may lawfully employ to defend against a present or potential hostile takeover.⁴⁵ In *Unocal Corp. v. Mesa Petroleum Co.*,⁴⁶ the Delaware Supreme Court held that a target corporation's self-tender for its own shares at a price higher than the raider's tender offer was legal even though the target did not extend this offer to the raider, which owned a substantial number of the target's shares.⁴⁷ Three months later, in *Moran v. Household International, Inc.*,⁴⁸ the Delaware Supreme Court approved the establishment of a rights plan by a target's directors which allowed the target's shareholders to purchase the raider's shares at a reduced price should the raider successfully take over the target.⁴⁹ Subsequently, the Second Circuit invalidated a lock-up option in *Hanson Trust PLC v. ML SCM Acquisition Inc.*⁵⁰ when it found that the target's directors breached their duty of care under the business judgment rule since there was no evidence that

42. See, e.g., *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984); *Horwitz v. Southwest Forest Indus.*, 604 F. Supp. 1130, 1134 (D. Nev. 1985).

43. See, e.g., *Northwest Indus. v. B.F. Goodrich Co.*, 301 F. Supp. 706, 712 (N.D. Ill. 1969) (directors may always be accused of attempting to preserve control when they oppose a tender offer); see also Lipton, *supra* note 18, at 101 (almost every successful takeover defense results in shareholder derivative action).

44. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (board has fundamental duty to protect corporate enterprise from harm reasonably perceived); *Northwest Indus. v. B.F. Goodrich Co.*, 301 F. Supp. 706, 712 (N.D. Ill. 1969) (directors obligated to oppose tender offers which are not in best interest of corporation or its shareholders). For a discussion of the dilemma of directors when confronted with a takeover attempt, see *supra* note 38.

45. See *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264 (2d Cir. 1986); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Moran v. Household Int'l*, 500 A.2d 1346 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

46. 493 A.2d 946 (Del. 1985).

47. *Id.* at 957. For a further discussion of *Unocal*, see *infra* notes 55-89 and accompanying text.

48. 500 A.2d 1346 (Del. 1985).

49. *Id.* at 1357. For a further discussion of *Moran*, see *infra* notes 90-120 and accompanying text.

50. 781 F.2d 264 (2d Cir. 1986).

the lock-up option would promote bidding between competing tender offerors and, thus, assure that the target's shareholders received the maximum value for their shares.⁵¹ Finally, the Delaware Supreme Court, in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,⁵² held that the target's directors violated their fiduciary duty both by entering into a lock-up option, which required the target to sell two of its key divisions to one of two competing tender offerors, and by entering into a "no shop" provision, which prevented the target from seeking a higher bid than that of the tender offeror who was to purchase the divisions.⁵³ In each of these cases, the business judgment rule was the benchmark for gauging the validity of the defensive mechanisms employed by the targets' directors.⁵⁴

A. Unocal Corp. v. Mesa Petroleum Co.

Mesa Petroleum ("Mesa") commenced a two-tier "front-loaded" tender offer⁵⁵ for sixty-four million shares of Unocal stock.⁵⁶ If success-

51. *Id.* at 283. For a further discussion of *Hanson Trust*, see *infra* notes 121-57 and accompanying text.

52. 506 A.2d 173 (Del. 1986).

53. *Id.* at 184-85. For a further discussion of *Revlon*, see *infra* notes 157-200 and accompanying text.

54. See, e.g., *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 272-83 (2d Cir. 1986) (evaluated lock-up option under business judgment rule); *Revlon, Inc. v. MacAndrew & Forbes Holdings, Inc.*, 506 A.2d 173, 179-84 (Del. 1986) (business judgment rule used to evaluate poison pill and lock-up option); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1355-57 (Del. 1985) (directors' action in adopting poison pill evaluated under business judgment rule); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985) (discretionary self-tender analyzed under business judgment rule).

55. *Unocal*, 493 A.2d at 949-50. A two-tier tender offer is a means for a raider to acquire one hundred percent of the shares of a target. Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964, 1966 (1984). The raider initiates this type of tender offer by offering to purchase enough of the target's shares to obtain a controlling interest in the target at a price which exceeds the current value of the shares. *Id.* The raider then offers to purchase the remaining shares at a lower price. *Id.* Since the price which the tender offeror is willing to pay in the first tier exceeds that which the tender offeror is willing to pay in the second tier, the tender offer is considered "front-loaded." *Unocal*, 493 A.2d at 949. A front-loaded tender offer gives the target's shareholders an incentive to tender their shares in the first tier, so that they can receive a premium for their shares. See Note, *supra*, at 1966. For instance, in *Unocal*, Mesa offered to pay 54 dollars in cash for every share tendered in the first tier. *Unocal*, 493 A.2d at 949. In the second tier, however, Mesa offered only high risk debt securities with a face value of 54 dollars. *Id.* at 949-50. These securities, labeled "junk bonds" by the Delaware Supreme Court, were actually worth far less than 54 dollars. *Id.*

Two-tier tender offers are considered coercive because they tend to coerce shareholders to tender their shares in the first of the two tiers so that they do not receive the lower value in the second tier. Office of the Chief Economist, Securities and Exchange Commission, *The Economics of Partial and Two-Tier Tender Offers*, 49 Fed. Reg. 26755, 26756-57 (June 29, 1984) [hereinafter cited as Chief Economist]. In addition, more shareholders are generally willing to tender their

ful, Mesa would have obtained a controlling interest (fifty-one percent) in Unocal.⁵⁷ The Unocal board of directors,⁵⁸ believing that the Mesa tender offer was inadequate, decided to employ a discretionary self-tender to ward off the tender offeror.⁵⁹ Under this defensive measure, if Mesa obtained a controlling interest in Unocal, then Unocal would offer to purchase the remaining forty-nine percent of its own shares at a price

shares in the first tier than the tender offeror is willing to acquire in the first tier. *Id.* at 26757-58. Under the prorationing rules of the Securities Exchange Act of 1934, the tender offeror must acquire that percentage of stock which it offered to acquire in the first tier on a pro rata basis. 15 U.S.C. § 78n(d)(6) (1982) (requires tender offeror to take up pro rata share of stock tendered by each security holder if tender offer oversubscribed 10 days after it is made). The shareholders will be forced to accept the value offered in the second tier for the remaining shares which the tender offeror does not acquire in the first tier. Chief Economist, *supra*, at 26757-58. Arguably, a two-tier tender offer is coercive because shareholders have no way to reject an offer if they believe that the combined value they will receive from tendering their shares in the first and second tier is too low because, if the shareholders refuse to tender their shares in the first tier, they would have to tender all of their shares in the second tier for the lower price. *Id.* See generally Finkelstein, *Antitakeover Protection Against Two-Tier and Partial Tender Offers: The Validity of Fair Price, Mandatory Bid, and Flip-Over Provisions Under Delaware Law*, 11 SEC. REG. L.J. 291, 293 (1984) (noting that two-step transactions are coercive because they put pressure on shareholders to tender in first step to avoid freeze-out for less consideration in second step); Lipton, *supra* note 18, at 113-14 (concluding that it is almost impossible for wise investor not to tender shares in first tier of two-tier tender offer). *But see* Chief Economist, *supra*, at 26757 (study questions coerciveness of two-tier tender offers because difference between premium in first and second tier often is not significant).

Courts have also recognized the coerciveness of two-tier tender offers. *Unocal*, 493 A.2d at 956 (noting that two-tier tender offers are well recognized as classic coercive measures); *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623, 630 (D. Md. 1982) (concluding that two-step offers are coercive).

56. *Unocal*, 493 A.2d at 949. 64 million shares represented approximately 37% of Unocal's outstanding shares. *Id.*

57. *Id.* Before the tender offer, Mesa owned just over 13% of the shares of Unocal. *Id.* Coupled with the 37% of Unocal's shares which Mesa wishes to acquire through the tender offer, Mesa would have obtained a controlling interest in Unocal. *Id.*

58. *Id.* at 950. Eight independent outside directors and six insiders sat on the Unocal board. *Id.* Throughout the *Unocal* opinion, the court emphasized the importance of the fact that a majority of the Unocal board of directors were independent and that they performed their fiduciary duties. *Id.* at 955. For a further discussion of the importance of the presence of independent directors on the board of a corporation confronted with a takeover, see *infra* notes 226-40 and accompanying text.

59. *Unocal*, 493 A.2d at 950. The Unocal board met with its legal and financial consultants, including representatives from investment bankers Goldman Sachs & Co. and Dillon, Read & Co., regarding the Mesa tender offer. *Id.* Using valuation techniques employed in the oil and gas industry, the financial consultants opined that the minimum cash value that could be expected from a sale or liquidation of 100% of Unocal's stock was in excess of \$60 per share. *Id.* Consequently, these consultants concluded that Mesa's \$54, two-tier, tender offer was inadequate. *Id.* Based upon this advice and their own deliberations, the Unocal board decided to reject Mesa's tender offer. *Id.* at 951.

higher than that offered by Mesa.⁶⁰ Unocal, however, prohibited Mesa from participating in the self-tender⁶¹ and, as a result, Mesa filed suit seeking to enjoin the self-tender.⁶²

In considering Mesa's claim, the Delaware Supreme Court began by evaluating whether directors have the authority to defend against takeovers.⁶³ The court concluded that directors have such authority for two reasons. First, Delaware corporate law allows directors to manage the corporation's "business and affairs"⁶⁴ and allows directors to control

60. *Id.* at 951. A representative from Goldman Sachs & Co. advised the Unocal board that a self-tender would cause Unocal to incur debt in excess of \$6 million, a sum which would necessitate the reduction of Unocal's exploratory drilling but would, nonetheless, enable it to remain a viable entity. *Id.* at 950.

Under the self-tender, Unocal offered senior debt securities with a par value of \$72 for its shares. *Id.* at 951. Debt securities are certificates which identify that the corporation is indebted to the holder of the certificate for the face value of the certificate. W. CARY & M. EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* 1108-10 (5th ed. 1979). Debt securities are different from shares of stock in that shares represent a shareholder's ownership or equity interest in the corporation. *Id.* at 1111-12.

Unocal later waived the condition that Mesa first obtain a controlling interest in Unocal for the purchase of 50 million shares or approximately 30% of the shares before Unocal would make its own exchange offer. *Unocal*, 493 A.2d at 951. This was done in reaction to a perceived concern of the shareholders that if their shares were tendered to Unocal no shares would be purchased by either offeror. *Id.*

61. *Unocal*, 493 A.2d at 951. Unocal would not allow Mesa to participate because the purpose of the self-tender was to assure that the 49% of the Unocal shareholders who did not exchange their shares in the first tier of the Mesa offer would not be forced to exchange their shares for Mesa's junk bonds in the second tier of the Mesa offer. *Id.* at 951. Every share that Mesa was allowed to exchange in the Unocal self-tender would prevent other Unocal shareholders from exchanging their shares for the \$72 debt securities which Unocal offered to protect them. *Id.*

62. *Id.* The Delaware Chancery Court issued an order temporarily restraining Unocal from proceeding with the exchange offer unless the offer was extended to include Mesa. *Id.* at 952. Unocal immediately sought an interlocutory appeal to the Delaware Supreme Court. *Id.* The Chancery Court declined to certify the appeal, ruling that the granting of a temporary restraining order did not decide a legal issue of first impression and that there existed no conflict with prior decisions of the Chancery Court. *Id.* The Delaware Supreme Court, however, ruled that the decision to grant a temporary restraining order was clearly determinative of substantive rights of the parties and presented an issue of first impression in Delaware. *Id.* The Supreme Court thus concluded that the temporary restraining order was an unappealable decision. *Id.* The Chancery Court thereafter certified Unocal's interlocutory appeal as a question of first impression. *Id.* at 953. Because of the need for a timely resolution of the case, the entire matter was scheduled on an expedited basis. *Id.* & n.5.

63. *Id.* at 953-56. The court stated the basic issue which it sought to resolve as follows: "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, is its action here entitled to the protection of the business judgment rule?" *Id.* at 953.

64. *Id.* The court noted that one source of a director's power to defend against takeovers is implicit within § 141(a) of the Delaware Corporate Code

the use of the corporation's stock.⁶⁵ Second, common law principles require directors to protect the corporate enterprise from harm which they reasonably perceive.⁶⁶

After determining that directors have the authority to defend against takeovers, the court evaluated the directors' conduct under the business judgment rule.⁶⁷ The court, however, altered the traditional burden of proof under the business judgment rule by determining that

which allows directors to manage the "business and affairs" of the corporation.

Id. Section 141(a) provides in pertinent part:

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. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

DEL. CODE ANN. tit. 8, § 141(a) (1983) (emphasis added).

65. 493 A.2d at 953. The court also found that § 160(a) of the Delaware Corporate Code, which allows directors to deal with the stock of its corporations, permits directors to use the stock as a deterrent to a takeover attempt. *Id.* (citing 8 Del. Laws 160(a) (1983)). Section 160(a) provides in pertinent part: "Every corporation may purchase, redeem, receive, take or otherwise acquire, own and hold, sell, lend, exchange, transfer, or otherwise dispose of, pledge, use and otherwise deal in and with its own share." 8 DEL. CODE ANN. tit. 8, § 160(a) (1983). The court noted that, under this provision, a Delaware corporation may deal selectively with its stockholders in the acquisition of its own shares, provided the directors do not act with a sole or primary purpose of entrenching themselves. 493 A.2d at 954 (citing *Kaplan v. Goldsamt*, 380 A.2d 556, 568-69 (Del. Ch. 1977); *Cheff v. Mathes*, 41 Del. Ch. 494, 504, 199 A.2d 548, 554 (1964); *Bennett v. Propp*, 41 Del. Ch. 14, 22, 187 A.2d 405, 408 (1962); *Kors v. Carey*, 39 Del. Ch. 47, 54, 158 A.2d 136, 140-41 (Del. Ch. 1960); *Martin v. American Potash & Chem. Corp.*, 33 Del. Ch. 234, 240, 92 A.2d 295, 302 (1952)).

66. *Unocal*, 493 A.2d at 954. The court found that a wide body of case law supports the idea that directors must act against potential harm to a corporation. *Id.* (citing, *inter alia*, *Panter v. Marshall Field & Co.*, 646 F.2d 271, 297 (7th Cir.) (lawful action taken to protect corporation valid under business judgment rule), *cert. denied*, 454 U.S. 1092 (1981); *Heit v. Baird*, 567 F.2d 1157, 1161 (1st Cir. 1977) (management has right and duty to resist takeover which would harm corporation by all lawful means)). The court continued by finding that defending against a takeover attempt is one way for a director to fulfill this duty. *Id.* at 957. The court further noted that it disagreed with commentators who suggest that the decision to resist a tender offer is entitled to less deference than are other corporate decisions under the business judgment rule. *Id.* at 954 & n.9 (citing, *inter alia*, *Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981)).

67. *Unocal*, 493 A.2d at 954. The court cited a recent decision by the Delaware Superior Court for the proposition that the business judgment rule is the proper yardstick to use in measuring the appropriateness of a defensive measure. *Id.* (citing *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984) (standards under business judgment rule should be used to evaluate directors conduct in takeover context)). The court also noted the effect of applying the business judgment rule, observing that the rule protects directors from any personal liability so long as the directors' decisions can be "attributed to any rational busi-

directors are not automatically afforded the protection of the business judgment rule when they employ defensive tactics.⁶⁸ Since the directors necessarily are protecting their own employment by defending against a takeover,⁶⁹ the Delaware Supreme Court reasoned that the directors can receive the protections of the business judgment rule only if they first prove that 1) the defensive measure is in the best interest of the corporation⁷⁰ and 2) the defensive measure is reasonable in relation to the threat posed.⁷¹

The court found that the Unocal discretionary self-tender was in the best interest of the corporation and that the primary purpose for the offer was not the entrenchment of the directors in their offices.⁷² The court agreed with the Unocal directors that the Mesa tender offer was inadequate and that the directors should fight the tender offer.⁷³ The

ness purpose." *Id.* (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. Super. Ct. 1971)).

68. *Id.* Traditionally, under the business judgment rule, the party challenging the board's decision had the initial burden of proving that the board breached their duty of loyalty or duty of care. *See, e.g.*, *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264-65 (2d Cir. 1984). For a discussion of the reallocation of the burden of proof by the Delaware courts in breach of fiduciary duty cases, see *supra* notes 37-40 and accompanying text.

69. *Unocal*, 493 A.2d at 954-55. The court found that, because of the potential that directors will act in their own best interest when they employ defensive tactics, the judiciary must carefully examine the directors' actions before affording the directors the protection of the business judgment rule. *Id.* For a discussion of the directors' potential conflict of interest in the context of defending against takeovers, see *supra* note 38 and accompanying text.

70. *Unocal*, 493 A.2d at 955. The directors must prove that it was reasonable for them to believe that a takeover would impede corporate policy and the ability of the corporation to operate. *Id.* (citing *Cheff v. Mathes*, 41 Del. Ch. 494, 504-05, 199 A.2d 548, 554-55 (1964)). The directors satisfy this burden by showing that they made a good faith investigation of the advantages and disadvantages of the takeover before deciding to defend against the takeover. *Id.* (citing *Cheff v. Mathes*, 41 Del. Ch. 494, 506, 199 A.2d 548, 555 (1964)). The court noted that proof of a good faith investigation is materially enhanced if a majority of the board is composed of independent directors who make a good faith investigation. *Id.* (citing *Panter v. Marshall Field & Co.*, 646 F.2d 271, 295 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *Puma v. Marriott*, 283 A.2d 693, 695 (Del. Ch. 1971)).

For a discussion of the importance of independent directors to courts evaluating a defensive tactic, see *infra* notes 226-40 and accompanying text.

71. *Unocal*, 493 A.2d at 955. The court cited no prior decisions to support this new element of balance. *Id.* Instead, the court cited only a recent commentator. *Id.* (citing Lipton & Brownstein, *Takeover Responsibilities and Director's Responsibilities: An Update*, ABA National Institute on the Dynamics of Corporate Control 7 (Dec. 8, 1983)).

72. *Unocal*, 493 A.2d at 956-57. The court noted several facts which aided it in finding that the primary purpose of the discretionary self-tender was not to entrench the directors. *Id.* at 956. First, the directors determined that the Unocal shares were worth more than the \$54 per share offer in the front end of the Mesa offer. *Id.* Second, the court noted that the back end of the Mesa offer involved "junk bonds" worth far less than \$54 per share. *Id.*

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

court then found Unocal's self-tender to be an effective defensive tactic because of the enormous debt which Unocal would incur as a result of the self-tender.⁷⁴ In addition, if Mesa's tender offer was successful, the Unocal self-tender would assure that the remaining Unocal shareholders, who would have been forced to tender their shares in the second tier of Mesa's two-tier tender offer, would receive adequate value for their shares.⁷⁵

The court also found that the defensive measure was reasonable in relation to the threat posed.⁷⁶ In evaluating the threat, the court suggested that the following factors be considered: 1) the legality of the tender offer; 2) the price of tender offer; and 3) the quality of the securities offered in the exchange.⁷⁷ The court found that the price per share offered by Mesa in its tender offer, and the quality of the securities offered in the second tier were inadequate.⁷⁸ Consequently, there was a legitimate threat posed to the shareholders of Unocal.⁷⁹

In evaluating the reasonableness of the defensive tactic to meet the threat, the court suggested that a target's board consider the interests of the shareholders that were at stake.⁸⁰ The court noted, however, that it may be appropriate for a board to sacrifice the interests of one shareholder, who was a short-term speculator, for the interests of long-term

74. *Id.* Unocal's self-tender would have increased the corporation's debt by \$6.1-6.5 billion. *Id.* at 950.

75. *Id.* at 956. The second tier of Mesa's offer consisted of highly subordinated debt securities with a face value of \$54. *Id.* at 949. The court characterized these securities as "junk bonds." *Id.* at 950. "Junk bonds" is a phrase used to describe bonds for which the issuing company probably will not be able to pay the face value. *Id.* These are high-risk, highly-subordinated bonds. *Id.* at 949. The Unocal self-tender, on the other hand, consisted of senior debt securities with a par value of \$72. *Id.* at 956. The court found that the Unocal directors acted in the best interest of the corporation by issuing these senior debt securities to protect the Unocal shareholders who would have had to tender their shares in the second tier of Mesa's tender offer if the Unocal self-tender was not available. *Id.*

76. *Id.* at 956-57.

77. *Id.* at 955. The court also suggested that the nature and timing of the offer, the impact of the tender offer on constituencies other than shareholders, and the risk that the tender offer may not materialize may be considered in evaluating the threat to the corporation. *Id.* The constituencies whom the court suggested that the directors can consider protecting were: shareholders, creditors, customers, employees and possibly the community at large. *Id.* For a further discussion of the discretion which directors have to consider the impact of a tender offer on constituencies other than shareholders, see *supra* note 23 and accompanying text.

78. *Unocal*, 493 A.2d at 950, 956. The court determined that the securities which Mesa was offering in the back end of its two-tier offer were junk bonds. *Id.* at 950.

79. *Id.* at 956. The court found that Mesa's tender offer was inadequate and coercive. *Id.* at 950, 956.

80. *Id.* at 955-56. The court stated that the board should consider all shareholders, including the raider who was going to deprive the other shareholders of the fair value for their shares. *Id.* at 956.

investors who have remained loyal to the corporation.⁸¹ Since Mesa was a short-term speculator with a national reputation of "greenmailing,"⁸² the court found that Unocal acted reasonably by using a defensive measure which aided all of the shareholders other than Mesa.⁸³

The *Unocal* court next addressed Mesa's assertion that the directors, by excluding one shareholder from the self-tender, breached their obligation to treat all shareholders equally.⁸⁴ The court began by noting that it had allowed a target's directors in the past to selectively repurchase shares in order to prevent a tender offeror from taking over the target.⁸⁵ The court then reasoned that, because prior case law allows

81. *Id.* The court noted that the front end of Mesa's two-tier offer was \$56 per share while the fair value of the shares exceeded \$60 per share. *Id.* at 950, 956. In addition, the back end of the two-tier offer consisted of junk bonds worth far less than \$54. *Id.* at 956. The court recognized that this two-tier tender offer was a "classic coercive measure by a short term speculator." *Id.* It was designed to force shareholders to tender in the first tier, even if the price was inadequate, in order to avoid being forced to receive less value in the second tier. *Id.* For a further discussion of the coercive nature of two-tier tender offers, see *supra* note 55.

82. *Unocal*, 493 A.2d at 956. "Greenmailing" refers to the situation in which a raider sells the target's shares which it owns to the target at a premium, instead of continuing its pursuit to take over the target. *Id.* at n.13. The court noted that Mesa is known nationally as a "greenmailer." *Id.* From 1982 through 1985, Mesa made 978 billion dollars through greenmailing activity with Supron, Cities Services, General American Oil, Superior Oil, Gulf and Phillips Petroleum. *High Times for T. Boone Pickens*, TIME, Mar. 4, 1985, at 55. The *Unocal* court also noted that Unocal's self-tender was a good faith attempt by the Unocal directors to eliminate the inadequacies of the Mesa tender offer and to avoid the payment of greenmail. *Unocal*, 493 A.2d 956 n.13. Recently, Mesa announced another takeover attempt in the oil industry. On December 3, 1986, Mesa made an offer to acquire Diamond Shamrock. Blumenthal, *Diamond Shamrock May Seek a Suitor of Slate Stock Buyback to Thwart Mesa*, Wall St. J., Dec. 4, 1986, at 4, col. 2. Mesa, and its associate in the takeover attempt, owned 4.5% of Diamond Shamrock's stock at the time of the offer. *Id.* Market analysts are predicting that Diamond Shamrock will buy back a large portion of its shares at a premium to counter this offer. *Id.* Mesa, it is suggested, will most likely participate in this buyback and, once again, receive greenmail.

83. *Unocal*, 493 A.2d at 956. The court analogized a tender offer to a merger. *Id.* at 956-57. In the merger context, a minority shareholder has a right to receive securities of substantially equivalent value after the merger as those he held before the merger. *Id.* at 956 (citing *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 304, 93 A.2d 107, 114 (1952)). The court felt that shareholders in the takeover situation should have the same right. *Id.* at 956-57. The court then concluded that Unocal's selective exchange offer would have assured Unocal shareholders other than Mesa of receiving a substantially equivalent value for their shares if the Mesa tender offer was successful. *Id.*

84. *Id.* at 957-58. Mesa contended that the discriminatory tender offer violated the Unocal directors' fiduciary duty to treat all shareholders equally. *Id.* at 953. Specifically, Mesa argued that because other shareholders would derive a financial benefit from which Mesa was excluded, Unocal could not sustain the burden of proving that the exchange offer was fair to all shareholders. *Id.*

85. *Id.* at 957 (citing *Cheff v. Mathes*, 41 Del. Ch. 494, 506, 199 A.2d 548, 554 (1964); *Bennett v. Propp*, 41 Del. Ch. 14, 20-21, 187 A.2d 405, 408 (1962); *Martin v. American Potash & Chemical Corp.*, 33 Del. Ch. 234, 245, 92 A.2d

directors to favor one group of shareholders over the others if such action is in the best interest of the corporation, it is logical that the directors may favor shareholders other than the tender offeror so long as such action is in the best interest of the corporation.⁸⁶ Since Unocal's offer favored all shareholders other than the tender offeror, the court found that Unocal's selective exchange offer was a legitimate defensive tactic.⁸⁷

The court concluded by noting that shareholders, such as Mesa, have a right to act in their own best interest.⁸⁸ However, when a board of directors finds that the shareholder's actions are inconsistent with the best interests of the corporation, the directors have a right to protect the corporation.⁸⁹

B. Moran v. Household International, Inc.

The Delaware Supreme Court considered another defensive technique, the preferred share purchase rights plan (rights plan), in *Moran v. Household International, Inc.*⁹⁰ In *Moran*, the board of directors of House-

295, 302 (1952)). The *Unocal* court found it ironic that a corporation such as Mesa would complain that it was not being treated the same as all other Unocal shareholders. *Id.* at 957. The court noted that Mesa had made enormous profits in the past when it accepted offers of greenmail that were not extended to any other shareholders of the target. *Id.* While the court conceded that none of its prior cases had sanctioned the use of defensive mechanisms to preclude a raider from sharing in a benefit available to all other stockholders, it found that this was a logical extension of its past decisions which allowed selective stock repurchases by a corporation. *Id.* The court suggested that simply because Delaware corporate law is silent as to a specific matter, namely whether directors may take action which favors other shareholders over a raider, does not mean that such action is prohibited. *Id.*

86. *Id.* at 957. The court emphasized that corporate law is not static and that it must develop in response to new developments in the corporate world. *Id.*

87. *Id.* Even though some board members were large shareholders, the court noted that this did not amount to a disqualifying pecuniary interest or defeat the operation of the business judgment rule. *Id.* at 958.

88. *Id.* at 958 (citing *Du Pont v. Du Pont*, 251 F. 937, 944 (D. Del. 1918) (shareholders do not stand in fiduciary relationship to corporation or other shareholders and are free to exercise their right to vote as they desire), *aff'd*, 256 F. 129 (3d Cir. 1918); *Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling*, 29 Del. Ch. 610, 617, 53 A.2d 441, 447 (1947) (not objectionable for shareholders to exercise voting right in manner that maximizes personal profit); *Heil v. Standard Gas & Electric Co.*, 17 Del. Ch. 214, 216, 151 A. 303, 304 (1930) (shareholders can exercise wide liberality in judgment)).

89. *Id.* According to the court, the board has not only a right, but also a duty to defend against a takeover which is not in the best interest of the corporation. *Id.* at 954.

90. 500 A.2d 1346 (Del. 1985). Household International, Inc., the defendant-appellee, is a diversified holding company whose principal subsidiaries engage in financial services, transportation and merchandising. *Id.* at 1349. Three of Household's wholly-owned subsidiaries are HFC, National Car Rental and Vons Grocery. *Id.*

hold International (“Household”) adopted a rights plan which provided each common shareholder with one “right” per common share if a certain triggering event should occur.⁹¹ Two events would trigger the option: the announcement of a tender offer for thirty percent of Household’s shares⁹² or the acquisition of twenty percent of Household’s shares by a single entity.⁹³ Should one of these triggering events occur and a successful tender offer result, each right would allow a Household shareholder to acquire a share of the tender offeror at one-half the market value of the share.⁹⁴ Moran, a director of Household and chairman of D-K-M Corp., the largest Household shareholder, brought suit along with D-K-M, to contest the validity of the rights plan.⁹⁵

In evaluating the rights plan, the *Moran* court first considered whether the Household directors had authority to adopt the plan under Delaware law.⁹⁶ The court found that section 157 of the Delaware Cor-

91. *Id.* at 1349. Moran, the plaintiff-appellant, was one of two Household International directors who had voted against the adoption of the rights plan. *Id.* He, additionally, was the chairman of Dyson-Kissner-Moran Corp. (D-K-M) which was the largest Household shareholder. *Id.* Both Moran and D-K-M brought suit against Household International. *Id.*

92. *Id.* at 1348.

93. *Id.* According to the trial court, the “20% trigger” would occur if a person or group of persons acquired 20% of Household’s common shares, had the right to purchase 20% of Household’s common shares, had the right to vote 20% of Household’s shares, or announced the formation of a group of persons holding 20% of Household’s shares to act together. *Moran*, 490 A.2d 1059, 1066 (Del. Ch.), *aff’d*, 500 A.2d 1346 (Del. 1985).

94. *Moran*, 500 A.2d at 1349. The rights plan was designed so that should an announcement of a tender offer for 30% of Household’s shares be made, the rights would issue and be immediately exercisable by Household shareholders to purchase 1/100 share of new preferred stock for \$100. *Id.* In this situation, the rights would be redeemable by the Household Board for \$.50 per right. *Id.* Should 20% of Household’s shares be acquired by anyone, the rights would issue, become non-redeemable, and be exercisable to purchase 1/100 of a share of preferred. *Id.*

Should a right not be exercised to purchase a preferred share and thereafter a merger or consolidation occur, the rights holder would have the option of exercising each right to purchase \$200 of the common stock of the tender offeror for \$100. *Id.* It was this “flipover” provision within the rights plan which was central to the litigation because of its likelihood to discourage potential acquirors from making a tender offer for Household shares. *Id.* Such a rights plan has been termed a “poison pill” defense. For a further discussion of the poison pill defense used in *Moran*, see Comment, *Delaware’s Attempt to Swallow a New Takeover Defense: The Poison Pill Preferred Stock*, 10 DEL. J. CORP. LAW 569 (1985); Note, *Delaware Serves Shareholders the “Poison Pill”*: *Moran v. Household International, Inc.*, 27 B.C.L. REV. 641, 669 (1986) (concluding that court’s decision, in absence of specific threat to the corporation, is unduly lenient interpretation of presumption in favor of directors under business judgment rule).

95. *Moran*, 500 A.2d at 1349.

96. *Id.* at 1351. Moran and D-K-M made two major arguments regarding the power of the Board to adopt the rights plan. *Id.* The first was that Delaware corporate law does not authorize issuance of the rights. *Id.* For a discussion of

porate Code authorizes such a plan.⁹⁷ Section 157 provides that “every corporation may create and issue . . . rights and options entitling the [share]holders . . . to purchase from the corporation any shares of its capital stock.”⁹⁸ Although this provision had never been utilized in a takeover situation, the court found that Delaware corporate law is dynamic and that section 157 could authorize a defensive mechanism.⁹⁹ Moran and D-K-M argued that section 157 only allows a corporation to give a shareholder the right to purchase its own stock.¹⁰⁰ The court, however, chose not to adopt this literal interpretation.¹⁰¹ Instead, the court analogized the rights plan, which allowed shareholders of the target to purchase shares of the tender offeror at a reduced rate,¹⁰² to an “anti-dilution” provision.¹⁰³ The purpose of an anti-dilution provision is to allow shareholders of one corporation to convert their shares into

the court’s response to this argument, see *infra* notes 97-109 and accompanying text. The second argument, in which Moran and D-K-M were joined by the SEC, was that the Board had no authority to usurp the opportunity of shareholders to receive hostile tender offers. *Moran*, 500 A.2d at 1351. For a discussion of the court’s response to this argument, see *infra* notes 110-12 and accompanying text.

97. *Moran*, 500 A.2d at 1351-53.

98. *Id.* at 1351. Section 157 provides in pertinent part:

Subject to any provisions in the certificate of incorporation, every corporation may create and issue, whether or not in connection with the issue and sale of any shares of stock or other securities of the corporation, rights or options entitling the holders thereof to purchase from the corporation any shares of its capital stock of any class or classes, such rights or options to be evidenced by or in such instrument or instruments as shall be approved by the board of directors.

DEL. CODE ANN. tit. 8, § 157 (1983).

99. *Moran*, 500 A.2d at 1351. The appellants argued that § 157 only pertained to the means by which a corporation could finance its endeavors. *Id.* The appellant came to this conclusion because § 157 had been previously used only in this context and because the legislative history only discusses § 157 in connection with corporate financing. *Id.* However, the court found that the legislative history does not limit the use of § 157 to corporate financing. *Id.* After noting that the corporate law is not static, the court decided to apply § 157 in a takeover setting. *Id.* (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (1985)).

100. *Id.* Section 157 provides that a corporation may issue rights which allow a shareholder to purchase shares of “its capital stock.” DEL. CODE ANN. tit. 8, § 157 (1983) (emphasis added).

101. *Moran*, 500 A.2d at 1352.

102. For a discussion of the intricacies of the rights plan, see *supra* notes 93-95 and accompanying text.

103. *Moran*, 500 A.2d at 1352. The appellant contended that § 157 only applies to corporate financing. *Id.* at 1351. The appellant further contended that “anti-dilution” provisions are valid only because they are incidental to a corporation’s right to finance itself through the issuance of various types of stock under § 157. *Id.* However, the appellant contended that the rights plan is not valid since it is not incidental to a corporation’s right to finance itself. *Id.* The court found no merit in the appellant’s distinction. *Id.* It did not accept Household’s basic premise that § 157 only applies to corporate financing as it could find no support for this premise in the legislative history or in prior case law. *Id.*

shares of another corporation in the event that the two corporations merge.¹⁰⁴ Because it had approved anti-dilution provisions in the past, the Delaware Supreme Court found that the rights plan also should be approved.¹⁰⁵

The court then rejected Moran's and D-K-M's contention that the Commerce Clause and the Supremacy Clause would be violated if it interpreted section 157 to authorize the rights plan.¹⁰⁶ Noting that the

104. *Id.* at 1352. The following is an example of an "anti-dilution" provision:

If any capital reorganization or reclassification of the capital stock of the Company, or consolidation or merger of the Company with another corporation, or the sale of all or substantially all of its assets to another corporation, shall be effected in such a way that holders of Common Stock shall be entitled to receive stock, securities or assets with respect to or in exchange for Common Stock, then, as a condition of such reorganization, reclassification, consolidation, merger or sale, the Company or such successor purchasing corporation, as the case may be, shall execute with the Trustee a supplemental indenture providing that the Holder of each Debenture then Outstanding shall have the right thereafter and until the expiration of the period of convertibility to convert such Debenture into the kind and amount of stock securities or assets receivable upon such reorganizations, reclassification, consolidation, merger or sale by a holder of the number of shares of Common Stock into which such Debenture might have been converted immediately prior to such reorganization, reclassification, consolidation, merger or sale, subject to adjustments which shall be as nearly equivalent as may be practicable to the adjustments provided for in this Article Thirteen.

AMERICAN BAR FOUNDATION, COMMENTARIES ON INDENTURE, 549-50 (1971).

105. *Moran*, 500 A.2d at 1352 (citing *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 946 (5th Cir.) (purpose of anti-dilution provisions is to protect shareholders' pre-existing rights), *cert. denied*, 454 U.S. 965 (1981); *Wood v. Coastal State Gas Corp.*, 401 A.2d 932, 937-39 (Del. 1979) (anti-dilution provisions appropriate in conversion contracts which allow shareholder to convert one type of shares into another); *B.S.F. Co. v. Philadelphia Nat'l Bank*, 204 A.2d 746, 750-51 (Del. 1964) (provisions which allow shareholders to exercise preexisting rights before consolidation or merger are lawful)). For a critical analysis of the court's use of these three cases, see *infra* notes 241-48 and accompanying text.

106. *Moran*, 500 A.2d at 1353. The Commerce Clause provides that "Congress shall have Power . . . [t]o regulate Commerce . . . among the several States." U.S. CONST. art. I, § 8, cl. 3. The Supremacy Clause provides that "the laws of the United States . . . shall be the supreme Law of the Land." U.S. CONST. art. VI. The appellant argued that an interpretation of § 157 which allowed for the rights plan would render § 157 unconstitutional under both the Supremacy Clause and the Commerce Clause because such an interpretation would be contrary to the purpose of a federal statute, the Williams Act. *Id.*; see Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (codified at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1976)). The purpose of the Williams Act is to require full disclosure of the facts surrounding a tender offer to the shareholders of the target so that they can make an informed decision about whether they should tender their shares. See *Edgar v. Mite Corp.*, 457 U.S. 624, 633-34 (1981) (legislative purpose for Williams Act was to provide sufficient information to shareholders so that they can make educated decisions). When Congress enacted the Williams Act, it specifically stated that it did not want to favor either the raider or the target in the takeover battle. S. REP. No. 550, 90th Cong., 1st Sess. 3 (1967) (Congress chose not to discourage takeover bids because "they serve a useful

Commerce Clause and the Supremacy Clause could be violated only if there was "state action,"¹⁰⁷ the court found that the Household directors, acting pursuant to a state statute, did not provide a sufficient nexus to the state for there to be "state action."¹⁰⁸ Consequently, there could not be a violation of the Commerce Clause or the Supremacy Clause.¹⁰⁹

purpose of providing a check on entrenched but ineffective management"); H.R. REP. NO. 1711, 90th Cong., 2d Sess. 4, reprinted in 1968 U.S. CODE CONG. & AD. NEWS 2811, 2813 ("bill avoids tipping the balance of regulation either in favor of management or in favor of person making the takeover bid"); see also *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 58-59 (1975) (Congress adopted policy of neutrality). Because an interpretation of § 157 which allows for the implementation of the rights plan by the target would clearly favor the target, the appellants argued that such an interpretation was contrary to the Williams Act and, therefore, void under the Supremacy Clause. Brief for Appellants at 46, *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985).

107. *Moran*, 500 A.2d at 1353. For instance, in *Edgar v. Mite Corp.*, 457 U.S. 624 (1981), the United States Supreme Court found that the Illinois Business Takeover Act violated the Commerce Clause and Supremacy Clause of the Constitution because it placed an undue burden on the tender offeror which was inconsistent with one of the purposes of the Williams Act. *Edgar*, 457 U.S. at 634-46. The Williams Act was enacted with the intention of not putting an excessive burden on either the tender offeror or the target. H.R. REP. NO. 1711, 90th Cong., 2d Sess. 4, reprinted in 1968 U.S. CODE CONG. & AD. NEWS 2811, 2813. The Illinois statute put an unconstitutionally excessive burden on the tender offeror as it required the tender offeror to give notice of its intent to make an offer and to appear at a hearing before the state secretary of state who could block the tender offer. *Edgar*, 457 U.S. at 634-40.

108. *Moran*, 500 A.2d at 1353 (citing *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1, 5 (2d Cir. 1983) (acts of private corporation in takeover context do not constitute state action). The court found that *Edgar v. Mite Corp.*, 457 U.S. 624 (1982), which invalidated the Illinois Business Takeover Act as an unconstitutional burden on interstate commerce, was not controlling because it applied only to state action. *Moran*, 500 A.2d at 1353.

109. *Moran*, 500 A.2d at 1352. The Delaware Supreme Court dismissed two other contentions of the appellants. *Id.* They alleged that the rights plan was a sham and that § 157 does not authorize the issuance of rights which are designed never to be exercised. *Id.* at 1351-52. The *Moran* court rejected this contention, noting that if one of the triggering events occurred, the Household shareholders could exercise their rights to purchase stock of the tender offeror at a reduced rate. *Id.* at 1352. The court supported this statement by citing a recent tender offer battle in which the shareholders of the target exercised their rights. *Id.* (citing *Goldsmith Wins Fight for Crown Zellerbach Corp.*, WALL ST. J., July 29, 1985, at 3, col. 1) (Sir James Goldsmith's successful takeover of Crown Zellerbach)).

The appellants also alleged that allowing the rights plan under § 157 is contrary to § 203 of the Delaware Corporate Code. *Id.*; see DEL. CODE ANN. tit. 8, § 203 (1983). Section 203 is a "notice statute" which requires a tender offeror to give timely notice to the target if it intends to make a tender offer. DEL. CODE ANN. tit. 8, § 203 (1983). Section 203 provides in pertinent part:

No offeror shall make a tender offer unless . . . not less than 20 nor more than 60 days before the date the tender offer is to be made, the offeror shall deliver personally or by registered or certified mail to the corporation whose equity securities are to be subject to the tender offer . . . a written statement of the offeror's intention to make the tender offer

The *Moran* court next considered whether the plan usurped the shareholders' right to receive tender offers.¹¹⁰ The court found that the rights plan did not prohibit tender offers since there were several ways for a potential raider to circumvent the rights plan,¹¹¹ noting, in fact, that a raider had recently taken over a target corporation with a rights plan similar to that of Household.¹¹²

After deciding that the directors had authority to implement the rights plan, the Delaware Supreme Court considered whether the directors had exercised their authority appropriately under the business judg-

Id. The appellants contended that the legislature intended for there to be no greater impediment to the takeover process than the notice requirement since the legislature enacted § 203 and not a more restrictive provision. *Moran*, 500 A.2d at 1353. The court rejected this line of reasoning, stating that the legislature's failure to enact more restrictive statutes governing the tender offer process does not indicate a legislative intent that there be no private regulation of the process such as the rights plan. *Id.*

110. *Moran*, 500 A.2d at 1353-55. The appellants alleged that the rights plan prevented the shareholder from receiving tender offers because it altered the fundamental structure of the corporation. *Id.* at 1353-54. The court rejected this reasoning on two grounds. *Id.* at 1354. First, it listed several ways that shareholders could receive tender offers while avoiding the operation of the rights plan. *Id.* For a discussion of the ways that shareholders can receive tender offers while the rights plan is in place, see *infra* note 111.

Second, the court stated that a rights plan has a less significant effect on Household's structure than would other defensive mechanisms. 500 A.2d at 1354. For instance, a rights plan does less harm to the value of a corporation than does the "scorched earth" defense under which the target sells its prize assets in order to deter the tender offeror from continuing its bid for the target. *Id.* (citing *Whittaker Corp. v. Edgar*, 535 F. Supp. 933 (N.D. Ill. 1982)). The rights plan also is less harmful than "greenmailing", a process by which the target pays the tender offeror a price above market value for the target's shares which the tender offeror has acquired in order to eliminate the tender offeror as a threat. *Id.* (citing *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (1964)).

Finally, as the court noted, the rights plan is less damaging than a discriminatory self-tender under which a target offers to acquire its own shares, from all shareholders other than the tender offeror, at a higher price than that offered by the tender offeror in order to assure that the tender offeror is not able to acquire those shares and, consequently, obtain control of the target. *Id.* (citing *Unocal*, 493 A.2d at 946).

111. *Id.* at 1354. The court suggested several ways that a raider could acquire a target which has a rights plan. *Id.* First, one could make a tender offer contingent upon the target's board redeeming the rights. *Id.* Second, one could make a tender offer contingent upon receiving a very large percentage of the target's shares and the corresponding rights. *Id.* This would reduce the negative impact of the rights plan since there would only be a minimal number of shareholders who could exercise the right and thereby obtain shares in the tender offeror at a reduced rate. *Id.* Last, one could obtain an amount of shares just below that amount which triggers the issuance of the rights plan and then attempt to solicit proxies from other shareholders to remove the target's board of directors and abolish the rights plan. *Id.*

112. *Id.* The court noted that Sir James Goldsmith successfully took over Crown Zellerbach even though Crown Zellerbach had enacted a rights plan similar to that of Household. *Id.* (citing *Goldsmith Wins Fight for Crown Zellerbach Corp.*, WALL ST. J., July 29, 1985, at 3, col. 1).

ment rule.¹¹³ The court reiterated its finding in *Unocal*, that the initial burden is on the directors who employ the defensive mechanism to prove: 1) that they acted in good faith and made a reasonable investigation before adopting the defensive mechanism¹¹⁴ and 2) that the defensive mechanism was reasonable in relation to the threat posed.¹¹⁵ The court noted that the members of the Household board had held extensive discussions among themselves about the advantages and disadvantages of the plan and sought the advice of outside consultants who prepared reports about the merit of the tender offer for the board.¹¹⁶ Thus, the court concluded that the Household board made a well-informed decision.¹¹⁷

Although there was no immediate threat of a hostile takeover, the *Moran* court found that Household's board met the burden of showing that the defensive measure adopted was reasonable in relation to the threat posed.¹¹⁸ The court based its conclusion on evidence in the record concerning the increasing frequency of hostile takeovers in the financial services industry and the pervasive use of coercive two-tier tender offers, which often force some of the target's shareholders to accept valueless securities in exchange for their shares in the target corporation.¹¹⁹ Accordingly, the court found that the Household board

113. *Id.* at 1355-57.

114. *Id.* at 1356 (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985)).

115. *Id.* The court noted that proof of the directors meeting their initial burden is "materially enhanced" where a majority of the board that approved the defensive mechanism consists of independent directors who acted in good faith and after reasonable investigation. *Id.* (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985); *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984)). Household's board consisted of 10 outside, independent directors and 6 directors who were members of management. *Id.* at 1348 n.2.

116. *Id.* at 1356. Representatives of the New York law firm of Wachtell, Lipton, Rosen and Katz provided the board with an opinion that the rights plan fell within the board's powers under the business judgment rule. *Id.* *Moran*, the appellant in the case and a member of Household's board, presented the negative aspects of the rights plan to the board. *Id.* Consequently, the court concluded that the board was well-informed as to the advantages and disadvantages of the plan. *Id.*

117. *Id.*

118. *Id.* at 1356-57. The Delaware Supreme Court first introduced the concept of balancing the reasonableness of the defensive measure against the threat posed by the tender offer in *Unocal*. In *Unocal*, there was a tender offeror who was attempting to take over the target. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 949 (Del. 1985). In *Moran*, there was no immediate threat of a hostile takeover. *Moran*, 500 A.2d at 1357. However, the Delaware Supreme Court still found that the Household board's implementation of the rights plan as a defensive mechanism was reasonable in relation to the threat posed. *Id.* The court stated that the increased frequency of takeovers in Household's industry (financial services) was a sufficient threat for the Household board to employ the rights plan in an effort to guard against a hostile acquisition. *Id.*

119. *Id.* An example of the second tier of a two-tier offer forcing the shareholders of the target to receive valueless securities can be found in *Unocal Corp.*

adopted a reasonable response to the threat of a hostile tender offer and, therefore, deserved the protection of the business judgment rule.¹²⁰

C. Hanson Trust PLC v. ML SCM Acquisition Inc.

In *Hanson Trust PLC v. ML SCM Acquisition Inc.*¹²¹ the United States Court of Appeals for the Second Circuit invalidated the use of a lock-up option to prevent a takeover attempt by an unfriendly suitor.¹²² Hanson Trust PLC ("Hanson Trust") attempted to take over SCM Corporation (SCM) by making a sixty dollar per share cash tender offer for any and all shares of SCM.¹²³ The SCM directors chose to defend against the tender offer by entering into a leveraged buyout agreement with Merrill

v. Mesa Petroleum Co., where the court labeled the second tier securities as "junk bonds." *Unocal*, 493 A.2d at 950. For a discussion of the coercive nature of two-tier tender offers, see *supra* note 55; see also Finkelstein, *supra* note 55 at 293 (noting that shareholders are pressured to tender shares in first tier for fear of receiving less value, such as junk bonds, in second tier); Lipton, *supra* note 18, at 113-14 (wise investor almost forced to tender shares in first of two tiers).

120. *Moran*, 500 A.2d at 1357. The court concluded its decision by noting that the Household board could not blindly activate the rights under the rights plan should it be confronted with an actual takeover bid. *Id.* The board still had a duty to the corporation and the shareholders to consider their best interests when deciding whether to activate the rights plan or to abolish the rights plan and accept the tender offer. *Id.* at 1357. Should a board choose to activate a rights plan, it must meet the *Unocal* test for defensive mechanisms. *Id.* For a discussion of the *Unocal* test, see *supra* notes 70-71 and accompanying text.

121. 781 F.2d 264 (2d Cir. 1986).

122. *Id.* at 283. The plaintiffs in the case were Hanson Trust PLC and three of its wholly owned subsidiaries: HSCM Industries Inc., Hanson Holding Netherlands B.V., and HMAc Investments Inc. *Id.* at 264. Hanson Trust PLC is a corporation organized under the laws of the United Kingdom. *Id.* at 268. HSCM Industries Inc. and HMAc Investments Inc. are incorporated under the laws of Delaware. *Id.* Hanson Holdings Netherlands B.V. is a limited liability company incorporated under the laws of the Netherlands. *Id.* One defendant and the target of the takeover attempt, SCM Corporation, is a highly diversified corporation organized under the laws of New York. *Id.* at 267. SCM has divisions in the following areas: chemicals, coating and resins, paper products, food and typewriters. *Id.* Pigments, a subdivision of SCM's Chemical division, and Durkee Famous Foods, a subdivision of its Foods division, accounted for approximately 50% of SCM's net generating income in recent years and were considered by Hanson Trust to be the "crown jewels" of SCM. *Id.* SCM entered into a lock-up option with Merrill Lynch which allowed Merrill Lynch to acquire these "crown jewels" if Hanson Trust or any other third party acquired one third of SCM's common stock. *Id.* at 270. The district court had found that it was permissible for the SCM directors to employ the lock-up option under New York's business judgment rule. *Hanson Trust PLC v. SCM Corp.*, 623 F. Supp. 848, 529 (S.D.N.Y. 1985). The Second Circuit reversed the district court, holding that such an agreement violated the directors' duty to obtain the maximum price possible for the shareholders' stock because it stifles, instead of promotes, bidding. 781 F.2d at 282-83.

123. *Id.* at 268. Hanson Trust made a \$60 cash tender offer for any and all shares of SCM. *Id.* at 268. During the month prior to the tender offer, the SCM stock was trading at less than \$50 per share. *Id.*

Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch") under which Merrill Lynch would make a seventy dollar per share cash tender offer for eighty-five percent of SCM's shares.¹²⁴ In response, Hanson Trust raised its offer to seventy-two dollars per share, conditioned on SCM's refraining from granting a lock-up option to anyone seeking control of SCM.¹²⁵ SCM and Merrill Lynch then negotiated a new offer, under which Merrill Lynch would make a seventy-four dollar per share cash tender offer.¹²⁶ In consideration for raising the tender offer price, SCM agreed to grant Merrill Lynch an option to purchase its two most profitable divisions if any third party acquired one-third of the SCM stock.¹²⁷

124. *Id.* at 269. The leveraged buyout agreement was to be accomplished through Merrill Lynch and its related entities, including ML SCM Acquisition Inc., Merrill Lynch Capitol Partners, Merrill Lynch Capitol Markets and Merrill Lynch & Co. Under the leveraged buyout agreement, Merrill Lynch would make a two-tier tender offer for all of the SCM shares. *Id.* In the first tier, Merrill Lynch would offer to purchase 10.5 million (85%) of the SCM shares for \$59.50 in cash and \$10.50 in debentures. *Id.* This would be followed by a second tier, in which the remaining shareholders could exchange their shares for high risk, high yield, subordinated debentures (junk bonds) valued at \$70 per share. *Id.* If the shareholders did not wish to participate in the second tier, they could settle for their appraisal rights under New York statutory law. *Id.* (citing N.Y. Bus. CORP. L. § 623 (McKinney 1983) (setting forth procedure shareholder must use to demand that corporation pays shareholder fair value for shares if corporation takes action to which shareholder objects)). The agreement also provided that SCM would pay Merrill Lynch an engagement fee ("hello fee") of \$1.5 million. *Id.* at 269. A target uses this type of fee to get a "white knight" to enter an agreement that will protect the corporation from the raider. *Id.* SCM also agreed to pay Merrill Lynch a break-up fee ("goodbye fee") of \$9 million. *Id.* These fees are paid to a "white knight" if the merger does not materialize. *Id.* In this case, the break-up fee was to be payable if any third party acquired one-third of the outstanding shares of SCM, an amount sufficient under New York law to block the Merrill Lynch-SCM merger. *Id.*

125. *Id.* at 270.

126. *Id.* Merrill Lynch's increased offer, however, was deceiving. *Id.* The offer allowed SCM shareholders to exchange their shares for \$59.20 in cash and \$14.80 in debentures. *Id.* Thus, the shareholders received 30 cents per share less in cash than they would have received in the previous leverage buyout agreement. *Id.* In addition, SCM agreed to pay Merrill Lynch an additional \$6 million as a "hello again" fee for increasing its offer. *Id.*

One further aspect of the leveraged buyout agreement was that the managing directors of SCM had the right to become equity participants in the corporation that resulted from the leveraged buyout. *Id.* at 269. The court noted the importance of the independent directors in this type of situation, suggesting that the independent directors must protect the interests of the shareholders because it is unreasonable to think that the managing directors, with a financial interest in the buyout, would consider solely the best interest of the shareholders when determining the options available in a tender offer situation. *Id.* at 277 (citing *inter alia*, Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83 (Summer 1985) (social and psychological pressures prevent managerial directors from objectively considering merits of tender offer and, thus, some commentators have suggested that independent directors act as safeguards for interests of shareholders)).

127. *Id.* at 267. Pigments and Durkee Famous Foods were the two entities

Hanson Trust then terminated its seventy-two dollar per share tender offer and brought suit against SCM in the United States District Court for the Southern District of New York to enjoin the exercise of the lock-up option.¹²⁸ Hanson Trust also declared its intention to make a seventy-five dollar per share tender offer for all outstanding shares of SCM, conditioned on the withdrawal or judicial invalidation of the lock-up option.¹²⁹

In determining the validity of the lock-up option, the Second Circuit began by discussing the operation of the business judgment rule in the takeover context.¹³⁰ Contrary to Delaware law, the court noted that directors enjoy a presumption of propriety under New York law, with the burden of proof on the plaintiff to show that the implementation of a defensive mechanism is a breach of the directors' fiduciary duty.¹³¹ Once a plaintiff has made a prima facie showing that the directors breached their fiduciary duty, the burden shifts to the directors to prove the fairness of the defensive mechanism.¹³²

The Second Circuit held that the district court erred in finding that Hanson Trust failed to make a prima facie showing that the SCM directors breached their fiduciary duty.¹³³ The Second Circuit found that the SCM directors breached their duty of care which required them to use reasonable diligence to acquire material information about a takeover and to make a reasonable inquiry into the information obtained.¹³⁴ As

involved in the lock-up option. *Id.* at 270. Pigments was a subdivision of SCM's chemical division while Durkee Famous Foods was a subdivision of its foods division. *Id.* at 267. The option price for Pigments was \$350 million and the option price for Durkee Famous Foods was \$80 million. *Id.*

128. *Id.* at 272. The district court denied Hanson Trust's request for a preliminary injunction against the use of the lock-up option, finding that under New York law the lock-up option was "part of a viable business strategy." Hanson Trust PLC v. SCM Corp., 623 F. Supp. 848, 859 (S.D.N.Y. 1985).

129. *Hanson Trust*, 781 F.2d at 272.

130. *Id.* The Second Circuit noted that the directors have a fiduciary duty to the shareholders and that it must decide whether the directors' conduct in reaction to Hanson Trust's tender offer breached that duty. *Id.* The court continued by stating that the business judgment rule "bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes." *Id.* at 273 (quoting *Auerbach v. Bennett*, 47 N.Y.2d 619, 629, 419 N.Y.S.2d 920, 926, 393 N.E.2d 994, 1000 (1979)).

131. *Id.* at 273. The court compared New York law with Delaware law, under which the initial burden is on the directors in a takeover situation to show that they had reasonable grounds for believing that the takeover would endanger corporate policy. *Moran v. Household Int'l Inc.*, 500 A.2d 1346, 1356 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985).

132. *Hanson Trust*, 781 F.2d at 272. The court observed that absent a showing of a breach of fiduciary duty, directors have "wide latitude in devising strategies to resist unfriendly [takeover] advances." *Id.* at 273 (quoting *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 260 (2d Cir. 1984)).

133. *Id.* at 267.

134. *Id.* at 273. The court stated that, under the duty of care analysis, the

to the first aspect, the court found that the directors, in one late night session, decided to grant Merrill Lynch the lock-up option without full knowledge as to the true value of the corporation, the type of event which would trigger the lock-up option, and the kind of corporation SCM would be without its two most lucrative divisions.¹³⁵ As to the second aspect, the court determined that the directors failed to inquire about the basis for their outside consultant's conclusory statements regarding the fairness and benefits of the leveraged buyout.¹³⁶

Having concluded that Hanson successfully shifted the burden to SCM, the court then considered the reasons which SCM gave in defense

directors enjoy a presumption that they acted appropriately. *Id.* The duty of care requires the directors to act with "conscientious fairness." *Id.* at 274 (citing *Alpert v. 28 Williams St. Corp.*, 63 N.Y.2d 554, 569, 483 N.E.2d 19, 26, 483 N.Y.S.2d 667, 674 (1984) ("all corporate responsibilities must be discharged in good faith and with conscientious fairness, morality, . . . honesty in purpose . . . [and] candor")). Put more simply, the duty of care requires the directors to make an informed decision. *Id.* at 284 (citing AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c)(2) (Tent. Draft No. 4, April 12, 1985) ("informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances"); H. BALLANTINE, LAW OF CORPORATIONS § 63a at 161 (rev. ed. 1946) ("presupposed that reasonable diligence and care have been exercised"); Arsh, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 111 (1979) (business judgment rule should not be available to directors who do "not exercise due care to ascertain the relevant and available facts before voting"))).

135. *Hanson Trust*, 781 F.2d at 275. The court noted that the directors had never asked what the top value of the two optioned divisions was, nor did they inquire as to why the divisions were being sold for one-third of the total purchase price of the entire company under the leveraged buyout agreement when they generated one-half of the corporation's income. *Id.* Nor did the directors discuss with financial advisors the viability of the corporation without its two most lucrative divisions. *Id.* The court rejected SCM's argument that the circumstances required the directors to make an emergency decision, pointing out that the delay in Hanson's acquisition efforts required by the federal securities law provided SCM with time which should have been used for more thorough investigation of defense options. *Id.*

The directors also alleged that they were a "working board" which was familiar with SCM and, consequently, that they could enter the leveraged buyout agreement without making further inquiries of their financial analyst. *Id.* The Second Circuit questioned the directors' familiarity with SCM since they did not find the prices for which the two divisions were being sold to be lower than the fair market value of the divisions. *Id.* The directors' investment banker and other sources had suggested to the directors that the divisions were more valuable than the price stated in the leveraged buyout agreement. *Id.*

136. *Id.* at 275-76. The court stated that directors have an obligation to become reasonably familiar with an advisor's report or opinion before they are entitled to rely on it. *Id.* at 275. The fact that the directors did not request documents to support the opinions of their financial advisors as to the "range of fair value" of the assets to be sold and, thus, did not discover that their advisors had not actually calculated that range, served to indicate that the directors had not met their duty. *Id.* at 276. Furthermore, a remark by one advisor that an "orderly sale" of assets could bring higher prices than those negotiated with Merrill Lynch, should have led to further investigation by the board. *Id.*

of the leveraged buyout agreement.¹³⁷ The directors contended that the valuation of the two divisions was appropriate and, thus, that it was in the best interest of the shareholders to enter into the leveraged buyout agreement with Merrill Lynch.¹³⁸ The court rejected this contention because the method of evaluation¹³⁹ and the information used in the valuation were suspect.¹⁴⁰

The SCM board also asserted that the primary purpose of the lock-up option was to obtain the best bid for the SCM shareholders.¹⁴¹ The court stated that the test for determining the primary purpose of a director's actions is whether the action "objectively" benefits the shareholders.¹⁴² Viewing the leveraged buyout agreement, which contained the

137. *Id.* at 277-83.

138. *Id.* at 277-78.

139. *Id.* at 278. The \$350 million option price for Pigments, a figure which SCM suggested was the proper valuation of the division, was based solely on the division's earnings for 1985 and 1986. *Id.* Pigments' actual earnings for 1985 were lower than they had been in the past ten years. *Id.* In addition, the division's projected earnings for 1986 were at their lowest in ten years. *Id.* Thus, the court felt that 1985 and 1986 did not adequately reflect the earning potential and, thus, the value of the division. *Id.*

140. *Id.* SCM attempted to show that a calculation of Rothschild, Inc., Hanson Trust's investment bank, accurately represented the value of the Pigments division. *Id.* This calculation estimated the value of Pigments at \$345 million. *Id.* The court rejected this calculation because it was based on incomplete data and without full knowledge of the operating income of the Pigments division. *Id.* at 278-79. In fact, Rothschild later valued the Pigments division between \$450 and \$500 million, a price far above the \$350 million offered by Merrill Lynch in the leveraged buyout agreement, after learning of the Pigments division's actual operating income. *Id.* at 279. Furthermore, SCM's own investment banker at Goldman Sachs & Co. testified at the injunction hearing that the value of the Pigments division was between \$420 and \$544 million. *Id.* Two other investment bankers also valued the Pigments division in this range during the injunction hearing. *Id.* The Second Circuit noted that even accepting the lowest of all the estimates, \$420 million, it would still suggest a \$70 million undervaluation by SCM in the optioned price at which Pigments was offered. *Id.*

The court further concluded that, in optioning the Durkee Famous Foods division for \$80 million, the SCM directors had considerably undervalued the division. *Id.* at 280. At the injunction hearing, Hanson Trust produced evidence that Borden Corp. was interested in purchasing the division for \$105 million and that Merrill Lynch itself hoped to receive \$125 million in selling the division. *Id.* Deposition testimony of representatives of SCM, Merrill Lynch, Prudential Insurance Co., Goldman Sachs & Co., and Bear, Stearns & Co., furthermore placed the value of Durkee Famous Foods at a range between \$90 and \$110 million. *Id.* On the basis of the evidence as to the undervaluation of both the Pigments and the Durkee Famous Foods divisions, the Second Circuit concluded that the district court erred in failing to consider this evidence in deciding Hanson Trust's motion for a preliminary injunction to restrain the exercise of the lock-up option. *Id.*

141. *Id.* at 281.

142. *Id.* In support of this test, the court cited N.Y. BUS. CORP. L. § 717 (McKinney 1983) (imposing on directors an "ordinary prudent person" standard); *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 266 (2d Cir. 1984) (directors must act in best interest of corporation and its shareholders); *MacAn-*

lock-up option, as a whole, the court found that the agreement did not benefit the shareholders.¹⁴³ By accepting the Merrill Lynch offer, the directors obtained two dollars per share in excess of the Hanson Trust offer, but at the cost of a six million dollar “hello again” fee¹⁴⁴ and an option to purchase SCM’s two major divisions at a price well below their fair value.¹⁴⁵

drews and Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1250 (Del. Ch. 1985) (“objective needs of shareholders”), *aff’d*, 506 A.2d 173 (Del. 1986); Bennett v. Propp, 41 Del. Ch. 14, 21, 187 A.2d 405, 409 (1962) (directors can take actions “primarily in the corporate interest”).

143. *Hanson Trust*, 781 F.2d at 281. The court stated that the directors pointed to little or no evidence to support a finding that they acted in the best interests of the shareholders. *Id.* The court further stated that evidence of directors’ good intentions is not sufficient to justify a lock-up option, which is inherently suspect because it forecloses bidding. *Id.* (citing *Thompson v. Enstar*, Nos. 7641, 7643 (Del. Ch. Aug. 16, 1984), *reprinted in* 9 DEL. J. CORP. L. 822 (1984)). The court noted finally that the district court had determined that the directors knew or should have known that the lock-up option would end the bidding process. *Id.*

144. *Id.* at 270. The “hello again” fee was demanded by Merrill Lynch as an inducement to resume negotiations after the first leveraged buyout agreement had been terminated. *Id.* When the negotiation initially began between SCM and Merrill Lynch, SCM paid Merrill Lynch a “hello” fee of \$1.5 million. *Id.* at 269. Thus, coupled with the \$6 million “hello again” fee, SCM paid Merrill Lynch \$7.5 million for entering the leveraged buyout agreements to prohibit Hanson Trust from acquiring SCM. *Id.* at 269-70. For a discussion of “hello fees” and “good-bye fees,” see *supra* note 124 and accompanying text.

145. *Hanson Trust*, 781 F.2d at 281-82. The court noted that the leveraged buyout will only be economically useful to the shareholders if SCM merges with Merrill Lynch and the emerging entity is financially sound. *Id.* at 282. Under New York law, Merrill Lynch must acquire two-thirds of the shares of SCM before the two companies can merge. *Id.* at 267 (citing N.Y. Bus. L. § 903(a)(2) (McKinney 1983)). Should Merrill Lynch acquire two-thirds of the SCM shares, those shareholders who tendered their shares to Merrill Lynch in the first tier of the two-tier tender offer would receive a joint debt and equity security. *Id.* at 270. If the emerging entity is not financially sound, it will not be able to pay the value of the debenture (debt) portion of the security. *Id.* at 282. In addition, the front end of Merrill Lynch’s offer only extended to 80% of the shares of SCM; therefore, shareholders holding 20% of SCM’s shares would be required to exchange their shares in the back end of the offer for high risk debentures. *Id.* at 270. If the emerging company is not financially sound, it will not be able to pay the face value of the debentures. *Id.* at 282. Thus, if Merrill Lynch and SCM merge, the former SCM shareholders only would benefit if the emerging corporation was financially sound and, therefore, able to pay the full value of the debentures. *Id.*

In the event that Merrill Lynch and SCM did not merge because a corporation other than Merrill Lynch acquired one-third of the SCM stock, the lock-up provision in the leveraged buyout agreement would allow Merrill Lynch to acquire the two SCM divisions. *Id.* at 270. If this were to occur, the remaining SCM shareholders would be left with effectively only one-half of the corporation that they had prior to the takeover struggle since they would lose their two most profitable divisions. *Id.* at 282. Moreover, the shareholders would not receive adequate consideration for the portion of the corporation that they lost since the court determined that the price for the divisions in the option provision was less than the actual value of the divisions. *Id.* at 282. Lastly, SCM’s treasury would

Finally, the court rejected SCM's argument that the leveraged buyout offer enhanced the competition for control of SCM.¹⁴⁶ The lock-up option prevented Hanson Trust and any other potential bidder from making a tender offer for shares of SCM because if the tender offeror acquired enough shares to trigger the lock-up option, Merrill Lynch would obtain SCM's two most profitable divisions at a below market price.¹⁴⁷ This would leave the tender offeror with a significant number of shares in a "denuded" corporation.¹⁴⁸ The court concluded that a preliminary injunction preventing SCM from exercising the lock-up option was appropriate, given the serious questions raised by Hanson Trust about the directors' failure to meet their duty of care and the potential for irreparable harm to the SCM shareholders.¹⁴⁹

In his dissent, Judge Kearsse objected to the majority's substantive interpretation of the business judgment rule under New York law.¹⁵⁰ Judge Kearsse noted that the business judgment rule requires directors to act in good faith, without fraud, and without self-dealing.¹⁵¹ The majority had conceded that the directors did not breach any of these duties.¹⁵² In addition, Judge Kearsse noted that the business judgment rule requires directors to exercise reasonable diligence when making

be depleted because \$16.5 million in fees would have been paid by SCM to Merrill Lynch: "hello fees" totaling \$7.5 million and a "breakup fee" of \$9 million. *Id.* at 269, 282 & n.12. Thus, if the merger was not successful because an entity other than Merrill Lynch acquired one-third of the SCM shares, the leveraged buyout agreement and the lock-up option would injure the SCM shareholders significantly. *Id.* at 282.

For a discussion of the problems facing a corporation that emerges out of a difficult takeover battle, see *supra* notes 14-15 and accompanying text. For a discussion of purchase prices for the two divisions involved in the lock-up option and disagreement over the valuation, see *supra* note 127.

146. *Hanson Trust*, 781 F.2d at 282. The court noted that this argument was flawed since it assumed that a competing bidder was not handicapped by the existence of a lock-up option. *Id.*

147. *Id.*

148. *Id.* at 283. The court noted that the triggering of the lock-up option would impose the greatest hardship on Hanson Trust, which is the largest minority shareholder of SCM. *Id.* at 282-83. If the option was triggered, Hanson Trust would hold one-third of the "denuded company," namely, SCM without its two most profitable assets, the Pigments and Durkee Famous Foods subdivisions, which generated 50% of SCM's income. *Id.* at 282. For a further discussion of the effect of the lock-up option being exercised, see *supra* note 145.

149. *Hanson Trust*, 781 F.2d at 283.

150. *Id.* at 285-87 (Kearsse, J., dissenting). Judge Kearsse noted that one of the premises for the business judgment rule is that the courtroom is not the appropriate forum to scrutinize decisions made in a corporate boardroom. *Id.* at 286 (Kearsse, J., dissenting) (citing *Auerbach v. Bennett*, 47 N.Y.2d 619, 629-31, 393 N.E.2d 994, 1000-01, 419 N.Y.S.2d 920, 926-27 (1979)).

151. *Id.* at 286-87 (Kearsse, J., dissenting). Judge Kearsse stated that the law presumes that directors have acted in good faith unless the party challenging their decision proves to the contrary. *Id.*

152. *Id.* at 274. The majority stated: "It is not enough that directors merely be disinterested and thus not disposed to self-dealing or other indicia of

their judgments.¹⁵³ Judge Kearsé noted that New York statutory law allows directors to rely on opinions and statements of expert advisors to the corporation.¹⁵⁴ Since the directors acted consistently with the law by relying on their advisor's determination of the value of the divisions, Judge Kearsé found that the directors met their duty to exercise reasonable diligence.¹⁵⁵ Thus, he concluded that the directors had acted within their scope of authority under the business judgment rule.¹⁵⁶

D. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.

In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,¹⁵⁷ the Delaware Supreme Court, in its latest proclamation on defenses to corporate takeovers, addressed the legitimacy of a number of defensive tactics.¹⁵⁸ In *Revlon*, a representative of Pantry Pride, Inc.¹⁵⁹ approached Revlon, Inc. with the hope of making a friendly acquisition of Revlon for forty to fifty dollars per share.¹⁶⁰ The Revlon directors thought the offer inad-

a breach of the duty of loyalty. Directors are also held to a standard of due care." *Id.*

153. *Id.* at 287 (Kearsé, J., dissenting). Judge Kearsé stated that the directors enjoy a presumption that they exercised reasonable diligence in reaching their decision. *Id.* (citing *Treadways Cos. v. Care Corp.*, 638 F.2d 357, 384 (2d Cir. 1980)).

154. *Id.* at 287 (Kearsé, J., dissenting). Section 717 of the New York Business Code provides, in pertinent part:

In performing his duties, a director shall be entitled to rely on information, opinion, reports or statements including financial statements and other data, in each case prepared or presented by . . . counsel, public accountants or other persons as to matters which the director believes to be within such person's professional or expert competence. . . .

N.Y. BUS. CORP. L. § 717 (McKinney Supp. 1984) (emphasis added).

155. *Hanson Trust*, 781 F.2d at 287 (Kearsé, J., dissenting). Judge Kearsé noted that although the district court hinted that it would have defended against the takeover in a manner other than that chosen by the directors, it recognized that, under New York law, the directors were entitled to rely on their advisor's opinion when entering into the leveraged buyout agreement. *Id.* (Kearsé, J., dissenting).

156. *Id.* at 291 (Kearsé, J., dissenting). Judge Kearsé believed that the directors complied with their duties under the business judgment rule and, therefore, he would have denied Hanson Trust's motion for a preliminary injunction. *Id.* In sum, Judge Kearsé found that the district court properly applied New York's substantive law on the business judgment rule and that the district court's findings of fact were not clearly erroneous. *Id.* at 285-91 (Kearsé, J., dissenting).

157. 506 A.2d 173 (Del. 1986).

158. *Id.*

159. *Id.* MacAndrews & Forbes Holdings, Inc. is the controlling shareholder of Pantry Pride, Inc. *Id.* at 175 n.1. For all practical purposes, Pantry Pride is the defendant in the case. *Id.* at 175.

160. *Id.* at 176. The chairman of the board and chief executive officer of Pantry Pride, Ronald O. Perelman, met with his counterpart at Revlon, Michel C. Bergerac. *Id.* Bergerac rebuffed all overtures by Perelman, based perhaps, as the court suggested, on Bergerac's strong personal antipathy to Perelman. *Id.*

quate¹⁶¹ and employed a combination of defensive tactics to deter Pantry Pride.¹⁶² Revlon first repurchased five million of its thirty million shares¹⁶³ and thereafter enacted a rights plan, which enabled Revlon shareholders to exchange their shares of common stock for sixty-five dollar notes, if anyone acquired twenty percent or more of Revlon's shares.¹⁶⁴

Undaunted by Revlon's defensive maneuvers, Pantry Pride made a forty-seven dollar and fifty cent tender offer for any and all of Revlon's common shares, conditioned upon the rights plan being revoked.¹⁶⁵ Once again, the Revlon directors thought this offer inadequate and made a self-tender for an additional ten million shares.¹⁶⁶ In connection with the self-tender, the board created certain covenants to deter any potential raiders.¹⁶⁷ These covenants severely limited Revlon's

161. *Id.* Bergerac dismissed the \$40 to \$50 per share offer by Perelman as considerably below Revlon's intrinsic value. *Id.*

162. *Id.* at 176-77. The Revlon board met specifically to consider the threat from Pantry Pride. *Id.* At the meeting, Revlon's investment banker, Lazard Frères, informed the board that Pantry Pride's offer was grossly inadequate and suggested that Revlon take defensive measures to combat the threat. *Id.* at 177.

Martin Lipton, an attorney with the New York law firm of Wachtell, Lipton, Rosen & Katz, suggested that Revlon repurchase up to 5 million of its nearly 30 million outstanding shares and that the company adopt a notes purchase rights plan as defensive maneuvers. *Id.* Both of Lipton's proposals were unanimously adopted by the Revlon board. *Id.*

163. *Id.*

164. *Id.* The rights plan allowed shareholders to exchange each of their shares for a \$65 note that matured in one year with an interest rate of 12%. *Id.* The rights would trigger if anyone acquired 20% of the Revlon shares, unless a purchaser acquired all the company's stock for cash at \$65 or more per share. *Id.* The purpose of the plan was to assure that the shareholders received \$65 per share should Revlon be taken over by another corporation. *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239, 1244 (Del. Ch. 1985), *aff'd*, 506 A.2d 173 (Del. 1986).

The rights plan employed by Household International in *Moran* was different from the one employed by Revlon. Two events could trigger the rights under Household's rights plan, the announcement of a tender offer for 30% of its shares by a party or the acquisition of 20% of its shares by a party, where as only one event could trigger the rights under Revlon's rights plan. *Moran*, 500 A.2d at 1348-49. In addition, Household's rights triggered regardless of the tender offer, whereas Revlon's rights would not trigger if the tender offer exceeded \$65 per share. *Id.* For a discussion of the intricacies of Household's rights plan, see *supra* notes 93-95 and accompanying text.

165. *Revlon*, 506 A.2d at 177. Pantry Pride also offered to acquire any and all of Revlon's preferred shares at \$26.67. *Id.*

166. *Id.* The security offered by Revlon consisted of a \$47.50 note and one-tenth of a share of preferred stock with a par value of \$100.00. *Id.* Thus, the value of this combined debt and equity security was \$57.50. *Id.* Revlon only offered its self-tender for 10 million of its 30 million issued and outstanding shares. *Id.* The shareholders tendered well in excess of the 10 million shares that Revlon offered to acquire. *Id.* Revlon acquired 10 million of the shares offered on a pro rata basis. *Id.*

167. *Id.*

ability to incur additional debt, sell assets or pay dividends unless Revlon's independent directors approved such action.¹⁶⁸

In response, Pantry Pride made several additional offers¹⁶⁹ which Revlon resisted by announcing that it would enter into a leveraged buyout agreement with another corporation, Forstmann Little & Co.¹⁷⁰ The leveraged buyout agreement allowed each Revlon shareholder to receive fifty-six dollars cash per share and allowed the current Revlon directors to become twenty-five percent equity participants in the new Revlon after the leveraged buyout.¹⁷¹ The agreement also provided that Revlon would nullify the covenants and rights made in connection with the earlier Revlon offers.¹⁷² The nullification of the covenants caused the value of the notes issued in connection with the ten million shares to drop by 12.5%.¹⁷³ Because of this decrease in value, the noteholders threatened to sue the Revlon directors.¹⁷⁴

Pantry Pride decided to stay in the bidding process and raised its offer to fifty-six dollars and twenty-five cents per share.¹⁷⁵ The Revlon

168. *Id.*

169. *Id.* After Revlon's self-tender, Pantry Pride made an offer of \$42 per share conditioned upon receipt of 90% of Revlon's shares. *Id.* Pantry Pride indicated that it would consider purchasing less than 90%, at an increased price, if Revlon removed the impending rights. *Id.* After this offer was rejected, Pantry Pride made offers of \$50, \$53, and \$56.25 per share. *Id.* The offer of \$56.25 per share was subject to the nullification of the rights plan, a waiver of the notes' covenants and the election of three Pantry Pride directors to the Revlon board. *Id.* at 178. Revlon rejected all of these offers. *Id.* at 177-78.

170. *Id.* at 178. Adler & Shaykin, Inc. and American Home Products, Inc. agreed to aid Forstmann Little in financing the leveraged buyout. *Id.* If the court had approved the leveraged buyout, Adler & Shaykin would have provided almost one-half of the purchase price to Revlon by purchasing Revlon's beauty care division for \$905 million. *Id.* American Home Products would have purchased two other divisions for \$335 million. *Id.*

171. *Id.* Under the terms of the leveraged buyout agreement Revlon management would be entitled to purchase stock in the "new" Revlon by the exercise of their "golden parachutes." *Id.* The parachutes enabled the Revlon directors to receive 25% of the equity in the "new" Revlon after the leveraged buyout. *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239, 1245, 1248 (Del. Ch. 1985), *aff'd*, 506 A.2d 173 (Del. 1986).

172. *Revlon*, 506 A.2d at 178. In return for Revlon's redemption of the rights and waiver of the notes' covenants, Forstmann Little agreed to assume the \$475 million debt which Revlon had incurred as a result of its self-tender. *Id.*

173. *Id.* The notes, which originally traded near par at \$100, dropped to as low as \$87, which represented a cumulative decline of about \$60 million. *Revlon*, 501 A.2d at 1245.

174. *Revlon*, 506 A.2d at 178. The drop in the value caused some of the noteholders to threaten suit against the directors for lifting the covenants on the notes in connection with the Forstmann Little leveraged buyout agreement because the nullification of the covenants was the direct cause of the decline in value of the notes. *Id.*

175. *Id.* Pantry Pride's offer was contingent on the revocation of the covenants made in connection with Revlon's self-tender, the rescission of the rights plan, and the placement of three Pantry Pride directors on the Revlon board as independent directors. *Id.*

directors, who were concerned about the threatened suit by the note-holders as well as the threat from Pantry Pride,¹⁷⁶ persuaded Forstmann Little to support the value of the notes¹⁷⁷ and increase its offer to fifty-seven dollars and twenty-five cents cash per share in exchange for additional consideration from Revlon.¹⁷⁸ Revlon provided Forstmann Little with a lock-up option that allowed it to purchase two of Revlon's divisions if any person or group acquired forty percent of Revlon's shares¹⁷⁹ and a no-shop provision which prevented Revlon from entertaining any additional takeover bids.¹⁸⁰ This agreement effectively ended the ability of any third party to bid for Revlon.¹⁸¹ Pantry Pride, nonetheless, made a subsequent offer of fifty-eight dollars cash per share conditioned upon the covenants, lock-up option and no-shop provision being revoked.¹⁸²

The *Revlon* court began its analysis by noting that the business judgment rule, which imposes duties of loyalty and care on corporate directors, should be used to evaluate the appropriateness of a board's decisions in response to a hostile takeover attempt.¹⁸³ The court found

176. *Id.* at 182.

177. *Id.* at 178. In order to restore the value of the notes issued by Revlon, Forstmann Little offered to exchange any of the Revlon notes for new notes which it would issue with the same face value. *Id.* at 178-79. The decline in the value of the notes had caused shareholders who had tendered their shares to Revlon for the combined debt and equity securities to threaten suit against the Revlon directors. *Id.* at 178.

178. *Id.* Prior to the increase in the offer price to \$57.25 per share, representatives of Revlon, Forstmann Little and Pantry Pride met to determine whether Revlon could be divided between Forstmann Little and Pantry Pride. *Revlon*, 501 A.2d at 1245.

179. *Revlon*, 506 A.2d at 178. The "lock-up" option allowed Forstmann Little to acquire Revlon's Vision Care and National Health Laboratories divisions for \$525 million if anyone acquired 40% of Revlon's shares. *Id.* The option price was \$100 to \$175 million below the value ascribed to the divisions by Lazard Frères. *Id.*

180. *Id.* In addition, the leveraged buyout agreement provided that Forstmann Little would receive a \$25 million cancellation fee if the agreement terminated or if another acquiror obtained more than 19.9% of Revlon's stock. *Id.* Unlike the prior agreement, this agreement would not provide the Revlon directors with an equity interest in the corporation after the merger. *Id.*

181. *Revlon*, 501 A.2d at 1249.

182. *Revlon*, 506 A.2d at 179. In response to the defensive measures implemented by Revlon, Pantry Pride filed suit contesting the rights plan, the notes' covenants and the leveraged buyout. *Id.* The Delaware Chancery Court found that the Revlon directors breached their duty of loyalty by granting concessions to Forstmann Little out of concern for their liability to the noteholders. *Id.* Accordingly, the Chancery Court prohibited any further transfer of assets to Forstmann under the leveraged buyout agreement, and enjoined the lock-up, no-shop and cancellation fee provisions of the agreement. *Id.*

183. *Id.* The court stated that the fiduciary duties of care and loyalty which directors owe to the corporation and its shareholders are the "bedrock" of the law governing corporate takeovers. *Id.* The court went on to state that in order for directors to enjoy the presumption that they acted appropriately under the business judgment rule, the directors must first show that they made a good

that the adoption of the rights plan after Pantry Pride first contacted Revlon fell within the business judgment rule because it prevented Pantry Pride from acquiring Revlon at an unfair price and because its effect was to promote the bidding process between Forstmann Little and Pantry Pride.¹⁸⁴ The court also found that the self-tender was in the best interest of the corporation since it stalled Pantry Pride from acquiring Revlon at a then inadequate price.¹⁸⁵

The Delaware Supreme Court's discussion of the legitimacy of the lock-up option began with a caution that the measure was not to be evaluated according to the precepts used when evaluating other defensive measures.¹⁸⁶ Since Revlon employed the lock-up option in conjunction with the leveraged buyout agreement, the court found that the Revlon directors, necessarily, were resolved to the idea of selling the corporation.¹⁸⁷ Hence, the directors could no longer perform their role as fiduciaries of the shareholders by defending the corporation.¹⁸⁸ The court

faith and reasonable investigation of the danger to corporate policy posed by the takeover threat, and that the responsive action taken was reasonable in relation to the threat posed. *Id.* at 180 (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985)).

184. *Id.* at 180. The Delaware Supreme Court found that when faced with an offer to merge by a potential suitor, the business judgment rule requires a target's directors to make a "good faith and reasonable investigation" as to whether they should accept or oppose the offer. *Id.* (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985)). If the directors choose to oppose the offer, they may only use those defensive measures which are reasonable in light of the threat posed to the target from an acquisition by the potential suitor. *Id.* at 180-81. The court found that the Revlon board met the criteria set out in *Unocal* when it employed the rights plan. *Id.* First, the court found that the board acted on an informed basis when they decided to defend against Pantry Pride's takeover threat because the price offered was below the fair value of the shares. *Id.* at 181. The court noted that Pantry Pride was a newcomer in the takeover arena and would probably issue "junk bonds" for Revlon shares. *Id.* at 181-82. In light of this uncertainty about the quality of the securities that Pantry Pride could offer, the court found that it was reasonable for the Revlon board to implement the rights plan in order to protect their shareholders from being forced to tender their shares for "junk bonds." *Id.* Second, the court found that the rights plan did not impose any burden on the corporation which would make other bidders shy away from attempting to acquire Revlon at a higher price. *Id.* Thus, the rights plan was a reasonable defensive measure in light of the threat posed by Pantry Pride's offer. *Id.*

185. *Id.* The court also analyzed the legitimacy of Revlon's self-tender. *Id.* at 181. The court found that the Revlon board acted appropriately when it employed the self-tender after Pantry Pride extended an offer of \$47.50 per share. *Id.* The court found that the board appropriately determined that the offer was inadequate after a reasonable investigation. *Id.*

186. *Id.* at 182. The court stated that the criteria for evaluating the lock-up option were "significantly altered" because of the context in which the directors used the option. *Id.*

187. *Id.*

188. *Id.* By entering into the agreement with Forstmann Little, the Revlon directors indicated that they intended to sell the corporation. *Id.* The directors no longer intended to defend Revlon against an unfriendly acquisition and,

stated that once the directors entered into the leveraged buyout agreement, their sole duty shifted to acting as auctioneers, with a duty to obtain the highest value that they could for the shares.¹⁸⁹ The court also stated that any action taken by the directors which inhibited the bidding process would prevent the shareholders from obtaining the highest value for the shares and, therefore, would breach the directors' fiduciary duty.¹⁹⁰ Since the lock-up option allowed Forstmann Little to acquire two of Revlon's lucrative divisions, the court found that it stifled the bidding process between Forstmann Little and Pantry Pride.¹⁹¹ The use of the lock-up option, thus, was a breach of the Revlon directors' fiduciary duty to its shareholders.¹⁹²

The Revlon directors alleged that they acted appropriately by promoting the Forstmann Little agreement which contained the lock-up provision since Forstmann Little was willing to guarantee the value of the notes issued by Revlon.¹⁹³ The directors further alleged that under *Unocal*, directors were permitted to consider the interests of constituencies, such as the noteholders, as well as the shareholders.¹⁹⁴ The court rejected the directors' interpretation of *Unocal*, finding that while a

therefore, the criteria first developed in *Unocal* for evaluating defensive measures were no longer applicable. *Id.*

189. *Id.* The directors have a fiduciary duty to the corporation and its shareholders. *Id.* at 179. Since the directors were resolved to selling Revlon, the directors could satisfy their duty to the shareholders only by obtaining the highest value for the Revlon shares. *Id.* at 182.

190. *Id.* The court also discussed the utility of a lock-up option in general. *Id.* at 183. The court noted that a lock-up option is not *per se* illegal. *Id.* Such options can be used to entice bidders to enter a contest for control of a corporation and, thus, bid up the value that the shareholders will receive for their shares. *Id.* However, the use of lock-up options, as in the present case, to foreclose bidding between two corporations already engaged in a battle for control of the target, operates to the disadvantage of the target's shareholders and, consequently, is a breach of the directors' duty of loyalty. *Id.* at 183-84 (citing *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264 (2d Cir. 1986)).

191. *Id.* at 184. The court stated that the lock-up option "ended the auction" between Revlon and Pantry Pride. *Id.*

192. *Id.*

193. *Id.* at 182. The Revlon directors also alleged that they had both a contractual duty under the agreements with the noteholders and a good faith obligation to sustain the value of the notes. *Id.* The court rejected this contention, stating that no contractual provisions were violated. *Id.* In addition, the court stated that the noteholders accepted the notes with the knowledge that the value of the notes could fluctuate based upon market conditions. *Id.*

194. *Id.* In *Unocal*, the Delaware Supreme Court stated that a board could consider constituencies other than the shareholders when evaluating the threat to a corporation from an impending takeover. *Unocal*, 491 A.2d at 955. In *Revlon*, the Delaware Supreme Court reaffirmed that such interests can be considered when evaluating a hostile takeover. *Revlon*, 506 A.2d at 182. However, the court stated that such considerations are not appropriate when, as in *Revlon*, the board was resolved to selling rather than maintaining the corporate enterprise. *Id.* In this situation, the directors' sole goal must be to aid the shareholders by obtaining the highest bid for the corporation's shares. *Id.*

board can consider the interests of constituencies other than its shareholders, all actions taken by the directors must benefit the shareholders.¹⁹⁵ Although the lock-up option assured that Forstmann Little would obtain Revlon and, thus, that the noteholders would be protected, it was to the detriment of the shareholders because it prevented the bidding war between Forstmann Little and Pantry Pride from continuing.¹⁹⁶

Finally, the Delaware Supreme Court considered the legitimacy of the no-shop provision which was part of the leveraged buyout agreement with Forstmann Little.¹⁹⁷ Noting that a no-shop provision is not *per se* illegal,¹⁹⁸ the court stated that a target could provide a white knight with a no-shop provision if a hostile bidder's advances have an adverse effect on the interests of the target's shareholders.¹⁹⁹ However, in the present case, where the bidders made relatively similar offers, the court stated that it was inappropriate for the directors to inhibit the bidding process with the use of a no-shop provision.²⁰⁰

V. ANALYSIS

The introduction of new defenses to corporate takeovers has forced courts to seek new ways of evaluating the legitimacy of such defenses.²⁰¹ The Delaware Supreme Court, it is submitted, was correct when it recognized, in *Unocal Corp. v. Mesa Petroleum Co.*, the need for a dynamic corporate law by which to evaluate innovative attempts by directors to ward off unwanted takeovers.²⁰² It is submitted that the early case law governing takeovers provided too great a protection for directors who employed defensive mechanisms since, in these early decisions, a plaintiff could be successful only if he could prove that the directors' "sole or primary purpose" for a defensive maneuver was the perpetuation of

195. *Id.*

196. *Id.* The court stated forcefully that no interests other than those of the shareholders can be considered when there is an active bidding process in progress. *Id.* The directors' sole motive must be to sell to the highest bidder. *Id.*

197. *Id.* at 184. The court found it ironic that Forstmann Little insisted on a no-shop provision since Revlon was already dealing with Forstmann Little exclusively. *Id.*

198. *Id.* Although no-shop provisions are not *per se* illegal, the court stated that they were never permissible where there is active bidding for a corporation and the directors have a responsibility to act as auctioneers and obtain the highest bid. *Id.*

199. *Id.*

200. *Id.* The Delaware Supreme Court also upheld the trial court's decision to block Forstmann Little from obtaining the \$25 million cancellation fee which was part of the second leveraged buyout agreement between Forstmann Little and Revlon. *Id.*

201. For a list of the new defensive techniques and the cases which have considered their legitimacy, see *supra* note 3.

202. *Unocal*, 493 A.2d at 957. The *Unocal* court noted that corporate law must adapt to and anticipate changes in the corporate world. *Id.*

their own employment.²⁰³ Only after the plaintiff met this difficult test would the courts consider whether the directors acted in good faith and for a valid corporate purpose.²⁰⁴ It is suggested that this distribution of the burden of proof is inconsistent with the theory that directors are to act in the best interest of the shareholders.²⁰⁵ There are many actions, it is submitted, which a director might take that may not be “solely or primarily” for self-perpetuation, but which, nonetheless, are not in the best interest of the corporation and its shareholders.²⁰⁶ Such actions would escape evaluation by the courts under the “sole or primary” purpose test because the plaintiffs would not be able to meet their initial burden of proof.

Because the inherent possibility of self-perpetuation accompanies any response by corporate directors to hostile takeover attempts,²⁰⁷ it is submitted that the Delaware Supreme Court acted appropriately in *Unocal* when it put the initial burden on the directors in a takeover setting to prove that they acted in good faith,²⁰⁸ after reasonable investigation²⁰⁹

203. For a list of those jurisdictions which have adopted the “sole or primary purpose” test, see *supra* note 39. It is submitted that most of these jurisdiction will not use this test in the future because of the attractiveness of the Delaware Supreme Court’s new formulation as set forth in *Unocal*.

204. See, e.g., *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984) (plaintiff must make prima facie showing that directors had self-interest in corporate transaction before burden shifts to directors to show that transaction was fair and in best interest of corporation); *Johnson v. Trueblood*, 629 F.2d 287, 293 (3d Cir. 1980) (to survive motion for summary judgment, plaintiff must show that sole or primary purpose for directors’ actions was to retain control), *cert. denied*, 450 U.S. 999 (1981).

205. See, e.g., *Unocal*, 493 A.2d at 955 (citing *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (Del. 1939)) (directors have fiduciary duty to act in best interest of corporation’s shareholders). For a discussion of a director’s fiduciary duty, see *supra* note 35 and accompanying text.

206. For instance, directors might defend against a takeover in order to aid a friend who is a supplier or a customer. The target’s directors may also defend against a takeover because of a personal dislike for the corporation which is trying to acquire the target. Additionally, although the target directors’ sole or primary motive may not be to retain their employment, it may be an important reason for using a defensive technique. Takeovers which occurred for any of the above stated reasons would go unchecked under the “sole or primary” purpose test because the plaintiff could not meet his initial burden; namely, that self-perpetuation was the directors’ sole or primary purpose for employing the defensive tactic.

207. See, e.g., *Unocal*, 493 A.2d at 955 (citing *Cheff v. Mathes*, 41 Del. Ch. 494, 505, 199 A.2d 548, 554-55 (1964)) (in light of their inherent interest in retaining control of corporation, directors must show that they had reasonable grounds for believing that there would be danger to corporate policy if another party acquired control of corporation).

208. *Unocal*, 493 A.2d at 955. The *Unocal* court emphasized the inherent conflict of interest which a director faces when deciding whether to defend against a takeover attempt. *Id.* (quoting *Bennett v. Propp.*, 41 Del. Ch. 14, 22, 187 A.2d 405, 409 (1962)). In light of this inherent conflict, the directors have the initial burden of proving that they had reasonable grounds for believing that a danger to the policies of the corporation and the effectiveness of the corpora-

and with the interests of the corporation and its shareholders as their primary concern.²¹⁰ Additionally, under the *Unocal* formulation, the directors must show that the defensive measure employed was reasonable in relation to the threat posed by the tender offeror.²¹¹ It is only after

tion would exist if the raider owned a controlling interest in the corporation. *Id.* (citing *Cheff v. Mathes*, 41 Del. Ch. 494, 505, 199 A.2d 548, 554-55 (1964)). The court went on to state that this burden is satisfied "by showing *good faith* and reasonable investigation." *Id.* (quoting *Cheff v. Mathes*, 41 Del. Ch. 494, 506, 199 A.2d 548, 555 (1964)) (emphasis added).

The court noted that directors' ability to meet this burden is "materially enhanced" where the defensive tactic is approved by a board with a majority of independent directors who acted in good faith and after reasonable investigation. *Id.* (citing *Panther v. Marshall Field & Co.*, 646 F.2d 271, 295 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Aronson v. Lewis*, 473 A.2d 805, 812, 815 (Del. 1984); *Puma v. Marriott*, 283 A.2d 693, 695 (Del. Ch. 1971)). For a discussion of the importance of independent directors, see *infra* notes 226-40 and accompanying text.

209. *Unocal*, 493 A.2d at 955. In *Smith v. Van Gorkam*, the Delaware Supreme Court specifically addressed the requirement that directors act on an informed basis in order to invoke the protection of the business judgment rule. *Smith v. Van Gorkam*, 488 A.2d 858, 872 (Del. 1985). The court found that directors act on an informed basis if they "informed themselves 'prior to making a business decision, of all material information reasonably available to them.'" *Id.* at 872 (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)). However, it is relatively easy for directors to meet the burden of acting on an informed basis, or put another way, of reasonable investigation. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). The directors can meet this burden by showing that they did not act with gross negligence. *Moran v. Household Int'l*, 500 A.2d 1346, 1356 (Del. 1985); *Smith v. Van Gorkam*, 488 A.2d 858, 873 (Del. 1985); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). The Delaware courts have offered multiple interpretations of "gross negligence" in the context of the business judgment rule. See, e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 722 (Del. 1971) ("fraud or gross overreaching"), *rev'g*, 261 A.2d 911 (Del. Ch. 1969); *Gimbel v. Signal Cos.*, 316 A.2d 599, 615 (Del. Ch.) (acting outside of "bounds of reason and recklessly"), *aff'd*, 316 A.2d 619 (Del. 1974) (per curiam); *Warshaw v. Calhoun*, 221 A.2d 487, 492-93 (Del. 1966) ("bad faith . . . or a gross abuse of discretion"); *Mitchell v. Highland-Western Glass Co.*, 19 Del. Ch. 326, 330, 167 A. 831, 833 (1933) (acting "so far without information that [the directors] can be said to have passed an unintelligent and unadvised judgment").

210. *Unocal*, 493 A.2d at 955. The Delaware Supreme Court has held that this criteria is met if the directors can show that their sole or primary reason for taking the defensive measures was not self-perpetuation. *Id.*; *Cheff v. Mathes*, 41 Del. Ch. 494, 504, 199 A.2d 548, 554 (1964). Courts have recognized that, in fighting a tender offer, directors are necessarily promoting a self interest—their continued employment. See, e.g., *Unocal*, 493 A.2d 405, 409 (1962). Consequently, courts have stated that directors have a right to defend against a takeover so long as their primary purpose is to protect the corporation and its shareholders, and not to perpetuate their own employment. *Id.* (restriction on selective stock repurchase is that directors may not act solely or primarily out of desire to perpetuate themselves in office).

For a discussion of the "sole or primary purpose" test, see *supra* notes 37-40 and accompanying text.

For a discussion of those jurisdictions which placed the burden on the plaintiff to show that the directors' "sole or primary" purpose was self-perpetuation, see *supra* note 39 and accompanying text.

211. *Unocal*, 493 A.2d at 955. For a discussion of the new balancing ele-

the directors make this initial showing that the new standard formulated by the Delaware Supreme Court affords them the protection of the business judgment rule.²¹²

It is submitted that placing the initial burden of proof on directors is consistent with the purpose of the business judgment rule, namely, to protect directors from liability for honest mistakes in judgment when such judgments appeared reasonable at the time that they were made.²¹³ It is submitted that a directorial decision can be considered reasonable and, therefore, deserving of the protection of the business judgment rule only after the directors show that their decision was made in good faith, after reasonable investigation, and with a primary concern for the interests of the shareholders and the corporation.²¹⁴

It is further submitted that balancing the severity of the defensive measure against the threat posed by a raider is an appropriate factor to inject into the considerations under the business judgment rule.²¹⁵ However, it is suggested that this balancing factor was rendered meaningless when applied by the court in *Moran v. Household International*,

ment which the Delaware Supreme Court introduced into its evaluation of defensive mechanisms under the business judgment rule, see *supra* notes 71 & 77 and accompanying text.

212. See *Unocal*, 493 A.2d at 955; *Moran*, 500 A.2d at 1356.

213. See, e.g., *Treco, Inc. v. Land of Lincoln Sav. and Loan*, 749 F.2d 374, 377 (7th Cir. 1984) (under Illinois law, directors will not be held liable for mistake in judgment when they acted in good faith and without corrupt motive); *Cheff v. Mathes*, 41 Del. Ch. 494, 506, 199 A.2d 548, 555 (1964) (directors will not be punished for honest mistake in judgment).

214. When directors defend against a takeover, they are putting themselves in a position in which their personal interest in continued employment with the corporation could inhibit their ability to act in the best interest of the corporation. See *Hanson Trust*, 781 F.2d at 277 (directors may have financial expectations associated with defensive techniques); *Unocal*, 493 A.2d at 954-55 (discussing inherent conflict of interest in perpetuation of control). Many courts have labeled this as an inherent conflict of interest, because a director may have to choose between what is best for himself and what is best for the corporation. See, e.g., *Unocal*, 493 A.2d at 955. Because of this inherent conflict, it is submitted that directors should prove that they acted in good faith, after reasonable investigation and with the interests of the corporation's shareholders as their primary concern before they are afforded the protection of the business judgment rule.

215. *Unocal*, 493 A.2d at 955. The Delaware Supreme Court first introduced the balancing element in *Unocal*. *Id.* It is submitted that, theoretically, the balancing element is appropriate in the context of a takeover situation. It prevents a board of directors from implementing a defensive technique which has a significant effect on the structure of the corporation when there is little or no chance that the corporation would be acquired by another corporation. For instance, presumably a defensive maneuver which allows for the sale of the prize assets of the corporation would not meet the balancing criteria if there is no immediate threat of a takeover. However, such a defensive maneuver may meet the balancing criteria if a raider is attempting to take over the corporation and the court finds that it would be in the best interest of the corporation and its shareholders for the corporation to exist without its prize assets rather than to be taken over by the raider.

*Inc.*²¹⁶ The Delaware Supreme Court, in *Unocal*, enunciated several factors for a court to consider in determining the threat posed.²¹⁷ All of these factors related to the threat of an imminent takeover by one particular raider.²¹⁸ In *Moran*, there was no imminent threat of a takeover.²¹⁹ The *Moran* court found, however, that the frequency of takeover attempts within the financial service industry provided a sufficient threat to justify the rights plan adopted by the corporation's directors.²²⁰ It is submitted that by so doing, the Delaware Supreme court diluted the balancing factor which had been central to its decision in *Unocal*.²²¹ Given

216. *Moran*, 500 A.2d 1346. For a discussion of the balancing test applied in *Moran*, see *supra* notes 118-20 and accompanying text.

217. *Unocal*, 493 A.2d at 955. The *Unocal* court suggested that the court consider: "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities offered in the exchange." *Id.* (citing Lipton and Brownstein, *Takeover Responses and Directors' Responsibilities: An Update*, A.B.A. National Institute on the Dynamics of Corporate Control, December 8, 1983, at 7).

218. *See id.* at 955. Although the Delaware Supreme Court, in *Unocal*, did not limit the constituencies that could be considered to those which it listed, it is submitted that all of the factors which the court suggests have the common thread of relating to a specific raider which is attempting to acquire the target. *See id.*

219. *Moran*, 500 A.2d at 1349. The rights plan implemented by the Household board was strictly a preventive mechanism. *Id.* The plaintiff, a member of the Household board, discussed a possible leveraged buyout with Household. *Id.* However, it is uncontradicted that these talks did not progress beyond the discussion stage. *Id.* For a discussion of the facts of *Moran*, see *supra* notes 90-95 and accompanying text.

220. *Moran*, 500 A.2d at 1356-57.

221. It may, however, be that rather than nullifying the balancing test, the *Moran* decision carried the test to its logical end. The balancing criterion weighs the severity of the defensive maneuver against the probability of a takeover of the target. *Unocal*, 493 A.2d at 955. Therefore, assuming that there is not a significant threat of a takeover, it is more likely that a defensive maneuver which has a minimal, as opposed to a dramatic, effect on the corporation will survive the balancing test. The rights plan does not have the adverse effects on the target corporation which other defensive maneuvers have. *Moran*, 500 A.2d at 1354. For instance, the rights plan does not require the target to pay out a large sum of cash as "greenmail." *Id.* The rights plan also does not impair the financial structure of the target as does a "discretionary self-tender." *Id.* Thus, one could argue that the *Moran* court did not disregard the balancing test, but rather carried it to its logical end by finding that a defensive technique, such as the rights plan, which has a minimal effect on the corporation, is acceptable when there is not a great threat of a takeover.

Unfortunately, the *Moran* court spent little time discussing its rationale for finding that the rights plan was reasonable in relation to the threat posed. *Id.* at 1356-57. The court simply stated that the increased frequency of takeovers in the financial services industry and the concern about shareholders not receiving adequate consideration for their shares justified the rights plan. *Id.* at 1357. Thus, it is not known whether the court was carrying the balancing element to its logical end.

It is further submitted that the effect of *Moran* on the balancing element may

the prevalence of takeovers in almost every industry today,²²² it is submitted that the approach of the Delaware Supreme Court in *Moran* would allow almost every corporation which implements a defensive mechanism to satisfy the balancing element regardless of whether the corporation was, in fact, presently the target of a takeover attempt.²²³ Thus, while a corporation in a takeover-intense industry itself may not be a desirable target for a takeover,²²⁴ the *Moran* holding suggests that it can implement a defensive mechanism simply because takeovers occur frequently in the industry in which it operates. Such an approach, it is submitted, negates the Delaware Supreme Court's original emphasis on consideration of the imminency of the threat posed and enables a corporation to take steps which render it essentially "target-proof" even though this might not be best for the corporation or its shareholders.²²⁵

In addition to altering the burden of proof under the business judgment rule when used to evaluate defensive techniques employed by target directors, it is submitted that the Delaware Supreme Court correctly placed a greater emphasis on the actions of independent directors.²²⁶ The Second Circuit, while disagreeing as to the burden of proof alloca-

not be as great as anticipated because the court states that when the directors are faced with a tender offer, they must evaluate the merits of the tender offer and determine whether it is in the best interest of the corporation. *Id.* at 1354. If the board finds that the tender offer is in the best interest of the corporation, the directors must revoke the rights plan and allow the tender offer to proceed. *Id.* Failure to do so would constitute a breach of the directors' duty of care. *Id.*

222. For a discussion of the dramatic increase in the number of takeovers within all industries, see *supra* notes 1 & 2 and accompanying text.

223. In *Moran*, the court stated that the defensive technique was reasonable in relation to the threat posed because of the increased frequency of takeovers in the financial services industry. *Moran*, 500 A.2d at 1357. There has been an increased frequency of takeovers in almost every industry today. *1985 Profile, MERGERS & ACQUISITIONS*, May-June 1986, at 46-50. Thus, it is submitted that corporations in almost any industry could implement a defensive maneuver and satisfy the balancing criterion.

224. It is suggested that there are a number of reasons why a corporation would not be a desirable target for a takeover. For instance, a corporation may have little capital, a bad workforce, or outdated equipment.

225. Takeovers, it is submitted, often benefit a corporation and its shareholders. For instance, shareholders benefit from the dramatic increase in the price of the target's stock which accompanies an impending takeover. See, e.g., Asquith, *supra* note 14, at 81 (price of target's stock increases dramatically after takeover bid is announced). In addition, a corporation may increase its productivity by merging with a supplier or customer or by merging with a corporation that has excellent management. See, e.g., S. OPPENHEIM, G. WESTON & J. MCCARTHY, *supra* note 1, at 417 (merger with supplier or customer assures uninterrupted access to raw material or market outlets); E. KINTNER, *supra* note 2, at 18-19 (highly trained, experienced managers can develop sound corporate programs which will increase profitability).

226. See *Moran*, 500 A.2d at 1356 (directors' ability to meet their initial burden of proof is "materially enhanced" where majority of board which approved defensive maneuver comprised independent directors who acted in good faith and after reasonable investigation); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 959-65 (Del. 1985) (same).

tion in takeover cases,²²⁷ joined the Delaware Supreme Court in this increased emphasis on the actions of independent directors.²²⁸ It is submitted that both courts would be reluctant to find that a defensive technique was not in the best interest of the target and its shareholders if the independent directors concurred in good faith with the implementation of the defensive technique after making a reasonable investigation. Since these independent directors are relatively free from the conflict of interest under which managerial directors labor in the takeover context,²²⁹ it is submitted that their decision should necessarily be accorded a greater presumption of validity.

The major concern which courts have when evaluating a defensive maneuver employed by a target's directors is the possibility that the directors have used the defensive maneuver solely to assure their continued employment.²³⁰ It is submitted that this concern is more warranted with managerial directors than it is with independent directors. Unlike independent directors, managerial directors usually depend upon their position with the target as a primary source of income.²³¹ A successful takeover by a tender offeror necessarily would have a significant economic toll on managerial directors who probably would lose their jobs.²³²

Furthermore, managerial directors are intimately involved in the

227. *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 273 (2d Cir. 1986) (under New York law, directors enjoy presumption of propriety). For a discussion of the Second Circuit's recognition that different burdens of proof are placed on directors under the business judgment rule in Delaware and New York, see *supra* note 131 and accompanying text.

228. *Hanson Trust*, 781 F.2d at 277. The Second Circuit found that independent directors have an important duty to protect shareholders in a takeover battle when the managerial directors are financially involved in the tender offer. *Id.* In *Hanson Trust*, the managerial directors had a 15% equity interest in the leveraged buyout which was used to fend off an unwelcome tender offer. *Id.* The Second Circuit emphasized that when managerial directors have an interest in the defensive mechanism employed, independent directors must carefully review the defensive mechanism suggested by managerial directors to assure that it is in the best interest of the shareholders. *Id.*

229. For a discussion of the difference between managerial and independent directors in a takeover context, see *infra* notes 230-37.

230. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173, 180 (Del. 1986) (citing *Unocal Corp. v. Mesa Petroleum, Inc.*, 493 A.2d 946, 954-55 (Del. 1985) (when board employs defensive maneuver, there arises "the omnipresent specter that a board may be acting primarily in its own interest, rather than those of the corporation and its shareholders"). For a discussion of the directors' potential conflict of interest when employing a defensive tactic, see *supra* note 38 and accompanying text.

231. Managerial directors generally are the most highly paid individuals in a corporation. C. PECK, *TOP EXECUTIVE COMPENSATION: 1987 Edition* 6-7. Empirical evidence shows that executives' income increases proportionately with an increase in sales by the corporation. *Id.* at 7 Exhibit 1.

232. For a discussion of the impact on managerial directors resulting from a takeover, see *supra* notes 230-35 and accompanying text.

daily operations of the corporation.²³³ Very often, these directors have actively participated in the growth of the corporation and have set goals which they wish the corporation to achieve.²³⁴ In light of the efforts they have expended, these directors will be naturally reluctant to turn over control of the corporation. Thus, it is submitted that, because of managerial directors' active participation in the corporation and their potential loss of employment, the courts are correct in strictly scrutinizing the ability of managerial directors to evaluate objectively the value of a tender offer to their corporation and its shareholders.²³⁵

Independent directors, on the other hand, are removed from the daily operations of the corporation and do not rely on their positions on the board as sources of income.²³⁶ Accordingly, it is submitted that independent directors are better able to safeguard the interests of shareholders by objectively evaluating the merits of a tender offer.²³⁷

233. Werner, *Corporation Law in Search of its Future*, 81 COLUM. L. REV. 1611, 1654 (1981) (noting that inside directors are truly the managers of corporations, and that independent directors are not able to manage as they spend only a small part of their time on corporate business).

234. *Id.*

235. Because of the possibility that managerial directors implement defensive measures for their own benefit, the Delaware Supreme Court puts the initial burden of proof in a takeover situation on the directors. *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985) (directors must show that they acted in good faith and after reasonable investigation before they may invoke protection of business judgment rule); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (same). Judge Oakes, in his concurring opinion in *Hanson Trust*, further argued that when directors of a corporation are involved in a management-participation leveraged buyout that involves a lock-up option, such arrangements warrant strict scrutiny. *Hanson Trust*, 781 F.2d at 284 (Oakes, J., concurring). Judge Oakes suggested that a court must determine whether the gain to the shareholders from the lock-up option outweighs the loss to the shareholders from the cessation of the bidding process for the corporation which often results from a lock-up option. *Id.* The only time when a court has found a lock-up option to benefit the shareholders is when it advances the bidding process by inducing a prospective bidder to compete for control of the target. Thomas v. Enstar Corp., Nos. 7641, 7643 (Del. Ch. Aug. 16, 1984), reprinted in 9 DEL. J. CORP. L. 822 (1984).

236. *See* Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. vol. 3, 83, 99 n.52 (salary is secondary consideration for independent director when deciding whether to accept position on board). In proportion to their annual income, the salary independent directors receive for sitting on a board is minimal. *Id.* at 93 n.52. For instance, in 1981 the average salary an independent director received for sitting on a board was approximately \$21,000. J. BACON, CORPORATE DIRECTORSHIP PRACTICES: COMPENSATION, THE CONFERENCE BOARD REPT. NO. 815, at 1 (1981). For the same period, the average annual cash income of newly-named directors was \$280,000, over ten times the compensation of an independent director. HEIDRICK & STRUGGLES, DIRECTOR DATA 8 (1982).

237. Commentators have suggested a "monitoring model" for corporate governance. *See* Eisenberg, *Legal Models of Management Structures in the Modern Corporation: Officers, Directors, and Accountants*, 63 CAL. L. REV. 375, 403-16 (1975) (leading proponent of this theory suggests that board comprised of all or a majority of independent directors should monitor actions of chief executive officer

Although the Delaware Supreme Court and the Second Circuit agree on the importance of decisions by independent directors, they differ on the interaction of such decisions with the business judgment rule. The Delaware Supreme Court stated that a good faith decision by independent directors to employ a defensive maneuver after reasonable investigation materially enhances the board's ability to meet its initial burden of proof.²³⁸ The Second Circuit found that the initial burden of proof continues to be on the plaintiff under New York law.²³⁹ However, the Second Circuit, it is suggested, relies heavily upon the independent directors to protect the interests of shareholders when managerial directors are involved financially in the defensive technique.²⁴⁰

and other management). Under this model, independent directors would restrict managerial power and would assure that it is exercised in the best interest of the shareholders. *Id.* at 404. The "monitoring model" has been heavily criticized because of its failure to recognize the intraworkings of modern boards. For instance, independent directors are often selected by the chief executive officer. Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1, 21 (1981). In addition, independent directors are often friends and social acquaintances of the chief executive or from the upper echelons of companies and professional firms patronized by or otherwise economically concerned with the corporation. These social and professional connections may overlap; regionally or nationally, the elites who do business together also work for the same community and charitable organizations, belong to the same social clubs, and even relax at the same camps.

Solomon, *Restructuring the Corporate Board of Directors: Fond Hope—Faint Promise?*, 76 MICH. L. REV. 581, 584-85 (1978); see also Cox & Munsinger, *supra* note 236, at 91 (independent directors generally have compatible personalities with management and accept the corporation's goals and methods of operation). In light of the close unity between the management and the independent directors, it is natural for independent directors to be deferential to management decisions, rather than to scrutinize the decisions. Cox & Munsinger, *supra* note 236, at 91; see also Solomon, *supra*, at 77 (independent directors are "sympathetic listeners rather than determined inquisitors").

238. *Moran*, 500 A.2d at 1356; *Unocal*, 493 A.2d at 954.

239. See *Hanson Trust*, 781 F.2d at 273 ("under New York law, the initial burden of proving directors' breach of fiduciary duty rests with the plaintiff").

240. *Id.* at 277. In *Hanson Trust* SCM's board delegated broad authority to the managing directors to structure a leveraged buyout with Merrill Lynch. *Id.* The Second Circuit recognized that such delegation was common. *Id.* However, the normal *post hoc* review by the board of the managing directors proposal is not sufficient where, as here, the managing directors have an interest in the proposed leveraged buyout. *Id.* The court found that because the managing directors had a 15% equity interest in the leveraged buyout, the independent directors should have taken some steps to indicate that they exercised due care. *Id.* (citing *Treadway Cos., v. Care Corp.*, 638 F.2d 357, 384 (2d Cir. 1980)).

The Second Circuit added that, in *Treadway*, it had suggested some actions which, if taken by the independent directors, would indicate that they acted with due care. See *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 384 (2d Cir. 1980). The directors could employ an investment banking firm to evaluate the leveraged buyout agreement and issue a "fairness" opinion, indicating that the agreement is fair to the target and its shareholders. *Id.* It is common for independent directors to take such action when managing directors are involved in the leveraged buyout. Daitz, Kaufman, Ley & Messineo, *Leveraged Buy-Outs, ACQUISITIONS*

Although it is suggested that the Delaware Supreme Court justifiably emphasized the importance of independent directors, it is further suggested that the same court, in *Moran*, disregarded a literal interpretation of the Delaware Corporate code. Section 157 of the Corporate Code provides that a corporation can issue rights "entitling holders to purchase from the corporation of any shares of its capital stock."²⁴¹ The rights plan in *Moran* provided the shareholders of Household International with a "right" which allowed them to purchase shares in any corporation which might take over Household International at one-half of the market value of the tender offeror's shares.²⁴² In effect, the court gave the directors of one corporation, Household, the power to shape the financial structure of another corporation, the potential tender offeror.²⁴³ It is suggested that this violates the clear import of the statute which only allows a corporation to issue rights to purchase "its [own] shares."²⁴⁴ The Delaware Supreme Court did not address this argument,²⁴⁵ preferring to analogize the rights plan to an "anti-dilution" clause which it had found to be legitimate in the past.²⁴⁶ While the

AND MERGERS 1985, 143, 160. Directors could also obtain information on the effect of the proposed action. *Treadway*, 638 F.2d at 384. Directors should become fully informed on the nature of the proposed action and should spend sufficient time deliberating so as to be sure that the action taken is fair to the corporation and its shareholders. *Id.*

In *Hanson Trust*, the Second Circuit found that the directors retained a law firm, Wachtell, Lipton, Rosen & Katz, to advise them as to the merits of the leveraged buyout. The directors, however, did not obtain sufficient information to evaluate the leveraged buyout, nor did they adequately consider the information which they did obtain. *Hanson Trust*, 781 F.2d at 277. Thus, the court found that the board did not exercise due care. *Id.*

241. DEL. CODE ANN., tit. 8, § 157 (1983) (emphasis added). For the text of § 157, see *supra* note 98.

242. *Moran*, 500 A.2d at 1349. For a discussion of the rights plan, see *supra* notes 91-95 and accompanying text.

243. By allowing a target corporation to employ a rights plan, it is submitted that the *Moran* court is allowing the target to control the financial composition of the raider after a successful takeover. If the target's shareholders are able to acquire shares of the raider at a reduced rate, then the raider will not receive an influx of capital which is commensurate with the number of shares that it sells to the target's shareholders. Thus, the raider will not have as much working capital as it would have had if the target's shareholders acquired shares at the fair market value. In addition, the original shareholders of the raider will have to share the amount of money allocated to dividends with the new shareholders who did not make a similar investment in the corporation.

244. DEL. CODE ANN. tit. 8, § 157. For the text of § 157, see *supra* note 98.

245. 500 A.2d at 1353. For a discussion of the court's failure to consider this argument, see *supra* notes 243-45 and accompanying text.

246. *Id.* An anti-destruction or anti-dilution provision is designed to preserve the value of a conversion privilege against diminution by directorial actions. *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 943 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981). A conversion privilege allows the holder of a corporate security to exchange his security for another security of the same corporation. *Id.* at 942. Generally, a holder converts debentures into shares of stock. *Id.* Thus, should corporation *A* merge into corporation *B*, and the merger agree-

court cited three cases to support this contention,²⁴⁷ none of these cases considered whether an "anti-dilution" clause is lawful under section 157.²⁴⁸ Consequently, no court has evaluated the legitimacy of a rights plan or an "anti-dilution" clause under section 157.

Finally, it is submitted that a lock-up option²⁴⁹ will not be adopted

ment provide for corporation *B* to give the shareholders of corporation *A* shares of stock in corporation *B* in exchange for their shares in corporation *A*, the right of conversion under an anti-dilution provision will survive a merger. *See, e.g., id.* at 943; *Wood v. Coastal States Gas Corp.*, 401 A.2d 932, 939 (Del. 1979). Consequently, a debenture holder in corporation *A* can exchange his debentures for shares in corporation *A* and then receive shares in corporation *B* as provided for in the merger agreement.

It is submitted that an anti-dilution provision is not analogous to a rights plan and that a rights plan imposes a much greater burden on the acquiring corporation in a takeover than does the anti-dilution provision on the surviving corporation in a merger. An anti-dilution provision allows the holder of a security, at the time of merger, to exercise a pre-existing right. That is, the provision allows the holder to exchange his securities for another type of security in the same corporation and receive the benefits afforded to the second type of security in the merger. A rights plan, it is suggested, rather than preserving a pre-existing right, creates a new right. The plan allows the shareholders of the target to purchase shares in the tender offeror at a reduced rate, not simply exchange one type of the target's securities for another type. Thus, it is submitted that the rights plan is not analogous to an anti-dilution provision.

Further, it is submitted that the rights plan should not enjoy the same protection as anti-dilution provisions because it allows the directors of one corporation unilaterally to provide its shareholders rights in another corporation. Anti-dilution provisions simply allow security holders in the target to exercise their preexisting right to exchange their securities for another type of security issued by the target. Then, upon the joint agreement of both corporations involved in the merger, people holding the latter type of security can exchange their securities for securities in the acquiring corporation.

247. 500 A.2d at 1352 (citing *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 946 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981); *Wood v. Coastal States Gas Corp.*, 401 A.2d 932, 937-39 (Del. 1979); *B.S.F. Co. v. Philadelphia Nat'l Bank*, 204 A.2d 746, 750-51 (Del. 1964)).

248. *See Board v. Rockwell Int'l Corp.*, 642 F.2d 929 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981); *Wood v. Coastal States Gas Corp.*, 401 A.2d 932 (Del. 1979); *B.S.F. Co. v. Philadelphia Nat'l Bank*, 204 A.2d 746 (1969).

The plaintiffs contended that § 157 of the Corporate Code does not permit the issuance of rights to purchase the shares of a corporation other than the one that issued the right. The court avoided this argument by analogizing the rights plan to an anti-dilution provision. It is submitted that this does not answer the plaintiff's contention that the rights plan is invalid under § 157 because none of the cases cited determined whether an anti-dilution provision is legitimate under § 157.

Consequently, the Delaware Supreme Court has never explicitly determined whether a rights plan or anti-dilution provision is inconsistent with a literal reading of § 157. For a criticism of the view that the rights plan is analogous to an anti-dilution provision, see *supra* note 246 and accompanying text. For the text of § 157, see *supra* note 98.

249. There are generally three types of lock-up options. First, a target may grant a white knight the option to purchase valuable assets of the target if the target is taken over by another party or a target simply may sell valuable assets to a white knight. *See, e.g., Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781

by directors in the future because of its limited utility.²⁵⁰ Directors often use a lock-up option as a means of enticing a corporation or "white knight" to acquire a target so that the target can avoid being taken over by an undesirable suitor.²⁵¹ The use of the lock-up option

F.2d 264, 270 (2d Cir. 1986) (SCM defended against acquisition by Hanson Trust by offering Merrill Lynch lock-up option on two lucrative divisions); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* 506 A.2d 173, 178 (Del. 1986) (one of defensive maneuvers employed by Revlon to avoid acquisition by Pantry Pride was to give Forstmann Little lock-up option on two of its profitable divisions). Second, a target may issue treasury shares to a white knight to help block a hostile tender offer. *Nelson, Mobil Corp. v. Marathon Oil Co.—The Decision and Its Implications for Future Tender Offers*, 7 CORP. L. REV. 233, 265 (1984). Third, a white knight may obtain a lock-up voting agreement under which it will receive the voting rights of a large block of shares. *Id.* at 267. Such an arrangement will prevent a hostile tender offeror from acquiring the target because the hostile tender offeror will not be able to obtain a controlling interest in the target without obtaining the shares over which the white knight has the voting rights. *Id.*

250. The Delaware Court of Chancery approved the use of a lock-up provision as a defensive tactic in *Thompson v. Enstar Corp.*, Nos. 7641, 7643 (Del. Ch. Aug. 16, 1984), reprinted in 9 DEL. J. CORP. L. 822 (1984). In *Enstar*, a shareholder was attempting to wage a proxy fight at an upcoming shareholder meeting, seeking to elect his slate of directors. *Id.*, slip op. at 2. In response to a perception that the shareholder would win the proxy fight, the directors attempted to sell the assets of the corporation before the meeting. *Id.* The court found that the entire board agreed that it was in the best interest of the corporation for the directors to sell the assets. *Id.* The court found that there was only one bidder for the assets of the corporation and that the bidder would not follow through with the acquisition unless the corporation would enter into a lock-up provision which gave it voting control of the target. *Id.*, slip op. at 8. The court then found that the lock-up provision was appropriate under the business judgment rule since it promoted the bidding process by assuring that the only bidder continued its pursuit to acquire the target. *Id.* Only in this very limited situation, where the lock-up provision promotes the bidding process, will courts approve use of a lock-up provision. *Id.* See also *Hanson Trust*, 781 F.2d at 281 (directors actions must redound for benefit of corporation and its shareholders); *Revlon*, 506 A.2d at 183 (lock-up options which draw bidders into takeover battle benefit shareholders and, therefore, are valid).

251. Courts have stated that a lock-up option withstands analysis under the business judgment rule only if it encourages or stimulates the bidding process. *Revlon*, 501 A.2d at 1250. It is submitted that the only time when a lock-up option can encourage the bidding process is if there is only one bidder. If there is more than one bidder and the target gives a lock-up option to one of the bidders, the other bidders will probably become discouraged and not continue to bid up the value of the target's shares in light of the valuable assets which the one bidder will receive under the lock-up option if one of the other bidders successfully acquires the target. See *Hanson Trust*, 781 F.2d at 281 (lock-up option is suspected to foreclose bidding).

If there are multiple bidders and the option is made at a fair price, one commentator suggests that bidders should not be deterred from continuing to bid because if they acquire the target, they will receive adequate compensation for the assets that are sold. *Nelson*, *supra* note 246, at 267. It is submitted that this argument fails because normally the assets involved in the lock-up option are very lucrative. Thus, it is submitted that the other bidders inevitably will find that the option price is not fair. In addition, it is submitted that this commentator ignores the fact that takeovers are often sought to acquire specific assets and

often will stifle the bidding process between the undesirable suitor and the white knight because the undesirable suitor will find the target less attractive after the white knight has an option to purchase valuable assets of the tender offeror. If directors are resolved to selling the target, the business judgment rule imposes a duty upon the directors to take steps directed only at obtaining the maximum value for the shareholders' stock.²⁵² As the implementation of a lock-up option will often discourage a potential bidder, namely the undesirable suitor, from increasing its bid, the shareholders will not receive the maximum value possible for their shares.²⁵³ Accordingly, a lock-up option often creates a result contrary to that which the directors have a duty to seek. It is, therefore, submitted that it will not be employed widely in the future.

VI. CONCLUSION

Consistently more ingenious defensive measures are being adopted by directors attempting to combat the continued threat of takeovers.²⁵⁴ The recent proclamations from the Delaware Supreme Court indicate that the rights plan in *Moran* and the discretionary self-tender in *Unocal* are two types of defense mechanisms which have survived scrutiny under the business judgment rule and will be employed in the future.²⁵⁵ However, the rights plan seems more attractive because it does not impose an enormous debt on the target, as does the self-tender, if the defensive mechanism is triggered.²⁵⁶ Thus, it is submitted that the rights

the capital which the target obtains from the sale of those assets may not be as attractive as the assets themselves.

252. *Hanson Trust*, 781 F.2d at 281 (lock-up option may not deter bidding); *Revlon*, 506 A.2d at 182 (obtaining highest price for stock should be "central theme" guiding director action).

253. See, e.g., *Hanson Trust*, 781 F.2d at 281 (lock-up option ended bidding); *Revlon*, 506 A.2d at 183 (lock-up option had destructive effect on auction process). In *Hanson Trust*, the directors of SCM implemented the lock-up option in order to discourage Hanson Trust from attempting to acquire SCM. *Hanson Trust*, 781 F.2d at 270. In *Revlon*, the directors of Revlon gave Forstmann Little a lock-up option in order to discourage Pantry Pride from attempting to acquire Revlon. *Revlon*, 506 A.2d at 178.

254. For a discussion of the types of defenses which corporations have employed, see *supra* note 3.

255. *Moran*, 500 A.2d at 1357 (Delaware Supreme Court approved rights plan); *Unocal*, 493 A.2d at 957 (Delaware Supreme Court approved discretionary self-tender).

256. A discretionary self-tender requires the target to incur enormous debt when it exchanges debt securities for the shares of stock owned by its shareholders. *Unocal*, 493 A.2d at 950. For instance, in *Unocal*, the target incurred \$6.1 to \$6.5 billion in additional debt as a result of the self-tender. *Id.* The rights plan, on the other hand, gives rights to the target's shareholders if there is a takeover. *Moran*, 500 A.2d at 1349. Such a plan does not alter the financial structure of the target by requiring it to incur large debts. *Id.* at 1354. Consequently, it is submitted that corporations will find it to be a very attractive means of guarding against a takeover. This is especially true if other jurisdictions follow the Delaware Supreme Court's finding in *Moran* that rights plans can be implemented

plan is destined to be the safe harbor for targets in the current storm of tender offers.²⁵⁷

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even though there are not corporations which are currently attempting to acquire the target. *Id.* at 1350, 1357.

257. As a result of the Delaware Supreme Court's approval of the rights plan in *Moran*, several corporations in the last quarter of 1985 and the first quarter of 1986 have implemented a similar poison pill defense. *New Guise for Poison Pill*, *MERGERS & ACQUISITIONS*, July-August 1986, at 21 (noting that several corporations installed poison pills after *Moran* decision came out on November 19, 1985, including Burroughs Corp. (now "Unisys" after acquiring Sperry), Pillsbury Co. and Ryder Systems); *Proliferation of Poison Pills*, *MERGERS & ACQUISITIONS*, March-April 1986, at 23 (noting increase in poison pills in the last quarter of 1985 resulting from the *Moran* decisions).

