Negotiating Business Combination Agreements—The "Seller's" Point of View

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I. INTRODUCTION

When a public company agrees to enter into a business combination transaction with another entity, the provisions contained in the agreement between the parties are designed: (1) to express the economic terms of the transaction; (2) to set forth the mechanics of the transaction, as mandated by, or included in response to, applicable law; (3) to create affirmative duties of each party to the other or, in certain cases, to specified third party beneficiaries of the agreement; and (4) to allocate risk between the parties as to various post-signing events or changes. This Article discusses, from the point of view of a "selling" company, issues raised by the latter two types of provisions.[1] In particular, Part V of this Article considers certain "deal protection" provisions, such as "no-shops," "break-up fees," and "lock-ups," that may be included in a business combination agreement at the buyer's request in order to reduce the likelihood of a third party interfering with the contemplated transaction. Under certain circumstances, the fiduciary duties of the

1. Except where important to the understanding of specific legal doctrines discussed in this outline, the terms "seller" and "buyer" and their respective variants are used colloquially to refer to the roles the parties choose.

board of directors of a selling company limit the availability of such protections. Accordingly, before discussing specific "deal protection" mechanisms, Parts II through IV of this Article review certain lines of cases decided by the Delaware courts regarding the fiduciary duties of the directors of Delaware corporations. Parts II through V also summarize the guidance provided by such cases with respect to structuring the process of investigation and decision making by the seller's board. The Article concludes, in Part VI, with a discussion of selected provisions of a business combination agreement that raise important issues with respect to risk allocation between the parties.

II. THE BUSINESS JUDGMENT RULE

The business judgment rule reflects the traditional reluctance of the courts to second-guess business decisions made in good faith by unconflicted directors. The rule establishes, for purposes of litigation, a rebuttable presumption that directors acted in good faith and used appropriate decision-making procedures. In *Cinerama, Inc. v. Technicolor, Inc.*, the Delaware Supreme Court noted that the business judgment rule "operates as *both* a procedural guide for litigants and a substantive rule of law."[2] The *Technicolor* court continued:

> As a *procedural* guide the business judgment presumption is a *rule of evidence* that places the initial burden of proof on the plaintiff. In *Cede II*, this Court described the rule's evidentiary, or procedural, operation as follows:
>
> > If a shareholder plaintiff fails to meet this evidentiary burden, the business-judgment rule attaches to protect corporate officers and directors and the decisions they make, and our courts will not second-guess these business judgments. If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the "entire fairness" of the transaction to the shareholder plaintiff.
>
> Burden shifting does not create *per se* liability on the part of the directors. Rather, it "is a procedure by which the Delaware courts of equity determine under what standard of review director liability is to be judged."[3]

"From a procedural perspective, the breach of any one of the board's fiduciary duties is enough to shift the burden of proof to the board to

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2. 663 A.2d 1156, 1162 (Del. 1995) (quoting Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) (referred to by the Delaware Courts as *Cede II*), *modified on reargument*, 636 A.2d 956 (Del. 1994)).

3. *Id.* at 1162 (quoting *Cede*, 634 A.2d at 361, 371) (citations omitted).

demonstrate entire fairness.'"[4] As a substantive rule of law, the business judgment rule provides the applicable standard of review of board decisions made in accordance with the directors' fiduciary duties of care and loyalty. The Delaware Supreme Court has stated that:

> [I]n cases where the traditional business judgment rule is applicable . . . the Court gives great deference to the substance of the directors' decision and will not invalidate the decision, will not examine its reasonableness, and "will not substitute [its] views for those of the board if the latter's decision can be 'attributed to any rational business purpose.'"[5]

A. The Duty of Care

The duty of care requires directors to use appropriate decision-making procedures. Directors satisfy this requirement principally by informing themselves "prior to making a business decision, of all material information reasonably available to them."[6] Under Delaware law, the standard under which a board's duty of care toward shareholders is measured is that of gross negligence.[7] If a plaintiff proves that a board was grossly negligent in the exercise of its duties, then the board is deemed not to have met its duty of care.[8]

In *Van Gorkom*, for example, the board of directors of the Trans Union Corporation approved a merger agreement after a twenty-minute oral presentation by the Chairman of the Board, who failed to explain the methodology behind determining the merger consideration. The board did not read the merger agreement, which arrived at the meeting too late for review.[9] The *Van Gorkom* court found the Trans Union board grossly negligent in the exercise of its duty of care.[10]

A like conclusion was reached in *Cede & Co. v. Technicolor*.[11] In connection with the purchase of Technicolor, Inc. by MacAndrews & Forbes Group, Technicolor's investment bankers were allowed to speak with only three Technicolor senior executives in formulating their fairness opinion. The investment bankers were "told" by Technicolor's Chief Executive Officer and Chairman of the Board to prepare, within

4. *Id.* at 1164.
5. Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 45 n.17 (Del. 1993) (quoting Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949 (Del. 1985), and Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).
6. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
7. Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) (quoting *Aronson*, 473 A.2d at 812).
8. *Id.*
9. *Id.* at 868.
10. *Id.* at 874.
11. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 345-58 (Del. 1993), *modified on reargument*, 636 A.2d 956 (Del. 1994).

three days, a fairness opinion based on a price of between $20 and $22.[12] In addition, a notice of a special meeting of Technicolor's board to approve the $23 per share cash merger did not disclose the reason for the meeting, and only a few of the directors had received the notice even one day prior to the meeting; three of the directors had limited knowledge of the proposed transaction and three of the directors had no knowledge of the proposed transaction prior to the meeting.[13] At the special meeting, the merger was approved by the entire board, including the Chairman, who had negotiated both the merger transaction and an employment agreement for himself. Additionally, he had sold his shares of Technicolor stock to MacAndrews. Another Technicolor director who had been involved in the negotiations stood to receive a $150,000 "finder's fee." The board also approved a stock option in favor of MacAndrews, the repeal of the supermajority provision in Technicolor's certificate of incorporation, the employment agreement, and the finder's fee. Although one Technicolor director suggested other bids be solicited before agreeing to the proposed transaction, such suggestion was rejected; the consensus of the board appeared to be "a bird in the hand was better than a bigger one in the bush."[14] According to the court, the plaintiff "clearly met its burden of proof . . . that the defendant directors of Technicolor failed to inform themselves fully concerning all material information prior to approving the merger agreement."[15]

In order for the board to protect itself against claims that it violated the duty of care, it must insist on access to all appropriate information reasonably available. No matter how comfortable a director may be with his or her own evaluation of the company, he or she should insist on a well-documented record, particularly regarding valuation methodology and the terms, conditions, and background of the proposed transaction, whether hostile or friendly. In this context, the retention of experienced investment bankers, both to aid in preparing valuation data and to provide an independent view on price, is clearly a wise investment.[16]

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12. *Id.* at 361.
13. *Id.*
14. *Id.* at 357.
15. *Id.* at 371; *see infra* Parts II.B, III for additional discussions of *Technicolor.*
16. Section 141(e) of the Delaware General Corporation Law "provides that directors are protected from a breach of the duty of care when the directors reasonably believe the information upon which they rely has been presented by an expert 'selected with reasonable care' and is within that person's 'professional or expert competence.'"

In addition, the board must resist being stampeded with unreasonable deadlines and should insist on sufficient time to understand thoroughly the values in the company and the nature and terms of any transaction. In particular, the board should request the information necessary for it to evaluate the benefits and detriments of any "transaction protection" provisions, such as an asset or stock "lock-up," a "no-shop" clause, "consolation" fees, expense reimbursement provisions, or the absence of a "fiduciary out."[17] Depending on the circumstances, it may be helpful for the board, if it is large, to appoint an executive or special committee to stay fully apprised of developments and negotiations, to provide guidance to the legal and financial advisors, to participate in the negotiations, if appropriate, and to provide a report to the full board. In any event, the board must take an active and participatory role in all negotiations and decisions. Finally, the board should insist on full documentation of the steps it took as well as clear articulation of its reasoning.

Where exigencies permit, it may be appropriate to separate the board's deliberations into multiple sessions on separate days. At the first session, board members should spend as much time as required becoming familiar with valuation matters and all the terms and conditions of the transaction, with a full briefing on its genesis and background. In later sessions, the seller's management and advisors should answer any remaining questions raised by the directors and the directors should discuss their evaluations of the transaction and all alternatives. While the board will necessarily rely greatly on management and advisors to brief it fully on all material facts, the board members need to be active and thoughtful interrogators. If the board members are found to have been unaware of material facts which they could have discovered with reasonable inquiry, they risk failure to satisfy the due care standard, rendering the decision uninformed.[18]

B. The Duty of Loyalty

The duty of loyalty owed by directors to the shareholders of a corporation requires directors to act solely for the benefit of the corporation, affirmatively refraining from any course of action that would cause the directors to benefit at the expense of the shareholders.

In re Cheyenne Software, Inc. Shareholders Litigation, C.A. 14941, Mem. Op. at 5 (Del. Ch. Nov. 7, 1996).

17. *See infra* Part V for a discussion of transaction protection mechanisms.

18. *See infra* Part IV.B.9 for additional discussion of the duty of care, including further suggestions regarding appropriate board procedures.

The Delaware courts have described the duty of loyalty as one which "mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally."[19] The members of a board of directors are also deemed to be "self-interested" in their own election. Accordingly, unilateral actions taken by a board of directors with the primary purpose of frustrating or thwarting the free exercise of the stockholder franchise may be found to violate the duty of loyalty.[20]

Whether a director's "self-interest" infects the entire board's decision to the extent of rebutting the presumption of loyalty, thereby stripping the board of the benefit of the business judgment rule, was addressed by Chancellor Allen with respect to the Technicolor transaction:

> [A] financial interest in a transaction that is material to one or more directors less than a majority of those voting is "significant" for burden shifting purposes . . . when the interested director *controls* or *dominates* the board as a whole or when the interested director *fails to disclose his interest* in the transaction to the board *and* a reasonable board member would have regarded the existence of the material interest as a significant fact in the evaluation of the proposed transaction.[21]

In the case of the decision to sell Technicolor to MacAndrews, for example, the Delaware Court of Chancery found that, with respect to the

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19. *Id.* at 361.

20. *See, e.g.*, Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988). In *Blasius*, Blasius Industries, the owner of approximately 9% of the outstanding Atlas Corp. common stock, was attempting to prod the Atlas board into developing and implementing a restructuring proposal. *Id.* at 654. Blasius initiated a consent solicitation seeking to amend the Atlas bylaws to expand the size of the Atlas board from seven to fifteen members and to elect Blasius nominees to the eight new directorships. *Id.* The Atlas board of directors, in an attempt to preempt the consent solicitation, unilaterally expanded the size of the board to nine members and filled the new directorships with its own nominees. *Id.* at 655. Blasius brought an action to challenge the validity of the board's action. The Court of Chancery held that while such an action is not invalid per se, the "board bears the heavy burden of demonstrating a compelling justification for such action." *Id.* at 661-62. The Court of Chancery found that the Atlas board did not have such a compelling justification and, notwithstanding having acted in good faith, had committed an "unintended breach of the duty of loyalty." *Id.* at 663. The holding in *Blasius* is not, however, applicable to actions that affect the stockholder franchise but that are approved by fully informed shareholders. *See* Stroud v. Grace, 606 A.2d 75, 95 (Del. 1992), and Williams v. Geier, 671 A.2d 1368, 1376 (Del. 1996).

21. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1153 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995).

issues of loyalty, "a large majority of the board of Technicolor was disinterested and independent . . . and neither of those two directors found or assumed to be interested, dominated or manipulated the process of board consideration."[22] As with a breach of the duty of care, if a plaintiff meets the burden of proving a breach of the duty of loyalty, the decision reached by the board of directors will not receive the benefit of the business judgment rule. Instead, the board will be required to prove "entire fairness," as described in Part III of this Article.[23]

III. THE ENTIRE FAIRNESS STANDARD

In the event that a shareholder plaintiff is successful in rebutting the presumption of the business judgment rule by offering evidence that the directors breached their fiduciary duties, the burden shifts to the directors to prove that the challenged transaction was "entirely fair" to all shareholders.[24] The entire fairness standard also applies to decisions made by "interested" directors (*e.g.*, directors who are on both sides of a transaction or have a financial interest not shared by stockholders generally). A determination that a board of directors failed to demonstrate the entire fairness of a transaction will lead to substantive liability.[25]

As demonstrated by the holding in *Technicolor* that the transaction in question was entirely fair, "an initial judicial determination that a given breach of a board's fiduciary duties has rebutted the presumption of the

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22. *Id.* at 1151.

23. The fiduciary duties of the board of directors of a Delaware corporation also include a "duty of candor," pursuant to which directors must "'disclose fully and fairly all material information within the board's control when it seeks shareholder action.' The obligation attaches to proxy statements and any other disclosures in contemplation of stockholder action. The essential inquiry is whether the alleged omission or misrepresentation is material." Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270, 1277 (Del. 1994) (citations omitted) (quoting Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992)). The *Arnold* court described the applicable materiality standard as follows:

> *An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . .* It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused a reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, *under all the circumstances*, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.

Id. at 1277 (quoting TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976), which was adopted as the Delaware standard in Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985)). For a comprehensive examination of the Delaware cases regarding a director's disclosure duties, see Hamermesh, *Calling Off the* Lynch *Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087 (1996).

24. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995).

25. *Id.* at 1163.

business judgment rule does not preclude a subsequent determination that the board action was entirely fair, and is, therefore, not outcome-determinative *per se*."[26] It should be noted, however, that "[b]ecause 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 litigation."[27] "To avoid substantive liability, *notwithstanding* the quantum of adverse evidence that has defeated the business judgment rule's protective procedural presumption, the board will have to demonstrate entire fairness by presenting evidence of the cumulative manner by which it otherwise discharged all of its fiduciary duties."[28]

Because the Delaware courts do not defer to the business judgment of the directors in cases that apply the entire fairness standard, the holdings and dicta of such cases provide important guidance for boards regarding how to structure the process of reviewing a business combination transaction in order to meet their fiduciary duties. The standard itself was explained by the Delaware Supreme Court in *Weinberger*:

> The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. . . . However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.[29]

Although demanding, an entire fairness test does not require perfection on the part of the board. The chancery court's finding that the Technicolor transaction was entirely fair to the shareholders, a decision

26. *Id.*; *see also* Kahn v. Lynch Communication Systems, Inc., 1995 Del. Ch. LEXIS 44 (Del. Ch. Apr. 17, 1995), *aff'd*, 669 A.2d 79 (Del. 1995); Rabkin v. Olin Corp., 16 DEL. J. CORP. L. 851 (Del. Ch. 1990), *aff'd*, 586 A.2d 1202 (Del. 1990); Shamrock Holdings, Inc. v. Polaroid, 559 A.2d 257 (Del. Ch. 1989).

27. *Technicolor*, 663 A.2d at 1163 n.8 (quoting AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986)).

28. *Id.* at 1163.

29. *Id.* at 1162-63 (quoting Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983)).

ultimately affirmed by the Delaware Supreme Court, rested on the following basis:

> (1) CEO Kamerman consistently sought the highest price that Perelman would pay; (2) Kamerman was better informed about the strengths and weaknesses of Technicolor as a business than anyone else . . . ; (3) Kamerman and later the board were advised by firms who were among the best in the country; (4) the negotiations led to a price that was very high when compared to the prior market price of the stock (about a 100% premium over unaffected market price) . . . ; (5) while the company was not shopped there is no indication in the record that more money was possible from Mr. Perelman or likely from anyone else; [and] management declined to do an MBO transaction at a higher price. . . ."[30]

The fact that a majority of the board was disinterested and the material conflict of the one interested director had been disclosed, combined with the process of considering and negotiating the transaction and the price paid, led to the determination that the transaction was entirely fair.[31]

IV. *UNOCAL* SCRUTINY AND *REVLON* DUTIES

Under certain circumstances, the Delaware courts will not afford the board of directors of a corporation the benefit of the business judgment rule without certain additional tests being met. In the case of board action with respect to (a) defensive measures taken unilaterally by the board in response to a threat to corporate control or effectiveness, or (b) a transaction involving a sale of control or the breakup of the company, Delaware courts will examine, using certain specific tests, the reasonableness of the board's actions.

A. Unocal Scrutiny

1. Unocal

Before applying the business judgment rule to a board decision concerning defensive measures employed against a threatened takeover, Delaware courts require that the actions of the board of directors meet a two-pronged test first articulated in *Unocal Corp. v. Mesa Petroleum Co.*[32] *Unocal* involved an exchange offer by Unocal Corporation for its own shares in order to defend against a hostile acquisition by Mesa Petroleum Company.[33] Mesa, which held approximately 13% of Unocal's outstanding common stock, proposed a two-tiered, front-end

30. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1140 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995).
31. *Id.* at 1144.
32. 493 A.2d 946, 954-55 (Del. 1985).
33. *Id.*

loaded merger, whereby Mesa would purchase approximately 37% of Unocal's outstanding common stock in a tender offer for $54 per share in cash. The remaining shareholders of Unocal would then exchange their shares for back-end merger consideration consisting of highly subordinated securities purportedly worth $54 per share. After rejecting the Mesa offer, the Unocal board approved an exchange offer, conditioned upon Mesa acquiring the shares it had tendered for, pursuant to which the remaining 49% of the outstanding Unocal shares would be exchanged for $72 per share in senior debt securities of Unocal. The board excluded Mesa from participating in the exchange offer in order to avoid displacing other stockholders from the opportunity to have a greater number of their shares repurchased and to keep from financing Mesa's "inadequate" proposal. Mesa then sued to enjoin the self-tender and its exclusion therefrom, charging that the discriminatory self-tender was a breach of the directors' fiduciary duties.[34]

In determining whether the board of directors possessed the power and the duty to take defensive measures to protect against a perceived threat to the corporation, the *Unocal* court stated:

> 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. There are, however, certain caveats to a proper exercise of this function. Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.
>
> In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership. However, they satisfy that burden "by showing good faith and reasonable investigation. . . ." Furthermore, such proof is materially enhanced, as here, by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards.[35]

The court further held that:

> The standard of proof established in *Cheff v. Mathes* as discussed supra . . . is designed to ensure that a defensive measure to thwart or impede a takeover is

34. *Id.* at 949-51.

35. *Id.* at 954-55 (citations omitted) (quoting Cheff v. Mathes, 199 A.2d 548, 554-55 (Del. 1964)).

indeed motivated by a good faith concern for the welfare of the corporation and its stockholders, which in all circumstances must be free of any fraud or other misconduct. However, this does not end the inquiry.

A further aspect is the element of balance. If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed. This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on "constituencies" other than shareholders (*e.g.*, creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange.[36]

Thus, under *Unocal*, a board must prove that (i) the board reasonably believed, after due investigation, that the corporate enterprise was in fact threatened and (ii) the defensive measures undertaken to protect the corporation were reasonable in relation to the perceived threat. According to *Unocal* and its progeny, if the first prong is satisfied, the scrutiny of a court turns to the second prong, which requires an objective analysis of the proportionality of the response.

In applying the first prong in the *Unocal* case, the court noted that the Unocal directors had determined that the company was worth substantially more than the $54 per share in cash offered in the front-end tender, and that the back-end of Mesa's proposed merger was worth far less than $54. The court further stated:

It is now well recognized that [two-tier] offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction. Wholly beyond the coercive aspect of an inadequate two-tiered tender offer, the threat was posed by a corporate raider with a national reputation as a "greenmailer."[37]

The court found that the Unocal board had, in good faith and with reasonable investigation, determined that Mesa's offer posed a threat to Unocal's corporate policy and effectiveness. With respect to the balancing required under the second prong, the *Unocal* court found that, given the coercive nature of the Mesa tender offer and the fact that allowing Mesa to participate in the exchange offer would "effectively subsidize" Mesa's tender offer, the selective exchange offer was reasonable in relation to the threat posed.[38] The dual goals of the exchange offer, to defeat the inadequate Mesa offer and to provide at least 49% of Unocal's shareholders with adequate value for their shares

36. *Id.* at 955 (citing *Cheff*, 199 A.2d at 554-55).
37. *Id.* at 956.
38. *Id.*

if the Mesa transaction was consummated, were found valid by the court.[39]

2. Time

In litigation stemming from the battle for control of Time Inc., the Delaware Supreme Court held that Time's tender offer for Warner Communication's stock was a reasonable response to the threat posed by Paramount Communication's tender offer for Time stock.[40] Prior to Paramount's tender offer, Time and Warner had agreed to a stock-for-stock merger whereby Warner would be merged into a Time subsidiary and Warner and Time shareholders would receive 62% and 38%, respectively, of the combined entity. The merger, touted as a "merger of equals," was the result of a several year process during which Time sought an alliance in order to pursue its long-term strategy of combining its "distribution" capacity with a company with a strong "content" capability.[41] That strategy, however, was tempered by Time management's requirement that the "Time culture," including its commitment to journalistic integrity, be preserved. The Time-Warner merger was structured so as to provide Time sufficient comfort as to the preservation of the "Time culture."[42]

However, on June 7, 1989, two weeks after Time had sent out a proxy to its shareholders,[43] Paramount announced an all-cash offer for Time shares at $175 per share. Time refused to negotiate with Paramount, the Time board deeming the offer inadequate both as to price and Time's long-term strategy. While the Time board's members believed that its shareholders "would not comprehend the long-term benefits of the Warner merger," the board was resolved to fight the perceived Para-

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39. *Id.* at 957.
40. Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1154-55 (Del. 1989).
41. *Id.* at 1145-46.
42. *Id.* at 1144 n.4.
43. Pursuant to New York Stock Exchange Rules, the exchange on which the Time shares were traded, the affirmative vote of a majority of Time shareholders was required in order to effect the issuance of the shares required to complete the Time-Warner merger. *See* New York Stock Exchange Listed Company Manual, Section 312.03. Time requested the New York Stock Exchange to alter its rules and allow the Time-Warner merger to proceed without stockholder approval, but such request was rejected. *Id.* at 1148.

mount threat because "[t]he board's prevailing belief was that Paramount's bid proposed a threat to Time's control of its own destiny" and "that a combination with Warner offered greater potential for Time."[44] Time's board also restructured the proposed merger with Warner whereby Time would make an all-cash offer for 51% of Warner's stock at $70 per share with back-end merger consideration of cash and stock.[45] When Paramount raised its offer to $200 in cash per Time share, the Time board refused the offer, again citing inadequate price, the threat to the Time culture and long-term strategy, and other conditions to Paramount's offer, including the removal of potential regulatory and legal constraints that clouded the certainty of the proposed merger's consummation.[46]

In addressing the application of the *Unocal* standard, the Delaware Supreme Court began by noting that it was not the role of the court to pass on the "wisdom" of the Time board's decision, but whether, as the lower court had concluded, "the initial Time-Warner agreement was the product of a proper exercise of business judgment."[47] Focusing on Time's long and deliberate search for a business combination that would enhance Time's long-term strategy and protect the "Time culture," the court found "ample" evidence that the original stock-for-stock "merger with Warner was entitled to the protection of the business judgment rule."[48] With respect to the revised merger agreement, however, there was no doubt that the actions of the Time board would be judged under the *Unocal* standard. The court rejected Paramount's argument that an all-cash tender offer for all shares that is reasonably within a range of values that would be acceptable to shareholders cannot be a threat to a corporation and its shareholders.[49] The court thereby rejected Paramount's argument "that a hostile tender offer can pose only two types of threats: the threat of coercion that results from a two-tier offer promising unequal treatment for non-tendering shareholders; and the threat of inadequate value from an all-shares, all-cash offer at a price below what a target board in good faith deems to be the present value of its shares."[50] To do so, the court maintained, would be to substitute the judgment of the court for the judgment of the board of directors as to which deal was "better."[51]

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44. *Time*, 571 A.2d at 1148.
45. *Id.*
46. *Id.* at 1149.
47. *Id.* at 1151.
48. *Id.* at 1152.
49. *Id.*
50. *Id.* at 1152-53.
51. *Id.* at 1153.

With respect to the second prong of the *Unocal* test, the court noted that "[t]he fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals," which may not be delegated by the directors to the shareholders.[52] "Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy."[53] Because there existed a basis to sustain Time's corporate strategy, including its choice of Warner as favored merger partner, the defensive restructuring of the Time-Warner merger was deemed reasonable in response to the perceived threat. In addition, the finding of proportionality was also supported by the fact that Paramount could, if it chose to do so, seek to acquire the combined Time/Warner entity.[54]

3. Unitrin

In early 1995, the Delaware Supreme Court revisited the second prong of the *Unocal* standard in *Unitrin, Inc. v. American General Corp.*[55] The case arose from American General Corporation's unsolicited offer to acquire all of the outstanding common stock of Unitrin, Inc. for $50⅜ per share in cash, a 30% premium to the market price. American General also indicated that it would be willing to negotiate a higher price. Unitrin's financial advisors concluded that the American General offer was inadequate but did not provide a range of values that might have facilitated negotiations with American General for an appropriate price. The Unitrin board then officially rejected the American General offer. After American General publicly announced its offer, the Unitrin board adopted a "poison pill" and amended Unitrin's by-laws to require 60 days' advance notice of a shareholder's intention to nominate board members or submit proposals for consideration at an annual stockholders' meeting. Most importantly, one week later, the board authorized the repurchase of up to ten million shares of its own stock on the open market using approximately $500 million of corporate funds (the "Repurchase Program"). Prior to giving effect to the Repurchase

52. *Id.* at 1154.
53. *Id.* (citation omitted).
54. *See infra* Part IV.B for the application of *Revlon* to the Time/Warner merger.
55. 651 A.2d 1361, 1367 (Del. 1995).

Program, a group of Unitrin directors controlled approximately 23% of the Unitrin common stock. After giving effect to the proposed buy-back, such directors would have controlled approximately 28% of the common stock. Given that Unitrin's certificate of incorporation required a supermajority vote of 75% of the stockholders to approve any merger not supported by the board of directors, American General contended that the Unitrin board would have had effective veto power over any proposed merger.

The Delaware Court of Chancery determined that, given the existence of the "poison pill" defense, the Repurchase Program was a disproportionate response to the "mild" threat posed by American General's negotiable, all-cash/all-shares offer.[56] The Delaware Supreme Court, however, concluded that the lower court "applied an incorrect legal standard when it ruled that the Unitrin board's decision to authorize the Repurchase Program was disproportionate because it was 'unnecessary.'"[57] The supreme court then noted that:

> [A] court applying enhanced judicial scrutiny should be deciding whether the directors made *a reasonable* decision, not a *perfect* decision. If a board selected one of several reasonable alternatives, a court should not second guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.[58]

The supreme court then described the second prong of *Unocal* as follows: "If a defensive measure is not draconian, however, because it is not either coercive or preclusive, the Unocal proportionality test requires the focus of enhanced judicial scrutiny to shift to 'the range of reasonableness.'"[59]

In applying the first prong of *Unocal*, the supreme court identified the threat reasonably perceived by the Unitrin directors as "substantive coercion, *i.e.*, that Unitrin's shareholders might accept American General's inadequate Offer because of 'ignorance or mistaken belief' regarding the Board's assessment of the long-term value of Unitrin's stock."[60] In applying the second prong, the supreme court stated that there was no showing on the record that the Repurchase Program was coercive. The supreme court remanded the case to the Court of

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56. *In re* Unitrin, Inc. Shareholders Litig., 1994 WL 698453, at *2, *19 (Del. Ch. Oct. 13, 1994).
57. *Unitrin*, 651 A.2d at 1385.
58. *Id.* at 1385-86 (quoting Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 45-46 (Del 1993) (citations omitted)).
59. *Id.* at 1387-88 (quoting *QVC*, 637 A.2d at 45-46).
60. *Unitrin*, 651 A.2d at 1385 (citations omitted).

Chancery for a determination of whether the Repurchase Program was preclusive and, if not, whether it was within a range of reasonableness. The supreme court directed the Court of Chancery to focus on "whether Unitrin's Repurchase Program would only inhibit American General's ability to wage a proxy fight and institute a merger or whether it was, in fact, preclusive because American General's success would either be mathematically impossible or realistically unattainable."[61] Earlier in the opinion, the supreme court had concluded, based on certain assumptions, that the record appeared to reflect that American General could still undertake a proxy contest to gain the power to combine the two companies. The court stated that if American General was to initiate a proxy contest before acquiring 15% of Unitrin's stock, it would need to amass only 45.1% of the votes assuming a 90% voter turnout. If it commenced a tender offer at an attractive price contemporaneously with its proxy contest, it could seek to acquire 50.1% of the outstanding voting stock.[62] The supreme court took issue with "the Court of Chancery's *sua sponte* determination that Unitrin's outside directors, who are also substantial stockholders, would not vote like other stockholders in a proxy contest, *i.e.*, in their own best economic interests."[63] In particular, the supreme court found that the Court of Chancery's determination that "the *stockholder directors* of Unitrin would reject an 'excellent offer,' unless it compensated them for giving up the 'prestige and perquisites' of directorship, appears to be subjective and without record support. It cannot be presumed."[64] The supreme court also noted, approvingly, that the board's conclusion that "a Repurchase Program would provide additional liquidity to those stockholders who wished to realize short-term gain, and would provide enhanced value to those stockholders who wished to maintain a long-term investment."[65] The supreme court directed the Court of Chancery, if it reached consideration of whether the Repurchase Program was within a range of reasonableness, to take this into account.[66] Also to be taken into account were "whether (1) [the Repurchase Program] is a statutorily authorized form of business decision which a board of

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61. *Id.* at 1388-89.
62. *Id.* at 1382-83.
63. *Id.* at 1380.
64. *Id.*
65. *Id.* at 1384.
66. *Id.* at 1389.

directors may routinely make in a non-takeover context; (2) as a defensive response to American General's Offer it was limited and corresponded in degree or magnitude to the degree or magnitude of the threat (*i.e.*, assuming the threat was relatively 'mild,' was the response relatively 'mild?') . . . ."[67]

B. Revlon *Duties*

1. Revlon

Under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[68] and its progeny, the duties of the board of directors are, in certain circumstances, conclusively deemed to be concerned solely with maximizing short-term shareholder value. One such circumstance is a transaction that will result in a change of control of the "selling" company, such a transaction being the last opportunity for current shareholders to receive a control premium for their shares even if they retain an equity interest in the entity resulting from the transaction. Other such circumstances include: (i) when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear breakup of the company and (ii) when, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the breakup of the company. According to the Delaware Supreme Court, the decision by the board of Revlon to end the active bidding process between Pantry Pride and Forstmann Little by granting Forstmann Little the right to purchase certain "crown jewels" of Revlon, a no-shop provision and a $25 million breakup fee was a breach of the Revlon board members' fiduciary duties. The fiduciary duties were breached when, as a result of increasing bids from Pantry Pride, it became apparent that the break-up of the company was inevitable.[69] According to the *Revlon* court:

> The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. 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

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67. *Id.* For a later case applying the *Unitrin* analysis to the second *Unocal* prong, *see* Moore Corporation Limited v. Wallace Computer Services, Inc., 907 F. Supp. 1545, 1463 (D. Del. 1995) (retention of poison pill by Wallace after receipt of all-cash/all-shares offer found not to be preclusive or coercive because Moore could pursue a proxy contest to replace target board and found to be within the range of reasonableness because the Board of Directors of Wallace reasonably believed that shareholders were entitled to protection from what they determined was a "low ball" offer).

68. 506 A.2d 173 (Del. 1986).

69. *Id.* at 182.

> stockholders' benefit. This significantly altered the board's responsibilities under the *Unocal* standards. It no 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. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.[70]

The *Revlon* court did, however, note that lock-ups and related agreements are not prohibited under Delaware law when approved in accordance with directors' fiduciary duties.[71]

2. Mills

In *Mills Acquisition Co. v. Macmillan, Inc.*,[72] the Delaware Supreme Court applied *Revlon* and an entire fairness standard to enjoin an asset lock-up and a no-shop agreement granted to a bidder in connection with a slightly superior bid at the end of an "unfair" auction. The court went on to find that, in general, the *Unocal* standard of review would apply to decisions of the board of directors on the manner in which to conduct an auction governed by *Revlon*. An offer by Robert Maxwell was competing against a management buy-out led by Kohlberg Kravis, Roberts & Co (KKR). The *Mills* court described the board's *Revlon* duties by stating: "[T]he proper objective of Macmillan's fiduciaries was to obtain the highest price reasonably available for the company, provided it was offered by a reputable and responsible bidder."[73]

The court found that the auction process was "clandestinely and impermissibly skewed in favor of KKR."[74] KKR had been given, after executing a confidentiality agreement, "detailed, non-public, financial information of Macmillan, culminating in a series of formal 'due diligence' presentations to KKR representatives by Macmillan senior management . . . ."[75] Maxwell, however, did not enjoy the same level of contact with Macmillan. In fact, Macmillan did not respond at all to Maxwell's offer. In order to force the issue, Maxwell launched a tender offer at $80 per share, subject to receiving the same information that had been provided to KKR. Maxwell subsequently contacted Macmillan to

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70. *Id.*
71. *Id.* at 176.
72. 559 A.2d 1261 (Del. 1988).
73. *Id.* at 1282 (citations omitted).
74. *Id.* at 1281.
75. *Id.* at 1272.

discuss the possibility of brokering a friendly merger or the purchase of Macmillan's information business for $1 billion. "Significantly, no Macmillan representative ever attempted to negotiate with Maxwell on any of these matters."[76] Further, Maxwell was not provided the same detailed information on Macmillan until almost two months after KKR was afforded such contact. Finally, while the chief executive officer of Macmillan suggested to KKR that Macmillan's management "endorse the concept and structure of the buyout to the board of directors, *even though KKR had not yet disclosed . . . the amount of its bid*," Maxwell was given less than 24 hours to prepare his bid before the auction was closed.[77] According to the court, the Macmillan board favored the KKR buyout in order to benefit management, in breach of the board's fiduciary duties under *Revlon*.

The final KKR bid was slightly higher than Maxwell's, but required agreement to no-shop language, the grant of a lock-up option on certain crown jewels, and the execution of a definitive merger agreement by the next day. No such conditions were contained in the Maxwell bid. The special committee selected KKR as the winner and a merger agreement was signed. A later bid by Maxwell that was slightly higher than the KKR offer that was accepted was rejected because it was conditioned upon the invalidation of the asset lock-up.

The Delaware Court of Chancery enjoined the operation of Macmillan's poison pill in order to permit shareholders to consider both offers, but held that the asset lock-up and the break-up fee and expenses were reasonable, since Maxwell had an opportunity to submit his highest offer in the auction process.[78] The Delaware Supreme Court affirmed the injunction against the poison pill, but reversed the failure to grant an injunction against the lock-up option and the fees because the auction was flawed. The supreme court indicated that the board should have recognized that the various procedural biases in favor of KKR could have acted to prevent Maxwell from submitting his highest bid. In addition, the court found that agreement to the option and fees was unjustified in light of the minor differences between the two bids. The court emphasized that where the playing field is tipped in favor of one bidder over another, such action must be "reasonable in relation to the advantage sought to be achieved or, conversely, to the threat which a particular bid allegedly poses to stockholder interests."[79]

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76. *Id.*
77. *Id.* at 1273.
78. Mills Acquisition Co. v. Macmillan, Inc., 1988 WL 108332 (Del. Ch. Oct. 18, 1988), *aff'd in part, rev'd in part*, 559 A.2d 1261 (Del. 1988).
79. *Id.* at 1288 (citation omitted).

3. Barkan

In *Barkan v. Amsted Industries Inc.*, plaintiff shareholders claimed that the directors of Amsted had breached their *Revlon* duties in approving a management buyout involving an employee stock option plan. The management buyout was approved by a special committee of the board of directors, after the special committee negotiated an increase in the cash portion of the merger consideration. The Delaware Supreme Court noted that: "Although the Special Committee was given the power to evaluate the fairness of any acquisition proposal made by a third party, the Committee was instructed not to engage in an active search for alternatives to an MBO."[80] The Delaware Supreme Court affirmed a Delaware Court of Chancery decision approving the settlement of lawsuits challenging a management buyout of Amsted. While the special committee did not actively seek other competing bids prior to approving the management buyout, the record reflected that the investment community had known for several months that Amsted was "in play" and no other bids had been received. Further, a stockholder rights plan had been removed five weeks prior to the consummation of the management buyout transaction. The plaintiff shareholders claimed that the selling process was not designed to obtain the highest price available for Amsted and that the requirements of *Revlon* had thus not been satisfied. The Delaware Supreme Court stated that:

> *Revlon* does not demand that every change in the control of a Delaware corporation be preceded by a heated bidding contest. *Revlon* is merely one of an unbroken line of cases that seek to prevent the conflicts of interest that arise in the field of mergers and acquisitions by demanding that directors act with scrupulous concern for fairness to shareholders. When multiple bidders are competing for control, this concern for fairness forbids directors from using defensive mechanisms to thwart an auction or to favor one bidder over another. When the board is considering a single offer and has no reliable grounds upon which to judge its adequacy, this concern for fairness demands a canvas of the market to determine if higher bids may be elicited. When, however, the directors possess a body of reliable evidence with which to evaluate the fairness of a transaction, they may approve that transaction without conducting an active survey of the market. As the Chancellor recognized, the circumstances in which this passive approach is acceptable are limited. "A decent respect for reality forces one to admit that . . . advice [of an investment banker] is frequently a pale substitute for the dependable information that a canvas of the

80. 567 A.2d 1279, 1282 (Del. 1989).

relevant market can provide." The need for adequate information is central to the enlightened evaluation of a transaction that a board must make. Nevertheless, there is no single method that a board must employ to acquire such information.[81]

The supreme court affirmed the court of chancery's holding that Amsted's directors had "acted in good faith to arrange the best possible transaction for shareholders."[82] Later in its opinion, the supreme court further limited its holding as follows:

> We certainly do not condone in all instances the imposition of the sort of "no shop" restriction that bound Amsted's Special Committee. Where a board has no reasonable basis upon which to judge the adequacy of a contemplated transaction, a no-shop restriction gives rise to the inference that the board seeks to forestall competing bids. Even here, a judicious market survey might have been desirable . . . . [W]e decline to fashion an iron-clad rule for determining when a market test is not required. The evidence that will support a finding of good faith in the absence of some sort of market test is by nature circumstantial; therefore, its evaluation by a court must be open-textured. However, the crucial element supporting a finding of good faith is knowledge. It must be clear that the board had sufficient knowledge of relevant markets to form the basis for its belief that it acted in the best interests of the shareholders. The situations in which a completely passive approach to acquiring such knowledge is appropriate are limited.[83]

4. Time

In *Time*, it was argued that *Revlon* duties were triggered as a result of the Time-Warner stock-for-stock merger agreement (pursuant to which Warner stockholders would own 62% of the combined entity).[84] The Delaware Court of Chancery rejected the *Revlon* claim, finding that there was no change of control because control of both Time and the new Time-Warner would be in "a fluid aggregation of unaffiliated shareholders representing a voting majority—in other words, in the market."[85] In affirming the chancery court's holding, the Delaware Supreme Court focused on the fact that, as opposed to the circumstances in *Revlon*, the dissolution or break-up of Time did not become inevitable upon either the commencement of merger negotiations with Warner or the recasting of the merger structure.[86] Furthermore, the court noted that Paramount was not foreclosed from making a bid for the combined Time-Warner entity and that, therefore, the shareholders were not foreclosed perma-

81. *Id.* at 1286-87 (alteration in original) (citations omitted) (quoting *In re* Amsted Indus. Litig., 1988 WL 92736, at *7 (Del. Ch. Aug. 24, 1988)).
82. *Id.* at 1287; *see infra* Part IV.B.10 for additional discussion of market checks.
83. *Id.* at 1288.
84. Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989).
85. *Id.* at 1150 (quoting the Chancellor's conclusion).
86. *Id.*

nently from enjoying a control premium, two circumstances which warrant application of *Revlon* duties. The court also rejected an argument by the plaintiffs that use of deal protection mechanisms, such as a lock-up agreement and a no-shop clause, prevented shareholders from obtaining a control premium in the immediate future and thus violated *Revlon*. The court stated:

> We agree with the Chancellor that such evidence is entirely insufficient to invoke *Revlon* duties; and we decline to extend *Revlon*'s application to corporate transactions simply because they might be construed as putting a corporation "in play" or "up for sale." The adoption of structural safety devices alone does not trigger *Revlon*. Rather, as the Chancellor stated, such devices are properly subject to a *Unocal* analysis.[87]

5. QVC

In *Paramount Communications Inc. v. QVC Network Inc.*,[88] the Delaware Supreme Court affirmed a lower court decision that a proposed stock-for-stock merger between Paramount and Viacom Inc. triggered *Revlon* duties because the controlling stockholder of Viacom would own approximately 70% of the voting securities of the combined company after the merger. The court distinguished *Time* based on the fact that both before and after the Time/Warner merger, Time was owned by "a fluid aggregation of unaffiliated stockholders."[89] In contrast, the proposed Paramount/Viacom merger would have shifted "control of Paramount from the public stockholders to a controlling shareholder. . . ."[90] The supreme court noted that: "Once control has shifted, the current Paramount stockholders will have no leverage in the future to demand another control premium. As a result, the Paramount stockhold-

87. *Id.* at 1151 (citations omitted).
88. 637 A.2d 34 (Del. 1993).
89. *Id.* at 46.
90. *Id.* at 48. The *QVC* court noted that it was deciding only the case before it, a case "which, on its facts, is clearly controlled by established Delaware law. Here, the proposed change of control and the implications thereof were crystal clear." *Id.* at 51. A test for a "change of control" for purposes of *Revlon* has not been articulated. In light of the Delaware courts' stated concern with maintaining the opportunity for public stockholders of the combined company to receive a control premium (notwithstanding the existence of a privately-held block of shares), it is not clear what form such a "change of control" test would take.

ers are entitled to receive, and should receive, a control premium and/or protective devices of significant value."[91]

The following is a brief summary of the facts in *QVC*. After several months of on and off negotiations, Paramount and Viacom agreed to a stock-for-stock merger. Under the terms of the proposed September 1993 Paramount/Viacom merger agreement, shares of Paramount common stock would have been converted into .10 shares of Viacom Class A voting stock and .90 shares of Viacom Class B nonvoting stock and $9.10 in cash (a value of approximately $69 per share). Upon consummation of the merger, the controlling shareholder of Viacom would have owned approximately 70% of the voting securities of the combined Paramount/Viacom entity. After the announcement of the Paramount/Viacom merger, QVC Network, which had previously expressed an interest in Paramount, contacted Paramount and offered .893 shares of QVC common stock and $30 in cash for each share of Paramount common stock (a value of approximately $80 per share). At a meeting of the Paramount board of directors called to discuss the QVC offer, the board's members were instructed by Paramount's Chairman and CEO that, under the terms of the "no-shop" provision of the Paramount/Viacom agreement, Paramount was restricted from negotiating with QVC until QVC provided evidence of its ability to finance the merger. After QVC provided such evidence, the Paramount board authorized management to meet with QVC. QVC subsequently announced a tender offer for 50.1% of Paramount's outstanding common stock at $80 per share in cash. In the second step of the merger, each remaining share of Paramount common stock would be converted into 1.42875 shares of QVC common stock. In response to the competing QVC bid, Paramount and Viacom renegotiated their proposed merger and agreed to an $80 cash bid by Viacom for 50.1% of Paramount common stock, and a second-step merger that would convert each remaining Paramount share into .20408 shares of Viacom Class A voting stock, 1.08317 shares of Viacom Class B nonvoting stock, and .20408 shares of a new series of Viacom convertible preferred stock. After both Viacom and QVC had launched their respective tender offers, Viacom raised the cash portion of its bid to $85 per share, with a similar increase

91. *Id.* at 43. The court, while expressing no opinion on the effect such "protective devices" would have had in the case, listed some devices: "Examples of such protective provisions are supermajority voting provisions, majority of the minority requirements etc." *Id.* at 42 n.12. The court also referred to standstill provisions. *Id.* Although no guidance is provided about how to evaluate such protective devices, it is clear that boards of directors will have some ability to take such devices into account in evaluating offers.

in the back-end value, which was subsequently topped by QVC's $90 per share bid. Notwithstanding the fact that the Paramount board did not communicate with QVC because of its interpretation of the restrictions imposed upon it by the no-shop agreement, "the Paramount Board determined that the new QVC offer was not in the best interests of the [Paramount] stockholders."[92]

After holding that enhanced duties were triggered, the Delaware Supreme Court stated that "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."[93] When enhanced duties apply, the board of a selling corporation must "act on an informed basis to secure the best value reasonably available to the stockholders."[94] According to the court in *QVC*, the directors of Paramount were "paralyzed by their uninformed belief that the QVC offer was 'illusory'" and thus failed to determine whether they had obtained the best value reasonably available under the circumstances.[95]

6. Arnold

In *Arnold v. Society for Savings Bancorp, Inc.*,[96] the Delaware Supreme Court held that, in a stock-for-stock merger that does not result in a change in control, *Revlon* duties do not attach. The opinion also suggests that a corporation may move into the realm of *Revlon* duties and then subsequently remove itself from the application of such duties.

In early 1991, the financially troubled Society for Savings Bancorp, Incorporated announced that it had retained a financial advisor to seek transactions which would enhance shareholder value. Offers, either for Society as a whole or in parts, were not readily forthcoming. The offers that did materialize, including an offer from Society's financial advisor to purchase part of Society's assets, were heavily conditioned and doubtful as to their ability to reach consummation. The board of Society ultimately dismissed its financial advisor and issued a public statement

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92. *Id.* at 41.
93. *Id.* at 46 (citing Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986)).
94. *Id.* at 37.
95. *Id.* at 50.
96. 650 A.2d 1270, 1273 (Del. 1994).

that it "intended to focus on strengthening itself as an independent entity."[97] Subsequently, the Bank of Boston contacted Society to discuss the possibility of an acquisition of Society. Under the terms of a proposed merger that emerged from negotiations, each Society share would be exchanged for .78 of a Bank of Boston share. In addition, the proposal included a no-shop provision as well as lock-up rights. The final version of the merger agreement approved by the board of Society provided for an exchange of each Society share for .80 of a Bank of Boston share, based on the trading price of Bank of Boston shares at the closing (subject to an adjustable $20 per share cap) and modified lock-up and no-shop provisions. In connection with the no-shop provision that was granted to the Bank of Boston, Society negotiated a "fiduciary out."

The Delaware Court of Chancery had rejected the plaintiff's claim that, when Society agreed to merge with the Bank of Boston, *Revlon* duties were triggered.[98] Citing *Time*, the chancery court noted that Society had neither "put itself on the auction block when it began negotiation with [the Bank of Boston]" nor abandoned its long-term strategy in response to a bidder's offer, the two traditional *Revlon* triggers.[99] According to the Court of Chancery, while *Revlon* duties had certainly been implicated upon the public announcement of the hiring of a financial advisor to seek bidders for Society, such duties did not apply to the subsequent merger with the Bank of Boston because, in the interim, the board of directors of Society had made a deliberate choice to remain independent and return to its long-term strategy.[100]

The plaintiff further argued that, once Society had decided to enter into the stock-for-stock merger with the Bank of Boston, *Revlon* duties attached. The chancery court, however, supported by the Delaware Supreme Court, found that *Revlon* duties were never implicated in this circumstance because there was no change of control of Society.[101] The supreme court noted that a "sale or change of control" was not implicated in this case because ownership of Society was being retained by a large, fluid aggregation of public shareholders.[102]

97. *Id.* at 1275.

98. Arnold v. Society for Sav. Bancorp, Inc., 1993 Del. Ch. LEXIS 275 (Del. Ch. Dec. 17, 1993), *aff'd in part, rev'd in part*, 650 A.2d 1270, 1273 (Del. 1994).

99. *Id.* at *31 (citing Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1151-52 (Del. 1989)).

100. *Id.*

101. *Arnold*, 650 A.2d at 1289.

102. *Id.* at 1289-90 (citing Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 42-47 (Del. 1993)).

7. Santa Fe

In June 1994, Santa Fe Pacific Corporation and Burlington Northern, Inc. (BNI) agreed to a stock-for-stock merger based on an exchange ratio of 0.27 BNI shares for each share of Santa Fe (worth about $13.50 per Santa Fe share).[103] Subsequently, Union Pacific Corporation proposed a competing stock-for-stock merger with Santa Fe worth about $18 per Santa Fe share. The Santa Fe board, basing its decision on antitrust concerns, the inadequacy of the offered price, and the fact that the Santa Fe/BNI merger agreement did not allow Santa Fe to consider Union Pacific's bid, rejected the competing offer. After BNI and Union Pacific both improved their bids, Union Pacific commenced a tender offer for up to 57.1% of Santa Fe stock. Santa Fe recommended to its shareholders that they not tender their shares into the Union Pacific tender offer. After Santa Fe adopted a "poison pill," Santa Fe and BNI amended their merger agreement to allow for a joint tender offer whereby both companies would purchase up to 33% of Santa Fe's shares for $20 per share in cash. The tender offer was conditioned upon Santa Fe's shareholders approving a "back-end" merger with BNI, the consideration for which was to be 0.4 BNI share for each Santa Fe share. Union Pacific then revised its bid and announced an all-shares/all-cash bid of $18.50 per Santa Fe share. Although Santa Fe's board announced that its financial advisors considered the latest Union Pacific offer fair, the board recommended that its shareholders not accept the offer. Santa Fe and BNI then completed their joint tender offer and the Santa Fe shareholders approved the merger with BNI in February of 1995.[104]

The plaintiff shareholders of Santa Fe claimed that the Santa Fe directors had breached their *Revlon* duties by not auctioning the company.[105] The Court of Chancery, however, rejected the claim, stating that:

> Although "Revlon duties" will attach when a "corporation initiates an active bidding process seeking to sell itself," *Arnold*, 650 A.2d at 1290, where the favored transaction does not involve a change of control, a disinterested, independent board of directors has the "prerogative . . . to resist a third party's

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103. *In re* Santa Fe Pac. Corp., Shareholder Litig. No. 13587, 1995 Del. Ch. LEXIS 70 (Del. Ch. May 31, 1995), *aff'd in part, rev'd in part*, 669 A.2d 59 (Del. 1995).
104. *Id.*
105. *Id.* at *15.

> unsolicited acquisition proposal or offer." In those circumstances a board may, consistent with its fiduciary duties, prefer a preexisting transaction without becoming subject to *Revlon* duties.[106]

The Court of Chancery noted that, although an active bidding process existed for Santa Fe, such process had not been initiated by Santa Fe.[107] The Court of Chancery also upheld a $50 million termination fee and $10 million expense reimbursement provision on a more than $3.5 billion transaction and certain other transaction protection mechanisms against a *Unocal* challenge.[108] The Supreme Court affirmed the Court of Chancery's holding with respect to the *Revlon* claim, noting that: "While the Board properly encouraged Union Pacific to improve its offer and may have used the result as leverage against Burlington, the Plaintiffs do not allege that the Board at any point decided to pursue a transaction which would result in a sale of control of Santa Fe to Burlington. Rather, the complaint portrays the Board as firmly committed to a stock-for-stock merger with Burlington."[109]

8. Mendel

In *Mendel v. Carroll*,[110] the Delaware Court of Chancery considered an action in which a plaintiff requested the grant of an option to purchase shares sufficient to dilute a controlling group of shareholders' holdings in order to allow minority shareholders to accept the terms of a merger proposal. The Carroll family controlled between 48% and 52% of the shares of Katy Industries and through legal agreements had agreed among themselves to purchase, but not voluntarily sell, their Katy shares. The Carroll family proposed a transaction to the Katy board to purchase all non-Carroll Katy shares for $22 per share in cash but advised the board that they had no interest in selling their Katy shares. At that time, Katy shares were trading at $24. A special committee of the board refused the proposal as inadequate, and insisted on $26 per share. Offering only up to $24, the Carrolls withdrew the offer. Subsequently, the Carrolls offered a new proposal to the Katy board, this time for $25.75 per share in cash. Relying on the opinion of their financial advisor that the offer was within a range of fairness, the special committee, together with the entire board, approved the Carroll proposal

106. *Id.* at *24 (citations omitted).
107. *Id.* at *25. The reasons for the Supreme Court's reversal and remand of the *Unocal* claim, which were unrelated to the specific lock-ups, are discussed *infra* in Part V.A.2.
108. *Id.* at *32 n.8.
109. *Santa Fe*, 669 A.2d at 71.
110. 651 A.2d 297 (Del. Ch. 1994).

as in the best interests of the Katy shareholders. Subsequently, a third party bidder emerged offering $29 per share in cash. The Katy board then informed the Carrolls that it could no longer endorse their merger proposal. Although the $29 proposal foundered, another party proposed to purchase all outstanding Katy shares for $28 (which was later adjusted down to $27.80) per share in cash. The special committee pursued negotiations with this latest suitor. The negotiations included a proposed stock option whereby the acquiror would be granted an irrevocable option to purchase 1.8 million Katy shares at the merger price along with the right, if the merger was not consummated, to put the 1.8 million shares to Katy. Over the vehement objections of the Carroll family, the special committee continued merger negotiations with the potential acquiror; the final stumbling block was the stock option. Finally, the Katy board refused to proceed with the merger proposal because their Delaware legal counsel was unable to give an opinion as to the legality of the stock option.

The Katy board then considered the following options to enhance shareholder value: "(i) a self-tender by Katy; (ii) a Dutch auction for Katy shares; and/or (iii) a dividend in excess of $10.00 per share on Katy's common stock."[111] The board subsequently approved a special cash dividend of $14 per common share. Before the dividend was paid, however, a suit was brought claiming that the Katy board's acceptance of the Carrolls' initial merger proposal invoked *Revlon* duties and that the board was therefore required to accept the subsequent higher bid and grant the option in order to break the control of the Carrolls. In refusing to order the granting of the option, the Delaware Court of Chancery first noted that Delaware law accepts the legitimacy, "albeit in a guarded fashion," of a controlling shareholder obtaining a control premium.[112] The court discussed the possibility that the Carroll offer of $25.75 per share could be fair while the higher offer of $27.80 per share could be inadequate, based upon the existence of a control premium contained in the Carrolls' block of shares.[113] "The significant fact is that in the Carroll Family Merger, the buyers were not buying corporate control . . .

111. *Id.* at 303.
112. *Id.* at 305.
113. *Id.* at 304-05.

[t]hey already had it."[114] Such was not the case with respect to the competing bid. According to the court, that:

> was an offer, in effect, to the controlling shareholder to purchase corporate control, and to all public shareholders, to purchase the remaining part of the company's shares, all at a single price. It distributed the control premium evenly over all shares. Because the Pensler proposed $27.80 price was a price that contemplated not simply the purchase of non-controlling stock, as did the Carroll Family Merger, but complete control over the corporation, it was not fairly comparable to the per-share price proposed by the Carroll Group.[115]

Thus, the plaintiff's argument that the alternative to the Carroll merger proposal had to be accepted by the Katy board under the application of *Revlon* duties was rejected by the court. However, the court continued:

> To note that these proposals are fundamentally different does not, of course, mean that the board owes fiduciary duties in one instance but not in the other. That is not the case . . . . In this circumstance . . . the board's duty was to respect the rights of the Carroll Family, while assuring that if any transaction of the type proposed was to be accomplished, it would be accomplished only on terms that were fair to the public shareholders and represented the best available terms from their point of view.[116]

The court then compared the duties of the Katy board when confronted with the Carroll proposal to those of a board upon the triggering of *Revlon* duties. "[I]f the board were to have approved a proposed cash-out merger, it would have to bear in mind that the transaction is a final-stage transaction for the public shareholders. Thus, the time frame for analysis . . . is immediate value maximization."[117] Accordingly, the board of directors, if their fiduciary duties will allow, is obligated to maximize the minority shareholder's value. Given the fact that a controlling shareholder is not required to sell its interest without some compelling need to protect the minority shareholder, a board of directors may not act against the interests of a majority shareholder.[118] Based on the above analysis, the court determined not only that *Revlon* did not require the forced dilution of the Carroll family interest, but that the fiduciary duties owed by the Katy board to the Carrolls italicize such action.[119]

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114. *Id.* at 305.
115. *Id.*
116. *Id.* at 305-06.
117. *Id.* at 306.
118. *Id.*
119. *Id.* at 307.

9. Revlon *and the Duty of Care*

Going back at least to *Barkan*, there has been an effort by the Delaware Supreme Court to explain *Revlon* duties as an incarnation of the fundamental duties of care and loyalty for specified factual circumstances.[120] More recently, *Technicolor* and *QVC* have focused on *Revlon* as an instance of the duty of care—or, more specifically, the duty of the board to inform itself of all material information reasonably available. The *Technicolor* opinion points out that the Chancery Court had "noted the relevance of *Revlon* in 'illuminat[ing] the scope of [the] board's due care obligations . . .' and implied that the Technicolor board's failure to auction the company evidenced a breach of their duty of care."[121] The supreme court also included the following in a footnote in its opinion:

> The Chancellor wrote: ". . . the due care theory and the Revlon theory do not present two separate legal theories justifying shareholder recovery . . . . [B]oth theories reduce to a claim that directors were inadequately informed (of alternatives, or of the consequences of executing a merger and related agreements). An auction is a way to get information. A pre- or post-agreement market-check mechanism is another, less effective but perhaps less risky, way to get information. A 'lock-up' is suspect because it impedes the emergence of information in that an alternative buyer that would pay (or would have paid) more is less likely to emerge once such an impediment is in place."[122]

In any situation in which *Revlon* duties are applicable and the board chooses not to conduct an auction, it is important to keep accurate records of the alternatives considered by the board, the information provided to the board regarding those alternatives, and the board's consideration of the pros and cons of various means of determining whether a particular transaction is the best one available. In effect, the board must be able to show that it made informed decisions about how to become informed. Accordingly, a record of work done by the board's

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120. *See* Barkan v. Amsted Indus. Inc., 567 A.2d 1279, 1286 (Del. 1989) ("[T]he basic teaching of [*Revlon* and *Unocal*] is simply that directors must act in accordance with their fundamental duties of care and loyalty.").

121. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 369 (Del. 1993), *modified on reargument*, 636 A.2d 956 (Del. 1994) (quoting Cinerama, Inc. v. Technicolor, Inc., 1991 WL 111134 at *40 (Del. Ch. June 24, 1991), *aff'd in part, rev'd in part*, 634 A.2d 345 (Del. 1993)).

122. *Id.* at 369 n.37 (quoting 1991 WL 111134 at *39-40); *see infra* Part V for a discussion of lock-ups and other transaction protection mechanisms.

advisors and by management, as reviewed by the board, is not enough unless the court also perceives that the board (and especially the independent directors) has taken "an active and direct role in the context of a sale of a company from beginning to end."[123] This does not mean that the board may not delegate negotiation and implementation of a transaction to management. However, the board must be prepared to defend its decisions based on the quality of the information it received and the thoroughness of its consideration of that information. Thus, it is important that the directors actively request any additional information they believe would be relevant. In addition, directors should probe the conclusions presented by their advisors and management and the assumptions on which such conclusions are based. The *QVC* court found it significant that certain questions it considered obviously important were not asked by the Paramount directors—*e.g.*, whether QVC would be able to obtain financing (a condition to the offer that affected the application of the "no-shop" provision of the Paramount/Viacom agreement). The court described what the Paramount board should have done:

> Since the Paramount directors had already decided to sell control, they had an obligation to continue their search for the best value reasonably available to the stockholders. This continuing obligation included the responsibility, at the October 24 board meeting and thereafter, to evaluate critically both the QVC tender offers and the Paramount/Viacom transaction to determine if: (a) the QVC tender offer was, or would continue to be, conditional; (b) the QVC tender offer could be improved; (c) the Viacom tender offer or other aspects of the Paramount/Viacom transaction could be improved; (d) each of the respective offers would be reasonably likely to come to closure, and under what circumstances; (e) other material information was reasonably available for consideration by Paramount directors; (f) there were viable and realistic alternative courses of action; and (g) the timing constraints could be managed so the directors could consider these matters carefully and deliberately.[124]

In contrast, the *Time* court was favorably impressed by how "Time's outside directors met frequently without management, officers or directors being present. At the request of the outside directors, corporate counsel was present during the board meetings and, from time to time, the management directors were asked to leave the board sessions."[125]

The above-described cases are evidence that courts are willing to immerse themselves in the deliberative process to determine what the directors didn't know, and why they didn't know it. The courts have

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123. *Id.* at 368.

124. Paramount Communications Inc., v. QVC Network Inc., 637 A.2d 34, 48-49 (Del. 1993).

125. Paramount Communications Inc. v. Time Inc., 571 A.2d 1140, 1147-48 (Del. 1989).

before them the record of the proceedings, the results of discovery, deposition and witness testimony, and resulting events. In other words, they have the answers, and they are often tempted to pose the questions which they believe a reasonable, prudent director should have asked. Directors, therefore, should make an effort to manage the deliberative process in a way that will ensure that they receive sufficient information and have sufficient time to reach a reasoned judgment. However, as the Delaware Supreme Court stated in *Barkan*:

> [T]here is no single blueprint that a board must follow to fulfill its duties. A stereotypical approach to the sale and acquisition of corporate control is not to be expected in the face of the evolving techniques and financing devices employed in today's corporate environment. Rather, a board's actions must be evaluated in light of relevant circumstances to determine if they were undertaken with due diligence and in good faith. If no breach of duty is found, the board's actions are entitled to the protections of the business judgment rule.[126]

10. Market Checks

A market check provides a means of meeting the obligation of the seller's board to inform itself with respect to the value of the company without entering into a formal auction process.[127] Even where *Revlon* would not be applicable, a market check can assist the board in meeting its duty of care in approving a transaction.

A pre-deal market check can be performed by a company's financial advisor by contacting companies that would be likely candidates to acquire the company before entering into negotiations with any one party. A pre-deal market check does, however, create risks. Rumors that the company will be for sale may begin to circulate, which may result in pressure to engage in a full-scale auction, regardless of whether the board believes that to be the best means of selling the company. On the other hand, a pre-deal market check allows a selling company to obtain information that could be very useful in subsequent negotiations with a particular purchaser.

The second type of market check, a post-deal market check, allows the selling company to complete the negotiations for the sale or merger of

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126. *Barkan*, 567 A.2d at 1286 (citations omitted).
127. *See, e.g., id.* at 1286 (when only one party has made an offer and the Board has "no reliable grounds upon which to judge its adequacy, [*Revlon*] demands a canvas of the market to determine if higher bids may be elicited").

the company and then have the latitude to seek higher bids. The initial bidder will most likely demand substantial termination fees and other protective mechanisms before agreeing to permit its bid to be shopped in this way.[128] If no higher offer results after a reasonable period of contacting prospective purchasers, the board will have established a strong basis for defeating any argument that it did not meet its fiduciary duties in approving the transaction. Even in the absence of efforts to contact alternate bidders, a significant period in which bidders are able to top an existing offer without triggering burdensome protection mechanisms will also allow the board to support its decision to approve a transaction.

V. TRANSACTION PROTECTION MECHANISMS AND RELATED MATTERS

A. *General Issues*

1. *If* Revlon *Duties Apply*

Acquirors (or both parties, in a merger of equals) often demand that the terms of the transaction include specified economic benefits to such party in the event a third party disrupts the transaction. In part, this reflects a desire to be compensated for the costs involved in pursuing a transaction and, in certain circumstances, for the benefits that could have been achieved from potential alternative opportunities that were forgone. In addition, these provisions function to remove the incentive to use the acquiror as a stalking horse for a superior transaction. The terms may include cash payments (break-up or termination fees or expense reimbursement), lock-up stock options (which permit the optionholder to participate with the other stockholders in a third party transaction), and options to purchase specified assets of the seller. In addition, an acquiror may demand that the transaction agreement be drafted in a manner that makes it difficult for the seller to have contacts with a third party regarding a potential offer (a "no-shop" provision) or for the seller to terminate the agreement to pursue another offer (such right, if it is included, is referred to as a "fiduciary out" or "fiduciary termination right").

Break-up fees and lock-up stock options make it more expensive for a third party to compete with the original acquiror. The third party not only must pay the stockholders for their shares, but also must bear the

128. *See infra* Part V for a discussion of transaction protection mechanisms.

cost of the transaction protection devices. This may skew the playing field in favor of the original acquiror and has made such devices controversial in cases where *Revlon* duties apply, especially when it appears from the magnitude of the total payments that the deterrent effect was the primary motivation for such devices and that the seller embraced such devices for their deterrent effect. If the original bidder's offer is inferior to the third party offer and the total compensation to be received by the original bidder in the event of interference is large, a court is likely to determine that the playing field has been impermissibly skewed in violation of the *Revlon* duties of the seller's board. The *Revlon* court described the appropriate considerations as follows:

> Such [devices] can entice other bidders to enter a contest for control of the corporation, creating an auction for the company and maximizing shareholder profit. Current economic conditions in the takeover market are such that a "white knight" . . . might only enter the bidding for the target company if it receives some form of compensation to cover the risks and costs involved . . . . However, while those [devices] which draw bidders into the battle benefit shareholders, similar measures which end an active auction and foreclose further bidding operate to the shareholders' detriment.[129]

At an appropriate point in an auction, however, even measures which end the auction may be appropriate if a substantial benefit is conferred on stockholders, after attempts have been made to negotiate with other bidders.[130]

QVC contains an extended analysis of the transaction protection mechanisms demanded by Viacom and agreed to by Paramount.[131] *QVC* makes clear that a board may not, if it enters into a business combination agreement that triggers *Revlon* duties (*e.g.*, for an all-cash transaction or a stock-for-stock transaction that would result in a change of control), contract away its obligation to meet its fiduciary duties with

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129. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 183 (Del. 1986).

130. *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1284 (Del. 1988).

131. Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1993). The analyses by the Court of Chancery and the Supreme Court of the lock-ups in *QVC* were criticized in Fraidin & Hanson, *Toward Unlocking Lockups*, 103 YALE L.J. 1739, 1757-64 (1994), an article applying economic theory to argue that courts should enforce virtually all lock-ups.

respect to competing offers from other parties.[132] The Delaware Supreme Court stated:

> The Paramount defendants contend that they were precluded by certain contractual provisions, including the No-Shop Provision, from negotiating with QVC or seeking alternatives. Such provisions, whether or not they are presumptively valid in the abstract, may not validly define or limit the directors' fiduciary duties under Delaware law or prevent the Paramount directors from carrying out their fiduciary duties under Delaware law. To the extent such provisions are inconsistent with those duties, they are invalid and unenforceable.[133]

In connection with the September 1994 merger agreement with Viacom described in Part IV.B.5, the Paramount board had approved the following transaction protection measures: (i) a "no-shop" provision which restricted Paramount from soliciting or negotiating a competing bid unless a third party made a bona fide bid without any material financing contingencies and the Paramount board determined such negotiations were necessary to comply with its fiduciary duties to shareholders; (ii) a "break-up fee" of $100 million payable upon either Paramount terminating the proposed merger agreement as a result of a competing transaction, Paramount shareholders not approving the transaction, or the Paramount board recommending a competing transaction; and (iii) a stock option agreement whereby Viacom would have the option to purchase approximately 19.9% of Paramount's common stock at $69.14 if the break-up fee was triggered for any reason.[134] Further, in addition to there being no "cap" on the stock option's value, under the terms of the proposed stock option, Viacom would have been permitted to finance the exercise of the option with a senior subordinated note, worth approximately $1.6 billion (the "Note Feature"), and to require Paramount to pay Viacom an amount in cash equal to the spread between the market price of the common stock subject to the option and the exercise price of the option (the "Put Feature").[135] Applying enhanced scrutiny, the *QVC* court concluded that, with respect to such measures, "the Paramount directors process was not reasonable, and the result achieved for the stockholders was not reasonable under the circumstances."[136] The supreme court further stated:

> When entering into the Original Merger Agreement, and thereafter, the Paramount Board clearly gave insufficient attention to the potential consequenc-

132. *Id.*
133. *Id.* at 48 (quoting *Revlon*, 506 A.2d at 184-85).
134. *Id.* at 34.
135. *Id.*
136. *Id.* at 49.

es of the defensive measures demanded by Viacom. The Stock Option Agreement had a number of unusual and potentially "draconian" provisions, including the Note Feature and the Put Feature. Furthermore, the Termination Fee, whether or not unreasonable by itself, clearly made Paramount less attractive to other bidders, when coupled with the Stock Option Agreement. Finally, the No-Shop Provision inhibited the Paramount Board's ability to negotiate with other potential bidders, particularly QVC which had already expressed an interest in Paramount.[137]

In footnotes, the supreme court noted that it was not expressing any opinion (a) as to "whether a stock option agreement of essentially this magnitude, but with a reasonable 'cap' and without the Note and Put Features, would be valid or invalid under other circumstances"[138] or (b) as to "whether certain aspects of the No-Shop Provision here could be valid in another context."[139] However, the supreme court proceeded to point out, "[w]here a board has no reasonable basis upon which to judge the adequacy of a contemplated transaction, a no-shop restriction gives rise to the inference that the board seeks to forestall competing bids."[140] Thus, when *Revlon* duties apply, transaction protection mechanisms are likely to be invalidated, unless the mechanisms in question can be shown to further the board's sole duty of getting the "highest value reasonably attainable" for the shareholders.[141] Although the *QVC* court invalidated certain of the transaction protection mechanisms agreed to by Paramount and Viacom, the holding of the court is limited to situations where *Revlon* duties have been triggered.[142] In addition, the *QVC* court did not say that such mechanisms are inherently problematic; rather, the court was critical of certain features of the Paramount/Viacom transaction protection mechanisms and of the size of the monetary benefits that would have accrued to Viacom.[143]

The *QVC* court was especially troubled by the fact that the Paramount board did not seek to renegotiate the transaction protection mechanisms when it might have been possible to do so in connection with the

137. *Id.* (footnotes omitted).
138. *Id.* at 49 n.19 (citations omitted).
139. *Id.* at 49 n.20.
140. *Id.* (quoting Barkan v. Amsted Indus. Inc., 567 A.2d 1279, 1288 (Del. 1989)).
141. *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1288 (Del. 1988) (quoting *Revlon*, 506 A.2d at 182).
142. *QVC*, 637 A.2d 34.
143. *Id.*

renegotiation of other terms of the Paramount/Viacom agreement. The supreme court stated that:

> Under the circumstances [existing at October 23-24], it should have been clear to the Paramount Board that the Stock Option Agreement, coupled with the Termination Fee and the No-Shop Clause, were impeding the realization of the best value reasonably available to the Paramount stockholders. Nevertheless, the Paramount Board made no effort to eliminate or modify these counterproductive devices, and instead continued to cling to its vision of a strategic alliance with Viacom.[144]

In addition, in discussing a later point when the QVC offer exceeded the Viacom offer by $1 billion, the supreme court rebuked the directors as follows:

> When the Paramount directors met on November 15 to consider QVC's increased tender offer, they remained prisoners of their own misconceptions and missed opportunities to eliminate the restrictions they had imposed on themselves. Yet, it was not "too late" to reconsider negotiating with QVC. The circumstances existing on November 15 made it clear that the defensive measures, taken as a whole, were problematic: (a) the No-Shop Provision could not define or limit their fiduciary duties; (b) the Stock Option Agreement had become "draconian"; and (c) the Termination Fee, in context with all the circumstances, was similarly deterring the realization of higher bids. Nevertheless, the Paramount directors remained paralyzed by their uninformed belief that the QVC offer was "illusory." This final opportunity to negotiate on the stockholders' behalf and to fulfill their obligation to seek the best value reasonably available was thereby squandered.[145]

By their nature, breach of fiduciary duty claims brought against boards (whether by hostile bidders or by shareholders) are litigated in expedited proceedings on essentially paper records. *QVC* highlights the importance of a board's deliberative process and the need for keen sensitivity to the living record created in considering a friendly business combination transaction or responding to an unsolicited one. When the record of the board's processes creates a favorable impression with the courts, as was the case in the *Time* litigation, the likelihood of the board's decision receiving deference is greatly increased.

2. *If* Revlon *Duties Do Not Apply*

Even if *Revlon* duties do not apply, the board's decision to agree to transaction protection mechanisms after emergence of a rival bid will clearly be subject to enhanced scrutiny under *Unocal* and *Unitrin*.[146]

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144. *Id.* at 50.

145. *Id.*

146. *In re* Santa Fe Pac. Corp., Shareholder Litig. No. 13587, 1995 Del. Ch. LEXIS 70, at *24 (Del. Ch. May 31, 1995), *aff'd in part, rev'd in part*, 669 A.2d 59 (Del. 1995) ("[O]nce the board determined to alter the Santa Fe-BNI transaction in response to the

Applying *Unocal* and *Unitrin*, if the mechanisms employed in the transaction are found not to preclude third party offers and not to have a coercive effect on stockholders, such mechanisms should be permissible if "within a range of reasonableness."[147] In *Santa Fe*, the transaction protection mechanisms that the plaintiffs claimed to be a breach of the Santa Fe directors' fiduciary duties included the adoption and application of a "poison pill" stockholder rights plan by Santa Fe and the $50 million termination fee and a $10 million expense reimbursement provision in favor of BNI contained in the Santa Fe/BNI merger Agreement.[148] The Court of Chancery found that the transaction protection mechanisms, particularly the discriminatory use of the poison pill, were reasonable, proportionate responses to the threat posed by Union Pacific's offer because the mechanisms "preserved the preferred BNI merger transaction, but only after first causing Union Pacific to offer the highest value that it was willing to pay, and after causing BNI to offer value that was either comparable or higher."[149] The Court of Chancery specifically noted that "[g]iven the magnitude of the transaction in question (over $3.5 billion), nothing alleged in the complaint gives rise to a claim that the $50 million termination fee and $10 million dollar expense reimbursement provision were not reasonable."[150]

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unwanted Union Pacific bid, the altered transaction, which included the joint tender offer and the repurchase program, became subject to enhanced scrutiny under Unocal. . . ."); Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1151-55 (Del. 1989) (no-shop clause adopted at the insistence of Warner and share exchange were properly subject to *Unocal* analysis).

147. *See* Unitrin, Inc. v. American General Corp., 651 A.2d 1361 (Del. 1995); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). *See supra* Part IV.A.1, for a discussion of *Unocal* and *supra* Part IV.A.3, for a discussion of *Unitrin.*

148. *Santa Fe*, 1995 Del. Ch. LEXIS at *27. *See supra* Part IV.B.7, for a description of the facts in *Santa Fe* and holdings of the Court of Chancery and the Supreme Court with respect to the *Revlon* claim in the case.

149. *Id.* at *33.

150. *Santa Fe*, 1995 Del. Ch. LEXIS 70, at *32 n.8. The Supreme Court, after holding that the Court of Chancery should not, for purposes of a motion to dismiss, have relied on statements contained in the proxy materials distributed to the shareholders of Burlington and Santa Fe, concluded that the Court of Chancery had erred in dismissing the *Unocal* claim. *Id.* at 72. In doing so, the Supreme Court noted that: "This case may very well illustrate the difficulty of expeditiously dispensing with claims seeking enhanced judicial scrutiny at the pleading stage where the complaint is not completely conclusory . . . . Here, there are well pleaded allegations on the *Unocal* claim. As the terminology of enhanced scrutiny implies, boards can expect to be required to justify their decisionmaking, within a range of reasonableness, when they adopt defensive measures with implicatins for corporate control. This scrutiny will usually not be

The above-cited cases do not, however, make clear whether *Unocal* scrutiny would be applicable to transaction protection mechanisms agreed to prior to the emergence of a particular third party bid or whether the business judgment rule would apply. If the mechanisms result from arm's length bargaining, as would clearly be the case in a merger of equals providing parallel protections for each party, it is difficult to see why the approval of such mechanisms should be second-guessed by the courts, absent a failure to act with due care. Whether or not transaction protection mechanisms are subject to enhanced scrutiny, the requirement of seeking shareholder approval provides a limit on the deterrent effect of such mechanisms, especially non-economic provisions such as a no-shop or the lack of a fiduciary termination right.[151]

B. Particular Transaction Protection Mechanisms

This part of the Article describes particular transaction protection mechanisms and certain variations in their features.

Except as specifically noted, the discussion in this part assumes that *Revlon* duties apply to the transaction in question. With respect to each mechanism, we have attempted to summarize any specific limits placed by courts on its use. In general, however, such limits remain vague and are subject to case-by-case review. In addition, as in *QVC*, one can expect the Delaware courts to look at the total package of transaction protection mechanisms in determining whether a violation of the board's fiduciary duties has occurred. Under *QVC*, acceptance of such mechanisms by the seller must be consistent with the board's sole duty of getting the "highest value reasonably attainable" for the shareholders by, for example, bringing in a bidder who would not otherwise make an

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satisfied by resting on a defense motion merely attacking the pleadings." *Id. See also* Wells Fargo Co. v. First Interstate Bancorp, 1996 Del. Ch. LEXIS 3, *18-*20 (Del Ch. Jan. 18, 1996).

151. Note, however, that shareholder approval of a merger will not be deemed to provide ratification on the transaction protection mechanisms employed in connection with the merger. *See Santa Fe*, 669 A.2d at 67-68, where the Supreme Court refused to find ratification because:

> In voting to approve the Santa Fe-Burlington merger, the Santa Fe Stockholders were not asked to ratify the Board's unilateral decision to erect defensive measures against the Union Pacific offer. The stockholders were merely offered a choice between the Burlington Merger and doing nothing. The Santa Fe stockholders did not vote in favor of the precise [transaction protection] measures under challenge in the complaint. . . .

If, however, a transaction protection mechanism was specifically approved by stockholders, it would not constitute "unilateral" action by the directors and *Unocal* would be inapplicable. *See* Williams v. Geier, 671 A.2d 1368, 1377 (Del. 1996) ("A *Unocal* analysis should be used only when a board unilaterally (*i.e.*, without stockholder approval) adopts defensive measures in reaction to a perceived threat").

offer or by causing a bidder to agree to more favorable terms with respect to some other aspect of the transaction.[152] In order to create a record of the benefit achieved in return for agreeing to transaction protection mechanisms, the seller will want to attempt to minimize the aggregate potential cost of such mechanisms. In addition, after *QVC* it is probably unwise, if *Revlon* duties are applicable, to leave uncapped the total amount of the monetary benefits that the acquiror may receive. The seller's board should be carefully briefed with respect to the negotiations with the acquiror regarding such provisions to allow the board to make a reasoned judgment in approving any such provisions. Counsel for seller should remind the board that, when *Revlon* duties apply, it is not a proper purpose for the seller to attempt to protect the transaction from credible third party offers that would be more favorable to the seller's stockholders, except to the extent the acquiror's bargaining power forces the seller to do so in order to get a "bird in the hand." On the other hand, there may be situations where the seller's bargaining power will allow the seller to retain its rights to shop the deal,[153] especially if the seller is willing to agree to appropriate compensation for the purchaser if a third party deal is chosen.

1. Break-Up or Termination Fees and Expense Reimbursement

Break-up or termination fees vary in two important respects: (a) their size and (b) the events that trigger payment. Reimbursement of either actual out-of-pocket expenses or a sum certain that approximates such expenses is not likely to raise significant issues with the courts. Generally speaking, a break-up fee of approximately 1%-3% of the aggregate transaction value (with the lower range of percentages in large transactions and the higher range in small transactions) is likely to be deemed reasonable if it results from arm's length bargaining and is not supplemented by a lock-up option. In transactions that do not implicate *Revlon* duties, larger amounts should be permitted as a means of defending the transaction from interference if they fall within a range of reasonableness for that purpose. The seller should seek to locate the trigger for payment of a fee on or after board approval of the competing

152. Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1993).
153. *See supra* Part IV.B.10 for a discussion of post-signing market checks.

transaction and execution of a definitive agreement, a point when the benefits of the second bid to the stockholders will be concrete. Typically, the purchaser will request that such fees be payable on termination of the agreement to which it is a party.

2. *Lock-Up Stock Options*

The seller may grant the purchaser an option to purchase an agreed upon number of shares of common stock at an agreed upon price in the event a third party interferes with the transaction. Options to purchase shares representing up to 19.9% of the seller's outstanding common stock were common prior to *QVC* and remain common in bank mergers. In light of the focus in *QVC* on the total consideration to be received by the purchaser in the event of a third party transaction and the vehemence of the court's objection to the lock-up option, recent transactions tend to rely on break-up fees and expense reimbursement provisions.[154] However, there is no reason that an option could not be substituted for a break-up fee if the maximum gain on the option is capped at a reasonable amount sufficient to assure the purchaser that it is not merely a "stalking horse." In transactions that do not implicate *Revlon* duties, greater gain on the options should be permitted as a means of defending the transaction from interference, if within a range of reasonableness for that purpose. Arguably, even uncapped options may pass muster under the *Unocal* proportionality analysis that could be applied.[155] In a merger of equals, the quid pro quo of mutual stock options would seem to be especially likely to be deemed within a range of reasonableness.

Typically, the options are exercisable at the deal price. The terms that vary among such options include the triggers for exercisability of the option. The deterrent effect, from the purchaser's point of view, will be increased if the option can be exercised at any time after termination of the transaction agreement to which it is a party. However, the seller should seek to locate the trigger closer to consummation of the competing transaction, at a point when the benefit to the stockholders of the second bid will be more concrete and consummation is more certain. Another typical trigger is failure to receive stockholder approval after being put up for a vote.

With respect to a third party with a perceived need to employ "pooling of interests" accounting, the existence of a stock option lock-up arrangement may also carry significant deterrent value. The exercise of

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154. *Id.*
155. *Unocal*, 493 A.2d 946.

the option may prevent such third party from using pooling of interests accounting.

3. *Voting Lock-Ups with Stockholders*

If a significant portion of the voting securities of the seller are concentrated in the hands of a small number of holders, the purchaser may demand, as a condition to entering into an acquisition agreement, that such persons enter into agreements with the purchaser that "lock up" the support of such persons for the transaction. The deterrent effect of such arrangements on third party bids will, of course, depend on the number of shares locked up and the vote required to approve the agreement. Unlike the other mechanisms described in this part, the seller is not a party to the voting lock-ups. Nonetheless, even if the decision of the individual stockholders to enter into such agreements is not directly reviewed by a court, the existence of the voting lock-ups will be taken into consideration in the court's review of the transaction protection mechanisms as a whole and their effect on third party bids. In particular, in evaluating the granting of a stock option lock-up, the courts will consider the number of shares subject to voting lock-ups in determining whether the stock option lock-up will foreclose further bidding. Furthermore, the involvement of the board and management of the seller in becoming parties to or procuring such agreements may be interpreted by a court as expressing their support for "locking up" the deal. As with other transaction protection mechanisms, if it is clear that voting lock-ups are being procured at the purchaser's request, and that the parties to such arrangements entered into them of their own accord without pressure from the seller's board, they should not reflect negatively on whether the board has fulfilled its fiduciary duties.

4. *No-Shop and Window Shop Provisions*

A "no-shop" provision is a promise not to solicit, encourage, provide information to, or otherwise deal with any third parties. The provision may or may not be subject to a contractual "fiduciary out" that would create automatic exceptions so long as the board determines, in good faith after consultation with counsel, that its fiduciary duties require otherwise. A "window shop" provision is a promise not to solicit other offers, but it permits a board to provide information to a third party and otherwise deal with the third party under specified circumstances. Under

QVC, a fiduciary out to a no-shop or window shop exists, when *Revlon* duties apply, as a matter of law.[156] However, by including a contractual fiduciary out, the seller's board can avoid the implication that it intends to breach its fiduciary duties and is impermissibly favoring one bidder. In addition, a contractual provision allows the parties to determine the mechanics and timing of the necessary board decisions and other procedural matters as to which Delaware law is silent. Some acquisition agreements also contain a specific right to terminate the agreement if required by the fiduciary duties of the seller's board. Use of fiduciary outs and fiduciary termination rights by the seller's board are often conditioned upon the third party offer meeting certain criteria as to financing or as to the amount by which the third party offer exceeds the original offer.[157]

As with other transaction protection mechanisms, no-shop provisions are not *per se* invalid, but must be justified as assisting the board in its "obligation to seek the best value reasonably available" for the stockholders.[158] For example, in litigation challenging the 1986 merger of Western Air Lines, Inc. and Delta Airlines, Inc., the former shareholders of Western claimed that the Western directors had breached their duty of care by, among other things, agreeing to a no-shop provision instead of taking steps to encourage competitive bidding.[159] The court, after quoting the above language from *QVC*, noted that the Western board had agreed to the no-shop provision in order to achieve greater certainty of closing (weakening of the material adverse change

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156. *QVC*, 637 A.2d at 48; *see* discussion *supra* Part V.A.1.

157. Query whether a no-shop, with no fiduciary out, but that automatically disappears on the occurrence of a shareholder vote with respect to a transaction, could, if demanded by the purchaser, be found to be consistent with the fiduciary duties of the seller's board under *Revlon* (assuming all other transaction protection devices are reasonable under the circumstances)? What if all the other devices also terminate with the vote? In that case, a limited period of great protection and a subsequent period of no protection would result. In order to get an agreement with one party, the board would be giving up, but only for a time, possible transactions with other parties. The auction, if one is to occur, is postponed but not foreclosed. Some indirect support for this idea is found in the *Unitrin* court's testing of the reasonableness of defensive measures against the ability of a bidder to conduct a proxy fight. See Part IV.A.3 above. If no other bidders seek to derail the vote in favor of the merger, would that be evidence that the directors have met their fiduciary duties? Is the result changed if the no-shop allows giving specified confidential information to other bidders that meet specified criteria (but not to solicit, encourage or negotiate with such bidders prior to the shareholder's meeting)? If applied only to other transaction protection mechanisms, but not to the no-shop, would a similar time limit allow increased protection until the shareholder vote?

158. *QVC*, 637 A.2d at 46.

159. Rand v. Western Air Lines, Inc., 1994 Del. Ch. LEXIS 26, at *11-*12 (Del. Ch. Jan. 6, 1995), *aff'd without op.*, 659 A.2d 228 (Del. 1995).

clause in the merger agreement).[160] The court noted that the market had already been canvassed and that Delta was the only viable remaining prospect and concluded that "Western gained a substantial benefit for its stockholders by keeping the only party expressing any interest at the table while achieving its own assurances that the transaction would be consummated."[161] In contrast, the Delaware Supreme Court found the no-shop provision contained in the original Viacom/Paramount merger agreement unreasonable because it prevented the Paramount board from learning the details of competing bids and therefore inhibited their ability to negotiate with other bidders at a time when interest was being expressed.[162]

Even in transactions in which *Revlon* duties do not apply, the seller (or the parties in a merger of equals) should negotiate for a fiduciary out to any no-shop provision. There are two reasons for this: (1) the facts or structure of the transaction may change and *Revlon* may apply at a later time; and (2) the board may wish to avoid creating the perception that it will not, under any circumstance, listen to any offers (even if only for the information as to the value of the company an offer provides). In addition, if the board determines to take defensive action against a third party offer, in order to assist it in meeting the first prong of *Unocal*, the board will want to have adequate information as to the threat posed.[163] The purchaser is often willing to permit the fiduciary out when *Revlon* does not apply. In such cases, the fiduciary out should provide a much more narrow exception to the no-shop because the fiduciary duties of the board would not require opening up the field to other offers. On the other hand, the purchaser may not be willing to include a fiduciary termination right in an acquisition agreement when *Revlon* does not apply, believing that this sends the wrong message to possible third parties when Delaware law would not require the board to terminate its agreement to accept a higher offer.

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160. *Id.* at *19.
161. *Id.* at *19-*20.
162. *QVC*, 637 A.2d at 49.
163. *Unocal*, 493 A.2d at 954-55.

5. *Asset Lock-Up Options*

A seller may agree to sell certain of its most valuable assets to an acquiror in the event a third party bidder seeks to interfere with a negotiated transaction or as a condition to bringing an acquiror into an auction. Such agreements, however, have not been popular since the mid-1980s due to the difficulty in defending such actions against claims that the directors have violated their fiduciary duties under *Revlon*.[164] In contrast to the somewhat more measured protective devices discussed above, an asset lock-up tends to foreclose other bids completely. Accordingly, if *Revlon* duties apply the use of an asset lock-up must confer a substantial benefit upon the shareholders to withstand scrutiny. In addition, if the option to purchase such assets provides a bargain price, the seller's board may be subject to charges of corporate waste in addition to claims that it breached its fiduciary duties. However, notwithstanding the holdings of the cases cited above (which involved *Revlon* duties and clear bias in favor of one bidder), if *Revlon* does not apply, it is possible to envision circumstances where, in furtherance of a strategic combination, an asset lock-up at fair value resulting from arm's length bargaining would be upheld as not being in violation of the board's fiduciary duties if adopted in good faith after due care. Furthermore, such a lock-up might be able to pass a *Unocal* proportionality test, if applicable.

6. *Commercial Transactions*

The parties to a merger may decide to enter into commercial arrangements, such as sales or distribution contracts or joint venture agreements, simultaneously with the execution of a merger agreement. Such arrangements are designed to integrate the operations of the two entities in order to begin immediately to achieve the synergies associated with the merger transaction. To the extent the arrangements survive the termination of the merger agreement, they will serve the purpose of deterring an unwanted third party bidder who would not want to be saddled with long-term agreements with a competitor. Before approving such a transaction, the board should determine whether the arrangements are defensible as commercially reasonable in their own right. As with other potentially preclusive mechanisms, if *Revlon* duties apply, the size,

164. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1988); Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264 (2d Cir. 1986).

nature, or importance of the commercial arrangements will determine the deterrent effect, which in turn will determine the level of benefit to stockholders required. If *Revlon* does not apply, and the commercial arrangements were negotiated at arm's length in furtherance of a strategic combination, then the arrangements would be upheld if the court finds that they were adopted in good faith after due care and, if applicable, that they were able to pass a *Unocal* proportionality test.

VI. SELECTED PROVISIONS OF THE MERGER AGREEMENT

The seller will be most concerned about provisions of the merger agreement that could allow the purchaser not to close the transaction based on events or circumstances that are not within the seller's control. The purchaser, on the other hand, will want to make sure that the business it acquires is the one it expected. The provisions discussed below are among the most heavily negotiated in any merger agreement.

A. Material Adverse Change Clauses and Related Matters

Given the fact that parties to a business combination transaction sign a merger agreement several months (or longer) prior to the closing of the transaction, there is a risk that during such period the seller will lose some of its value. A purchaser will seek to condition its obligation to consummate the transaction on the absence of a material adverse change (MAC) in the seller. MAC clauses are often the subject of intense negotiation between the seller and the purchaser. Ideally, the seller would like to force the purchaser to accept all risk of such a change. Certain merger agreements between parties in the same industry, where the purchaser already faces the same business risks as the seller, contain no MAC condition or a very limited MAC condition. More typically, the parties negotiate a MAC clause that leaves some of the risk with the seller. The purchaser would, ideally, prefer to be able to avoid closing if, between the signing and the closing of the merger agreement, there is:

> any circumstance, change in, or effect on, the Seller or any subsidiary of the Seller that, individually or in the aggregate with all other circumstances, changes in, or effects on, the Seller or its subsidiaries: (a) is, or could be, materially adverse to the business, operations, assets or liabilities, results of operations or the condition (financial or otherwise) of the Seller and its subsidiaries taken as a whole or (b) could materially adversely affect the ability

of the Purchaser to operate or conduct the business of the Seller in the manner in which it is currently operated or conducted by the Seller.

The seller, on the other hand, will seek to limit the MAC clause in several ways. First, the seller will want to remove the word "could" in clause (b) and any reference to prospects, in order to avoid any possibility that the purchaser can get out of the agreement based on its subjective view of future events. In addition, the seller may wish to remove clause (b) entirely because without the "could" it is merely a restatement of what is covered in clause (a). In addition, the type of effects covered by clause (b) could include events or circumstances relating solely to the purchaser, which should be explicitly excluded. Other possible exclusions to ask for are: (1) an exclusion for changes that affect the seller's industry as a whole (especially if the purchaser is in the same industry), or the economy as a whole; and (2) an exclusion for changes resulting from the announcement or consummation of the transaction. The latter can be especially important in vertical mergers because the customers of the acquired company may be competitors of the acquiror.

A "back-door" MAC condition may be accomplished through the use of a "bring-down" condition (that the representations are true as if made on the closing date). In the case of an agreement with broad representations, this would have an effect similar to that of including a MAC condition.

B. Due Diligence Issues

The seller (especially if it is a public company) should resist provisions that permit the acquiror to forgo closing based on the results of any due diligence or similar investigation after the signing of the acquisition agreement. In general, the effect of such a provision (unless the threshold of problems that would allow the buyer not to close is very high) would be to grant the buyer an option to purchase the company. The failure of the transaction to close after a definitive agreement has been entered into may brand the company as "damaged goods," which, at the least, would give significant leverage to the acquiror in any pre-closing negotiations.

The seller should also resist any attempt by the acquiror to include a so-called "10b-5 representation" in the acquisition agreement. The name "10b-5 representation" comes from Rule 10b-5 promulgated under the Securities Exchange Act of 1934.[165] The representation, following the

165. 17 C.F.R. § 240.10b-5.

general anti-fraud language of Rule 10b-5, provides that the acquisition agreement "does not contain any untrue statement of a material fact or omit to state any material fact necessary to make the statement contained herein not misleading." Such a representation broadens the applicability of the other representations and does not merely duplicate the rules provided by the securities laws with respect to the transfer of corporate stock. Mere duplication does not occur because of the prima facie case required, and the defenses (including those provided by the applicable statutes of limitations) available with respect to the statutory rules differ from those applicable by contract. In fact, the seller will usually wish to demand language indicating that the buyer has had the opportunity to perform due diligence, is satisfied with the results, and, most importantly, can refuse to close based only on the untruth of the representations and warranties made in the agreement (at signing and, to the extent provided in the bring-down condition, again at closing). In addition, the seller should seek to include language by which the acquiror explicitly acknowledges that it understands that it is not to rely on anything not contained within the agreement and related disclosure schedule, even if provided to the acquiror during the due diligence investigation. However, it is generally appropriate for a seller that is a public company to make a representation that *its filings* with the Securities and Exchange Commission "did not, at the time they were filed, contain any untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary in order to make the statements therein, in light of the circumstances under which they were made, not misleading." In effect, the seller is representing that it has complied with duties imposed on it by the securities laws as a result of its status as a public company. This representation will usually be accompanied by a representation that such filings were in proper form and otherwise prepared and filed in accordance with the securities laws.

C. *Antitrust Issues*

The Hart-Scott-Rodino Antitrust Improvements Act requires parties involved in certain types of business combination transactions to supply specific information to the Antitrust Division of the Department of Justice and the Federal Trade Commission prior to the consummation of

a merger.[166] Such information will be used in determining whether the proposed transaction will have any anti-competitive effects that would require the transaction to be terminated or restructured.

Depending on the level of risk that the combined company may be required to divest certain assets, the seller may wish to include language in the acquisition agreement that binds the purchaser to go through with the transaction notwithstanding such requirements (a "hell or high water" provision) or that otherwise sets, in advance, a threshold of what the purchaser is willing to do. The purchaser may be unwilling to agree to a "hell or high water" requirement for fear that, once the regulatory authorities know that it has agreed to do anything it takes to complete the transaction, the purchaser will lose all of its bargaining power with respect to the regulators.

166. Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18a (1994).