Michigan Law Review

Volume 87 | Issue 1

1988

Corporate Auctions And Directors' Fiduciary Duties: A Third-Generation Business Judgment Rule

Steven G. Bradbury
University of Michigan Law School

Follow this and additional works at: https://repository.law.umich.edu/mlr

Part of the Business Organizations Law Commons, and the State and Local Government Law Commons

Recommended Citation
Steven G. Bradbury, *Corporate Auctions And Directors' Fiduciary Duties: A Third-Generation Business Judgment Rule*, 87 MICH. L. REV. 276 (1988).
Available at: https://repository.law.umich.edu/mlr/vol87/iss1/8

This Note is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

Corporate Auctions and Directors' Fiduciary Duties: A Third-Generation Business Judgment Rule

Delaware courts have toughened the standard of review under the business judgment rule for upholding takeover defensive measures approved by target boards of directors.[1] In *Unocal Corp. v. Mesa Petroleum Co.*,[2] the Delaware Supreme Court created a two-prong test that put the burden on target directors to show (1) that they have reason to believe a takeover bid poses a threat to the corporate enterprise, and (2) that their defensive actions are reasonable in relation to the threat.[3] In *Revlon, Inc. v. MacAndrews & Forbes Holdings*[4] the court tightened the second prong of the *Unocal* test by adding the requirement that any defensive measures be rationally related to shareholder benefit.[5] Further, the *Revlon* court held that when sale or break up of a target corporation becomes "inevitable," the directors must act as auctioneers whose primary responsibility is to realize the best sale price for the benefit of stockholders.[6] The directors must deal fairly and equally with competing bidders and must not close off active bidding without significant gain for shareholders.[7]

The *Unocal* two-prong test for business judgment rule protection has limited relevance in the auction phase[8] of a takeover contest. The

---

1. *See* Brennan, *New Cases on the Business Judgment Rule: Defending Defensive Tactics Becomes More Difficult*, 14 SEC. REG. L.J. 245 (1986); Wander & LeCoque, *Boardroom Jitters: Corporate Control Transactions and Today's Business Judgment Rule*, 42 BUS. LAW. 29 (1986); Gerlits & Barnard, *Poison Pill Takeover Defense Lays Open Corporate Boards*, Natl. L.J., May 27, 1985, at 15, col. 1. A basic definition of "takeover" is contained in 1 M. LIPTON & E. STEINBERGER, TAKEOVERS & FREEZEOUTS § 1.01[1] (1987):

> 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. Most commonly, takeover bids are made directly to shareholders of the target as a cash tender offer or as an exchange offer of raider securities for target stock.
>
> The principal takeover approaches include a "friendly" transaction negotiated with management; a "bear hug," in which the raider notifies the target of a proposed acquisition transaction; a "hostile" offer made directly to target shareholders, without management approval; and, as a supplement or alternative to these approaches, large open market and/or privately negotiated purchases of target stock.

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

3. 493 A.2d at 955.

4. 506 A.2d 173 (Del. 1986).

5. 506 A.2d at 182; *see* Greene & Palmiter, *Business Judgment Rule Tightened for Takeovers*, Legal Times, Jan. 20, 1986, at S3, col. 1. The *Unocal-Revlon* formulation has been termed the "second generation" of the business judgment rule. *See* Mirvis, *Corporate Takeovers and the Business Judgment Rule: The Second Generation*, N.Y.L.J., Aug. 11, 1986, at 37, col. 1.

6. 506 A.2d at 182.

7. *See* 506 A.2d at 184.

8. This Note uses the term "auction phase" to refer to that phase of a takeover battle in which sale of the target is "inevitable" and the company's directors are charged with the responsibilities of auctioneers. The term "response phase" will refer to the initial stages of a takeover

Unocal test balances defensive actions against perceived threats to the corporation, but any question of a threat to the enterprise is "moot" during a *Revlon* auction.[9] After commencement of a corporate auction, the director-auctioneers may no longer defend the company against threats to the corporate enterprise.[10] *Revlon* does not explicitly formulate a new business judgment rule test for reviewing the actions of a target board once a corporate auction has begun.[11] It does

---

attempt which occur prior to the auction phase. Of course, many takeover attempts are blocked or aborted before reaching an auction phase.

While the response phase of a transaction may not prove difficult to identify, determining when an auction phase commences is not a settled question. Uncertainty has resulted because the cases that discuss the auction phase contain fact situations where it is obvious that a company will or will not "inevitably" be sold. In *Revlon*, for example, the court determined that pressure from one potential acquirer, Pantry Pride, had made the sale of Revlon inevitable, and Revlon's directors had assumed the duties of auctioneers when they recognized this inevitability by authorizing management to negotiate a sale to a third party. *Revlon*, 506 A.2d at 182. The court supported this finding of inevitability with evidence of the board's willingness to break up Revlon (by authorizing management to negotiate a sale to a third party) and grant lock-up options on its various divisions. *See Revlon*, 506 A.2d at 178-79, 182. The existence of a competitive auction was further shown by the presence of two competing bidders. Because this evidence pointed conclusively toward the finding of a competitive auction, however, the *Revlon* rationale fails to help future courts identify the beginning of an auction phase in ambiguous cases.

In many situations, the authorization to negotiate a sale to a third party may not signify a corporate auction but rather a preliminary step toward serious negotiation. Such a subsequent sale could be contingent on receiving a satisfactory and well-financed offer. In Delaware, corporate boards are allowed to explore the possibility of a merger or acquisition without being irrevocably drawn toward that course of action. In Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987), for example, the Delaware Supreme Court refused to impose auctioneering duties on directors where the target was stalked by a single hostile bidder. The court refused application of the *Revlon* analysis even though the Newmont board's solicitous dealings with a third party (Newmont's largest shareholder) kept the company independent by the slimmest fractional percentage. *See* note 75 *infra*. The court accepted the directors' arguments that their response to the coercive offer had actually preserved Newmont's independence, that they did not plan to sell the company, and that the third party was not a competing bidder but merely a shareholder out to protect its significant stake in the target. "*Revlon* applies here," the court stated, "only if it was apparent that the sale of Newmont was 'inevitable'." 535 A.2d at 1345. Since Newmont was never for sale, the auctioneering duties of *Revlon* never applied.

In contrast to *Newmont Mining*, the Sixth Circuit in Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986), identified the commencement of an auction in the mere fact that the raider, Asher Edelman, had announced an intention to make an all-cash tender offer for all Fruehauf shares at a price likely to elicit tender from the company's shareholders. The important point to the court was that the target board "realized that a change of ownership of Fruehauf was imminent and that the company would end up being sold." 798 F.2d at 884. Fruehauf management acted on this realization by arranging its own leveraged buyout proposal. 798 F.2d at 884. *Fruehauf* also provides little substantive guidance since the question of whether Edelman's attempted takeover of Fruehauf had entered the auction phase was not an issue before the court. *See* 798 F.2d at 886 ("All sides agree that Fruehauf is on the auction block.").

Some recent takeover battles have involved disputes over whether the auction phase has commenced, especially when the battle involves two or more potential suitors. *See, e.g.*, Black & Decker Corp. v. American Standard, Inc., 682 F. Supp. 772 (D. Del. 1988); CRTF Corp. v. Federated Dept. Stores, 683 F. Supp. 422 (S.D.N.Y. 1988). At the same time, the question of when an auctioneer's duty arises has begun to attract some commentary. *See, e.g.*, Bogen & Duke, *The Auctioneer's Duty: Unraveling* Revlon, INSIGHTS, July 1988. at 3, 6.

9. 506 A.2d at 182.

10. 506 A.2d at 182.

11. The *Revlon* court applied the *Unocal* test, although no business judgment rule test was really required in reviewing the Revlon directors' conduct of the corporate auction given the

not provide guidance in cases where sale of the target is inevitable but a lively auction has not yet developed. In these cases the target board may attempt to obstruct a tender offer for the purpose of attracting other bidders and stimulating a competitive bidding contest.[12] Commencement of an auction phase in a control contest might trigger a judicial review into the substantive fairness of such actions.[13] This review could be similar to the duty of loyalty analysis employed by courts in cases where there is evidence of director conflict of interest.[14]

A recent opinion authored by Judge Richard Posner highlights the need for a standard of review of auction-phase control transactions that is coherent with the *Unocal-Revlon* elaboration of the business judgment rule. In *Dynamics Corp. of America v. CTS Corp. (CTS II),*[15] the Seventh Circuit relied on the *Revlon* decision to challenge a poison pill rights plan adopted after the CTS board had voted to sell the company, even though the district court had found the plan reasonably designed to stimulate further bidding. In reviewing the board's actions under the second prong of the *Unocal* test, the court demanded extensive proof that the terms of the rights plan were supported by sound financial analysis, and reserved judgment on whether a board is ever justified in taking defensive measures after it has com-

---

strong evidence of disloyalty. *See* R. GILSON, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 112 (Supp. 1987) ("the court found that the Revlon directors violated their duty of loyalty in agreeing to the lock-up, thereby rendering the new [*Unocal*] two-step review irrelevant"); *see also* notes 101-03 *infra* and accompanying text.

12. *See* CRTF Corp. v. Federated Dept. Stores, 683 F. Supp. 422 (S.D.N.Y. 1988); Dynamics Corp. of Am. v. CTS Corp. (CTS II), 635 F. Supp. 1174 (N.D. Ill.), *supplemented on rehg.,* 638 F. Supp. 802 (N.D. Ill.), *affd. in part, vacated in part, and remanded,* 805 F.2d 705 (7th Cir. 1986); *see also* note 8 *supra.*

13. *Cf.* Block & Barton, *Burden Shifted: Boards' Role in 'Hanson' and 'Revlon',* Natl. L.J., Apr. 21, 1986, at 19, col. 4, at 26, col. 2:

> The unifying theme of these cases is that, when directors usurp the stockholders' right to control the corporation's destiny, the burden of proof is on the directors to prove the fairness of their actions — i.e., that the stockholders have achieved a real benefit. Once a sale of the company is ordained, the best interests of the stockholders normally are served by allowing market forces to operate freely. In such circumstances, a defensive tactic that artificially terminates a competitive auction for corporate control will be difficult to justify.

It has been argued that *Revlon* "narrowed" a board's ability to meet the *Unocal* good-faith standard by precluding any actions that foreclose bidding during an auction and that this required good-faith showing is necessary to overcome a "presumption" of self-dealing by the directors. *See* Comment, *Statutory Limitations on Directors' Liability in Delaware: A New Look at Conflicts of Interest and the Business Judgment Rule,* 24 HARV. J. ON LEGIS. 527, 556-59 (1987).

14. For examples of the duty of loyalty analysis in the context of a takeover defense, see Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 278 (2d Cir. 1986) ("When engaging in defensive maneuvers, such as a lock-up option, a director's primary obligation is to ensure the overall fairness, including a fair option price, to the shareholders."); Norlin Corp. v. Rooney, Pace, Inc., 744 F.2d 255, 265-66 (2d Cir. 1984) (directors' locking up voting control in their own hands constituted self-interest sufficient to require a demonstration that their actions were fair and reasonable); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 114-15 (Del. Ch. 1986) (coercive self-tender violates the second prong of the *Unocal* test and "can only be sustained if it is objectively or intrinsically fair"); *see also* Part II *infra.*

15. 805 F.2d 705 (7th Cir. 1986).

mitted itself to a sale of the corporation.[16] The scrutiny contemplated in *CTS II* bears close resemblance to the duty of loyalty analysis,[17] and may herald an abandonment of the business judgment rule in the context of a corporate auction. However, a standard of review that allows judicial examination into the financial analysis behind an auction-phase decision may hamstring a board's ability to generate a competitive auction that could maximize shareholder wealth.[18] Such a result would be inconsistent with Delaware case law. While imposing strict limitations on the conduct of target directors in corporate auctions, the Delaware Supreme Court continues to maintain a strong preference for fostering the active exercise of business judgment.[19]

This Note proposes a rationale and a methodology for applying the business judgment rule when directors resist a hostile bid during the auction phase of a control contest. Part I examines the changes that occur in the responsibilities of target directors when a corporate auction is initiated. This Part describes the *Unocal* business judgment rule test and discusses its usefulness in the auction phase of a takeover. While the test requires modification if it is to complement effectively the auction-phase duties announced in *Revlon,* this Part suggests that the business judgment rule continues to be relevant and important during a corporate auction. Finally, this Part discusses target resistance in the auction phase, and closely examines the standard of review employed in *CTS II* to determine whether this case represents an un-

16. 805 F.2d at 717.

17. For a discussion of the duty of loyalty analysis, see Part II *infra.*

18. *Cf.* Bebchuk, *The Case for Facilitating Competing Tender Offers,* 95 HARV. L. REV. 1028 (1982) [hereinafter Bebchuk, *Tender Offers*]. Bebchuk advocates a federal "rule of auctioneering" to displace the existing common law of corporate fiduciary duties. His rule of auctioneering would impose a time delay in tender offers allowing target management an opportunity to communicate information about the target firm for the purpose of soliciting competing bids. Bebchuk argues that such regulation would benefit target shareholders by maximizing premiums in all acquisitions — whether negotiated or hostile. He would assign to target management the role of auctioneer since management can best provide the information prospective acquirers must have in deciding whether and at what price to bid. Concomitantly, he advocates a complete ban on defensive tactics that inhibit tender offers. He argues that target managers cannot be trusted to acquiesce in a sale of the company or to deal impartially between favored and disfavored bidders. For Bebchuk, allowing management to obstruct unsolicited takeover bids made directly to shareholders inevitably translates into a loss in premium and diminished shareholder welfare.

This Note similarly advocates the facilitation of corporate auctions and, like Bebchuk's thesis, focuses on the role target directors may play in soliciting competitive bids. However, this Note does not address hypothetical federal regulation. Rather, the Note is confined to an examination of current Delaware law and the possibility of effectuating auctions by refining the chief judicial tool for reviewing director conduct, the business judgment rule.

19. This preference for an active target board is evident in Delaware court opinions respecting every phase of takeovers. *See* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987) (defensive "street sweep" and standstill agreement upheld); Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 184 n.16 (Del. 1986) (during a corporate auction, "[t]he directors' role remains an active one"); Moran v. Household Intl., Inc., 500 A.2d 1346 (Del. 1985) (prospective adoption of rights plan protected by the business judgment rule); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (discriminatory self-tender offer done in response to a hostile takeover attempt upheld under the business judgment rule).

due departure from the use of the business judgment rule developed in *Unocal* and *Revlon*. Part II defines those situations in which the duty of loyalty analysis should supersede the business judgment rule. This Part distinguishes suspected conflicts of interest from manifest conflicts of interest, and argues that business judgment rule protection should be available in cases involving no more than a suspected conflict of interest. Finally, Part III formulates a standard of review for applying the business judgment rule in the auction phase. This Part suggests that the reasonableness of target resistance be measured using Delaware's policy of facilitating corporate auctions for the maximization of shareholder gain.

I. CORPORATE AUCTIONS AND THE BUSINESS JUDGMENT RULE

The business judgment rule is a judicial standard for the review of corporate decisionmaking. The traditional rule protects from liability disinterested directors who have, in the exercise of their business judgment, satisfied the standards of conduct required by state law.[20] These standards of conduct derive from the duties of care and loyalty that directors, as fiduciaries, owe the corporation and its shareholders.[21] As long as a board has acted in good faith, on an informed basis, and in the honest belief that its actions are in the best interests of the company, courts will refrain from further scrutiny of a business decision.[22]

20. *See* Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979); *see also* D. BLOCK, N. BARTON & S. RADIN, THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS AND OFFICERS 9-17 (1987) [hereinafter THE BUSINESS JUDGMENT RULE]. In their comprehensive and up-to-date treatise on the business judgment rule, Block, Barton, and Radin describe the rule as requiring the presence of five factors: a business decision, disinterestedness, due care, good faith, and no abuse of discretion. *Id.* at 9; *see also* 3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1040, at 58 (1986). The presence of a business decision is a prerequisite since business judgment rule protection is not available where directors have failed to act. The rule requires an affirmative business decision, which may include a conscious decision not to act. *See* Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984). The "no abuse of discretion" element in this description of the business judgment rule refers primarily to court decisions concerning the wasting of corporate assets or other actions that have no rational business purpose. *See* THE BUSINESS JUDGMENT RULE, *supra*, at 15-18.

21. THE BUSINESS JUDGMENT RULE, *supra* note 20, at 23. Under the duty of care, corporate directors must perform their responsibilities with the care of an ordinarily prudent person under similar circumstances. Norlin Corp. v. Rooney, Pace, Inc., 744 F.2d 255, 264 (2d Cir. 1984); REVISED MODEL BUSINESS CORP. ACT § 8.30(a)(2) (1984). For purposes of the business judgment rule, due care means that directors have informed themselves "prior to making a business decision, of all material information reasonably available to them." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). Similarly, the duty of loyalty demands that when making decisions affecting the company, directors place allegiance to the enterprise above their own self-interests. *See* Committee on Corporate Laws, ABA Section of Corporation, Banking and Business Law, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1599 (1978) (directors "should not use . . . corporate position to make a personal profit or gain other personal advantage").

22. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see also* Kennedy, *The Standard of Responsibility for Directors*, 52 GEO. WASH. L. REV. 624 (1984); Veasey & Manning, *Codified Standard — Safe Harbor or Uncharted Reef?*, 35 BUS. LAW. 919 (1980); Arsht & Hinsey, *Codified Standard — Same Harbor*

The traditional business judgment rule creates a presumption that disinterested directors have met all required standards of conduct.[23]

Behind the rule stands a judicial policy of practical deference. Courts hesitate to interfere with business operations and will not substitute their inexpert judgment for the judgment of a board of directors whose decisions are attributable to "any rational business purpose."[24] The principal concern is that corporate directors be given sufficient discretion to develop business strategies that may enhance the company's effectiveness and profitability in response to complex and rapidly changing market forces.[25] Imposing judicial process into business decisionmaking may undermine director discretion, thereby discouraging directors from pursuing desirable business risks.[26] Judicial oversight may also impede the free play of market forces, which demand efficiency in corporate management and by themselves operate as a check on board power.[27]

The traditional version of the business judgment rule covers operational decisions made by directors in the day-to-day conduct of the corporation's affairs, including, for example, decisions to purchase new capital assets or expand production capacity.[28] The approval by a target board of a defensive measure affecting corporate control differs from a normal operational business decision because of the strong possibility that target directors have acted in their own self-interest to

---

But Charted Channel: A Response, 35 BUS. LAW. 947 (1980). *Cf.* REVISED MODEL BUSINESS CORP. ACT § 8.30(a) (1984):

> A director shall discharge his duties as a director, including his duties as a member of a committee:
>
> (1) in good faith;
>
> (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
>
> (3) in a manner he reasonably believes to be in the best interests of the corporation.

Twenty-two states have enacted statutory standards of conduct that track Model Act § 8.30(a). *See* THE BUSINESS JUDGMENT RULE, *supra* note 20, app. C, at 361. The Delaware standards have been articulated by the courts and have not been codified.

23. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Treadway Co. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980); R. BALOTTI & J. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.6, at 74 (1986). A plaintiff seeking to hold directors liable for harm resulting from their decisions has the burden of rebutting these presumptions. *Aronson*, 473 A.2d at 812.

24. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

25. *See* Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621, 650-51 (1983); *see also* Comment, *The Presumptions and Burdens of the Duty of Loyalty Regarding Target Company Defensive Tactics*, 48 OHIO ST. L.J. 273, 274 (1987). The board of directors is statutorily assigned responsibility over the corporate helm. *E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1983); CAL. CORP. CODE § 300(a) (West 1977); REVISED MODEL BUSINESS CORP. ACT § 8.01(b) (1984).

26. *See* Comment, *The Misapplication of the Business Judgment Rule in Contests for Corporate Control*, 76 NW. U. L. REV. 980, 983-84 (1982).

27. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1196 (1981).

28. Wander & LeCoque, *supra* note 1, at 42.

retain control.[29] Nevertheless, Delaware courts apply the business judgment rule to shield the decisions of target directors who resist a takeover in situations where the directors can show that they have satisfied their duties of care and loyalty to the corporate enterprise and can show that any defensive measures adopted are reasonable and rationally related to shareholder benefit.[30]

A. *Director Conduct and the* Unocal *Test*

The principal case governing the fiduciary duties of target directors and the applicability of the business judgment rule to takeover defenses is *Unocal Corp. v. Mesa Petroleum Co.*[31] In *Unocal,* the Delaware Supreme Court reaffirmed use of the business judgment rule in

---

29. *See* Block & Miller, *The Responsibilities and Obligations of Corporate Directors in Takeover Contests,* 11 SEC. REG. L.J. 44, 49 (1983).

30. Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 179-82 (Del. 1986); *see also* Moran v. Household Intl., Inc., 500 A.2d 1346, 1350 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

Before 1985, courts generally applied the favorable presumptions of the traditional business judgment rule to protect from injunction defensive control transactions. Courts held that the business judgment rule was appropriate provided the target directors who approved such transactions were not acting for the primary purpose of entrenching themselves in office. *See* Panter v. Marshall Field & Co., 646 F.2d 271, 297 (7th Cir.), *cert. denied,* 454 U.S. 1092 (1981); Treadway Co. v. Care Corp., 638 F.2d 357, 383 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980), *cert. denied,* 450 U.S. 999 (1981); Pogostin v. Rice, 480 A.2d 619, 627 (Del. 1984); *see also* Block & Miller, *supra* note 29, at 47-52. The burden of showing improper motive lay with the plaintiffs. Where a primary purpose of entrenchment was shown, the burden would shift to the directors to show that the transaction was, in fact, fair to the corporation. *See* S. LORNE, ACQUISITIONS AND MERGERS: NEGOTIATED AND CONTESTED TRANSACTIONS § 4.05[3][a] (1988). The so-called "primary purpose" test actually differed little from the traditional application of the rule, which required a "rational business purpose," since under the primary purpose test courts usually demanded no more than a showing of "reasonable grounds to believe a danger to corporate policy and effectiveness existed." Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred,* 97 HARV. L. REV. 1964, 1970 n.45 (1984) (emphasis removed) (quoting Cheff v. Mathes, 41 Del. Ch. 494, 506, 199 A.2d 548, 555 (1964)).

Application of the business judgment rule to protect a board's *decision* rather than the directors themselves has been termed the business judgment "doctrine." *See* Hinsey, *Business Judgment and the American Law Institute's Corporate Governance Project: the Rule, the Doctrine, and the Reality,* 52 GEO. WASH. L. REV. 609, 611-13 (1984); Veasey, *The New Incarnation of the Business Judgment Rule in Takeover Defenses,* 11 DEL. J. CORP. L. 503, 505 (1986). Courts largely ignore the distinction between the "rule" and the "doctrine," however, referring to both as the business judgment rule. *See, e.g.,* Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 180 n.10 (Del. 1986). This Note will adhere to the terminology used by the courts.

31. 493 A.2d 946 (Del. 1985). *Unocal* is a leading case in or out of Delaware because many states look to Delaware for guidance on questions of corporate fiduciary duty. *See, e.g.,* Dynamics Corp. of Am. v. CTS Corp. (CTS I), 794 F.2d 250, 253 (7th Cir. 1986), *revd. on other grounds,* 107 S. Ct. 1637 (1987). Federal law generally does not govern the review of a target board's defensive strategies. *See* Schreiber v. Burlington N., Inc., 472 U.S. 1 (1985); Santa Fe Indus. v. Green, 430 U.S. 462 (1977). The only federal securities law relevant to mergers and acquisitions is the Williams Act, 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1982). *See* Edgar v. MITE Corp., 457 U.S. 624 (1982). The Williams Act imposes certain disclosure duties in connection with tender offers and sizable open market stock purchases, and provides tendering shareholders the right to withdraw their shares and the right to receive the highest price paid in the tender offer, distributed among all tendered shares on a pro rata basis. Piper v. Chris-Craft Indus., 430 U.S. 1, 23 (1977).

reviewing a board's response to a hostile tender offer.[32] The court held that during the initial phase of resistance to a nonnegotiated bid, or response phase,[33] the duties of care and loyalty require the board to play an active role in determining whether an offer is in the best interests of the corporation and its shareholders.[34] In certain cases, the duty of loyalty will demand that the board resist an offer that poses a threat to the shareholders or to corporate policy and effectiveness.[35] Where directors satisfy their duties of care and loyalty in evaluating and responding to an offer, the *Unocal* test provides the judicial deference that is the hallmark of the traditional business judgment rule.[36]

Implicit in the *Unocal* court's application of the business judgment rule is a reluctance to conclude that target directors always stand in conflict with the corporation and its shareholders.[37] The *Unocal* test makes it evident that target directors, during the response phase, need not concern themselves solely with the wealth interests of shareholders who seek a short-term profit on their investment in the company.[38] In responding to a takeover bid, a target board may determine that a

32. 493 A.2d at 954; *see also* THE BUSINESS JUDGMENT RULE, *supra* note 20, at 77-78; Comment, Unocal Corp. v. Mesa Petroleum Co., 72 VA. L. REV. 851, 853, 865-66 (1986) [hereinafter Comment, Unocal Corp.]. The court further held that

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

493 A.2d at 954.

33. *See* note 8 *supra.*

34. 493 A.2d at 954. The court explicitly rejected the suggestions of some scholars, *e.g.*, Easterbrook & Fischel, *supra* note 27, who have argued that the duty of loyalty requires directors to remain strictly passive during a takeover attempt. 493 A.2d at 955 n.10.

35. 493 A.2d at 955; *accord* Treco, Inc. v. Land of Lincoln Sav. & Loan, 749 F.2d 374, 378 (7th Cir. 1984); Treadway Co. v. Care Corp., 638 F.2d 357, 381 (2d Cir. 1980); Heit v. Baird, 567 F.2d 1157, 1161 (1st Cir. 1977); Turner Broadcasting Sys., Inc. v. CBS, Inc., 627 F. Supp. 901, 908 (N.D. Ga. 1985); Panter v. Marshall Field & Co., 486 F. Supp. 1168, 1194-95 (N.D. Ill. 1980), *affd.*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *see also* Note, *supra* note 30, at 1968 & n.29 (citing also Northwest Indus. v. B.F. Goodrich Co., 301 F. Supp. 706, 712 (N.D. Ill. 1969); Gerdes v. Reynolds, 28 N.Y.S.2d 622 (Sup. Ct. 1941)). Some courts disagree over whether the duty of loyalty requires active resistance to a harmful takeover bid. *See, e.g.*, Minstar Acquiring Corp. v. AMF Inc., 621 F. Supp. 1252, 1259-60 & 1260 n.6 (S.D.N.Y. 1985).

36. Delaware has widened use of the *Unocal* standard of review to cover decisions by directors to adopt defensive measures affecting a company's financial structure, such as poison-pill rights plans, in *anticipation* of a threat to the company from a possible future takeover attempt. Moran v. Household Intl., Inc., 500 A.2d 1346 (Del. 1985).

37. Directors who act with a conflict of interest are never entitled to the protections of the business judgment rule. *See, e.g.*, Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (business judgment rule does not cover corporate decisions that are "tainted by a conflict of interest"), *cert. denied*, 460 U.S. 1051 (1983). Generally, target directors with a conflict of interest must prove the fairness in fact of any control transactions they have approved. *See* Part II *infra.*

38. *See Unocal*, 493 A.2d at 955-56 & n.11 ("*While not a controlling factor*, it also seems to us that a board *may* reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor.") (emphasis added); *cf.* Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979) (discussing directors' obligation to interests other than

policy of preserving the company's independence best serves long-term business planning.[39] The board may act to protect corporate independence by fending off potential acquirers, even where the price of a takeover bid or tender offer is at a premium over the current trading price for the company's stock.[40] Moreover, directors in the response phase do not breach the duty of loyalty when they consider the effect of a proposed takeover on corporate constituencies other than shareholders.[41] Satisfaction of the interests of creditors, for example, can increase value for shareholders who have a long-term investment interest in the company as a going concern.[42]

At the same time, the *Unocal* test recognizes that defensive transactions involve the *possibility* that directors have breached their duty of loyalty by acting primarily for the purpose of retaining control.[43] This concern raises the question of director "good faith" — the subjective motivations of corporate directors. Directors lack good faith when they act for the purpose of entrenching themselves in office and without the honest belief that their actions are in the company's best interest.[44] Subjective motivations, however, are difficult to prove. For that reason, the *Unocal* court shifted to the directors the burden of

---

short-term shareholder gain). *But see* Dynamics Corp. of Am. v. CTS Corp. (CTS I), 794 F.2d 250, 253 (7th Cir. 1986), *revd. on other grounds,* 107 S. Ct. 1637 (1987).

39. *See, e.g.,* GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016, 1019 (S.D.N.Y. 1985); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341-42 (Del. 1987); *see also* Lipton, *supra* note 38; Wander & LeCoque, *supra* note 1, at 42.

40. *See* Pogostin v. Rice, 480 A.2d 619, 627 (Del. 1984); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 114 (Del. Ch. 1986).

41. *See Unocal,* 493 A.2d at 955; *accord* GAF Corp. v. Union Carbide Corp., 624 F. Supp. at 1017-18; *cf.* McDaniel, *Bondholders and Corporate Governance,* 41 BUS. LAW. 413 (1986) (arguing that corporate directors should owe fiduciary duties to public bondholders as well as to equity shareholders); Williamson, *Corporate Governance,* 93 YALE L.J. 1197 (1984) (arguing that boards of directors should also represent nonshareholder interest groups). Some state antitakeover statutes now expressly allow directors to evaluate a proposed takeover's impact on employees, suppliers, customers, and communities in which the corporation does business. *See, e.g.,* Pennsylvania Shareholder Protection Act § 408(B), 42 PA. CONS. STAT. ANN. § 8363 (Purdon Supp.1988); Newlin & Gilmer, *The Pennsylvania Shareholder Protection Act: A New State Approach to Deflecting Corporate Takeover Bids,* 40 BUS. LAW. 111 (1984). The constitutionality of certain variations of antitakeover statutes is still unsettled, *see* Note, *The Constitutionality of Second Generation Takeover Statutes,* 73 VA. L. REV. 203 (1987), notwithstanding the Supreme Court's recent decision in CTS Corp. v. Dynamics Corp. of Am., 107 S. Ct. 1637 (1987), upholding Indiana's control share acquisition statute (which gives nonmanagement shareholders of companies incorporated in Indiana the right to vote on whether to enfranchise an acquirer of a large block of stock, thereby deterring a freezeout merger or second-tier acquisition that could be harmful to shareholders). Regardless of the constitutionality question, however, some argue that it is imperative for courts to recognize the policies represented by such legislation when adjudicating matters of state corporation law. *See, e.g.,* Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web,* 85 MICH. L. REV. 1, 10 (1986).

42. *See* Lipton, *supra* note 38, at 109-12.

43. *Unocal,* 493 A.2d at 954-55 (citing Bennett v. Propp, 41 Del. Ch. 14, 22, 187 A.2d 405, 409 (1962)). Here, the court echoes the language used by courts applying the older primary purpose test. *See* note 30 *supra.*

44. THE BUSINESS JUDGMENT RULE, *supra* note 20, at 14-15.

showing that their conduct was proper, a fact presumed by the traditional business judgment rule.[45] The *Unocal* court created a two-prong test: the first prong directs an inquiry into the board's decisionmaking process; the second prong examines the reasonableness of defensive measures approved by the board. If the target directors satisfy both prongs of the test, the burden then shifts to the plaintiffs to show that the primary purpose behind the board's defensive tactics was entrenchment of incumbent management, rather than a bona fide business purpose, such as protection of shareholder welfare or corporate effectiveness.[46]

Under the first prong of the *Unocal* test, target directors who have approved a defensive measure must show that they had reason to believe the resisted offer posed a threat to the corporate enterprise.[47] The court stated that directors will satisfy this prong "by showing good faith and reasonable investigation."[48] In practice, the first prong of the test examines whether the directors have undertaken a reasonable investigation into the relative merits of the acquisition offer they are attempting to block (*i.e.,* whether they have acted in accordance with the duty of care).[49] The duty of care inquiry focuses on the objective conduct of target directors rather than on their subjective motivations. Here the court will review the *process* by which the directors have arrived at their decision to oppose the offer. Reasonable investigation usually involves a thorough and detached analysis by the board and generally must include an evaluation of the acquisition proposal by an impartial financial adviser.[50] The presence of objective factors tending to show due care on the part of the target directors operates as

45. *See* 493 A.2d at 954-55; Comment, *supra* note 13, at 554-55.

46. *See* 493 A.2d at 955; CRTF Corp. v. Federated Dept. Stores, 683 F. Supp. 422, 437 (S.D.N.Y. 1988); Dynamics Corp. of Am. v. CTS Corp. (CTS II), 635 F. Supp. 1174, 1176, 1181 (N.D. Ill.), *supplemented on reh.,* 638 F. Supp. 802 (N.D. Ill.), *affd. in part, vacated in part, and remanded,* 805 F.2d 705 (7th Cir. 1986).

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

48. 493 A.2d at 955 (quoting Cheff v. Mathes, 41 Del. Ch. 494, 506, 199 A.2d 548, 555 (1964)).

49. Use of the hackneyed incantation "good faith and reasonable investigation" perpetuates confusion. The court shifted the initial burden onto the directors for the very reason that it doubted their ability to prove their own good faith. *Cf.* Comment, Unocal Corp., *supra* note 32, at 867 ("[T]he court's formulation of the reasonable perception standard reintroduces the business judgment rule into the test of whether the business judgment rule should be applied at all."). This reading of *Unocal* is consistent with the usual application of the business judgment rule that presumes loyalty and scrutinizes the directors' decisionmaking process to ensure due care. *See* R. GILSON, *supra* note 11, at 112 ("Directors who do not satisfy a business judgment review violate their duty of *care,* not their duty of *loyalty.*") (emphasis in original); *see also* Wander & LeCoque, *supra* note 1, at 38-41. To understand the degree of diligence required by the duty of care, see Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

50. *See* Coffee, *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis,* 52 GEO. WASH. L. REV. 789 (1984); Note, *The Business Judgment Rule, Due Care and Experts: How Much Information is Enough?,* 7 J.L. & COM. 225 (1987); Note, *Investment Bankers' Fairness Opinions in Corporate Control Transactions,* 96 YALE L.J. 119 (1986).

a surrogate for proof of good faith.[51] In addition, the court in *Unocal* emphasized that a showing of good faith and reasonable investigation is strengthened where the decision to oppose a tender offer has been made by a committee of outside, independent directors.[52] The independence of the corporate decisionmakers — that is, the extent to which the members of the board who voted to resist the takeover are disassociated from management — is one objective item of evidence directly relevant to whether the primary purpose behind the defensive tactic was entrenchment. In sum, a reasonably cautious board that is aware of its obligations under the duty of care will have little difficulty satisfying this threshold, procedural inquiry. The first prong is simply meant to identify some rational business purpose behind the board's actions sufficient to overcome the suspicion of self-dealing.[53] This inquiry is borrowed from older Delaware cases,[54] which required target directors to show reasonable investigation where an inference of self-interest existed.[55]

The real innovation in the *Unocal* decision was the addition of the second prong, under which the target board must show that its defensive measures are reasonable in relation to the perceived threat posed by the takeover.[56] The concern behind the reasonableness requirement is that directors acting in the heat of a takeover battle may abuse the discretion accorded them under the business judgment rule.[57] This prong of the *Unocal* test "entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise."[58] Takeovers present a variety of potential dangers that may threaten a

---

51. *Cf.* Siegel, *Tender Offer Defensive Tactics: A Proposal for Reform,* 36 HASTINGS L.J. 377, 391 (1985) ("In determining whether management acted for a corporate, rather than a personal, benefit, . . . the court in *Cheff* considered facts that were more probative of whether management exercised due care.") (discussing Cheff v. Mathes, 41 Del. Ch. 494, 505-06, 199 A.2d 548, 554-55 (Del. 1964)).

52. 493 A.2d at 955; *see also* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1343 (Del. 1987) ("with the independent directors in the majority, proof that the board acted in good faith and upon reasonable investigation is materially enhanced"); Polk v. Good, 507 A.2d 531, 537 (Del. 1986); Moran v. Household Intl., Inc., 500 A.2d 1346, 1350 (Del. 1985). *But see* Dynamics Corp. of Am. v. CTS Corp. (CTS I), 794 F.2d 250, 256 (7th Cir. 1986), *revd. on other grounds,* 107 S. Ct. 1637 (1987):

> When managers are busy erecting obstacles to the taking over of the corporation by an investor who is likely to fire them if the takeover attempt succeeds, they have a clear conflict of interest, and it is not cured by vesting the power of decision in a board of directors in which insiders are a minority.

53. *See* AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 112 (Del. Ch. 1986).

54. *See, e.g.,* Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964); Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405 (1962).

55. *See* note 51 *supra.*

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

57. *See* 493 A.2d at 955 ("A corporation does not have unbridled discretion to defeat any perceived threat by any Draconian means available.").

58. 493 A.2d at 955.

target's corporate enterprise.[59] The court provided several examples of possible factors a board may consider in addition to basic shareholder wealth interests: "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders . . . , the risk of nonconsummation, and the quality of securities being offered in the exchange."[60] A defensive transaction must be a reasonably balanced response to such an identifiable threat.[61] In addition, *Revlon, Inc. v. MacAndrews & Forbes Holdings*[62] clarified the reasonableness prong by highlighting the restriction that takeover defenses must be rationally related to shareholder benefit.[63]

The second prong of the *Unocal* test appears more substantive than the threshold duty of care inquiry.[64] The reasonableness prong allows a court to strike down defensive tactics where the potential harmful effects of the tactics outweigh the threat identified by the board.[65] A board may not approve, for example, transactions that are themselves

---

59. These dangers may be associated with, for example, a grossly inadequate price, a coercive or two-tiered offer, an offer supported by questionable or low-grade financing, a bust-up or bootstrap acquisition, the extortion of greenmail, the simple disruption of long-term corporate planning, or other more general social and economic ill effects. *See* SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, TENDER OFFER DISCLOSURE AND FAIRNESS ACT OF 1987, S. REP. No. 265, 100th Cong., 1st Sess. 8-18, 70-80, *reprinted in* Fed. Sec. L. Rep. (CCH) No. 1268, pt. 2 (Jan. 13, 1988); Scherer, *Takeovers: Present and Future Dangers,* BROOKINGS REV., Winter-Spring 1986, at 15; Lipton, *Takeover Abuses Mortgage the Future,* Wall St. J., Apr. 5, 1985, at 16, col. 4. *See also* Coffee, *supra* note 41, at 40-73; Lipton, *Takeover Bids in the Target's Boardroom: An Update After One Year,* 36 BUS. LAW. 1017, 1024 n.30 (1981) [hereinafter Lipton, *Takeover Bids Update*]. On the dangers associated in particular with greenmail, see Comment, *Greenmail: Can the Abuses Be Stopped?,* 80 NW. U. L. REV. 1271 (1986); Note, *Greenmail: Targeted Stock Repurchases and the Management-Entrenchment Hypothesis,* 98 HARV. L. REV. 1045 (1985).

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

61. In *Unocal,* the target company's directors approved a discriminatory self-tender offer in response to a two-tiered tender offer from T. Boone Pickens's Mesa Petroleum. The Unocal board had concluded after reasonable investigation that Mesa's offer would coerce shareholders caught in the back-end of the tender offer to accept debt securities worth less than the cash received by first-tier offerees. The court upheld as a reasonable response to this threat a self-tender offer that was open to all shareholders except Mesa. 493 A.2d at 956-57.

62. 506 A.2d 173 (Del. 1986).

63. 506 A.2d at 182. This restriction does not undercut the board's ability under *Unocal* to resist unsolicited acquisition offers in favor of corporate independence. The board in responding to a prospective takeover may reasonably determine that a policy of independence will confer benefit on shareholders in the long term. *See* notes 38-42 *supra* and accompanying text.

64. *Cf.* R. GILSON, *supra* note 11, at 112-16 (*Unocal*'s second-step "proportionality test" may be applied more rigorously than the "largely rhetorical" primary purpose first step.) (discussing AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986)); Oesterle, *The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court,* 72 CORNELL L. REV. 117, 118 (1986) (the reasonableness requirement "overwhelms" the first prong of the *Unocal* test and "[i]n effect, this new test . . . becomes the sole and complete standard, and the court should recognize it as such").

65. Some courts will weigh the claimed benefits of a takeover defense against the impact of the defense on the prospective acquirer and the financial burden it will impose on the target. *E.g.,* Dynamics Corp. of Am. v. CTS Corp. (CTS II), 638 F. Supp. 802, 806 (N.D. Ill.), *affd in part, vacated in part, and remanded,* 805 F.2d 705 (7th Cir. 1986).

coercive for shareholders,[66] that block any and all potential tender offers,[67] or that usurp for the board all control over the company's destiny.[68] While this balancing test appears to involve the potential for a more searching analysis, Delaware courts, in practice, show great deference toward a target board's reasonable determination that an offer poses a threat to the corporate enterprise.[69] Whether the directors' perception of a threat is reasonable often turns on the coercive nature of the offer or the likelihood that it is motivated by a desire for greenmail profits.[70] Where the offeror is a well-known corporate raider who, in the past, has used coercive tactics to extract big payoffs from vulnerable targets, the courts are likely to agree with the board's assessment that a threat exists, and will uphold almost any response-phase defense.[71] Moreover, Delaware courts usually will strike down a defensive device that is aimed at thwarting a *noncoercive* offer only when the defense is itself grossly abusive of the shareholders' welfare or their ability to make choices about fundamental corporate change.[72]

In a recent opinion, *Ivanhoe Partners v. Newmont Mining Corp.*,[73] the Delaware Supreme Court indicated that the second prong of the *Unocal* test may simply be a specific application of the first prong to the particular defensive tactics employed by the target board. The court stated that the directors' *entire* burden of proof under *Unocal* is satisfied by a single showing: that they exercised good faith and reasonable investigation in analyzing the nature of the takeover bid and its effect on the corporate enterprise.[74] In *Newmont Mining,* the court

66. *See* AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 113-14 (Del. Ch. 1986).

67. *See, e.g.,* Amalgamated Sugar Co. v. NL Indus., 644 F. Supp. 1229, 1234-39 (S.D.N.Y. 1986); Dynamics Corp. of Am. v. CTS Corp. (CTS I), 794 F.2d 250, 259 (CTS rights plan "effectively precludes a hostile takeover, and thus allows management to take the shareholders hostage"), *revd. on other grounds,* 107 S. Ct. 1637 (1987); *see also* Wander & LeCoque, *supra* note 1, at 47; *cf.* Moran v. Household Intl., Inc., 500 A.2d 1346, 1353-55 (Del. 1985) (upholding a defensive purchase rights plan as not blocking all tender offers).

68. *See, e.g.,* Norlin Corp. v. Rooney, Pace, Inc., 744 F.2d 255, 258 (2d Cir. 1984).

69. *Cf., e.g.,* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1342-44 (Del. 1987); Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 180-81 (Del. 1986); Moran v. Household Intl., Inc., 500 A.2d 1346, 1356-57 (Del. 1985).

70. *See* Oesterle, *supra* note 64, at 148.

71. *See, e.g., Newmont Mining,* 535 A.2d at 1342:

> Newmont . . . specifically recognized that Mr. Pickens, who controls Ivanhoe, had been involved in several attempts to acquire and break-up other corporations, resulting in the payment of "greenmail" or severe restructuring of the target companies. The series of Ivanhoe maneuvers . . . were all viewed by the defendants as classic elements of Mr. Pickens' typical *modus operandi.* Thus, the Newmont board could properly conclude that the Ivanhoe tender offer was not in the shareholders' best interests or those of their company.

(citations omitted).

72. *Cf., e.g.,* AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986) (directors could not undertake a coercive self-tender offer in response to a hostile offer that was neither inadequate nor coercive).

73. 535 A.2d 1334 (Del. 1987).

74. 535 A.2d at 1341:

found that the board had reason to conclude that a partial tender offer from T. Boone Pickens posed a threat to Newmont and its shareholders. To avoid this threat, the board had embarked on a strategy involving a standstill agreement and a defensive "street sweep."[75] The court upheld these actions under the reasonableness prong of the *Unocal* test by finding that they were essential elements in the board's plan to prevent Newmont's takeover.[76] *Newmont Mining* therefore establishes that business judgment rule protection under the *Unocal* test will primarily depend upon the target board's reasonable perception of a threat to corporate policy and effectiveness. Where such a threat is shown, defensive tactics will be upheld if they are reasonably necessary to defeat the threatened takeover.

B. *Judicial Review of the Corporate Auction*

Once an auction has begun,[77] the target board's responsibilities alter significantly and its discretion is substantially curtailed. When reviewing director conduct in the auction phase of a takeover, courts must first consider the *Revlon* holding. Under the *Revlon* decision, when sale or breakup of the target becomes "inevitable," the directors may no longer concern themselves with defending corporate policy and effectiveness but must put all efforts into selling the company to the highest bidder.[78] At this stage, the board becomes an "auctioneer" charged with supervising an orderly and profitable disposition of the shareholders' property.[79] The *Revlon* decision also directs a court to ensure that a board involved in an auction deals fairly and equally with competing bidders. The board may not play favorites by denying one bidder negotiating advantages accorded to another.[80] The require-

---

> This Court has addressed [the] potential for conflict by placing upon the directors the burden of proving that they have not acted solely or primarily out of a desire to perpetuate themselves in office, that the threatened takeover posed a danger to corporate policy and effectiveness, and that the defensive measures adopted are reasonable in relation to the threat posed. The target directors must satisfy these prerequisites by showing good faith and reasonable investigation before enjoying the presumptions afforded by the business judgment rule. This requires directorial analysis of the nature of the takeover bid and its effect on the corporate enterprise.

(citations omitted).

75. Newmont entered into a standstill agreement with its largest shareholder, Gold Fields. Gold Fields agreed to limit its holdings in Newmont to 49.9% of Newmont's outstanding stock and its representation on the Newmont board to 40% of the directors. In return, Newmont distributed a $33 per share dividend which enabled Gold Fields to "sweep the street" for Newmont shares and obtain the ownership percentage allowed under its standstill agreement. 535 A.2d at 1340. As a result of this agreement, Newmont had created a "white squire" capable of blocking Pickens's takeover bid. For a definition of "white squire," see note 148 *infra.*

76. 535 A.2d at 1343-44.

77. For a discussion regarding when the auction phase commences, see note 8 *supra.*

78. Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1986); *see also* note 8 *supra.*

79. 506 A.2d at 182.

80. 506 A.2d at 184:

ment of fair dealing follows necessarily from the board's responsibility in supervising an orderly auction for the purpose of obtaining the best sale price for shareholders. The goal of the *Revlon* analysis is to allow the market to drive up the price paid for the target company free of directorial favoritism.[81] Accompanying this change in responsibilities is a corollary shift in the focus of directors' fiduciary duties. Directors in an auction owe their duties of care and loyalty exclusively to the shareholders because they are now acting as bargaining agents in negotiating a cash-out of the shareholders' equity interests. In the auction phase, therefore, directors breach their duty of loyalty when they favor any consideration other than short-term shareholder wealth maximization.[82]

While protecting the market for corporate control from all interests that may interfere with shareholders' wealth, the *Revlon* test continues to insist that "the board remain free to negotiate in the fulfillment of" its duties.[83] The court rejected the notion that a board should stand by passively while market forces control the auction. In the auction phase, just as in the response phase identified by the *Unocal* test, "[t]he directors' role remains an active one, changed only in the respect that they are charged with the duty of selling the company at the highest price attainable for the stockholders' benefit."[84] *Revlon* leaves to the target board the discretion to decide how best to maximize that benefit. In the auction phase, the business judgment rule will not shield actions of directors that go beyond this circumscribed discretion, even where the directors can show that their purpose was not to retain control. But the rule will protect the proper exercise of board discretion in the auction phase; it will protect from further judicial review many decisions about whether and how to generate a higher price for the company.[85] Without the business judgment rule, a board's ability to conduct an auction would be wholly at the discretion

---

> 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 make relatively similar offers, or dissolution of the company becomes inevitable, the directors cannot fulfill their enhanced *Unocal* duties by playing favorites with the contending factions.

The court here seems to indicate that the duty of fair dealing is triggered by receipt of two or more competitive offers or by a recognition that the company must be dissolved and its assets sold off. *Cf.* note 116 *infra.*

81. *See* 506 A.2d at 184 ("Market forces must be allowed to operate freely to bring the target's shareholders the best price available for their equity.").

82. *See* 506 A.2d at 182 (by favoring noteholders, "the directors breached their primary duty of loyalty"). It should be noted that commentators have had difficulty identifying whether *Revlon* was decided on the basis of the duty of loyalty or the duty of care. *See, e.g.,* R. GILSON, *supra* note 11, at 112 n.11; Comment, *supra* note 13, at 549-50.

83. 506 A.2d at 184.

84. 506 A.2d at 184 n.16; *see also* note 34 *supra.*

85. *See* Wander & LeCoque, *supra* note 1, at 37: "[*Revlon*] indicates that, in effect, the business judgment rule will only be applied to board decisions on how to maximize the price of the shares once an auction has begun."

of a reviewing court. The board could not play an independent, active role in seeking out competitive bids.[86]

In *Revlon,* the court reviewed decisions made by Revlon's board during the corporate auction to determine whether these decisions qualified for business judgment rule protection.[87] Ultimately, the court concluded that the directors had violated their auction-phase duties by cutting short an active auction out of concern for noteholders and withheld the protection of the rule.[88] The Revlon board abruptly ended competitive bidding between a white knight, Forstmann Little & Co., and Pantry Pride, a hostile bidder, by approving an acquisition proposal from Forstmann. The Forstmann proposal included a lock-up option, a no-shop provision (giving Forstmann exclusive negotiating privileges), and a cancellation fee.[89] The board approved the proposal primarily because it contained a promise by Forstmann to support the value of notes issued by Revlon in a previous defensive exchange offer.[90] The company's shareholders gained little if anything from the Forstmann proposal, since Forstmann's offer was only marginally higher than Pantry Pride's last bid and acceptance of the proposal meant a premature end to a lively auction.[91]

In reviewing the board's decision to approve the Forstmann proposal, the *Revlon* court relied on the *Unocal* two-prong test.[92] The court held that the directors failed to satisfy either prong of the *Unocal* test. Because they had favored noteholders over shareholders, the directors could not make the good faith showing required by the first prong.[93]

---

86. *See* Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension,* 35 STAN. L. REV. 23 (1982) [hereinafter Bebchuk, *Reply and Extension*]; Bebchuk, *Tender Offers, supra* note 18; Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel,* 55 N.Y.U. L. REV. 1231 (1980). *But see* Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers,* 35 STAN. L. REV. 1 (1982); Easterbrook & Fischel, *supra* note 27.

87. *See Revlon,* 506 A.2d at 180-82.

88. *See* 506 A.2d at 182.

89. 506 A.2d at 178-79; *see also* note 8 *supra.*

90. To deter an initial cash tender offer by Pantry Pride, Revlon had undertaken its own self-tender offer in which it had bought back over a quarter of its outstanding common stock in exchange for debt securities. 506 A.2d at 177. Under the terms of these newly issued notes, Revlon's merger with Forstmann would constitute a waiver of the notes' protective covenants. As a result of the public announcement of the intended merger, the trading value of the notes dropped substantially, and irate noteholders threatened to sue Revlon's directors. 506 A.2d at 178-79, 183-84. The directors hoped to escape possible liability by arranging a merger agreement with Forstmann that contained a promise by Forstmann to guarantee the value of the notes.

91. The merger agreement with Forstmann abruptly ended a bidding war that promised even higher returns for shareholders. 506 A.2d at 184. Pantry Pride's CEO Ronald Perelman had made clear his intention to better any offer made by Forstmann. 506 A.2d at 178. Yet Revlon accepted Forstmann's last offer without giving Pantry Pride an opportunity to beat it.

92. 506 A.2d at 180.

93. *See* 506 A.2d at 182:

> The original threat posed by Pantry Pride — the break-up of the company — had become a reality which even the directors embraced. Selective dealing to fend off a hostile but determined bidder was no longer a proper objective. Instead, obtaining the highest price for the benefit of the stockholders should have been the central theme guiding director action.

Under the second prong, they could not show that their actions were reasonable in relation to a threat to the company, because the board itself had voted to break up Revlon (leaving nothing to defend), and the noteholders were already sufficiently protected from loss by their contractual agreements with the company.[94]

The *Unocal* test, however, is not an adequate standard for upholding the special duties of directors in a corporate auction, and application of the test in an auction setting only confuses the analysis. The *Unocal* test does not require maximizing shareholder value in the short term[95] or treating hostile bidders fairly.[96] Rather, the *Unocal* test balances the reasonableness of measures taken by a board in response to a takeover attempt against the threat posed by the takeover. This test is tailored to the *response* phase when a board in its discretion may pursue a policy of corporate independence through defensive measures. If the threat to the corporate enterprise is sufficiently great, the directors need not negotiate with the hostile bidder; they may keep the target independent by engaging in, among other things, discriminatory stock transactions, asset sales and reorganizations, or exclusive dealings with third parties.[97] The *Revlon* test, in contrast, rules out any consideration of a threat to corporate policy and effectiveness.[98] This shift in emphasis is triggered when the target board manifests an

---

> Thus, the Revlon board could not make the requisite showing of good faith by preferring the noteholders and ignoring its duty of loyalty to the shareholders. The rights of the former already were fixed by contract. The noteholders required no further protection, and when the Revlon board entered into an auction-ending lock-up agreement with Forstmann on the basis of impermissible considerations at the expense of the shareholders, the directors breached their primary duty of loyalty.

(citations omitted). In this regard, the court noted that the board did not include a majority of outside, independent directors. 506 A.2d at 176 n.3.

94. *See* 506 A.2d at 182-83.

95. *See* notes 38-39 *supra* and accompanying text.

96. The court in *Unocal* held that a target board's duty of loyalty to a particular shareholder is superseded by the board's duty to protect the corporate enterprise where that shareholder is seeking to acquire the company by a takeover that threatens corporate policy or effectiveness. 493 A.2d at 958. If the board may discriminate against such a shareholder, it goes without saying that the board is not required by *Unocal* to deal fairly with a bidder that has not yet gained a stake in the company.

97. *Newmont Mining* illustrates the liberality of the *Unocal* test. Because Pickens's bid was reasonably perceived as coercive and inadequate, the Newmont directors were justified in maintaining the company's "independence" by entering into an exclusive deal with Gold Fields whereby Newmont kindly financed (by selling off undervalued assets) Gold Fields's acquisition of a near majority of Newmont shares. Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987). Newmont certainly did not deal fairly and equally as between Pickens and Gold Fields. But this unequal dealing was irrelevant under *Unocal*. The directors had identified a danger in the Pickens bid and reacted against that danger to protect the company's independence for the long-term benefit of its shareholders — no matter that the non-Gold Fields shareholders retained only a .1% margin of control. The Newmont board was not expected to negotiate with Pickens.

98. 506 A.2d at 182:

> The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the *Unocal* standards. It no

intention to sell or break up the company and takes some action in furtherance of that goal.[99]

The court denied the Revlon directors business judgment rule protection primarily because they did not fulfill their responsibilities in facilitating the auction process they had initiated.[100] From the beginning of the auction, they dealt preferentially with Forstmann to the exclusion of Pantry Pride. As the court found, "Forstmann was given every negotiating advantage that Pantry Pride had been denied: cooperation from management, access to financial data, and the exclusive opportunity to present merger proposals directly to the board of directors."[101] Finally, the board's lock-up agreement with Forstmann terminated the auction, stifling Pantry Pride's ability to make a higher offer. The *Revlon* analysis emphasizes the manner in which the board conducts the corporate auction, not the magnitude of the threat facing the targeted business. The board must act to stimulate and sustain competitive bidding, not foreclose it; and must deal fairly with competing bidders. In *Revlon,* this simple analysis was clouded by the fact that in addition to misconduct that violated their special auction-phase responsibilities, the Revlon directors breached their underlying duty of loyalty. They favored nonshareholder interests after sale of the company became inevitable (the point after which benefiting other corporate constituencies cannot rationally benefit the shareholders who are about to sell their stock), and they did so in order to protect themselves from litigation.[102] Moreover, the board's decisions were not made by a majority of outside, independent members.[103] In the end, it is accurate to conclude that the fact situation in *Revlon* did not provide a favorable occasion to refine a workable test for applying business judgment rule protection in an auction phase.[104]

---

longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot.

99. *See* note 116 *infra.*

100. In contrasting *Revlon* with *Unocal* and *Newmont Mining,* it is significant to note that the Revlon board, like the boards of Unocal Corp. and Newmont, was threatened with a hostile bid from a notorious corporate raider — in this case, Ronald Perelman. The difference in outcomes may betray a special antipathy in Delaware toward T. Boone Pickens, or it may underscore the irrelevance of the threat concept in the context of a *Revlon* auction.

101. 506 A.2d at 184; *see also* Wander & LeCoque, *supra* note 1, at 36-37.

102. *See* note 90 *supra.*

103. *See Revlon,* 506 A.2d at 176 n.3.

104. *Cf.* R. GILSON, *supra* note 11, at 112: "And we learn little more about the nature of the proportionality test from *Revlon.* There the court found that the Revlon directors violated their duty of loyalty in agreeing to the lock-up, thereby rendering the new two-step review irrelevant."

In a more recent case, Hecco Ventures v. Sea-Land Corp., Civ. No. 8486, slip op. (Del. Ch. May 19, 1986), *reprinted in,* 12 DEL. J. CORP. L. 282 (1987), the chancery court of Delaware did confer business judgment rule protection on a target board's conduct of a corporate auction. The *Sea-Land* court refused to issue a temporary restraining order against directors who satisfied their auction-phase duties by supervising the ultimate sale of the company through a competitive bidding contest without discriminating among bidders. This case demonstrates the importance of preserving the business judgment rule in judicial review of a corporate auction. However, the

C. *Target Resistance in the Auction Phase*

May a board that has announced its intention to sell the company continue to resist a bidder in order to solicit additional competitive offers? In a *Revlon* auction, where two or more potential acquirers are bidding head-to-head for the company, the requirement of fair dealing may preclude using devices that discourage one of the bidders from pursuing the merger. The lock-up option and cancellation fee approved by the Revlon board are examples of devices that may be unfair during an active auction.[105] But a defensive measure might be employed properly during an auction where, for example, a potential acquirer attempts to circumvent the auction process by making a tender offer directly to shareholders. Rational shareholders will tender their shares when the price offered includes a control premium, so that tender offers may be inherently coercive.[106] A tender offer could undermine the board's ability to negotiate an auction that might result in a deal more favorable to shareholders. *Revlon* imposes on directors the responsibility of auctioning the company for the highest price attainable and, at the same time, allows them the discretion to fulfill this responsibility. Such discretion logically includes the power to stimulate a more competitive auction. Under certain circumstances, it may also include the authority to resist a tender offer in order to spur the offeror back into the auction process and sustain the "level playing field"[107] among participating bidders.[108]

In *CRTF Corp. v. Federated Department Stores,*[109] for example, a

---

Sea-Land court, deciding under expedited conditions only the narrow issue of whether a temporary restraining order was justified, made no attempt to craft a new business judgment rule standard of review.

105. Both the lockup option and cancellation fee contained in the Forstmann proposal were designed to be triggered upon another party's acquiring a fixed percentage of Revlon. The lockup option gave Forstmann the right to purchase two Revlon divisions at a price substantially below estimated value if another acquirer got 40% of Revlon's stock. *Revlon,* 506 A.2d at 178. Forstmann was to receive the $25 million cancellation fee in the event the deal fell through or another acquirer amassed a greater than 19.9% stake in the company. 506 A.2d at 178. These devices were part of "the overall plan to thwart Pantry Pride's efforts." 506 A.2d at 184. Like a poison pill, the lockup option and cancellation fee were effective means of preventing Pantry Pride from making a tender offer before the merger with Forstmann could be consummated. Pantry Pride had little choice but to challenge their validity in court.

106. *See* Lipton, *supra* note 38, at 113-15; *see also* Booth, *The Promise of State Takeover Statutes,* 86 MICH. L. REV. 1635, 1646-47 (1988) (arguing that tender offers, even all cash offers for any and all shares, are always coercive because individual shareholders lack sufficient information or bargaining power to resist tendering).

107. THE BUSINESS JUDGMENT RULE, *supra* note 20, at 85.

108. *See* CRTF Corp. v. Federated Dept. Stores, 683 F. Supp. 422, 439-42 (S.D.N.Y. 1988) (upholding validity of a poison pill used to defeat a coercive tender offer for the purpose of further promoting an ongoing auction); *see also* Oesterle, *supra* note 64, at 150 ("When more than one bidder is involved, the negotiation model suggests that the target may temporarily block one bidder to encourage others or may neutralize the advantage that a partial tender offer has over an any-or-all offer.") (footnote omitted).

109. 683 F. Supp. 422 (S.D.N.Y. 1988).

federal district court upheld a poison pill defense employed in the midst of a bidding contest. The court relied on *Revlon*'s affirmation of an active role for directors in the auction phase, and held that a rule requiring the target to let down all defenses once an auction begins would be inconsistent with that active role.[110] Federated's poison pill allowed the directors to spur on the bidding, driving up the price offered by the rival bidders, Robert Campeau and R.H. Macy & Co. The pill prevented Campeau from subverting the auction through the use of a preemptive tender offer. As the court put it, use of the pill "provide[d] the directors with a shield to fend off coercive offers, and with a gavel to run an auction."[111]

Where the board has decided to sell the company under pressure from a *single* persistent offeror, the board might resist an immediate takeover in order to solicit other offers which could generate a competitive auction. It makes sense that a court would allow the board even wider discretion where there is only one bidder, since the board's actions may increase the competitive alternatives for shareholders and would not run the risk of chilling an already active bidding contest.[112] But in *Dynamics Corp. of America v. CTS Corp. (CTS II)*,[113] the Seventh Circuit, construing Delaware law, questioned a board's authority under *Revlon* to resist a takeover with any defensive measure like a poison pill once the board has decided to sell the company.[114] Writing for the panel, Judge Posner demanded extensive proof regarding the fairness to shareholders of a rights plan that enabled the CTS board to block acquisition bids below a fixed price.[115] The standard of review

110. 683 F. Supp. at 441.

111. 683 F. Supp. at 439. Not surprisingly, the court in *Federated Dept. Stores* looked to *Unocal* to support its conclusion that the directors were justified in fearing the coercive threat of a tender offer from Campeau. *See* 683 F. Supp. at 439-40. But this "threat" was not a threat in the *Unocal* sense — a threat to corporate policy or effectiveness. Rather, a tender offer by Campeau would be an impairment to the directors' ability to conduct the auction in fulfillment of their *Revlon* duties.

112. *Cf.* GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016, 1018 (S.D.N.Y. 1985) (target's offer to exchange debt instruments for 35% of its own shares "was an alternative available for the stockholders' consideration" which "was not intended to and does not discriminate against bidders for control").

113. 805 F.2d 705 (7th Cir. 1986).

114. *See* 805 F.2d at 716-17. Poison pills, or shareholder rights plans, are devices "by which shareholders receive the right to be bought out by the corporation at a substantial premium on the occurrence of a stated triggering event." *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 180 (Del. 1986) (citing Moran v. Household Intl., Inc., 500 A.2d 1346 (Del. 1985)). Directors of Delaware corporations are permitted to adopt rights plans under statutory provisions broadly authorizing transactions in the corporation's stock. *Moran*, 500 A.2d at 1351; *see also* DEL. CODE ANN. tit. 8, §§ tr. 122(13), 141 (1983). Poison pills are an effective and widely used deterrent to an unwanted takeover. For a detailed description of the various species of pill, see SEC Office of the Chief Economist, *A Study on the Economics of Poison Pills*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,971 (Mar. 5, 1986). *See also* Helman & Junewicz, *Fresh Look at Poison Pills*, 42 BUS. LAW. 771 (1987); Fleisher & Golden, *Poison Pill*, Natl. L.J., Feb. 24, 1986, at 17, col. 2; Note, *supra* note 30.

115. The rights plan approved by the CTS board was a "back-end" or equity "flip-in" pill.

in *CTS II* seems to entail a significantly greater scrutiny than *Revlon* requires, suggesting that some courts may deny the protections of the business judgment rule altogether whenever a target company employs defenses after a takeover has entered the auction phase.[116]

The CTS rights plan was designed to insure an orderly auction of the company.[117] The plan was adopted in light of Dynamics Corp.'s acquisition, by tender offer, of a substantial stake in CTS.[118] A special

See Dynamics Corp. of Am. v. CTS Corp. (CTS II), 635 F. Supp. 1174, 1176-77 (N.D. Ill.), *supplemented on reh.*, 638 F. Supp. 802 (N.D. Ill.), *affd. in part, vacated in part, and remanded,* 805 F.2d 705 (7th Cir. 1986). Under the plan, rights were distributed to stockholders that, when triggered, would enable them to exchange each share of their stock for a $50 debenture, payable in one year at 10% interest. The rights would be triggered upon the acquisition by any shareholder of 28% of CTS's outstanding stock, and would not be distributed to the triggering shareholder. At the time the plan was approved, Dynamics held 27.5% of CTS after completing a tender offer at $43 per share. The rights were good for one year and could be cancelled at any time by the board or automatically if anyone made a cash tender offer of $50 or more for all outstanding shares. *CTS II,* 805 F.2d at 707. Generally, flip-in pills have been upheld when "employed in the midst of a battle for control to place a specific value on the company in the face of an ongoing, inadequate offer." *Phillips Shareholders Settle for New Pill and Bylaw but No Cash,* Corporate Control Alert, Aug. 1986, at 1; *see also* Fraidin & Golden, *The Value Assurance Plan: A Pill Without Any Poison,* N.Y.L.J., Aug. 11, 1986, at 35, col. 4. *But see* Edelman v. Phillips Petroleum Co., No. 7899, slip op. at 14-15 (Del. Ch. June 3, 1986) (noting "serious legal challenges" to a notes rights plan); Minstar Acquiring Corp. v. AMF, Inc., 621 F. Supp. 1252, 1259, 1260 n.6 (S.D.N.Y. 1985) (rights plan "questionable" and "troublesome" as possible breach of fiduciary duty). For recent, informative commentary on these rights plans, see Clemens, *Poison Debt: The New Takeover Defense,* 42 BUS. LAW. 747 (1987).

116. There is a significant question, however, as to whether the attempted takeover of CTS had even entered an auction phase. In *Revlon,* unlike *CTS II,* the court's finding that sale of the company was inevitable was conclusively supported by the board's willingness to break up Revlon and grant lockup options on its various divisions. *See Revlon,* 506 A.2d at 178-79, 182. In *CTS II,* it should be noted, the district court, which initially approved the CTS flip-in plan, did not find that the plan had been adopted in an auction phase:

> *Revlon* is also distinguishable in that the rights plan in that case instigated a bidding war and caused the unfriendly bidder to raise its price; CTS is still without a buyer. In this case, however, there was no active bid to acquire 100% of the company at the time the plan was adopted, and the comparison is therefore somewhat tenuous.

CTS II, 638 F. Supp. 802, 807 (N.D. Ill.), *affd. in part, vacated in part, and remanded,* 805 F.2d 705 (7th Cir. 1986).

Assuming the *CTS II* takeover had not entered the auction phase, under Delaware law the CTS board would only have had to satisfy the response-phase *Unocal* test to get the benefit of the business judgment rule. *Cf. Revlon,* 506 A.2d at 180-81 (rights plan similar to the CTS pill, adopted in good faith and upon reasonable investigation before the auction phase, held valid as it "afforded a measure of protection consistent with the directors' fiduciary duty in facing a takeover threat perceived as detrimental to corporate interests"). The court in *CTS II* found that an auction phase had commenced when the directors of CTS decided to sell the company. *See CTS II,* 805 F.2d at 716-17 ("Although the . . . poison pill in this case is said to be modeled on the one upheld in *[Revlon],* and indeed bears a family resemblance to it, Revlon had adopted its poison pill before the directors decided to sell the company. . . . The . . . poison pill in the present case came *after* CTS's board decided to sell the company.") (citations omitted) (emphasis in original). It was also significant that the CTS directors had announced to shareholders their intention to auction off the company in connection with their own reelection to the board and had represented that the rights plan was part of their strategy to maximize the sale price. *See* 805 F.2d at 707.

117. *See CTS II,* 638 F. Supp. at 805.

118. Dynamics Corp. was able to complete its tender offer following the court's earlier opinion, Dynamics Corp. of Am. v. CTS Corp. (CTS I), 637 F. Supp. 406 (N.D. Ill.), *affd.,* 794 F.2d 250 (7th Cir. 1986), *revd. on other grounds,* 107 S. Ct. 1637 (1987), enjoining CTS's initial poison

committee of outside directors had determined that the best way to maximize the value of stock held by the remaining shareholders was through a sale of the entire company by auction, and that Dynamics was in a position to thwart such a sale.[119] The committee recommended the rights plan as a means of keeping Dynamics at bay while management sought white-knight bidders to generate a competitive auction.[120] The district court denied a preliminary injunction requested by Dynamics, holding that the board's decision to sell CTS and its adoption of the plan were entitled to the protections of the business judgment rule under the *Unocal* test. The court held that the board showed good faith and reasonable investigation in its decision-making process. This showing was supported by the appointment of a special committee that had carefully and thoroughly investigated shareholder wealth interests, including the ability of Dynamics to block future bids. The court was further impressed by the committee's solicitation of advice from investment bankers Smith Barney.[121] The court also found that the valuation of the company for purposes of the exercise price in the rights plan reasonably represented the high end of value over the next year.[122] With respect to the second prong of the *Unocal* test, the court held that the board's actions were reasonable responses to the threat posed by Dynamics. The rights plan did not insulate management from all hostile offers, and it satisfied the board's responsibility to maximize value for shareholders because it was aimed at facilitating an orderly auction.[123] Dynamics was unable to rebut the board's evidence by showing that the rights plan was adopted for the self-interest of the directors. The court found that the directors were committed to a sale of CTS, which included the prospect that they could eventually be replaced by a new board.[124]

These conclusions did not satisfy the Seventh Circuit. Judge Pos-

---

pill. *See CTS II,* 805 F.2d at 707. Dynamics did not express an intention of taking over CTS, *see CTS II,* 638 F. Supp. at 806, but did wage a proxy contest for control of the CTS board. *CTS II,* 635 F. Supp. at 1176. In connection with the proxy vote, both the incumbent board and Dynamics announced an intention to sell the company if elected. 638 F. Supp. at 805-06.

119. *CTS II,* 635 F. Supp. at 1177. The committee of outside directors determined that Dynamics could thwart the company's efforts to maximize value in an auction either by acquiring more stock, thereby gaining a blocking position that could deter any potential bidders, or by engaging in a second-step tender offer at less than fair value. *See* 635 F. Supp. at 1177.

120. *See* 635 F. Supp. at 1177.

121. *See* 635 F. Supp. at 1178-80. The court found that the advice provided by the bankers was conjectural but reasonable and supported by second opinions, and, therefore, the court refused to second-guess it. 635 F. Supp. at 1179.

122. 635 F. Supp. at 1179.

123. 635 F. Supp. at 1180. In addition, the court found that the potential for a large amount of issued debt under the rights plan was reasonable given the low probability the rights would be triggered and the company's ability to restructure existing debt to mitigate the effects. 635 F. Supp. at 1180-81.

124. 635 F. Supp. at 1181. The court also refused to equate the board's hostility toward Dynamics with a purpose of entrenchment. 635 F. Supp. at 1181.

ner remanded the case for a thorough analysis of "the relationship between the terms of the . . . poison pill and the welfare of CTS's shareholders."[125] Specifically, the court required a detailed explanation of the basis for Smith Barney's opinion that an acquisition of less than fifty percent of CTS stock could properly trigger the pill,[126] and a complete review of the methodology employed by Smith Barney in computing the valuation of the company.[127] The inquiry suggested by

---

125. 805 F.2d at 712.

126. *See* 805 F.2d at 712-13. Judge Posner demanded evidence explaining how an ownership of less than 50% of the company could constitute a blocking position in light of the fact that under Indiana law CTS could consummate a merger with the support of a simple majority of the shares. He rejected the unexplained conclusions of CTS's investment banker Smith Barney, requiring instead evidentiary justification for setting the rights plan trigger at the particular acquisition percentage chosen. This skepticism regarding the economic justification for a less-than-majority-ownership trigger percentage echoes Judge Posner's opinion striking down a prior rights plan adopted by CTS. *See* Dynamics Corp. of Am. v. CTS Corp. (CTS I), 794 F.2d at 259 ("If the rationale is to protect minority shareholders, [the rights plan] should be triggered by a transaction that creates a majority shareholder or that attempts to squeeze out the minority shareholders . . . ."), *revd. on other grounds,* 107 S. Ct. 1637 (1987).

127. *See CTS II,* 805 F.2d at 713-15. Judge Posner noted that a rights plan that discourages tender offers at less than a fixed price is not unlawful if it represents a reasonable, good faith effort to sell the company at the highest possible price. But in that regard,

> [t]he trigger price . . . is highly relevant to the issues of reasonableness and good faith, since if set too high it will prevent all tender offers, not just those that are below the corporation's sale value. Since the entire premise of the . . . poison pill was that it was designed to facilitate the sale of the company, the pill cannot be upheld if the trigger price is an unreasonably high sale price.

805 F.2d at 714. In this case, Judge Posner was unwilling to say that the district court was clearly erroneous in finding that the $50 trigger price in the CTS rights plan represented a reasonable and good-faith valuation of the company. However, he found "troublesome" the price-earnings ratio and the earnings projection utilized by Smith Barney to arrive at a range of value for CTS. The price-earnings ratio chosen was based on a comparison with other similar manufacturing companies; apparently no account was taken of CTS's peculiar situation as a struggling company with a history of exaggerated earnings forecasts that might lead the market to expect a lower ratio. 805 F.2d at 714. The $3.23 per share earnings projection used by Smith Barney was extravagant in light of the company's recent earnings, was arguably inconsistent with earlier estimations by Smith Barney of the likelihood of selling CTS at certain prices below $50 per share, and was not *particularly* verified by a second investment banker (although Merrill Lynch had "advised the [CTS] board of directors that Smith Barney's methodology in valuing the company was sound"). 805 F.2d at 714-15.

These methodological flaws, in combination with concerns over the trigger percentage in the CTS rights plan, *see* note 126 *supra,* and CTS's history of dogged resistance of Dynamics (exemplified by CTS's first attempt to adopt a poison pill without reasonable deliberation, *see CTS I*) led Judge Posner to suspect that the rights plan was an entrenchment device, notwithstanding the district court's finding to the contrary. He therefore remanded for further, more searching examination into the reasonableness of the plan's trigger percentage and trigger price. 805 F.2d at 715-16.

In addition, Judge Posner expressed concern over CTS's method of compensating Smith Barney, which might have included (the record was unclear) a bonus upon sale to a white knight. 805 F.2d at 710-11. But this concern alone would not have warranted remand without the court's more substantial doubts regarding the terms of the rights plan. 805 F.2d at 711-12. Also, the court was skeptical about the independence of the board's special committee of outside directors. But there was ample evidence of reasonable investigation by the special committee, and the court determined:

> [W]e are not minded to hold directors to a standard of procedural scrupulousness that would transform their role from that of businessmen to that of Article III judges. Furthermore, if directors can be sued both for selling their company too hastily (*Van Gorkom*), that

Judge Posner would probe deeper than the simple procedural review of board decisionmaking that characterizes the first prong of the *Unocal* business judgment rule. It would also go beyond the *Unocal* reasonableness prong, because under this test Delaware courts have upheld similar rights plans — even plans that are triggered at a lower percentage of stock acquisition.[128]

To justify greater scrutiny of the economic merits of the CTS pill, Judge Posner relied on *Revlon.* In the board's decision to sell CTS he identified the commencement of an auction phase, and held that the auction-phase responsibilities imposed on directors by *Revlon* call for stricter judicial review.[129] In contrast, the district court had accepted the CTS board's argument that its rights plan was an integral part of a strategy to stimulate a competitive auction in fulfillment of the *Revlon* duties. The detailed factfinding demanded by Judge Posner evidently required more. Rather than reviewing the directors' *conduct* in facilitating an auction for the maximum benefit of shareholders, Judge Posner wished to evaluate the substantive merits of the financial analysis supporting the CTS rights plan to determine whether the plan would actually result in shareholder wealth maximization. This difference represents a shift in the legal standard away from the business judgment rule as developed by the *Unocal* and *Revlon* courts[130] and toward the duty of loyalty analysis, which is used by courts where there is

---

> is, at too low a price, and for selling it too slowly (this case), that is, for setting too high a price, they are placed on a legal razor's edge.

805 F.2d at 711. Given the level of detailed scrutiny called for by Judge Posner, it could be argued that the court not only *was* creating a legal razor's edge for corporate directors but was at the same time transforming article III judges into businessmen (or, more precisely, investment bankers).

128. *See, e.g.,* Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173,180-81 (Del. 1986) (debt pill like that approved by CTS reasonable under *Unocal*); Moran v. Household Intl., Inc., 500 A.2d 1346 (Del. 1985) (flip-over poison pill triggered by 20% stock acquisition held reasonable under *Unocal* test); *see also CTS II,* 638 F. Supp. at 806-07 (to construct a majority acquisition requirement "as an inflexible rule for all rights plans would be inconsistent with Delaware law," so that the Seventh Circuit's discussion of a 51% acquisition trigger appeared to the court "illustrative rather than binding").

129. *See CTS II,* 805 F.2d at 716-17; note 116 *supra.*

130. Compare the following counter-prophetic remarks from the district court in response to the Seventh Circuit's (again Judge Posner's) opinion in *CTS I:*

> One discernible area in which the Seventh Circuit's interpretation of Delaware law potentially differs from mine concerns the degree of inquiry a court should entertain before determining that a board of directors has met its burden under *Household.* . . . Mindful that the Delaware Supreme Court's cases have in spirit been highly protective of defensive measures, this court concluded that the directors need only show that their decision was reasonable. To engraft a "less restrictive alternative" approach from constitutional law onto matters of corporate governance seemed to this court inappropriate and inconsistent with Delaware law because it would encourage too much judicial second-guessing of business decisions. The Seventh Circuit has not yet addressed this issue. While I see no indication in their opinion that they might disagree with me, and doubt that a more "searching" inquiry would have changed my result, the issue is at least an open one.
>
> For these reasons, the court concludes that the Seventh Circuit did not purport to change the legal standards.

CTS II, 638 F. Supp. at 807-08.

evidence of entrenchment, unfair dealing, or other bad faith.[131]

There is little or no objective evidence in *CTS II* from which to infer that the board acted for the purpose of entrenchment. Yet Judge Posner was highly skeptical of any other explanation for the board's actions. He suspected that the CTS directors breached their duty of loyalty by approving a bar against all acquisition bids that did not meet with their approval, that is, all bids that did not ensure their retention of control over the company.[132] On the basis of this suspicion alone, and on the theory that the legal standard of review may significantly change in the auction phase of a takeover contest, Judge Posner would apply the duty of loyalty analysis.

II. THE DUTY OF LOYALTY ANALYSIS

To some extent, the interests of management always conflict with the interests of shareholders.[133] That managers have great discretion to take risks with investors' capital goes to the heart of the theory of the corporate firm and provides a basis for business judgment rule protection of board decisionmaking.[134] But where particular directors are shown to have a private financial interest in a corporate transaction, the business judgment rule will not shield them or the transaction.[135] Instead, a shareholder can void a transaction where a director has a conflict of interest unless, as provided by safe-harbor statutes, the interested director disclosed the conflict before the transaction was approved or the court finds that the transaction was actually fair to the corporation when approved.[136] In the takeover context, managers face the imminent prospect of losing their jobs, and this fact exacerbates the natural conflict within the corporation between the managers

131. *See* Part II *infra*.

132. *See CTS II*, 805 F.2d at 715.

133. *See* Coffee, *supra* note 41, at 16-24; Williamson, *supra* note 41, at 1198-200; *cf.* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

134. *See* ABA Section of Corporation, Banking and Business Law, *Report of Committee on Corporate Laws: Changes in the Model Business Corporations Act*, 30 BUS. LAW. 501, 504 (1975) ("A director attempting to create profits for his corporation will frequently make decisions involving risk for the enterprise. No personal liability should be imposed upon him in the event his good faith decision, in the exercise of business judgment, later seems to have been erroneous.").

135. Courts make no business judgment presumptions in favor of directors who "appear on both sides of a transaction [or] expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see also* Sinclair Oil Corp v. Levien, 280 A.2d 717, 720 (Del. 1971); Cheff v. Mathes, 41 Del. Ch. 494, 504, 199 A.2d 548, 554 (1964); Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 298, 93 A.2d 107, 109-10 (1952); Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971).

136. *See* DEL. CODE ANN. tit. 8, § 144 (1983); REVISED MODEL BUSINESS CORP. ACT § 8.31 (1984). For an attempt at a standard codification of directors' obligations with respect to conflict-of-interest transactions, see the American Law Institute's *Principles of Corporate Governance*:

A director or senior executive who enters into a transaction with the corporation (other than

and shareholders.[137] Courts treat target directors who adopt defensive measures for purposes of entrenchment as if they have a pecuniary self-interest and require them, under the duty of loyalty analysis, to show the fairness in fact of the transactions approved.[138] This fairness standard applies when target directors cannot satisfy either the duty of care or reasonableness requirements under the *Unocal* test,[139] or where those challenging the defensive transaction can show director bad faith. It will also apply where directors fail to act in accordance with their *Revlon* auction-phase responsibilities.[140]

The duty of loyalty analysis stands in sharp contrast to the deferential review of the business judgment rule. It entails an inquiry into "all relevant factors" bearing on the actual, objective fairness of a transaction.[141] In evaluating the fairness of defensive measures, courts do not look to the subjective motivations behind management's actions but only to the actions themselves,[142] asking, for example, whether a board's valuation of the company in connection with a white-knight merger or for purposes of fixing the exercise price in a poison pill fairly represents the company's value in light of all relevant economic and financial considerations.[143] Such an exhaustive inquiry often allows the court to second-guess complex business decisions and requires an

---

a transaction involving the payment of compensation) fulfills his duty of loyalty to the corporation with respect to the transaction if:

(1) disclosure concerning the conflict of interest and the transaction is made to the corporate decisionmaker who authorizes or ratifies the transaction; and

(2)(A) the transaction is fair to the corporation when entered into; or

(B) the transaction is authorized, following such disclosure, by disinterested directors, and could reasonably be believed to be fair to the corporation at the time of such authorization; or

(C) the transaction is authorized or ratified, following such disclosure, by disinterested shareholders, and does not constitute a waste of corporate assets at the time of the shareholder action.

PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.02(a) (Tent. Draft No. 5, 1986) (cross-references omitted).

137. *See* Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 825 (1981); *see also* Dynamics Corp. of Am. v. CTS Corp. (CTS I), 794 F.2d 250, 256 (7th Cir. 1986), *revd. on other grounds*, 107 S. Ct. 1637 (1987); Northwest Indus. v. B.F. Goodrich Co., 301 F. Supp. 706, 712 (N.D. Ill. 1969).

138. *See, e.g.*, Norlin Corp. v. Rooney, Pace, Inc., 744 F.2d 255, 265-66 (2d Cir. 1984). Where a conflict of interest exists in the takeover context, directors must prove the fairness of their transactions under the statutory standards, since authorization by "disinterested" directors is not possible where all the directors stand to lose their jobs, and the extreme time constraints created by the takeover process make ratification by disinterested shareholders impracticable. *See* Siegel, *supra* note 51, at 395.

139. *See* AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 114 (Del. Ch. 1986); Comment, *supra* note 13, at 557-58.

140. *See* Comment, *supra* note 13, at 558-59.

141. Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983); THE BUSINESS JUDGMENT RULE, *supra* note 20, at 49-55.

142. *See AC Acquisitions*, 519 A.2d at 115.

143. *Cf. Weinberger*, 457 A.2d at 711-15 (detailing factors involved in determining fair dealing and appraising fair price in the context of a parent-subsidiary cashout merger).

extensive evidentiary hearing, perhaps even including expert testimony by market analysts. It is thus easy to see why courts generally grant a preliminary injunction of a target's defenses where the business judgment rule is held inapplicable and the standard of review is the duty of loyalty analysis.[144] For most takeover battles that end up in court, the choice of judicial standard of review is outcome determinative.[145]

A. *Manifest Conflicts of Interest*

In judicial review of takeover defensive tactics, there is a useful distinction between situations where a conflict of interest is manifest and those where a conflict is merely suspected. A manifest conflict of interest exists where there is sufficient objective evidence from which a court can infer entrenchment or other self-interest on the part of a target board or where the board cannot make the prima facie showings required by *Unocal* and *Revlon.*

Certain defensive transactions are so obviously "a brazen attempt"[146] at entrenchment that courts will deny business judgment rule protection without further inquiry into director good faith. *Norlin Corp. v. Rooney, Pace, Inc.,*[147] provides such an example. *Norlin* involved a white squire arrangement[148] by which the board of directors of Norlin transferred huge blocks of authorized but unissued voting stock to a foreign subsidiary and to a newly created employee

144. In a rapid-fire battle for corporate control, a disgruntled shareholder group (most often the prospective hostile acquirer) is usually quick to challenge target defensive tactics in court, seeking a preliminary injunction on the basis of a breach of fiduciary duty. The court's decision as to whether to enjoin the target's defenses is made on the basis of an evidentiary hearing following a short, frantic period of expedited discovery. *See, e.g.,* MacAndrews & Forbes Holdings v. Revlon, Inc., 501 A.2d 1239, 1242, 1246 (Del. Ch. 1985), *affd.,* 506 A.2d 173 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 953 & n.5 (Del. 1985); *see also* Wachtell, *Special Tender Offer Litigation Tactics,* 32 BUS. LAW. 1433, 1433 (1977) ("You are essentially compressing into a span of four, five or six days what would normally be months and months, if not years, of typical big case litigation . . . ."). To win a preliminary injunction, the plaintiffs must show a reasonable probability of success on the merits and irreparable harm if no injunction is issued, and must also show that their harm will outweigh the harm to the defendant if the injunctive relief is granted. Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341 (Del. 1987).

145. *See AC Acquisitions,* 519 A.2d at 111: "Because the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of derivative litigation." The preliminary injunction hearing is a critical juncture for target management because an injunction of the target's defenses usually tolls a swift and adverse end to the control contest. *See* Lipton, *supra* note 38, at 118 ("The target of an unsolicited tender offer must successfully litigate or be faced with a *fait accompli* . . . .").

146. Wander & LeCoque, *supra* note 1, at 51.

147. 744 F.2d 255 (2d Cir. 1984).

148. A white squire is an entity friendly to incumbent management but not interested in, or capable of, acquiring the company as a white knight. The white squire may be, among other things, an outside group or company, a subsidiary of the target, or the target's employee pension fund. Typically, a large amount of stock is issued to the white squire to ensure that control over the stock remains in friendly hands. *See* Wander & LeCoque, *supra* note 1, at 51; THE BUSINESS JUDGMENT RULE, *supra* note 20, at 91-93, 187-90.

stock ownership plan ("ESOP") controlled directly by the board.[149] As a result of these transactions, the board arrogated to itself control over forty-nine percent of Norlin's outstanding stock.[150] The Second Circuit held that the evidence "was more than adequate to constitute a prima facie showing of self-interest on the board's part,"[151] and that the white-squire arrangement constituted "a wholesale wresting of corporate power from the hands of the shareholders."[152] The circumstances surrounding creation of the ESOP made plain that it was nothing more than "a tool of management self-perpetuation."[153] This demonstration of self-dealing was sufficient to persuade the court to resort to the duty of loyalty analysis.[154] By virtue of this manifest breach of the duty of loyalty, the court quickly concluded that a preliminary injunction was appropriate to prevent Norlin's directors from voting the stock in their control.[155] Along with *Norlin,* some poison pill cases involve situations where courts have reacted with hostility when target management has overtly manipulated corporate structure by, for example, creating disproportionate voting rights within a single class of shareholders,[156] restricting the transferability of voting

---

149. 744 F.2d at 259.

150. 744 F.2d at 259.

151. 744 F.2d at 265.

152. 744 F.2d at 267. *Cf.* Podesta v. Calumet Indus., [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,433, at 93,560 (N.D. Ill. May 9, 1978) ("use of the issuance of shares to accomplish an improper purpose, such as to enable a particular person or group to maintain or obtain voting control, against the objection of shareholders from whom control is thereby wrested," constitutes breach of fiduciary duty) (quoting Yasik v. Wachtel, 25 Del. Ch. 247, 256, 17 A.2d 309, 313 (1941)).

153. 744 F.2d at 266. The court explained:

> [The ESOP] was created a mere five days after the district court refused to enjoin further stock purchases by Piezo, and at a time when Norlin's officers were clearly casting about for strategies to deter a challenge to their control. No real consideration was received from the ESOP for the shares. The three trustees appointed to oversee the ESOP were all members of Norlin's board, and voting control of all of the ESOP shares was retained by the directors. We therefore conclude that the record supports the finding that the transfer of stock to the ESOP was part of a management entrenchment effort.

744 F.2d at 266-67 (footnotes omitted); *cf.* Buckhorn, Inc. v. Ropak Corp., 656 F. Supp. 209, 231-32 (S.D. Ohio 1987), *affd.,* 815 F.2d 76 (6th Cir. 1987)(ESOP enjoined as entrenchment device where no showing of benefit to shareholders).

154. "Once self-dealing or bad faith is demonstrated, the duty of loyalty supersedes the duty of care, and the burden shifts to the directors to 'prove that the transaction was fair and reasonable to the corporation.' " 744 F.2d at 265 (quoting Treadway Cos. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980)).

155. *See* 744 F.2d at 269. Delaware has similarly enjoined use of an ESOP to dilute the voting power of a hostile majority shareholder. Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 408 (Del. 1985) (primary purpose of the funding of the ESOP was entrenchment and this "improper motive overrides the ordinary protection of the business judgment rule"). Not all courts have denied business judgment rule protection for boards that have engaged in defensive manipulation of ESOPs. *See* Danaher Corp. v. Chicago Pneumatic Tool Co., 633 F. Supp. 1066, 1070-71 (S.D.N.Y. 1986) (upholding ESOP manipulation where it occurred several months before takeover initiation).

156. *See, e.g.,* Minstar Acquiring Corp. v. AMF Inc., 621 F. Supp. 1252, 1259 (S.D.N.Y.

rights,[157] or effecting a discriminatory dilution of shareholders' equity.[158]

Some takeover cases involving substantial evidence of entrenchment (like *Norlin*) or gross manipulation of corporate structure may also be classified as violations of the reasonableness prong of the *Unocal* test. Director approval of an unreasonably harmful takeover defense can be sufficient to establish a manifest conflict of interest. In *AC Acquisitions Corp. v. Anderson, Clayton & Co.,*[159] for example, the Delaware chancery court enjoined a defensive, partial self-tender offer by Anderson, Clayton, which the evidence indicated was coercive.[160] The self-tender offer was held unreasonable in relation to the "threat" presented by an all-cash tender offer made by an acquiring group at a price that Anderson, Clayton's own advisers considered fair.[161] Because of the coercive nature of the self-tender offer, Anderson, Clayton's directors failed to convince the court that the offer would have the effect of preserving an option for shareholders who might wish to retain an equity interest in the company (in fact, the transaction would destroy shareholders' ability to choose).[162] The court found that the self-tender offer would have an "obvious entrenchment *effect*"[163] and, objectively viewed, its adoption constituted a breach of the duty of loyalty.[164] This conflict of interest existed even though the board was able to articulate a bona fide corporate purpose for the transaction in satisfaction of *Unocal*'s threshold, duty of care inquiry.[165]

In the response phase of a control contest, the target board's wide discretion to thwart a takeover and preserve corporate independence complicates the identification of a manifest conflict of interest. As illustrated in *AC Acquisitions,* a balancing of harms under the second prong of *Unocal* effectively counteracts this problem. By contrast, in a

1985) ("such major changes in structure and voting rights may only be approved by shareholders").

157. *See, e.g.,* Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407, 410 (S.D.N.Y. 1985) ("Under Delaware law, a change in corporate structure of this magnitude, reducing the transferability of a shareholder's ability to vote and the value of his or her asset to this degree, requires stockholder approval . . . ."). *But see* City Federal Savings & Loan Assn. v. Mann, No. 84-4010, slip op. (D.N.J. Aug. 2, 1985), *affd.,* 782 F.2d 1027 (3d Cir. 1986).

158. *See, e.g.,* Amalgamated Sugar Co. v. NL Indus., 644 F. Supp. 1229, 1233-39 (S.D.N.Y. 1986) (approval of flip-in poison pill, "subject[ing] an acquiring person's equity to discriminatory dilution" and effectively leaving "no tender offer possible by anyone within the next ten years," was an ultra vires act).

159. 519 A.2d 103 (Del. Ch. 1986).

160. No rational shareholder could afford not to tender into the offer since the value of the Anderson, Clayton stock was certain to drop materially after consummation of the transaction, producing a substantial loss for holders of the remaining shares. 519 A.2d at 113-14.

161. *See* 519 A.2d at 110.

162. 519 A.2d at 113-14.

163. 519 A.2d at 114 (emphasis in original).

164. 519 A.2d at 114-15.

165. *See* 519 A.2d at 112; Comment, *supra* note 13, at 557 n.139.

corporate auction, where the more narrowly focused auction-phase duty of loyalty test closely circumscribes acceptable director conduct, detecting a conflict of interest should be simpler. A manifest conflict of interest was established in *Revlon,* for example, by evidence that the following factors were present. During the corporate auction, Revlon's directors negotiated openly with Forstmann while stonewalling Pantry Pride. Their eventual lock-up agreement with Forstmann preempted an active bidding contest in return for a promise to protect irate noteholders who had threatened to sue the directors.[166] The directors clearly violated the auction-phase duty of loyalty and consequently lost the good favor of the business judgment rule.[167]

Similarly, in *Hanson Trust PLC v. ML SCM Acquisition, Inc.,*[168] SCM's board ended a highly competitive auction by granting a lock-up option to a favored bidder — in this case, a leveraged buyout consortium in which management had a substantial equity interest.[169] Hanson Trust was effectively foreclosed from further bidding.[170] Although the Second Circuit enjoined the lock-up as a breach of the duty of care, the court was chiefly concerned with the directors' apparent lack of loyalty.[171] The court held that independent directors must

166. *See* notes 90-91 *supra* and accompanying text.

167. An even clearer example of an auction-phase conflict of interest is Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986). There, the directors of Fruehauf shut down a competitive auction by prematurely accepting a management leveraged buyout (LBO) proposal. The board had voted to finance the management LBO with corporate funds and to approve a no-shop agreement restricting the company's ability to negotiate a better deal elsewhere. In flagrant disregard of their auctioneering responsibilities, the directors refused to deal with the hostile bidder Asher Edelman, rejecting without deliberation an offer from Edelman to acquire Fruehauf at a higher price than management offered. 798 F.2d at 885.

168. 781 F.2d 264 (2d Cir. 1986).

169. The bidding opened with Hanson making a $60 per share cash tender offer, which was followed by a leveraged buyout offer by SCM's management and Merrill Lynch at $70 per share (85 percent cash, 15 percent debt securities). Hanson answered with a $72 cash bid, and the SCM management-Merrill group raised its bid to $74 per share (80 percent cash, 20 percent debt securities). In return for this $74 bid, SCM's board granted Merrill a lock-up option . . . .

THE BUSINESS JUDGMENT RULE, *supra* note 20, at 103-04. SCM management held a 15% equity interest in the LBO. *Hanson Trust,* 781 F.2d at 277.

170. *See* 781 F.2d at 282-83. Under the agreement approved by the board, an acquisition of one third of SCM would trigger the lock-up option, 781 F.2d at 266-67, giving the LBO group the irrevocable right to purchase two of SCM's most important assets at a price "conceivably well below fair value," 781 F.2d at 282. *See* 781 F.2d at 279-80 & n.10; THE BUSINESS JUDGMENT RULE, *supra* note 20, at 39 n.73 (the option price was at least $80 million and perhaps as much as $230 million below fair value). The court also found that the LBO offer approved by the board was coercive to shareholders. *See* 781 F.2d at 282.

171. The court held that the business judgment rule did not protect the transaction because the SCM directors had breached their duty of care in "hastily" approving the LBO, 781 F.2d at 277, without an informed judgment as to the fair value of the optioned assets, 781 F.2d at 275. But there was significant evidence that the directors actually did exercise due care. *See* 781 F.2d at 287-91 (Kearse, J., dissenting). Evidently, the court found that it could not reach the merits of the board's actions based on a breach of the duty of loyalty since the directors who approved the LBO were not members of management and did not have a pecuniary interest in the transaction. *See* Comment, *supra* note 13, at 551 ("the court labelled the fiduciary breach as one of the duty

protect shareholder interests where self-interested management proposes a defensive LBO.[172] By rubber stamping management's proposal (without seeking a higher offer from Hanson[173]), the directors "failed to ensure that alternative bids were negotiated or scrutinized by those whose only loyalty was to the shareholders,"[174] and the directors "knew or should have known" that their approval of the lock-up would end the bidding.[175] The "inescapable conclusion" of the court was that the board ruined a competitive auction in order to keep management's LBO "in the picture at all costs."[176] Under the *Revlon* test, this conduct is a breach of the auction-phase duty of loyalty and presents a manifest conflict of interest.[177]

Approval of a lock-up in the auction phase will not always constitute a breach of the duty of loyalty. The Second Circuit distinguished SCM's defensive asset lock-up from lock-up agreements that can serve to stimulate an auction by coaxing an otherwise reluctant bidder into the bidding contest.[178] The *Revlon* court drew the same distinction.[179] The target boards in *Hanson Trust* and *Revlon* used lock-up options (on prime corporate assets) as devices to shutdown active auctions that threatened management's retention of control.[180] But other kinds of lock-ups, as both courts acknowledge, can benefit shareholders by creating incentives for prospective acquirers — incentives that are not

---

of care, apparently because the only issue was the propriety of a decision made by directors who did not stand to gain financially from the leveraged buyout").

172. 781 F.2d at 277.

173. 781 F.2d at 271.

174. 781 F.2d at 277.

175. 781 F.2d at 277 (quoting Hanson Trust PLC v. ML SCM Corp., 623 F. Supp. 848, 855 (S.D.N.Y. 1985), *revd.*, 781 F.2d 264 (2d Cir. 1986)).

176. 781 F.2d at 283 (quoting MacAndrews & Forbes Holdings v. Revlon, Inc., 501 A.2d 1239, 1249 (Del. Ch. 1985), *affd.*, 506 A.2d 173 (Del. 1986)).

177. *Hanson Trust* was decided before the Delaware Supreme Court handed down its opinion in *Revlon* (which relied significantly on *Hanson, see* 506 A.2d at 183-84). Had the *Hanson Trust* court had the benefit of the *Revlon* analysis, it might have held that SCM's directors breached the duty of loyalty by shirking their auction-phase responsibilities.

178. *Hanson Trust,* 781 F.2d at 274; *see also* Note, *Lock-Up Options: Towards a State Law Standard,* 96 HARV. L. REV. 1068, 1078-81 (1983) (arguing that "lock-ups designed to stimulate bidding" should be encouraged and those "that tend to foreclose all bidders but the optionee" should be discouraged). Lock-ups may attract hesitant bidders and stimulate a more aggressive auction:

> [A] prospective white knight faces unavoidable expenses, substantial risk, and uncertain prospects for a profitable return on its investment of corporate resources. A lock-up option gives the white knight a running start — which enhances its probability of ultimate success — and simultaneously serves as insurance against failure. When a white knight is drawn into a fight it would otherwise have avoided, the target's shareholders are the primary beneficiaries.

Id. at 1078 (footnotes omitted).

179. *Revlon,* 506 A.2d at 183.

180. *Cf.* Mobil Corp. v. Marathon Oil Co., 669 F.2d 366, 375 (6th Cir. 1981) (asset lock-up which deters competitive bidding and sets an "artificial ceiling on the value . . . shareholders can receive for their shares" may be manipulative under § 14(e) of Williams Act, 15 U.S.C. § 78n(e) (1982)). For a critical appraisal of this opinion, see Note, *supra* note 178, at 1069-74.

unfair to existing bidders[181] and that demonstrate the board's interest in facilitating the auction market for the greatest shareholder gain rather than defeating an unfriendly bidder at all costs.[182] Logically, this justification can apply to other devices, like rights plans, which have defensive uses, but which also may be employed by a board for the purpose of generating a competitive auction market that will achieve a higher price for shareholders. A rights plan can interrupt temporarily a raider's strategy to acquire the target by tender offer, thus giving management an opportunity to attract other prospective bidders.[183] This use of a rights plan is not unfair dealing under *Revlon* because it does not foreclose the raider from participating in the resulting auction. *Hanson Trust* and *Revlon* proscribe (deny business judgment rule protection for) auction-ending devices because approval of measures that cut off competitive bidding is a breach of the duty of loyalty. But where use of similar devices is auction-generating, the duty of loyalty may be served and no manifest conflict of interest is established.

B. *Suspected Conflicts of Interest and the Business Judgment Rule*

Where objective evidence is insufficient to create a manifest conflict of interest, there remains in all control contests the suspicion of a conflict of interest. Often circumstances spotlight the suspected conflict of interest. In *CTS II*, for example, there was obvious hostility between target management and the potential acquirer, Dynamics Corp., and the directors of CTS authorized a search for more friendly bidders who might have offered management the possibility of retaining control.[184] Also, the compensation scheme for CTS's financial adviser, Smith Barney, cast doubt on the directors' motivations.[185] In the response phase of a takeover battle, target board actions that evidence no more than a suspected conflict of interest are reviewed under the *Unocal* test. That test was designed specifically for the purpose of reviewing the activities of a board that is *suspected* of a conflict of inter-

---

181. A lock-up agreement may be fair to competing bidders where, for example, in an asset lockup, no option is granted on the target's crown jewels or, in a stock lockup, the option price is equal to the white knight's tender offer price. Note, *supra* note 178, at 1080.

182. *See* Samjens Partners I v. Burlington Indus., 663 F. Supp. 614, 624 (S.D.N.Y. 1987); Yanow v. Scientific Leasing Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,660 (Del. Ch. Feb. 8, 1988).

183. *See* CRTF Corp. v. Federated Dept. Stores, 683 F. Supp. 422, 437-43 (S.D.N.Y. 1988).

184. *See* Dynamics Corp. of Am. v. CTS Corp. (CTS II), 635 F. Supp. 1174, 1181 (N.D.Ill.), *supplemented on rehg.*, 638 F. Supp. 802 (N.D. Ill), *affd. in part, vacated in part, and remanded,* 805 F.2d 705 (7th Cir. 1986).

185. *See* note 127 *supra.* Judge Posner could perhaps have based his decision to remand in *CTS II* solely on the possibility of unreasonable bias in Smith Barney's compensation scheme. He chose instead to second-guess the substantive terms of the CTS rights plan, and used a cumulation of unanswered questions, including questions about Smith Barney's compensation, to rationalize a broader, more substantive scrutiny.

est.[186] Under the *Revlon* test, board actions in cases involving only a suspected conflict of interest remain eligible for business judgment rule protection during the auction phase, since the business judgment rule is the only means available under state law to protect the discretion needed for target directors to satisfy fully their responsibilities as defined by the *Revlon* court.[187] Moreover, in a corporate auction the directors have committed themselves to selling the company. Sale of control necessarily involves the possibility that the current managers will lose their jobs, and this reality should mitigate a suspected motive of entrenchment.[188]

CTS II did not involve an auction-phase manifest conflict of interest because the CTS board, unlike SCM's and Revlon's directors, did not shut down or dampen a lively auction and did not treat competing bidders unequally. Only one bidder was offering to purchase CTS stock.[189] The CTS directors, reacting to the possibility that Dynamics would obtain a blocking position and use that position to thwart a future sale, adopted a rights plan in order to preserve their ability to negotiate a competitive auction. Like the beneficial lock-up agreements discussed approvingly in *Hanson Trust* and *Revlon,* the CTS pill was designed as part of a strategy to generate, not preempt, a wealth-maximizing auction by allowing management the opportunity to attract another bidder (perhaps with a beneficial lock-up). The pill was not a takeover defense erected for the purpose of protecting corporate independence, since, as Judge Posner recognized, the board had committed itself to a sale of the target and failure to negotiate a favorable sale would have caused shareholder revolt.[190] The board had determined that a favorable sale of the company would best be achieved by auction and that an auction might not be possible if Dynamics acquired a larger stake.[191] Whether or not that determination was correct, approval of the rights plan did not destroy or interrupt an existing auction, and did preserve the possibility of a future competitive auction. Indeed, the plan may have made an auction more likely, depending on management's ability to attract other offers.

In approving the rights plan, the CTS board also did not engage in unfair dealing as proscribed by *Revlon. Revlon* imposes on directors

---

186. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985); text accompanying notes 37-46 *supra.* Under the analysis in Part II.A *supra,* a target board whose actions fail the *Unocal* test (by not evidencing due care or reasonableness) thereby reveals a manifest conflict of interest, and its actions will of course be subject to the duty of loyalty analysis.

187. *See* Hecco Ventures v. Sea-Land Corp., Civ. No. 8486, slip op. (Del. Ch. May 16, 1986), *reprinted in,* 12 DEL. J. CORP. L. 282 (1987); notes 83-86 *supra* and accompanying text.

188. *See CTS II,* 635 F. Supp. at 1181.

189. The lone bidder, Dynamics Corp., had not even expressed an interest in acquiring CTS. *See* note 118 *supra.*

190. *See CTS II,* 805 F.2d at 715; note 116 *supra.*

191. *See* note 119 *supra* and accompanying text.

the auction-phase responsibility of fair dealing with bidders where (1) the directors decide to dissolve the company and sell off its assets piecemeal, or (2) comparable offers are made by two or more bidders (that is, where a competitive auction has begun).[192] A fair-dealing requirement is a sensible protection for shareholder wealth interests in these situations. Where the company's assets are sold piecemeal, allowing all interested buyers an equal chance to negotiate with the board and gain access to corporate information may help ensure an orderly sale at fair value of all assets. And where an auction has begun, treating competing bidders equally will help maximize the final sale price attained. In *CTS II,* the board had decided to sell the company as a whole, not piecemeal, and had received no bids besides the tender offer from Dynamics. *Revlon* does not suggest that target directors have an affirmative obligation to negotiate with a single bidder or to allow that bidder access to corporate information. The *Revlon* test requires only that treatment of one prospective acquirer be fair in relation to other prospective acquirers. Were CTS management successful in attracting another offeror, the board would have an obligation to deal fairly with Dynamics relative to the second bidder. The rights plan did not exclude Dynamics from participating equally in any auction that might result; the plan merely prevented Dynamics temporarily from engaging in further tender offers for CTS at less than the exercise price fixed by the board.

Of course, the CTS board's actions would be subject to further judicial review under *Revlon* if the board made no effort to generate alternative competitive bids after putting its rights plan in place. In light of their obligation to facilitate an auction of the company, the directors could not use their pill to prevent a change of control.[193] The use of the pill would have to be reasonably related to the facilitation of an auction. The district court in *CTS II* concluded that the CTS rights plan could be used to facilitate an auction and that the plan was therefore reasonable. But by questioning the substance of the financial advice upon which the CTS special committee based its decision to approve the rights plan, the Seventh Circuit left the board no opportunity to carry out its strategy for selling the company. Judge Posner's review suggests that the CTS rights plan could not be reason-

192. Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 184; note 80 *supra.*

193. Not only would it cause a revolt among shareholders, it would violate the reasonableness prong of *Unocal* to employ a poison pill to thwart permanently all unwanted tender offers. *See* note 67 *supra* and accompanying text. Yet while many poison pills make a nonnegotiated takeover highly unattractive, just as many pass muster under the *Unocal* test. *See* note 128 *supra.* Under the *Revlon* auction-phase analysis, however, it seems plain that directors who have obtained negotiating strength with a poison pill would have to direct their negotiating efforts toward a reasonably imminent sale of the company. Perhaps that is one reason why some courts are eager to find that an auction phase has commenced. *See* Wander & LeCoque, *supra* note 1, at 53 ("courts are increasingly forcing boards into the role of an auctioneer").

able unless it was supported by sound financial analysis — a standard of review that cannot be derived from *Revlon.*

III. An Auction-Phase Business Judgment Rule

Delaware has announced a strong preference for the facilitation of corporate auctions. Lively auctions make it possible for competitive market forces to drive up acquisition prices for the maximization of shareholder wealth.[194] Where sale of the target is recognized as inevitable, *Revlon* imposes on the board of directors special auctioneering responsibilities while preserving an active role for the board in facilitating the auction. But as *CTS II* demonstrates, *Revlon* does not articulate a standard of review that both complements directors' auction-phase responsibilities and protects their discretion to negotiate and conduct competitive bidding. The *CTS II* court recognized that the *Unocal* test for business judgment rule protection is not suited to this function since it measures the target board's actions by the threat posed by the takeover. In an auction setting, a takeover is the goal, not a threat. Thus lacking precise guidance from the Delaware courts as to the proper standard by which to review the auction-phase actions of a target board, Judge Posner imposed a standard of review akin to the duty of loyalty analysis — a standard that allowed him to question the economic merits of the CTS rights plan in relation to the goal of maximizing shareholder wealth. The duty of loyalty analysis, however, effectively takes away from target directors the discretion to facilitate an auction in accordance with Delaware law because it looks through director conduct to the substance of a decision, thereby eliminating any vestige of the business judgment rule. A better standard for reviewing an auction-phase control transaction (where the transaction on its face does not present a manifest conflict of interest) would involve a test for business judgment rule protection that is modified to encourage good faith auctioneering conduct. This Part proposes such a test.

The auction-phase standard of review could be structured into a two-part analysis similar to the *Unocal* test. Like the first prong of *Unocal,* the first part of the auction-phase test would screen the motivations behind the target board's actions through an objective, duty-of-care inquiry into the board's decisionmaking process. The second part would review the board's conduct according to the *Revlon* guidelines, gauging the reasonableness of the board's actions in relation to the goals of generating, stimulating, or facilitating a lively auction. The directors would retain the burden of proof in each inquiry since the danger of entrenchment is not lessened in an auction setting — it

194. *See Revlon,* 506 A.2d at 182, 184; Bebchuk, *Tender Offers, supra* note 18.

is, if anything, compounded (as *Hanson Trust* and *Revlon* acknowledge).

The threshold inquiry of the suggested test would determine whether the board has reason to believe a particular offer is inadequate compared to the sale price that may be obtained through a competitive auction of the company as a whole, or through a dissolution and piecemeal sale of its assets. The directors would have to show that they have fully examined the adequacy of the offer with the input of impartial financial advisers.[195] In evaluating the adequacy of the offer, the board may not give consideration to the potential harmful effects of the prospective takeover on any members of the corporate community if such consideration may tend to hamper short-term shareholder gain. If the board concludes that an offer is inadequate, it may begin an investigation into possible means for negotiating a higher offer or stimulating a higher alternative bid — again, closely assisted and supported by an independent investment adviser. The directors would have to show that when they acted to resist the offer they had grounds for concluding that a wealth-maximizing auction was a reasonable possibility. Where feasible, the court should require that this decision-making process be turned over to a special committee of the board, comprised entirely of outside, independent directors, and that the special committee secure in its own behalf independent legal and investment advice. The special committee would have to present a "paper trail" showing that its deliberations were thorough and that reasonably prudent consideration was given to all material aspects of the decisions made.

The second step in the test would require directors to prove that they have dealt fairly with all competing bidders and that any measures taken to resist an auction-phase bid were reasonably designed to elicit a higher bid. This examination ensures satisfaction of the directors' core auctioneering responsibilities. A double-bracketed standard of proof may be appropriate here. Where the bidding for the target company is not yet competitive, as in *CTS II,* courts should allow the special committee greater discretion to stimulate competition by creating an auction market. The measures the committee adopts should receive business judgment rule protection if at the time adopted they were reasonably related to the goal of ultimate shareholder gain.[196] Of

195. To ensure the impartiality of the investment adviser, the court may require that the board secure the services of an investment banker other than the banker historically retained by management or that the board at least solicit a second opinion from another banker. The court may also determine that the requirement of impartiality is incompatible with a compensation scheme that rewards the adviser with a bonus if the company is ultimately sold to a white knight. *See* note 185 *supra; CTS II,* 805 F.2d at 710-11.

196. The fair-dealing requirement is relevant only where two or more bidders have made comparable offers for the target or where the board has decided to break up the company. *See* notes 80 & 192 *supra* and accompanying text.

course, the directors must confine their resistance to a reasonable timeframe. They may not act to relieve themselves of all pressure for as long as they wish, while management solicits every possible white knight or attempts to secure highly contingent financing for its own leveraged buyout.

On the other hand, the directors may receive less deference where two or more bidders have made competitive offers for the target. The board must scrupulously avoid conferring a significant benefit on one bidder to the disadvantage of another. Any transaction approved by the board's special committee that affects control during an active auction should be protected by the business judgment rule only if, at the time approved,[197] it was reasonable to expect that the transaction would result in appreciable shareholder gain. In an active bidding situation, transactions like rights plans or lock-ups may impede the auction process by dampening a bidder's interest in the target. Therefore, transactions affecting a lively auction must be of short duration or designed to elicit a reasonably quick, beneficial response from one of the prospective acquirers. The board may not halt an already active auction in the hope of attracting an additional bidder.

IV. CONCLUSION

This formulation of the business judgment rule test should prove useful in judicial review of auction-phase transactions that involve the exercise of business discretion in stimulating higher offers and facilitating competing bids. The policy of judicial deference that underlies the business judgment rule remains relevant during the corporate auction, and, as Delaware courts have made plain, application of the rule is appropriate where directors have satisfied the stricter auction-phase fiduciary duties and have dealt fairly with competing bidders. Directors may employ devices like rights plans and lock-ups (which in the response phase are nothing more than defensive) as tools in negotiating a more beneficial auction. If courts review under the duty of loyalty analysis any decision to resist a bidder in this fashion, the potential for a wealth-maximizing auction may be lost. By a simple test that focuses on objective evidence of director conduct in light of the strict guidelines laid down in *Revlon,* the standard of review suggested in this Note preserves business judgment rule protection for a

197. Under either standard of proof, the transaction at issue should be judged by its reasonableness at the time approved. In order to preserve in the auction phase the basic policies behind the business judgment rule, the court's emphasis should be on the conduct of the board, not the results of the board's actions.

target board that acts within its discretion to create a competitive auction market.

— Steven G. Bradbury