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### Defenders of the Corporate Bastion in Revlon Zone: Paramount Communications Inc. v. Time Inc.

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**DEFENDERS OF THE CORPORATE  
BASTION IN THE *REVLON* ZONE:  
*PARAMOUNT COMMUNICATIONS, INC. v.  
TIME INC.***

For the past decade, litigation spawned by the unprecedented number of takeovers and mergers among corporations in the United States has kept Delaware courts especially busy. Much of the litigation has involved challenges to actions of the boards of directors of "target" corporations, in suits by shareholders of the target corporation, or by other corporations seeking control of the target.<sup>1</sup> Traditionally, the Delaware courts apply the business judgment rule when reviewing actions taken by a corporation's board of directors.<sup>2</sup> The business judgment rule holds that a court will not enjoin or set aside a business decision made by a board of directors as long as an informed, rational basis for the decision can be demonstrated.<sup>3</sup> Courts will not hold directors liable for harm resulting from a decision that the business judgment rule protects.<sup>4</sup> As target corporations devised complex defensive

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1. See, e.g., *Grobow v. Perot*, 539 A.2d 180 (Del. 1988); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334 (Del. 1987); *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840 (Del. 1987); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985); *Datapoint Corp. v. Plaza Sec. Co.*, 496 A.2d 1031 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *Pogostin v. Rice*, 480 A.2d 619 (Del. 1984); *Lewis v. Anderson*, 477 A.2d 1040 (Del. 1984); *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227 (Del. 1988); *In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770 (Del. Ch. 1988); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986); *In re Beatrice Cos. Litig.*, 12 DEL. J. CORP. L. 199 (Del. Ch. 1986), *aff'd mem.*, 522 A.2d 865 (Del. 1986), *cert. denied*, 484 U.S. 898 (1987).

2. See 1 E. FOLK, R. WARD & E. WELCH, *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 141.2.2, at 104 (2d ed. 1988); see also *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984) ("[T]he business judgment rule operates only in the context of director action. . . . [I]t has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act.").

3. See D. BLOCK, N. BARTON & S. RADIN, *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 2-3, 8 (3d ed. 1989) [hereinafter *THE BUSINESS JUDGMENT RULE*]. Some authorities speak of a distinction between the business judgment rule, which protects the decisionmaking process, and the business judgment doctrine, which protects the decision itself. See *Johnson & Siegel, Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 323 n.26 (1987). Delaware courts, however, have not applied the distinction because the rule and the doctrine operate upon the same principles. See *Revlon*, 506 A.2d at 180 n.10.

4. *Johnson & Siegel, supra* note 3, at 311; see also *infra* notes 39-53 and accompanying text (discussing the business judgment rule).

tactics to repel takeovers,<sup>5</sup> however, the Delaware courts altered the business judgment rule to require a showing by directors that a threat to the corporation's interests existed.<sup>6</sup> The target corporation's board generally considers takeovers hostile to its interests because a takeover usually results in a loss of the board's control of the corporation and a subsequent change in corporate policy.<sup>7</sup> To satisfy the business judgment rule in the takeover context, a board must now prove, in addition to the elements required under the traditional business judgment rule, that some threat existed.<sup>8</sup>

Decisions in the Delaware courts during the 1980's explored the boundaries of the business judgment rule in the context of corporate control battles.<sup>9</sup> The problem inherent in corporate control battles is the conflict between directors' and shareholders' interests. Delaware law charges directors with a duty to manage the business and affairs of the corporation.<sup>10</sup> Although the business judgment rule grants directors wide latitude in their discretion to make corporate decisions,<sup>11</sup> directors ultimately owe a fiduciary duty to the corporation and its shareholders.<sup>12</sup> Further, the business judg-

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5. "A takeover is an attempt by a bidder ('raider') to acquire control of a subject company ('target') through acquisition of some or all of its outstanding shares." 1 M. LIPTON & E. STEINBERGER, TAKEOVERS & FREEZEOUTS § 1.01[2] (1989). The most common form of takeover is a bid made directly to shareholders of the target, either in the form of a cash tender offer or as an offer of raider securities in exchange for target stock. *Id.*

Defensive tactics evolved as a result of the increase in the use of tender offers as a means to achieve corporate control. See R. WINTER, M. STUMPF, & G. HAWKINS, SHARK REPELLENTS AND GOLDEN PARACHUTES: A HANDBOOK FOR THE PRACTITIONER 3-4 (Supp. 1989). Federal and state statutes governing tender offers provided the potential target corporation little protection, so corporations that feared hostile offers began to include deterrent provisions in their charters and bylaws. *Id.*; see also *infra* notes 82-84, 87-88 and accompanying text (discussing examples of deterrent provisions).

6. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* 506 A.2d 173 (Del. 1986); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); see *infra* notes 54-89 and accompanying text.

7. See Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257, 1263 (1985).

8. See *Unocal Corp.*, 493 A.2d at 955; *infra* notes 65-76 and accompanying text.

9. See, e.g., *Paramount Comms., Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1988); *Kleinhandler v. Borgia*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,525, at 93,324 (Del. Ch. July 7, 1989); *TW Servs., Inc. v. SWT Acquisition Corp.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,173 (Del. Ch. Mar. 2, 1989); *In re Holly Farms Corp. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,181, at 91,641 (Del. Ch. Dec. 30, 1988).

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

11. The business judgment rule allows courts to review only the process by which a board of directors reaches a decision, not the decision itself. See *Johnson & Siegel*, *supra* note 3, at 324 n.29.

12. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). The fiduciary duty includes both a duty of care and a duty of loyalty. *Id.* at 872-73; see also *Guth v. Loft, Inc.*, 2 A.2d 225

ment rule does not protect any decision tainted by a conflict of interest.<sup>13</sup> Accordingly, where the business decision concerns control of the corporation, as in the context of a takeover, resolution of the conflict between directors' and shareholders' interests turns on how much discretion courts will allow directors under the business judgment rule.

In *Paramount Communications, Inc. v. Time Inc.*,<sup>14</sup> the Delaware Supreme Court addressed challenges to actions of the board of directors of Time Inc. The plaintiffs, Paramount and shareholders of Time, sought an injunction against a proposed purchase of Warner Communications by Time.<sup>15</sup> The plaintiffs alleged that Time's board of directors violated its duties to the shareholders when the board decided to purchase, rather than merge with, Warner Communications, following a hostile takeover bid for Time stock by Paramount Communications.<sup>16</sup> Time's board abandoned its original plan to merge with Warner in order to avoid a vote by Time's shareholders.<sup>17</sup> The board feared that the shareholders would not approve the merger.<sup>18</sup>

The *Paramount* court addressed two issues. First, the court assessed whether the business judgment rule protected the Time board's response to the Paramount board's tender offer.<sup>19</sup> Second, the court questioned whether the Time directors' decision to merge with Warner was subject to the business judgment rule, or whether Time's board instead had an obligation to seek the current maximum share value for its shareholders because the proposed transaction could result in a change in control of the corporation.<sup>20</sup>

The Delaware Supreme Court, affirming the court of chancery, upheld Time's board of directors on both questions.<sup>21</sup> In so doing, the supreme court significantly broadened the lower court's decision. In holding that Time's board satisfied the business judgment rule and that no change in con-

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(Del. Ch. 1938), *aff'd*, 5 A.2d 503, 510 (1939) (stating that public policy forbids allowing a corporate director to profit from a breach of fiduciary duty).

13. See *Van Gorkom*, 488 A.2d at 872-73; *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986).

14. 571 A.2d 1140 (Del. 1989).

15. *Id.* at 1142.

16. *Paramount Comms., Inc. v. Time Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,265 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989).

17. *Id.* at 93,273-74.

18. *Id.*

19. *Paramount Communications*, 571 A.2d at 1142.

20. *Id.*; see also *infra* notes 90-108 and accompanying text. Thus, the court considered whether Time's board was "in the Revlon zone." See *infra* notes 214-34 and accompanying text.

21. *Paramount Communications*, 571 A.2d at 1142.

trol of Time occurred, the court demonstrated a more extensive judicial deference to director discretion than it had in previous decisions.

The *Paramount* court relied on two earlier Delaware cases in reaching its decision. The first case, *Unocal Corp. v. Mesa Petroleum Co.*<sup>22</sup> established the duties of directors when faced with a hostile tender offer.<sup>23</sup> The second case, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,<sup>24</sup> established a new "auctioneer" fiduciary duty for directors when the "break-up" of the corporation becomes "inevitable."<sup>25</sup> Specifically, in *Revlon*, the court stated that when a board recognizes that the corporation is for sale, it must seek "the best price for the stockholders at a sale of the company."<sup>26</sup> Based on the reasoning presented in these two cases, the *Paramount* court did not hold Time's directors to the stricter *Revlon* standard.<sup>27</sup>

This Note analyzes the Delaware Supreme Court's decision in *Paramount Communications, Inc. v. Time Inc.* in light of *Unocal*, *Revlon*, and other recent corporate "control" cases. This Note begins by tracing the development in case law of the business judgment rule as applied to hostile takeovers and defensive tactics, and by examining the standards applied by courts when reviewing directors' decisions in corporate control cases. Next, the Note examines the *Revlon* standard and the courts' difficulty in defining the auctioneer duty. Then, the Note reviews the Delaware Supreme Court's decision in *Paramount Communications, Inc. v. Time Inc.*, in light of its prior *Unocal* and *Revlon* decisions. Finally, this Note analyzes the court's rationale in *Paramount* and concludes that the Delaware Supreme Court's new expansive reading of director discretion harms shareholders' interests.

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22. 493 A.2d 946 (Del. 1985).

23. See *id.* at 955; *infra* notes 65-76 and accompanying text.

A tender offer generally involves an offer by one corporation to "acquire control of another corporation by buying its securities or exchanging them for securities of the offeror." 1 Corp. Guide (P-H) ¶ 2701, at 2702 (Apr. 17, 1990). An aggressor generally uses a tender offer when target corporation management opposes the aggressor's attempt to gain control of the target. A corporation may make a self-tender offer to buy back its own shares as a defensive maneuver to prevent a raider from acquiring control. *Id.* § 2720a at 2726.

24. 506 A.2d 173 (Del. 1986).

25. *Id.* at 182; see *infra* notes 90-108 and accompanying text.

26. *Revlon*, 506 A.2d at 182.

27. See *Paramount Comms., Inc. v. Time Inc.*, 571 A.2d 1140, 1142 (1989).

## I. EVOLUTION OF THE BUSINESS JUDGMENT RULE

### A. Traditional Business Judgment Rule Analysis

Corporations, as "creatures of state law,"<sup>28</sup> derive their general powers from charters granted by the states.<sup>29</sup> Consequently, state law generally regulates the actions of corporate boards of directors, including responses to takeovers.<sup>30</sup> Delaware's laws governing corporations assume national importance because more than half of the major publicly owned corporations in the United States are chartered in Delaware.<sup>31</sup>

Under Delaware law, directors owe fiduciary duties of loyalty and care to shareholders and to the corporation.<sup>32</sup> The duty of loyalty requires directors "to protect the interests of the corporation and . . . to refrain from doing anything to injure it."<sup>33</sup> Courts interpreting this duty of loyalty require that directors possess "an undivided and unselfish loyalty to the corporation"<sup>34</sup> and forbid conflict between a director's duty and a director's own self-interest.<sup>35</sup> The existence of a fiduciary relationship prohibits self-dealing; "[t]he duty of loyalty is derive[d] from . . . [this] prohibition . . . ."<sup>36</sup> Delaware common law holds that a director's duty of care is breached when a director acts with gross negligence in making a corporate decision.<sup>37</sup> Directors must conduct reasonable investigations and make informed decisions.<sup>38</sup>

28. *Cort v. Ash*, 422 U.S. 66, 84 (1975).

29. See DEL. CODE ANN. tit. 8, §§ 101-105 (1983 & Supp. 1990).

30. State law "is the font of corporate directors' powers." *Burks v. Lasker*, 441 U.S. 471, 478 (1979). Directors' powers are statutory. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (1983) ("The business and affairs of a corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

Federal law has limited applicability to defensive tactics. See Note, *Corporate Auctions and Directors' Fiduciary Duties: A Third Generation Business Judgment Rule*, 87 MICH. L. REV. 276, 282 n.31 (1988).

31. See *Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250, 253 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987) (Indiana law "takes its cue" from Delaware); see also *Gilson & Kraakman, Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 248 (Feb. 1989) ("Delaware corporate law . . . governs the largest proportion of the largest business transactions in history.").

32. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

33. See W. KNEPPER & D. BAILEY, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* 81 (4th ed. 1988).

34. *Id.* (quoting *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (1939)).

35. W. KNEPPER & D. BAILEY, *supra* note 33, at 81; see *TW Servs., Inc. v. SWT Acquisition Corp.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,173 (Del. Ch. Mar. 2, 1989).

36. W. KNEPPER & D. BAILEY, *supra* note 33, at 82.

37. See *Aronson v. Lewis*, 473 A.2d 805, 812 & n.6 (Del. 1984).

38. See *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

When stockholders challenge an act of a corporate board of directors, the business judgment rule protects directors from liability by creating a judicial presumption that the decision was proper.<sup>39</sup> The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."<sup>40</sup> Courts will presume that a board of directors has complied with the five elements of the business judgment rule—a business decision, disinterestedness, due care, good faith, and no abuse of discretion.<sup>41</sup> The business judgment rule permits courts to review only the decisionmaking process, and not the final decision of the board,<sup>42</sup> thereby ensuring that deference to directors' decisions will control judicial review of those decisions.

Because the court recognizes a presumption in favor of directors through the business judgment rule, the challenging party must carry the burden of proving that the directors violated their duty in some way.<sup>43</sup> The burden of proof shifts, however, if a plaintiff shows that a majority of the directors have a personal interest in the transaction.<sup>44</sup> As the Delaware Supreme Court stated in an early case involving review of director discretion, "[t]he rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest."<sup>45</sup> Consequently, when the burden of proof shifts to the directors, the directors must show that the transaction was fair.<sup>46</sup> The burden does not shift to directors merely because their personal ownership interests in the corporation may benefit more from a transaction than the interests of shareholders generally.<sup>47</sup> To cause the burden of proof to shift to directors, a plaintiff

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39. See *Maldonado v. Flynn*, 413 A.2d 1251, 1256 (Del. Ch. 1980), *rev'd on other grounds*, 430 A.2d 779 (Del. 1981).

40. *Aronson*, 473 A.2d at 812; see *Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1988); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985); *Van Gorkom*, 488 A.2d at 872.

41. THE BUSINESS JUDGMENT RULE, *supra* note 3, at 12; see *Treadway Co. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980).

42. See *Johnson & Siegel*, *supra* note 3, at 323.

43. *Aronson*, 473 A.2d at 812; see Note, *supra* note 30, at 280 n.20.

44. See THE BUSINESS JUDGMENT RULE, *supra* note 3, at 14.

45. *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (1939).

46. See THE BUSINESS JUDGMENT RULE, *supra* note 3, at 14-15; see also *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986) ("[court's] unwillingness to assess the . . . [fairness] of business decisions ends when a transaction is one involving a predominantly interested board with a financial interest in the transaction adverse to the corporation").

47. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985); *Cheff v. Mathes*, 41 Del. Ch. 494, 502, 199 A.2d 548, 554 (1964).

must show that a director will "appear on both sides of a transaction [or] expect to derive . . . personal financial benefit from [the transaction] in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all shareholders generally."<sup>48</sup>

The rationale for judicial application of the business judgment rule is four-fold.<sup>49</sup> First, by acknowledging that individuals make wrong decisions, but shielding them from liability for those decisions, the rule encourages qualified persons to accept directorships.<sup>50</sup> Second, because decisions that are intended to be effective and promote corporate interests are inherently risky, the rule entitles decisionmakers to a degree of discretion.<sup>51</sup> Third, the rule reflects a policy of judicial deference to corporate directors and management, based on a belief that they are better equipped to make such decisions than are courts.<sup>52</sup> Finally, the rule ensures that corporations are centrally managed, reducing interference from stockholders.<sup>53</sup>

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48. *Aronson v. Lewis*, 473 A.2d, 805, 812 (Del. 1984) (citing *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)).

49. See THE BUSINESS JUDGMENT RULE, *supra* note 3, at 6-8.

50. See *id.* at 6. The corporate form provides limited liability for business obligations, allowing corporate owners to shield personal assets from corporate creditors. This limited liability is often a motivating factor for business persons choosing to incorporate.

51. *Id.* Directors, elected by shareholders, have discretion to make unilaterally many corporate decisions, such as whether to declare dividends. DEL. CODE ANN. tit. 8 § 170 (1983). See generally *id.* § 141 (powers of directors). Directors generally must present other decisions, such as whether to amend articles of incorporation or merge with another corporation, to shareholders for approval. See, e.g., *id.* §§ 242(b)(1), 251(c) (1983 & Supp. 1984) (requiring approval by a majority of the shareholders entitled to vote on the proposal).

52. See THE BUSINESS JUDGMENT RULE, *supra* note 3, at 6-7; see also *Johnson & Siegel*, *supra* note 3, at 323 n.27. The Delaware Chancery Court has stated:

Because businessmen and women are correctly perceived as possessing skills, information and judgment not possessed by reviewing courts and because there is great social utility in encouraging the allocation of assets and the evaluation and assumption of economic risk by those with such skill and information, courts have long been reluctant to second-guess such decisions when they appear to have been made in good faith.

*In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770, 780 (Del. Ch. 1988) (quoting *Solash v. Telex Corp.*, (1987-1988 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶ 93,608 at 97,727 (Del. Ch. Jan. 19, 1988)).

53. See THE BUSINESS JUDGMENT RULE, *supra* note 3, at 7-8. One commentator has stated: "Although it is customary to think of the business judgment rule as protecting directors from stockholders, it ultimately serves the more important function of protecting stockholders from themselves." *Id.* at 8 (quoting *Dooley & Veasey, The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 522 (Feb. 1989)).



### B. The "Enhanced" Business Judgment Rule

When the challenged action of directors involves a defensive response to a takeover attempt, the business judgment rule still applies to judicial review of that action.<sup>54</sup> Delaware courts applying the rule in this context, however, have "enhanced" directors' duties and given less deference to the decision-making process.<sup>55</sup> This enhanced duty arises out of the inherent conflict between shareholders' and directors' interests in a corporate takeover situation. Directors, confronted with a threat to their control of corporate decisionmaking, face the possibility of losing their jobs if a prospective buyer accomplishes a takeover. Any measures adopted by a board to preclude the possibility of a takeover or to thwart the takeover process once it has begun carry with them the suggestion that directors are acting to entrench their own positions.<sup>56</sup> Such actions conflict with their duty to act in the best interests of the corporation. Delaware law charges directors with running the corporation.<sup>57</sup> Consequently, directors must have discretion to make decisions. If Delaware law required directors to remain neutral, thus forcing shareholders to make corporate decisions, shareholders could face losses caused by decisions made with a paucity of information about the financial impact of the takeover. Because of the risk of a conflict of interest in the takeover context, the enhanced business judgment rule shifts the initial burden of proof to directors.<sup>58</sup>

An early Delaware case interpreting the business judgment rule, *Cheff v. Mathes*,<sup>59</sup> applied the rule to a board of directors' actions in response to a threat to its control of corporate policy. In *Cheff*, shareholders asserted that directors approved the use of corporate funds to purchase the corporation's own stock in order to prevent another shareholder from gaining control, and

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54. *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984). Prior to 1985, courts applied the traditional business judgment rule to defensive control transactions unless the plaintiffs could show that the directors' "primary purpose" was to entrench themselves in office. See Note, *supra* note 30, at 282 n.30.

55. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985). The "enhanced" duty calls for "judicial examination at the threshold before the protections of the business judgment rule may be conferred." *Id.*; see *In re Holly Farms Corp. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,181, at 91,643 (Del. Ch. Dec. 30, 1988).

56. See *Unocal*, 493 A.2d at 955 (citing *Bennett v. Propp*, 41 Del. Ch. 14, 21-22, 187 A.2d 405, 409 (1962)).

57. See *supra* note 30.

58. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985); *Unocal*, 493 A.2d at 955.

59. 41 Del. Ch. 494, 199 A.2d 548 (1964).

to perpetuate the board's control.<sup>60</sup> The board believed that the shareholder was a "raider"<sup>61</sup> who wanted to liquidate the corporation or substantially change corporate policies.<sup>62</sup>

The court upheld the actions of the directors, stating that the directors met their burden of "showing reasonable grounds to believe a danger to corporate policy and effectiveness existed" because of the shareholder raider's stock ownership and his past practices of acquiring and liquidating companies.<sup>63</sup> Thus, the directors satisfied their burden of proof "by showing good faith and reasonable investigation" of the raider's motives.<sup>64</sup>

In *Unocal Corp. v. Mesa Petroleum Co.*,<sup>65</sup> the issue before the Delaware Supreme Court was to determine whether directors enacted a selective stock exchange plan as a defense against a raider's tender offer with a good faith concern for the corporation, or whether its primary purpose was to perpetuate the directors' terms in office.<sup>66</sup> The raider, Mesa, owned 13% of Unocal's stock, and made a two-tier tender offer for Unocal's stock.<sup>67</sup> In the offer's initial stage, Mesa would acquire an additional 37% of Unocal's shares for \$54 per share cash.<sup>68</sup> In the second stage, Mesa would exchange debt securities (junk bonds) allegedly also worth \$54 per share, in exchange for all remaining shares.<sup>69</sup> Unocal's board, after investigating the offer, determined that the offer was "grossly inadequate."<sup>70</sup> In response, the Unocal board adopted a plan whereby if Mesa were successful in its first stage, then Unocal would exchange debt securities worth \$72 per share for the remaining 49% of its shares.<sup>71</sup> The Unocal board's exchange plan, however, was selective because it excluded Mesa from participation.<sup>72</sup> The Unocal board believed that excluding Mesa was necessary to further its purpose. That purpose was to defeat Mesa's offer or, if Mesa succeeded, to give the 49% shareholders a senior security interest superior to other corporate obligations.<sup>73</sup> The court upheld the directors' approval of the stock plan, holding that, in

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

61. "Raider" is the term used for an individual or corporation seeking to acquire control of a target corporation. See 1 M. LIPTON & E. STEINBERGER, *supra* note 5, § 1.01[2].

62. *Cheff*, 41 Del. Ch. at 499-500, 199 A.2d at 551-52.

63. *Id.* at 506, 199 A.2d at 555.

64. *Id.*

65. 493 A.2d 946 (Del. 1985).

66. *Id.* at 949.

67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.* at 950.

71. *Id.* at 951.

72. *Id.*

73. *Id.* at 956.

addition to the directors' initial burden of proof of showing that a threat existed from either a third party or other shareholders, the defensive tactic used "must be reasonable in relation to the threat posed."<sup>74</sup> The court found that the repurchase plan satisfied this test for two reasons: One, because the raider's two-tier tender offer was considered "inadequate and coercive"<sup>75</sup> and, two, because the raider was a well-known "greenmailer," who initiated takeovers in an attempt to coerce the target corporation to repurchase its stock at a premium price in order to defeat the takeover.<sup>76</sup>

Taken together, the Delaware Supreme Court decisions in *Cheff* and *Unocal* announce a two-part test for judicial review of directors' actions in the corporate takeover setting: Directors must show initially that they had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed";<sup>77</sup> then, the directors must show that the action taken in response to that threat was "reasonable in relation to the threat posed."<sup>78</sup> If directors comply with this two-part test, they satisfy the business judgment rule.<sup>79</sup> The burden of proof then shifts to the plaintiffs to show "by a preponderance of the evidence that the directors' decisions were primarily based on perpetuating themselves in office, or some other breach of fiduciary duty such as fraud, overreaching, lack of good faith, or being uninformed."<sup>80</sup>

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74. *Id.* at 955. The court stated that, in conducting an investigation of an offer, directors must analyze "the nature of the takeover bid and its effect on the corporate enterprise." *Id.* The court provided examples of legitimate threats: "[T]he inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of the securities being offered in the exchange." *Id.* (citing Lipton & Brownstein, *Takeover Responses and Directors' Responsibilities: An Update*, ABA NAT'L INST. ON THE DYNAMICS OF CORP. CONTROL 7 (Dec. 8, 1983)).

75. *Id.* at 958. *Unocal's* board determined that the debt-financed second stage of Mesa's offer was actually worth far less than \$54. The court noted that "[i]t is now well recognized that such offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction." *Id.* at 956.

76. *Id.* at 956 & n.13.

77. *Id.* at 955.

78. *Id.*

79. *Id.* at 958.

80. *Id.* Some commentators have labeled the *Unocal* standard of review the "proportionality test." See Gilson & Kraakman, *supra* note 31, at 248; see also *City Capital Assocs. v. Intero Inc.*, 551 A.2d 787, 796 (Del. Ch.), ("*Unocal* . . . created a new intermediate form of judicial review to be employed when a transaction is neither self-dealing nor wholly disinterested. That test has been helpfully referred to as the 'proportionality test.'"), *appeal dismissed without opinion*, 556 A.2d 1070 (Del. 1988).

Despite applying the enhanced business judgment rule, courts have upheld a wide variety of takeover defense tactics.<sup>81</sup> Generally, such tactics take one of two forms, financial or structural.<sup>82</sup> Structural defenses, also known as "shark repellents," are designed to discourage takeovers. For example, a "poison pill" provision may give shareholders the right to receive a substantial premium price for stock from a raider when a stated triggering event occurs.<sup>83</sup> The high premium thus makes the "pill" hard to swallow.<sup>84</sup> Structural defenses are included in the articles of incorporation or in amendments to the corporate charter by vote of the shareholders. Consequently, a shareholder derivative suit challenging a structural provision is unlikely to succeed.<sup>85</sup> In a derivative suit, one or more shareholders sues on behalf of the corporation to prevent harm to the corporation and subsequently to himself as a shareholder of the corporation. A shareholder's right to bring the action derives from the shareholder's status as an owner of the corporation.<sup>86</sup> Therefore, where a majority of shareholders vote to approve a structural defense, shareholders limit their right to challenge implementation of that action.

Financial defenses, such as the so-called "pac man" defense, in which the target corporation attempts to take over the raider, are initiated by direc-

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81. See, e.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271, 297 (7th Cir.) (corporation made acquisition in order to create antitrust problems for potential raider), *cert. denied*, 454 U.S. 1092 (1981); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1353 (Del. 1985) (preferred purchase rights plan whereby raider's holdings would become diluted).

82. See Green & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PA. L. REV. 647, 701-06 (1984).

83. A *poison pill* is a defensive measure usually involving the issuance of "rights" as dividends on preferred stock that are "triggered" when any one person or group acquires a certain percentage . . . of the target corporation's voting stock; the triggering of the rights allows the holders to buy stock at bargain prices, thus making a takeover by an outsider "poisonously" expensive.

1 Corp. Guide (P-H), *supra* note 23, ¶ 2720a, at 2727 (emphasis in original).

84. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986); see also R. WINTER, M. STUMPF & G. HAWKINS, *supra* note 5, at 505.

Other examples of "shark repellents" include supermajority provisions and fair price provisions. A supermajority provision requires more than a statutory minimum number of shareholders to approve a merger or sale of assets. See Note, *The Reasonableness of Defensive Takeover Maneuvers When the Corporate Raider is Mr. T. Boone Pickens: Ivanhoe Partners v. Newmont Mining Corp.*, 57 U. CIN. L. REV. 739, 752 n.100 (1988). A fair price provision requires a supermajority vote (for example, 95%) of outstanding shares to approve a merger, unless shareholders receive the highest price possible when an acquirer is buying shares of the target. See R. WINTER, M. STUMPF & G. HAWKINS, *supra* note 5, at 46.

85. See Note, *supra* note 84, at 751-52.

86. 1 Corp. Guide (P-H), *supra* note 23, ¶ 1551. A shareholder derivative action "is a suit brought by one or more shareholders to enforce a cause of action belonging to the corporation." W. KNEPPER & D. BAILEY, *supra* note 33, at 570 (citing *Ross v. Bernhard*, 396 U.S. 531, 534 (1970)).

tors.<sup>87</sup> Generally, financial defenses increase the likelihood of shareholder derivative suits.<sup>88</sup> Financial defensive tactics are therefore subject to the enhanced business judgment rule.

Although a few court decisions outside of Delaware express a minority view that courts should not apply the business judgment rule when reviewing defensive tactics used to thwart hostile takeovers, Delaware courts continue to apply the rule.<sup>89</sup> The difficulty with the rule in the takeover context

87. See Green & Junewicz, *supra* note 82, at 701-02.

88. The Sixth Circuit upheld a "pac man" defense in *Martin-Marietta Corp. v. Bendix Corp.*, 690 F.2d 558 (6th Cir. 1982).

Other examples of financial defenses include "white knight" and "scorched earth" defenses. A "white knight" is an acquirer either sought out or preferred by management of the target corporation. See Note, *Corporate Takeovers and the Business Judgment Rule: The Second Circuit Puts Target Corporations on the Auction Block*, 53 BROOKLYN L. REV. 409, 414 n.23 (1987). If the target finds the "raider" unacceptable, it may offer inducements to a white knight to enter the bidding. *Id.* A "scorched earth" defense involves the target selling off valuable assets (crown jewels) that may attract a potential or actual raider in order to reduce interest in a takeover. *Id.* at 419 n.48.

89. See THE BUSINESS JUDGMENT RULE, *supra* note 3, at 118-20. The authors cite two United States Circuit Court of Appeals decisions, *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981), and *Johnson v. Trueblood*, 629 F.2d 287 (3d Cir. 1980) (applying Delaware law), *cert. denied*, 450 U.S. 999 (1981), in which dissenting judges concluded that the business judgment rule should not apply in such a context. In *Johnson*, the dissenting judge thought that the burden of proof should shift to the directors upon a showing by the plaintiff that the directors' desire to retain control was merely one motive (but not the controlling one) in the transaction. *Johnson*, 629 F.2d at 301 (Rosenn, J., concurring and dissenting) (cited in THE BUSINESS JUDGMENT RULE, *supra* note 3, at 109).

In another case that applied the business judgment rule in finding that the burden shifted to the directors, one court questioned use of the rule:

The rule was developed to protect directors' judgments on questions of corporate governance. . . . Courts have no place substituting their judgments for that of the directors.

Defensive tactics, however, raise a wholly different set of considerations. The problem is that defensive tactics often, by their very nature, act as a restraint on business purposes. Therefore, the application of the business judgment rule in this context seems, to us, questionable, however, the weight of authority dictates that the rule be applied. . . .

. . . . The right of a shareholder to sell his stock is a private transaction between a willing seller and a willing purchaser and in no way implicates the business judgment rule. Therefore, a board of director's assertion of a unilateral right, under the business judgment rule, to act as a surrogate for the shareholder's independent right of alienation of his stock is troublesome.

*Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252, 1259-60 & n.6 (S.D.N.Y. 1985) (applying New Jersey law) (quoted in THE BUSINESS JUDGMENT RULE, *supra* note 3, at 119-20); see also *Johnson & Siegel*, *supra* note 3, at 325 (criticizing use of the business judgment rule in takeover situations because "inside" directors (those who both occupy management positions and sit on the board) may reject a bid for reasons of personal financial concerns, job security, or simple desire to retain control).

thus remains the struggle to apply it consistently to the issue of whether directors or shareholders should decide ultimate questions concerning control of the corporation.

### C. Changes in Control and the "Auctioneer" Duty

Since *Unocal*, Delaware courts have found few defensive tactics unreasonable, giving rise to concerns that the "enhanced" test is no more protective of shareholders' interests—in particular, their interest in preventing entrenchment of management—than is the traditional business judgment rule.<sup>90</sup> In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,<sup>91</sup> however, the Delaware Supreme Court recognized that, in hostile takeover contests, there can be a point where directors no longer have a legitimate interest in taking action to preserve the corporate entity. At that point, directors have a duty to "maximiz[e] . . . the company's value at a sale for the stockholders' benefit."<sup>92</sup> The issue Delaware courts have struggled with in takeover cases since *Revlon* is determining when a board has reached that crucial point.

In *Revlon*, the board of Revlon, Inc., instituted a series of defensive measures aimed at thwarting an imminent hostile tender offer for Revlon shares by Pantry Pride, Inc.<sup>93</sup> The Revlon directors believed that the Pantry Pride offer would be inadequate, and that Pantry Pride's directors intended to acquire Revlon and break up the corporation by selling off its assets.<sup>94</sup> After Pantry Pride made a tender offer, Revlon's board rejected the offer and implemented additional defensive measures.<sup>95</sup> Subsequent escalating offers

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90. Only three cases have found defensive measures unreasonable in relation to the threat posed. In *City Capital Associates v. Interco Inc.*, 551 A.2d 787, 790-91, 802 (Del. Ch.), *appeal dismissed*, 556 A.2d 1070 (Del. 1988), the Delaware Court of Chancery held that the defensive measures enacted by Interco's board of directors were not reasonable in relation to the threat posed by a tender offer, but that the defensive measures did not contemplate a sale and thus did not invoke *Revlon* duties. The court noted, however, that even though a "merger may be regarded as a sale," *Revlon* does not require that an auction occur before there can be a merger. *Id.* at 802; see *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227 (Del. Ch. 1988); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986); see also *Johnson & Siegel*, *supra* note 3, at 229-38 (arguing that, although courts acknowledge that target directors have a conflict of interest when defending against a hostile takeover, directors can overcome their burden merely by "devoting time and attention to making the decision" to reject the offer; thus, "[t]he *Unocal* test is . . . unresponsive to target shareholders' concerns because it is the directors' loyalty to the corporation, not their care, that is at issue"). *But cf.* *Gilson & Kraakman*, *supra* note 31, at 256 (arguing that the "proportionality" test of *Unocal* is "not an empty threshold test," unlike the "policy conflict/primary purpose" test of the traditional business judgment rule).

91. 506 A.2d 173 (Del. 1986).

92. *Id.* at 182.

93. *Id.* at 177.

94. *Id.*

95. *Id.*

from Pantry Pride ensued.<sup>96</sup> Following Pantry Pride's second offer, which the Revlon board also rejected, the board authorized negotiations with other companies interested in taking over Revlon.<sup>97</sup> Revlon's board eventually approved a sale to Forstmann Little & Co. on terms that included liquidating some of Revlon's assets to finance the sale.<sup>98</sup> The agreement also included a "lock-up option" which gave Forstmann an option to buy two divisions of Revlon for a price substantially below their actual value.<sup>99</sup>

The Delaware Supreme Court stated that in certain instances involving takeover negotiations, "the directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price."<sup>100</sup> The court determined that under the facts of *Revlon*, the Revlon board's duty as defender of the corporation changed when it rejected Pantry Pride's tender offer as inadequate, but then authorized negotiations with other parties.<sup>101</sup> At the point when the Revlon board "recogni[z]ed that the company was for sale" it had a duty to get the best price possible for the company.<sup>102</sup> When the Revlon board granted Forstmann a lock-up option, it violated its duty to maximize share value because the lock-up ended the auction.<sup>103</sup> The court stated that the Revlon board's initial defensive measures had the effect of benefiting Revlon's noteholders at the expense of the shareholders, and that its later measures, including the lock-up option, primarily served to shield the directors from liability to the shareholders.<sup>104</sup> The court therefore asserted that the Revlon board could not overcome its burden under *Unocal*'s "enhanced scrutiny" by proving that the defensive actions were reasonable in relation to the threat posed to the corporation by Pantry Pride's offer.<sup>105</sup>

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96. *Id.* at 177-78.

97. *Id.* at 177.

98. *Id.* at 178.

99. *Id.* "Lock-up options" are structural defenses designed to deter hostile acquirors. See Nachbar, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.—The Requirement of a Level Playing Field in Contested Mergers, and its Effect on Lock-ups and Other Bidding Deterrents*, 12 DEL. J. CORP. L. 473, 473 n.2 (1987).

100. *Revlon*, 506 A.2d at 178.

101. *Id.* at 177, 182.

102. *Id.* at 182.

103. *Id.* at 183-84. Lock-ups are not per se illegal. Some options may induce bidders to seek control, creating an auction in which shareholders will realize maximum value for their shares. Lock-ups that serve to end the auction, however, hurt the shareholder. See *id.* at 183; see also *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 274 (2d Cir. 1986) (court acknowledged that "lock up options" that prevent bidders from competing with the optionee bidder are harmful to shareholders).

104. *Revlon*, 506 A.2d at 184.

105. *Id.* at 183-84.

Following *Revlon*, the business judgment rule appeared to protect directors' actions that prevented the breakup of the corporation, as long as those actions complied with the standards of *Unocal*. In the event of an "inevitable" breakup,<sup>106</sup> however, *Revlon* required that a board become auctioneers and remain neutral between competing bidders.<sup>107</sup> Courts have experienced difficulty applying this test, however, and the extent of directors' liability under *Revlon* remains unclear.<sup>108</sup>

## II. THE *REVLON* STANDARD EXAMINED: WHEN IS A BOARD OF DIRECTORS IN "THE *REVLON* ZONE"?

No court has defined explicitly when a corporation is "in the *Revlon* zone," "for sale," or "contemplating a change in control," phrases employed in various decisions to indicate the triggering of the directors' auctioneer duty under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*<sup>109</sup> In *Revlon*, the court stated that recognition by a board of directors that the company is for sale triggers a duty to maximize current share value.<sup>110</sup> After *Revlon*, decisions addressing change in control issues have determined that the crucial question is deciding when, during complex corporate transactions, directors reach the point where *Revlon* duties arise.<sup>111</sup> These decisions, however, offer no clear guidance to directors as to what events trigger their auctioneer duties. While some cases indicate some expansion of "the *Revlon* zone,"<sup>112</sup> more recent decisions by the Delaware courts indicate an unwillingness to apply a more stringent standard than the *Unocal* enhanced

106. *Id.* at 182.

107. *See* Nachbar, *supra* note 99, at 476-80, 494.

108. Some commentators have urged that management remain completely passive following a takeover. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981). No court, however, has accepted this approach. *See* Edelman v. Fruehauf Corp., 798 F.2d 882, 888 (6th Cir. 1986) (Guy, J., dissenting).

109. *Revlon*, 506 A.2d at 182.

110. *Id.*

111. *See, e.g.*, Black & Decker Corp. v. American Standard, Inc., 682 F. Supp. 772 (D. Del. 1988); Kleinhandler v. Borgia, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,525, at 93,324 (Del. Ch. July 7, 1989); TW Servs., Inc. v. SWT Acquisition Corp., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,173 (Del. Ch. Mar. 2, 1989); *In re Holly Farms Corp. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,181, at 91,641 (Del. Ch. Dec. 30, 1988).

The decisions are clear that *after* a sale or auction has started, a director's foremost duty is one of fairness. *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1285 (Del. 1988); *In re Holly Farms Corp.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,181, at 91,643 (Del. Ch. Dec. 30, 1988).

112. *See, e.g.*, Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986), *aff'd sub nom.* Priddy v. Edelman, 883 F.2d 438 (6th Cir. 1989); Black & Decker Corp., 682 F. Supp. 772; Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1988); *In re Holly Farms Corp.*,



business judgment rule in situations where directors' and shareholders' interests conflict.<sup>113</sup>

### A. Interpretations of Revlon Favoring Directors

Some recent Delaware decisions upholding directors' actions provide well-defined examples of when *Revlon* will not apply. In *Ivanhoe Partners v. Newmont Mining Corp.*,<sup>114</sup> the Delaware Supreme Court interpreted strictly the *Revlon* holding. In *Ivanhoe*, Ivanhoe Partners and Ivanhoe Acquisition Corporation (collectively, Ivanhoe), increased its stock holdings in Newmont Mining Corporation (Newmont) in preparation for a hostile tender offer.<sup>115</sup> At the time, Newmont was operating under an agreement with Consolidated Gold Fields PLC (Gold Fields) that required, among other conditions, that Gold Fields limit its ownership of Newmont to 33.33%, but provided that Gold Fields could terminate the agreement should a third party acquire at least 9.9% of Newmont's shares.<sup>116</sup>

When Ivanhoe increased its ownership to 9.95% in an attempt to compel Gold Fields to terminate the agreement and negotiate with Ivanhoe in a takeover of Newmont, Newmont's board enacted defensive measures.<sup>117</sup> The Newmont directors exempted Gold Fields from these measures because they were uncertain whether Gold Fields intended to remain an ally of Newmont or intended to attempt a takeover.<sup>118</sup> Gold Fields thus constituted a reasonable threat to Newmont.<sup>119</sup> When Newmont's board refused to meet with representatives of Ivanhoe to negotiate a private sale of Newmont to Ivanhoe, Ivanhoe made a hostile tender offer for 42% of

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[1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,181, at 91,641 (Del. Ch. Dec. 30, 1988); see *infra* notes 140-65 and accompanying text.

113. See, e.g., *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840 (Del. 1987); *Kleinhandler v. Borgia*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,525, at 93,324; see also *Mills*, 559 A.2d at 1285 n.35:

Clearly not every offer or transaction affecting the corporate structure invokes the *Revlon* duties . . . . Circumstances may dictate that an offer be rebuffed, given the nature and timing of the offer; its legality, feasibility, and effect on the corporation and the stockholders; the alternatives available and their effect on the various constituencies, particularly the stockholders; the company's long term strategic plans; and any special factors bearing on stockholder and public interests.

114. 535 A.2d 1334 (Del. 1987).

115. *Id.* at 1338.

116. *Id.*

117. *Id.*

118. *Id.* at 1339.

119. *Id.*

Newmont's shares.<sup>120</sup> Newmont's board rejected that offer and a subsequent offer as inadequate.<sup>121</sup>

Faced with threats from both Ivanhoe and Gold Fields, Newmont's board developed a plan to thwart Ivanhoe and maintain Newmont's independence. The plan called for Newmont to sell certain assets, then use the proceeds to pay a dividend to all shareholders.<sup>122</sup> The dividend would allow Gold Fields to purchase additional shares of Newmont in a "street sweep."<sup>123</sup> At the same time, Newmont and Gold Fields would enter into a new agreement that would allow Gold Fields to own up to 49.9% of Newmont's stock, but limit Gold Fields' representation to 40% of the board of directors and also require the board members from Gold Fields to support Newmont's board nominees.<sup>124</sup> The defensive measures enacted by Newmont's board would allow it to retain control of the corporation.

The Delaware Supreme Court held that Newmont's board was not subject to the auctioneer duty imposed by *Revlon*.<sup>125</sup> The court stated that "*Revlon* applies . . . only if it was apparent that the sale of Newmont was 'inevitable.'"<sup>126</sup> While the court's phraseology takes some liberty with *Revlon*'s wording,<sup>127</sup> the court's reasoning for why it could not find a sale illuminates the decision. Specifically, the court found that a sale was not inevitable for two reasons: First, "Newmont was never for sale,"<sup>128</sup> and second, "there was neither a bidding contest, nor a sale."<sup>129</sup> The court held that the dividend, which allowed Gold Fields to "sweep the street" and increase its ownership to 49.7%, did not constitute a sale by Newmont to Gold Fields.<sup>130</sup> Gold Fields was not a bidder, and increased its shareholdings by buying shares through private sellers rather than directly from Newmont.<sup>131</sup> The court further held that the Newmont board's actions were reasonable in response to the threat posed by Ivanhoe's inadequate and coercive tender offer

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120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.* at 1337, 1339-40. A "street sweep" occurs when a buyer purchases shares of target stock on the open market, normally at a premium, during and immediately after the tender offer period. *Id.* at 1337 n.3.

124. *Id.* at 1340.

125. *Id.* at 1345.

126. *Id.* (emphasis added).

127. In *Revlon*, the Court held that at the point of "inevitable" breakup, auctioneer duties take effect. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

128. *Ivanhoe*, 535 A.2d at 1345.

129. *Id.*

130. *Id.*

131. *Id.*

and were not intended to entrench Newmont's management.<sup>132</sup> Therefore, the Delaware Supreme Court was willing to end its analysis of the *Revlon* issue based on a finding that no "sale" occurred.

In *Bershad v. Curtiss-Wright Corp.*,<sup>133</sup> the plaintiff, an individual shareholder, asserted that the Curtiss-Wright Corporation's board of directors had a duty to conduct an auction of a subsidiary corporation, rather than arrange a merger with the subsidiary by buying all of its stock. The Delaware Supreme Court held that a majority stockholder has no duty to sell its stock to the highest bidder simply to benefit a minority stockholder.<sup>134</sup> In its opinion, the court made clear that the subsidiary was not for sale, and thus *Revlon* did not apply.<sup>135</sup> Accordingly, the court reasoned that there is no principle of law that requires a majority shareholder to conduct an auction when it decides to merge by cashing out the minority.<sup>136</sup>

Similarly, in *Kleinhandler v. Borgia*,<sup>137</sup> the plaintiff charged that the board of directors at Columbia Pictures Industries (Columbia), owner of 42% of the stock of Walter Reade Organization, Inc. (WRO), had a duty to put WRO up for auction when the Columbia board decided to acquire all of WRO's stock in a merger. Following *Bershad*, the Delaware Court of Chancery rejected the plaintiff's claim as "'unsupported by any accepted principle of law.'"<sup>138</sup> The court stated that *Revlon* duties arise only when the board decides to sell the corporation to a third party rather than to a majority stockholder.<sup>139</sup>

### B. Interpretations of *Revlon* Applying the Auctioneer Duty

The Delaware Court of Chancery interpreted *Revlon* more expansively in *Freedman v. Restaurant Associates Industries, Inc.*<sup>140</sup> In *Freedman*, the plaintiffs, shareholders of Restaurant Associates Industries, Inc., sought an injunction against a leveraged buyout of the company by the management.<sup>141</sup> Although the court denied the injunction, it stated that when a

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132. *Id.*

133. 535 A.2d 840 (Del. 1987).

134. *Id.* at 844-45.

135. *Id.* at 842 (citing *Ivanhoe*, 535 A.2d at 1334).

136. *Id.* at 845.

137. *Kleinhandler v. Borgia*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,525, at 93,324 (Del. Ch. July 7, 1989).

138. *Id.* at 93,326 (quoting *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 845 (Del. 1987)).

139. *Id.*

140. [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,502, at 97,214 (Del. Ch. Oct. 16, 1987).

141. *Id.* at 97,215.

corporation "is to be subject to a change in control," current share maximization under *Revlon* is required.<sup>142</sup>

The United States District Court for the District of Delaware followed the *Freedman* reading of *Revlon* in *Black & Decker Corp. v. American Standard, Inc.*<sup>143</sup> There, the court, interpreting Delaware law, stated that "[i]t seems unreasonable to conclude that the Delaware Supreme Court would limit the applicability of the duties under *Revlon*, to only those situations involving the complete sale of all shares of the company."<sup>144</sup>

In *Black & Decker*, the board of American Standard, Inc., instituted a management recapitalization plan that would result in management controlling 55% of American Standard's common stock.<sup>145</sup>

The American Standard directors conceived and implemented the plan following a hostile tender offer by Black & Decker Corporation. The court held that the plan was an "offer to gain control" of the corporation by the board,<sup>146</sup> triggering *Revlon* duties. Thus, the court concluded, a "transaction which results in a change of control of a corporation amounts to a 'sale' under *Revlon*."<sup>147</sup>

In *Mills Acquisition Co. v. Macmillan, Inc.*,<sup>148</sup> the Delaware Supreme Court also expanded the class of situations to which *Revlon* duties may apply. Specifically, the court stated that the sale, whether transacted as "an active auction, a management buyout, or a 'restructuring,'" triggers *Revlon* duties.<sup>149</sup> In an earlier decision,<sup>150</sup> the court of chancery enjoined a restructuring plan, holding that "although not a sale of an absolute majority inter-

142. *Id.* at 97,218.

143. 682 F. Supp. 772, 779 (D. Del. 1988). The defendant board argued that *Revlon* did not apply because, under the management recapitalization plan at issue, management would not gain control. Instead, the public would own 46% of the corporation, management would own 24%, and an Employee Stock Option Plan would control 30%. In addition, *Black & Decker* involved no lock-up, as did *Revlon*, and the board claimed to have acted to preserve its independence and to have no intention of selling. *Id.*

144. *Id.* at 781. The District Court gave the following rationale for expanding *Revlon*:

To require that the *Revlon* principle apply only to an offer to purchase 100% of a company's stock would ignore the inevitability of a break-up which could follow a partial tender offer. The effect of a partial tender offer is that "it allows a raider to gain control of a target and hold a minority interest captive, with little protection for the stockholder against self-dealing or a squeeze-out merger."

*Id.* n.4 (quoting Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 17-18 (1986)).

145. *Id.* at 782.

146. *Id.*

147. *Id.* at 781.

148. 559 A.2d 1261 (Del. 1988).

149. *Id.* at 1285. The court noted that the case did not require the court to determine precisely when Macmillan was for sale.

150. *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227 (Del. Ch. 1988).

est, [the plan] does constitute a sale of effective control."<sup>151</sup> Early drafts of the restructuring plan called for more than 50% management ownership. The board, advised that such a plan could be considered a sale, revised it to give management less than 50% ownership. This reduction, the court noted, meant that "the risk of triggering *Revlon* duties would be reduced if not eliminated, yet the objective of giving effective control would still be accomplished. The change, then, was one of form, not substance. . . ."<sup>152</sup>

In *In re Holly Farms Corp. Shareholders Litigation*,<sup>153</sup> the Delaware Court of Chancery found that a stock swap transaction in response to a hostile tender offer constituted a sale that triggered *Revlon* duties.<sup>154</sup> The court's decision rejected any suggestion that some members of the target board did not believe that their actions put the corporation up for sale, or "in play."<sup>155</sup> Further, even though the board chose the most attractive option available at the time, the court found a violation of *Revlon* duties because the board ended the opportunity for an auction by implementing a defensive "lock-up option."<sup>156</sup>

The United States Courts of Appeals for the Second and Sixth Circuits also have read broadly *Revlon's* holding.<sup>157</sup> In *Edelman v. Fruehauf Corp.*,<sup>158</sup> the Sixth Circuit held that *Revlon's* holding included mergers.<sup>159</sup>

151. *Id.* at 1242. The restructuring allowed the board to gain control of one of two newly created divisions. *Id.* The court of chancery found the plan inferior to the hostile tender offers and enjoined the plan because the only threat to the target board was its "incumbency" and loss of its expectation of a controlling interest under the new plan. *Id.* at 1246-47.

152. *Id.* at 1243. The court found that "the restructuring involves a transfer of effective control that under normal market conditions would command a control premium." *Id.*

153. [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,181, at 91,641 (Del. Ch. Dec. 30, 1988).

154. *Id.* at 91,643.

155. *Id.* at 91,644. *Cf. Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334 (Del. 1987) (the court appeared to defer to the Newmont board's assertions that no sale of the company was intended); *supra* notes 114-32 and accompanying text (discussing the *Ivanhoe* decision).

156. *In re Holly Farms*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,644-45. "[L]ock-ups 'which end an active auction and foreclose further bidding operate to the shareholders' detriment'" and are presumed to violate *Revlon*. *Id.* at 91,644 (quoting *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 183 (Del. 1986)).

157. *See generally Edelman v. Fruehauf Corp.*, 798 F.2d 882, 886 (6th Cir. 1986) (leveraged buyout by management enjoined where "it appear[ed] that the Board simply decided to make a deal with management no matter what other bidders might offer"); *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 281 (2d Cir. 1986) (lock-up option enjoined where board "'knew or should have known'" that it would end bidding (quoting *Hanson Trust PLC v. SCM Corp.*, 623 F. Supp. 848, 855 (S.D.N.Y. 1985)).

158. 798 F.2d 882 (6th Cir. 1986).

159. *Id.* at 884, 887; *see also Johnson & Siegel, supra* note 3, at 372 ("all merger[s] . . . inherently involve the sale of the target"). The Ninth Circuit has disagreed with the auction requirement in a merger context, however. In *Jewel Cos. v. Pay Less Drug Stores Northwest*,

In *Edelman*, Fruehauf Corporation's board, following a tender offer, agreed to form a new company comprised of Fruehauf management and a "white knight," an acquiror sought out by the board whom the board preferred to the raider.<sup>160</sup> After the new company formed, it completed a merger agreement with Fruehauf's board.<sup>161</sup> Finding that Fruehauf had in fact been for sale, the court extended the proscription against favoring a particular bidder once the target corporation is for sale to include the management bidding group.<sup>162</sup> The court held that the directors violated their duty to shareholders by approving the merger "without fostering a real bidding process."<sup>163</sup>

The "auctioneer duty" decisions reveal that directors' duties to shareholders in a takeover context vary with the facts and circumstances involved in each case. A defensive tactic that may be reasonable at an early stage of hostile takeover proceedings may, at a later point, be unreasonable in relation to the threat and thus violate directors duties under both *Unocal* and *Revlon*.<sup>164</sup> As one court stated, as a "bidding war" escalates, "the transition from corporate defender to auctioneer becomes inevitable."<sup>165</sup>

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741 F.2d 1555 (9th Cir. 1984), Jewel entered into a merger agreement with Pay Less Drug Stores (Pay Less), which prohibited Pay Less from entering into other transactions; subsequently, Pay Less Drug Stores Northwest made a tender offer for Pay Less, which the Pay Less board accepted, and terminated the merger agreement with Jewel. The court found for Jewel on breach of contract grounds, but stated that California law does not support the auction theory. *Id.* at 1557-58, 1560-62.

160. *Edelman*, 798 F.2d at 884-85.

161. *Id.* Fruehauf agreed to pay its "white knight," Merrill Lynch, "break-up" and other fees, and also agreed to a "no-shop" provision.

A break-up fee is paid by a target corporation to a bidder if a proposed transaction or merger between bidder and target does not take place. *See Nachbar, supra* note 99, at 485.

A no-shop clause is an agreement by a corporation not to solicit or accept better subsequent offers, but to deal exclusively with its white knight. *See THE BUSINESS JUDGMENT RULE, supra* note 3, at 226.

The Delaware Supreme Court struck down a no-shop provision in *Revlon*:

Favoritism for a white knight to the total exclusion of a hostile bidder might be justifiable when the latter's offer adversely affects shareholder interests, but when bidders made relatively similar offers, or dissolution of the company becomes inevitable, the directors cannot fulfil their enhanced *Unocal* duties by playing favorites with the contending factions. Market forces must be allowed to operate freely to bring the target's shareholders the best price available for their equity.

*Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 (Del. 1986).

162. *Edelman*, 798 F.2d at 886. The court indicated that a target's board could use corporate assets for management buyouts or to encourage bidders only if the board was neutral and objective in its actions. *Id.* at 887.

163. *Id.* at 885. Although the court applied Michigan law, it followed the Michigan courts in looking to Delaware case law on this issue. *See Priddy v. Edelman*, 883 F.2d 438, 444 (6th Cir. 1989).

164. *See W. KNEPPER & D. BAILEY, supra* note 33, at 488-92.

165. *Gelco Corp. v. Coniston Partners*, 652 F. Supp. 829, 847 (D. Minn. 1986) (citing *Revlon*, 506 A.2d at 181-82), *aff'd in part and vacated in part*, 811 F.2d 414 (8th Cir. 1987).

### III. PARAMOUNT COMMUNICATIONS, INC. V. TIME INC.

#### A. Negotiations Between Time Inc. and Warner Communications

*Paramount Communications, Inc. v. Time Inc.*,<sup>166</sup> is among the most recent Delaware decisions that address the issue of when directors are in "the Revlon zone." In *Paramount*, the Time board's long-range corporate planning led the company to conclude that, due to Time's evolution from a focus on print-oriented communications products to an emphasis on video and entertainment-oriented products, it should become more vertically integrated.<sup>167</sup> To further this goal and to become more competitive in international markets, Time sought ownership opportunities for the production of the video products it distributed through cable subsidiaries.<sup>168</sup> Time's original talks with Warner Communications, after being approached by Warner in the spring of 1987, centered on possible joint ventures between Time and Warner.<sup>169</sup> Between the time of the original Time-Warner talks and July 1988, Time's board of directors determined that a complete merger with Warner could meet Time's long-term planning goals.<sup>170</sup> Consequently, at a board meeting on July 21, 1988, Time's board approved, subject to conditions, merger agreement negotiations.<sup>171</sup>

The chief condition relating to the merger stated that any agreement must ensure that Time's senior management would ultimately control the resulting company.<sup>172</sup> Time's board wanted to preserve the editorial independence of the company's magazines.<sup>173</sup> Specifically, the directors believed that keeping the editorial review structure in place was crucial to ensuring the journalistic integrity of Time's writers and editors.<sup>174</sup> The board considered this integrity an asset to the company and its shareholders.<sup>175</sup> Thus,

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166. 571 A.2d 1140 (Del. 1989).

167. See *id.* at 1143-44. Vertical integration may be defined narrowly as "the union within one firm of conventionally distinct states of production and distribution." R. POSNER & F. EASTERBROOK, *ANTITRUST* 869 (2d ed. 1981). Prior to merging with Warner, Time owned the Home Box Office (HBO) and Cinemax cable networks and several cable television franchises, in addition to magazine and book publishing operations.

168. *Paramount Communications*, 571 A.2d at 1143.

169. See *Paramount Comms., Inc. v. Time Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,267-3 (Del. Ch. July 17, 1989) *aff'd*, 571 A.2d 1140 (Del. 1989).

170. *Paramount Communications*, 571 A.2d at 1144.

171. *Id.*

172. *Id.* Some board members, however, believed that the proposed merger could put Time "in play." *Id.*

173. *Paramount Communications*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,268.

174. *Id.*

175. *Id.* at 93,268-69.

the directors asserted that preserving editorial independence would help keep Time financially viable.<sup>176</sup>

Merger negotiations lasted until March 3, 1989, when the boards of both companies approved the merger agreement.<sup>177</sup> The agreement called for a twenty-four-member board comprised of twelve incumbent directors from both Time and Warner.<sup>178</sup> At Warner's insistence, Time agreed that the merger would take the form of a stock for stock swap.<sup>179</sup> The ratio ultimately agreed upon was that one share of Warner common stock would trade for .465 of one share of Time common stock.<sup>180</sup> Because the market value ratio of Warner stock to Time stock at that time was roughly .38, the agreement represented an approximate 12% premium for Warner shareholders.<sup>181</sup> Under this agreement, "Warner stockholders would have held approximately 62% of the common stock [and voting power] of Time-Warner."<sup>182</sup>

The boards of both companies took several steps to protect the merger agreement. First, the boards signed a Share Exchange Agreement giving both parties the option to trigger an exchange of shares that would result in Warner owning 11.1% of Time stock and Time owning 9.4% of Warner stock.<sup>183</sup> In doing so, the boards intended the Share Exchange Agreement to discourage outside actions that might disrupt the merger.<sup>184</sup> Second, Time paid several banks "dry up" fees in exchange for promises by the banks not to lend money to any third party interested in acquiring Time.<sup>185</sup> The Time board also agreed not to consider any other merger or acquisition pro-

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176. *Id.* at 93,268.

177. *Id.* at 93,269-70. Outside directors comprised a majority of both boards. *Id.* at 93,270. The court found that the agreement was "an arms-length negotiated agreement between two parties seeking individual advantage through mutual action." *Id.* Courts generally look more favorably upon decisions approved by a board with a majority of outside independent directors. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

178. *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1146 (Del. 1989). J. Richard Munro, chairman and chief executive officer (CEO) of Time, and Steven Ross, CEO of Warner, were to serve as co-CEOs of the merged company until Munro retired in 1990. *Id.* Ross agreed to retire five years after the merger, at which point N.J. Nicholas, Time's president and chief operating officer, who would succeed Munro at Time, would become the sole CEO of Time-Warner. *Id.* at 1145.

179. *Id.* at 1145.

180. *Id.* at 1146.

181. *Id.*

182. *Id.* (footnote omitted). The court pointed out that this percentage does not take into account the shareholders who owned stock in both Time and Warner. *Id.* n.7

183. *Id.* at 1146.

184. *Paramount Communications*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,270 (Del. Ch. July 17, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989).

185. *Id.* at 93,270-71.



posals.<sup>186</sup> Finally, the board included a provision in the merger agreement that gave Warner the option of getting out of the agreement if the Time board entered negotiations with a takeover bidder.<sup>187</sup>

The formal structure of the agreement called for the merger of Warner into a wholly-owned subsidiary of Time, TW Sub. Inc. Warner would be the subsidiary's sole holding.<sup>188</sup> Warner common stock then would be converted into Time common stock as agreed, and the name of Time would be changed to Time-Warner.<sup>189</sup> This structure required a vote of approval by a majority of the shareholders of both companies.<sup>190</sup> Time's shareholders were to vote at the company's annual shareholder meeting on June 23, 1989.<sup>191</sup>

#### B. Paramount's Tender Offer and Subsequent Negotiations

On June 7, 1989, Paramount Communications, Inc., made a cash tender offer for Time's stock at \$175 per share, a considerable increase over its then-current trading price of \$126 per share.<sup>192</sup> The offer was subject to numerous conditions, including the termination of the Time-Warner merger and the Share Exchange Agreements.<sup>193</sup> Time's board rejected the offer on June 16, 1989, stressing its commitment to a merger with Warner.<sup>194</sup> The board stated that Time was not for sale, and that even if it were for sale the offer would be inadequate.<sup>195</sup> In addition, Time's board believed the conditions

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186. *Id.* at 93,271.

187. *Id.*

188. *Id.* at 93,270.

189. *Id.*

190. DEL. CODE ANN. tit. 8, § 251 (1983 & Supp. 1990) requires that the board of directors of a corporation seeking to merge or consolidate "shall adopt a resolution approving an agreement of merger or consolidation." *Id.* This agreement must then "be submitted to the stockholders of [the] corporation at an annual or special meeting for the purpose of acting on the agreement." *Id.* The statute requires a majority of the outstanding voting stock of the corporation for adoption. *Id.*

Under Delaware law, only Warner's shareholders needed to approve the merger because Time's shares technically would remain unaffected. New York Stock Exchange rules, however, required a vote by Time's shareholders as well. *Paramount Communications*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,270.

191. *Paramount Communications*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,271.

192. *Paramount Communications*, 571 A.2d at 1147.

193. *Paramount Communications*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,271.

194. *Id.* at 93,272.

195. *Id.* Time's investment bankers advised that if an aggressor company purchased Time's shares, adequate share valuation could be as high as \$250. *Id.*

imposed upon the offer would considerably delay action, and that Paramount was not well suited to Time's long-range planning strategies.<sup>196</sup>

Realizing, however, that many shareholders, including institutional investors and other money managers, would prefer immediate cash rather than wait for possible greater appreciation of their stock following the proposed merger, Time's board decided to avoid the possibility that its shareholders might veto the merger agreement.<sup>197</sup> The Time directors first requested that the New York Stock Exchange waive its requirement that mergers of listed companies receive stockholder approval, but the Exchange refused.<sup>198</sup> At that point, the board decided to scrap the stock swap and acquire Warner in a leveraged buyout, assuming between \$7 billion and \$10 billion in debt and paying \$70 per share for 51% of Warner's stock.<sup>199</sup> Warner's board approved the revised transaction on June 16, 1989, after Time's board agreed to complete the merger, unless enjoined.<sup>200</sup>

On June 23, 1989, Paramount increased its offer for Time stock to \$200 per share.<sup>201</sup> On June 26, 1989, the Time board rejected the offer, stating that it believed the merger with Warner offered greater potential.<sup>202</sup> At no time did the Time and Paramount boards negotiate on any terms of acquisition.

### C. Plaintiffs' Revlon and Unocal Arguments

Following the Time board's rejection of Paramount's \$200 per share offer, Paramount and shareholders of Time filed suit against Time seeking to enjoin the Time-Warner combination.<sup>203</sup> The shareholder plaintiffs asserted that the original merger agreement constituted a decision by the Time board to transfer control of the corporation, thus putting the corporation in the "Revlon mode."<sup>204</sup> The shareholder plaintiffs based their suit on several arguments. First, they argued that any change in corporate control triggers the *Revlon* duties.<sup>205</sup> Second, they contended that the exchange ratio giving

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196. *Id.* at 93,273.

197. *Paramount Comms., Inc. v. Time Inc.*, 571 A.2d 1140, 1148 (Del. 1989).

198. *Id.* The lower court had noted that although Time "seeks to avoid or obscure" the fact that it wanted to avoid a shareholder vote, its decision to recast the proposed merger "must be seen as a reaction" to Paramount's offer and its effect on the shareholders. *Paramount Communications*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,274.

199. *Paramount Communications*, 571 A.2d at 1148.

200. *Id.*

201. *Id.* at 1149.

202. *Id.*

203. *Id.*

204. *Id.*

205. *Id.*

Warner shareholders 62% of Time-Warner stock constituted an effective change of control.<sup>206</sup> Third, they argued that the merger would have prevented Time from considering higher bids, thus denying Time shareholders the opportunity to realize a premium price for their shares.<sup>207</sup> In essence, the shareholders asserted that the duty to maximize current shareholder value should accompany the merger even if the merger did not constitute a change in control.<sup>208</sup>

Paramount based its suit on *Unocal*.<sup>209</sup> Paramount first asserted that Time's board did not have a reasonable basis for considering Paramount a threat.<sup>210</sup> Next, it claimed that the Time board's response to Paramount's offer was unreasonable because the response prevented Time shareholders from voting on the original merger agreement and from tendering their shares to Paramount.<sup>211</sup>

The Delaware Chancery Court denied the application for injunction.<sup>212</sup> The Supreme Court of Delaware affirmed that decision in a July 1989 oral decision, and released its written decision in February 1990.<sup>213</sup>

#### IV. THE RATIONALE AND IMPLICATIONS OF *PARAMOUNT*

##### A. *The Courts' Holdings in Paramount*

The Delaware Court of Chancery's decision did not resolve the issue of exactly when *Revlon* duties arise. The court did state, however, that "not every offer or transaction affecting the corporate structure invokes the *Revlon* duties,"<sup>214</sup> and that "a board may find itself in a *Revlon* mode without reaching an express resolve to 'sell' the company."<sup>215</sup> The court went only so far as to assert that a "transaction that does represent a change in corporate control" places a board in the *Revlon* mode.<sup>216</sup> The court held that the

206. *Id.*

207. *Id.* A change in control premium is the amount over the current market price offered by a bidder in a takeover.

208. *Id.*

209. *Id.*

210. *Id.*

211. *Id.*

212. *Paramount Communications*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 at 93,284 (Del. Ch. July 17, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989).

213. *Paramount Communications*, 571 A.2d at 1155.

214. *Paramount Communications*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 at 93,279 (quoting *Mills Acquisition Corp. v. Macmillan*, 559 A.2d 1261, 1285 (Del. 1988)).

215. *Id.* at 93,279; see *Mills Acquisition Co. v. Macmillan*, 559 A.2d 1261, 1285 (Del. 1988).

216. *Paramount Communications*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,279.

Time-Warner merger agreement did not "contemplate" such a transaction and thus did not trigger *Revlon* duties.<sup>217</sup>

The court of chancery declared that it would look for a change in control in the actions of the board. "If the appropriate inquiry is whether a change in control is contemplated," the court stated, "the answer must be sought in the specific circumstances surrounding the transaction."<sup>218</sup> The court indicated that a stock swap, such as that called for in the Time-Warner agreement, could be a transfer of control if Warner were a private company.<sup>219</sup> Because both Time and Warner were public corporations traded in public markets, however, the court held that "control" ultimately remained with the public.<sup>220</sup>

The Delaware Supreme Court affirmed the court of chancery's holding on the *Revlon* issue.<sup>221</sup> The court framed the issue as whether Time, "by entering into the proposed merger with Warner, put itself up for sale."<sup>222</sup> The supreme court, however, based its decision on a broader reading of directors' discretion.<sup>223</sup> The court emphasized that Delaware law charges a board of directors with managing the corporation; this duty includes "the authority to set a corporate course of action, including time frame, designed to enhance corporate profitability."<sup>224</sup> Accordingly, there is no "*per se* duty to maximize shareholder value in the short term, even in the context of a takeover."<sup>225</sup>

The court opined that generally two situations lead to *Revlon* duties: One occurs when a company "initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company";<sup>226</sup> the other occurs when "a target abandons its long-term strategy and seeks an alternative transaction also involving the breakup of the company,"<sup>227</sup> in response to a tender offer. The court held that *Revlon* does not apply to actions "simply because they might be construed as putting a corporation either 'in play' or 'up for sale.'"<sup>228</sup> When the Time directors decided to change their merger plans and purchase Warner instead, a sale or

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217. *Id.*

218. *Id.*

219. *Id.*

220. *Id.*

221. *Paramount Comms., Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989).

222. *Id.* at 1150.

223. *Id.* at 1154.

224. *Id.* at 1150.

225. *Id.*

226. *Id.*

227. *Id.*

228. *Id.* at 1151.

breakup of Time Inc. was not "inevitable," and the board had not abandoned its strategic plans.<sup>229</sup> Because no *Revlon* duties applied, the court held that "*Unocal* alone applies to determine whether the business judgment rule attaches to the revised agreement."<sup>230</sup>

The plaintiffs in *Paramount* also asserted that, because a merger would have had the effect of precluding a future control premium, the directors' fiduciary duties required them to immediately seek a control premium through a sale of the corporation.<sup>231</sup> The court of chancery dismissed this assertion, stating that to create the auctioneer duty would require an expansion of *Revlon* by going beyond sales or other change in control transactions.<sup>232</sup> Because such a rule would "dramatically restrict the functioning of the board whenever an offer was made,"<sup>233</sup> the court of chancery determined that it would judge the board's decision on a reasonableness standard rather than the narrower *Revlon* standard.<sup>234</sup> The supreme court addressed this argument only briefly, stating that the new Time-Warner entity was not so big that it could not itself be taken over, in which event the shareholders would realize a premium.<sup>235</sup>

The Delaware Supreme Court also affirmed the court of chancery's holding on *Paramount's Unocal* claims. The court of chancery found the original merger agreement protected by the traditional business judgment rule, but applied the stricter standard of *Unocal* to the Time board's later decision to abandon the merger plan in favor of a buyout of Warner.<sup>236</sup> The supreme court agreed with the lower court that *Paramount's* offer constituted a threat to Time, and that the Time board's response to that threat was reasonable under the circumstances.<sup>237</sup>

In holding that the Time directors met the *Unocal* standard, the supreme court rejected *Paramount's* assertion that its hostile tender offer represented a threat only if less valuable than the Time board's merger plan.<sup>238</sup> The supreme court stated that *Paramount's* assertion of what constituted a threat was too narrow: "The open-ended analysis mandated by *Unocal* is not in-

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229. *Id.*

230. *Id.*

231. *Id.* at 1154.

232. *Paramount Comms., Inc. v. Time Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,280-81 (Del. Ch. July 14, 1989), *aff'd*, 570 A.2d 1140 (Del. 1989).

233. *Id.*

234. *Id.* at 93,281.

235. *Paramount Communications*, 571 A.2d at 1151.

236. *Paramount Communications*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,282.

237. *Paramount Communications*, 571 A.2d at 1153.

238. *Id.*

tended to lead to a simple mathematical exercise: that is, of comparing the discounted value of Time-Warner's expected trading price at some future date with Paramount's offer and determining which is the higher."<sup>239</sup> The court held that under the *Unocal* standard of review, a court may not "substitut[e] its judgment as to what is a 'better' deal for that of a corporation's board of directors,"<sup>240</sup> thereby expressly rejecting an approach taken by the court of chancery in previous decisions.<sup>241</sup> The court found that Time's board showed a reasonable basis for believing that Paramount's offer contained threats to Time's corporate planning beyond the threat of an inadequate price.<sup>242</sup> The court also found that Time's subsequent decision to buy Warner was a reasonable response, given Time's long-range business plans.<sup>243</sup> Accordingly, the court held that the decision by Time's board was protected under *Unocal*.<sup>244</sup>

In sum, the plaintiffs in *Paramount* were unsuccessful because the court refused to find that the Time board's actions triggered *Revlon* duties. The court, emphasizing the directors' intent in structuring the proposed merger and subsequent restructuring to avoid a shareholder vote, granted the board the protection of the business judgment rule. The court considered the Paramount offer a threat to the corporation but held that the Time board's tender offer for Warner stock was reasonable in relation to the danger posed by Paramount's threat.

### B. Implications of Paramount

The actual effects upon corporate behavior of the Delaware Supreme Court's decision in *Paramount* have yet to be fully realized, but the potential impact is significant. The decision has drawn criticism on both legal and financial grounds, primarily by shareholders who seek to encourage corporate directors and management to increase the value of the corporation's stock, rather than to make nebulous "strategic" plans. Such planning, many

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239. *Id.*

240. *Id.*

241. *Id.* *But see* TW Servs., Inc. v. SWT Acquisition Corp., [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,173 (Del. Ch. Mar. 2, 1989); City Capital Assocs. v. Inteco Inc., 551 A.2d 787 (Del. Ch.), *appeal dismissed*, 556 A.2d 1070 (Del. 1988).

242. *Paramount Communications*, 571 A.2d at 1153. According to the court, the Time board's concerns included that shareholders "might elect to tender into Paramount's cash offer in ignorance or a mistaken belief of the strategic benefit which a business combination with Warner might produce." *Id.* The court also cited Time's concern over the conditions and timing of Paramount's offer. *Id.*

243. *Id.* at 1154.

244. *Id.*

shareholders believe, allows directors to remain unaccountable for poor management performance.

The control cases prior to the decision in *Paramount* indicate that the Delaware Supreme Court could have found a triggering of *Revlon* duties in *Paramount*. One of the plaintiffs' assertions in *Paramount* was that the original merger agreement was an "implicit decision" to transfer control to Warner and its shareholders.<sup>245</sup> Specifically, the plaintiffs argued that if the shareholders approved the merger agreement, Warner's shareholders would have owned 61% of Time's equity.<sup>246</sup> Thus, the plaintiffs argued that the Time directors had "entered a *Revlon* mode" because a change of control constituted a sale.<sup>247</sup> The Delaware Court of Chancery in *Freedman* and the Delaware Supreme Court in *Mills* had affirmed this position.<sup>248</sup> The court's decision in *Paramount* therefore represents a significant cutting back in the number of situations in which *Revlon* duties might arise. Although the contemplated merger with Warner would not have caused the dissolution of Time Inc., some change in control would have resulted. Because a merger, even a defensive one as in *Paramount*, arguably involves a "sale" due to the change of control that occurs,<sup>249</sup> the pursuit of immediate maximum share value, as required by *Revlon*, would have served shareholder interests.

Clearly, the Time board's decision not to negotiate with Paramount hurt Time's shareholders. Paramount offered \$200 per share for Time's stock when the stock traded for \$126. On the day of publication of the Delaware Supreme Court's decision, seven months after the Chancellor denied the plaintiffs' injunction, Time Warner stock traded for approximately \$95.75.<sup>250</sup> Further, because of the debt assumed by Time to purchase Warner, few stock analysts believed that the stock would reach the level of

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245. *Paramount Comms., Inc. v. Time Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 at 93,278 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989).

246. *Paramount Communications*, 571 A.2d at 1149.

247. *Id.* at 1150.

248. *See Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1988); *Freedman v. Restaurant Assocs. Indus.*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,502, at 93,218 (Del. Ch. Oct. 16, 1987); *infra* text accompanying notes 141-42, 148-52.

249. *See Johnson & Siegel, supra* note 3, at 372 & n.208 (The authors contend that *Revlon*'s principles apply to both defensive mergers and to uncoerced mergers because the threat of a hostile takeover can spur directors to consider a defensive, negotiated merger.).

250. Professor Bernard Black of Columbia University Law School stated, "If you try to figure out what long-term values it would take to equal a Paramount offer of \$200 or \$220 a share, you would need a tremendous increase in Time stock. There is no way that this is better for Time shareholders—short term or long term." (quoted in the *Washington Post*, July 15, 1989, at D10, col. 1.)

The *Washington Post*'s John Crudele noted that:

[F]rom a shareholder point of view, the combination of Time and Warner could go down in history as one of the worst deals ever. . . . Arbitrageurs on Wall Street still

Paramount's offer for some time.<sup>251</sup> Although Time Warner expected some losses as a result of the combination,<sup>252</sup> the question remains as to how much loss a shareholder must absorb simply because a long-term business plan protects management. Under *Paramount*, so long as directors follow a strategic plan, they can refuse to let shareholders decide whether to seek a maximum return on their investment. "The question of 'long-term' versus 'short-term' values is largely irrelevant," the Delaware Supreme Court stated in *Paramount*, "because directors, generally, are obliged to charter a course for a corporation which is in its best interests without regard to a fixed investment horizon."<sup>253</sup> The court thus gave directors broad authority to stand behind "deliberately conceived corporate plan[s]."<sup>254</sup> The court will allow shareholders to successfully challenge the plan only if there is "clearly no basis"<sup>255</sup> for the plan to continue.

The Delaware Supreme Court's decision in *Paramount* disregards important shareholder considerations, including shareholders' interests in increasing the value of their ownership in a corporation. In addition, the decision disregards conflicts of interest that lead to management entrenchment to the detriment of the corporation and its shareholders. Courts have recognized that the risk of directors acting in a self-interested manner is always present when the transaction affects control. The Time board structured its merger with Warner to avoid a loss of control by hostile takeover. The board recognized that, in the face of Paramount's tender offer, Time's shareholders would not approve the merger. A conclusion that the board acted in strictest self-interest when it chose to restructure the merger agreement into a

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contend that Time's decision not to negotiate with Paramount may have been the biggest blunder in the history of the takeover business.

Crudele, *Was Time Warner Merger a Mistake?*, Washington Post, Mar. 11, 1990, at H15, col. 2.

251. See Crudele, *supra* note 250, at H15, col. 1. "I didn't think it [Time Warner's trading price] would get this low . . . [F]rom a short-term perspective it's a significant disappointment for the shareholder." *Id.* (quoting Edward Atorino, an analyst with Salomon Brothers). "I don't have them in the black until 1993," said James Goss, an analyst at Chicago's Duff & Phelps." *Id.* But see U.S. News & World Report, Mar. 5, 1990, at 70, wherein Jack Egan noted that, despite Time Warner's \$10.8 billion debt, the company is "perhaps the most diversified entertainment enterprise around," that it has several valuable assets, and that several stock analysts are recommending the stock as a bargain. Cf. Crovitz, *Can Takeover Targets Just Say No to Stockholders?*, Wall St. J., Mar. 7, 1990, at A19, col. 4 ("Investment bankers working for Time Warner predicted in August [1989] that [in 1990] the stock would trade in the \$133 to \$213 range . . . . In the longer term, the bankers predicted that by 1993, Time Warner's shares would go for between \$302 and \$380").

252. Crovitz, *supra* note 251, at A19, col. 4.

253. *Paramount Communications*, 571 A.2d at 1150.

254. *Id.* at 1154.

255. *Id.*



leveraged buyout is not unreasonable. Certainly, the court could have found such action not protected by the business judgment rule by following the reasoning of prior decisions holding that an action in contemplation of a change in control invokes *Revlon* duties. The court also could have determined that the Time board's decision to avoid a shareholder vote was an unreasonable response to the Paramount tender offer, which was clearly not inadequate.

One effect of the decision could be that corporate boards of directors will entrench their positions by creating long-term plans as defenses against potential hostile takeover attempts. These plans would serve as records of boards' justifications for rejecting hostile tender offers should they face suits.<sup>256</sup> The Delaware Supreme Court, however, decided *Paramount* in light of the particular facts and circumstances of the case; Time and Warner conducted extensive investigations and negotiations. Whether courts would uphold other "strategic plans" to avoid hostile takeovers would depend upon the details of the plans, although the *Paramount* court rejected an approach that would have the court "appraise and evaluate the relative merits of a long-term versus short-term investment goal for shareholders."<sup>257</sup>

In the wake of the *Paramount* decision other influences may alter directors' behavior. One example is the decreasing use of hostile takeovers as a tool for effecting a change in corporate control. The shift away from hostile takeovers is partly because the broad protection afforded directors to enact defensive measures reduces the effectiveness and efficiency of hostile takeovers. It is also because the use of debt financing to acquire a target company has become an unpopular and unprofitable strategy. Other takeover strategies, including proxy battles, may replace hostile takeovers.<sup>258</sup> After *Paramount*, it remains to be seen whether the Delaware courts will allow directors broader discretion in fighting other forms of takeover attempts.

## V. CONCLUSION

The business judgment rule primarily reflects a policy of judicial deference to corporate boards of directors. Courts intend for this deference to provide incentive for directors to pursue profitable courses of business dealings without fear of judicial second-guessing. Directors owe fiduciary duties of loyalty and care to the corporation, however, and may not act in conflict with the corporation's interests. When directors act defensively to avoid loss of

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256. See Samuelson, *The Entrenching of Management*, Washington Post, Aug. 9, 1989, at A21, col. 2.

257. *Paramount Communications*, 571 A.2d at 1153.

258. See McCartney, *New Takeover Tactic: Ballots Instead of Bonds*, Washington Post, Apr. 8, 1990, at H1, col. 1.

control of the corporation, the rule of *Unocal Corp. v. Mesa Petroleum, Inc.*, requires that courts apply an enhanced business judgment standard, because of the increased risk of a conflict of interest.

The Delaware courts have inconsistently applied the enhanced business judgment rule. Generally, this inconsistent application has favored directors. By approving the actions of Time's board of directors and holding that those actions did not satisfy the *Revlon* change in control test, the Delaware Supreme Court, in *Paramount Communications, Inc. v. Time Inc.*, further weakened the fragile protection that the business judgment rule provides shareholders.

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