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A Primer on the Basics of Directors' Duties in Delaware: The Rules of the Game (Part II)

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A PRIMER ON THE BASICS OF DIRECTORS' DUTIES IN DELAWARE: THE RULES OF THE GAME (PART II)

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I. INTRODUCTION

ONE must know the rules of any game to play it. Winning, however, requires preparation, skill, luck and an understanding of the fundamentals of the game. This Article focuses on the fundamentals. Part I of this Article appeared in an earlier issue of the *Villanova Law Review* and covered the fundamentals that underlie directors' decisions and shareholder challenges for day-to-day board decisions.[1] Understanding Part II of this Article requires that the reader explore and comprehend Part I.

Typically, corporate litigation begins when a shareholder challenges a board's decision. The challenging shareholder may bring suit to prevent the corporation from taking action, to require the corporation to take action or to seek damages arising out of actions taken or decisions made by the board.[2] These cases require the court to review the challenged board decisions. In reviewing those decisions, the court must decide upon and apply the appropriate level of scrutiny. The level of scrutiny is frequently referred to as "the standard of review." The court must also decide which party—

1. *See generally* Craig W. Palm & Mark A. Kearney, *A Primer on the Basics of Directors' Duties in Delaware: The Rules of the Game*, 40 VILL. L. REV. 1297 (1995) ("Part I").

2. *See* Heineman v. Datapoint Corp., 611 A.2d 950, 952 (Del. 1992) (holding derivative suit is equitable remedy where shareholder asserts claim on behalf of corporation); *see also* Palm & Kearney, *supra* note 1, at 1330-49 (discussing derivative challenges to board action).

the challenging shareholder or the board—will have the burden of proof with respect to issues involved in the case. Part I discussed the deferential rule usually applied to day-to-day decisions of the board—the "business judgment rule."[3] Part II addresses the enhanced scrutiny standard of review that courts apply to transactions involving actual or potential conflicts of interest on the part of the directors or a controlling shareholder.

Delaware courts have played a preeminent role in defining fiduciary duties because of the significant number of major corporations incorporated in Delaware. In recent years, increased shareholder scrutiny of board decisions has resulted in many cases brought by shareholders challenging board decisions. In turn, the Delaware courts have recently decided a number of cases that discuss and clarify the duties of Delaware directors when they seek to adopt defensive measures, when there is a sale of the company or a change in control and when the board seeks to manipulate shareholder voting rights.[4]

This Part intends to serve as a primer for those seeking an understanding of the standards used by courts applying Delaware law when reviewing directors' responses to shareholder challenges. In Part I, we outlined the rules applicable in the majority of cases in which shareholders challenge a board's decision involving basic operational matters.[5] In such situations, Delaware courts presume that the board's decision was proper and in the best interests of the corporation, unless the shareholder can show a breach of the board's fiduciary duties of care, loyalty or good faith.[6] If the shareholder rebuts the court's presumption of propriety, known as the "business judgment rule," then the court will apply a stricter stan-

3. *See* Palm & Kearney, *supra* note 1, at 1300-20 (explaining what business judgment rule is, when it is applied and why presumptions attach).

4. *See generally* Revlon, Inc. v. MacAndrews & Forbes Holding Co., 506 A.2d 173 (Del. 1986) (defining standard to review board's conduct where corporation is up for sale or there is change in control situation); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (defining standard to review board's adoption of defensive measures); Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988) (defining standard to review board's manipulation of shareholder voting rights).

5. *See generally* Palm & Kearney, *supra* note 1 (discussing basic rules of directors' duties in Delaware).

6. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) [hereinafter *Cede II*] (stating business judgment rule presumes corporate directors acted with due care, good faith and loyalty).

dard of review and will require the board to show that its decisions were "entirely fair" to the shareholders.[7]

This Part reviews the directors' obligations under heightened standards of review applied by courts when shareholders challenge directors' decisions that involve defensive measures, the sale or change of control of the company or shareholder voting rights. Section II provides a historical background of the enhanced scrutiny standard that courts apply in the takeover context.[8] Section III addresses the context in which directors unilaterally adopt defensive measures in response to a threat to corporate control.[9] Section IV explains the duties of a corporation's directors when the corporation is offered for sale or is subject to a change in control.[10] Section V discusses the court's strict standard of review of directors' actions perceived to impede or frustrate the shareholders' voting franchise.[11] Section VI explains the impact that approval or ratification by disinterested directors or shareholders can have on a breach of fiduciary duty suit challenging the board's business decisions.[12] Section VII concludes by discussing the complexities of the law and recognizing the necessity of compartmentalizing this Article to provide a better understanding of corporate law for the student and practitioner. Appendix A is a decision tree that depicts the application of the primary rules discussed in Parts I and II of this Article.[13]

It is important to recognize that the differing standards of review and the shifting burdens and presumptions discussed in this Article necessarily result in each party structuring arguments to try to persuade the courts to apply the standard of review most favorable to that party. The authors intend the rules set out in this Article to serve as a teaching tool and an outline for the business law practitioner and student in reviewing the propriety of directors'

7. *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995) (holding, where plaintiff rebuts business judgment rule, directors must prove entire fairness).

8. For a discussion of the historical background surrounding the creation of enhanced scrutiny, see *infra* notes 14-43 and accompanying text.

9. For a discussion of the enhanced *Unocal* standard, see *infra* notes 44-94 and accompanying text.

10. For a discussion of the enhanced *Revlon* standard, see *infra* notes 95-149 and accompanying text.

11. For a discussion of the enhanced *Blasius* standard, see *infra* notes 150-87 and accompanying text.

12. For a discussion of ratification in the nonmerger context, see *infra* notes 188-282 and accompanying text.

13. For a discussion of the conclusion of this Article, see *infra* notes 283-85 and accompanying text.

actions when the directors face an inherent conflict between their position and the best interests of the corporation and its shareholders. This Article does not, and could not, advise the reader of every nuance in each area. Rather, as in all disciplines, the authors hope that the reader will master the basic rules and then, when faced with these issues, will become the author of a new creative challenge or defense when shareholders challenge a board's decision.

II. HISTORICAL CONTEXT OF TRANSACTIONS REQUIRING ENHANCED JUDICIAL REVIEW

As discussed in great detail in Part I, directors of a Delaware corporation may generally rely upon the business judgment rule to protect day-to-day business decisions.[14] As both an evidentiary and substantive rule, the rule attaches the presumption that, in making business decisions, the board acted on an informed basis, in good faith and in the honest belief that its decision was in the best interests of the corporation.[15] A court, therefore, will not substitute its judgment for that of a board.[16] The protections of the business judgment rule also attach to a board's decision not to act.[17] A shareholder can rebut the presumptions of the business judgment rule by proving, by a preponderance of the evidence, that the directors breached one of the fiduciary duties of loyalty, care and good faith.[18] Upon rebutting the business judgment rule, the burden

14. *See* Palm & Kearney, *supra* note 1 (detailing business judgment rule, entire fairness and shifting standards of review and burdens of proof); *see also* Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1372 (Del. 1995) (stating that business judgment rule will be applied if there is no defensive measure employed); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (noting that board has obligation to determine whether hostile offer is in best interest of shareholders and "its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment").

15. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (pointing out that courts presume that directors normally act in good faith and with honest belief that action was taken in best interest of corporation).

16. *See id.* (noting effect of directors' breach of fiduciary duty on applicability of business judgment rule); *see also Unocal*, 493 A.2d at 958 (stating that court would not substitute its judgment for judgment of board unless decisions were made with purpose of staying in office or as result of some other breach of fiduciary duty). *But see* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (applying court's own judgment when parent company received benefit to exclusion of subsidiary).

17. *See Aronson*, 473 A.2d at 813 ("[A] conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule.").

18. *See* A.C. Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 112-13 (Del. Ch. 1986) (describing how court will examine facts concerning unreasonableness of board's actions).

shifts to the board to demonstrate, by a preponderance of the evidence, that its actions were entirely fair to the shareholders.[19]

The standard of review and burden of proof issues for day-to-day business decisions were explored in depth in Part I of this Article.[20] Occasionally, however, the board faces decisions that affect the very core of the corporation's existence. The most typical types of these decisions involve: (1) the institution of defensive mechanisms, or so-called "takeover defenses," to protect the corporation from potentially harmful suitors; (2) the sale of, or change of control in, the corporation; or (3) the board taking action that may thwart or dilute the shareholders' right to vote.[21] These categories can overlap. For example, the board may desire to sell the corporation to a particular buyer and adopt defensive measures to thwart any other potential suitors.[22]

A takeover, merger, acquisition or change of control may be harmful to the shareholders or it may be beneficial. On the one hand, a merger or acquisition may benefit the shareholders if they get a high price for their stock. A merger can result in synergies that benefit the stockholders of both companies.[23] On the other hand, a takeover can leave the company in financial ruins and the individual investor with little more than a worthless stock certificate.

Because of the obvious importance of a decision to sell the company, directors in Delaware play a pivotal role in determining

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19. *See id.* at 114-15 (holding that directors' failure to meet enhanced scrutiny standard of review will result in application of "entire fairness" standard of review because directors violated their duty of loyalty); *see also* Cinerama Inc. v. Technicolor, Inc., 663 A.2d 1156, 1179 (Del. 1995) (illustrating that entire fairness standard requires careful analysis by courts); Ryan v. Tad's Enters., Inc., No. CIV.A.11977, 1996 WL 204502, at *14 (Del. Ch. Apr. 24, 1996) (finding that lack of fair dealing and fair pricing resulted in breach of fiduciary duty); Palm & Kearney, *supra* note 1, at 1316-20 (discussing how business judgment rule affects standard of review that court employs).

20. For an in depth discussion of the shifting standards of review and burdens of proof, see Palm & Kearney, *supra* note 1, at 1316-20.

21. For a discussion of when Delaware courts apply "enhanced scrutiny," see *infra* notes 44-187 and accompanying text.

22. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180-81 (reviewing Revlon's adoption of "poison pill" to avoid hostile takeover by Pantry Pride).

23. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955-56 (Del. 1985) (describing how short-term investors may prosper from merger and recognizing that board may reasonably consider basic stockholder interests at stake, including those of short-term speculators whose hope for short-term gain fuels hope of hostile offeror at expense of long-term investor).

what best serves the interests of the corporation.[24] For instance, as a statutory prerequisite, a board must approve a merger or sale of the corporation before the shareholders may vote on the issue.[25] As will be discussed, Delaware law also permits corporations to erect defensive measures designed to discourage or inhibit unwanted suitors.[26]

A variety of conflicts of interest may arise when the board acts in the face of a possible takeover or sale of the company.[27] A takeover of the corporation may result in the loss of a job for an inside director, a director who is also employed as an officer of the corporation, while an outside director may be ousted from the board, losing the prestige and privileges attendant to that position.[28] In addition, visions of the corporation's future may conflict. The incumbent board may seek long-term continued growth, whereas the acquiror or some shareholders may desire short-term gain.

These conflicts raise several issues. Can directors unilaterally enact defensive measures? Can directors favor one bidder's offer over another when a change in control is imminent? Can directors take action that affects the shareholders' voting rights in order to assist the board in achieving the board's goal? Can directors rely

24. *See id.* at 954 (citing Panter v. Marshall Field & Co., 646 F.2d 271, 297 (7th Cir. 1981); Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690, 704 (2d Cir. 1980); Heit v. Baird, 567 F.2d 1157, 1161 (1st Cir. 1977); Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706, 712 (M.D. Ill. 1969); Cheff v. Mathes, 199 A.2d 548, 556 (Del. 1964); Martin v. American Potash & Chem. Corp., 92 A.2d 295, 302 (Del. 1952); Kaplan v. Goldsamt, 380 A.2d 556, 568-69 (Del. Ch. 1977); Kors v. Carey, 158 A.2d 136, 141 (Del. Ch. 1960)).

25. *See* DEL. CODE ANN. tit. 8, § 251(b) (1974 & Supp. 1994) ("The board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation.").

26. *See id.* § 214 ("The certificate of incorporation . . . may provide that . . . each holder of stock . . . shall be entitled to . . . the number of votes which . . . he would be entitled to cast for the election of directors."); *see also Revlon* 506 A.2d at 180 (noting that board has power to adopt defensive measures such as poison pill). Other mechanisms include "white knights," classified board memberships, blocked stock, street sweeps and cumulative voting.

27. *See Unocal*, 493 A.2d at 954 (detailing "omnipresent specter" of conflict of interest when directors are faced with enacting defensive measures in response to unwelcome challenge for corporate control).

28. *See* Kahn v. Roberts, 679 A.2d 460, 465 (Del. 1996) (recognizing temptation for directors to act to retain their positions "in order to protect their own powers and perquisites"). When a director is faced with voting upon a hostile offer, however, the prestige and perquisites of their position will not be presumed to outweigh a director's economic self-interest in obtaining the most profit possible. *Cf.* Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1380 (Del. 1995) (noting that courts cannot presume, without evidence, that directors will be subconsciously motivated to vote against otherwise adequate hostile offers merely because these offers do not include compensation for directors' loss of "prestige and perquisites").

upon a majority of informed shareholders to ratify their decisions? In each case, the ultimate question is what deference should be given by the reviewing court to board decisions that affect the well-being and continued existence of the corporation.[29]

When courts review board decisions in these "extraordinary" cases, they find themselves on the horns of a dilemma in deciding which standard of review to apply. On the one hand, protecting the corporation and its shareholders from harm is among the board's primary responsibilities.[30] Because courts should encourage and protect such decisions, applying the deferential business judgment rule standard to these defensive decisions seems appropriate.[31]

On the other hand, defensive measures are often used to ward off unwanted suitors that desire to buy or otherwise obtain a controlling interest in the company. If successful in fending off would-be suitors, the defensive measure has the obvious effect of helping the incumbent board remain in office. Thus, defensive measures that touch upon control of the corporation raise the potential inference that they were adopted, not to protect the corporation, but rather to maintain the board's power and privileges.[32] If the latter reason is the director's underlying motivation, their conflict of in-

29. *See Unitrin*, 651 A.2d at 1374 (citing E. Norman Veasey, *The New Incarnation of the Business Judgment Rule in Takeover Defenses*, 11 DEL. J. CORP. L. 503, 504-05 (1986)).

30. *See* Mills Acquisition Corp. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1988) ("Not only do [the duties of care and loyalty] demand that corporate fiduciaries absolutely refrain from any act which breaches the trust reposed in them, but also to affirmatively protect and defend those interests entrusted to them."); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) (recognizing duty of board to protect shareholders from harm). In *Guth*, the Delaware Supreme Court concluded that:

> Public policy . . . has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interest of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of privity or advantage which his skill and ability might properly bring to it, or enable it to make in the reasonable and lawful exercise of its powers.

Id.

31. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("The business judgment rule exists to promote the full and free exercise of the management power granted to Delaware directors.") (citing Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981)).

32. *See* Stroud v. Grace, 606 A.2d 75, 83 (Del. 1992) (recognizing presumption that board acted without ratifying vote of shareholders in order to retain control); Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964) ("[B]ear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult." (citing Bennett v. Propp, 187 A.2d 405, 409 (Del. 1962))).

terest should trigger strict scrutiny, requiring the board to prove the entire fairness of the transaction.[33] Determining the real motive of the board, however, is very difficult.[34]

Because defensive measures frequently protect the corporation and shareholders from harmful actions, strict scrutiny might in fact hurt the shareholders because fewer defensive measures could survive the onerous entire fairness standard.[35] Although this would seem to justify the application of the deferential business judgment rule, applying the business judgment rule in these situations seems to minimize the inherent potential conflict of interest of the board in such situations.[36]

Recognizing this dilemma, the Delaware Supreme Court chose neither the business judgment rule nor the entire fairness standard as the applicable standard in such situations. Instead, the court adopted a new standard of review that recognizes both the board's potential conflict of interest and the salutary effects of some defen-

33. *See* Ryan v. Tad's Enters., Inc., No. CIV.A.11977, 1996 WL 204502, at *5 (Del. Ch. Apr. 24, 1996) (analyzing aspects of entire fairness).

34. *See id.* at *14 (noting that board's actual motive is often disputed).

35. *See In re* Gaylord Container Corp. Shareholders Litig., No. CIV.A.14616, 1996 WL 752356, at *3 (Del. Ch. Dec. 19, 1996) (recognizing that "proper course" in enhanced scrutiny case "is to deny the motion to dismiss, permit the plaintiffs to pursue discovery, and give the defendants an opportunity to satisfy the enhanced scrutiny standard"); A.C. Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) ("Because the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of [the] litigation.").

36. *See* Solash v. Telex Corp., No. CIV.A.9518, 1988 WL 3587, at *8 (Del. Ch. Jan. 19, 1988) ("Because businessmen and women are correctly perceived as possessing skills, information and judgment not possessed by reviewing courts . . . courts have long been reluctant to second-guess such decisions when they appear to have been made in good faith."); *see also* Gilbert v. El Paso Co., 575 A.2d 1131, 1144 (Del. 1990) (stating that *Unocal* applies when threat touches upon issues of control). The *Gilbert* court noted that "[b]earing in mind that *Unocal*'s enhanced scrutiny arises from the appearance of certain inherent conflicts attendant to the invocation of defensive measures designed to thwart or impede a takeover, no clearer application of *Unocal* could be conceived than under the circumstances here." *Id.* (citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985)). In *Gilbert*, Burlington, a stockholder in El Paso, made a tender offer for 49.1% of El Paso's outstanding stock. *Id.* at 1135. Upon successful completion of the tender offer, Burlington would retain control of 51.8% of El Paso's outstanding stock. *See id.* The court stated that the existence of a back-end, freeze-out merger was significant and constituted a threat to the interests of El Paso and its stockholders. *See id.* at 1146 (stating that record showed El Paso's directors were concerned about shareholder interests). The tender offer included no plans to purchase the remaining minority shares. *See id.* Therefore, the board satisfied the first prong of *Unocal* and could enact proportionate defensive measures. *See id.* at 1145-46 (indicating that directors' actions were reasonable and their investigation exhaustive).

sive measures.[37] The new standard of review formed a compromise between the entire fairness standard, which places the burden on the board, and the business judgment rule, which places the burden on the challenging party. The compromise mandates that, before the courts apply the business judgment rule, the board has the threshold burden to show that its decision to erect defensive measures was reasonable.[38]

This standard of review, referred to as intermediate or "enhanced" scrutiny, shifts the burden of proof to the board of directors to demonstrate the reasonableness of its actions before the courts will apply the presumptions of the business judgment rule.[39] "Enhanced scrutiny," however, is a misnomer. Although enhanced scrutiny review is more stringent than the business judgment rule, it is far less exacting than the entire fairness standard of review because the board is not required to show that the decision was fair; rather the board must show only that the decision was reasonable.[40]

37. *See Unocal*, 493 A.2d at 957 (asserting that defensive steps against dissident shareholder groups have been upheld by Delaware courts) (citing Hibbert v. Hollywood Park, Inc., 457 A.2d 339 (Del. 1983); Hall v. Trans-Lux Daylight Picture Screen Corp., 171 A. 226 (Del. 1934)). Specifically, the court applied a heightened scrutiny standard in change of control situations. Additionally, the court applied heightened scrutiny when directors attempted to dilute shareholder ownership. *See* Condec Corp. v. Lunkenheimer Co., 230 A.2d 769, 776 (Del. Ch. 1967) (applying per se heightened scrutiny to invalidate target directors issuance of new shares because directors failed to demonstrate justifiable belief that there was threat from majority shareholders). Further, the Delaware courts long applied more exacting standards of review to directors' conduct when it appeared that the directors sought to alter the shareholders' voting franchise.

38. *See* Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995) (discussing well-known *Unocal* standard that requires board to prove that actions were reasonable and proportionate).

39. *See id.* at 1374-75 (discussing how court must review directors' decision where stockholders' rights affected). *But see* Emerson Radio Corp. v. International Jensen Inc., No. CIV.A.15130, 1996 WL 483086, at *13 (Del. Ch. Aug. 20, 1996) (requiring action by shareholder to have standing to claim that court must apply enhanced scrutiny to contemplated transaction). Faced with the enhanced risk that the directors may breach their duty of loyalty by benefitting themselves and possibly overlooking the shareholders' best interests, the courts applied an "enhanced scrutiny" to directors' action before attaching the presumptions of the business judgment rule. *See Unitrin*, 651 A.2d at 1373 (noting that directors' satisfaction of enhanced scrutiny standard is threshold or condition precedent to court's application of business judgment rule); *Unocal*, 493 A.2d at 954-55 (recognizing enhanced duty upon directors in this conflict of interest situation); *see also* U.S. West, Inc. v. Time Warner, Inc., No. CIV.A.14555, 1996 WL 307445, at *21 (Del. Ch. June 6, 1996) (requiring "that corporate fiduciaries not prefer their own interests to corporate interests even in transactions in which neither the fiduciary nor an affiliate is a participant").

40. *See Unocal*, 493 A.2d at 954-55 (defining enhanced scrutiny standard).

This shifting of the initial burden of proof to the directors allays the concerns about possible director interest.[41]

If the directors meet their threshold burden of proof that their decision was reasonable, the standard of review changes to the business judgment rule with the burden on the challenging party to rebut the business judgment rule's presumption of propriety.[42] Conversely, if the board does not meet the enhanced scrutiny burden of first establishing that their decision was reasonable, the business judgment rule will not apply and the board will have to demonstrate that the transaction was entirely fair to the shareholders.[43]

III. DEFENSIVE MEASURES—*UNOCAL*'S ENHANCED SCRUTINY STANDARD OF REVIEW

The Delaware Supreme Court first enunciated the enhanced scrutiny or intermediate standard of review in *Unocal v. Mesa Petroleum Co.*[44] In *Unocal*, the court applied "enhanced scrutiny" to the Unocal board's rejection of a hostile tender offer and adoption of a selective self-tender offer.[45] The court adopted the two-prong en-

41. *See Unitrin*, 651 A.2d at 1374 (finding that shareholders retain at all times ultimate burden of persuasion, even when burden of proof shifts to directors after rebuttal of business judgment rule) (citing Spiegel v. Buntrock, 571 A.2d 767, 774 (Del. 1990)); *see also* Uni-Marts, Inc. v. Stein, No. CIV.A.14713, 1996 WL 466961, at *10 (Del. Ch. Aug. 12, 1996) (commenting that in *Unocal*, "the Delaware Supreme Court dilated upon the pleading and proof burdens in [a claim that the directors are entrenching themselves in office] and held that when corporate action was taken as a defensive step in the face of a threatened corporate takeover, directors faced an inherent if somewhat attenuated conflict").

42. *See Unitrin*, 651 A.2d at 1372-73 (stating that if shareholders do not rebut presumption of business judgment rule, court will not substitute its judgment for that of board if board's decision can be attributed to any rational purpose); *Unocal*, 493 A.2d at 957 ("If the board of directors is disinterested, has acted in good faith and with due care, its decision in the absence of an abuse of discretion will be upheld as a proper exercise of business judgment."). In *Unitrin*, the court stated that in transactional justification cases, "[i]f the directors' actions withstand *Unocal's* reasonableness and proportionality review, the traditional business judgment rule is applied to shield the directors' defensive decision rather than the directors themselves." *Unitrin*, 651 A.2d at 1374 (citing Joseph Hinsey, IV, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine and the Reality*, 52 GEO. WASH. L. REV. 609, 611-13 (1984)).

43. *See* A.C. Acquisitions Corp. v. Anderson, Clayton & Co., 519 A. 2d 103, 114-15 (Del. Ch. 1986) (applying entire fairness standard when directors failed to meet enhanced scrutiny standard).

44. 493 A.2d 946 (Del. 1985).

45. *Id.* at 954-55 (describing proper standard of review in assessing defensive measures that board employed). Mesa, a 13% stockholder of Unocal, offered Unocal a two-tiered, all-cash, front-loaded tender offer for 37% of Unocal's stock at $54 per share. *See id.* at 949. After thorough investigation, the board rejected Mesa's offer as wholly inadequate and began planning a self-tender exchange of-

hanced scrutiny test which requires that the board demonstrate that: (1) it reasonably perceived that a threat to corporate policy or effectiveness existed; and (2) its response was reasonable in relation to the threat posed.[46] As the Delaware Supreme Court noted: "Because of the omnipresent specter that a board may be acting primarily in its own interest, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protection of the business judgment rule may be conferred."[47] If the board meets the two-prong *Unocal* burden, the court will then review the board's decision under the business judgment rule standard with the burden of

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fer. *See id.* at 950. After consideration of expert financial and legal advice, the directors unanimously approved the exchange offer at a share price of $72 per share and agreed to exclude Mesa from the self-tender proposal. *See id.* at 951. According to their plan, as soon as Mesa acquired 37% of the Unocal stock, Unocal would buy the remaining 49% of its outstanding shares, excluding Mesa from the offer. *See id.*

46. *Id.* at 955 (deciding whether board had power to act by using proportionality test). The Delaware Supreme Court stated that T. Boone Pickens, a noted "greenmailer," controlled Mesa. *See id.* at 949 n.1, 956 ("Wholly beyond the coercive aspect of an inadequate two-tier tender offer, the threat was posed by a corporate raider with a national reputation as a 'greenmailer.'"). The court further defined "greenmail" as "the practice of buying out a takeover bidder's stock at a premium that is not available to other shareholders in order to prevent the takeover." *Id.* at 956 n.13. Hence, because Mesa had a reputation for being a corporate raider, the board properly perceived a threat to the corporation. *See id.* at 956 (noting that offers such as Mesa's are well-recognized threats at takeover attempts). The court noted that Unocal responded with the self-tender because of the inadequate offer and wished to provide the remaining shareholders with an alternative, rather than to be forced to accept junk bonds. *See id.* at 957. The court further held that the board's response, the self-tender offer, was reasonably related to the threat posed because the board acted to insure that its minority shareholders could receive the substantial equivalent in value of what they owned before the tender offer. *See id.* at 956 ("[T]he minority stockholder shall receive the substantial equivalent in value of what he had before." (citing Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 114 (Del. 1952)); *see also Unitrin*, 651 A.2d at 1373 (fulfilling both parts of enhanced scrutiny standard required before business judgment rule attaches); Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1154 (Del. 1990) (same); Revlon, Inc. v. MacAndrews & Forbes Holding Co., 506 A.2d 173, 181 (Del. 1986) (same); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1355-57 (Del. 1985) (same); *A.C. Acquisitions*, 519 A.2d at 114-15 (noting that failure to meet second prong of enhanced scrutiny results in application of "entire fairness" standard of review because directors violated their duty of loyalty).

47. *Unocal*, 493 A.2d at 954. The court also noted:

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

Id. (footnote omitted); *see also Revlon*, 506 A.2d at 179 (noting that management of business and affairs of corporation is ultimate responsibility of board).

proof on the challenging party to rebut the rule's presumption of propriety.[48] If the board does not meet both prongs of the *Unocal* threshold test, it must then prove that its decision was entirely fair to the corporation and its stockholders.[49]

A. *Reasonably Perceiving a Threat to Corporate Policy and Effectiveness*

In order to meet their burden under *Unocal*, the directors must first show "that the board of directors had reasonable grounds for believing that a danger to corporate policy and effectiveness existed."[50] The threat may be either actual (that is, presently existing) or perceived (that is, one that could reasonably arise in the future).[51] The Delaware Supreme Court has held that a board satis-

48. *See Unitrin*, 651 A.2d at 1374 ("If the directors' actions withstand *Unocal*'s reasonableness and proportionality review, the traditional business judgment rule is applied to shield the directors' defensive decision." (citing Hinsey, *supra* note 42, at 611-13)).

49. *See A.C. Acquisitions*, 519 A.2d at 114 (applying entire fairness standard when directors failed to meet enhanced scrutiny standard).

50. *Unocal*, 493 A.2d at 955 (deciding directors must first demonstrate reasonable ground for believing danger existed, then show that defensive measure used was reasonable in light of danger posed); *cf.* Uni-Marts, Inc. v. Stein, No. CIV.A.14713, 1996 WL 466961, at *10 (Del. Ch. Aug. 12, 1996) (describing *Unocal* as arguably shareholder friendly); City Capital Assocs. Ltd. v. Interco, Inc., 551 A.2d 787, 796 (Del. Ch. 1988) (describing *Unocal* as "the most innovative and promising case in any recent corporation law"). The court in *Unocal* instituted a heightened scrutiny because of the possibility of a conflict of interest among a corporation's directors; therefore, the threat must target corporate policy and effectiveness in order for a board to validly enact defensive measures. *Unocal*, 793 A.2d at 955; *accord* Polk v. Good, 507 A.2d 531, 537 (Del. 1986) (describing first prong of *Unocal* as questioning whether potential conflict of interest exists).

51. *See Moran*, 500 A.2d at 1350-53 (applying enhanced scrutiny to adoption of rights plan in contemplation of some yet undefined threat to corporation); *In re* Gaylord Container Corp. Shareholders Litig., No. CIV.A.14616, 1996 WL 752356, at *2 (Del. Ch. Dec. 19, 1996) (stating that Delaware law is "settled that a board's precautionary adoption of a defensive device is subject to enhanced scrutiny"). *But see* Tate & Lyle PLC v. Staley Continental, Inc., No. CIV.A.9813, 1988 WL 46064, at *7 (Del. Ch. May 9, 1988) (applying "entire fairness" standard and not enhanced scrutiny when, months before threat of tender offer, board adopted officer compensation plans to benefit themselves in event of change of control).

For example, General Motors' (GM) shareholders alleged that the board's decision to repurchase H. Ross Perot's stock was the result of board entrenchment in *Grobow v. Perot*, 539 A.2d 180, 185 (Del. 1985). The shareholders claimed that the repurchase "was carried out principally to save GM's Board from further public embarrassment by Perot." *Id.* The court held that the plaintiffs did not plead sufficient facts to show that Perot threatened the board's policy or effectiveness, and therefore, enhanced scrutiny did not apply. *See id.* at 188 (noting that because Perot only owned 0.8% of GM's voting stock, any threats made by him could not possibly effect GM's policy or effectiveness).

The court in *Moran* stated that "in reviewing a pre-planned defensive mechanism it seems even more appropriate to apply the business judgment rule." *Moran*, 500 A.2d at 1350 (defining preplanned mechanism as one that is "adopted to ward off possible future advances and not a mechanism adopted in reaction to a specific

fies its burden of proving reasonableness under the first prong of *Unocal* by showing reasonable investigation and good faith.[52] The directors must show that they took reasonable care and honestly concluded that a threat to corporate policy and effectiveness was present.[53] Not surprisingly, approval by a majority of independent, outside directors materially enhances the board's burden in satisfying reasonableness under the first prong because there is only a small possibility that the independent, outside director acted primarily to retain the power and privileges of being a director.[54]

threat"). The board in *Moran* adopted a rights plan after it became concerned about the corporation's vulnerability in the takeover context. *Id.* at 1349. The announcement of a tender offer for more than 30% of Household's shares or the acquisition of 20% of its shares by a single entity would trigger the rights plan. *See id.* at 1348. The court noted that the plaintiff adequately demonstrated that the adoption of the rights plan was in reaction to "what it perceived to be the threat in the market place of coercive two-tier tender offers." *Id.* at 1356 (applying enhanced *Unocal* standard before board could enjoy presumptions of business judgment rule).

52. *See Unocal*, 493 A.2d at 955.

53. *See id.* at 956 (holding that two-stage, front-loaded cash offer for 37% of company stock for inadequate price is coercive); *see also* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1342 (Del. 1987) (describing how reputation and statements by suitors allowed Newmont's board to take defensive actions); Henley Group, Inc. v. Santa Fe S. Pac. Corp., No. CIV.A.9569, 1988 WL 23945, at *5 (Del. Ch. Apr. 12, 1988) (stating in securities filings that suitor "might seek to acquire control . . . through a tender offer or a proxy solicitation [although] it remained willing to pursue acquisition negotiations"). Courts also consider an offeror's partial, front-loaded tender offer a threat if the shareholders feel compelled to tender to avoid being treated unfavorably. *See* Gilbert v. El Paso Co., 575 A.2d 1131, 1145 (Del. 1990) (finding that coercive two-stage tender offer is "serious" threat to shareholders). Moreover, a threat may exist if the shareholders are not aware of substantial technological or other confidential innovations achieved by the target that will result in the tendering of shares at an inadequate price. *See* Moore Corp. v. Wallace Computer Servs., 907 F. Supp. 1545, 1560 (D. Del. 1995) ("The favorable results from the board's *past* actions are now beginning to be translated into financial results which even surpass management and financial analyst projections, and the financial data which manifests these results are facts known only to [the directors]."); *Unitrin*, 651 A.2d at 1375 (finding that inadequate price proposed to uninformed shareholders in hostile offer created threat); *see also* Kahn v. Roberts, 679 A.2d 460, 466 (Del. 1996) (finding that repurchase of disgruntled shareholders' interest did not create actual threat to corporate control, and therefore, no enhanced scrutiny applied). Similarly, when a nonhostile offer requires the consent of the target board, there is no threat to corporate policy or effectiveness. *See* Robert M. Bass Group, Inc. v. Evans, 552 A.2d 1227, 1240-41 (Del. Ch. 1988) (finding that tender offer conditioned on target board's approval was not "threat"). Additionally, if consummation of a transaction results in the violation of a federal antitrust or state regulation, a threat to corporate policy or effectiveness is not likely. *See Unitrin*, 651 A.2d at 1375 (failing to dispute Chancery Court's finding that threat created by possible violation of antitrust or state regulations was nothing more than "makeweight excuse" for defensive action).

54. *See Polk*, 507 A.2d at 537 (stating that presence of 10 outside directors with investment and legal advice constituted prima facie showing of reasonableness); *See also Unitrin*, 651 A.2d at 1375 ("An 'outside' director has been defined as a non-

B. *Reasonably Responding to That Threat*

Once the board establishes that it reasonably perceived a threat to corporate policy and effectiveness, the board must then show that its response was reasonable in relation to the threat posed.[55] In this context, a reasonable response is one that is proportionate to the magnitude of the threat.[56] The court has identi-

employee and non-management director. Independence 'means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.'" (citations omitted) (quoting Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984))); Tomczak v. Morton Thiokol, Inc., No. CIV.A.7861, 1990 WL 42607, at *13 (Del. Ch. Apr. 5, 1990) (holding that vote by all outside directors coupled with advice of legal and financial counsel constituted prima facie showing of good faith and reasonable investigation to believe threat existed).

55. *See Unocal*, 493 A.2d at 955 ("A further aspect is the element of balance.").

56. *See Unitrin*, 651 A.2d at 1389-90 (delineating test Chancery Court should use to determine whether board's defensive response was reasonable). The Chancery Court, on remand, must review the nonselective repurchase of all shares to determine its reasonableness, taking into consideration whether: (1) it was a statutorily authorized form of business decision that the board of directors may routinely make in a nontakeover context; (2) as a defensive response, it was limited and corresponded in degree or magnitude to the degree or magnitude of the threat (i.e., assuming the threat was relatively "mild"); and (3) the board properly recognized that all shareholders were not alike, and provided immediate liquidity to those shareholders who wanted it. *See id.* at 1389.

The courts have held that when a board has acted defensively to protect its shareholders or provide them with an alternative to the threat, the board has satisfied the *Unocal* standard, and thus, should enjoy the protection of the business judgment rule. *See id.* at 1376 (holding that redemption of poison pill to protect shareholders from "low ball" bid was reasonable); *see also Gilbert*, 575 A.2d at 1146 (holding that meeting with bankers and lawyers to discuss proposed takeover and initiating exhaustive search for better option for its shareholders was reasonable); Stahl v. Apple Bancorp, Inc., 579 A.2d 1115, 1124 (Del. 1990) (holding that delay of annual meeting that was consistent with bylaws and Delaware law in response to possible proxy fight and tender offer was reasonable); *Polk*, 507 A.2d at 573 n.3 (noting use of greenmailing was permitted under *Unocal* when it quashed immediate and long-term disruptive effect posed by dissident's action and was beneficial to stockholders); Kidsco, Inc. v. Dinsmore, 674 A.2d 483, 496 (Del. Ch.) (finding that adopting bylaw amendment to delay shareholder vote for purpose of informing shareholders was reasonable response), *aff'd*, 670 A.2d 1338 (Del. 1995); *In re* Holly Farms Corp. Shareholders Litig., 564 A.2d 342, 351-52 (Del. Ch. 1989) (stating that redemption of poison pill to prevent shareholder vote from being blocked was reasonable response to protect shareholder interest in pending merger agreement); *In re* Damon Corp. Stockholders Litig., Nos. CIV.A.10173, 10189, 1988 WL 96192, at *9 (Del. Ch. Sept. 16, 1988) (holding that adoption of rights plan in response to all-cash tender offer was reasonable and that "[t]he test of whether a particular defense mechanism or a series of defense mechanizing are reasonable therefore is predicated on whether the tender offer price is fair to the stockholders and the directors' action is not tainted by any impropriety"). Additionally, when the board sought to protect corporate policy, the board has satisfied the heightened standard as well. *See Henley*, 1988 WL 23945, at *15 (holding distributing payment in kind debentures was matter of corporate policy that permitted stockholders to realize liquid value of company and was not unreasonable to threat of two-step takeover transaction).

fied several factors that help to determine whether the board's response was reasonable, including:

> the adequacy and terms of the offer; its fairness and feasibility; the proposed or actual financing for the offer, and the consequences of that financing; questions of illegality; the impact of both the bid and the potential acquisition of other constituencies, provided that it bears some reasonable relationship to general shareholder interests; the risk of nonconsummation; the basic stockholder interests at stake; the bidder's identity, prior background and other business venture experiences; and the bidder's business plans for the corporation and their effects on stockholder interests.[57]

When the board adopts multiple defensive measures, the court will scrutinize those measures individually and collectively to determine whether they were a reasonable response to the perceived threats.[58] The second prong of the enhanced scrutiny test does not focus on whether the board's actions were "necessary" or the best

57. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1282 n.29 (Del. 1989) (noting factors considered in assessing whether bidder is "reputable and responsible").

58. *See Unitrin*, 651 A.2d at 1386-87 (noting that singular actions alone may not be disproportionate, but taken as whole will rise to level of unreasonable). In *Unocal*, the Delaware Supreme Court held that in light of Mesa's coercive two-tiered, grossly inadequate offer, the Unocal board's self-tender, which excluded Mesa, was appropriate. *See Unocal*, 493 A.2d at 956 (stating board's response should offer shareholders more valuable economic alternative, including, at minimum, choice for shareholders). *Compare Bass Group*, 552 A.2d at 1243-44 ("Under *Unocal* the directors were obligated to give the shareholders a choice. The restructuring, because it deprives them of that choice, is manifestly unreasonable."), *with* A.C. Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 114 (Del. Ch. 1986) (finding that, in response to hostile tender offer, directors acted reasonably in providing shareholder with self-tender restructuring choice, but that this choice was coercive and ineffective and accordingly, directors failed to meet second prong of *Unocal* enhanced scrutiny).

In *Gilbert*, in response to a back-end, freeze out merger, the El Paso board sought a better option for its shareholders. *Gilbert*, 575 A.2d at 1146 (pointing to El Paso board's attempt to negotiate better protection for stockholders). Once the break-up of the corporation became apparent, the board had the duty to maximize shareholder value, hence it renegotiated the earlier offer, received better terms for all shareholders and tendered its shares in the subsequent offer. *See id.* (holding that board's response met enhanced *Unocal* standard, and therefore, board could receive benefit of business judgment rule). The court has also held that a board's amendment of its bylaws to extend the minimum time for calling a shareholder-initiated special meeting in opposition to a proxy contest was "proportional" to the threat, given that the bylaw amendment only delayed and did not prevent a stockholder vote. *See Kidsco*, 674 A.2d at 497 (noting that action "clearly fell within a range of reasonable alternatives" and was "an extremely mild response to the threat").

possible options. Rather, the defensive measure need only be "within a range of reasonableness" to satisfy *Unocal*'s proportionality prong.[59]

In *Kidsco*, hostile suitor SoftKey International, Inc. announced a tender offer to acquire a majority of The Learning Company's ("TLC") outstanding shares for cash, to be followed by a stock-for-stock merger. *See id.* at 486-87. To further its tender, SoftKey simultaneously announced that it would solicit proxies to call a special shareholders meeting of TLC to replace TLC's directors with SoftKey nominees. *See id.* at 487. In response, the TLC board amended TLC's bylaws to extend the minimum time for calling a stockholder-initiated special meeting from 35 to 60 days. *See id.* at 487-89. As a result of that amendment, a shareholder meeting to replace the TLC board could not take place until approximately 25 days after a more favored transaction had been considered by TLC stockholders. *See id.* at 488-90. The court, in finding the TLC board's defensive action reasonable and not draconian, held that the delay enabled the TLC board to present the favored transaction without the distraction of a concurrent proxy solicitation focused upon the directors' incumbency. *See id.* at 496-97 (noting if favored transaction was not approved, additional time until shareholders' meeting would provide TLC board with time to explore and develop alternative transactions on improved terms).

Similarly, the issuance of debentures as a responsive measure can be reasonable when it does not reduce any existing value or create new value in the corporation, even with restrictive covenants preventing leveraged acquisitions and hindering an acquiror with substantial debt that cannot be subordinated. *See Henley*, 1988 WL 23945, at *12-14 (stating that issuance of debentures limited in time and scope was reasonable to protect planned restructuring). Moreover, the divestiture of an attractive subsidiary at a profit is a reasonable response to a "creeping tender offer." *See Tomczak*, 1990 WL 42607, at *10 (finding divestiture of profitable subsidiary to be proportional and reasonable response). "[A] 'creeping tender offer' is an 'acquisition device which avoids or minimizes the control premium which a would-be acquiror is usually required to pay in a conventional tender offer.'" *Id.* (quoting Telvest v. Bradshaw, 697 F.2d 576, 577 n.1 (4th Cir. 1983)). Finally, a poison pill rights plan alone may be neither preclusive or coercive and may be reasonable if it enables the board to take concrete steps to protect and advance the stockholder interests. *See In re Holly Farms*, 564 A.2d at 351-53 (maintaining poison pill is reasonable response to threat posed by suitor's possible blockage of meaningful shareholder vote on merger agreement and until such time as suitor's offer becomes competitive, rights plan served valid purpose); Nomad Acquisition Corp. v. Damon Corp., No. CIV.A.10173, 1988 WL 383667, at *5 (Del. Ch. Sept. 16, 1988) (holding maintenance of poison pill appropriate when it is integral to protect value of shareholders holdings). *But see* Grand Metro. Pub., Ltd. v. Pillsbury Co., 558 A.2d 1049, 1057-58 (Del. Ch. 1988) (failure to redeem poison pill is unreasonable in relation to threat posed by noncoercive tender offer when projected restructuring plan that may increase share value might never be reality).

59. *See Unitrin*, 651 A.2d at 1386 ("The Court of Chancery's determination that the Unitrin Board's adoption of the Repurchase Program was unnecessary constituted a substitution of its business judgment for that of the Board."). The court in *Paramount* stated:

> Although an enhanced scrutiny test involves a review of the reasonableness of the substantive merits of a board's actions, a court should not ignore the complexity of the directors' task in a sale of control. There are many business and financial considerations implicated in investigating and selecting the best value reasonably available. The board of directors is the corporate decisionmaking body best equipped to make those judgments. Accordingly, a court applying enhanced judicial scrutiny

In *Unitrin, Inc. v. American General Corp.*,[60] the Delaware Supreme Court refined the second prong of the enhanced scrutiny standard to examine whether the defensive measure was "draconian."[61] A draconian response is per se outside of the range of reasonableness. In this context, a draconian response is one that is either preclusive or coercive.[62] A preclusive defense is one that is so effective that it would preclude a rational bidder from ever trying to buy the company or attempt to gain control of the company through a tender offer or proxy fight.[63] A coercive defense forces

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> should be deciding whether the directors made *a reasonable* decision, not *a perfect* decision.

Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 45 (Del. 1994) (emphasis added).

60. 651 A.2d 1361 (Del. 1995)

61. *See id.* at 1383-84 n.34 ("'Draconian, adj. Of or pert. to Draco, an archon and member of the Athenian expatridae, or the code of laws which is said to have been framed about 621 B.C. by him as thesmothete. In them the penalty for most offenses was death, and to a later age they seemed so severe that they were said to be written in blood. Hence, barbarously severe; harsh; cruel.'" (quoting WEBSTER'S NEW INTERNATIONAL DICTIONARY 780 (2d ed. 1951))).

62. *See id.* at 1388 (holding that Unitrin's nonselective offer to repurchase all shares was not coercive because it did not necessarily preclude future bids or proxy contests by shareholders who declined to participate in purchase and generally did not discriminate because all shareholders could voluntarily realize same benefit by selling). The Delaware Supreme Court stated that it must review Unitrin's actions, including adoption of a poison pill rights plan, an advance notice bylaw and a repurchase program for up to ten million shares of outstanding stock, on the basis of whether they were preclusive and fell within the range of reasonable behavior. *See id.* at 1389 (remanding to Chancery Court and requiring court to examine whether nonselective offer to repurchase all shares was preclusive because hostile bidder's chances of success would either be mathematically impossible or realistically unattainable).

As described in *Unitrin*, the proliferation of sophisticated takeover defenses that have been upheld by courts, such as poison pills, "[have] resulted in such a remarkable transformation in the market for corporate control that hostile bidders who proceed when such defenses [were] in place will usually 'have to couple proxy contests with tender offers.'" *Id.* at 1379 (quoting Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 Stan. L. REV. 857, 858 (1993)); *see also* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1351 n.7-8 (Del. 1985) (noting that poison pill rights plan usually involved issuance of warrants or preferred stock to favored shareholders that had more valuable exercise or conversion rights in event of change in control, including allowing rights holder to purchase shares of either surviving company or acquiror at substantial profit); Dennis J. Block et al., *Chancellor Allen, The Business Judgment Rule and the Shareholders' Right to Decide*, 17 DEL. J. CORP. L. 785, 825-26 n.274 (1992) (noting that it is allowable to leave poison pill in place for reasonable time, while threat is present); Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 30-31 (1987) (describing poison pill as effective defensive measure).

63. *See Unitrin*, 651 A.2d at 1387 (discussing holdings in *Time* and *Moran* in which Delaware Supreme Court found that neither boards' actions were preclusive because they did not stop acquiror from making offer and did not "strip" stockholders of right to receive tender offers).

the board's plan on the shareholders.[64] If the defensive measure adopted by the board is preclusive and/or coercive, it is per se unreasonable under *Unocal*'s proportionality prong. In such cases, the burden shifts to the board to establish that the defensive measures were entirely fair to the corporation and its shareholders.[65]

If the defensive measure met the first prong of the enhanced scrutiny test, was not draconian and fell in the range of reasonableness, the court applies the business judgment rule and places the burden on the challenging party to rebut the business judgment rule's presumptions of good faith, due care and loyalty.[66] If the challenging party can rebut the presumption of propriety provided by the business judgment rule, then the burden would shift back to the board to establish that the decision it made was entirely fair to the corporation.[67] For example, if outside influences or fraud

64. *See id.* (noting that *Time* offer did not have effect of "cramming down" management-sponsored alternative on shareholders, and thus, was not coercive).

65. *See* A.C. Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 113 (Del. Ch. 1986) (holding board's action unreasonable in response to threat posed). In *A.C. Acquisitions*, BS/G made an all-cash, all-share tender offer to the shareholders of A.C. Acquisitions for $56 dollars per share. *Id.* at 108-09. BS/G also proposed a second-stage cash merger conditioned on the tender of the majority of A.C Acquisitions's outstanding stock, abandonment of A.C Acquisitions's company transaction and approval by the board. *See id.* at 109. In response, the A.C. Acquisitions board voted to reject the tender offer and to enact a self-tender offer. *See id.* at 108. The court applied the *Unocal* standard. *See id.* at 112. The court held that the self-tender served to further a corporate purpose, thereby fulfilling the first tier of the *Unocal* standard. *See id.* The court went on to hold that, although a threat was posed by the BS/G offer, the self-tender did not constitute an option to the stockholders, but rather it precluded the stockholders from accepting the BS/G offer, and therefore, the action by the A.C. Acquisition board was unreasonable. *See id.* at 113; *see also* Grand Metro. Pub., Ltd. v. Pillsbury Co., 558 A.2d 1049, 1061 (Del. Ch. 1988) (holding that poison pill adopted by board removed any alternatives from shareholders and, thus, put their interest at stake and was unreasonable response to threat posed); Robert M. Bass Group, Inc. v. Evans, 552 A.2d 1227, 1241-44 (Del. Ch. 1988) (stating that *Unocal* requires directors give shareholders options, but restructuring plan devised by board in response to Bass Group offer deprived shareholders of that choice and was manifestly unreasonable).

66. *See* Palm & Kearney, *supra* note 1, at 1300-16 (discussing triad of fiduciary duties, what they are and how conduct satisfies duties); *see also* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 958 (Del. 1986) (stating that court would not substitute its judgment for board unless decisions were made with purpose of staying in office or as result of some other breach of fiduciary duty); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (noting effect of directors' breach of fiduciary duty on applicability of business judgment rule). *But see* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (applying court's own judgment when parent company received benefit to exclusion of subsidiary).

67. *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995) (holding that when plaintiffs rebut presumption of business judgment rule, directors must prove "entire fairness"); *Cede II*, 634 A.2d 356, 361 (Del. 1993) (same); Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993) (holding that when plaintiffs

tainted the board's decision-making process or the primary motive of the board was entrenchment, the business judgment rule would not protect the board and the board would be obligated to prove the entire fairness of its decision.[68]

C. *When Does* Unocal *Apply?*

One of the primary issues that arises is when should the court apply *Unocal*? First, the action must be defensive and touch upon issues of control.[69] Second, the action must be the result of unilateral board action.[70] The board unilaterally acts when it reaches decisions "to the exclusion of, or in limitation upon, a valid shareholder vote."[71] Hence, if the shareholders have specifically and properly approved a defensive measure, *Unocal* will not apply.[72] Third, the *Unocal* standard applies only when a shareholder challenges the validity of the protective measure itself by seeking an injunction to restrain the board from instituting or continuing the defensive measure. In other words, *Unocal* applies only in "transac-

rebut presumption of business judgment rule, director's actions are reviewed under entire fairness); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1284 (Del. 1989) (asking whether board was fully informed when it approved bid because if not, directors may be misled and transaction cannot receive benefit of business judgment rule).

68. *See Unitrin*, 651 A.2d at 1371. For example, if the board's primary motivation in adopting the defensive measure in question is entrenchment, the business judgment rule will not apply and the board will have to establish the entire fairness of the defense. *See id.* at 1371 n.7 (noting that entire fairness standard applies if presumption of business judgment rule is defeated); *Unocal*, 493 A.2d at 954 (noting that "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interest . . . there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred"); Cheff v. Mathes, 199 A.2d 548, 556 (Del. 1964) (noting that evidence was inconsistent with finding that directors acted to maintain control); Bennett v. Propp, 187 A.2d 405, 409 (Del. 1962) (noting that when director acted to preserve his control on board, burden was on directors "to justify [transaction] as one primarily in the corporate interest").

69. *See* Stroud v. Grace, 606 A.2d 75, 82 (Del. 1992) (expanding application of *Unocal* beyond hostile contests to perceived threats to control); Gilbert v. El Paso Co., 575 A.2d 1131, 1136, 1144 (Del. 1990) (delineating that golden parachute agreements, employee savings and stock ownership plans, and shareholder supermajority voting provisions adopted after initiation of tender offer were defensive); *see also* DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 243-51 (4th ed. 1993 & Supp. 1995) (discussing when board conduct is defensive).

70. *See* Williams v. Geier, 671 A.2d 1368, 1376-77 (Del. 1996) (requiring unilateral action by board in order for enhanced scrutiny to attach).

71. *Stroud*, 606 A.2d at 82.

72. *See id.* ("Under Delaware law a fully informed shareholder vote in favor of a disputed transaction ratifies board action in the absence of fraud."). For an in depth discussion of claim extinguishment, see *infra* notes 263-82 and accompanying text.

tional justification" cases and not in any part of a case dealing with the damages liability of a director for a board's decision.[73] The business judgment rule, not *Unocal*, applies when a party is seeking damages against the board for a decision that it has made even if that decision involves the first two triggers of *Unocal*.[74]

The courts have not given any bright-line tests for distinguishing between defensive and nondefensive measures primarily because the question is so fact specific.[75] Courts will typically find conduct defensive when the timing and purpose of the action indicate that the board is responding to a threat to its control.[76] The courts, however, may also find the action defensive even when the board's purpose was initially unrelated to any threat posed to corporate control, but subsequent events result in the mechanism having a defensive impact on a control situation. Timing, therefore, is important.[77]

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73. *See Unitrin*, 651 A.2d at 1374 (distinguishing between "transactional justification" cases and cases involving personal liability of directors).

74. *See id.* (clarifying when business judgment rule and when enhanced scrutiny apply). The court in *Unitrin* stated:

> [I]n transactional justification cases involving the adoption of defenses to takeovers, the director's actions invariably implicate issues affecting stockholder rights. In transactional justification cases, the directors' decision is reviewed judicially and the burden of going forward is placed on the directors. If the directors' actions withstand *Unocal*'s reasonableness and proportionality review, the traditional business judgment rule is applied to shield the directors' defensive decision rather than the directors themselves.

Id. (citations omitted).

75. *See id.* at 1372 (concluding that Court of Chancery properly found facts and then proceeded to apply *Unocal*); *see also* Glazer v. Zapata Corp., 658 A.2d 176, 186 (Del. Ch. 1993) ("Thus, like most equity cases, resolution of issues of this sort are highly particularized; factual.").

76. *See* American Gen. Corp. v. Unitrin, Inc., Nos. CIV.A.13656, CIV.A.13699, 1994 WL 698483, at *6 (Del. Ch. Oct. 13, 1994) (mem.) ("The timing of the board's consideration and implementation of the repurchase program indicates that the repurchase program has a defensive purpose."), *rev'd*, 651 A.2d 1361 (Del. 1995).

77. *See* Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1154 (Del. 1990) (evaluating both Paramount's tender offer and revised agreement under second prong of *Unocal*). The court affirmed the Chancellor's rulings and explained:

> Here, on the record facts, the Chancellor found that Time's responsive action to Paramount's tender offer was not aimed at "cramming down" on its shareholders a management-sponsored alternative, but rather had as its goal the carrying forward of a pre-existing transaction in an altered form. Thus, the response was reasonably related to the threat. The Chancellor noted that the revised agreement and its accompanying safety devices did not preclude Paramount from making an offer for the combined Time-Warner company or from changing the conditions of its offer so as not to make the offer dependent upon the nullification of the Time-Warner agreement. Thus, the response was proportionate.

When the primary purpose of the action is to thwart a change of control, the *Unocal* standard also applies.[78] Additionally, the degree of existing control at the time is important in the court's analysis of whether a board acted defensively.[79] In short, the key to avoiding *Unocal*'s enhanced standard is for the board to argue that the board's actions are not defensive because they are not in reaction to an actual or perceived threat and they do not have the purpose of responding to a threat to corporate control.[80]

Two additional points should be kept in mind when dealing with a *Unocal* claim. First, *Unocal* does not require that the board's decision be perfect or the best decision possible; rather, the decision need only be reasonable.[81] Second, *Unocal*'s enhanced scrutiny is very fact specific.[82] As the Delaware Supreme Court admonished in *Unitrin*: "The enhanced judicial scrutiny mandated by *Unocal* is not intended to lead to a structured, mechanistic, mathematical exercise. Conversely, it is not intended to be an abstract theory. The *Unocal* standard is a flexible paradigm that jurists can

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Id.

78. *See Glazer*, 658 A.2d at 186 (noting that when terms were supportive of raising capital, and "not of a masked corporate control purpose," *Unocal* did not apply). *Compare* Packer v. Yampol, No. CIV.A.8432, slip op. at 39 (Del. Ch. Apr. 18, 1986) (stating that supervoting preferred stock gave corporate president control of 44% of voting power and, although corporation stated that its purpose was to raise capital, court found primary purpose was to obstruct proxy contest), *with Glazer*, 658 A.2d at 186 (finding that sale of securities package carrying 17% of corporation's voting power to affiliate after shareholder obtained 40% of corporate stock was not defensive because board contemplated stock issuance for over one year).

79. *See* Tomczak v. Morton Thiokol, Inc., No. CIV.A.7861, 1990 WL 42607, at *9 (Del. Ch. Apr. 5, 1990) (examining degree to which potential suitor infringed on board control). In *Tomczak*, a board decided to sell a division of the corporation to a shareholder who owned eight percent. *Id.* The court applied the *Unocal* standard and stated that the board's actions satisfied this enhanced scrutiny. *See id.* at *9-10 (noting sale had at least purpose of removing threat of possible takeover). The Delaware Supreme Court in a later case, however, held that the *Unocal* standard did not apply to the board's adoption of a general option agreement giving the controlling shareholder family a right of first refusal to purchase any shares offered to people outside of the family. *See* Stroud v. Grace, 606 A.2d 75, 83 (Del. 1992). The *Stroud* court held that because three directors owned over 50% of the corporation, they had control of the corporation in fact, and in law, therefore, the corporation was not a takeover target. *Id.* (refusing to apply *Unocal* standard).

80. *See Glazer*, 658 A.2d at 186 (finding acts nondefensive). *See generally* BNS, Inc. v. Koppers Co., Inc., 683 F. Supp. 458 (D. Del. 1988) (recognizing as nondefensive board's right to extend date when rights detach from tender offer).

81. *See* Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1385-86 (Del. 1995) (explaining that enhanced judicial scrutiny requires determination of whether directors made reasonable decision, not perfect decision).

82. For a discussion of the fact-specific nature of the determination of whether a board's decision is reasonable, see *supra* note 75-77 and accompanying text.

apply to the myriad of 'fact scenarios' that confront corporate boards."[83]

The application of *Unocal* in the typical case in which a challenging party seeks an injunction is clear only if each party's burden is understood. The party seeking the injunction has the burden of establishing that an injunction is appropriate.[84] In order to do so, the party seeking the injunction must establish a reasonable probability of success on the merits if the case goes to trial.[85]

In order for the *Unocal* enhanced scrutiny to apply, the challenging party must first establish that the board unilaterally adopted a defensive measure that touched upon issues of control.[86] If the challenging party is unable to show that the board's action triggered *Unocal*, then the presumptions of the business judgment rule apply.[87] If, however, the challenging party establishes unilateral board adoption of a defensive measure touching on issues of control, then the directors have the burden of meeting *Unocal's* two-prong test.[88]

At that point, the board must demonstrate that it reasonably perceived a threat to corporate policy and effectiveness, and the defensive measure was reasonable in relation to the threat posed.[89] If the board presents no evidence or does not meet its burden under *Unocal*, then the board could nevertheless win the lawsuit if it

83. *Unitrin*, 651 A.2d at 1373 (citations omitted).

84. *See id.* at 1371 (noting that to succeed in preliminary injunction motion, plaintiff must establish that there is "a reasonable probability of irreparable harm" and that harm imposed on plaintiff "outweighs the harm to the defendant").

85. *See id.*

86. *See* Stroud v. Grace, 606 A.2d 75, 82 (Del. 1992) (expanding application of *Unocal* beyond hostile contests to perceived threats to control); Gilbert v. El Paso Co., 575 A.2d 1131, 1136, 1144 (Del. 1990) (delineating that golden parachute agreements, employee savings and stock ownership plans, and shareholder supermajority voting provisions adopted after initiation of tender offer were defensive); BLOCK ET AL., *supra* note 69, at 243-51 (discussing when board conduct is defensive).

87. *See Unitrin*, 651 A.2d at 1373 (discussing presumptions of business judgment rule and procedure for rebutting such presumptions).

88. *See* Williams v. Geier, 671 A.2d 1368, 1376-77 (Del. 1996) (requiring unilateral board action before *Unocal* standard attaches).

89. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (stating that because pending takeover bid necessarily placed board of directors in conflict of interest, director "must show that they had reasonable grounds for believing that a danger . . . existed" and "[i]f a defensive measure is to come within ambit of the business judgment rule, it must be reasonable in relation to the threat posed").

demonstrates that the defensive measure satisfies the entire fairness standard.[90]

Alternatively, if the board meets the *Unocal* enhanced standard of review, the board would then receive the protections of the business judgment rule.[91] In that case, the burden shifts back to the challenging party to rebut the business judgment rule's presumption that the board acted in good faith, with due care and loyalty.[92] If the challenging party is unsuccessful in rebutting the business judgment rule's presumption, the board's decision would be upheld as long as it was not irrational.[93] Conversely, if the challenging party successfully rebutted the business judgment rule by demonstrating that the board breached one or more of its fiduciary duties owed to the corporation and its shareholders, then the burden would shift back to the board to establish the entire fairness of the defensive measure at issue.[94] When shareholders challenge director action in a sale of the company or a change of control transaction, similar issues arise but the board's goals change.

IV. SALE OR CHANGE OF CONTROL—ENHANCED *UNOCAL* DUTIES IN THE *REVLON* MODE

When a board approves a transaction that results in the sale of the corporation or a change of corporate control, the transaction is subject to enhanced judicial scrutiny.[95] In these situations, the courts require the board to act reasonably and seek the transaction

90. *See* Cinerama v. Technicolor, Inc., 663 A.2d 1156, 1180 (Del. 1995) [hereinafter *Cede III*] (holding that when board meets burden of showing entire fairness, board will defeat shareholder challenge); *see also* Palm & Kearney, *supra* note 1, at 1318-19 (discussing entire fairness standard).

91. *See Cede III*, 663 A.2d at 1162 (holding that when plaintiffs rebut presumption of business judgment rule, directors must prove entire fairness); *Unitrin*, 651 A.2d at 1371 n.7 (noting that entire fairness applies when business judgment rule is rebutted); Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993) (same); A.C. Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 114 (Del. Ch. 1986) (applying entire fairness standard when directors failed to meet enhanced scrutiny standard).

92. *See Cede II*, 634 A.2d 345, 361 (Del. 1993) ("To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the *triads* of their fiduciary duty—good faith, loyalty or due care.").

93. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 719 (Del. 1971) (noting that board's decisions "will not be disturbed if they can be attributed to any rational business purpose").

94. *See Cede III*, 663 A.2d at 1162 (holding that when business judgment rule's presumption is rebutted by proof of breach of triad of fiduciary duties, corporation must prove transaction was entirely fair).

95. *See* Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 44 (Del. 1994).

that offers the best value available to the shareholders.[96] Several Delaware Supreme Court decisions have discussed the board's fiduciary duties in the sale or change of control context.[97] One of the most significant cases is *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[98] In *Revlon*, the Delaware Supreme Court held that in the event of a sale of the corporation, the directors must maximize the current value of the shareholders' stock.[99]

In *Revlon*, Pantry Pride initiated a hostile takeover attempt of Revlon.[100] The court first applied the enhanced *Unocal* standard to the board's initial defensive attempts to rebuff the hostile takeover attempts by Pantry Pride.[101] Subsequently faced with the choice of sale of the company by either a hostile takeover by Pantry Pride or a friendly leveraged buyout by Forstmann Little, the Revlon directors chose to enter into the buyout agreement with Forstmann Little.[102]

96. *See id.* ("In the sale of control context, the directors must focus on one primary objective—to secure the transaction offering the best value reasonably available for the stockholders."); Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989) (holding that "the board must act in a neutral manner to encourage the highest possible price for shareholders"); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) ("The duty of the board . . . [is] the maximization of the company's value at a sale for the stockholders' benefit."); Mills Acquisition Co. v. Macmillan, Inc., 459 A.2d 1261, 1288 (Del. 1970) ("[I]n a sale of corporate control the responsibility of the directors is to get the highest value reasonably attainable for the shareholders.").

97. *See* Equity-Linked Investors, L.P. v. Adams, No. CIV.A.15513, 1997 WL 225708, at *12 (Del. Ch. Apr. 25, 1997) (holding that "most prominent" of cases dealing with directors' duties in sale of control transaction was *Revlon* because "that case had been widely thought to announce special directorial duties in the event of a 'sale' of the corporation").

98. 506 A.2d 173 (Del. 1986).

99. *Id.* at 182 (holding that, when it became apparent that sale of company was pending, "duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholder's benefit").

100. *Id.*

101. *See id.* at 180-81 (describing *Revlon*'s plan to thwart hostile takeover attempt by Pantry Pride, through creation of "poison pill" plan and adoption of exchange offer for ten million of its shares). Applying the *Unocal* test to these defensive measures, the court concluded that the board's actions were reasonable in light of the threat of a hostile takeover and were made on an informed basis. *See id.* (explaining that Revlon directors concluded that Pantry Pride's offer was grossly inadequate). After Pantry Pride increased its offer price, the Revlon directors considered a leveraged buyout proposal made by Forstmann Little that would transfer ownership to the Revlon directors themselves. *See id.* at 178. The agreement with Forstmann Little provided for acquisition of 100% of Revlon's outstanding stock by Forstmann and the subsequent breakup of Revlon. *See id.*

102. *See id.* at 184 (explaining board's reason for accepting Forstmann Little offer). The court explained:

> While Forstmann's $57.25 offer was objectively higher than Pantry Pride's $56.25 bid, the margin of superiority is less when the Forstmann price is adjusted for the time value of money. In reality, the Revlon board ended

The court held that when the sale of the company became inevitable, the board's role changed.[103] Instead of being "defenders of the corporate bastion," the board became "auctioneers charged with getting the best price for the stockholders at a sale of the company."[104]

A. *The Basis for the* Revlon *Duty*

The courts have given several reasons justifying an enhanced scrutiny standard of review in sale and change of control transactions. First, such transactions frequently have a negative effect on shareholder voting rights.[105] Second, the transaction typically results in the sale and loss of the shareholders' control premium.[106]

A control premium recognizes not only the value of a control block of shares, but also compensates the shareholders for their loss

> the auction in return for very little actual improvement in the final bid. The principal benefit went to the directors, who avoided personal liability to a class of creditors to whom the board owed no further duty under the circumstances.

Id.

103. *See id.* at 182 (discussing that, when breakup of company is inevitable, "[t]he duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit").

104. *Id.*

105. *See* Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 42 (Del. 1994) ("When a majority of a corporation's voting shares are acquired by a single person or entity, or by a cohesive group acting together, there is a significant diminution in the voting power of those who thereby become minority shareholders."). Delaware courts have consistently acted to protect stockholders from interference with their voting rights by applying an enhanced judicial scrutiny standard to transactions that affect voting rights. *See id.* (explaining importance of voting rights and court's willingness to protect shareholders from interference with such rights). The court stated:

> Under the statutory framework of the General Corporation Law, many of the most fundamental corporate changes can be implemented only if they are approved by a majority vote of the stockholders. Such actions include elections of directors, amendments to the certificate of incorporation, mergers, consolidations, sales of all or substantially all of the assets of the corporation, and dissolution. . . . Because of the overriding importance of voting rights, this Court and the Court of Chancery have consistently acted to protect shareholders from unwarranted interference with such rights.

Id.

106. *See id.* The *Paramount* court stated:

> Such scrutiny is mandated by: (a) the threatened diminution of current shareholders' voting power; (b) the fact that an asset belonging to public stockholders (a control premium) is being sold and may never be available again; and (c) the traditional concern of Delaware courts for actions which impair or impede shareholder voting rights.

Id.; *see also* Mills Acquisition Co. v. Macmillan, Inc. 459 A.2d 1261, 1287 (Del. 1970) (explaining general concern of Delaware courts in sale of control transactions).

of voting power.[107] Once control has shifted in a sale or change of control transaction, the resulting minority stockholders will have no ability to demand another control premium.[108] Therefore, the directors are obliged to "take the maximum advantage of the current opportunity to realize for the stockholders the best value reasonably available."[109]

Following the *Revlon* decision, questions arose as to what transactions trigger enhanced scrutiny under *Revlon* and what the responsibilities under *Revlon* specifically entail.[110] Some courts interpreted *Revlon* as "limit[ing] the range of good faith business judgment[s]" that a board might make once a sale or change of corporate control was inevitable.[111] This regulatory approach led to holdings generally requiring boards to conduct auctions, disallowing "lock-up" agreements and preventing boards from displaying favoritism among bidders without good cause.[112]

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107. *See Paramount*, 637 A.2d at 43 (discussing protection of minority stockholders). The court defined a control premium:

> The acquisition of majority status and the consequent privilege of exerting the powers of majority ownership come at a price. That price is usually a control premium which recognizes not only the value of a control block of shares, but also compensates the minority shareholders for their resulting loss of voting power.

Id.

108. *See id.* (explaining significance of control premiums in Paramount-Viacom transaction). The court stated, "[b]ecause of the intended sale of control, the Paramount-Viacom transaction has economic consequences of considerable significance to the Paramount stockholders. Once control has shifted, the current Paramount stockholders will have no leverage in the future to demand another control premium." *Id.*

109. *Id.* (holding that result of Paramount-Viacom transaction was that resulting shareholders were entitled to receive control premiums).

110. *See* Equity-Linked Investors, L.P. v. Adams, No. CIV.A.15513, 1997 WL 225708, at *12 (Del. Ch. Apr. 25, 1997) (holding that *Revlon*'s "broad generalization masks more questions than it answers"). The court stated that the "meaning of *Revlon*—specifically, when its special duties were triggered, and what those duties specifically required—were questions that repeatedly troubled the bench and the bar in the turbulent wake of the *Revlon* decision." *Id.*

111. *See id.* ("One view of the holding in *Revlon* was that it was premised on a duty . . . that was different in some way from ordinary director duties: to act in good faith pursuit of corporate welfare and to be informed and attentive."). The court stated that "[o]n this view, once a 'sale' of the corporation was in contemplation, 'Revlon duties' would be thought to limit the range of good faith business judgment that the board might make . . . and afforded a reviewing court additional (fairness) grounds in any judicial review of director action." *Id.*

112. *See id.* (citing examples of Delaware Supreme Court decisions which held that, in sale of control transaction, directors' duties were altered, thereby requiring them to perform and refrain from specific types of conduct); *see also* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1286 (Del. 1988) (interpreting *Revlon* as holding that "no-shop" clause will not be allowed "[a]bsent a material advantage to the stockholders").

Other opinions interpreting *Revlon* focused on the necessity of preserving the board's ability to make business judgments.[113] In these cases, the Delaware Supreme Court based its decisions on such factors as whether the board adequately informed itself and whether it acted in good faith when it approved the transaction to sell or to change corporate control.[114] In these cases, the court did not interpret *Revlon* as requiring directors to follow a set formula or to treat all bidders equally and "keep a level playing field."[115] Rather, courts merely required directors to comply with their basic fiduciary duties while attempting to maximize shareholder value.[116] Courts thereby gave significant deference to directors in conducting a corporate sale as long as the board's decisions were reasonably related to maximizing shareholder value.[117]

B. *Maximizing Shareholder Value*

In *Paramount, Inc. v. QVC Network, Inc.*,[118] the court clarified many of the remaining issues arising from the earlier cases.[119] The court in *Paramount* held that when a board approves a transaction that results in a change of corporate control, such that the stockholders are no longer able to participate in a change of control premium, the board must be reasonable and act in good faith in obtaining the best offer reasonably available.[120] The court in *Para-*

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113. *See Equity-Linked Investors*, 1997 WL 225708, at *13 (holding that some cases "tended to 'normalize' directors' duties in these important transactions; they reflect greater deference to an independent board even in a 'sale' context, and acknowledged the necessity of an independent board to make business judgment even in that setting").

114. *See id.* ("[T]hese cases tended to evaluate board conduct . . . in terms of the board's steps to be informed and its good faith.").

115. *See* TW Servs. Inc. v. SWT Acquisition Corp., Nos.CIV.A 10427, 10298, 1989 WL 20290, at *7,(Del. Ch. Mar. 2, 1989) ("[T]he so-called *Revlon* duty is not necessarily a duty to conduct an 'auction' or to keep 'a level playing field' when the firm is for sale,. . . or, indeed, to proceed in any prescribed way; rather, it is the duty to exercise judgment (in good faith and prudently) in an effort to maximize immediate share value.").

116. *See Equity-Linked Investors*, 1997 WL 225708, at *13 ("So long as it satisfied a burden to show compliance with its basic duties—independence, good faith and due attentiveness—the board's judgments would be respected.").

117. *See id.* ("Under this more business judgment like view, the board continued to possess substantial discretion with respect to conducting a sale.").

118. 637 A.2d 34 (Del. 1994).

119. *See Equity-Linked Investors*, 1997 WL 225708, at *13 ("[The] existing uncertainty respecting the meaning of '*Revlon* duties' was substantially dissipated by the Delaware Supreme Court's opinion in *Paramount*.").

120. *See id.* (noting where directors' loyalties should be in change of control situation). The court in *Equity-Linked Investors* summarized *Paramount*'s holding:

> [*Paramount*] teaches a great deal, but it may be said to support these generalizations at least: (1) where a transaction constituted a "change in cor-

mount held that a reasonableness standard of review would apply in sale or change of control situations.[121]

The *Paramount* holding represents a middle ground between the earlier, arguably more regulatory interpretations of *Revlon* and those interpretations that seemed more focused on preserving the business judgment rule.[122] In reconciling these two arguably conflicting lines of cases, *Paramount* adopted an intermediate approach that recognized the importance of allowing directors to make business judgments in a sale or change of control situation, so long as the board acted reasonably in carrying out its duties of good faith, care and loyalty to obtain the best available offer.[123]

The court in *Paramount* also stated that the directors must be "especially diligent" when pursuing their duty to maximize shareholder value.[124] Specifically, the board must adequately inform itself before negotiating a sale of control.[125] These methods may

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> porate control," such that the shareholders would thereafter lose a further opportunity to participate in a change of control premium, (2) the board's duty of loyalty requires it to try in good faith to get the best price reasonably available (which specifically means that the board must at least discuss an interest expressed by any financially capable buyer), and (3) in such context courts will employ an (objective) "reasonableness" standard of review (both to the process and the result!) to evaluate whether the directors have complied with their fundamental duties of care and good faith (loyalty).

Id.

121. *See Paramount,* 637 A.2d at 43 (holding that "[t]he courts will apply enhanced scrutiny to ensure that the directors will have acted reasonably").

122. *See Equity-Linked Investors,* 1997 WL 225708, at *13 (stating that *Paramount* "in effect mediates between the 'normalizing' tendency of some prior cases and the more highly regulatory approach of others").

123. *See id.* The court in *Equity-Linked Investors* stated that:

> [*Paramount*] adopts an intermediate level of judicial review which recognizes the broad power of the board to make decisions in the process of negotiating and recommending a "sale of control" transaction, so long as the board is informed, motivated by good faith desire to achieve the best available transaction, and proceeds "reasonably." *Id.*

124. *See Paramount,* 637 A.2d at 44 (explaining required diligence of directors when acting on behalf of corporation).

125. *See id.* (noting that Delaware Supreme Court "has stressed the importance of the board being adequately informed in negotiating a sale of control: 'The need for adequate information is central to the enlightened evaluation of a transaction that a board must make.'" (quoting Barkan v. Amsted Indus., 567 A. 2d 1279, 1287 (Del. 1989))) The court recognized that there are several methods through which boards may fulfill their *Revlon* duty. *See id.* ("Delaware law recognizes that there is 'no single blueprint' that directors must follow." (citations omitted) ; *see also* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1285-86 (Del. 1988) (explaining, for example, that "[d]irectors are not required by Delaware law to conduct an auction according to some standard formula, only that they observe the significant requirement of fairness for the purpose of enhancing general shareholder interests"). The court stated that the *Revlon* duty "does not preclude differing treatment of bidders when necessary to advance [shareholder] interests.

include, but do not always require that the board conduct an auction or canvass the market.[126] In addition, the court considered participation from independent, outside directors an important factor because of the potential management bias towards a particular offeror.[127]

In all cases, the board's clear objective must be to inform itself of all of the material information that is reasonably available to determine what alternative provides the best value to the stockholders.[128] In determining what alternative provides the greatest value for the shareholders, the board can consider factors other than the total dollar amount of the offer, including the offer's fairness, the type of financing behind the offer, information concerning the bidder and the likelihood of consummating the deal.[129]

Thus, if a shareholder challenges a transaction that triggers the *Revlon* responsibilities, courts perform an enhanced scrutiny test to determine the reasonableness of the board's decisions.[130] The

Variables may occur which necessitate such treatment. However, the board's primary objective, and essential purpose, must remain the enhancement of the bidding process for the benefit of the stockholders." *Id.* at 1286-87.

126. *See Barkan*, 567 A.2d at 1286-87 (explaining some of methods by which boards can fulfill their *Revlon* duties).

127. *See Paramount*, 637 A.2d at 44 ("Moreover, the role of outside, independent directors becomes particularly important because of the magnitude of a sale of control transaction and the possibility, in certain cases, that management may not necessarily be impartial.").

128. *See id.* at 44-45 ("While the assessment of these factors may be complex, the board's goal is straightforward: Having informed themselves of all material information reasonably available, the directors must decide which alternative is most likely to offer the best value reasonably available to the stockholders.").

129. *See id.* ("In determining which alternative provides the best value for the stockholders, a board of directors is not limited to considering only the amount of cash involved and is not required to ignore totally its view of the future value of a strategic reliance."). The court in *Paramount* stated that

> the directors should analyze the entire situation and evaluate in a disciplined manner the consideration being offered. Where stock or other non-cash consideration is involved, the board should try to quantify its value, if feasible, to achieve an objective comparison of the alternatives. In addition, the board may assess a variety of practical considerations relating to each alternative, including: "[an offer's] fairness and feasibility; the proposed or actual financing for the offer, and the consequence of that financing; questions of illegality; . . . the risk of nonconsum[m]ation; . . . the bidder's identity, prior background and other business venture experiences; and the bidder's business plans for the corporation and their effects on stockholder interests."

Id. (quoting *Mills*, 559 A.2d at 1282 n.29).

130. *See id.* 637 A.2d at 45 (holding that board action subject to enhanced scrutiny when stockholder voting power was threatened and when control premium was being sold and may never be available again). The court noted that two key aspects of enhanced scrutiny test are "(a) a judicial determination regarding the adequacy of the decisionmaking process employed by the directors, including

court in *Paramount* stressed that because of the intricacies involved in a sale or change of control transaction, the board's decision need not be perfect. Instead, the board's decision must be reasonable under the circumstances that existed when the decision was made.[131] As long as the board's decision was reasonable when made, the courts will not question that decision.[132]

C. *When Does* Revlon *Apply?*

Before a court will apply enhanced scrutiny in this context, a plaintiff has the initial burden of establishing that the transaction will result in the sale or change of control of the company.[133] In *Paramount*, the Delaware Supreme Court held that there are generally two scenarios that trigger enhanced scrutiny review under *Revlon*: (1) when a corporation initiates an active bidding process in an attempt to sell itself or breakup the company and (2) when a corporation responds to a bidder's offer by abandoning its long-term strategy in an attempt to sell or breakup the company.[134]

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the information on which the directors based their decisions; and (b) a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing." *Id.*

131. *See id.* (applying same reasonableness standard that is applied in change of control situations). The court stated:

> Although an enhanced scrutiny test involves a review of the reasonableness of the substantive merits of a board's actions, a court should not ignore the complexity of the directors' task in a sale of control. There are many business and financial considerations implicated in investigating and selecting the best value reasonably available. The board of directors is the corporate decisionmaking body best equipped to make those judgments. Accordingly, a court applying enhanced judicial scrutiny should be deciding whether the directors made *a reasonable* decision, not *a perfect* decision.

Id. (emphasis added).

132. *See id.* ("If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination.").

133. *See In re* Wheelabrator Tech. Inc. Shareholders Litig., No. CIV.A.11495, 1992 WL 212595, at *8 (Del. Ch. Sept. 1, 1992) (holding that challenging party must prove that *Revlon* applies).

134. *See Paramount*, 637 A.2d at 47 (discussing application of *Revlon* duties). The court explained what actions trigger *Revlon* duties:

> Under Delaware law there are, generally speaking and *without excluding other possibilities*, two circumstances which may implicate *Revlon* duties. The first, and clearer one, is when a corporation *initiates an active bidding process seeking to sell itself* or to effect a business reorganization involving a clear breakup of the company. However, *Revlon* duties may also be triggered where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the breakup of the company.

Id. (citing Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1150 (Del. Ch. 1990)).

In the first situation, the active bidding process must make it inevitable that the target company will be sold to one of the competing bidders.[135] A sale is "inevitable" when a corporation's board solicits bids for the sale of the company after recognizing that the company is the likely target of a hostile takeover.[136] Actions such as merger agreements, however, do not necessarily indicate an inevitable sale and do not alone trigger enhanced judicial scrutiny.[137] Thus, a sale of control is not necessarily inevitable any time a company enters into a business combination or acquisition agreement with another company.[138]

135. *See id.* at 46 ("The decisions of this Court following *Revlon* reinforced the applicability of enhanced scrutiny and the director's obligations to seek the best value reasonably available for the stockholders where there is a pending sale of control, regardless of whether or not there is to be a breakup of the corporation.").

136. *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1284-87 (Del. 1988) (holding that *Revlon* duties were triggered when Macmillan board, after recognizing that company was likely target for hostile takeover bid, formally authorized Macmillan's investment advisors to explore sale of company); *see also* Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 67-69 (Del. 1989) (holding that *Revlon* duties were triggered once board "shopped the company" to potential buyers after concluding that it would be in best interests of stockholders to sell company).

137. *See Time*, 571 A.2d at 1151 (refusing to extend *Revlon*'s application to corporate transactions "simply because they might be construed as putting a corporation either 'in play' or 'up for sale'"). In *Ivanhoe Partners v. Newmont Mining Corp.*, 533 A.2d 585 (Del. Ch. 1987), Newmont's board of directors allowed its largest stockholder to attempt a street sweep in order to prevent a hostile takeover by Ivanhoe. *See id.* The court held that the sole fact that Ivanhoe solicited a friendly investor to own 49% of its stock in an attempt to thwart a hostile takeover did not alone trigger *Revlon* duties. *See id.* (holding that friendly investor was not "bidder" because investor's "primary desire was to protect its investment in Newmont, not to acquire and operate that company").

138. *See* Arnold v. Society for Sav. Bancorp., Inc., No. CIV.A.12883, 1993 WL 526781, at *10 (Del. Ch. Dec. 17, 1993) (noting that combination or agreement can keep directors in control, and therefore, directors can still focus on long-term goals of company), *rev'd on other grounds*, 650 A.2d 1270 (Del. 1994). In *Arnold*, the court applied the two-category test used in *Time* and found that the company's actions did not trigger a duty under either category. *See id.* Specifically, the court found that the company's "deliberate choice to pursue . . . long-term business and recovery options" removed the company from the auction block, and moreover, there was no change of control here that would trigger *Revlon*. *See id.* at *10-11 (considering following factors in determining whether such market existed: (1) both companies were publicly owned; (2) one individual or entity did not own large controlling block of shares in either company; and (3) nothing suggested that "continuity of Bancorp's shareholders in the merged entity is threatened"). For example, a sale of only a division of a company is not necessarily evidence of a future change of control. *See* Tomczak v. Morton Thiokol, Inc., No. CIV.A.7861, 1990 WL 42607, at *15 (Del. Ch. Apr. 5, 1990) (holding that *Revlon* duty was not triggered because sale of division of Thiokol "did not constitute the sale of the entire company, or even most of the company, nor was [the company] seeking to effect a business reorganization involving a clear break-up of the company").

Though the Paramount board did not have the subjective intent to sell or breakup the company, the "Paramount board, albeit unintentionally, had initiated an active bidding process seeking to sell itself by agreeing to sell control of the corporation to Viacom in circumstances where another potential acquiror (QVC) was equally interested in being a bidder."[139] In *Paramount*, a sale of control took place because the transaction would have transferred control of Paramount to a single individual, Viacom's majority shareholder.[140] On the other hand, no change of control transaction or sale occurs when "an aggregation of unaffiliated shareholders own the corporation before the transaction, and a different aggregation of unaffiliated shareholders" own the corporation after the consummation of the transaction.[141]

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139. *Paramount*, 637 A.2d at 47-51 (finding that sale of control occurred and applying *Revlon* duties). In mid-1993, Viacom and Paramount signed a merger agreement replete with defensive provisions, including a $100 million termination fee, a no-shop provision limiting Paramount's ability to consider other deals and a "lock-up" provision giving Viacom the right to purchase up to 20% of Paramount's stock, at then-existing market prices, if the deal was not completed. *See id.* at 39. About one month after the merger announcement, QVC announced a substantial tender offer for 51% of Paramount's stock. *See id.* at 40. In response, Viacom and Paramount amended their merger agreement and Viacom commenced a tender offer for Paramount's shares without modification of its defensive provisions. *See id.* at 40-41. A "bidding war" ensued and Paramount's board rejected QVC's tender, arguing that the QVC offer was excessively conditional and that the Viacom offer "would be more advantageous to Paramount's future business prospects than a QVC transaction." *Id.* at 41. QVC sued to enjoin consummation of the Viacom tender offer, and the court issued a preliminary injunction that stopped the Paramount-Viacom deal. *See id.*

140. *Id.* at 43 (explaining that, in event of Paramount-Viacom transaction, there would be single controlling stockholder who would have ultimate voting power).

141. *See id.* (concluding that *Revlon* duties were triggered because proposed sale of control would have removed control of corporation from "fluid aggregation of unaffiliated stockholders"). Before a court will apply *Revlon*'s enhanced scrutiny, a plaintiff must prove that a transaction will cause a change of control, even though it is not always clear if a single person, entity or group will control the corporation until after a transaction occurs. *See In re* Santa Fe Pac. Corp. Shareholders Litig., 669 A.2d 59, 71 (Del. 1995) (dismissing *Revlon* claim because plaintiff did not allege that control, after transaction, would not remain "in a large, fluid, changeable and changing market"). If a stockholder's ownership of a corporation following a transaction is less than 50%, personal and/or commercial relationships between the shareholder and the board of directors may be sufficient to support a finding of future control. *See In re* Tri-Star Pictures, Inc., 634 A.2d 319, 328-29 (Del. 1993) (holding that stockholder who owned only 36.8% of company but had commercial agreements with directors could exercise effective control over company). The plaintiff proved that the stockholder had relationships with the board of directors which indicated that the stockholder had dominion over the board. *See id.* Absent these relationships though, the Delaware courts have not found that shareholders owning less than 50% of a corporation will presumably obtain control. *See* Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1113-14 (Del. 1994) (holding that "'shareholder who owns less than 50% of a corpora-

A board's action also triggers *Revlon* when, in response to a bidder's offer, a target company abandons its long-term strategy and attempts to sell or breakup the company.[142] When the board chooses to sell the company, it is giving up its control and no longer has a long-term interest in corporate policy and effectiveness. Therefore, when courts apply the duty to maximize shareholder value in the company, the board can only look to short-term interests.[143] If a board of directors abandons the corporation's continued existence and decides to sell the company in response to a hostile tender offer, then the courts will apply the enhanced *Unocal* standard and the board must maximize shareholder value.[144] If, however, the board merely adopts defensive measures that do not result in the breakup of the company or sale of corporate control, the courts will apply the enhanced *Unocal* duties to determine if the board acted reasonably to protect the corporation.[145]

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tion's outstanding stocks does not, without more, become a controlling shareholder of that corporation, with a concomitant fiduciary status'" (quoting *Citron*, 569 A.2d at 70)). To establish a relationship between a shareholder and the directors, the plaintiff must prove that the directors subverted their judgment to serve the personal conflicting interests of the "controlling" shareholder. *See Kahn*, 638 A.2d at 1113-14 (stating that, for plaintiffs to establish such relationship, they must "allege domination by a minority shareholder through actual control of corporation conduct"); Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993) (holding that in order to establish directors' lack of independence, plaintiff must show that directors were "beholden" to shareholders).

142. *See Paramount*, 637 A.2d at 47 (rejecting defendant's argument that both change of control and breakup were required to trigger *Revlon*). The court stated:

> Such a holding would unduly restrict the application of *Revlon*. . . . There are few events that have a more significant impact on the stockholders than a sale of control or a corporate breakup. Each event represents a fundamental (and perhaps irrevocable) change in the nature of the corporate enterprise from a practical standpoint. It is the significance of *each* of these events that justifies: (a) focusing on the directors' obligation to seek the best value reasonably available to the stockholders; and (b) requiring a close scrutiny of board action which could be contrary to the stockholders' interests.

Id. at 47-48.

143. *See* Mills Acquisition Co. v. Macmillan Corp., 559 A.2d 1261, 1268 (Del. 1988) (explaining how certain defense measures trigger *Revlon* duties). The court in *Mills* held that lock-ups trigger *Revlon* duties when the lock-ups served as a detriment to the shareholders by ending an active auction and foreclosing further bidding. *See id.* Additionally, the court held that no-shop clauses trigger *Revlon* duties when they fail to provide a "material advantage" to the stockholders. *See id.*

144. *See* Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1150 (Del. 1989) (explaining that *Revlon* court's decision to impose duty to maximize shareholder value was triggered because board responded to hostile takeover by "contemplating a 'bust-up' sale of assets in a leveraged acquisition" (quoting Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986))).

145. *See Time*, 571 A.2d at 1151 ("The adoption of structural safety devices alone does not trigger *Revlon*."). In *Time*, the court found that Time's stated belief of a long-term strategic alliance with its suitor, Warner Communications, was evi-

When *Revlon* responsibilities attach, the burden is on the board to prove its actions were reasonable.[146] If the board proves that its actions were reasonable, the board then receives the protection of the presumptions of the business judgment rule.[147] If, however, the board cannot satisfy its *Revlon* duties, the court will review the transaction under the entire fairness standard.[148] When the decision of the board is tainted by self-interest, this duty of loyalty breach will rebut the presumption of propriety under the business judgment rule and the court will review the transaction under the entire fairness standard.[149] In addition to situations in which the board unilaterally adopts defensive measures or decides to sell the company, courts will also apply a different type of enhanced judicial scrutiny to cases in which board actions significantly interfere with shareholder voting rights.

V. MANIPULATING THE SHAREHOLDER FRANCHISE—*BLASIUS'* COMPELLING JUSTIFICATION STANDARD OF REVIEW

Courts apply a different enhanced scrutiny standard of review to board action that directly manipulates shareholder voting rights

dence that Time's board of directors did not intend to sell control of the company. *See id.* at 1154 ("Directors are not obliged to abandon a deliberately conceived corporate plan for a short term shareholder profit unless there is clearly no basis to sustain the corporate strategy."). The court held that Time's adoption of defensive measures to protect its stock-for-stock merger with Warner did not trigger the *Revlon* duty. *See id.* at 1151 ("The adoption of structural safety devices alone does not trigger *Revlon.*"). In addition, the court concluded that Time's recasting of its merger agreement with Warner, from a share exchange to a share purchase after an unwarranted tender offer was made by Paramount, did not provide sufficient reason to conclude that Time had either abandoned its long-term strategic plan or made a sale of Time inevitable. *See id.* ("[W]e do not find in Time's recasting of its merger agreement with Warner from a share exchange to a share purchase a basis to conclude that Time had either abandoned its strategic plan or made a sale of Time inevitable."). Even though Warner would end up with 62% of Time's stock as a result of the new agreement, the court held that a sale of control was not made because the merger merely represented a strategic plan for Time's expansion in which Time's board of directors would retain control. *See id.* at 1146 (explaining ownership percentages following proposed merger).

146. *See Revlon,* 506 A.2d at 180 (noting that when potential for conflict exists, burden rests on directors to prove reasonableness).

147. *See Paramount,* 637 A.2d at 45 ("When *Revlon* duties devolve upon directors, this Court will continue to exact an enhanced judicial scrutiny at the threshold, as in *Unocal,* before the normal presumptions of the business judgment rule will apply.").

148. *See Mills,* 559 A.2d at 1287 (stating that when *Revlon* test is met, *Unocal* standards will apply); *see also* Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1377 (Del. 1995) (holding that when *Unocal's* reasonableness standard is met, court will review transaction under entire fairness standard).

149. *See* Palm & Kearney, *supra* note 1, at 1309-12 (defining effect of breach of loyalty on application of business judgment rule).

in order to thwart those rights.[150] Heightened scrutiny is appropriate in these situations because the board's tactics effectively deny the shareholders' basic right to exert control over the board's management, thereby altering the fundamental allocation of power between the shareholders and the board of directors.[151] Once the challenging shareholder shows that the board has manipulated shareholder voting rights in order to thwart those rights, the burden shifts to the directors to show that the board had a compelling justification for infringing upon the effective exercise of the shareholder franchise.[152] If the board meets this burden, the board gets the benefit of the business judgment rule and the burden shifts back to the challenging shareholder to rebut the rule's presumptions of propriety.[153]

A. Blasius' *Compelling Justification Standard of Review*

The genesis for the "compelling justification" requirement can be found in two early Delaware court decisions, *Condec Corp. v. Lunkenheimer Co.*[154] and *Schnell v. Chris-Craft Industries, Inc.*[155] In

150. *See* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988) (holding that enhanced scrutiny is applied to board actions that impede shareholder voting rights); *see also* Kidsco, Inc. v. Dinsmore, 674 A.2d 483, 495-96 (Del. Ch.) (recognizing application of enhanced scrutiny test when directors impede shareholder franchise), *aff'd*, 670 A.2d 1338 (Del. 1995).

151. *See Blasius*, 564 A.2d at 659 (emphasizing importance of maintaining shareholder franchise). The court stated:

> The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests. Generally, shareholders have only two protections against perceived inadequate business performance. They may sell their stock (which, if done in sufficient numbers, may so affect security prices as to create an incentive for altered managerial performance), or they may vote to replace incumbent board members. . . . [W]hether the vote is seen functionally as an unimportant formalism, or as an important tool of discipline, it is clear that it is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own. Thus, when viewed from a broad, institutional perspective, it can be seen that matters involving the integrity of the shareholder voting process involve consideration not present in any other context in which directors exercise delegated power.

Id.

152. *See id.* at 661 (stating that when board acts for primary purpose of impeding stockholders' voting exercise, actions will be upheld only when board meets "the heavy burden of demonstrating a compelling justification for such action").

153. *See In re* Santa Fe Pac. Corp. Shareholder Litig., 669 A.2d 59, 71 (Del. 1995) (noting that once boards meet enhanced scrutiny burden, whether it be *Unocal* or *Blasius*, presumptions of business judgment rule attach).

154. 230 A.2d 769 (Del. Ch. 1967).

155. 285 A.2d 437 (Del. 1971). In *Schnell*, the Delaware Supreme Court enjoined management from advancing an annual shareholders' meeting that was set according to the bylaws to an earlier date in order to impede a successful proxy

Condec, the Chancery Court adopted a per se rule that a good faith dispute over corporate policy could never justify board action enacted primarily to reduce the voting power of a controlling shareholder.[156] Although *Condec*'s per se rule was eventually abandoned by the Delaware courts as being overly broad, the holding highlighted the court's assiduous protection of corporate democracy.[157] The court in *Schnell* introduced the principle that courts would not condone technically "legal" acts when used to achieve inequitable ends.[158]

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fight by shareholders. *Id.* at 439-40 (holding that advancement of bylaw date of stockholders' meeting by board, in attempt to obstruct legitimate efforts of dissident stockholders in exercise of their rights to undertake proxy contest against management, is contrary to established principles of corporate democracy and, thus, was impermissible). The court concluded that the primary purpose of the board action was "inequitable," and therefore, not permissible because it was an attempt to utilize the "corporate machinery and the Delaware Law for the purpose of perpetuating itself in office." *See id.* at 439 ("[The board of directors] attempted to utilize the corporate machinery and the Delaware Law for the purpose of perpetuating itself in office . . . . These are inequitable purposes, contrary to established principles of corporate democracy."). The fact that management acted legally and complied strictly with the provisions of Delaware corporate law does not allow an inequitable action to become permissible. *See id.*

156. *Condec*, 230 A.2d at 775-77 (holding that board's issuance of additional authorized but unissued shares to selectively dilute majority shareholder into minority shareholder was per se invalid). The court stated that

> [such board action] was clearly unwarranted because it unjustifiably strikes at the very heart of corporate representation by causing a stockholder with an equitable right to a majority of corporate stock to have his right to a proportionate voice and influence in corporate affairs to be diminished by the simple act of an exchange of stock which brought no money into the Lunkenheimer treasury, was not connected with a stock option plan or other proper corporate purpose, and which was obviously designed for the primary purpose of reducing Condec's stockholdings in Lunkenheimer below a majority.

Id. at 777.

157. *See Blasius*, 564 A.2d at 661 (stating that per se rule that would strike down any board action taken for primary purpose of interfering with effectiveness of corporate vote has advantage of "vigorously enforcing" concept of corporate democracy, but also has disadvantage that it may sweep too broadly); *see also* Phillips v. Insituform of N. Am., Inc., No. CIV.A.9173, 1987 WL 16285, at *8 (Del. Ch. Aug. 27, 1987) (refusing to apply per se rule of *Condec* and leaving open whether Delaware law created "unyielding prohibition to the issuance of stock for the primary purpose of depriving a controlling shareholder of control or whether, as *Unocal* suggests . . ., such an extraordinary step might be justified in some circumstances"). The court in *Phillips* held that "no justification has been shown that would arguably make the extraordinary step of issuance of stock for the admitted purpose of impeding the exercise of stockholder rights reasonable in light of the corporate benefit, if any, sought to be obtained." *Id.*

158. *See, e.g.*, Lerman v. Diagnostic Data, Inc., 421 A.2d 906, 907 (Del. Ch. 1980) (enjoining board of directors from taking action that was legal, but that was intended to prevent shareholder proxy contest). The court noted that "[i]n *Schnell*, as it is by now well known to those involved with Delaware corporation law, it was held that inequitable action by management in amending corporate bylaws

Following *Condec* and *Schnell*, Delaware courts began to apply heightened scrutiny to directors' actions that impeded shareholder voting rights.[159] Even after *Unocal*'s enhanced scrutiny became the standard of review for defensive actions taken by directors to prevent takeover attempts, courts continued to distinguish between defensive actions and those actions involving the direct manipulation of shareholder voting rights.[160] Delaware courts applied an even stricter scrutiny in the latter cases, many of which involved situations in which the board was losing a voting battle.[161]

The Chancery Court of Delaware first enunciated the "compelling justification" standard in *Blasius Industries, Inc. v. Atlas Corp.*[162] In that case, Blasius was a new stockholder of Atlas who had accumulated over nine percent of Atlas' common stock within four months; Blasius then subsequently recommended that Atlas restructure the company, amend its bylaws to increase the size of its board and fill the new directorships with Blasius' nominees.[163] The board viewed Blasius' action as an attempt to takeover the company.[164] The board then amended the corporation's bylaws to change the date of the shareholders' meeting, increased the size of its board

so as to change the date of the annual meeting did not become permissible simply because it was legally possible." *Id.* at 907, 914 (enjoining board from changing its bylaws and scheduling annual meeting, after receiving notice of shareholders' intent to commence a proxy contest, so that shareholders could not comply with notice provisions concerning director nominations); *see also* Giuricich v. Emtrol Corp., 449 A.2d 232, 239 (Del. 1982) ("The courts of this state will not allow the wrongful subversion of corporate democracy by manipulation of the corporate machinery or by machinations under the cloak of Delaware law." (citing *Schnell*, 285 A.2d 437)). The court found that the election of successor directors had been effectively frustrated by a willful perpetuation of a deadlock for the admitted "primary purpose" of giving the incumbents "the governing hand in forthcoming executive compensation contract negotiations." *Id.* (applying "careful judicial scrutiny," and recommending appointment of custodian for corporation). The act may have been legal, but the court rendered it invalid. *See id.* ("This is an unworthy purpose, creating a situation violative of corporate democracy.").

159. *See* Aprahamian v. HBO & Co., 531 A.2d 1204, 1207 (Del. Ch. 1987).

160. *See id.* (rejecting argument that decision to delay annual meeting was in stockholder interest and should be given deference and holding that evidence existed that decision manipulated election machinery and that, therefore, board had burden of justification). The court explained that "[w]hen the election machinery appears, at least facially, to have been manipulated, those in charge of the election have the burden of persuasion to justify their actions." *Id.*

161. *See Schnell*, 285 A.2d at 439 (holding that management's attempt to utilize Delaware law for purposes of perpetrating itself in office and obstructing legitimate efforts of dissident stockholders to exercise their rights to undertake proxy contest against management is impermissible). The fact that management's inequitable action is legally possible is not sufficient to render it permissible. *See id.*

162. 564 A.2d 651 (Del. Ch. 1988).

163. *See id.* at 653-54.

164. *See id.*

from seven to nine and filled the two new positions with nominees friendly to the incumbent board.[165]

In reviewing these board actions, the court recognized that the directors acted to protect the company and its stockholders from what they, in good faith, believed was an unwise and potentially harmful consent solicitation proposed by a shareholder.[166] The court also found that the incumbent board acted within its legal authority in increasing the board's size from seven to nine.[167] Nonetheless, because the board's primary purpose in acting was to thwart a hostile shareholder's majority vote, the court found that the board had committed an unintended breach of the duty of loyalty to the corporation's shareholders.[168] The court ruled that because the board's actions inevitably involved a conflict of interest, the court should not apply the deferential business judgment rule, but should instead review the board's actions under a stricter standard—the compelling justification standard.[169] Under this standard, the court rejected the board's justification that "the board knows better than do the shareholders what was in the corporation's best interest."[170] Probably because of the difficulty of meet-

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165. *See id.* (discussing board's emergency decision to expand number of directors by amending bylaws). Although there was a scheduled meeting within a week, the board called an emergency meeting in order to add additional directors. *See id.* Evidence suggested, and the court concluded, that the board was motivated to preclude the holders of a majority of the company's shares from placing a majority of new directors on the board through Blasius' consent solicitation. *See id.* at 656 (concluding that board immediately endorsed persons for board in order to preclude majority of shareholders from electing new board members selected by Blasius).

166. *See id.* at 663 (noting that board entitled to take steps to evade perceived risk).

167. *See id.* ("[T]he addition of these qualified men would, under other circumstances, be clearly appropriate as an independent step."). The court noted that if the board was not motivated to thwart a shareholder majority, "but rather had taken action completely independently of the consent solicitation, . . . it is very unlikely that such action would be subject to judicial nullification." *Id.* at 655 (citing Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 407 (Del. 1985); Moran v. Household Int'l, Inc., 490 A.2d 1059, 1080 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985)).

168. *See Blasius*, 564 A.2d at 655 (concluding that even though "the action taken was taken in good faith, it constituted an unintended violation of the duty of loyalty that the board owed to the shareholders").

169. *See id.* at 660-61 (noting that when action interferes with effectiveness of shareholder vote, there inevitably exists conflict between board and shareholder majority and "the board bears the heavy burden of demonstrating a compelling justification for such action").

170. *Id.* ("The theory of our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters."). The court, however, elaborated on its reluctance to adopt a per se rule:

> In my view, our inability to foresee now all of the future settings in which a board might, in good faith, paternalistically seek to thwart a share-

ing the "compelling justification" standard and the few situations in which the board acts in order to impede the shareholder franchise, Delaware courts have sparingly applied the *Blasius* analysis.[171]

In *Blasius*, the court noted that *Unocal*'s standard of review did not apply to an action "designed for the primary purpose of interfering with the effectiveness of a stockholder vote."[172] The court in *Blasius* held that such action required closer scrutiny than that provided by *Unocal* because of the importance of the shareholder franchise to the scheme of corporate governance.[173] In later cases, however, issues arose over what standards applied in situations arguably involving the manipulation of shareholder voting rights, but also involving defensive responses that precluded, coerced or significantly affected shareholder choices.[174] The issue became whether *Unocal*, *Blasius* or some combination of the two provided the applicable rules in such cases. This distinction between *Blasius* and *Unocal* was recognized by the Delaware Supreme Court in the *Unitrin* decision, when the court clarified a number of issues under *Unocal*, including the relationship between *Blasius* and *Unocal*.[175]

> holder vote, counsels against the adoption of a per se rule invalidating, in equity, every board action taken for the sole or primary purpose of thwarting a shareholder vote, even though I recognize the transcending significance of the franchise to the claims to legitimacy of our scheme of corporate governance. It may be that some set of facts would justify such extreme action.

Id.

171. *See* Dolgoff v. Projectavision, Inc., No. CIV.A.14805, 1996 WL 91945, at *7 (Del. Ch. Feb. 26, 1996) (holding that "equitable power" of *Blasius* "obviously must be invoked sparingly and only when circumstances make relatively clear that inequitable behavior or manipulation is present" (citing Alabama By-Prods. Corp. v. Neal, 588 A.2d 255, 258 n.1 (Del. 1991); Staar Surgical Co. v. Waggoner, 588 A.2d 1130, 1137 n.2 (Del. 1991))).

172. *Blasius*, 564 A.2d at 659 ("Our authorities, as well as sound principles, suggest that the central importance of the franchise to the scheme of corporate governance, requires that, in this setting, [*Unocal*'s enhanced scrutiny] not be applied and that closer scrutiny be accorded to such transaction.").

173. *See id.* at 662.

174. *See* Kidsco, Inc. v. Dinsmore, 674 A.2d 483, 495 (Del. Ch.) (recognizing that certain claims raise "the question of what form of analysis—*Blasius*, *Unocal*, or an amalgam of both—is to be employed"), *aff'd*, 670 A.2d 1338 (Del. 1995); *see also* Gregory W. Werkheiser, Comment, *Defending the Corporate Bastion: Proportionality and the Treatment of Draconian Defenses from* Unocal *to* Unitrin, 21 DEL. J. CORP. L. 103, 124-26 (1996) (examining "the continued viability of *Blasius* as a separate doctrine in the post-*Unitrin* landscape").

175. *See* Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1373-74 (Del. 1995) (stating that enhanced judicial scrutiny mandated by *Unocal* is not structured, mechanical exercise, but rather "a flexible paradigm that jurists can apply to the myriad of 'fact scenarios' that confront corporate boards" (citing Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1153 (Del. 1990))).

B. *Distinctions Between the* Blasius *and* Unocal/Unitrin *Standards of Review*

Determining whether the *Unocal/ Unitrin* "enhanced scrutiny" or the *Blasius* "compelling justification" standard of review should be applied is sometimes difficult.[176] To determine whether *Blasius* alone or *Unocal* applies to a particular board action, it is necessary to distinguish board actions that intentionally interfere with shareholder voting rights "in circumstances unrelated to a tender offer or other contested acquisition . . . and . . . in circumstances where an acquiror launches both a tender offer and a proxy fight to remove the board to facilitate the offer."[177] In the former situation, the courts will apply the *Blasius* "compelling justification" standard in free-standing form.[178] In the latter context, the board action will trigger a hybrid analysis incorporating both *Unocal* and *Blasius.*[179]

Under this hybrid analysis, the courts will evaluate the board's decision to enact a defensive measure under *Unocal* and the board will have to establish a compelling justification to meet the proportionality prong of the *Unocal* standard.[180] Delaware courts have generally applied this hybrid analysis in two types of situations, both involving the manipulation of shareholder voting rights in the context of a defensive mechanism. First, the courts perform the hybrid analysis when a board action has the effect of "precluding effective

176. *See* Stroud v. Grace, 606 A.2d 75, 92 n.3 (Del. 1992) (noting that *Blasius* and *Unocal* tests are "not mutually exclusive").

177. *Kidsco,* 674 A.2d at 495 (explaining how role of *Blasius* is affected by circumstances surrounding board action).

178. *See id.* at 496 (stating that *Blasius* analysis would apply in circumstances unrelated to tender offer or other contested acquisition).

179. *See id.* at 495 ("[T]he board action will 'necessarily invoke both *Unocal* and *Blasius* because both tests 'recognize the inherent conflicts of interest that arise when shareholders are not permitted free exercise of their franchise.'" (quoting *Stroud,* 606 A.2d at 92 n.3)).

180. *See Unitrin,* 651 A.2d at 1375 (stating that both parts of *Unocal* inquiry must be satisfied before business judgment rule attaches to defensive actions of board of directors). The second aspect or the proportionality test of the *Unocal* burden requires that the board demonstrate the proportionality of its response to the threat posed by the offer. *See id.* at 1376 (examining Unitrin's poison-pill defense to protect stockholders from "low ball" bid). The *Unitrin* court accepted "the basic legal tenets" set forth in *Blasius* and stated that "the board bears the heavy burden of demonstrating a compelling justification for such action." *Id.* at 1378-79 (quoting Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988)); *see Kidsco,* 674 A.2d at 495 ("[A] board's unilateral decision to adopt a defensive measure 'touching upon issues of control' that 'purposefully disenfranchises its shareholders' will be evaluated under *Unocal.* However, even within that framework that board decision will be viewed as 'strongly suspect . . . and cannot be sustained without a "compelling justification."'" (quoting *Stroud,* 606 A.2d at 92 n.3)).

shareholder action."[181] Second, board action triggers the hybrid test when the action has the effect of "snatching victory from an insurgent slate on the eve of the noticed meeting."[182]

If, in response to a contested takeover attempt, a board acts defensively by manipulating shareholder voting rights, then courts will apply the *Blasius* test in the proportionality prong of the *Unocal/ Unitrin* test.[183] If the board frustrates the shareholder franchise when there is no actual or perceived threat to corporate control,

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181. *See Kidsco*, 674 A.2d at 495 (acknowledging application of hybrid analysis where board action interfered with voting rights and acquiror launched both tender offer and proxy fight to remove board to facilitate offer). The court stated that "the board action will 'necessarily [invoke] both *Unocal* and *Blasius* because both tests 'recognize the inherent conflicts of interest that arise when shareholders are not permitted free exercise of their franchise.'" *Id.* (quoting *Stroud*, 606 A.2d at 92 n.3); *see also* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) (finding that attempt of management to move stockholders' meeting forward in order to impede successful proxy fight by shareholders, gave shareholders little chance to wage successful proxy fight).

182. *See* Aprahamian v. HBO & Co, 531 A.2d 1204, 1206-07 (Del. Ch. 1987) ("The corporate election process, if it is to have any validity, must be conducted with scrupulous fairness and without any advantage being conferred or denied to any candidate or slate of candidates."). In *Aprahamian*, the board moved the date of a stockholder meeting back to the conclusion of a proxy contest after learning that a dissenting shareholder group held proxies representing a majority of the outstanding shares. *See id.* The court stated:

> In the interests of what is left of corporate democracy, those in charge of the election machinery of a corporation must be held to the highest standards in providing for and conducting corporate elections. The business judgment rule therefore does not confer any presumption of propriety on the acts of the directors in postponing the annual meeting. Quite to the contrary. When the election machinery appears, at least facially, to have been manipulated, those in charge of the election have the burden of persuasion to justify their actions.

Id.

183. *See Kidsco*, 674 A.2d at 495 (holding that board action will "necessarily [invoke] both the *Unocal* and *Blasius* [tests]" if action interferes with voting rights and acquiror launches both tender offer and proxy fight to remove board) (citing *Stroud*, 606 A.2d at 92 n.3). The court stated that both the *Unocal* and *Blasius* tests "recognize the inherent conflicts of interest that arise when shareholders are not permitted free exercise of their franchise." *Id.*; *see also* Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278, 286 (Del. Ch. 1989) (holding that *Blasius* should not be construed as new standard separate from *Unocal*, instead *Blasius* is "a specific expression of the proportionality test as applied to conduct that effectively precluded the election of directors"). In *Polaroid*, the target issued stock to a friendly investor engaged in a self-tender and bought back its own stock coincidental with a hostile tender offer. *See id.* at 280-85. The Chancery Court found that the target's action did not have the primary purpose of interfering with the election. *See id.* at 286 (finding that challenging shareholders would have had approximately same percentage of likely votes as target). The court then applied the enhanced scrutiny standard announced in *Unocal* and found that suitor's offer, albeit noncoercive and possibly inadequate, justified some level of defensive response and that the issuance of preferred stock to friendly investors, as well as the stock repurchases, were not disproportionate to the threat. *See id.* at 287-90 (noting that in most situations, noncoercive, inadequate tender offer does not constitute threat).

however, then *Blasius* alone will apply.[184] If a board acts defensively to counter a hostile tender offer in a manner that does not impede shareholder voting rights, then only the *Unocal* standard of review applies.[185]

Finally, mindful that the purpose of the enhanced scrutiny standard of review is to ensure that directors are not manipulating the corporate machinery to thwart the shareholder franchise, the Delaware Supreme Court has made it clear that even if the directors' actions have the effect of impeding the shareholder franchise, the directors may rely upon a fully informed majority of shareholders as proper justification for their actions.[186] In such cases, the shareholders themselves vote to limit their franchise rights; the limitation is not imposed on them by unilateral board action. Thus, the result of a vote by a fully informed majority of shareholders, although giving greater authority to the board or ceding authority from the shareholders, does not implicate either the *Unocal* or *Blasius* analysis.[187] As discussed in the next Section, shareholder approval can also affect a shareholder challenge of a board's decision in other contexts.

184. *See Kidsco,* 674 A.2d at 495-96 (stating that *Blasius* analysis would normally be applied by itself when board action interferes with shareholder voting rights in circumstances unrelated to tender offer or other contested acquisition).

185. *See id.* at 496 (explaining that board action "only delayed, but did not preclude, a shareholder vote"). For example, in *Kidsco,* the court concluded that only the *Unocal/ Unitrin* analysis was appropriate in evaluating a board action that amended the bylaws to give the directors an additional 25 days to call a shareholder meeting in response to a proxy solicitation challenging the target director's incumbency. *See id.* (holding that *Unocal/ Unitrin* standard applies when bylaw amendment only delayed, rather than precluded, shareholder vote). The court concluded that because the purpose of the bylaw amendment was merely to give the board time to "explore and develop other options" and because the effect of the amendment did not "preclude a shareholder vote on the director's continued incumbency" but merely delayed it by 25 days, the board action did not frustrate the shareholder franchise, and therefore, the heightened scrutiny of *Blasius* was not appropriate. *See id.*

186. *See Stroud,* 606 A.2d at 95 (holding that fully informed shareholder vote removes need to inquire whether board acted for improper purpose when changing bylaws). The shareholders in *Stroud,* unlike the shareholders in *Blasius* and *Aprahamian,* had a full and fair opportunity to vote on the bylaw amendments and did so. *Id.* at 83 (recognizing that shareholders had option to accept or reject amendment).

187. *See id.* ("In the absence of fraud, a fully informed shareholder vote in favor of even a 'voidable' transaction ratifies board action and places the burden of proof on the challenger.").

VI. Ratification—Shifting the Burden of Proof, Changing the Standard of Review and/or Extinguishing Claims

The approval or ratification of a transaction by the shareholders or a majority of disinterested directors of a corporation can have a significant effect on a challenge to a business decision made by a board.[188] Under certain circumstances, such approval or authorization can change the standard of review, shift the burden of proof or even extinguish a breach of fiduciary duty claim.[189] This Section discusses the effect of shareholder and disinterested director approval or ratification on a board decision.

A number of distinct situations permit or require a board to ask for shareholder approval of a business decision.[190] First, the Delaware statutes require shareholder approval of most fundamental corporate changes, including certificate amendments, mergers

188. *See In re* Wheelabrator Tech., Inc. Shareholders Litig., 663 A.2d 1194, 1202-03 (Del. Ch. 1995) [hereinafter *Wheelabrator II*] (explaining that ratification of parent-subsidiary merger or cash-out merger results in complex judicial examination into applicable standard of review and placement of burden of proof). Typically, the determination as to the applicable standard of review and the placement of burden of proof rests on the type of interested transaction at issue and the roles of the participants in the transaction. *See id.* at 1203 ("[T]he operative effect of shareholder ratification in duty of loyalty cases has been either to change the standard of review to the business judgment rule, with the burden of proof resting upon the plaintiff, or to leave 'entire fairness' as the review standard, but shift the burden of proof to the plaintiff.").

189. *See* Lewis v. Vogelstein, 699 A.2d 327, 334 (Del. Ch. 1997) (discussing effect of ratification on transaction). The Chancery Court in *Vogelstein* stated:

> Four possible effects of shareholder ratification appear logically available: First, one might conclude that an effective shareholder ratification acts as a complete defense to any charge of breach of duty. Second, one might conclude that the effect of such ratification is to shift the substantive test on judicial review of the act from one of fairness that would otherwise be obtained (because the transaction is an interested one) to one of waste. Third, one might conclude that the ratification shifts the burden of proof of unfairness to plaintiff, but leaves the shareholder-protective test in place. Fourth, one might conclude (perhaps because of great respect for the collective action disabilities that attend shareholder action in public corporations) that shareholder ratification offers no assurance of assent of a character that deserves judicial recognition.

Id. Additionally, the court stated that "[i]n all events, informed, uncoerced, disinterested shareholder ratification of a transaction in which corporate directors have a material conflict of interest has the effect of protecting the transaction from judicial review except on the basis of waste." *Id.* at 336.

190. For an in-depth discussion of situations in which statutes require the board to obtain shareholder approval of a transaction, see DEL. CODE ANN. tit. 8, §§ 242(b), 251(c), 275 (1974 & Supp. 1990), *infra* notes 202-29 and accompanying text.

and dissolution.[191] Second, section 144 of the Delaware General Corporation Law provides the options of obtaining disinterested director or shareholder approval in an interested director transaction.[192] Third, shareholders can ratify a board action even though the board had no actual authority to take the action initially.[193] Finally, the board can seek shareholder approval in an effort to protect the board's decision from breach of fiduciary duty claims.[194]

As discussed previously in Part I and Part II of this Article, the standard of review and burden of proof that courts use to scrutinize a challenged transaction hinges on the type of action taken and the status of the parties to the transaction.[195] On the basis of these fac-

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191. *See* DEL. CODE ANN. tit. 8, § 242(b) (requiring shareholder approval of certificate amendment); *id.* § 251(c) (requiring shareholder approval of merger); *id.* § 275 (requiring vote by majority of outstanding stock entitled to vote before dissolution certificate is valid).

192. *See id.* § 144(a)(2)-(3) (voiding some contracts between corporation and its directors, unless shareholders were informed of transaction and approved of transaction as "fair as to the corporation").

193. *See* Michelson v. Duncan, 407 A.2d 211, 220 (Del. 1979) (holding that when stockholders ratify unauthorized acts of board, ratification of stockholders is binding).

194. *See, e.g., Wheelabrator II*, 663 A.2d 1194, 1196 (Del. Ch. 1995) (holding that informed shareholder vote approving authorized board action extinguished claims that board breached fiduciary duties).

195. *See id.* at 1203 (discussing two categories of transactions and their effect on standard of review and burden of proof). The court stated that when concerned with

> "interested" transaction cases between a corporation and its directors (or between the corporation and an entity in which the corporation's directors are also directors or have a financial interest) . . . [a]pproval by fully informed, disinterested shareholders pursuant to § 144(a)(2) invokes "the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction."

Id. (quoting Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987)). The court further explained that when independent shareholder ratification of interested director actions occurs, the burden shifts to the challenging party to prove that "no person of ordinary sound business judgment would say that the consideration received for the options was a fair exchange for the options granted." *Id.*

Furthermore, ratification may affect action when a transaction is between the corporation and its controlling stockholder. *See id.* (noting that ordinary standard of review for parent-subsidiary merger is entire fairness). "But where the merger is conditioned upon approval by a 'majority of the minority' stockholder vote, and such approval is granted, the standard of review remains entire fairness, but the burden of demonstrating that the merger was unfair shifts to the plaintiff." *Id.* (citations omitted); *see also* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985) (stating that defendant bore initial burden of proving fairness because it was majority shareholder and that business judgment standard applied because merger was conducted at arm's length); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (holding that directors who are on "both sides of a transaction" are required to prove good faith and fairness of bargain); Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 109-10 (Del. 1952) (holding that directors who "stand on both sides of transaction" bear burden of establishing entire fairness); Citron v. E.I. Du Pont de

tors, a court first determines whether the business judgment rule, enhanced scrutiny or the entire fairness standard of review applies.[196] As noted previously, the business judgment rule is the proper standard of review unless the challenging party pleads facts sufficient to rebut the rule's presumption that the directors have acted in accord with their fiduciary duties.[197] If the challenging party rebuts the business judgment rule's presumption by proving a breach of the duty of care, loyalty or good faith, then the board will have the burden to establish the entire fairness of its decision.[198]

In many cases, a challenged transaction has received approval by disinterested shareholders or a committee of disinterested directors. The issue then becomes, what effect, if any, the approval or ratification has on the challenged transaction.[199] For example, even if the challenging party has rebutted the presumption of pro-

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Nemours & Co., 584 A.2d 490, 500-01 (Del. Ch. 1990) (discussing contexts in which courts invoke entire fairness).

The Delaware Supreme Court has held that when "neither shareholder ratification nor disinterested director approval could be obtained (due to a deadlock) the 'intrinsic fairness' review standard would govern." *Id.* at 500 (citing *Marciano*, 535 A.2d at 405). The *Citron* court also noted that "shareholder ratification of challenged stock options issued to directors shifts the burden of proof to the plaintiff and causes the transaction to be reviewed under the business judgment standard." *Id.* (citing *Michelson*, 407 A.2d at 224; Gottlieb v. Heyden Chem. Corp., 91 A.2d 57, 59 (Del. 1952); Kaufman v. Shoenberg, 91 A.2d 786, 793 (Del. Ch. 1952)).

196. *See* Palm & Kearney, *supra* note 1, at 1316-20 (detailing shifting burdens, business judgment rule and entire fairness standards).

197. *See Cede II*, 634 A.2d 345, 360 (Del. 1993) ("[In managing the business and affairs of a corporation], directors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interest of its shareholders."). The court in *Cede II* concluded that the business judgment rule "posits a powerful presumption in favor of actions taken by the directors in that a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be 'attributed to any rational business purpose.'" *Id.* at 361 (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)); *see also* Palm & Kearney, *supra* note 1, at 1300-20 (discussing business judgment rule and duties of care, loyalty and good faith).

198. *See Cede III*, 663 A.2d 1156, 1162 (Del. 1995) (holding that when plaintiffs rebut business judgment rule presumption, directors must prove entire fairness); Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1371 n.7 (Del. 1995) (noting entire fairness applies when business judgment rule presumption is rebutted); *Cede II*, 634 A.2d at 361 (same); Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993) (holding that when plaintiffs rebut business judgment rule presumption, directors' actions are reviewed under entire fairness standard); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1988) (stating that interested directors must show entire fairness of transaction).

199. *See, e.g.*, *Rosenblatt*, 493 A.2d at 937 (discussing effect of "approval of a merger . . . by an informal vote of the minority shareholders"); *Weinberger*, 457 A.2d at 703 (addressing burden of proof upon parties when merger has been "approved" by vote of majority of minority shareholders); *Wheelabrator II*, 663 A.2d at 1198 (noting defendant's argument that "fully informed shareholder vote approving the merger" extinguished plaintiffs' claims).

priety under the business judgment rule so that the entire fairness standard applies, the court may decide that ratification by a majority of the disinterested directors or stockholders shifts the burden of proof to the challenger to show that the transaction was unfair to the corporation, rather than leaving the burden on the board to prove the transaction's entire fairness.[200]

Two types of transactions form the basic paradigms for the effect of ratification on a board's decision: (1) mergers between the corporation and its controlling shareholder and (2) interested director transactions.[201] This Section will first discuss the effect of ratification for these two paradigms and then discuss the effect of ratification in other types of transactions.

A. *Self-Interested Transactions Between the Corporation and Its Controlling Shareholder*

Traditionally, a controlling or dominating stockholder that stands on both sides of a transaction with the corporation it controls bears the burden of proving the transaction's entire fairness.[202] Sometimes the controlling shareholder will condition the consummation of the transaction on the approval of a majority of the minority stockholders or disinterested board members.[203] An

200. *See Rosenblatt*, 493 A.2d at 937 (stating that ratification of parent-subsidiary merger involving controlling stockholder by majority of minority stockholders invokes entire fairness standard of review with burden of proof shifting to plaintiff to show merger's unfairness to corporation).

201. *See, e.g., Wheelabrator II*, 663 A.2d at 1203 ("The ratification decisions that involve duty of loyalty claims are of two kinds: (a) 'interested' transactions cases between a corporation and its directors . . . and (b) cases involving a transaction between the corporation and its controlling shareholder.").

202. *See Rosenblatt*, 493 A.2d at 937. The court stated that "approval of a merger . . . by an informed vote of a majority of the minority shareholders, while not a legal prerequisite, shifts the burden of proving the unfairness of the merger entirely to the plaintiffs." *Id.* Nevertheless, the majority shareholder retains "the burden of showing complete disclosure of all material facts relevant to that vote." *Id.*; *see also* Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1116 (Del. 1994) ("Thereafter, this Court recognized that it would be inconsistent with its holding in *Weinberger* to apply the business judgment rule in the context of an interested merger transaction, which, by its very nature, did not require a business purpose."); *Weinberger*, 457 A.2d at 703 ("[T]he ultimate burden of proof is on the majority shareholder to show by a preponderance of the evidence that the transaction is fair."). Additionally, when ratification by a majority of the minority stockholders is required, either by statute or by corporate charter, the controlling stockholder bears the burden of showing that it "completely disclosed" all material facts relevant to the transaction. *See id.* (holding that, in this case, vote was not informed one).

203. *See Kahn*, 638 A.2d at 1116-17 (involving stockholder ratification of cash-out merger between corporation and its de facto controlling stockholder). The court, however, noted:

example of a self-interested controlling shareholder transaction is the merger of a subsidiary with its parent corporation.

In *Weinberger v. UOP, Inc.*,[204] the court discussed many of the rules governing a parent-subsidiary cash-out merger, including the effect of ratification in such mergers.[205] The court in *Weinberger* held that, to invoke the entire fairness standard, the party challenging the merger has the initial burden of showing some basis to invoke the entire fairness standard.[206] After making that showing, the burden shifts to the parent corporation to establish the entire fairness of the cash-out merger transaction.[207] The court observed that approval of the transaction by an informed majority of the minority stockholders shifts the burden to the party challenging the transaction to establish that the transaction was unfair to the corpora-

> The controlling stockholder relationship has the potential to influence, however subtly, the vote of [ratifying] minority stockholders in a manner that is not likely to occur in a transaction with a noncontrolling party. . . . Consequently, in a merger between the corporation and its controlling stockholder—even one negotiated by disinterested, independent directors—no court could be certain whether the transaction terms fully approximate what truly independent parties would have achieved in an arm's length negotiation.

Id. at 1116; *see* Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490, 502 (Del. Ch. 1990) (involving stockholder ratification of cash-out merger between corporation and its de jure controlling stockholder); *see also* Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 841-42 (Del. 1987) (involving stockholder ratification of cash-out merger between corporation and its controlling stockholder); *Rosenblatt*, 493 A.2d at 937-38 (same); *Weinberger*, 457 A.2d at 710 (same).

204. 457 A.2d 701 (Del. 1983).

205. *Id.* at 710 ("There is no 'safe harbor' for such divided loyalties in Delaware. When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.").

206. *Id.* at 703 ("[E]ven though the ultimate burden of proof is on the majority shareholder to show by a preponderance of the evidence that the transaction is fair, it is first the burden of the plaintiff attacking the merger to demonstrate some basis for invoking the fairness obligation.").

207. *See id.* at 710 ("The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness."). After allocating the ultimate burden of proving entire fairness, the court observed:

> The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger . . . . However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.

Id. at 711 (citations omitted).

tion.[208] Thus, shareholder ratification in this situation only has the effect of shifting the burden of proof. The standard of review—entire fairness—remains the same. The controlling shareholder relying on the ratification to shift the standard of review has the burden of showing that the controlling shareholder disclosed all the material facts to the disinterested shareholders or an independent directors committee ratifying the transaction and those directors or shareholders were fully informed of all material facts relating to that transaction.[209]

In a later case, the Delaware Supreme Court held that the same rules apply to a parent-subsidiary merger with a de facto controlling shareholder.[210] Like *Weinberger*, the court held that when an independent committee of directors approves a merger between the company and its de facto controlling shareholder, the burden may shift to the challenging party to establish that the transaction was unfair.[211] For the burden to shift when an independent committee

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208. *See id.* at 703 (rejecting then-existing requirement that parent must show business purpose to justify parent-subsidiary merger). In *Weinberger*, the court attempted to emphasize that disinterested stockholder ratification, while important in shifting the burden of proof, had no effect on the standard of review. *Id.* at 715 (stating that it did not believe that any additional meaningful protection is afforded minority shareholders by business purpose requirement and, thus, "such requirement shall no longer be of any force or effect"). Essentially, no business purpose is required to justify a transaction in which a controlling stockholder acts to merge out the minority, and therefore, the business judgment rule cannot be the applicable standard of review in such situations. *See id.* ("[W]here corporate action has been approved by an informed vote of a majority of the minority shareholders . . . the burden entirely shifts to the plaintiff to show that the transaction was unfair to the minority." (citing Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979))).

209. *See* Kahn v. Lynch Communication Sys., Inc., 669 A.2d 79, 88 (Del. 1995) ("A controlling shareholder owes a duty of complete candor when standing on both sides of a transaction and must disclose fully all the material facts and circumstances surrounding the transaction" (citing Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270, 1276 (Del. 1994))).

210. *See* Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1116 (Del. 1994) (determining that *Weinberger* entire fairness standard applied to situations in which stockholder maintained de facto control over subsidiary). In *Kahn*, Alcatel USA Corporation attempted to acquire Lynch Communication Systems, Inc. in a cash-out merger. *Id.* at 1114. The controlling shareholder claimed that the business judgment rule should apply because the transaction had been approved by an independent committee of the board. *See id.* In order for the *Kahn* court to determine whether Alcatel, who held 43.3% of Lynch stock, was a de facto controlling shareholder, the court stated that "'a shareholder owes a fiduciary duty only if it owns a majority interest in or *exercises control* over the business affairs of the corporation.'" *Id.* at 1113-14 (quoting Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987)).

211. *See id.* at 1114. The court noted that if the controlling shareholder secured an effective approval or ratification, then the burden of proof would shift to the challenging party. *See id.* at 1117 ("[A]pproval of the transaction by an independent committee of directors or an informed majority of minority sharehold-

approves the merger, however, "the majority stockholder must not dictate the terms of the merger" and the independent committee must possess "real bargaining power that it can exercise with the majority shareholder on an arms length basis."[212] In short, the in-

ers shifts the burden."). Although the board formed a special committee who determined that the merger was fair, the court held that, under these circumstances, the burden of establishing the transaction's unfairness to the subsidiary would not shift to the challenging party. *See id.* at 1120-21 (finding that independent committee's ability to negotiate at arm's length was compromised by controlling shareholder's threat of hostile takeover). According to the court:

> A condition precedent to finding that the burden of proving entire fairness has shifted in an interested merger transaction is a careful judicial analysis of the factual circumstances of each case. Particular consideration must be given to evidence of whether the special committee was truly independent, fully informed, and had the freedom to negotiate at arm's length. "Although perfection is not possible," unless the controlling or dominating shareholder can demonstrate that it has not only formed an independent committee but also replicated a process "as though each of the contending parties had in fact exerted its bargaining power at arm's length," the burden of proving entire fairness will not shift.

Id. (quoting *Weinberger*, 457 A.2d at 709-10 n.7).

212. *Id.* at 1116 ("[T]he unchanging nature of the underlying 'interested' transaction requires careful scrutiny." (citing *Weinberger*, 457 A.2d at 710)). Relying on the decision in *Citron*, the *Kahn* court stated that

> in a merger between the corporation and its controlling stockholder . . . no court could be certain whether the transaction terms fully approximate what truly independent parties would have achieved in an arm's length negotiation. Given that uncertainty, a court might well conclude that even minority shareholders who have ratified a . . . [parent-subsidiary] merger need procedural protections beyond those afforded by full disclosure of all material facts. One way to provide such protections would be to adhere to the more stringent entire fairness standard of judicial review.

Id. at 1116-17 (quoting Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490, 502 (Del. Ch. 1990)); *See Wheelabrator II*, 663 A.2d 1194, 1205 (Del. Ch. 1995) (noting that de facto or de jure status of controlling stockholder was critical in prior decisions and stating that "the potential for process manipulation by the controlling stockholder, and the concern that the controlling stockholder's continued presence might influence even a fully informed shareholder vote, justify the need for the exacting judicial scrutiny and procedural protection afforded by the entire fairness form of review"). The court in *Kahn* relied on *Rosenblatt* and *Citron* for its decision. *See* Rosenblatt v. Getty Oil Company, 493 A.2d 929, 937 (Del. 1985) (reexamining standard of review and allocation of burden of proof established in *Weinberger*); *Citron*, 584 A.2d at 502 (evaluating merger of Remington Arms Company with Dupont).

Rosenblatt involved a cash-out merger that was ultimately ratified by a majority of the corporation's disinterested shareholders. *See Rosenblatt*, 493 A.2d at 931-34. The court found that Getty Oil Company, the majority stockholder of the target company, bore the burden of establishing the merger's entire fairness. *See id.* at 937 (reaffirming its view that although burden of proving merger's unfairness shifted entirely to plaintiffs, controlling stockholder defendant maintained burden of showing complete disclosure of facts that would have been relevant to vote of minority stockholders) (citing *Weinberger*, 457 A.2d at 703). In analyzing the fairness of the merger, the court stated that an "independent bargaining structure, while not conclusive, is strong evidence of the fairness" of a merger transaction.

dependent committee must have the power to negotiate freely, which includes the power to reject the offer of the de jure or de facto controlling shareholders.

Thus, in situations involving transactions between a self-interested controlling shareholder and a corporation, disinterested shareholder ratification or approval by independent directors shifts the burden of proof to the plaintiff to prove that the transaction is unfair.[213] As noted above, these cases frequently involve, but are

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See id. at 938 n.7 (citing *Weinberger*, 457 A.2d at 709-11, 709 n.7). Therefore, the existence of an independent committee does not affect the standard of review, but rather, affects the ability of the plaintiff to prove the unfairness of the transaction. *See id.* (noting that use of "independent bargaining structure," although not conclusive, is evidence of fairness).

In *Citron*, in light of the merger's ratification by a vote of a fully informed majority of Remington's minority stockholders, the court imposed the entire fairness standard of review and shifted the burden onto the plaintiff to establish the merger's unfairness. *Citron*, 584 A.2d at 502 (ruling that shareholder ratification in context of parent-subsidiary merger "operates only to shift the burden of persuasion, not to change the substantive standard of review (entire fairness)"). According to the court, an inference could be drawn from the language in *Weinberger* that the substantive review standard for such a transaction would be the business judgment rule. *See id.* (citing *Weinberger*, 457 A.2d at 703). Further, regarding the subsidiary's directors, the court concluded that "adversarial, arm's length negotiations by a special committee of directors 'may give rise to the proposition that the directors' actions are more appropriately measured by business judgment standards.'" *Id.* at 501 n.16 (quoting *Rosenblatt*, 493 A.2d at 937-38). The court continued: "However, nowhere does the *Rosenblatt* opinion suggest that in these circumstances the claims against the parent corporation would likewise be evaluated under the business judgment standard." *Id.* at 501 (noting more stringent entire fairness standard is applied in parent-subsidiary mergers that involve controlling stockholder). The court stated:

> Parent-subsidiary mergers . . . are proposed by a party that controls, and will continue to control, the corporation, whether or not the minority stockholders vote to approve or reject the transaction. The controlling stockholder relationship has the inherent potential to influence, however subtly, the vote of minority stockholders in a manner that is not likely to occur in a transaction with a noncontrolling party.

Id. at 502 (justifying use of entire fairness standard on belief that "no court could be certain whether the transaction terms fully approximate what truly independent parties would have achieved in an arm's length negotiation," and thus, entire fairness standard serves as "procedural protection").

213. *See Kahn*, 638 A.2d at 1117 (summarizing effect of shareholder ratification in situations involving controlling shareholder). The court explained:

> The initial burden of establishing entire fairness rests upon the party who stands on both sides of the transaction. However, an approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff. Nevertheless, even when an interested cash-out merger transaction receives the informed approval of a majority of minority stockholders or an independent committee of disinterested directors, an entire fairness analysis is the only proper standard of judicial review.

not limited to, parent-subsidiary mergers that have been approved by a majority of the minority shareholders.[214]

Two reasons underlie the policy of maintaining the more stringent entire fairness standard of review in parent-subsidiary mergers even though disinterested directors or shareholders ratified the transaction. First, the entire fairness standard limits the potential coercive power that the controlling shareholder may exert over the minority.[215] When a transaction involves a controlling shareholder, there is a strong possibility that the transaction will not be the result of an arm's length bargain, even when disinterested shareholder approval exists.[216] The disinterested stockholders may recognize

Id. (citations omitted); *see Wheelabrator II*, 663 A.2d at 1205 ("In both *Kahn* and *Stroud*, the Supreme Court determined that the effect of a fully informed shareholder vote was to shift the burden of proof within the entire fairness standard of review.") (citations omitted).

214. *See Kahn*, 638 A.2d at 1117 (ruling that entire fairness standard applied to parent-subsidiary mergers, with shareholder ratification acting to shift burden of proof to plaintiff to establish unfairness) (citing *Rosenblatt*, 493 A.2d at 937); *Weinberger*, 457 A.2d at 709-10 n.7 ("Particularly in a parent-subsidiary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness." (citing Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 886 (Del. 1970))); *see also Citron*, 584 A.2d at 502 ("Even where no coercion is intended, shareholders voting on a parent-subsidiary merger might perceive that their disapproval could risk retaliation of some kind by the controlling stockholder.").

215. *See Kahn*, 638 A.2d at 1116 (defining policy rationale for applying entire fairness even when ratification exists). According to the court, the entire fairness standard is the appropriate standard of review in interested merger transactions because the controlling stockholder may unduly influence minority stockholders or retaliate against opposing stockholders by withholding dividends or effecting a subsequent cash-out merger at a "less favorable price." *See id.* at 1116-17. Accordingly, *Kahn* seems to stand for the proposition that the entire fairness standard applies exclusively to such transactions. The *Kahn* court stated that

> this Court holds that the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness. . . . [E]ven when an interested cash-out merger transaction receives the informed approval of a majority of minority stockholders or an independent committee of disinterested directors, an entire fairness analysis is the only proper standard of judicial review.

Id. at 1117 (citations omitted).

216. *See id.* at 1116 ("The controlling stockholder relationship has the potential to influence, however subtly, the vote of [ratifying] minority stockholders in a manner that is not likely to occur in a transaction with a noncontrolling party."). Furthermore, the court stated:

> "[A] shareholder who owns less than 50% of a corporation's outstanding stocks does not, without more, become a controlling shareholder of that corporation, with a concomitant fiduciary status. For a dominating relationship to exist in the absence of controlling stock ownership, a plaintiff must allege domination by a minority shareholder through actual control of corporation conduct."

that a no vote on a transaction desired by a controlling shareholder could lead to adverse consequences for the minority because the controlling shareholder will remain such after the vote occurs.[217] Second, courts have refused to apply the business judgment rule to parent-subsidiary cash-out mergers because, under Delaware law, they do not require a business purpose.[218] The rules described above concerning the effect of ratification seem also to be applicable in self-interested, nonmerger transactions between a controlling shareholder and the corporation.

The Delaware Supreme Court's decision in *Stroud v. Grace*[219] discusses the applicable standard of review in a self-interested, nonmerger transaction between a controlling shareholder and the corporation.[220] The court in *Stroud* stated that "[u]nder Delaware law

Id. at 1114 (alterations in original) (quoting Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 70 (Del. 1989)).

217. *See Wheelabrator II*, 663 A.2d at 1205 (justifying application of entire fairness standard even where shareholders ratify controlling shareholder transactions because of overriding concerning that "the controlling stockholder's continued presence might influence even a fully informed shareholder vote").

218. *See Kahn*, 638 A.2d at 1116 ("[I]t would be inconsistent with . . . *Weinberger* to apply the business judgment rule in the context of an interested merger transaction which, by its very nature, did not require a business purpose." (citing *Rosenblatt*, 493 A.2d at 937)).

219. 606 A.2d 75 (Del. 1992).

220. *Id.* at 80 (noting that board's amendments established, among other things, new method of qualifying directors for membership). *Stroud* involved directors of a privately held corporation who wished to amend their bylaws regarding board qualifications and disqualification of future board nominees. *Id.* The board unanimously adopted amendments, sent out notice and held a board meeting to approve the amendments. *See id.* Several shareholders sued, alleging that the board provided misstatements of material fact within the notice for the shareholder meeting. *See id.* The plaintiffs argued for application of *Unocal's* enhanced scrutiny; however, the court rejected such an application because of the shareholder vote and the fact that the corporation faced no threat to its policy, effectiveness or control. *See id.* at 82-83 (holding that because directors already controlled over 50% of corporation's stock before they approved amendments, there was no threat to corporate control).

In *Stroud*, the Supreme Court of Delaware considered a challenge to the fairness of charter and bylaw amendments proposed by the corporation's controlling stockholders in their capacity as members of the board of directors. *Id.* at 79-80. In *Stroud*, as in *Kahn*, *Rosenblatt* and *Weinberger*, a fully informed majority of the minority shareholders voted to approve the transaction, which in *Stroud* involved charter amendments. *Id.* The court in *Stroud* ruled that the effect of involvement by controlling stockholders was to invoke the entire fairness standard, and that the stockholder ratification "[shifted] the burden of proof to the [plaintiffs] to prove that the transaction was unfair." *Id.* at 90 (citing Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 846 (Del. 1987); Smith v. Van Gorkom, 488 A.2d 858, 890 (Del. 1985); Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983); Michelson v. Duncan, 407 A. 2d 211, 224 (Del. 1979); Gottlieb v. Heyden Chem. Corp., 91 A.2d 57, 58-59 (Del. 1952)). Specifically, the court stated that the plaintiff held the burden of establishing that the charter amendments were unfair to the corporation. *See id.* (holding that, because controlling stockholder directors had not

a fully informed shareholder vote in favor of a disputed transaction ratifies board action in the absence of fraud."[221] Of course, the burden of proving that the shareholders were fully informed of all the material facts relevant to their approval of the transaction is on the interested shareholder relying on the vote.[222] The court held that because a majority of disinterested and informed shareholders ratified the transaction and the challenging party could not prove inadequate or misleading disclosures or prove that the board acted fraudulently, wastefully or with any other misconduct, the burden then shifted to the challenging party to prove that the transaction was unfair.[223] Although the court in *Stroud* did not clearly articulate why the entire fairness standard was applicable in the first instance, the only reasonable explanation is that it found the transaction to

breached their fiduciary duties in connection with stockholder ratification vote, burden rested on challenging party to prove entire fairness).

221. *Id.* at 82 (citing *Bershad,* 535 A.2d at 846; *Van Gorkom,* 488 A.2d at 890; *Weinberger,* 457 A.2d at 703; *Michelson,* 407 A.2d at 224; *Gottlieb,* 91 A.2d at 58-59; Gerlach v. Gillam, 139 A.2d 591, 593 (Del. Ch. 1958)). In *Van Gorkom, Michelson* and *Gottlieb,* the courts applied the business judgment rule as the appropriate standard of review. *See Van Gorkom,* 488 A.2d at 870-71 (applying business judgment rule); *Weinberger,* 457 A.2d at 703-04 (same); *Michelson,* 407 A.2d at 224-25 (same). *Van Gorkom* involved a cash-out merger with a noncontrolling third party, and therefore, the decision of the board of directors to approve the merger, followed by stockholder ratification, was subject to business judgment rule review. *Van Gorkom,* 488 A.2d at 864-70. The holdings in *Van Gorkom* and *Wheelabrator II* are consistent—the business judgment rule is the applicable standard of review in cases involving mergers between a corporation and a noncontrolling stockholder. *See Wheelabrator II,* 663 A.2d 1193, 1204-05 (Del. Ch. 1995) (stating that ratified transaction not involving controlling stockholder is reviewed under business judgment rule with burden on plaintiff to prove gift or waste).

Michelson and *Gottlieb* involved nonmerger transactions, leading the courts to apply the business judgment rule. The court's choice of the business judgment rule standard in these cases is understandable, especially in light of *Kahn,* which applies the entire fairness standard solely because that case involved a cash-out merger with a controlling stockholder—a transaction involving no valid business purpose. *See Michelson,* 407 A.2d at 224 (applying business judgment rule to case involving stockholder ratification of stock-option plan); *Gottlieb,* 91 A.2d at 58-59 (same). Because the decisions made by the boards of directors in *Michelson* and *Gottlieb* involved transactions pertaining to valid business purposes, it is understandable that the courts in those cases would choose to apply the business judgment rule, particularly in light of *Kahn. See Kahn,* 638 A.2d at 1116-17 (stating that entire fairness standard must be applied to review cash-out merger involving controlling stockholder because such transaction had no valid business purpose that would cause business judgment rule to be invoked).

222. *See Stroud,* 606 A.2d at 84 (holding that "burden . . . remains on those relying on the vote to show that all material facts relevant to the transaction were fully disclosed").

223. *See id.* at 84, 90.

be a transaction between a self-interested controlling shareholder and the company.[224]

The common fact in the *Weinberger* line of cases and *Stroud* was that each transaction involved a self-interested controlling shareholder.[225] Therefore, the concern about the controlling shareholder influencing—expressly or potentially—the true freedom of choice of the shareholders is present whether the transaction involves a merger or a nonmerger decision. Consequently, the effect of fully informed, noncoerced, disinterested shareholder or director ratification in such cases is only to shift the burden of proof to the challenging party, while retaining fairness as the appropriate standard of review.[226]

These rules are only applicable to transactions between a *self-interested* controlling shareholder and the corporation.[227] As noted above, regardless of ratification, these cases implicate the entire fairness standard because of the self-interest of the controlling

224. *See Bershad* 535 A.2d at 841-42, 846 (applying entire fairness standard to cash-out merger between corporation and controlling stockholder); *Weinberger*, 457 A.2d at 703 (same). Because *Bershad* and *Weinberger* involved controlling stockholders in cash-out mergers, it is difficult to see how they relate to *Stroud*, in which there was no merger, but merely an amendment of the corporate charter, an activity that would appear to be an act of directorial business judgment. *See Stroud*, 606 A.2d at 79-80 (discussing nature of transaction). The holding of *Stroud* complicates later case law.

In *Wheelabrator II*, for example, the Delaware Court of Chancery cites *Stroud* for the proposition that the entire fairness standard is the applicable standard of review for all transactions involving controlling stockholders, regardless of the nature of the transaction. *Wheelabrator II*, 663 A.2d at 1203 & nn.6-7 (citing *Stroud*, 606 A.2d at 90). The court in *Wheelabrator II* found that ratification by a "majority of the minority" shifts the burden regardless of whether the case involves mergers or other types of transactions. *Id.* at 1203.

This statement by the Court of Chancery in *Wheelabrator* appears to conflict with *Kahn* and is unsupported by Supreme Court of Delaware precedent. *See Kahn*, 638 A.2d at 1116 (stating that entire fairness is applicable standard of review regarding parent-subsidiary mergers because no valid business purpose existed, so business judgment rule cannot be invoked). If *Kahn* is controlling, however, then entire fairness should not be the standard of review in a nonmerger transaction case, regardless of whether the transaction involves a controlling stockholder.

225. *Compare Stroud*, 606 A.2d at 90 (applying entire fairness standard to challenge of charter and bylaw amendments ratified by controlling shareholders), *with Weinberger*, 457 A.2d at 703 (applying entire fairness standard to cash-out merger between corporation and controlling shareholder).

226. *See* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985) (stating that ratification of parent-subsidiary merger involving controlling stockholder by majority of minority stockholders invokes entire fairness standard of review with burden of proof shifting to plaintiff to show merger's unfairness to corporation).

227. For examples of cases involving controlling shareholders, see generally *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del. 1994), *Stroud v. Grace*, 606 A.2d 75 (Del. 1992) and *Wheelabrator II*, 663 A.2d 1193 (Del. Ch. 1995).

shareholder.[228] Not all transactions between a controlling shareholder and the corporation will implicate the entire fairness standard. For example, if the controlling shareholder is receiving a benefit that is shared by the other minority shareholders, the controlling shareholder will not be considered to be engaging in a self-interested transaction and the business judgment rule will be the appropriate initial standard of review.[229]

B. *Interested Director Transactions and Section 144*

Conflict of interest concerns are also present in transactions between a corporation and its directors. Historically, all "interested director" transactions were voidable per se under common law because of the great potential for conflict of interest.[230] Gradually, however, courts began to recognize that they should review interested director transactions under the entire fairness standard because interested director transactions could be beneficial to the

228. *See Kahn*, 638 A.2d at 1117 (stating entire fairness is only applicable standard when controlling shareholder is part of transaction).

229. *See, e.g.*, Williams v. Geier, 671 A.2d 1368, 1378 (Del. 1996) (noting that entire fairness does not apply to situation in which controlling shareholder receives no "non-pro rata or disproportionate benefit"); Puma v. Marriott, 283 A.2d 693, 694-96 (Del. 1971) (holding that, in nonmerger transaction between corporation and controlling shareholder, business judgment rule applied to transaction that was approved by outside, independent board in absence of proof that controlling shareholder in fact controlled or dominated board); Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 886-87 (Del. 1970) (holding that, in nonmerger transaction between parent and subsidiary, business judgment rule applied to terms of transaction set by third party). As the Delaware Supreme Court noted in one decision:

> A parent does indeed owe a fiduciary duty to its subsidiary when there are parent-subsidiary dealings. However, this alone will not evoke the intrinsic fairness standard. This standard will be applied only when the fiduciary duty is accompanied by self-dealing—the situation when a parent is on both sides of a transaction with its subsidiary. Self-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary.

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

230. *See* Marciano v. Nakash, 535 A.2d 400, 403-04 (Del. 1987) (comparing common law rule with other case law decided prior to enactment of title 8, section 144 of Delaware Code). In *Marciano*, the plaintiffs argued that, absent compliance with section 144, interested director transactions were voidable per se. *See id.* at 403. The Delaware Supreme Court rejected this argument and pointed out that in cases decided before section 144 was enacted, "interested director transactions were deemed voidable only after an examination of the fairness of a particular transaction *vis-a-vis* the nonparticipating shareholders and a determination of whether the disputed conduct received the approval of a noninterested majority of directors or shareholders." *Id.* at 404 (citing Blish v. Thompson Automatic Arms Corp., 64 A.2d 581, 602 (Del. Ch. 1948); Keenan v. Eshleman, 2 A.2d 904, 908 (Del. Ch. 1938)).

corporation, even though an obvious conflict of interest existed in such transactions.[231] Later, the courts' review of interested director transactions was also affected by whether the transaction received the approval of disinterested directors or shareholders.[232]

Section 144 of the Delaware General Corporation Law defines an "interested director" transaction as a "contract or transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers are directors or officers, or have a financial interest."[233] In each of the described situations, the director stands, directly or indirectly, on both sides of the transaction and has an actual or potential conflict of interest with respect to the transaction or contract.[234] Section 144 does not apply every time a corpo-

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231. *See* Oberly v. Kirby, 592 A.2d 445, 467 (Del. 1991) (stating that some transactions are not inherently detrimental and should not be automatically voidable). "As long as a given transaction is fair to the corporation, and no confidential relationship betrayed, it may not matter that certain corporate officers will profit as the result of it." *Id.*

232. *See Marciano*, 535 A.2d at 404 (finding that some Delaware cases decided before enactment of section 144 looked at whether disputed conduct received approval of noninterested majority). The Delaware Legislature codified this approach in section 144. *See id.* (explaining that Delaware legislature adopted courts' test and that it "is now crystallized in the ratification criteria of section 144(a)").

233. DEL. CODE ANN. tit. 8, § 144(a) (1974 & Supp. 1990).

234. *See Cede II*, 634 A.2d 345, 362 (Del. 1993) ("Classic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally."); *Levien*, 280 A.2d at 720 (noting that self-dealing occurs when parent is on both sides of transaction with its subsidiary). The Supreme Court of Delaware stated that "[s]elf-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary." *Id.*; *see also Puma*, 283 A.2d at 695 (stating that Marriott Group cannot be standing "on both sides of the transaction" within meaning of rule when valuations of property companies and Marriott stock were made by majority of Marriott directors whose independence is unchallenged and whose information was based upon appraisals, analysis, information and opinions provided by independent experts).

Thus, there are three distinct, specific situations that constitute an interested director transaction under section 144. First, a contract or transaction between a director and the corporation would fall within the purview of section 144. A typical situation would be one in which the director sells a piece of his property to the corporation. Second, a contract or transaction between an organization in which the director is an officer and a director and the corporation would also be considered an interested director transaction. Third, a contract or transaction between the corporation and any other party in which the director had a financial interest would also be considered an interested director transaction governed by section 144.

ration's directors stand to profit from a particular transaction.[235] For example, section 144 will not apply to a transaction in which all the shareholders in the corporation share the benefits of the transaction.[236] In addition, insignificant or speculative benefits or financial interests will not make the transaction subject to the section 144 interested director transaction rules.[237]

The purpose of section 144 is to provide various methods by which an interested director can remove the taint of the self-interest in an interested director transaction by obtaining the approval of a "neutral decision maker."[238] If the interested director obtains approval by an impartial body, the courts will shelter the transac-

235. *See* DEL. CODE ANN. tit. 8, § 144 (stating situations in which contracts or transactions involving interested directors are not void or voidable).

236. *See Cede III*, 663 A.2d 1156, 1170 (Del. 1995) (agreeing with Court of Chancery's finding that director's hope for better employment is not type of interest dealt with by section 144). The Delaware Supreme Court stated that "[i]n *Cede II*, this Court distinguished classic self-dealing from incidental director interest. To be disqualifying, the nature of the director interest must be substantial." *Id.* at 1169; *see also Cede II*, 634 A.2d at 363 ("Provided that the terms of 8 *Del. C.* § 144 are met, self-interest, alone, is not a disqualifying factor even for a director. To disqualify a director, for rule rebuttal purposes, there must be evidence of disloyalty.").

237. *See Cede III*, 663 A.2d at 1170 (adopting test originally formulated by Court of Chancery for determining when director's incidental self-interest in transaction is substantial enough to destroy independence of whole board). A director's interest in a transaction is incidental if the director has no present financial interest in the other corporation, but rather hopes to benefit from the transaction in other ways, such as a better employment opportunity. *See id.* at 1169 (noting that incidental director interest, if it is substantial, can be breach of loyalty). This "materiality test" is a two-part test that requires a shareholder to show

> (1) the materiality of a director's self-interest to the given director's independence; and (2) the materiality of any such self-interest to the collective independence of the board. Proof of materiality under either part requires a showing that such an interest is reasonably likely to affect the decision-making process of a reasonable person on a board composed of such persons.

Cede II, 634 A.2d at 363 (stating that while Delaware Supreme Court did not apply this materiality test directly to interested director transactions, it was likely that it would adopt this test when faced with interested director transactions where director had very little financial interest in transaction, but did in fact stand on both sides of transaction). This test would make Delaware law consistent with the de minimis principle advocated by the A.L.I.'s *Principles of Corporate Governance*, which provides that "§ 5.02 [the interested director transaction rule] should not be applied to transactions that involve relatively trivial amounts." AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.02, at 212 (1994).

238. *See Cede II*, 634 A.2d. at 365 ("Section 144(a)(1) appears to be a legislative mandate that . . . an approving vote of a majority of informed and disinterested directors shall remove any taint of director or directors' self-interest in a transaction.").

tion with the protections of the business judgment rule.[239] Approval by a neutral decision maker does not, however, remove a transaction from all judicial scrutiny and will not validate an unfair transaction.[240]

Section 144 requires that the challenging shareholder first rebut the presumption of the business judgment rule by showing that the transaction constituted an interested director transaction.[241] Once the challenging shareholder has met this burden, the transaction will not be automatically voidable if one of the safe harbors provided by section 144 are met.[242] The safe harbors include either approval of the transaction by the disinterested directors on the board or by the shareholders.

Under section 144(a)(1), approval by fully informed, disinterested and independent directors acting in good faith shelters an

239. *See* Oberly v. Kirby, 592 A.2d 445, 467 (Del. 1991) ("The key to upholding an interested transaction is the approval of some neutral decision-making body. Under 8 *Del. C.* § 144, a transaction will be sheltered from shareholder challenge if approved by either a committee of independent directors, the shareholders, or the courts."); Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) ("[A]pproval by fully-informed disinterested director under section 144(a)(1), or disinterested stockholders under § 144(a)(2), permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction.").

240. *See* DEL. CODE ANN. tit. 8, § 144(a)(3) (requiring that contract or transaction be "fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee thereof, or the shareholders").

241. *See id.* § 144(a) (defining "interested director transaction" as "contract or transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers are directors or officers, or have a financial interest"); Kahn v. Roberts, No. CIV.A.12324, 1995 WL 745056, at *4-5 (Del. Ch. Dec. 6, 1995) ("The business judgment rule will not apply, however, if the party challenging the corporate conduct establishes a lack of independence on the part of the directors who approved the transaction." (citing BLOCK ET AL., *supra* note 69, at 23-24)).

242. *See Oberly*, 592 A.2d at 467 ("We see no reason why independent directors and courts should not also have the power to evaluate fairness of an interested transaction."); *Marciano*, 535 A.2d at 404-05 (holding that compliance with section 144 is not only way to prevent interested director transactions from becoming automatically voidable). In *Marciano*, the corporation was unable to approve or ratify an interested director transaction because the shareholder directors were deadlocked. *Id.* at 401. Because section 144(a) requires approval or ratification of an interested director transaction, the plaintiffs in *Marciano* argued that the interested director transaction should be voidable, regardless of its fairness to the corporation. *Id.* at 402-04. The court, however, disagreed and found that even if section 144 was not invoked, fair transactions would be upheld if, upon judicial review, the transaction withstands the close scrutiny of intrinsic elements. *See id.* at 404-05 (holding that interested director could prevent transaction from becoming voidable by proving that transaction was entirely fair to corporation).

interested director transaction.[243] The whole board or a committee may authorize the transaction provided that the authorization is made by a majority of all the disinterested directors on the board.[244] The number of disinterested directors need not be sufficient to constitute a quorum as long as a quorum of directors, including interested directors, is present at the time of the vote.[245] In order to invoke the protective effects of section 144, the interested director must disclose all material facts relating to the transaction and the director's interest to the authorizing directors so that the disinterested directors will be fully informed when approving the transaction.[246]

243. *See* DEL. CODE ANN. tit. 8, § 144(a)(1) ("No contract or transaction between a corporation and . . . its directors or officers, or between a corporation and any other corporation . . . in which one or more of its directors [have an interest], shall be void or voidable . . . if . . . material facts as to his relationship or interest . . . are disclosed."); *Oberly*, 592 A.2d at 466 (finding that enactment of section 144 limited stockholders' power in two ways). The Supreme Court of Delaware stated that

> section 144 allows a committee of disinterested directors to approve a transaction and bring it within the scope of the business judgment rule. . . . When a challenge to fairness is raised, the directors carry the burden of "establishing . . . [the transaction's] entire fairness, sufficient to pass the test of careful scrutiny by the courts." . . . If, however, the directors meet their burden of proving entire fairness, the transaction is protected from stockholder challenge.

Id. (quoting Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983)); *see also Cede III*, 663 A.2d 1156, 1169 (Del. 1995) (requiring that directors be "independent and disinterested," meaning director has no financial interest in other corporation or organization, and is not "beholden" to interested director).

244. *See* DEL. CODE ANN. tit. 8, § 144(a)(1) (requiring good faith authorization). The statute states in relevant part:

> (a) No contract or transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee thereof which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if:
>
> (1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum.

Id.

245. *See id.* § 144(b) ("Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.").

246. *See id.* (requiring ratification by fully informed majority of disinterested outside directors).

Under section 144(a)(1), disinterested director approval meets the requirements of that subsection and eliminates the automatic voidability of the transaction.[247] In addition, judicial decisions have held that such approval also affects the standard of review and burden of proof.[248] Because authorization under section 144(a)(1) requires that the authorizing directors be disinterested, fully informed and act in good faith, effective section 144(a)(1) approval necessarily meets the triad of fiduciary duties imposed on the directors.[249] Thus, the courts have held that compliance with section 144(a)(1) changes the standard of review from entire fairness to the business judgment rule with issues limited to gift or waste.[250] Disinterested director authorization also shifts the burden of proof from the interested director to the challenging party.[251]

Similarly, section 144(a)(2) provides that approval of the transaction by a majority of the minority shareholders also creates a safe harbor for interested director transactions.[252] Section 144(a)(2) re-

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247. *See id.*

248. *See Cede II*, 634 A.2d 345, 365 (Del. 1993) (noting that section 144(a) removes "interested director cloud" from transaction and permits otherwise interested transactions to be brought within protection of business judgment rule). The Supreme Court of Delaware explained the significance of section 144:

> Enacted in 1967, section 144(a) codified judicially acknowledged principles of corporate governance to provide a limited safe harbor for corporate boards to prevent director conflicts of interest from voiding corporate action . . . . At the very least section 144(a) protects corporate actions from invalidation on grounds of director self-interest if such self-interest is: (1) disclosed to and approved by a majority of disinterested directors; (2) disclosed to and approved by the shareholders; or (3) the contract or transaction is found to be fair "as to the corporation."

Id. (citations omitted); *see also* Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490, 500 (Del. Ch. 1990) (stating that under section 144, if shareholder challenges interested director transaction, it will not be void "solely for that reason" if transaction is (1) approved in good faith by informed majority of disinterested directors on board (or committee comprised of majority of board's disinterested directors); (2) ratified in good faith by informed shareholder vote; or (3) entirely fair to corporation at time it was approved or ratified).

249. *See Cede II*, 634 A.2d at 360 (defining business judgment rule as "'presumption that in making a business decision, the directors of a corporation acted on an informed basis [i.e., with due care], in good faith and in the honest belief that the action taken was in the best interest of the company'" (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (alteration in original)).

250. *See* Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) (comparing subsection 144(a)(3) with subsections 144(a)(1) and (2) and noting that, in latter subsections, burden of proof falls upon party attacking transaction).

251. *See* Cooke v. Oolle, No. CIV.A.11134, 1997 WL 367034, at *9 (Del. Ch. June 23, 1997).

252. *See* Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976) (explaining effect of subsection 144(a)(2)). Although the statute does not require that the ratification be made by disinterested and independent shareholders, the Delaware courts will only shelter an interested director transaction under the business judgment

quires that the shareholders act in good faith and that the interested director disclose all the material facts relating to the director's interest and the transaction to the shareholders.[253] Section 144(a)(2) does not require that the approval be made by disinterested shareholders. If the shareholders approving the interested director transaction are not disinterested and independent, but the transaction is otherwise approved in compliance with section 144(a)(2), the effect of the approval is only that the interested director transaction will not be automatically voidable.[254] Because the approval was not made by a neutral decision maker, the burden of proof will remain on the interested director to establish the entire fairness of the transaction.[255] When a majority of the disinterested shareholders approves an interested director transaction in compliance with the other requirements of section 144(a)(2), the

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rule if the transaction is approved by a majority of the disinterested shareholders. *See id.* at 221 (holding that decision was not protected under business judgment rule when shareholders were not disinterested and independent).

In *Fliegler*, shareholders brought a derivative action on behalf of Agau Mines, Inc. against the directors and officers of Agau and United States Antimony Corporation ("USAC"). *See id.* at 219. The plaintiffs claimed that the defendants, in their capacity as officers and directors of both corporations, had usurped a corporate opportunity belonging to Agau and wrongfully profited by causing Agau to exercise an option to purchase that opportunity. *See id.* The defendants had formed USAC to develop a mineral prospect without risk to Agau. *See id.* at 220. The mineral prospect turned out to be promising, so the defendants caused Agau to exercise its option to purchase the mineral prospect from USAC. *See id.* The decision was put to the shareholders, including the defendants, for approval. *See id.*

When minority shareholders challenged the decision, the defendants claimed that the business judgment rule protected their decision. *See id.* The court disagreed:

> The purported ratification by the Agau shareholders would not affect the burden of proof in this case because the majority of shares voted in favor of exercising the option were cast by defendants in their capacity as Agau shareholders. Only about one-third of the "disinterested" shareholders voted, and we cannot assume that such non-voting shareholders either approved or disapproved. Under these circumstances, we cannot say that "the entire atmosphere has been freshened" and that departure from the objective fairness test is permissible. . . . Nor do we believe that the Legislature intended a contrary policy and rule to prevail by enacting 8 Del. C. § 144 . . . .

Id. at 221 (citations omitted) (recognizing that interested director who is also large shareholder could ratify transaction that was not in best interests of corporation).

253. *See* DEL. CODE ANN. tit. 8, § 144(a)(2) (setting forth factors required to validate transactions).

254. *See Fliegler*, 361 A.2d at 222 ("Section 144 merely removes an 'interested director' cloud when its terms are met and provides against invalidation of an agreement 'solely' because such a director or officer is involved.").

255. *See id.* at 221 (refusing to allow ratification by majority of shareholders to affect burden of proof when majority of shares voted in favor of option were cast by defendants, who were interested parties).

approval not only eliminates the automatic voidability of the transaction, but also changes the standard of review to the business judgment rule with the burden on the challenging party to show gift or waste.[256]

Even if the interested director cannot prove that disinterested directors approved the transaction under section 144(a)(1) or disinterested shareholders approved the transaction under section 144(a)(2), the interested director may still shelter the transaction from the rule of per se voidability and validate the transaction by proving that the transaction is entirely fair to the corporation under section 144(a)(3) or otherwise.[257]

C. *Transactions Not Involving Controlling Shareholders or Interested Director Transactions in Which Loyalty Claims Arise*

As noted above, when a majority of the disinterested directors on a board approves or a majority of the minority stockholders ratifies a transaction involving a corporation and its self-interested controlling shareholder, courts apply the entire fairness standard but shift the burden of proof to the plaintiff to establish the unfairness of the challenged transaction.[258] In contrast, the effect of disinterested director or shareholder approval in an interested director transaction is to shift the burden to the challenging party to prove

256. For a discussion of shifting burdens of proof, see *supra* notes 35-43 and accompanying text. Because approval was made by shareholders who were disinterested, fully informed and acted in good faith, approval by disinterested shareholders under subsection 144(a)(2) again changes the standard of review to the business judgment rule with the issues limited to gift or waste (i.e., whether the decision was rational).

257. *See Fliegler*, 361 A.2d at 221 (requiring interested director to show entire fairness of transaction); *see also* Oberly v. Kirby, 592 A.2d 445, 467 (Del. 1991) (stating that approval by committee of independent directors or shareholders is sufficient to shelter transaction from shareholder challenge); Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) ("[A]pproval by fully-informed disinterested directors under section 144(a)(1), or disinterested stockholders under section 144(a)(2), permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction."); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (stating that in interested director transactions, directors "are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain . . . . The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness").

258. *See* Cooke v. Oolle, No. CIV.A.11134, 1997 WL 367034, at *9 (Del. Ch. June 23, 1997) (noting that only way burden shifts to challenger to prove unfairness of transaction is if corporation demonstrates approval by "truly independent," and fully informed body).

that the transaction amounted to gift or waste.[259] The next issue that arises is which paradigm, if either, will govern a transaction that: (1) involves ratification by disinterested directors or shareholders; and (2) triggers the entire fairness standard because a majority of the board is interested or not independent; but (3) is neither an interested director transaction nor a self-interested controlling shareholder transaction.

In *In re Wheelabrator Technologies, Inc. Shareholders Litigation* ("*Wheelabrator II*"),[260] the court held that the business judgment rule was applicable to the situation in which informed disinterested shareholders ratified a transaction involving a breach of the duty of loyalty because a majority of the board was interested or not independent but which did not involve a controlling shareholder or interested director.[261] In such a situation, the court held that the applicable review standard changes to the business judgment rule and the burden of proof shifts to the challenging party.[262]

259. *See* DEL. CODE ANN. tit. 8, § 144(a)(2) (stating that approval limits issues to gift and waste); *see also* Stroud v. Grace, 606 A.2d 75, 92 (Del. 1992) ("In sum, after finding that the shareholder vote was fully informed, and in the absence of any fraud, manipulative or other inequitable conduct, that should have ended the matter on basic principles of ratification.").

260. 663 A.2d 1194 (Del. Ch. 1995).

261. *Id.* at 1196-97. In *Wheelabrator II*, the board recommended a merger with Waste Management, Inc. ("WMI") to its shareholders. *Id.* at 1198. A majority of disinterested shareholders approved the merger. *See id.* The shareholder plaintiffs brought a suit against Wheelabrator alleging that the directors violated their duty to disclose all material facts to the shareholders, breached their duty of care and breached their duty of loyalty in that several directors had conflicts of interest with WMI that prevented them from seeking the best price for the shareholders. *See id.* at 1196-97. The board claimed that the plaintiffs had extinguished their claims by approving the merger through a shareholder vote. *See id.* at 1196.

262. *See id.* at 1203 (holding that in interested transactions between corporation and its directors, between two corporations that share certain directors or when directors of one corporation have interest in other corporation, approval by majority of fully informed shareholders invoked business judgment rule). The court stated, "[a]pproval by fully informed, disinterested shareholders pursuant to § 144(a)(2) invokes 'the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction.'" *Id.* at 1203 (quoting *Marciano*, 535 A.2d at 405 n.3). The court in *Wheelabrator II*, recognizing that the result was the same in "interested" transaction cases not decided under section 144, stated that "[w]here there has been independent shareholder ratification of interested director actions, the objecting stockholder has the burden of showing that no person of ordinary sound business judgment would say that the consideration received for the options was a fair exchange for the options granted." *Id.* (quoting Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979)).

D. *Claim Extinguishment*

Over thirty years ago, the Delaware Supreme Court held that "the entire atmosphere is freshened and a new set of rules invoked where formal approval has been given by a majority of independent, fully informed stockholders."[263] The Delaware courts have recently tried to explain the situations in which valid shareholder ratification will provide a complete defense to a breach of fiduciary duty claim.[264] There are two situations in which a fully informed shareholder vote extinguishes a shareholder claim.

First, shareholder approval can extinguish a shareholder challenge when a board acts in good faith, but exceeds its actual authority.[265] Second, valid shareholder approval may extinguish a shareholder claim when the board does not adequately inform itself before approving a transaction, but receives fully informed, disinterested shareholder approval.[266]

The first situation is a restatement of the traditional agency rule that ratification by the principal (in this case, the shareholders), cures unauthorized acts of the agent (the board), unless the ratification procedure was unfair or procedurally defective.[267] It is important here to distinguish between voidable and void acts. Voidable acts are those that the board performed in the interest of the corporation in which the board exceeded its actual authority. Void acts are those acts that are ultra vires, fraudulent or constitute

263. Gottlieb v. Heyden Chem. Corp., 91 A.2d 57, 59 (Del. 1952) (finding that within corporate realm "the majority may enforce its will upon a dissenting minority").

264. *See Wheelabrator II*, 663 A.2d at 1202 (noting that view that shareholder ratification constitutes full defense to breach of fiduciary duty claims is overbroad in light of complex nature of law).

265. *See Michelson*, 407 A.2d at 219-24.

266. *See Wheelabrator II*, 663 A.2d at 1202 (explaining instances in which Delaware Supreme Court has found shareholder ratification of voidable director conduct to result in claim extinguishment).

267. *See Michelson*, 407 A.2d at 219-20 ("[A] validly accomplished shareholder ratification relates back to cure otherwise unauthorized acts of officers and directors. . . . If shareholders have approved an otherwise voidable act, their approval extinguishes any claim for losses based on prior lack of authority of the directors to undertake such action."). In *Michelson*, the Delaware Supreme Court held that a less than unanimous shareholder vote was procedurally adequate to ratify board action. *Id.* at 220 (holding ratification permissible even where action made beyond the scope of its authority "unless the ratification procedure proved to be lacking in fairness or procedurally defective"). The plaintiff shareholder in *Michelson* brought a derivative suit, claiming that the board exceeded its authority by granting stock options to officers and directors of the corporation. *Id.* at 215. In response to this claim, the board obtained ratification of the transaction from less than a unanimous shareholder vote. *See id.* at 219.

gift or waste.[268] Shareholder ratification can cure voidable acts.[269] Even some void acts can be cured, but only by unanimous shareholder approval.[270]

The second situation in which a shareholder vote can extinguish a claim against the board is when the board has breached its duty of care because the directors failed to adequately inform themselves before undertaking the challenged transaction.[271] For example, in *Smith v. Van Gorkom*,[272] the Delaware Supreme Court concluded that a fully informed shareholder vote could cure a board's uninformed decision to merge.[273]

Shareholder ratification, however, does not extinguish duty of loyalty claims.[274] Instead, regardless of what type of duty of loyalty

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268. *See id.* at 218-19 (explaining difference between voidable and void acts). The Delaware Supreme Court stated:

> The essential distinction between voidable and void acts is that the former are those which may be found to have been performed in the interest of the corporation but beyond the authority of management, as distinguished from acts which are *ultra vires*, fraudulent or gifts or waste of corporate assets.

Id.

269. *See Wheelabrator II*, 663 A.2d at 1202. The court stated:

> The Delaware Supreme Court has found shareholder ratification of "voidable" director conduct to result in claim-extinguishment in only two circumstances. The first is where the directors act in good faith, but exceed the board's *de jure* authority. . . . The second circumstance is where the directors fail "to reach an informed business judgment" in approving a transaction.

Id. (citations omitted); *see Michelson*, 407 A.2d at 220 (explaining that question of whether shareholders were fully informed, making their ratification of director action valid, "turns on the fairness and completeness of the proxy materials submitted by the management to the . . . shareholders"); *see also*, Gottlieb v. Heyden Chem. Corp., 91 A.2d 57, 59 (Del. 1952) ("[T]he entire atmosphere is freshened and a new set of rules invoked where a formal approval has been given by a majority of independent, fully informed stockholders.").

270. *See Michelson*, 407 A.2d at 219 (explaining that "practical distinction" between voidable and void acts is that voidable acts are susceptible to cure by shareholder ratification while void acts are not); *see also* Lewis v. Vogelstein, 699 A.2d 327, 335 (Del. Ch. 1997) (stating that for shareholders to ratify waste, vote must be unanimous).

271. *See* Smith v. Van Gorkom, 488 A.2d 858, 881 (Del. 1985) (concluding that board was grossly negligent for failing to act in informed manner when agreeing to merger).

272. 488 A.2d 858 (Del. 1985).

273. *Id.* at 889-90 ("The fact that the Board had no reasonably adequate information indicative of the intrinsic value of the Company, other than a concededly depressed market price, was without question material to the shareholders voting on the merger.").

274. *See Wheelabrator II*, 663 A.2d 1194, 1201 (Del. Ch. 1995) (explaining that *Weiss* and *Wheelabrator I* are no longer applicable). The court stated that

> since 1990, the law has changed, and there is now significant reason to conclude that *Wheelabrator I* and *Weiss* would not be regarded as good law today. Not only has the Delaware Supreme Court never endorsed the

claim is made, shareholder ratification only alters either the standard of review and/or shifts the burden of proof in duty of loyalty claims.[275] For example, as previously discussed in *Wheelabrator II*, the court held that even though the challenged party raised a duty of loyalty claim that implicated the entire fairness standard, a fully informed shareholder vote can change the standard of review and shift the burden of proof, but does not automatically extinguish the plaintiff's duty of loyalty claim.[276] As noted above, loyalty claims are not extinguished in situations involving ratification of self-interested controlling shareholder or interested director transactions.[277] In such situations, the duty of loyalty claim is not extinguished, but the ratification does shift the burden of proof in both situations and changes the standard of review for interested director transactions.[278]

The Delaware Supreme Court recently held that a shareholder vote approving a merger could not ratify unilateral board decisions

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> view adopted in those cases, the decisions that postdate *Weiss* and *Wheelabrator I* persuasively indicate that the Supreme Court would not hold that shareholder approval of a board action claimed to violate the fiduciary duty of loyalty would operate automatically to extinguish a duty of loyalty claim.

Id.

275. *See* Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994) (holding that effect of shareholder ratification on cash-out merger between corporation and controlling stockholder is to change standard of review to entire fairness and shift burden of proof to challenging shareholder); *see also Wheelabrator II*, 663 A.2d at 1204 (explaining that *Kahn* holding indicates that duty of loyalty claims are not extinguishable). The *Wheelabrator II* court stated:

> Had *Weiss* or *Wheelabrator I* been viewed as the correct ratification rule, the Supreme Court [in *Kahn*] could have stated that the effect of shareholder ratification would be to extinguish the duty of loyalty claim. Instead, however, the Supreme Court held that in an interested merger with a controlling stockholder, the applicable judicial review standard is entire fairness, and shareholder ratification merely shifts the burden of proof on the fairness issue from the controlling stockholder to the challenging plaintiff.

Id. (citing *Kahn*, 638 A.2d at 1117). Furthermore, the court found the *Stroud* holding to indicate that duty of loyalty claims are not extinguishable. *Id.*; *see also* Stroud v. Grace, 606 A.2d 75, 90 (Del. 1992) (holding that ratification of charter amendments by fully informed vote of majority of minority shareholders resulted in application of entire fairness standard of review and shifted burden of proof to plaintiffs).

276. *See Wheelabrator II*, 663 A.2d at 1200 (noting that fully informed shareholder vote operated to extinguish duty of care claims, but not duty of loyalty claims).

277. *See id.* at 1202 ("More specifically, no Supreme Court case has held that shareholder ratification operates automatically to extinguish a duty of loyalty claim.").

278. *See id.* (noting that effect of ratification in duty of loyalty claims is for burden to shift or for standard of review to change, or both).

that were made leading up to the ultimate merger agreement.[279] The court chose not to categorize *Revlon* and *Unocal* duties as arising from either the duty of care or the duty of loyalty, thereby avoiding the issues as to which ratification approach, if any, applied in those situations.[280] Because the shareholders did not specifically approve the underlying decisions of the board leading up to the merger and because of the significance of a contest for control, the court noted that even if a majority of stockholders approved the merger, it would still review the decisions leading up to the merger under enhanced judicial scrutiny because to do otherwise would frustrate the purposes underlying enhanced judicial scrutiny.[281]

279. *See In re* Santa Fe Pac. Corp. Shareholder Litig., 669 A.2d 59, 68 (Del. 1995) ("Since the stockholders of Santa Fe merely voted in favor of the merger and not the defensive measures, we decline to find ratification in this instance."). In *Santa Fe,* the shareholder plaintiffs claimed that the board had breached its duty under *Revlon* to seek maximum shareholder value by not considering alternatives to the Burlington Northern, Inc. ("BNI") merger offer and that the board had violated its *Unocal* duty by implementing a poison-pill plan in response to a merger offer from Union Pacific. *Id.* at 65. Santa Fe favored a merger with BNI. *See id.* As a result, the board adopted a poison-pill plan to prevent a merger with Union Pacific. *See id.* The plan provided that if any bidder other than BNI accumulated more than 10% of Santa Fe's stock, the shareholders would have the option to sell their shares for twice their value. *See id.* The board eventually agreed to merge with BNI, and the shareholders approved the transaction. *See id.* The plaintiff shareholders brought suit against the board claiming that (1) the board breached its *Revlon* duty by not seeking the best value available; (2) the board breached its *Unocal* duty by adopting the poison-pill plan; and (3) the board did not fully disclose all material facts of the deal. *See id.* The board argued that, by voting to approve the merger, the plaintiffs had extinguished their claims. *See id.*

280. *See id.* at 67 (explaining refusal to categorize *Revlon* and *Unocal* duties). The Delaware Supreme Court stated:

> While the Court of Chancery concluded that claimed breaches of the duty of loyalty are not extinguished by a fully-informed stockholder vote and that *Revlon* and *Unocal* claims are duty of loyalty claims for ratification purposes, we reach the same result on different grounds. *Revlon* and *Unocal* and the duties of a Board when faced with a contest for corporate control do not admit of easy categorization as duties of care or loyalty. In any event, categorizing these more specific duties as primarily arising from due care or loyalty would not be nearly as helpful in determining the effect of a fully-informed stockholder vote as would an examination of their underlying purposes.

Id. (footnote omitted).

281. *See id.* at 68 (explaining underlying purposes of enhanced judicial scrutiny). The court stated that the "*Unocal* standard of enhanced judicial scrutiny rests in part on an 'assiduous . . . concern about defensive actions designed to thwart the essence of corporate democracy by disenfranchising shareholders.'" *Id.* at 67 (quoting Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1378 (Del. 1995)). In addition, the court noted that "*Revlon* also rests on the 'overriding importance of voting rights.'" *Id.* at 68 (quoting Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 42 (Del. 1993)). The court in *Santa Fe* explained its reluctance to find ratification of the defensive measures:

> In voting to approve the Santa Fe-Burlington merger, the Santa Fe stockholders were not asked to ratify the Board's unilateral decision to erect

On the other hand, because one of the requisites for triggering review under *Unocal* or *Blasius* is unilateral board action, noncoerced shareholder ratification of the specific defensive measure or action effecting the shareholder franchise will eliminate any *Unocal* or *Blasius* claims.[282]

VII. CONCLUSION

Part II of this Article has described the basic principles that apply in situations in which conflicts of interest arise in transactions that involve decisions outside the ordinary course of business. This area of the law is even more fact sensitive than the rules governing the day-to-day decisions discussed in Part I. The nuances involved in these cases are very important and often subtle, but are crucial in determining how the courts will review the challenged transaction.

There are numerous law review articles and treatises that discuss the nuances in the areas covered by Part II. As we noted in the Introductions to Parts I and II, our goal is to provide a primer on the basic rules of the game. In Part II, we have tried to give our readers a simple road map to enable them to understand how courts review transactions that involve board conflicts of interest in three situations. First, when the board adopts defensive measures.[283] Second, when the corporation is up for sale or there is a

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> defensive measures against the Union Pacific offer. The stockholders were merely offered a choice between the Burlington Merger and doing nothing. The Santa Fe stockholders did not vote in favor of the precise measures under challenge in the complaint. Here, the defensive measures had allegedly already worked their effect before the stockholders had a chance to vote. In voting on the merger, the Santa Fe stockholders did not specifically vote in favor of the Rights Plan, the Joint Tender or the Termination Fee. Since the stockholders of Santa Fe merely voted in favor of the merger and not the defensive measures, we decline to find ratification in this instance.

Id. (footnotes omitted). Furthermore, the court in *Santa Fe* added that

> Board action which coerces stockholders to accede to a transaction to which they otherwise would not agree is problematic. "We have found that even in light of a valid threat, management actions that are coercive in nature or force upon shareholders a management sponsored alternative to a hostile offer may be struck down as unreasonable and non-proportionate responses." Thus, enhanced judicial scrutiny of Board action is designed to assure that stockholders vote or decide to tender in an atmosphere free from undue coercion.

Id. (citations omitted) (quoting Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1154 (Del. 1990)).

282. For a discussion of *Unocal* and *Blasius*, see *supra* notes 176-87 and accompanying text.

283. For an in-depth discussion of the standard that Delaware courts employ when a board adopts defensive measures, see *supra* notes 44-94 and accompanying text.

change of control transaction.[284] And third, when the board manipulates shareholder voting rights.[285]

We must caution those relatively unfamiliar with Delaware law that while understanding the rules of the game is essential to effective representation of the players, the simplicity of both Parts of this Article and the decision tree in Appendix A do not fully reflect the sophistication and complexity of most cases in the Delaware courts. As we noted before, the Delaware courts have been particularly adept at maintaining a high degree of flexibility in shaping the Delaware law to fit diverse and complex situations, while at the same time consistently applying the basic rules of the game.

We must also warn the reader that real life is not quite as structured as the reader might surmise from reading Parts I and II. Frequently, there is no clear indication of who has the burden of proof and what the ultimate standard of review is until the Delaware Chancery Court considers the evidence from both sides. At that point, the court decides (1) what the appropriate initial standard of review is; (2) which party has the initial burden of proof; (3) whether the standard of review changed; (4) whether the burden of proof shifted one or more times; (5) whether any effective ratification occurred; and (6) what, if any, legal effect the ratification had on the transaction. The underlying legal tenets outlined above form the backdrop for the final decisions on these issues made by the Chancery Court.

In virtually every case, both parties try to present their best factual and legal case and then argue that (1) the opposing side has the burden; (2) the opposing side's burden is the most stringent one possible; (3) the opposing side failed to meet that burden; (4) even if our side has the burden, the least stringent form of review applies; and (5) our side satisfied its burden under even the most stringent standard of review.

This Article necessarily compartmentalizes the various principles to make them easier to understand. Thus, a reader unfamiliar with Delaware practice could infer that the shifting burdens and standards of review are always easily discernable. In practice, there are very few bright lines. No bells ring or lights shine when the presumption of the business judgment rule is rebutted or the board proves entire fairness. Rather, each party presents its best case on

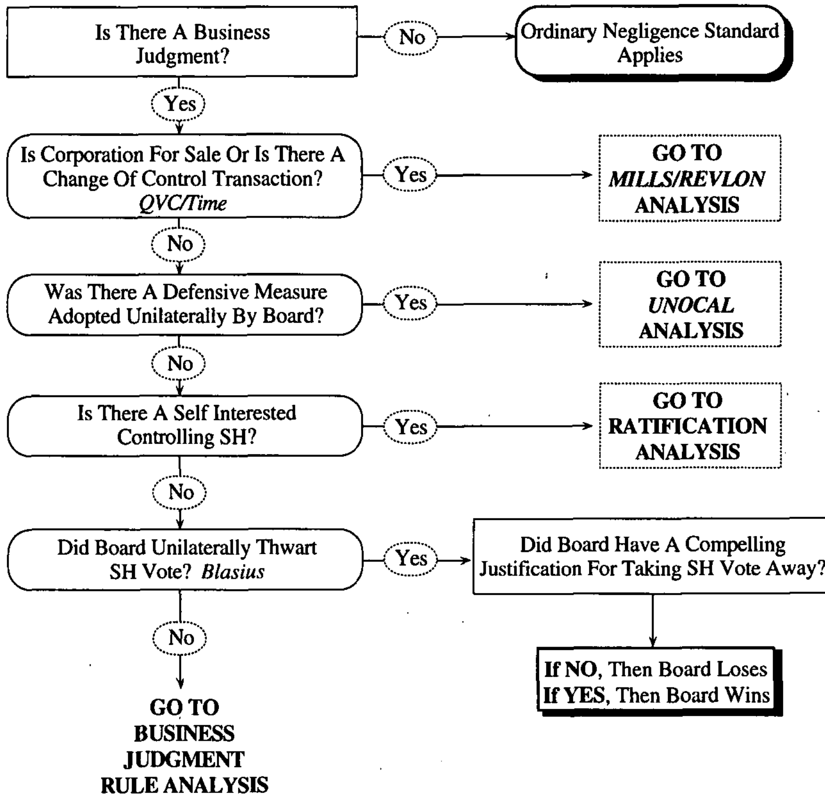
284. For an in-depth discussion of the enhanced *Revlon* standard, see *supra* notes 95-149 and accompanying text.

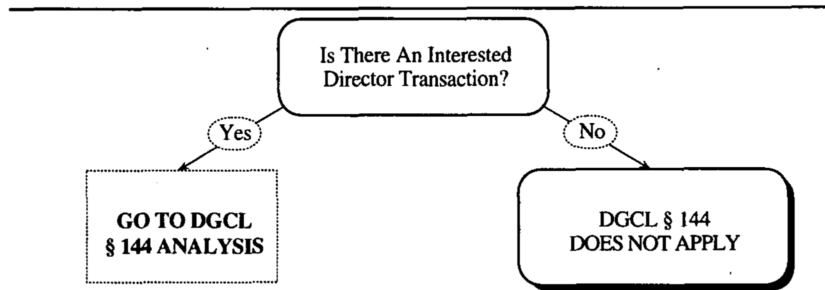
285. For an in-depth discussion of the *Blasius* "compelling justification" standard, see *supra* notes 150-87 and accompanying text.

the assumption that the court will impose the burden of proof and the least desirable standard of review upon that party. Typically, the winner of the game is not known until the Chancery Court, and often the Delaware Supreme Court, ultimately determines the appropriate standard of review and burden of proof and resolves the legal and factual issues involved. The parties, however, will use the basic rules of the game to persuade the courts to apply the most favorable standard of review and shift the burden of proof to their adversary.

The nuances that this Article did not discuss are varied and are frequently outcome determinative. Like all games, however, the nuances cannot be appreciated or used effectively until the basics have been mastered. Unlike a game, these cases often involve millions or billions of dollars and can have a tremendous impact on people's lives. Sensitive to these ramifications, the courts use these rules as they should be used, as tools designed to achieve just, fair and rational results. The authors urge each reader to do the same.

APPENDIX A
BOARD OF DIRECTOR DUTY/LIABLITY DECISION TREE UNDER DELAWARE CORPORATE LAW

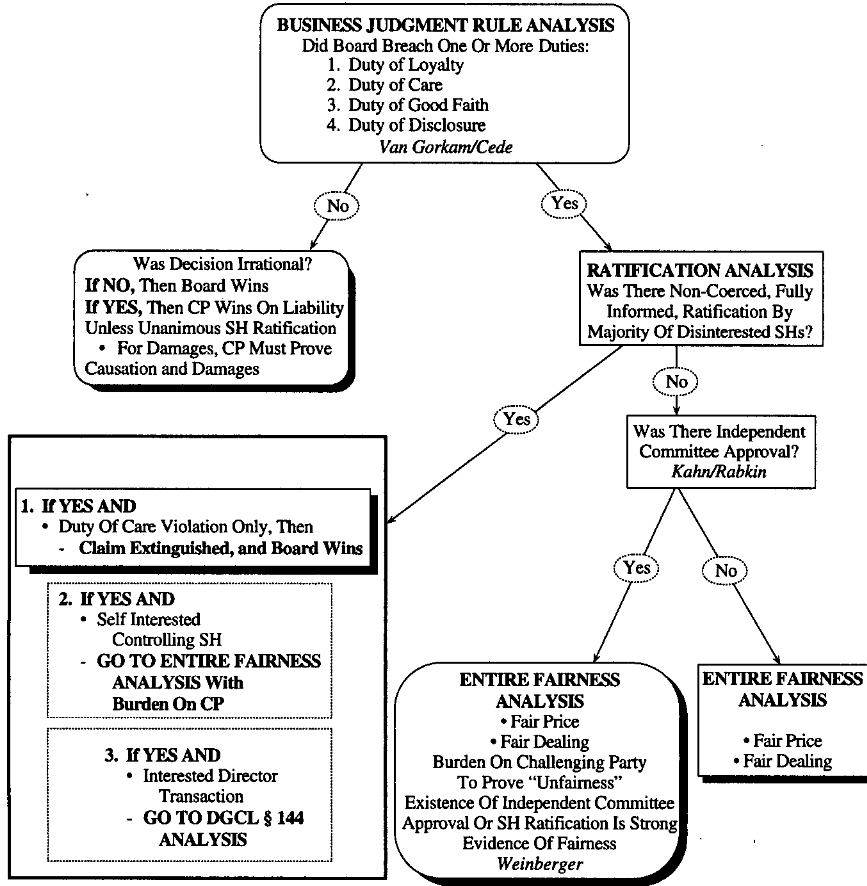


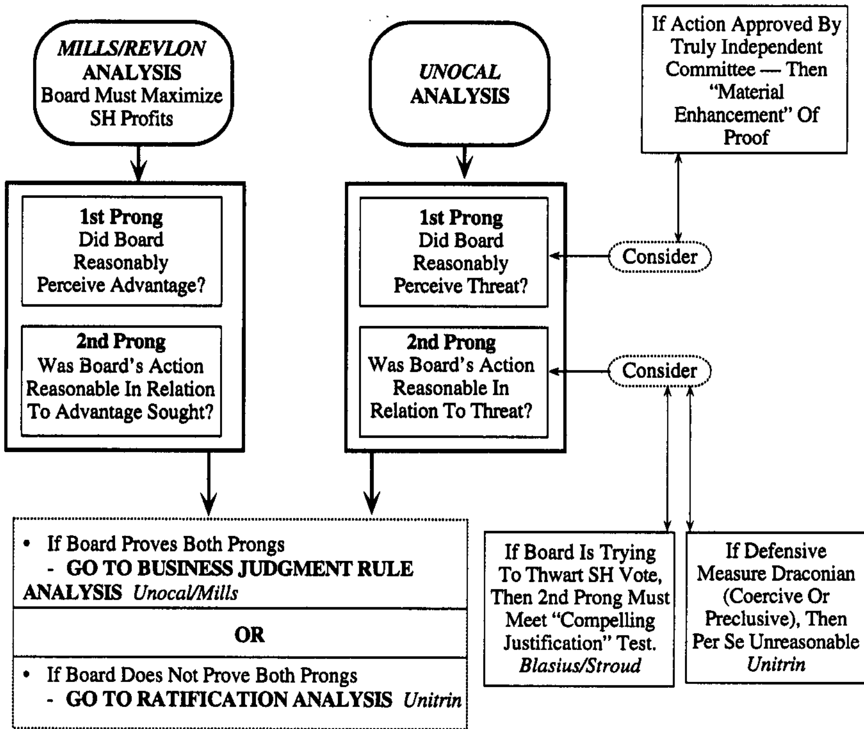


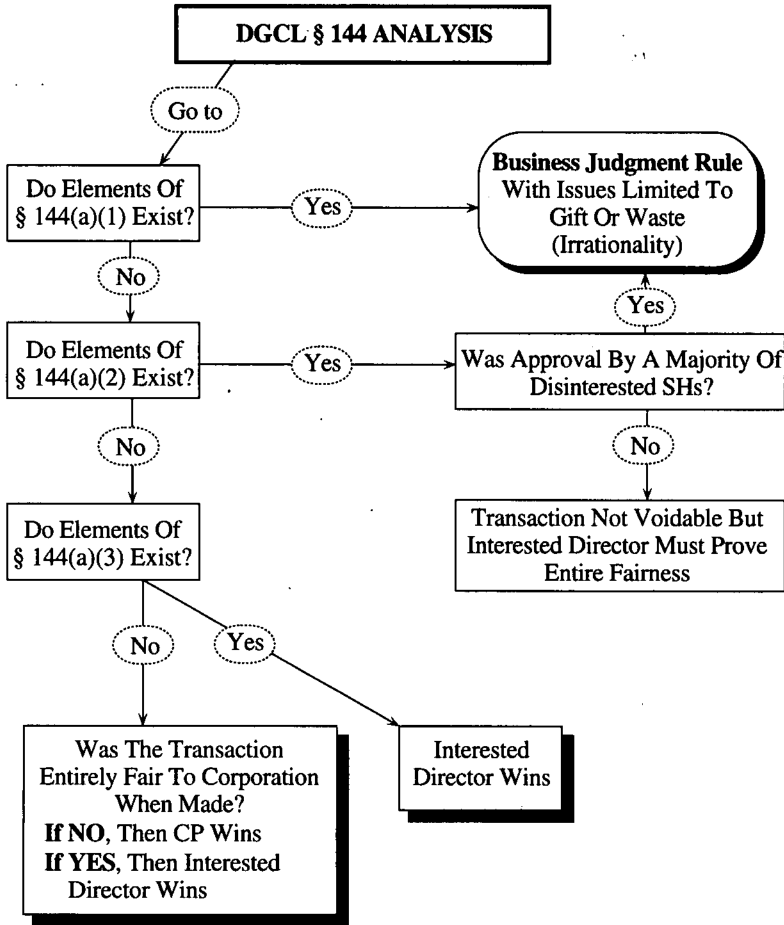
Key

Burden On Board | Burden On Challenging Party | Termination Point | Go To Information

Abbreviations: CP, challenging party; SH, shareholder.


BUSINESS JUDGMENT RULE ANALYSIS
Did Board Breach One Or More Duties:
1. Duty of Loyalty
2. Duty of Care
3. Duty of Good Faith
4. Duty of Disclosure
Van Gorkam/Cede
No
Yes
Was Decision Irrational?
If NO, Then Board Wins
If YES, Then CP Wins On Liability
Unless Unanimous SH Ratification
• For Damages, CP Must Prove
Causation and Damages
RATIFICATION ANALYSIS
Was There Non-Coerced, Fully
Informed, Ratification By
Majority Of Disinterested SHs?
Yes
No
Was There Independent
Committee Approval?
Kahn/Rabkin
1. If YES AND
• Duty Of Care Violation Only, Then
- Claim Extinguished, and Board Wins
2. If YES AND
• Self Interested
Controlling SH
- GO TO ENTIRE FAIRNESS
ANALYSIS With
Burden On CP
3. If YES AND
• Interested Director
Transaction
- GO TO DGCL § 144
ANALYSIS
Yes
No
ENTIRE FAIRNESS
ANALYSIS
• Fair Price
• Fair Dealing
Burden On Challenging Party
To Prove "Unfairness"
Existence Of Independent Committee
Approval Or SH Ratification Is Strong
Evidence Of Fairness
Weinberger
ENTIRE FAIRNESS
ANALYSIS
• Fair Price
• Fair Dealing


MILLS/REVLON ANALYSIS Board Must Maximize SH Profits
UNOCAL ANALYSIS
If Action Approved By Truly Independent Committee — Then "Material Enhancement" Of Proof
1st Prong Did Board Reasonably Perceive Advantage?
2nd Prong Was Board's Action Reasonable In Relation To Advantage Sought?
1st Prong Did Board Reasonably Perceive Threat?
2nd Prong Was Board's Action Reasonable In Relation To Threat?
Consider
Consider
• If Board Proves Both Prongs - GO TO BUSINESS JUDGMENT RULE ANALYSIS Unocal/Mills
OR
• If Board Does Not Prove Both Prongs - GO TO RATIFICATION ANALYSIS Unitrin
If Board Is Trying To Thwart SH Vote, Then 2nd Prong Must Meet "Compelling Justification" Test. Blasius/Stroud
If Defensive Measure Draconian (Coercive Or Preclusive), Then Per Se Unreasonable Unitrin


DGCL § 144 ANALYSIS
Go to
Do Elements Of § 144(a)(1) Exist?
Yes
Business Judgment Rule With Issues Limited To Gift Or Waste (Irrationality)
No
Yes
Do Elements Of § 144(a)(2) Exist?
Yes
Was Approval By A Majority Of Disinterested SHs?
No
No
Do Elements Of § 144(a)(3) Exist?
Transaction Not Voidable But Interested Director Must Prove Entire Fairness
No
Yes
Was The Transaction Entirely Fair To Corporation When Made?
If NO, Then CP Wins
If YES, Then Interested Director Wins
Interested Director Wins

Villanova Law Review, Vol. 42, Iss. 4 [1997], Art. 1