SHAREHOLDER ALTERNATIVES TO HOSTILE TAKEOVERS: RESTRUCTURINGS, AUCTIONS, AND *MACMILLAN II* *

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* The views expressed in this article are those of the authors alone and do not necessarily reflect the opinions of their employers.

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I. INTRODUCTION

As recently as 1985, a target corporation's response to a hostile tender offer was "virtually unassailable"[1] under the business judgment rule.[2] In the past few years there have been many changes in the world of corporate takeovers, but many have been merely changes of degree: large acquisitions have become even larger;[3] inventive offensive and defensive takeover tactics have

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[1] Johnson, *The Eventual Clash Between Judicial and Legislative Notions of Target Management Conduct*, 13 J. CORP. L. 35 (1988).

[2] The business judgment rule, of course, presumes the validity of most actions of a board of directors and protects those actions from second-guessing by the courts. A leading formulation of the rule provides:

> In the absence of a showing of bad faith on the part of the directors or of a gross abuse of discretion the business judgment of the directors will not be interfered with by the courts. . . . The acts of directors are presumptively acts taken in good faith and inspired for the best interests of the corporation, and a minority stockholder who challenges their *bona fides* has the burden of proof.

Warshaw v. Calhoun, 43 Del. Ch. 148, 157-58, 221 A.2d 487, 492-93 (1966) (citations omitted). *See generally* H. HENN & J. ALEXANDER, HANDBOOK OF THE LAW OF CORPORATIONS 661-63 (3d ed. 1983) (discussing business judgment rule); Wander & LeCoque, *Boardroom Jitters: Corporate Control Transactions and Today's Business Judgment Rule*, 42 BUS. LAW. 29 (1986) (judicial decisions have begun to scrutinize the actions of corporate directors); Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979) (business judgment rule is misunderstood today).

[3] Cash tender offers amounted to less than $200 million in 1960, yet grew to almost $1 billion by 1966. *Senate Hearings on S. 510 before the Subcomm. on Securities of Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 33 (1967). In 1988, the aggregate dollar value of tender offers peaked at $153.9 billion. *Tender Offer Update: 1989*, 23 MERGERS & ACQUISITIONS L. REP. 25 (1989).

In the 1960s, most deals were relatively small. But by 1981, single deals topped $6 billion. For example, Du Pont bought Conco for about $6.8 billion. MERGERS AND ACQUISITIONS ALMANAC & INDEX 8 (1982). By the late 1980s, multibillion dollar deals were commonplace. *A New Strain of Merger Mania*, BUS. WK. Mar.

been replaced by a steady stream of even more creative strategies;[4] and the cast of players eager to grab a piece of the action has grown larger and larger.[5] But one change has been qualitative; the courts no longer give anything close to "complete deference" to the business judgments of target boards in hostile takeovers, unless the boards scrupulously follow established structural and procedural guidelines.[6] Even then, substantive court review often occurs. For better or for worse, the courts, primarily the Delaware courts,[7] have abandoned the nearly conclusive deference once given to the business judgments of target boards and have thereby largely reshaped the offensive and defensive tactics and procedures invoked in hostile corporate takeovers.

A primary result of this evolution in takeover strategies is a new emphasis on the importance of providing alternatives for target shareholders to consider. Increasingly, those alternatives are provided not by traditional white knights,[8] but by the corpo-

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21, 1988, at 122. Almost any corporation of any size is currently subject to takeover. Smith, *Size Alone No Longer Offers Takeover Immunity*, Wall St. J., Oct. 25, 1988, at C1, col. 4 (S.W. ed.), as illustrated by the 1988-1989 purchase of RJR/Nabisco by KKR for over $25 billion. Anders, *RJR Finale Will Send Money Coursing*, Wall St. J., Feb. 9, 1989, at C1, col. 3 (S.W. ed.).

4 Many of those often colorfully named strategies, such as poison pills, will be discussed in this article. The terms will be defined as they arise. As long as corporate attorneys and investment bankers are being paid hundreds and even thousands of dollars an hour in tender offer battles, they will turn their creative minds to the invention of new tactics and strategies. *See* Stewart & Hertzberg, *Investment Bankers Feed a Merger Boom and Pick Up Fat Fees*, Wall St. J., Apr. 2, 1986, at 1, col. 6 (S.W. ed.) (noting that many believe investment bankers' search for fees to be a main factor in fueling takeover boom).

5 Herman & Lowenstein, *The Efficiency Effects of Hostile Takeovers*, KNIGHTS, RAIDERS & TARGETS, THE IMPACT OF THE HOSTILE TAKEOVER, (J. Coffee, L. Lowenstein & S. Rose-Ackerman, ed. 1988) [hereinafter KRT] (there are now "sharks" in the business of putting companies "into play" and "wolf packs" of big investors willing to fund any takeovers promising substantial returns).

6 *E.g.*, *In re* Holly Farms Corp. Shareholders Litig., No. 10350 (Del. Ch. Dec. 30, 1988) (striking down lock-up option and other provisions where they were used to inhibit rather than promote auction); Edelman v. Fruehauf Corp., 798 F.2d 882, 889 (6th Cir. 1986) (enjoining a board which simply rubber-stamped a management-sponsored buy-out and did not run a fair auction).

7 "Delaware is far and away the preeminent state in terms of the number of publicly held corporations incorporated there. . . . It also has an unusually well-developed case law in the corporate area." W. CARY & M. EISENBERG, CORPORATIONS 101 (6th ed. 1988).

8 A "white knight," of course, is "[a] third company solicited by a takeover target to outbid the original aggressor, because the white knight is more acceptable to the target than the original aggressor." J. BROOKS, THE TAKEOVER GAME 375 (1987).

rate management itself in the form of restructurings,[9] including leveraged recapitalizations,[10] and management-sponsored leveraged buy-outs (MBO's).[11] The increasing number of leveraged recaps, MBO's and the like constitute a positive development for target shareholders[12] but raise a myriad of difficult issues.

This article undertakes five tasks. First, it will trace the development of the business judgment rule in the takeover context as refined primarily by the Delaware courts illustrating that the harsh tactics of yesteryear, tactics that were designed to stop hostile tender offers in their tracks, have been largely replaced by kinder, gentler defensive tactics featuring primary concern with producing valuable alternatives from which shareholders will be free to choose.[13]

Second, it will explain and illustrate the most popular of the new defensive tactics which exemplify the ideal of the new legal regime: corporate restructuring, leveraged recapitalization, and MBO's.[14]

Third, the article will summarize and analyze the case law developed by the Delaware courts in the litigation over defensive uses of restructurings, recaps, and MBO's.[15] A recent profusion of litigation has led to many new rules and some inconsistencies. This section will also highlight various issues that the lower Delaware courts have had much difficulty resolving.

Fourth, the article will summarize one of the most important decisions in the tender offer area since 1985, *Mills Acquisition Co. v. Macmillan, Inc.* (*Macmillan II*).[16] In so doing, the article will explain the answers that *Macmillan II* provides to important, yet

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[9] *See infra* notes 108 to 134 and accompanying text.

[10] *See infra* notes 109 to 127 and accompanying text.

[11] *See infra* notes 135 to 139 and accompanying text.

[12] *See* Johnson, *supra* note 1, at 38 (Courts, by encouraging auctions, have encouraged target managements to restructure and leverage companies resulting in target company shareholders being "greatly enriched.").

Whether or not these tremendous benefits to target shareholders translate into benefits for the economy and society at large is another question altogether. Debates on various issues raised by the current tender offer boom tend to gloss over this distinction. *Id.* at 71. *See* Johnson, *State Takeover Statutes; Constitutionality, Community and Heresy*, 45 WASH. & LEE L. REV. 1051, 1052 (1988); Johnson & Millon, *Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. 846, 856 (1989).

[13] *See infra* notes 18 to 107 and accompanying text.

[14] *See infra* notes 108 to 139 and accompanying text.

[15] *See infra* notes 140 to 221 and accompanying text.

[16] 559 A.2d 1261 (Del. 1988), discussed *infra* at notes 222 to 263 and accompanying text.

Macmillan has been called "the most significant decision by the Delaware Supreme Court" in nearly two years. Cohen, *Delaware High Court Rules a Company*

previously unresolved issues raised by the application of the business judgment rule in the context of restructurings, recapitalizations, and defensive MBO's.

Finally, the article will analyze and evaluate *Macmillan II*, suggesting that, for the most part, *Macmillan II's* holdings were both clarifying and correct.[17] While *Macmillan II* has not answered all questions in the area, its holdings are a welcome and beneficial addition to one of the most important and rapidly changing bodies of law in the country.

II. Evolution of the Business Judgment Rule

The Securities Exchange Commission (SEC) is certainly a major factor in the tender offer game. Its rules, promulgated pursuant to authority granted by the Williams Act[18] help shape the strategies and tactics of tender offerors and targets.[19] Nonetheless, the Supreme Court decisions in *Santa Fe Industries v. Green*[20] and *Schreiber v. Burlington Northern*[21] effectively ceded jurisdiction over such matters to the state courts to interpret the scope of the business judgment rule. Therefore, attention is turned to this evolving body of state law.

*A. Pre-*Norlin *Law*

The business judgment rule, as typically formulated and applied, means that corporate shareholders having elected a board of directors will have no more control over most of the decisions of the managers than the Board of Regents of Indiana University

Can't Use 'Lock-Up' Just to Stop a Suitor, Wall St. J., May 8, 1989, at B2, col. 3 (S.W. ed.) (quoting Arthur Fleischer, Jr.).

17 *See infra* notes 264-371 and accompanying text.

18 15 U.S.C. §§ 78m(d)-78m(e), 78n(d)-78n(f) (1986).

19 As an example, when the Delaware Supreme Court approved a discriminatory self-tender offer as a defensive tactic in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), the SEC immediately outlawed the practice with its "All Holders Rule." *See* Amendments to Tender Offer Rules—All Holders and Best-Price, Exchange Act Release No. 23,421 [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,016 (July 11, 1986).

20 430 U.S. 462 (1977) (holding that mere breach of fiduciary duty, absent misleading statements or omissions, was not a violation of Sec. 10(b) of the Securities Exchange Act and therefore claim was relegated to state courts).

21 472 U.S. 1 (1985) (holding that mere unfair treatment, absent fraud, was not "manipulative" within the meaning of Section 14(e) of the Williams Act and accordingly relegated claim to the state courts).

The importance of state takeover law was also heightened, obviously, when the United States Supreme Court approved a second generation state antitakeover law in CTS Corp. v. Dynamics Corp. of America, 107 S. Ct. 1637 (1987), thus bringing state legislatures as well as state courts into the debate over tender offer policies.

has over the selection of Bobby Knight's starting five in any given game.[22] In general, the business judgment rule has been applied to protect all corporate decisions including choice of strategy and tactics in meeting hostile bids for corporate control.

As the tide of hostile tender offers rose in the 1960's, 1970's, and early 1980's,[23] it was met with a variety of extreme defensive measures designed to preserve the independence of target corporations and to defeat outright the aggressive intentions of the tender offerors. Many of these defensive tactics were colorfully named. For example, "shark repellent" amendments to corporate charters sought to bar an offeror from buying a controlling interest in the target or, failing that, to block the offeror from gaining operational control.[24] "Golden parachutes" were designed to provide protection for target management, at the same time, making it much more expensive for a hostile offeror to complete an acquisition.[25] "Cyanide capsules" were designed to accelerate a target's debt payment or force renegotiation of its important labor and supplies contracts should a change of control occur.[26] The "Pac-Man" defense was a retaliatory tender offer for control of the would-be shark.[27] Sale of a "crown jewel"[28] was frequently one aspect of "scorched earth" policies aimed at leaving the corporation so stripped down that it would no longer be attractive to acquirers.[29] Even "corporate suicide," complete

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22 Couric, *Takeover Defense Costs Insured*, Legal Times of Wash., Nov. 3, 1980, at 3, col. 2 (quoting tender offer expense insurer stating that business judgment rule has led to "almost complete deference" by the courts to target management decisions).

23 *See supra* note 3.

24 *See, e.g.*, Burrough, *Tenneco, A Rumored Takeover Target, Proposing Sweeping Defensive Measures*, Wall St. J., Mar. 29, 1985, at 8, col. 3; Vartanian & Ledig, *Thrift Institutions Adopting More Shark Repellents*, Legal Times, Oct. 1, 1984, at 12, col. 1; Bancroft, *MCI Limits Shareholder Powers in the British Fashion*, Legal Times, Feb. 28, 1983, at 14, col. 1.

25 *See, e.g.*, Steinberg & Seto, *The Burnishing of Golden Parachutes*, 12 DIRECTORS & OFFICERS 24 (Winter 1988); Riger, *Taking a New Look at the Validity of Golden Parachute Agreements*, Nat'l L.J., Sept. 16, 1985, at 26, col. 1; Herzel & Collig, *Controversial "Golden Parachutes" Offer Protection*, Legal Times, Aug. 23, 1982, at 10, col. 1.

26 *See, e.g.*, Hertzberg, *Takeover Targets Find Loading Up on Debt Can Fend Off Raiders*, Wall St. J., Sept. 10, 1985, at 1, col. 6 (S.W. ed.).

27 *See, e.g.*, Feit, *Pac-Man Defense Upsets Majority Holder Rule*, Nat'l L.J., May 23, 1988, at 33, col. 1; Herzel & Schmidt, *SEC is Probing "Double Pac-Man" Takeover Defense*, Legal Times, Apr. 18, 1983, at 27, col. 1; Masters, *Use of "Pac-Man" Tactic in Takeovers Raises Hackles*, Legal Times, Sept. 27, 1982, at 7, col. 1.

28 A "crown jewel" is a corporation's most desirable asset, division or subsidiary. By selling that part of itself, a corporation may abate the hostile offeror's interest. Prentice, *Target Board Abuse of Defensive Tactics: Can Federal Law be Mobilized to Overcome the Business Judgment Rule?*, 8 J. CORP. L. 337, 343 (1983).

29 *See* Herzel & Schmidt, *Shareholders Can Benefit from Sale of "Crown Jewels"*, Legal

liquidation of the company, was occasionally considered as a means of defeating a hostile bid.[30]

The business judgment rule's loose rein coupled with the natural desire of corporate managers to keep their jobs led to some spectacular instances of subordination of shareholder interests.[31] A favorite example is *Panter v. Marshall Field & Co.*,[32] where a threatened tender offer by Carter Hawley Hale (CHH) induced Marshall Field's management to buy stores the company arguably did not need but which competed with CHH. Antitrust suits were a long favored method of responding to a hostile takeover,[33] but creation of an antitrust problem where none existed before was a slightly more extreme approach. It was also an effective approach and it caused CHH to drop the idea of making an offer. The numbers quickly demonstrate why Marshall Field shareholders subsequently sued their board of directors. Marshall Field stock had been trading at around $28 per share before the contemplated offer, which was to be at $42 per share. After CHH rescinded the offer, Marshall Field stock, now saddled with the extra burden of the unneeded stores, dropped below $20 per share. Over a stinging dissent by Judge Cudahy,[34] the Court of Appeals for the Seventh Circuit rather routinely applied the business judgment rule as an almost talismanic shield for the target board's actions.[35]

Times, Oct. 24, 1983, at 33, col. 1; Riley, *Takeover Decision May Spur Tactical Shift*, Nat'l L.J., Jan. 20, 1986, at 3, col. 1.

30 Such an attempt was enjoined as too severe a defensive tactic in Joseph E. Seagram & Sons, Inc. v. Abrams, 510 F. Supp. 860 (S.D.N.Y. 1981).

31 Target shareholders are typically more than willing to sell their shares at a profit when a tender offer is made. Klein, *A Brief Against Managements That Fight Off Tender Offers*, FORTUNE, Mar. 12, 1979, at 160 ("[E]very analysis I've seen shows that most stockholders are happy to sell out at a profit").

32 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

33 *E.g.*, Berman v. Gerber Prods., 454 F. Supp. 1310, 1326 (W.D. Mich. 1978); Anaconda Co. v. Crane, 411 F. Supp. 1210, 1216-19 (S.D.N.Y. 1975).

The popularity of the antitrust defense has been lessened by various rulings that target corporations had no standing to challenge hostile takeovers on antitrust grounds. *E.g.*, Central Nat'l Bank v. Rainbolt, 720 F.2d 1183, 1187 (10th Cir. 1983); A.D.M. Corp. v. Sigma Instruments, Inc., 628 F.2d 753, 754 (1st Cir. 1980). *See generally* Note, *Antitrust Standing of Target Corporations to Enjoin Hostile Takeovers Under Section 16 of the Clayton Act*, 55 FORDHAM L. REV. 1039 (1987).

34 *Panter*, 646 F.2d at 299 ("I emphatically disagree that the business judgment rule should clothe directors, battling blindly to fend off a threat to their control, with an almost irrebuttable presumption of sound business judgment, prevailing over everything but the elusive hobgoblins of fraud, bad faith or abuse of discretion.").

35 *Id.* at 293-95. Many other cases could be cited to support the proposition that the business judgment rule in the 1970s and early 1980s at least presented a

B. Norlin *Signals a Change*

So long as target boards of directors were given virtually untrammelled authority to act to defeat hostile tender offers, would-be offerors decided that their only hope of overcoming these extreme defenses was with more extreme tactics of their own, meeting fire with fire. Thus were born such extreme offensive strategies as the front-end loaded, two-tiered tender offer,[36] the bust-up takeover,[37] the bootstrap offer,[38] and the general use of junk bonds in financing offers,[39] which served to put virtually any corporation in America "into play."[40] These extreme tactics led to counter escalations on the defensive side,[41] including most

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"nearly insurmountable obstacle" to any challenge to target management defense tactics. *See, e.g.*, Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980); Whittaker Corp. v. Edgar, 535 F. Supp. 933 (N.D. Ill. 1982). *See also* Lynch & Steinberg, *The Legitimacy of Defensive Tactics in Tender Offers*, 64 CORNELL L. REV. 901, 926 (1979) ("business purpose test poses a nearly insurmountable obstacle for plaintiffs challenging defensive tactics").

36 A two-tiered, front-end loaded tender offer "typically [consists of] a cash offer that produces control, followed by acquisition of the remaining equity [through a merger] at a lower price for debt or equity securities of the acquiring company." L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 499 (2d ed. 1988). *See generally* Prentice, *Front-End Loaded, Two-Tiered Tender Offers: An Examination of the Counterproductive Effects of a Mighty Offensive Weapon*, 39 CASE W. RES. 389 (1988) (explaining the development of the front-end loaded, two-tiered offer and its impact on federal and state law).

37 A bust-up takeover occurs when the offeror can afford to purchase the target only if it can, upon gaining control, start "busting up" the target, selling its component parts to pay the purchase price. R. PRENTICE, LAW OF BUSINESS ORGANIZATIONS AND SECURITIES REGULATION 719 (1987). *See generally* Lipton, *Greenmail, Bust-Up Takeovers—A Discussion Memorandum*, N.Y.L.J., Sept. 7, 1984, at 1, col. 3 (stating that greenmail and bust-up takeovers are inherently bad); Mishkin, *Greenmail, Bust-Up Takeovers—Comment on the Lipton Proposal*, N.Y.L.J., Sept. 18, 1984, at 1, col. 3 (agreeing with Lipton that greenmail is bad, but questioning his premise that bust-up takeovers are inherently bad).

38 One method of making a bootstrap offer is for a "shark" which cannot truly afford to buy control of a target to make a very lucrative offer for, say, 15% of the target's shares. It is likely that the target's shareholders will be so eager to have at least some percentage of their shares purchased at the premium price that they will tender over 50% of the target's shares. The shark can then go to potential lenders and point out that control of the target is "there for the taking" and, in effect, use the target's own assets as collateral. R. PRENTICE, *supra* note 37, at 718.

39 A "junk bond" is a high yield, non-investment grade security that, in recent years, has provided virtually unlimited funds for hostile tender offers, leveraged buy-outs, and corporate restructurings. Pioneered by the recently-indicted Michael Milken of Drexel Burnham Lambert, junk bonds have transformed the takeover business. *See* C. BRUCK, THE PREDATOR'S BALL (1988).

40 Bruck, *The World of Business*, NEW YORKER, May 8, 1989, at 81.

41 One of the authors of this article has recently argued that the apparently coercive nature of the front-end loaded, two-tiered tender offer led not only to inven-

importantly Martin Lipton's invention of the "poison pill,"[42] a defensive shield of truly extreme proportions.[43]

Just as inventive legal minds were reaching the "Dr. Strangelove" stage, the Second Circuit Court of Appeals finally recognized the conflict of interest of target boards that commentators had been highlighting.[44] More importantly, the court actually second guessed a board in a particular case, *Norlin Corp. v. Rooney Pace, Inc.*[45] In response to an imminent tender offer by Piezo Electric Products in conjunction with Rooney Pace, Inc., the Norlin board of directors created an employee stock option plan (ESOP) and transferred enough shares to it and to Norlin subsidiaries to account for 49% of all outstanding Norlin shares. Because the board of directors controlled the shares held by both the ESOP and the subsidiaries, a successful tender offer was impossible at any premium.

In affirming the trial judge's grant of a preliminary injunction, the Second Circuit noted that the precipitous timing of the transfers of voting control to the target directors with no rationale other than a determination to avoid a takeover at all costs made it clear that the directors were motivated by a desire to retain control over corporate affairs.[46] The court rejected the view that a target board, having "conclude[d] that an actual or antici-

tion and court approval of increasingly extreme defensive tactics, but also to more stringent state and federal regulation of the tender offer process. *See* Prentice, *supra* note 36 at 405-10, 424-33.

42 Poison pill preferred stock is typically issued as a pro rata dividend to all holders of a corporation's common stock. It carries special redemption and conversion privileges that are triggered when a hostile offeror purchases a certain percentage (*e.g.*, 33% or 51%) of a target's shares. There are many ways the pill can be structured but it might, for example, upon being triggered allow target shareholders to buy $200 worth of the target's shares for $100, thus diluting the holdings of the offeror. A good description of various types of poison pills is contained in Damson, Pence & Stone, *Poison Pill Defensive Measures*, 42 BUS. LAW. 422, 426-31 (1987). *See* Martin & Struxness, *A Review of Current Developments in Shareholders Rights Plans*, 2 MERGERS & ACQUISITIONS L. REP. 234 (1989); Flood, *Per Se Illegality of Flip-In Pills*, 1 MERGERS & ACQUISITIONS L. REP. 6 (1988); Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964 (1985).

43 The SEC has described the poison pill "as the most potent defensive tactic available against hostile takeovers that does not require approval by shareholders." OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMM'N, THE EFFECTS OF POISON PILLS ON THE WEALTH OF TARGET SHAREHOLDERS 2 (Oct. 23, 1986).

44 *See, e.g.*, Lynch & Steinberg, *supra* note 35, at 915; Gelfond & Sebastian, *Reevaluating the Duties of Target Management in a Hostile Tender Offer*, 60 B.U.L. REV. 403 (1980).

45 744 F.2d 255 (2d Cir. 1984).

46 *Id.* at 265.

pated takeover attempt is not in the best interests of the company, . . . may take any action necessary to forestall acquisitive moves." The court stated:

> The business judgment rule does indeed require the board to analyze carefully any perceived threat to the corporation and to act appropriately when it decides that the interests of the company and its shareholders might be jeopardized. . . . [H]owever, the duty of loyalty requires the board to demonstrate that any actions it does take are fair and reasonable. We conclude that Norlin has failed to make that showing.[47]

The actions of the Norlin board were truly heavy-handed, yet little in previous case law warned the board that it should, at the very least, have paid more attention to appearances. The actions of target boards, no matter how extreme or clumsy, had almost always been rubber-stamped by the courts. *Norlin* signalled that a change was in the wind. However, no such change in the area of corporate law is truly significant until its breeze is felt in the jurisdiction of Delaware.

C. *The Delaware Response:* Unocal's *Two-Step Test*

In January of 1985, the Delaware Supreme Court stunned the corporate world with its decision in *Smith v. Van Gorkom*.[48] Applying a gross negligence standard, the court held that the business judgment rule's protection was not available to a board of directors that had not informed itself prior to approving the sale of the company.[49] Given that failure, even the presumption of good faith was insufficient to grant business judgment rule protections to the board.[50]

The true significance of the *Van Gorkom* decision continues to be debated.[51] But for purposes of this article, its importance lies in the fact that even though it did not involve a hostile tender

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47 *Id.* at 265-66.

48 488 A.2d 858 (Del. 1985).

49 *Id.* at 873.

50 *Id.* at 893.

51 *See, e.g.*, Macey & Miller, *Trans Union Reconsidered*, 98 YALE L.J. 127 (1988) (arguing that *Smith v. Van Gorkom* was "not, at bottom, a business judgment case, . . . [but] a takeover case" which did "not pose a serious threat of liability to officers and directors"); Block & Hoff, *'Business Judgment':* Van Gorkom *Revisited*, N.Y.L.J., Oct. 13, 1987, at 5, col. 1 (concluding that the case did not seriously damage the business judgment rule in that defensive actions will continue to be protected if directors follow minimal procedural requirements and act in good faith); Herzel & Katz, Smith v. Van Gorkom: *The Business of Judging Business Judgment*, 41 BUS. LAW. 1187 (1986) (assailing *Van Gorkom* as an assault on the business judgment rule).

offer and its attendant target-generated defensive tactics, *Van Gorkom* illustrated that the Delaware Supreme Court believed that the sale of a corporation was an important matter to shareholders and that the judgments of Delaware boards of directors in such transactions were no longer sacrosanct.[52] These points became clear in the hostile tender offer arena just a few months later in *Unocal Corp. v. Mesa Petroleum Co.*,[53] a case which has become arguably the most important ever decided regarding the application of the business judgment rule to target defensive tactics.

Unocal arose out of classic circumstances. On one side was infamous raider T. Boone Pickens and his Mesa Petroleum Co.[54] On the other side was Unocal Corporation, quite often a target in such battles. Already owning 13% of Unocal's shares, Mesa weighed in with a two-tier, front-end loaded offer for 37% at $54 per share cash. The second tier was to be a back-end merger wherein shareholders would receive not cash but highly-subordinated junk bond securities that Mesa valued at $54 but which were quite arguably worth less.[55]

Unocal's board of eight outside and six inside directors accepted the judgments of two investment bankers that the Mesa bid was inadequate and that Unocal's liquidation value was at least $60 per share.[56] Several defensive alternatives were proposed, including a self-tender for 37% of the shares at a price of $72, which would have saddled the corporation with substantial debt and which would have reduced exploratory drilling but would have nevertheless maintained independence. The outside directors met independently with financial advisors and attorneys and then rejected the Mesa bid and ultimately launched the self-tender with an interesting feature, the offer to repurchase was not extended to Mesa.[57]

The Delaware Supreme Court, reviewing the vice-chancel-

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52 Lesser, *Directors*, Nat'l L.J., Feb. 24, 1986, at 17, col. 1 ("courts are scrutinizing the decision-making process [in takeovers] with increasing vigor").

53 493 A.2d 946 (Del. 1985).

54 The Delaware Supreme Court was not at all kind to Pickens, labeling him "a corporate raider with a national reputation as a 'greenmailer.'" *Id.* at 956. A "greenmailer," of course, is one who buys a significant amount of a target's shares, not truly intending to buy control but hoping to "rattle the sword" and thereby convince target management to repurchase his shares at a premium. *See* Gilson, *Drafting an Effective Greenmail Prohibition*, 88 COLUM. L. REV. 329 (1988); Comment, *Greenmail: Can the Abuses Be Stopped?*, 80 NW. U.L. REV. 1271 (1986).

55 *Unocal*, 493 A.2d at 949.

56 *Id.* at 950.

57 *Id.* at 951. The discriminatory self-tender offer has been termed a "lollipop" because it provides something sweet for the normal target shareholders, but is a

lor's decision to enjoin the self-tender offer, confronted the issue of whether "the Unocal board [had] the power and duty to oppose a takeover threat it reasonably perceived to be harmful to the corporate enterprise, and if so, [was] its action . . . entitled to the protection of the business judgment rule."[58] The court commenced its discussion with a basic summary of the powers, responsibilities, and legal protections of directors. A quick review of Delaware's corporate statutes satisfied the court that "in the broad context of corporate governance, including issues of fundamental corporate change, a board of directors is not a passive instrumentality."[59] Further, the court noted that when a board's powers were exercised in the takeover context, the business judgment rule did apply[60] and a court would not substitute its judgment for that of the board if the board's decision could be "attributed to any rational business purpose."[61]

The court, however, quickly recognized limits to the protections provided by the business judgment rule. As the Second Circuit had done in *Norlin*, the Delaware high court noted that "[b]ecause of the omnipresent specter that a board [in the tender offer context] 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."[62] In the face of this conflict of interest, the *Unocal* opinion set forth a two-part test for judging the defensive actions of target management.

First, the directors had to show that they had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership."[63] Such a burden could be satisfied, the court explained, by showing good faith and reasonable investigation.[64] The court also noted that the board's showing was "materially enhanced" because the

bitter pill for the shark. Leefeldt, *A Sweet Way to Foil Takeover Bids*, Wall St. J., Sept. 4, 1985, at 24, col. 4 (S.W. ed.).

58 *Unocal*, 493 A.2d at 953.

59 *Id.* at 954. The court noted that even in traditional areas of corporate change such as charter amendments, mergers, sales of assets, and dissolution, director action is a prerequisite to final action under the Delaware Corporate Code. *Id.* at n.8.

60 *Id.* at 954 (citing Pogostin v. Rice, 480 A.2d 619 (Del. 1984)).

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

62 *Id.* (emphasis added).

63 *Id.* at 955 (citing Cheff v. Mathes, 199 A.2d 548, 554-55 (1964)).

64 *Id.*

board was comprised of a majority of outside directors.[65] Second, because the board's powers were not absolute and it did not have "unbridled discretion to defeat any perceived threat by any Draconian means available,"[66] the defensive measure must have been "reasonable in relation to the threat posed."[67]

The court then enumerated several examples of what a target board could properly consider as threats to corporate policy and effectiveness, including: "inadequacy of the price offered; nature and timing of the offer; questions of illegality; the impact on 'constituencies' other than shareholders (*i.e.*, creditors, customers, employees, and perhaps even the community generally); the risk of nonconsummation; and the quality of securities being offered in the exchange."[68]

In *Unocal*, the selective self-tender offer, which was both innovative and extreme, was held protected by the business judgment rule. The court initially agreed with the target board that a front-end loaded, two-tiered tender offer at an arguably inadequate price sponsored by a "corporate raider with a national reputation as a 'greenmailer,' "[69] was coercive, and therefore, a threat to corporate policy and effectiveness. Next, the court viewed the self-tender offer as reasonable in relation to the threat posed because it offered $72 worth of senior debt to the 49% of its shareholders who might otherwise be forced to accept Mesa's highly subordinated junk bonds.[70]

The *Unocal* two-part test is an intermediate application of the business judgment rule, lying between the traditional automatic application of the rule's protection where there is no "omnipresent specter" of a conflict of interest and the even more stringent test of "intrinsic fairness" applied to the "going private" phenomenon[71] in such cases as *Weinberger v. UOP, Inc.*[72] Although the wording of the two-part test reveals the potential of substan-

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65 *Id.*

66 *Id.*

67 *Id.* (emphasis added).

68 *Id.*

69 *Id.* at 956.

70 *Id.* at 956-57.

71 In a "going private" transaction, variously called a "freeze-out," "cash-out," or "take-out" merger, minority shareholders are forced to give up their shares of stock in a corporation to the controlling majority in exchange for cash or securities. *See generally* Booth, *The New Law of Freeze-Out Mergers*, 49 Mo. L. Rev. 517 (1984) (appraising Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) and its ramifications).

72 457 A.2d 701 (Del. 1983). *See* Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099 (Del. 1985); Joseph v. Shell Oil Co., 498 A.2d 1117 (Del. 1985).

tive court review of target board decisions, many commentators initially viewed the *Unocal* test as "toothless,"[73] perhaps because the result in *Unocal* was the validation of the specific defensive tactic used. While early applications of the *Unocal* test did not prove too useful,[74] in 1988 and 1989 the Delaware courts used the *Unocal* approach to put real substance into their review of target board defensive tactics.[75]

D. *The* Revlon *Auction Duty*

Before the *Unocal* test had reached full bloom, the Delaware Supreme Court added to its scrutiny of target board defensive tactics a very important facet in the form of the "auction duty" ruling in *Revlon, Inc. v. MacAndrews & Forbes Holdings*.[76] The notion of an auction duty did not spring fully-formed from the *Revlon* decision. Other courts[77] and several commentators[78] had supported the notion that defensive tactics which encouraged higher alternative bids should be treated differently than tactics which simply blocked hostile offers. *Revlon*, however, is undeniably the key case.

Revlon arose out of a proposal by Pantry Pride to buy Revlon stock for a price in the $40-$50 per share range. Partly because of personal antipathy between the CEO's of the two companies and partly because the Revlon board considered the bid inadequate, Revlon adopted a poison pill and a self-tender for one-sixth of its shares in exchange for various notes, including one-

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[73] *E.g.*, Johnson & Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 330 (1987).

[74] *E.g.*, Moran v. Household Int'l, 500 A.2d 1346, 1350-54 (Del. 1985) (upholding poison pill in face of possible coercive offer); Polk v. Good, 507 A.2d 531-37 (Del. 1986) (upholding corporate repurchase of shares so long as done in good faith following reasonable investigation).

[75] *See infra* notes 140 to 221 and accompanying text.

[76] 506 A.2d 173 (Del. 1986). *See generally* Stephenson, *Auctions: Companies in Play and at Work*, 2 20TH ANNUAL INSTITUTE ON SECURITIES REGULATION 431 (PLI 1988); Shea, *'Auction' Duties of Directors*, Nat'l L.J., June 13, 1988, at 13, col. 1; Note, *Corporate Auctions and Directors' Fiduciary Duties: A Third-Generation Business Judgment Rule*, 87 MICH. L. REV. 276 (1988) ("Delaware courts have strengthened the standard of review under the business judgment rule" using the *Unocal* two-prong test which has limited relevance in the auction phase context.).

[77] For example, in *Hanson Trust PLC-ML v. SCM Acquisition, Inc.*, 781 F.2d 264, 274 (2d Cir. 1986), the Second Circuit had alluded to the auction concept, striking down lock-up options "that effectively preclude bidders from competing with the optionee bidder."

[78] *E.g.*, Oesterle, *Target Managers as Negotiating Agents for Target Shareholders: A Reply to the Passivity Thesis*, 71 CORNELL L. REV. 53, 95 (1985); Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1050 (1982).

tenth of a share of $9 cumulative convertible preferred stock that Revlon's banker opined would trade at a face value of $100. The notes carried various covenants limiting Revlon's ability to incur additional debt, sell assets, or pay dividends unless approved by non-management directors. Pantry Pride made its first hostile offer at $47.50, subject to financing and redemption of the poison pill. Revlon recommended rejection of the offer and proceeded with its self-tender; 87% of the company's shares were tendered, and some were purchased on a pro rata basis.[79] After the self-tender offer was completed, Pantry Pride announced a new all-cash, all-shares offer at $42 per share. As maneuvers progressed, Pantry Pride raised its bid to $50, then to $53, and finally to $56.25.

In the meantime, it became clear to the Revlon board that Pantry Pride's determination would ultimately lead to sale of the company. Therefore, it negotiated with Forstmann Little & Co. (Forstmann), an investment group, and agreed to a purchase by Forstmann at $56 per share cash, contingent on a redemption of the poison pill and waiver of the covenants to the notes so that portions of Revlon could be sold to pay for the acquisition. When the deal was announced, the notes stopped trading at $100 and slipped to $87.50, angering bondholders.

Pantry Pride announced that it would bid a fraction higher than any Forstmann bid, despite the fact that it was not given access to confidential Revlon information that was being shared with Forstmann. Nonetheless, the Revlon board continued to resist Pantry Pride and agreed to support Forstmann's bid with: a lock-up option to purchase two Revlon divisions at a bargain price if any other bidder succeeded in buying 40% of Revlon; a "no-shop" provision;[80] and a $25 million "good-bye fee."[81] In return, Forstmann agreed to support the par value of the faltering notes by an exchange of new notes. This was a major reason for the Revlon board's favoring the Forstmann bid, because the board had been threatened with litigation by angry bondholders.[82]

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79 *Revlon*, 506 A.2d at 177.

80 In a "no-shop" provision, a target promises not to allow another party to compete with the bidder given the no-shop promise. Sometimes these provisions allow "window shopping," which means that the target is allowed to talk to other bidders who initiate contact with the target.

81 A "good-bye" fee is essentially an expenses provision which reimburses a losing bidder for the amounts it spent in pursuing an unsuccessful bid.

82 *Id.* at 178-79.

Pantry Pride sued, challenging the various defensive tactics, and the chancery court ruled against Revlon's board. On appeal, the Delaware Supreme Court upheld both the adoption of the poison pill and the self-tender as reasonable in relation to the threat posed by the initial Pantry Pride offer, which was grossly inadequate.[83] However, when Pantry Pride kept raising its offer and the board turned to negotiation with Forstmann, the court concluded that changed circumstances necessitated different rules by which to judge the board's actions:

> [W]hen Pantry Pride increased its offer to $50 per share, and then to $53, it became apparent to all that the break-up of the company was inevitable. 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 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 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.*[84]

In *Revlon*, the directors forfeited their protection under the business judgment rule by failing to select the highest possible bid for shareholders, opting instead to protect bondholders, and thereby protecting themselves from litigation and creating a conflict of interest.[85] The lock-up option, "no-shop" clause, and "good-bye" fees were all struck down because, although not per se illegal, in this case they impeded rather than promoted the auction of Revlon stock.[86]

E. *Characteristics of the Current Regime*

No longer do courts simply go through the motions in ap-

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[83] *Id.* at 180-82.

[84] *Id.* at 182 (emphasis added).

[85] *Id.* at 183. The court objected to directors' actions which were aimed primarily at "protection of the noteholders (who were threatening litigation) over the shareholders' interests." *Id.* at 184. Other courts have indicated that a board may not be able to ignore noteholders' or other creditors' interests. *E.g.*, Wieboldt v. Schottenstein, No. 87C8111 (N.D. Ill. Dec. 1, 1988). Such holdings might place directors in quite a bind if either of two constituencies with conflicting interests can call them to account. The matter of conflicting constituencies is discussed *infra* notes 321-366.

[86] *Revlon*, 506 A.2d at 183.

proving defensive tactics taken by target boards in hostile takeovers. Rather, the *Unocal/Revlon* line of cases, as applied by the courts, has led to a relatively active form of case-by-case review, with generally beneficial results for target shareholders. Emphasis should be placed on three prominent features of the current legal regime.

i. Coercive Offensive and Defensive Tactics Have Been Minimized.

Before *Unocal* and *Revlon*, combatants in hostile takeovers battled without much interference from the courts, resulting in rather extreme offensive and defensive measures. *Unocal's* proportionality test meant that extreme offensive tactics justified extreme defensive tactics. Sharks that continued to launch coercive, front-end loaded, two-tiered tender offers saw the courts ratify the most extreme defensive tactics available, including poison pills,[87] golden parachutes,[88] and special dividends.[89]

Eventually, tender offerors got the message. If front-end loaded, two-tiered offers could legally be met with the fiercest resistance under *Unocal*, why not shift to all-cash, all-shares bids that were not viewed by the courts as coercive?[90] *Unocal's* proportionality test would appear to prevent target boards from responding too vigorously to such an offer. Indeed, in the post-*Unocal* era, two-tiered bids have almost disappeared.[91]

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87 Desert Partners v. USC Corp., 686 F. Supp. 1289, 1299 (N.D. Ill. 1988); Buckhorn, Inc. v. Ropak Corp., 656 F. Supp. 209, 231 (S.D. Ohio 1987) (although the court generally approved use of the poison pill, it held that the board had not done its homework in setting the price); Moran v. Household Int'l, 500 A.2d 1346, 1356 (Del. 1985).

88 Buckhorn, Inc. v. Ropak Corp., 656 F. Supp. 209, 228-29 (S.D. Ohio 1987).

89 Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987). The special dividend in *Ivanhoe* allowed a "white squire" (a friendly party which holds shares for the target but, unlike a white knight, does not bid for control) to make a "street sweep" (a large purchase of shares in the open market) which frustrated the hostile tender offer.

90 All offers are arguably coercive to at least some extent. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695, 1723 (1985); Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PA. L. REV. 647, 679 (1984); Note, *supra* note 42, at 1966. But front-end loaded, two-tiered offers are viewed by the courts as being especially coercive. *E.g.*, Desert Partners v. USG Corp., 686 F. Supp. 1289, 1298-99 (N.D. Ill. 1988); CRTF Corp. v. Federated Dep't Stores, [1987-1988 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 93,680 (S.D.N.Y. Mar. 18, 1988); Buckhorn, Inc. v. Ropak Corp., 656 F. Supp. 209 (S.D. Ohio 1987). All-cash, all-shares bids, on the other hand, are not typically viewed as coercive. *See infra*, note 92 and accompanying text.

91 In 1982, front-end loaded, two-tiered tender offers accounted for 20% of all tender offers and were featured in most of the really large battles of 1981 and 1982.

The surmise of the hostile offerors was largely correct. When they made all-cash, all-shares offers, the courts presumed such offers to be non-coercive,[92] and generally speaking, strictly limited the defensive tactics invoked against such offers. Thus, poison pills,[93] lock-up options,[94] and self-tenders,[95] among other tactics, have been invalidated as being too severe in proportion to the minimal threat posed by all-cash, all-shares bids. In essence, milder offenses begat milder defenses under *Unocal*.[96]

However, by 1986, only 3% of tender offers were front-end loaded, two-tiered in nature and by 1987 the tactic had almost disappeared. Grundfest, *Two-Tier Bids Are Now a Defensive Technique*, Nat'l L.J., Nov. 9, 1987, at 26, col. 4 & 27, col 1.

92 Most courts have difficulty finding anything coercive about all-shares, all-cash offers, even if allegedly made at an inadequate price. *E.g.*, Shamrock Holdings Inc. v. Polaroid Corp., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,340, at 92,223 (Del. Ch. Mar. 17, 1989) ("It is difficult to understand how, as a general matter, an inadequate all cash, all shares tender offer, with a back end commitment at the same price in cash, can be considered a continuing threat under *Unocal*."); MAI Basic Four, Inc. v. Prime Computer, Inc., [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,179, at 91,634 (Del. Ch. Dec. 20, 1988) (there is "nothing about" an all-shares, all-cash bid that is coercive).

93 *E.g.*, Grand Metro. PLC v. Pillsbury Co., 558 A.2d 1049 (Del. Ch. 1988); Southdown, Inc. v. Moore McCormack Resources, Inc., 686 F. Supp. 595, 604 (S.D. Tex. 1988).

94 *E.g.*, *In re* Holly Farms Corp. Shareholders Litig., No. 10350 (Del. Ch. Dec. 30, 1988) (striking down lock-up option and termination fees used to stifle an auction and to favor a white knight over a hostile all-shares, all-cash offer).

95 *E.g.*, AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 114-15 (Del. Ch. 1986) (applying *Unocal* test to restrain coercive self-tender offer in face of an all-shares, all-cash bid).

96 Indeed, much of the milder atmosphere of the case law has spilled over into that of the commentators. Before *Unocal* and *Revlon*, the debate among commentators was focused on the polar extremes, with, for example, Martin Lipton arguing that target boards should be given complete discretion to defeat hostile tender offers while Easterbrook and Fischel argued for total managerial passivity in the face of such offers. *E.g.*, Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 N.Y.U. L. REV. 1231 (1980); Lipton, *Takeover Bids in the Target's Boardroom: An Update After One Year*, 36 BUS. LAW. 1017 (1981); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Easterbrook & Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733 (1981); Easterbrook & Fischel, *Is Takeover Defense in Shareholders' Best Interest?*, Legal Times of Wash. Aug. 10, 1981, at 42, col. 1.

A decade later, Lipton still sticks to his guns. *E.g.*, Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1 (1987). And an occasional voice will support the passivity thesis. *E.g.*, Schwartz, *Search Theory and the Tender Offer Auction*, 2 J.L. ECON. & ORG. 229 (1986); Schwartz, *Bebchuk on Minimum Offer Periods*, 2 J.L. ECON. & ORG. 271 (1986). However, for most commentators the terms of the debate have also moderated and now tend to focus on less dramatic issues, such as who should have the burden of proof. *See, e.g.*, Cohen, *Opinion*, 1 MERGERS & ACQUISITIONS L. REP. 731 (1988) (suggesting that *Unocal* proportionality test be supplemented by rebuttable presumption of shareholder choice); Coffee, *Opinion*, 1

ii. Shareholder Freedom of Choice Has Been Recognized as Having Independent Value.

Numerous cases have invalidated defensive tactics, such as poison pills or lock-up options, that block a tender offer or hinder the auction process, but nevertheless approved those same tactics, when they were used to promote an auction or otherwise produce alternatives for shareholders.[97] Such suits are often decided in the midst of an ongoing struggle for control and it is not unusual for courts to decline to interfere with defensive maneuvers being used to run an auction. These same courts, however, have threatened to enjoin those maneuvers the moment it appeared that they were stifling, rather than promoting, the bidding process.[98] Once an auction reaches its "end stage," many courts intimate that virtually no defensive tactics will be permitted to interfere with the bidding process.[99]

These cases go hand in hand with others expressly stressing shareholder freedom of choice as a variable of independent and increasing significance.[100] This notion was expressed by the Delaware Chancery Court in *Mills Acquisition Co. v. Macmillan, Inc.*,

MERGERS & ACQUISITIONS L. REP. 981 (1989) (suggesting that at the end-stage of a non-coercive offer, *Unocal* proportionality test should be disregarded in favor of more conclusive right of shareholders to accept offers the board deems inadequate); Gilson & Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to the Proportionality Review*, 44 BUS. LAW. 247 (1989) (arguing that court should engage in "searching internal analysis of any management plan" when target board asserts non-coercive bid is inadequate). Even in this debate, the contestants admit that their differences might simply be over matters of nomenclature. Coffee, *Opinion*, 1 MERGERS & ACQUISITIONS L. REP. 989 (1989).

97 *E.g.*, Cottle v. Storer Communication, 849 F.2d 570, 576 (11th Cir. 1988) (upheld lock-up option granted by board committed to sale at "end stage" of auction in order to secure the arguably more favorable bid).

98 *E.g.*, MAI Basic Four, Inc. v. Prime Computer [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,179, at 91,635 (Del. Ch. Dec. 20, 1988) (refusing to order redemption of poison pill in early stages of tender offer, but noting that redemption might be ordered later because "if the present stalemate continues indefinitely the [target's] stockholders will be denied an opportunity to make their own investment judgment"); Doskocil Cos. v. Griggy, No. 10,095 (Del. Ch. Oct. 7, 1988) (poison pill left in place where it appeared that target board was ready to use it to run an auction); Facet Enters. v. Prospect Group, No. 9746 (Del. Ch. Apr. 15, 1988) (allowing poison pill to stay in place until the auction process has reasonably run its course).

99 *E.g.*, City Capital Assocs. v. Interco, 551 A.2d 787, 798 (Del. Ch. 1988) (allowing poison pill to stay in place to assist in auction, but indicating that it would have to be removed when the auction reached its "end stage" and the pill could no longer be helpful in inducing higher bids but could only block shareholder choice).

100 *E.g.*, Blasius Indus. v. Atlas Corp., Fed. Sec. L. Rep. (CCH) ¶ 93,965, at 90,846 (Del. Ch. July 25, 1988) (only in extreme cases may board take actions intended primarily to thwart effective exercise of shareholder choice).

where a target board, which had agreed to redeem a poison pill as to one bidder in a competitive auction, but not as to the other, was ordered to redeem as to both so that shareholders would not be deprived of a choice.[101]

Despite this strong trend, notable exceptions have recently occurred which have subordinated shareholder choice to directorial discretion in unusual circumstances.[102] However, it is unlikely that these exceptions will reverse the recent trend emphasizing the importance of shareholder choice.

iii. Restructurings, Leveraged Recapitalizations, and MBO's are Increasingly Being Used as Defensive Tactics.

Court decisions favoring auctions, shareholder freedom of choice, and shareholder alternatives, combined with various other factors including the easy availability of financing,[103] have led inexorably to an increase in the defensive use of restructurings, leveraged recapitalizations, and MBO's. This fact is supported by a cursory glance at the recent case law involving the business judgment rule in the takeover context.[104] This article will now briefly describe these new defensive tactics,[105] summarize the cases litigating their validity, focus on unanswered questions,[106] and then summarize and evaluate *Macmillan II* and its answers to those questions.[107]

III. Restructurings, Recapitalizations, and MBO's—A Brief Primer

Cases such as *Unocal* and *Revlon* send an important message to the boards of directors of target and potential target corpora-

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[101] Robert M. Bass Group v. Evans, 552 A.2d 1227 (Del. Ch. 1988), *rev'd* 559 A.2d 1261 (Del. 1989).

[102] *E.g.*, Paramount Communication v. Time, Inc., Civ. No. 10866 (Del. Ch. July 14, 1989); Shamrock Holdings v. Polaroid Corp., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,340 (Del. Ch. Mar. 17, 1989).

[103] Lowenstein, *Opinion*, 2 Mergers & Acquisitions L. Rep. 427 (1989) ("[l]iberal financing made it possible" to sell $1.2 trillion worth of American industry in 1980's).

[104] During 1988 and the first half of 1989, seldom did a week go by when a major takeover was not being litigated in some court, usually the Court of Chancery in Delaware. *See* Meyers, *Showdown in Delaware: The Battle to Shape Takeover Law*, Inst. Investor, Feb. 1989, at 97.

[105] *See infra* notes 108 to 139 and accompanying text.

[106] *See infra* notes 140 to 221 and accompanying text.

[107] *See infra* notes 222 to 368 and accompanying text.

tions. In essence, courts view tender offers as beneficial for target shareholders because they give target shareholders an opportunity to sell their shares at a profit. Target boards should, therefore, think primarily in terms of offering alternatives to their shareholders rather than blocking hostile bids altogether. Those alternatives might come in the form of an auction between the shark and white knights recruited by target management, or uninvited "gray knights" might join in.

Increasingly, however, those alternatives are provided directly by the target itself in the form of restructurings, recapitalizations, and MBO's. Sometimes these alternatives are directly responsive to a hostile bid. At other times they are used proactively to preempt the making of hostile bids. In either event, it is important to understand how these restructurings are effected and their impact.

The broad concept of a "restructuring" encompasses any of a number of changes in corporate strategy and redeployment of corporate assets. A restructuring can take the form of a recapitalization, the sale of attractive assets, the divesting by spin-off or otherwise of non-core operations, creation of master limited partnerships (MLP's) to hold key assets, and even the most extreme option, the MBO.[108]

A. *Recapitalizations*

Recapitalizations constitute a very important subcategory of corporate restructurings. A "leveraged recapitalization" involves a corporation replacing a large portion of its equity with debt by exchanging cash, securities, or a combination of both for the shares held in public hands. While the public shareholders retain roughly their proportionate interest in the company after the recapitalization, they hold "stub shares" representing a smaller share base in a more highly leveraged company.[109] Management and employee stock option plans, on the other hand, generally forgo the cash payment, trading their shares solely for stock in the company, thus substantially increasing their aggregate percentage equity interest in the recapitalized company.[110]

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[108] *See* Block & Hoff, *Recapitalizations and Restructurings*, N.Y.L.J., May 14, 1987, at 5, col. 1.

[109] *See generally* Teeters, *The Leveraged Recap: Controversial New Defense Maneuver*, J. BUS. STRATEGY, Mar.-Apr. 1988, at 26 (discussing risks of the new recap); Willens, *Recap of Leveraged Recaps*, Barron's Weekly, July 6, 1987 at 36, col. 1 (discussing the leveraged recap as a popular new anti-takeover defense).

[110] *See* Foye, *Defensive Recapitalization: A New Value Alternative*, in STRUCTURING

Despite many potential drawbacks,[111] as defensive measures, recapitalizations provide a multitude of advantageous features. The fact that a recapitalized company is highly leveraged greatly reduces the opportunity for a hostile bidder to rely on the assets of the target for financing. Further, a large portion of future cash flows are committed to debt holders rather than equity holders,[112] which in turn discourages hostile bidders. In the case of a large dividend, the shareholders' desire for cash may in large part be appeased while at the same time cash reserves which might attract an unwanted suitor are reduced.[113] Another feature increasing the defensive aspect of recapitalizations, and hence their popularity, is the fact that to the extent management has increased its percentage ownership in the company, a takeover will be rendered that much more difficult.

Some commentators feel that the recent surge in leveraged recapitalizations is largely demand driven.[114] This characteriza-

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LEVERAGED BUYOUTS: DEFENSIVE RECAPITALIZATION AND OTHER DEFENSIVE TECHNIQUES 198 (1988); Fogg, *Leveraged Recaps: Maximizing Shareholder Value*, Nat'l L.J., Feb. 8, 1988, at 24, col. 1 ("Typically, [recaps] substantially increase the equity participation in the corporation of management and other employees.").

[111] Prior to the consummation of a recapitalization, the directors must ensure that the transaction does not run afoul of the law of fraudulent conveyances. Delaware corporation law and the law of most states imposes several financial tests upon the distribution of assets to shareholders, whether through means of a dividend or a share purchase. Primarily, no dividend or share repurchase may be completed if the effect of such payment is to leave the corporation unable to meet its obligations as they come due. DEL. CODE ANN. tit. 8, § 170 (1983); REVISED MODEL BUSINESS CORP. ACT (RMBCA) § 6.40(c)(1) (1985). Additionally, no shares may be purchased or redeemed by the corporation when the capital of the corporation is impaired or would become impaired as a result of the transaction. DEL. CODE ANN. tit. 8, § 160 (1983). RMBCA § 6.40(c)(2). Under Delaware law, capital impairment exists when liabilities exceed the value of the corporation's assets. DEL. CODE ANN. tit. 8, § 154 (1983). RMBCA § 6.40(c)(2).

The fraudulent conveyance problem is usually circumvented by having the board "write up" the assets to their fair market value, thus creating sufficient surplus to avoid the impairment of capital. Such a practice has been approved in Delaware. Morris v. Standard Gas & Elec., 31 Del. Ch. 20, 63 A.2d 577, 583 (1949). If a particular state's law does not allow the board to create "revaluation surplus," it may be necessary to include a reincorporation merger in the recap plan and to obtain shareholder approval. Fogg, *supra* note 110, at 24, col. 2.

[112] Block, Levine & Berger, *Corporate Recapitalization: Structuring the Transaction*, in RESTRUCTURING THE CORPORATION: RECAPITALIZATION AND OTHER TAKEOVER DEFENSES 38 (1987).

[113] *Id.*

[114] DeMott, *Directors' Duties in Management Buyouts and Leveraged Recapitalization*, 49 OHIO ST. L.J. 517 (1988).

There is also evidence that many of these deals are tax-driven. Bartlett, *Corporate Reorganizations, Leveraged ESOPs*, Nat'l L.J., Feb. 8, 1988, at 30. col. 1 ("Corporate reorganizations of all types are generally tax driven.").

tion advances the view that the market forces which make recapitalizations more attractive also determine the demand for the assets produced as a result of these transactions. Among these market forces are the emphasis on short-term value in the marketplace, the high prices at which the stub shares have been trading,[115] and the continued availability of debt and equity financing.

Recapitalizations had also been considered popular due largely to the fact that they were not viewed as a "sale" or change of control that would give rise to the *Revlon* auction duty.[116] However, recent court decisions indicating that this is no longer the case[117] may affect recapitalization practices. Recapitalizations can be implemented in several ways.

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[115] Foye, *supra* note 110, at 199.

Several of the major recaps implemented to date have seen the market place substantial value on the post-recap stub stock. For example, the Multimedia stub equity was valued at $8.37 on May 2, 1985, the date the recap was announced. As of May 28, 1987, Multimedia shares were selling at $52.40 (a 535% increase, impressive when compared with a 62% increase in the S&P 500 for the same period). Cowan, *The New Way to Halt Raiders*, N.Y. Times, May 29, 1987, at D1, col. 2. Likewise, in the FMC recap, the stub shares were trading at $19.25 on May 29, 1986, the first day after the recap was effected. As of June 1, 1987, FMC shares were selling at $34.75, giving the entire recap package a value of $114.75 per share. On August 31, 1987, the price reached $45.18, bringing the total value to $125.13. *See The FMC Recapitalization*, *infra* note 121, at 51.

The price of these high returns is increased volatility. While a Drexel Burnham Lambert study showed that 38 restructured stocks outperformed the S&P 500 by a wide margin between August 1983 and August 1987, in the heart of the bull market, shares associated with Drexel Burnham Lambert (the most active underwriter of highly leveraged transactions) fell 50% between August 28, 1987 and October 28, 1987, when the S&P 500 fell by only 30% in the same period. Smith, *Performance of High-Debt Firms After Crash Bears Out Warnings of Volatility in Downturn*, Wall St. J., Nov. 3, 1987, at 71, col. 3.

[116] Cases which indicated that a recap might not trigger the *Revlon* auction duty included *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334 (Del. 1987) and *Gelco v. Coniston Partners*, 811 F.2d 414 (8th Cir. 1987).

Several commentators have traced the popularity of recaps to this perception. Gilson, *Macmillan: Was It Worth the Wait*, 2 MERGERS & ACQUISITIONS L. REP. 623, 625; Cowan, *The New Way to Halt Raiders*, N.Y. Times, May 29, 1987, at D1, col. 2 & D4 col. 4.

[117] The case which is the focus of this article, *Mills Acquisition Co. v. Macmillan* ("*Macmillan II*"), 559 A.2d 1261 (Del. 1988), implies, but does not explicitly hold, that recaps transferring control give rise to the *Revlon* auction duty. *See* discussion *infra* notes 287 to 312 and accompanying text. However, even before *Macmillan II* there were cases which indicated that the mere fact that a defensive transaction was structured as a recap would not necessarily allow evasion of the *Revlon* auction duty. *E.g.*, Black & Decker Corp. v. American Standard, Inc., 682 F. Supp. 772, 781-82 (D. Del. 1988).

i. Recap as Merger.

In a recapitalization structured as a merger, a shell corporation is merged into the company, with the company as the surviving corporation. In the merger, each share of the company's stock is converted into cash, or cash and debt plus a new share and each share of the shell corporation's stock is converted into new shares. The shell corporation's stock is received by management immediately prior to the merger in exchange for their shares of the company's stock.[118] Under Delaware law, shareholder approval is required and those opposing the merger are entitled to appraisal rights.[119]

ii. Recap as Reclassification.

A reclassification requires an amendment to the corporation's certificate of incorporation, reclassifying existing shares into new shares and authorizing issuance of a new class of preferred shares that immediately converts into cash, or cash and debt.[120] Immediately prior to the transaction, management typically exchanges its shares for shares of another series of preferred stock, which is in turn reclassified and converted solely into new shares.[121]

Because a shareholder vote is required in both the merger and reclassification form of recapitalization, a company's flexibility may be limited by time constraints. This takes on particular significance when a recapitalization is implemented in response

[118] Lederman & Goroff, *Recapitalization Transactions*, 19 SEC. & COMMODITIES REG. 241 (1986).

A leading example is the 1986 Owens-Corning recapitalization which was structured as a merger in which OCF paid "$52 in cash and one $35 principal amount junior subordinated debenture and one new common share for each outstanding common share." Certain employee benefit plans received equivalent value in the form of 5.6 new common shares for each old share. *See The Owens-Corning Recap*, 22 MERGERS & ACQUISITIONS L. REP. 51 (1987).

[119] DEL. CODE ANN. tit. 8 § 251 (1983). Delaware law requires a majority vote for approval of such a merger. *See also* RMBCA §§ 11.03 and 13.02 (requiring a majority vote and allowing appraisal rights for dissenters).

[120] DEL. CODE ANN. tit. 8 § 242(a)(3) (1983). Delaware law requires a majority vote by the shareholders to amend the articles of incorporation. *See also* RMBCA §§ 10.03 and 10.04 (requiring majority vote).

[121] A leading example of this type of recapitalization occurred when FMC Corp. used the reclassification structure in its 1986 recap. In the reclassification, public shareholders received 1/100th of a share of a new series of preferred stock, which immediately after issuance was redeemed for $80 in cash and one share of new common stock for each share of old common stock. Employee stock option funds and management received 5.667 new shares in exchange for each old share. *See The FMC Recapitalization*, MERGERS & ACQUISITIONS L. REP. 51 (1987).

to a takeover bid by an unwanted suitor. For this reason, companies often submit shareholder rights' plans or other charter amendments for shareholder approval in a single, unified proposal along with the recapitalization plan. Adoption of these "anchors" has been justified as providing a corporation with sufficient time to realize the anticipated value to be achieved by the recapitalization.[122]

iii. Recap as Dividend.

In a recapitalization structured as a dividend, shareholders receive a special cash dividend substantial in amount relative to the current trading price of the company's common stock. Management and ESOP's however, generally receive additional shares through a combination of new stock plans and a reinvestment of the cash dividend they receive.[123] From a tactical standpoint, dividends do not require shareholder approval and accordingly do not give rise to appraisal rights.[124]

iv. Recap as Share Repurchase or Self-Tender.

Large open market share repurchases or self-tender offers provide additional means of recapitalizing a company. These methods involve a company's offer to purchase a substantial number of its own shares for cash, or a combination of cash, debt securities and preferred stock.[125]

Share repurchases are often accompanied by the simultaneous creation of an ESOP, to which the company issues shares. Typically, the company borrows funds which are reloaned to the newly-created ESOP on substantially similar terms. The funds

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122 *See* Block & Hoff, *supra* note 108, at 5, col. 2.

123 *See* Foye, *supra* note 110, at 201.

124 A prime example of a recap in the form of a special dividend is that effected by Harcourt Brace Jovanovich (HBR). In the face of a $44 per share merger proposal from British Printing & Communication Corp., HBJ approved a dividend of cash and preferred stock with a combined value of $50 per HBJ share. HBJ also purchased a significant amount of its common stock in the open market after the announcement of its dividend. *See* British Printing & Communication v. Harcourt Brace Jovanovich, Inc., 664 F. Supp. 1519, 1525 (S.D.N.Y. 1987) (upholding the recap, because an independent board did its homework and an auction was not entirely foreclosed, even though one bidder was favored).

125 Examples of this form of recapitalization abound. As noted in the previous footnote, the HBJ recap involves repurchase of a substantial number of shares in the open market. A self-tender offer was attempted and invalidated in AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 109-10 (Del. Ch. 1986). Anderson Clayton might have fared better had its self-tender not been a front-end loaded, two-tiered scheme to defeat a non-coercive hostile offer. *Id.* at 113.

are subsequently returned to the company as payment for the stock issued to the ESOP. The ESOP then repays the loan out of the company's future tax-deductible contributions to the ESOP.[126] In addition to the advantage of placing a greater percentage of shares in friendly hands, creation of ESOP's also allows institutional investors making ESOP loans to companies to exclude one-half of the interest on the loan from gross income. This tax benefit is generally shared with the company through lower interest rates.[127]

v. Sale of Attractive Assets.

Another form of restructuring is the sale of those assets most attractive to a potential or actual suitor,[128] the "crown jewels." This defensive approach has a long history[129] and has recently become even more popular as the general concept of restructuring and the more specific notion of "deconglomeration" have come into vogue.[130]

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126 *See* Rosen, *The Growing Appeal of the Leveraged ESOP*, 10 J. BUS. STRATEGY 16, 17 (Jan./Feb. 1989).

127 *Id.* at 144-45.

For a detailed overview of the tax treatment of recaps and restructurings in general, *see* 1 FREEMAN, *Tax Strategies for Leveraged Buyouts and Other Corporate Acquisitions, Restructurings and Financings*, 7 (1988). Regarding the specific tax advantages of restructuring through an ESOP, *see* 2 LUDWIG, *New Techniques, Special Features, and Enhanced Incentives in Utilizing ESOPs*, 491 (addressing general tax advantages of ESOPs), and 2 Serota, *New Techniques, Special Features, and Enhanced Incentives in Utilizing ESOPs*, at 467 (addressing sale of divisions).

Note, however, that Congress is considering reducing some of the tax advantages that ESOP's have enjoyed. *See* Birnbaum & Winker, *Rostenkowski Acts to Repeal Tax Break From ESOPs' Sale of Bonds to Buy Stock*, Wall St. J., June 8, 1989, at B5, col. 5 (S.W. ed.).

128 *See supra* note 28.

129 Among the leading early instances of sale of a crown jewel was Brunswick's sale of its Sherwood Medical subsidiary to American Home Products, which caused Whittaker Corporation to abandon its hostile offer for Brunswick. *Whittaker Abandons Battle for Brunswick as Court Clears Sale of Sherwood Medical*, Wall St. J., Mar. 9, 1982, at 5, col. 1 (S.W. ed.). That defensive maneuver was challenged in court. However, under the pre-1985 version of the business judgment rule it was, of course, upheld. Whittaker Corp. v. Edgar, 535 F. Supp. 933 (N.D. Ill. 1982).

Also famous is Marathon Oil Company's granting of a lockup option to purchase its crown jewel (an interest in the Yates oil field) to white knight U.S. Steel to allow it to defeat hostile offeror Mobil Corporation. O'Boyle & Rotbart, *Marathon Oil Holders Vote Its Acquisition by U.S. Steel, Which Plans to Keep All of It*, Wall St. J., Mar. 12, 1982, at 3, col. 2 (S.W. ed.). The granting of these lock-up options was later declared invalid by the Sixth Circuit, albeit under an erroneous interpretation of federal law. Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981).

130 *See* Arieff, *Firms Reverse Field, Start Selling Subsidiaries*, Legal Times, Oct. 31,

vi. Corporate Spin-Offs.

One method of increasing market value for shareholders by calling the stock market's attention to the value of underlying assets is the spin-off. This usually entails placing some valuable assets in a newly-formed corporation and selling some of the shares in an initial public offering.[131] The spin-off is usually motivated by the same general factors that give rise to sale of crown jewels, and often carries tax benefits.[132]

vii. Master Limited Partnerships.

Natural resource industries have restructured through the creation of master limited partnerships (MLP's) into which are placed undervalued corporate assets so that the cash flow they generate may be more visible to the market and more directly realizable by shareholders.[133] Again, tax benefits are involved,[134] but the thrust is often to channel value to shareholders and away from potential appropriation by a hostile offeror.

B. Management Buyouts

MBO's are perhaps the most extreme form of defensive restructuring—one in which the target's management buys all of the stock from non-management shareholders in a highly leveraged transaction.[135] In situations where the *Revlon* rule appears

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1983, at 2, col. 1 ("a new trend . . . [is] . . . 'asset redeployment' or 'disaggregation' ").

For example, as part of its major restructuring in 1987, Colt Indus., sold five different subsidiaries for $56 million as part of a plan to raise shareholder value and strengthen takeover defenses. *See Profile of a Corporate Restructuring: Colt Indus.*, Corporate Restructuring, Mar. 1988, at 9. Another example occurred when Liggett Group, attempting unsuccessfully to fend off a bid by Grand Metropolitan that was thought to be motivated in large part by a desire to acquire Liggett's Austin Nichols subsidiary, sold that subsidiary to Pernod Ricard S.A. *See* Lederman, *Restructuring As a Takeover Defense*, in 19TH ANNUAL INSTITUTE ON SECURITIES REGULATION 197-98 (1987).

131 A leading example of the spin-off technique was Pillsbury's attempt to spin off its Burger King subsidiary as part of its restructuring plan to defeat a bid by Grand Met. Unfortunately for Pillsbury, the spin-off was enjoined by the court. Grand Metrop. PLC v. Pillsbury Co., 558 A.2d 1049 (Del. Ch. 1988).

132 Lederman, *supra* note 130, at 199.

133 *Id.* at 198.

134 *Id.* at 199. Among the corporations that have used the MLP technique are Diamond Shamrock, International Paper, Unocal, and T. Boone Pickens' Mesa Petroleum. *Id.* Some MLPs have had problems, *see, e.g.*, Maita, *The Bloom is Off MLP Market*, S.F. Chronicle, July 27, 1987, at 23, col. 2.

135 Oesterle & Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207, 210 (1988); Williams, *Procedural Safeguards to Ensure*

to mandate sale of the company, target managements often question why they should not be the purchasers. After all, modern junk bond financing provides an abundant source of funds and requires very little financial commitment by the managers personally.[136]

In the typical MBO, management forms a holding corporation (Newco) which proposes a merger with the publicly-held target corporation. In accordance with the merger agreement, Newco survives and then acquires the business and assets of the target. The public shareholders of the latter receive cash and/or securities for their shares. The transaction is usually financed by borrowing heavily against the cash flow and assets of the target. Thus, MBO's are correctly viewed as simply a form of a leveraged buyout (LBO).[137]

MBO's have been heavily criticized on several grounds[138] and their use raises numerous questions that are beyond the

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Fairness in the Management Buyout: A Proposal, 21 COLUM. J.L. & SOC. PROBS. 191 (1988).

[136] Bruner & Paine, *Management Buyouts and Managerial Ethics*, 30 CAL. MGMT. REV. 89, 90-91 (1988).

[137] *See generally* Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978) (discussing freezeouts that involve public stockholders who have no active role in managing the corporation and a small percentage interest in the company).

It is important to distinguish MBO's from the broader category of freeze-out or cash-out mergers. In a freeze-out merger, the purchaser already owns a majority interest in the target and acts to eliminate the public shareholders through a merger by forcing them to trade their shares for cash. A management which does not already own a majority interest may acquire it through a tender offer (by "Newco" which management controls) or by a redemption by the target of its own shares, thus increasing management's ownership to a majority percentage level. Such a transaction is known as a "two-step" transaction. *See* Repetti, *Management Buyouts, Efficient Markets, Fair Value, and Soft Information*, 67 N.C.L. REV. 120 (1988).

[138] The controversy surrounding MBO's centers on the fact that management places itself in the precarious position of being both the buyer and the seller of the corporation, creating a conflict of interest which potentially jeopardizes its duty of undivided loyalty. *See* Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 739 (1985); Stein, *A New Low?* Barron's Weekly, Nov. 14, 1988, at 17; Longstreth, *Fairness of Management Buyouts Needs Evaluation*, Legal Times, Oct. 10, 1983, at 15, col. 1. This conflict is most disturbing when shareholders sell to their managers a faltering firm marked by historically low share prices, only to watch the same management team turn the firm around and sell it for a handsome profit only a few years later. *See* Oesterle & Norberg, *supra* note 135, at 241; *Beatrice Buyout May Net Investors Eightfold Return*, Wall St. J., June 18, 1987, at 4, col. 1.

There is also fear that management is taking unfair advantage of the shareholders by utilizing nonpublic information, and worse, that management will use such inside information and its position to manipulate share prices so that it can get a bargain. *See* Lowenstein, *supra* note 138, at 740 (listing examples). *But see* Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U. L.

scope of this article.[139] For the purpose of this article it is noteworthy that target managers, faced with hostile bids and constrained by the *Unocal* and *Revlon* rules, will likely continue to find the MBO an attractive method of offering an alternative avenue for shareholder choice.

IV. RESTRUCTURINGS, RECAPS, MBO'S, AND THE BUSINESS JUDGMENT RULE

In the last two years or so, the post-*Unocal/Revlon* litigation regarding the business judgment rule in the hostile takeover environment has focused increasingly on restructurings, recaps and MBO's. As noted earlier, these devices have been used repeatedly and litigation about their validity has escalated. A chronological summary of the main cases decided since *Unocal* and *Revlon* provides background helpful to an ultimate discussion of the key unresolved issues.

The Southern District of New York, in *GAF Corp. v. Union Carbide Corp.*,[140] upheld a defensive recapitalization in the form of an exchange offer of $20 in cash and debentures that restricted the sale in any one year of more than 25% of the company's net assets and, in certain circumstances, limited such sales to 5% per year. The court, without citing *Unocal*, echoed its view that a target board can attempt to protect constituencies other than shareholders—in this case, protecting them from the "bust-up" takeover that GAF was planning.[141] The court viewed the GAF plan as unfair, commenting that "[s]elf-appointed potential acquirers of control are not a protected species in corporate law . . . entitled to have Boards of Directors smooth [their] path to control."[142]

REV. 630, 638 (1980) (rejecting the view that MBO's necessarily involve misuse of inside information).

139 For example, like standard recapitalizations, MBO's raise fraudulent conveyance problems. *See generally* Smyser, *Going Private and Going Under: Leveraged Buyouts and the Fraudulent Conveyance Problem*, 63 IND. L.J. 781 (1988) (arguing that MBO's create a fraudulent conveyance problem); Baird & Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985) (arguing that MBO's should be excluded from fraudulent conveyance law).

140 624 F. Supp. 1016 (S.D.N.Y. 1985) (applying New York law).

141 *Id.* at 1019. A GAF official admitted that GAF intended to sell $4 billion in Union Carbide assets in order to finance the purchase. Thus, the possibility of substantial dislocation for employee/shareholders was clear. *Id. GAF* is one of the leading cases suggesting that non-shareholder constituencies may properly be considered by the board of directors in deciding whether or not to oppose a tender offer.

142 *Id.* at 1020. While other courts have intimated that sharks deserve to be

In *Edelman v. Fruehauf Corp.*,[143] the Sixth Circuit Court of Appeals enjoined a target board's rubberstamping of an MBO made in response to a hostile tender offer. The court reasoned that the board prevented the hostile bidder from raising its bid in response to the MBO and provided $100 million of corporate funds to finance the MBO, funds that were not available to the hostile offeror, well-known shark, Asher Edelman.[144]

AC Acquisitions v. Anderson, Clayton & Co.[145] involved a self-tender offer and sale of shares to an ESOP which defendant management proposed in response to a $56 per share all-cash, all-shares offer by plaintiff.[146] The self-tender was a front-end loaded, two-tiered offer that would pay shareholders $60 per share for 65% of the company's shares and leave them holding shares trading at $22-$31 or $37-$52, depending on which investment banker was believed. Applying the *Unocal* test, the court viewed the self-tender offer as satisfying the first prong regarding a threat to corporate effectiveness or policy. Although plaintiff's offer might have been preferable, the court noted that the self-tender did involve a large, tax-advantaged cash distribution to shareholders who would continue to participate in the new, highly-leveraged company.[147] However, the court determined that the self-tender offer not to be reasonable in relation to the threat posed in that its coercive two-tiered nature virtually precluded the shareholders from considering any alternatives.[148] Because the defense failed the second prong of the *Unocal* test, the court held that the action did not qualify for protection under the business judgment rule, deeming it a breach of the duty of

treated fairly by a target board, especially when an auction is undertaken, *e.g.*, Samjens Partners I v. Burlington Indus., 663 F. Supp. 614, 624 (S.D.N.Y. 1987), *GAF* appears to disagree.

143 798 F.2d 882 (6th Cir. 1986) (applying Michigan law).

144 *Id.* at 885-87. Although Michigan law controlled, the court quoted *Revlon* regarding the auction duty and commended the trial court for setting a framework to open the bidding process. *Id.* at 887.

145 519 A.2d 103 (Del. Ch. 1986).

146 *Id.* at 104. The self-tender offer was Anderson Clayton's second response to the hostile offer. *Id.* at 106. The first, a recapitalization, had been enjoined by a court not long before. *Id.*

147 *Id.* at 112. Obviously it could be argued that the self-tender with its "stub" equity for shareholders was the preferable choice, because it allowed shareholders some immediate benefit and also promised them the opportunity to participate in the long-term prosperity, if any, of the company. The value of such "stub" shares is the focus of much of the debate on the right of directors to "just say no" and to run an auction that favors a recapitalization plan over a hostile offer that provides more immediate value.

148 *Id.* at 113.

loyalty even if motivated in good faith. The judge further commented that the duty would be satisfied only by a showing that the offer was "objectively or intrinsically fair."[149]

Gelco Corp. v. Coniston Partners[150] involved a management-sponsored exchange offer that would have placed 53% of the voting power in the hands of target management and its investment advisor, Merrill Lynch. The plan was developed before a competing hostile bid by Coniston, but launched afterward. Coniston subsequently sought to enjoin the restructuring plan. Applying the *Unocal* test, the trial judge determined that the board, composed of a majority of outside independent directors, satisfied the test's first prong by demonstrating good faith and reasonable investigation. Next, the court viewed the response as reasonable in light of evidence that the hostile offer was inadequate and that the offeror, Coniston, had a reputation as a raider bent on liquidation. Furthermore, the court found that no auction duty arose from either the fact that the hostile bid was an all-cash, all-shares bid[151] or from the arguable shift of control to management and its "ally" Merrill Lynch, given that the Merrill Lynch shares were redeemable and that Merrill Lynch was not bound to vote them in any particular way. The Court of Appeals for the Eighth Circuit affirmed, reaching only a few of the issues.[152]

The Southern District of New York, in *British Printing & Communications Corp. v. Harcourt Brace Jovanovich, Inc.*,[153] upheld a recapitalization[154] finding that an independent board had done its homework and the recap did not foreclose an acquisition entirely. The recapitalization was allowed even though the board

[149] *Id.* at 115. This "intrinsically fair" language is perilously close to the "entire fairness" test, which has generally been reserved for situations where management has a rather patent financial conflict of interest. A self-tender offer, standing alone, should not be sufficient to invoke the entire fairness test unless it transfers control to management or, as here, is coercive (front-end loaded, two-tiered).

[150] 652 F. Supp. 829 (D. Minn. 1986), *aff'd*, 811 F.2d 414 (8th Cir. 1987) (applying Minnesota law).

[151] *Id.* at 847. Although the court applied Minnesota law, like most other jurisdictions, it drew heavily from Delaware law. This was one of the first cases to explicitly struggle with the question of what circumstances are required to trigger the *Revlon* auction duty.

[152] 811 F.2d 414 (8th Cir. 1987). The circuit court's opinion dealt mainly with the propriety of injunctive relief given the unlikelihood of irreparable injury.

[153] 664 F. Supp. 1519 (S.D.N.Y. 1987) (applying New York law).

[154] *See supra* note 124 for details of the recapitalization. The recapitalization by HBJ served as the model for the recapitalization used by the Macmillan company and addressed by the Delaware Supreme Court in *Mills Acquisition Co. v. Macmillan, Inc.* (*Macmillan II*), 559 A.2d 1261 (Del. 1989).

showed favoritism to investment bankers who participated in the transactions and profited rather handsomely. The court noted that the board believed that the hostile bidder, whose proposed merger prompted the recap, had made an offer that was inadequate and not entirely serious. Though the recap discouraged this particular bidder, the court did not view it as a bar to a bidder with sufficient capital and determination.[155]

Ivanhoe Partners v. Newmont Mining Corp.,[156] like *Unocal*, arose out of a battle initiated by a T. Boone Pickens' two-tiered offer. Given that such an offer is considered a serious threat to corporate policy and effectiveness under the first prong of the *Unocal* test,[157] the Delaware Supreme Court upheld Ivanhoe's response, a restructuring which involved a large dividend to existing shareholders given for the purpose of reducing liquidity and facilitating a "street sweep"[158] by target Newmont's largest shareholder, Gold Fields. The court held the *Revlon* duty to auction inapplicable because sale of Newmont was not "inevitable," although after the street sweep, Gold Fields held 49% of Newmont shares. A "stand still" agreement,[159] the court noted, limited Gold Fields to that 49% ownership and to a 40% position on the board of directors.[160]

In *The Henley Group v. Santa Fe Southern Pacific Corp.*,[161] the court upheld the decision of Santa Fe's board to remain independent and to pursue a restructuring in the face of a takeover

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155 *British Printing & Communications Corp.*, 664 F. Supp. at 1529.

156 535 A.2d 1334 (Del. 1987), *aff'g* 533 A.2d 585 (Del. Ch. 1987).

157 *Id.* at 1342. Following its earlier decisions in *Moran* and *Unocal*, the Delaware Supreme Court further emphasized the distinction between the "coercive" front-end loaded, two-tiered tender offers and the non-threatening all-cash, all-shares offers. This helped resolve one set of issues, but raised another, can a board ever oppose an all-cash, all-shares bid as coercive simply on grounds that the price offered was inadequate? *Ivanhoe*, however, did not address this issue.

158 As noted earlier, a "street sweep," also called a "market sweep," is a large purchase of shares on the open market that occurs while a tender offer is pending or immediately after one has been terminated. *See id.* at 1337 n.3. The SEC is not pleased with the street sweep tactic, believing that it allows acquirors undue latitude to skirt the provisions of the Williams Act and thereby disadvantages small investors. *See* Blanc, *Commission Proposes to Outlaw Market Sweeps*, Nat'l L.J., Nov. 9, 1987, at 28, col. 1.

159 A "standstill" agreement binds a potential bidder not to pursue aggressive takeover measures, such as a tender offer or proxy fight. *See generally* Bartlett & Andrews, *The Standstill Agreement: Legal and Business Considerations Underlying a Corporate Peace Treaty*, 62 B.U.L. REV. 143 (1982) (examining standstill agreements, describing potential legal problems, and offering suggestions for contract drafters).

160 *Ivanhoe Partners*, 535 A.2d at 1344-45.

161 Civ. Action No. 9569, 1988 W.L. 23945 (Del. Ch. Mar. 11, 1988).

bid by a major shareholder, The Henley Group. The board protected the restructuring plan with a poison pill. Both tactics were sustained by the court as reasonable because Henley's Schedule 13D filing had implicitly threatened a two-tiered offer.[162] Because the board was offering an economic alternative to the shareholders, the court noted that it was entitled to protect that alternative with the poison pill, even though some of its actions impeded a fair proxy context.[163]

Black & Decker Corp. v. American Standard, Inc.[164] culminated in a federal district judge issuing an order enjoining target American Standard's recapitalization plan which, with a coordinated offering of shares to an ESOP, would have increased management control from a relatively small position to 55%. The recap also had the affect of making $230 million of target funds available to finance the recap that was not available to the hostile offeror. The court held that the *Revlon* duty to auction arose not only from the inevitable sale of all shares of a target, but also from a change of control, as happened here.[165] The duty to auction was breached, according to the court, by several actions of target management which favored the recap over Black & Decker's hostile offer, even though the recap was not the clearly superior alternative.[166]

The Southern District of Texas in *Southdown, Inc. v. Moore McCormack Resources*,[167] invalidated a poison pill and a restructuring plan holding that the target board had violated its *Revlon* auction duty when it used the pill to prevent the shareholders from choosing between the restructuring and a non-coercive, all-cash, all-shares offer.[168]

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162 *Id.* at 30 (slip op.). Thus, even the *threat* of a two-tiered offer can justify extreme defensive measures.

163 *Id.* Again, it must be stressed that the cases summarized here involve recaps, MBO's and the like, which provide alternatives to target shareholders. Whether *Henley*, for example, would have reached the same result if target management had simply said "no" without offering an alternative is unresolved.

164 682 F. Supp. 772 (D. Del. 1988).

165 *Id.* at 781-82. This holding seemingly clashed with the Delaware Supreme Court's *Ivanhoe* ruling, where no auction duty was found despite a transaction leading a white squire to hold 49% of the target's shares. It thus highlighted one of the key issues to be addressed by the Delaware Supreme Court in *Macmillan II*.

166 *Id.* at 784. Among other advantages, the recapitalization plan made $130 million of corporate funds available to fund the recap that was not available to hostile bidder Black & Decker. *Id.* at 786.

167 686 F. Supp. 595 (S.D. Tex. 1988) (applying Delaware law).

168 *Id.* at 604. Although the court did not cite *Unocal*, it clearly believed that the defensive maneuvers were out of proportion to the threat posed by a "simple, uniform, straight-forward, and nondiscriminatory" bid by Southdown. *Id.*

Robert M. Bass Group v. Evans (*Macmillan I*)[169] a precursor to *Macmillan II*, which will receive substantial attention in the next section of this article, evaluated management's defensive plan to split the company, Macmillan, Inc., into two separate corporations, with management owning 39% of one of them. The Delaware Chancery Court held that this transaction was not proportional to the minimal threat posed by an all-cash, all-shares bid, especially because the board already had in place a multitude of defensive measures including a poison pill, golden parachutes, and shark repellent amendments.[170] Additionally, the court viewed the restructuring as a "sale" to management which arguably triggered the *Revlon* auction duty.[171] The court held that the board's claim that its restructuring carried the benefit of allowing public shareholders to continue to enjoy the benefits of the company through their "stub" shares did not justify precluding them from choosing between the two offers, especially where the Bass Group's bid was, quite arguably, economically superior.[172]

In re Fort Howard Corp. Shareholders Litigation[173] approved an MBO, even though the target board showed some favoritism to the management group over competing bidders. The court held that *Revlon's* auction duty did not require board passivity or total neutrality if lock-ups and topping fees[174] would advance the auction.[175] Though there were "suspicious" circumstances, the court concluded that the board had acted in good faith.[176]

169 552 A.2d 1227 (Del. Ch. 1988). For clarification, it must be emphasized that *Macmillan I* arose out of the same battle for control for the Macmillan Company that later led to the decisions that are the main focus of this article. *See infra* notes 223-234.

170 *Macmillan I*, 552 A.2d at 1245.

171 *Id.* at 1243, 1246. Thus, *Macmillan I* followed *Black & Decker* in implying that the *Revlon* auction duty is triggered by transfer of effective *control* of the company, and not only when the sale of the target is "inevitable."

172 *Id.* at 1246-47. The court also noted that the recapitalization plan would make Macmillan virtually "takeover proof" and that management would profit handsomely from the restructuring. *Id.*

The court's overruling management's position regarding the value of the "stub" share would appear to mitigate against a right for target management to "just say no." On the other hand, this was not a case where target management was simply trying to defeat a hostile bid; rather, it involved two competing bids, one hostile and one a recap sponsored by management.

173 Civ. Action No. 9991, 1988 W.L. 83147 (Del. Ch. Aug. 8, 1988).

174 A "topping fee" is an expense provision that typically requires the target to pay to the grantee a fee equal to the amount by which a competing bidder "tops" the bid made by the grantee.

175 *In re* Fort Howard Corp., Civ. Action No. 9991, at 35 (slip op.).

176 *Id.* at 30, 34. The court overcame its suspicions, in part, because the board

In re Amsted Industries, Inc. Litigation,[177] similar to *Fort Howard*, upheld a settlement in a class action suit brought to challenge an MBO sponsored by a senior management group and an ESOP. Although the company was not "shopped," the court nonetheless approved the transaction because objecting shareholders did not demonstrate that the board's special committee of outside directors, who consented to the deal, was grossly negligent or acted in bad faith. Although the plaintiffs' claim was litigable, under the proposed settlement the bid was raised by $.75 per share. The court deemed this to be a fair settlement price for the litigation, particularly since it was approved by the special committee and the company's largest shareholder.[178]

Nomad Acquisition Corp. v. Damon Corp.[179] turned on the court's conclusion that an investment banker's opinion provided solid evidence that a hostile tender offer price was inadequate. The court, therefore, refused to enjoin target management's adoption of (and refusal to redeem) a poison pill, its planned restructuring in the form of a spin-off,[180] and its planned search for a white squire.[181] The court was not swayed by the hostile bidder's argument that its all-cash offer was non-coercive.[182]

In re KDI Shareholders Litigation[183] involved a shareholder challenge to an MBO which was rejected on the ground that, although there were some suspicious circumstances, the board had conducted a fair auction. Because the board had tried diligently but unsuccessfully to produce other offers, even good-bye fees and expenses for the MBO group were approved by the court.[184]

Similar to *Nomad*, the court in *City Capital Associated v. Interco Inc.*[185] held that a board is justified in acting against an all-share,

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acted through an independent "Special Committee" that made substantial (though not perfect) efforts to shop the company. *Id.* at 32-33.

177 Civ. Action No. 8224 (Del. Ch. Aug. 24, 1988).

178 *Id.* at 21-22, 27-28 (slip op.). Both this case and *Fort Howard* illustrate that a court is less likely to overturn a board's actions when the case is at the settlement stage, rather than just beginning.

179 [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,040 (Del. Ch. Sept. 16, 1988) (also titled *In re* Damon Corp. Stockholders Litig.).

180 This was an unusual proposal for a spin-off of shares of a subsidiary directly to shareholders. *Id.* at 90,869.

181 *Id.* at 90,873.

182 *Id.* at 90,874. Thus, this opinion gave less weight to the shareholders' right to choose, and more discretion to the board of directors, than many others.

183 Civ. Action No. 10,278 (Del. Ch. Nov. 1, 1988).

184 *Id.*

185 551 A.2d 787 (Del. Ch. 1988).

all-cash offer if it is inadequate. The action approved, it must be noted, was the arranging of a new alternative for the shareholders, not a simple rejection of the hostile bid.[186] The court noted that an inadequate offer can be a threat to corporate policy and effectiveness. In this case, however, the target's restructuring alternative was allegedly worth only 3% more than the hostile bid. Therefore, the court determined that the threat was very mild and the target's poison pill was too severe in relation to that threat.[187] Because the restructuring could be considered the more desirable alternative, however, the court approved this as a reasonable response.[188] In addition, the court held that the *Revlon* auction duty did not always require the selling of the company but that it may instead simply require the obtaining of information about the value of various alternatives. If the restructuring is a more beneficial alternative, reasoned the court, then no auction is required.[189]

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[186] *Id.* at 797-98. The court distinguished between threats to voluntariness and threats from "inadequate" but noncoercive offers. A coercive bid that threatens the shareholders may be defended by a wide variety of measures. The classic example given by the court, naturally, was the front-end loaded, two-tiered offer. *Id.* at 797.

However, the court viewed a threat from an "inadequate" but noncoercive offer differently. *Id.* This brought up the "just say no" issue. The court stated that "it would not be surprising or unreasonable to claim that where an offer is not coercive or deceptive . . . a board . . . is not authorized to take preclusive action" even if it believes the bid to be inadequate. *Id.* However, the court rejected that position, reasoning:

> Even where an offer is noncoercive, it may represent a 'threat' to shareholder interests in the special sense that an active negotiator with power, in effect, to refuse the proposal may be able to extract a higher or otherwise more valuable proposal, or may be able to arrange an alternative transaction or a modified business plan that will present a more valuable option to shareholders.

Id. at 797-98.

This passage can be read in two ways. First, it could be read to indicate that the board can "just say no." Second, it could be read to say that a board can "just say no," *but only* for purposes of arranging for an alternative offer either by management or by a third party. The second interpretation is supported, but not conclusively, by *Interco's* next sentence which was: "Our cases, however, also indicate that in the setting of a noncoercive offer, absent unusual facts, there may come a time when a board's fiduciary duty will require it to redeem the rights and to permit the shareholders to choose." *Id.* at 798.

Thus, *Interco* is a very important, if somewhat obscure, case regarding the availability of the "just say no" defense.

[187] *Id.* at 798-99.

[188] *Id.* at 801.

[189] *Id.* at 803.

The court stated:

> [I]f a board does probe prudently to ascertain possible alternative val-

In *Grand Metropolitan Public Ltd. v. Pillsbury Co.*[190] the court held that an all-cash, all-shares offer, even if inadequate in price, posed no threat to corporate policy and effectiveness, but did pose a threat to shareholder welfare.[191] Because such a bid is non-coercive, the court held that shareholders should be allowed to choose for themselves.[192] Therefore, the Delaware Chancery Court struck down Pillsbury's poison pill which barred shareholder choice and enjoined a restructuring "spin-off." The court noted the irony that it was target management that was proposing the "bust-up" of the company.[193]

Shamrock Holdings, Inc. v. Polaroid Corp. (*Polaroid I*)[194] arose out of an all-cash, all-shares hostile bid by Shamrock for Polaroid. Polaroid had earlier adopted a poison pill and considered creating an ESOP. When the Shamrock bid started to surface, Polaroid's management decided to increase the holdings of the ESOP from 5% to 14%. The board of directors approved the plan without full knowledge of the impending Shamrock bid.

The vice-chancellor found *Unocal* inapplicable because it judges the reasonableness of a response to a hostile tender offer. Because outside members were uninformed, the Polaroid board did not know that it was responding to a tender offer when it adopted the ESOP plan.[195] Therefore, the court applied the stricter "entire fairness" test,[196] approving the ESOP plan despite its antitakeover aspects because: (a) the plan served a legitimate corporate purpose in improving employee incentives; (b) the plan was not controlled by management in that it had mir-

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> ues, and thus is in a position to act advisedly, I do not understand the *Revlon* holding as requiring it to turn to an auction alternative, if it has arrived at a good faith, informed determination that a recapitalization or other form of transaction is more beneficial to shareholders.

Id.

190 558 A.2d 1049 (Del. Ch. 1988).

191 *Id.* at 1056.

192 *Id.* at 1059. Thus, *Pillsbury* seemed to come down strongly against a "just say no" defense where all management could argue was that a non-coercive offer was "inadequate." This is especially so since the Court viewed the real threat of "loss" as not being the difference between the $63 that the hostile offeror was offering in cash and the $68 that the board predicted its restructuring would be worth in a few years, but the difference between the $63 and the $38 or so that the market price Pillsbury's stock would fall to if the offer were defeated. *Id.*

193 *Id.* at 1061.

194 [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,176 (Del. Ch. Jan. 6, 1989), *remanded sub nom. In re* Polaroid Corp. Shareholders Litig., No. 13 (Del. Mar. 6, 1989).

195 *Id.* at 91,620.

196 *Id.*

rored voting;[197] and (c) it did not prevent shareholders from receiving or considering alternatives. On appeal the Delaware Supreme Court remanded the case in light of new developments.[198]

In re RJR Nabisco, Inc. Shareholders Litig.[199] arose from the largest corporate takeover in history.[200] An MBO bid by RJR Nabisco's management was met with a competing bid by KKR. Each bid was very complicated, involving cash and various types of securities. The KKR bid was estimated to be worth $108 to $108.50 while the management bid was estimated to be worth $108.50 to $109. The court upheld the board's choice of the KKR bid over management's bid because the two were substantially equal, yet KKR's bid provided a potential for greater shareholder equity participation and carried the promise of fewer divestitures.[201] An intangible factor appeared to be the unpopularity of the head of the MBO team because he was viewed as "greedy" and as having attempted to "low-ball" the RJR Nabisco shareholders.

Shamrock Holdings, Inc. v. Polaroid Corp. (*Polaroid II*)[202] brought back before the original trial judge additional defensive tactics by Polaroid in the form of an issuance of convertible preferred stock to a white squire[203] and a $1.1 billion stock repurchase plan. Shamrock's bid was all-cash, all-shares. While Polaroid claimed that the bid was inadequate, Shamrock responded that the shareholders should be allowed to make that determination, not the board. This time, applying the *Unocal* test the judge admitted some skepticism "about the general proposition that a non-coercive inadequate offer constitutes a cognizable threat."[204] However, the court found such a threat in the "unusual circumstances"[205] of this case. Those unusual circumstances arose from a ten-year patent infringement suit against Kodak that

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197 *Id.* at 91,620-21.

198 *In re* Polaroid Corp. Shareholders Litig., No. 13 (Del. Mar. 6, 1989).

199 [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194 (Del. Ch. Jan. 31, 1989).

200 *Id.* at 91,701. *See generally* DeMott, *Introduction—The Biggest Deal Ever*, 89 DUKE L.J. 1 (The total value of the transaction measured approximately $25 billion).

201 *In re RJR Nabisco* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. at 91,715.

202 [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,340 (Del. Ch. Mar. 17, 1989).

203 The white squire, Corporate Partners, had advertised itself as being in the business of helping target management's block tender offers by infusing capital and holding large blocks of voting stock to support target management. The court took a surprisingly benign view of this none-too-subtle defensive approach.

204 *Id.* at 92,223.

205 *Id.*

had recently resulted in a favorable judgement on liability. Damages had not yet been determined in the multi-billion dollar claim. Because Polaroid's stockholders had no way of "assessing the present worth of this extremely valuable asset,"[206] the court found a cognizable threat to shareholder welfare. Accordingly, the court found no violation of the *Unocal* proportionality test.[207]

V. UNANSWERED QUESTIONS

The foregoing cases provide flesh and sinew for the bone provided by *Unocal* and *Revlon*. The basic concepts of the proportionality test and the auction duty were applied in a variety of circumstances not previously encountered. The new emphasis on recaps and restructurings required that these principles be applied in new contexts raising new issues. Some of those issues were resolved, but several remained unanswered.

For example, the courts have not yet determined precisely what standard of court review applies in the auction context. As noted earlier, before *Unocal* two basic standards of court review applied to target board management decisions. Most board decisions were judged by the standard business judgment rule, a not-too-vigorous scrutiny, which presumed the validity of most board actions and minimized second-guessing by courts. A much stricter test, the "entire fairness" standard, was applied by the courts to situations where the directors were in a classic conflict-of-interest situation. *Unocal*, however, provided a middle tier. Because *Unocal* recognized the inherent danger of a conflict of interest arising in the tender offer context, not because target managers were financially involved on both sides of the transactions, but because they feared loss of their positions, perks and prestige, the Delaware Supreme Court provided the proportionality test.[208]

Neither *Revlon* nor any case decided subsequently made clear which standard should govern the review of a target board's

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206 *Id.* at 92,224. Polaroid was seeking $5.7 billion in damages and had various methods of calculating its damages that gave results ranging from $400 million to $6.4 billion. Some outside observers predicted a recovery in the $2 billion range.

207 *Id.* In so holding, the court unrealistically minimized the effect of the combined restructuring which would place more than 30% of the voting shares of Polaroid in the hands of Corporate Partners and the ESOP.

208 It has been said that the most significant aspect of the *Unocal* decision was its recognition that the business judgment rule must be applied differently in the corporate control context. Note, *Auctioning the Corporate Bastion: Delaware Readjusts the Business Judgment Rule*, 40 Sw. L.J. 1117, 1126 (1986). This recognition can be traced back to the Second Circuit's decision in *Norlin*.

efforts to auction a company. Once a board decides to sell and undertakes the auction, no one knows whether its actions should be judged by the standard business judgment rule, by the more vigorous *Unocal* test, or by the entire fairness standard.[209]

Another important issue left unanswered by the courts is when the duty to auction arises. The lower courts appear confused on this matter. Specifically, *Revlon* stated that when the sale of a target is "inevitable" the target board's role shifts from defender of the corporate bastion to auctioneer.[210] Given that language, the Delaware Supreme Court in *Ivanhoe Partners v. Newmont Mining Corp.*[211] found that the auction duty did not arise even though the target's defensive tactics transferred 49.9% of the shares of the target to a white knight, subject to a standstill agreement.[212] On the other hand, the federal district court in *Black & Decker Corp. v. American Standard, Inc.*,[213] found a duty to auction where a recapitalization plan placed 55% of the voting stock in management control. Various other cases demonstrate that the courts were not in agreement on this matter.[214]

Whether a target board can consider the interests of non-shareholder constituencies in running an auction is another question lurking in the dark. While courts have held that a board of directors is empowered to consider non-shareholder constituencies,[215] and several courts have so held regarding target boards fighting hostile takeovers,[216] *Revlon* appeared to hold that once a

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209 Given the difference in the approaches of these three standards, which one is chosen will make a great difference regarding the outcome of the particular case.

210 Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1986).

211 535 A.2d 1334 (Del. 1987).

212 *Id.* at 1345.

213 682 F. Supp. 772 (D. Del. 1988).

214 *E.g.*, Gelco Corp. v. Coniston Partners, 652 F. Supp. 829 (D. Minn. 1986), *aff'd*, 811 F.2d 414 (8th Cir. 1987).

215 *E.g.*, American Rolling Mill Co. v. Commissioner, 41 F.2d 314, 315 (6th Cir. 1930) (approving community contributions as business expense); Armstrong Cork Co. v. H.A. Meldrum Co., 285 F. 58, 59 (W.D.N.Y. 1922) (educational contributions approved as reasonably likely to benefit corporation).

216 Most importantly, *Unocal* held that in formulating a response "reasonable in relation to the threat posed," the directors could analyze such concerns as "inadequacy of the price offered, nature and timing of the offer, questions of illegality, *the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)*, the risk of nonconsummation, and the quality of securities being offered in exchange." Unocal Corp. v. Mesa Petroleum, 493 A.2d 946, 955 (Del. 1985) (emphasis added) (citing Lipton & Brownstein, *Takeover Responses and Directors' Responsibilities: An Update*, ABA NATIONAL INSTITUTE ON THE DYNAMICS OF CORPORATE CONTROL 7 (Dec. 8, 1983)).

See also Amanda Acquisition Corp. v. Universal Foods Corp., 708 F. Supp. 984

decision to sell the company was made, other interests should not be considered.[217] However, *Revlon* was not definitive.[218]

Finally, can a target board can ever "just say no" to a tender offer on the grounds that the tender offer is simply financially inadequate? Can it use a poison pill to prevent target shareholders from deciding whether to tender? Or alternatively, must a target board always produce alternatives such as a white knight bid or a management-sponsored recapitalization? The lower courts have disagreed on this matter. *Pillsbury*,[219] for example, was viewed by many experts as virtually spelling an end to the "just say no" defense.[220] Yet, *Polaroid I*[221] and *Polaroid II*[222] seemed to revive it, at least in limited circumstances.

This article now turns its attention to a factual summary and

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(E.D. Wis. 1989), *aff'd*, 877 F.2d 496 (7th Cir. 1989) (Wisconsin statute allows consideration of other constituencies); Gelco Corp. v. Coniston Partners, 652 F. Supp. 829, 850 (D. Minn.), *aff'd*, 811 F.2d 414 (8th Cir. 1987).

217 The court stated:

> The Revlon board argued that it acted in good faith in protecting the noteholders because *Unocal* permits consideration of other corporate constituencies. Although such considerations may be permissible, there are fundamental limitations upon that prerogative. A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders . . . . *However, such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell to the highest bidder.*

Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1986) (emphasis added).

218 Some commentators read *Revlon* to completely eliminate consideration of non-shareholder constituencies in the auction context. *E.g.*, Note, *supra* note 208, at 1130-31. However, others found some room for consideration of these other interests. *E.g.*, Reder, *The Obligation of a Director of a Delaware Corporation to Act as an Auctioneer*, 44 BUS. LAW. 275, 279 (1989) ("a transaction which is substantially responsible to a broad range of constituencies may be an acceptable fulfillment of fiduciary duty at a lower price than one that would ultimately bring down the auctioneer's gavel in an auction breaking up the entity").

219 Grand Metro. PLC v. Pillsbury Co., 558 A.2d 1049 (Del. Ch. 1988) (board ordered to redeem poison pill over its objection that the hostile bid was inadequate).

220 According to Professor Coffee, *Pillsbury*, in conjunction with *Interco* and *Macmillan I*, completely eliminated the "just say no" defense. Coffee, *supra* note 96, at 983.

221 Shamrock Holdings v. Polaroid Corp., [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,176 (Del. Ch. Jan. 6, 1989) (approving ESOP transaction which effectively stopped hostile bid in its tracks).

222 Shamrock Holdings v. Polaroid Corp., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,340 (Del. Ch. Mar. 17, 1989) (approving ESOP transaction, stock repurchase plan, and issuance of shares to white squire in face of all-cash, all-shares bid).

legal analysis of the *Macmillan* decisions which provide some answers to these important questions.

VI. THE MACMILLAN DECISIONS

A. Macmillan I

It is somewhat ironic that the catalyst for the *Macmillan II* opinion was Robert Maxwell's failed bid for Harcourt Brace Jovanovich (HBJ). Watching HBJ narrowly escape Maxwell's bid inspired Macmillan's management to emulate HBJ's successful defensive tactics. The chosen course of action was a restructuring (similar to that used by HBJ) to protect Macmillan's independence by placing majority control of Macmillan in the hands of select members of management.[223] The final version of the restructuring also proposed a division of the company into two segments—the Information and Publishing segments—as well as creation of an ESOP and adoption of a poison pill.

On October 21, 1987, shortly after Macmillan began consideration of a recap, Fort Worth entrepreneur Robert M. Bass, filed a Schedule 13D[224] disclosing a 7.5% ownership stake in Macmillan. In response to Bass's filing, Macmillan's management called a special meeting of the board. At this meeting, Bass was described by management as an especially threatening green-

[223] The initial restructuring was designed to place an absolute majority of Macmillan shares in the hands of management. Mills Acquisition Co. v. Macmillan Inc., 559 A.2d 1261, 1265 (Del. 1988) (Macmillan II) (quoting Robert M. Bass Group v. Evans, 552 A.2d 1227, 1229 (Del. Ch. 1988 (Macmillan I)). However, the final version of the restructuring proposal divided Macmillan into two separate companies—Information and Publishing. *Id.* at 266 (citing *Macmillan I*, 552 A.2d at 1231 & n.10). Management was to receive 39.2% of Information's shares and 3.2% of Publishing's shares. *Id.* at 1270 (citing *Macmillan I*, 552 A.2d at 1236). Management's increased ownership was to be effected by management's forgoing the cash and debenture portion of the recap to be distributed to the public shareholders. *Id.* Instead, management would exchange the forgone cash and certain restricted stock and unexercised options for the increased stake in the restructured company. *Id.* The decision to reduce management's stake in the new companies from a majority to 39.2% and 3.2% came from a desire to avoid having the recap classified as a "sale" which might invoke the *Revlon* auction duty. *Id.* (citing *Macmillan I*, 552 A.2d at 1243).

[224] A Schedule 13D must be filed whenever someone accumulates 5% of the shares of a class of stock issued by a publicly held corporation. *See* § 13(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78m(d). As this article is being written, the SEC is considering amending its rules under Section 13(d) in a way that would have implications for merger and acquisition disclosure. *See* Block & Hoff, *SEC Proposed Rules Under Sections 13 and 17 For M&A Activities*, N.Y.L.J., May 11, 1989, at 5, col. 1.

mailer—a characterization that was later described by the court as less than accurate.[225] As the facts subsequently revealed, this was the first of several steps taken by management to mislead the board of directors.

Management, having already decided to create a Special Committee to evaluate the takeover attempt, began seeking a financial adviser to assist the yet-to-be-formed Special Committee. Through the advice of its own financial adviser, Wasserstein Perella, management settled on Lazard Freres. Lazard's professionals worked over 500 hours with management on the proposed restructuring before Lazard's "client," the Special Committee, even came into existence.[226] On May 17, 1988, the Bass group made its initial offer to acquire all of Macmillan's stock for $64 per share in cash. The following day, the Special Committee, consisting of five outside directors, was formally created and assigned the task of "considering, investigating, evaluating and reporting to the full board . . . as to antitakeover matters and economic alternatives, including the possible recapitalization."[227]

The Special Committee met for the first time one week later. The meeting was attended by Edward P. Evans (Macmillan's chairman and CEO), William F. Reilly (president and chief operating officer), Beverly C. Chell (vice-president, general counsel, and secretary), and Charles McCurdy (a vice-president). At the meeting, Lazard was retained as the Special Committee's financial adviser and the law firm of Wachtell, Lipton, Rosen & Katz was retained as legal counsel.

As correctly noted by Vice-Chancellor Jacobs in subsequent litigation, the events that led up to and followed the formation of the Special Committee raised serious doubts as to its independence from the influence of management.[228] First, the Commit-

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225 *Macmillan II*, 559 A.2d at 1267 (quoting *Macmillan I*, 552 A.2d at 1232 & n.15).

226 *Id.* at 1268 (citing *Macmillan I*, 552 A.2d at 1233-34).

227 *Macmillan I*, 552 A.2d at 1234.

228 *Id.* at 1240-41. Since cases such as *Van Gorkom*, it has become almost a reflexive response for target corporations to respond to hostile offers by creating such a "Special Committee." Regardless of whether the committee actually carries out its responsibilities seriously, it is widely believed that creation of such a committee is an important element in gaining favorable judicial review of target defenses. *See generally* Simpson, *The Emerging Role of the Special Committee—Ensuring Business Judgment Rule Protection in Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest*, 43 BUS. LAW. 665 (1988) (reviewing the usefulness of special committees in light of the business judgment rule); Warren & Maimone, *Special Committee May Ameliorate Conflict of Interest*, N.Y.L.J., June 5, 1989, at 37, col. 1 (examining the powers and duties of special committees); Block & Hoff,

tee members were hand-picked by Evans. Second, Lazard had done substantial work with management before the Committee came into existence, and then was retained by the Committee at Evans' behest. Finally, Evans and his management colleagues failed to disclose to the Committee their substantial prior dealings with Lazard, a fact one outside director admitted would have raised questions as to Lazard's independence.[229] Thus, it was not surprising when, at the Special Committee's next meeting, attended by the same four members of management, the Committee advised the board to reject the Bass offer as inadequate and to pursue instead the management-sponsored restructuring valued at $64.15 per share in cash and securities. Lazard and Wasserstein Perella both presented valuations of the restructuring to support this recommendation, which would have shifted substantial control of the company into the hands of the four managers in attendance.[230]

Prior to the board's final adoption of the recap, a Bass representative met with McCurdy to discuss the Bass offer. The meeting, however, was little more than Evans' directed response, which was to tell the Bass Group to "get lost."[231] Following the board's public announcement of the recap, Bass raised its offer to $73 per share and alternatively proposed a recap identical to that adopted by the board, differing only in that the Bass Group, and not management, was to retain control of Macmillan. Given Lazard's pre-tax break-up valuation of Macmillan at $72-$80 per share, the Special Committee recommended, and the board adopted, a formal rejection of both of the Bass proposals.[232] Bass then filed suit to enjoin the restructuring plan.

Given the defensive purpose behind the restructuring, the court in *Macmillan I* employed the *Unocal* test to measure the legality of the board's actions. As dictated by *Unocal*, the court be-

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The Emerging Role of Special Committees, Nat'l. L.J., June 15, 1989, at 5, col. 1 (examining cases that illustrate the effective use of special committees).

229 *Macmillan I*, 552 A.2d at 1234-35 n.22.

230 Lazard valued the recap at $64.73 per share and valued Macmillan on a pre-tax sale basis at $72.57 per share to $80 per share. Wasserstein valued Macmillan at $63-68 per share. Both firms cited the restructuring as fair and the bid price as inadequate. *Id.* at 1235-36.

231 *Id.* at 1235.

232 The chancery court noted the inconsistency in the fact that a Wasserstein representative considered the Bass recap a sale of the company but did not consider the identical (differing only in that public shareholders were to receive $5.65 per share less in cash) management recap to be a sale. Because the Bass proposal was a "sale", its rejection was recommended. It is noteworthy that neither Wasserstein nor Lazard viewed the Bass proposal as inadequate. *Id.* at 1242.

gan by assessing the threat posed by the Bass offer. Given that the offer was within the range established by both of Macmillan's financial advisers and all-cash, all-shares, the court deemed the threat to be minimal. Furthermore, given that evidence showed Bass not to be a greenmailer as management had portrayed, the court determined that the only threat posed by the Bass offer was that it was not the highest that Macmillan's financial advisers believed could be obtained.[233]

The court next turned to the reasonableness of the board's response, holding:

> [G]iven the nature of the threat, a reasonable response would, at a minimum, offer stockholders higher value than the Bass Group offer or, at the very least, offer stockholders a choice between equivalent values in different forms. The management restructuring offers neither. Not only does it offer inferior value to the shareholders, it also forces them to accept it. No shareholder vote is afforded; no choice is given. The restructuring is crafted to take the form of a dividend, requiring only director approval.[234]

Accordingly, the court preliminarily enjoined the restructuring as an unreasonable response to a minimal threat.

B. Macmillan II

On the same day that Vice-Chancellor Jacobs ruled in *Macmillan I*, Evans and Reilly formally abandoned the proposed restructuring and instead began to explore a possible sale of the company to third parties. While six potential bidders[235] initially appeared on the scene, the field was soon narrowed to only two: Maxwell Communications Corporation (MCC)[236] and Kohlberg, Kravis, Roberts & Co. (KKR). The Bass Group then exited the contest when its $75 per share bid was topped by MCC's proposed friendly merger at $80 per share. While Macmillan held extensive talks with KKR, it did not respond to MCC's $80 per share initial offer. This incongruous treatment was only a taste of things to come.

Having heard nothing from Macmillan for five weeks, on Au-

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233 *Id.* at 1240-41.

234 *Id.* at 1242.

235 The six potential bidders included the Bass Group, Maxwell's MCC, KKR, Gulf and Western, McGraw-Hill, and News-America Corporation. *Macmillan II*, 559 A.2d at 1272 n.17.

236 MCC was an English corporation controlled by Robert Maxwell, the unsuccessful bidder in the HBJ takeover attempt.

gust 12, 1988, MCC commenced an all-cash, all-shares tender offer to Macmillan at $80 per share.[237] Based on new opinions issued by its financial advisers, the Macmillan board rejected the bid as unfair and inadequate.[238] In the meantime, Macmillan's management stepped up its discussions with KKR in order to reach an accord on a KKR-sponsored LBO in which Evans and Reilly would retain a substantial ownership interest in the new company.[239]

On September 6, Macmillan representatives met with KKR to finalize a buyout transaction in which senior managers would receive a 20% interest in the company to be formed. At this meeting, Evans offered his endorsement of the transaction prior to learning what KKR's final bid price was to be. Given this "extraordinary commitment," KKR responded that it would make a firm offer by the week's end. In response, Macmillan's management notified the six potential bidders that any bids for Macmillan should be submitted by Friday afternoon, September 9. Coming on the evening of September 8, the notification gave MCC less than 24 hours to respond.

In this first round of the auction, MCC weighed in with an $84 per share all-cash, all-shares offer.[240] KKR made an oral bid, reduced to writing on the next day, that involved a two-tiered, highly-leveraged transaction with management-participation and a face value of $84 per share. In addition, KKR's offer was conditioned upon payment of its expenses and a "break-up" fee of $29.3 million should KKR lose to a higher bidder. Based on the opinion of its financial advisers, the Macmillan board rejected the MCC offer and recommended the KKR bid as the superior alternative.

Undeterred by the board's rejection, MCC, on September 15, increased it bid to $86.60 per share in cash. In response, the Macmillan board withdrew its recommendation of the KKR offer and reopened the auction.

In the next round of bidding, MCC raised its all-cash, all-shares bid to $89 per share. KKR submitted another two-tiered bid with a face value of $89.50 per share, $82 in cash and the

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237 *Id.* at 1272.

238 *Id.* at 1272-73. Macmillan's financial advisers showed a remarkable ability to issue exactly the opinion that best suited management's purposes.

239 *Id.* at 1273.

240 *Id.* Included in MCC's offer was Maxwell's statement: "If you have a financed binding alternative proposal which will generate a greater present value for shareholders, I will withdraw my bid." *Id.*

balance in subordinated securities. Like KKR's earlier bid, this one was subject to major conditions, namely: (1) a "no-shop" clause; (2) a lock-up provision granting KKR the right to buy eight Macmillan subsidiaries for $950 million; and (3) execution of a definitive merger agreement on the following day. Given the slight difference in value between the two bids, Macmillan's financial analysts were unable to recommend either bid. Thus, the bidding moved into the final round.[241]

Prior to the final round of bidding, any shred of even-handedness quickly disappeared. The deterioration in equality of treatment began when Evans, in the presence of Reilly and a Macmillan lawyer, Queenan, telephonically "tipped" MCC's bid to KKR. KKR's representative, when he realized the impropriety, abruptly ended the conversation.[242] Ignorant of Evans' tip to KKR, Bruce Wasserstein prepared a script to be read to both parties in order to instigate the final round of bidding. The script began: "We are not in a position at this time to recommend any bid. If you would like to increase your bid, let us know by 10:00 p.m."[243] There was more to the script, but this part was read only to KKR:

> TO KKR: [f]ocus on price but be advised that we do not want to give a lockup. If we granted a lockup, we would need: (1) a significant gap in your bid over the competing bid; (2) a smaller group of assets to be bought; and (3) a higher price for the assets to be bought.[244]

Shortly before the midnight deadline, Mr. Pirie of MCC called to inquire whether Macmillan had received any bids higher than its $89 per share. If it had, Pirie implied that MCC would top that bid. However, absent an offer higher than $89 per share, MCC refused to bid against itself. On grounds that he believed any response to this questioning would violate KKR's no-shop clause, Bruce Wasserstein responded simply that if Maxwell had anything further to say he should do it by midnight. Maxwell and Pirie "reasonably, but erroneously" concluded that Wasserstein was attempting to force MCC to bid against itself. Therefore, MCC stood pat.

Ten minutes before midnight on September 26, KKR submitted a two-tiered bid with a face value of $90 per share. The bid contained the same three conditions imposed on its earlier offer, but

241 *Id.* at 1275.
242 *Id.*
243 *Id.* at 1275-76.
244 *Id.* at 1276.

reduced the lock-up right to cover only four subsidiaries at a purchase price of $775 million.[245]

The final disparate treatment of the two parties came when, after the midnight deadline for bids, Macmillan's advisers negotiated with the parties over wholly different matters. Macmillan negotiated with MCC solely over some unresolved terms in MCC's bid, refusing to suggest that MCC increase its bid. On the other hand, Macmillan negotiated for almost eight hours with KKR in order to extract a higher bid. At the end of negotiations, KKR increased its bid to $90.05, a total increase of $1.6 million, and extracted three more subsidiaries for the lock-up at a total price of $865 million. Additionally, the lock-up agreement was structured on a cash basis, resulting in an immediate $250 million tax liability to Macmillan, reducing the net proceeds to only $615 million.[246]

The following morning, the Macmillan board met to consider the competing bids. During the meeting, chaired by Evans, Wasserstein made several assertions as to the fairness of the auction, concluding that the KKR bid of $90.05 was the higher of the two. At no time did Evans or Reilly mention that they had tipped KKR as to MCC's bid. After a closed session, the board of directors decided to recommend the KKR bid.[247] MCC then responded by amending a previously-filed suit asking that the court enjoin the lock-up agreement, the break-up fees, and the expenses granted to KKR.[248]

KKR filed the required documents with the SEC, reflecting its new bid price of $90.05. It was in these documents that Evans' tip to KKR was revealed for the first time. MCC amended its cash tender offer to $90.25, conditioned upon invalidation of the lock-up. After lengthy discussions, the Macmillan board determined that its previous commitment to the KKR bid was binding and thus rejected MCC's bid as containing conditions that the board could not fulfill.

The trial court refused to enjoin the lock-up agreement, the break-up fees, or the expenses granted by the Macmillan board to KKR. In ruling for Macmillan, the trial court held that although KKR was consistently and deliberately favored throughout the auction process, MCC was not prevented from, or "misled to refrain from, submitting a higher bid."[249]

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245 *Id.*

246 *Id.*

247 *Id.* at 1277-78.

248 *Id.* at 1278.

249 *Id.*

However, the court found that Macmillan's shareholders should have had the opportunity to consider the alternative offer, and therefore, the court enjoined the operation of Macmillan's "poison pill."[250] Although the trial court refused to condone the many "deficiencies" of the auction contest, it left MCC only one option—to proceed with its $90.25 bid in face of the many advantages granted to KKR that were still in place.

The Delaware Supreme Court orally reversed the ruling of the chancery court, finding that the breaches of fairness in the auction process were so significant that merely enjoining the poison pill was insufficient. The court stated:

> When senior management is a party to such breaches and, as here, has a personal interest in the outcome of the board's action, the process is tainted. The business judgment rule has no application. Instead, the matter is governed by principles of intrinsic fairness. The trial court ignored this basic rule of law and reversal is mandated.[251]

Six months later, the Delaware Supreme Court finally issued its *Macmillan II* opinion in written form providing at least partial clarification of previously unresolved issues. The court reminded, articulating that the sole issue before it was the lock-up option "with its attendant breakup fees and expenses."[252] The court further reiterated that, in a case involving not only deception but also "the board's own lack of oversight in structuring and directing the auction [which] afforded management the opportunity to indulge in the misconduct which occurred," the "entire fairness" standard of scrutiny must be applied.[253] Finding that the auction was "clandestinely and impermissibly skewed in favor of KKR," the court noted that "[w]hen presumably well-intentioned outside directors remove themselves from the design and execution of an auction, then what occurred here, given the human temptations left unchecked, was virtually inevitable."[254] The court acknowledged that corporate directors are normally accorded business judgment rule protection when they rely in good faith upon opinions and reports of officers and experts "selected with reasonable care."[255] But it also noted that "when a board is deceived by those who will gain from such miscon-

250 *Id.*
251 Mills Acquisition Co. v. Macmillan, Inc., 550 A.2d 35 (Del. 1988).
252 *Macmillan II*, 559 A.2d at 1278.
253 *Id.* at 1279. The court found the board to be "torpid, if not supine" in its efforts to run an auction. *Id.* at 1280.
254 *Id.* at 1281.
255 *Id.* 8 Del. C. (quoting § 141(e)).

duct, the protections girding the decision itself vanish."[256] Thus, lock-up options and no-shop clauses, though not per se illegal, could not survive in the factual circumstances of this case.[257]

In clarifying the *Revlon* auction duty, Justice Moore noted that no decision was required regarding when Macmillan was for sale and, thus, when the auction duty arose, because by any standard the company had been for sale since the Bass Group's bid.[258] Rather, the court stated, its job was to determine "the scope of the board's responsibility in an active bidding contest once their role as auctioneer has been invoked under *Revlon*."[259] The court partially answered its own question by stating that whether the "sale" is in the form of an active auction, an MBO, or a "restructuring" such as that at issue in *Macmillan I*, "[a]t a minimum, *Revlon* requires that there be the most scrupulous adherence to ordinary principles of fairness in the sense that stockholder interests are enhanced, rather than diminished."[260]

The court also noted that once the auction duty was activated, "[t]he defensive aspects of *Unocal* no longer apply. . . . The sole responsibility of the directors in such a sale is for the shareholders' benefit."[261] Further, *Revlon* held that while lock-ups and no-shop clauses that draw bidders into a battle are permissible, those that end an active auction are forbidden. The court invalidated the advantages granted KKR in this case because they did not gain "a material advantage to the stockholders."[262]

That holding led to the court's final thrust—an extension of the *Unocal* "enhanced" standard of review into the auction context. Holding that when a company is for sale, "the board's *responsibilities* under the enhanced *Unocal* standards are significantly altered," but its "*duties* . . . remain unchanged,"[263] the court adapted the *Unocal* two-stage test to the auction setting. The *Macmillan II* court explained:

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256 *Macmillan II*, 559 A.2d at 1284.

257 *Id.*

258 *Id.* at 1285.

259 *Id.*

260 *Id.* The court obviously felt that this standard was not met in this case. It approved the concept of a blind auction, but concluded that in this case, "[o]nly Maxwell was blind." *Id.*

261 *Id.* (citing Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1986)). Later in the opinion, the court reemphasized that in the auction context, "the board's primary objective, and essential purpose, must remain the enhancement of the bidding process for the benefit of the stockholders." *Id.* at 1287.

262 *Id.* at 1286.

263 *Id.* at 1287.

> At the outset, the plaintiff must show, and the trial judge must find, that the directors of the target company treated one or more of the respective bidders on unequal terms. It is only then that the two-part threshold requirement of *Unocal* is truly invoked, for in *Revlon* we held that "[f]avoritism for a white knight to the total exclusion of a hostile bidder might be justifiable when the latter's offer adversely affects shareholder interests, but . . . the directors cannot fulfill their enhanced *Unocal* duties by playing favorites with the contending factions."
>
> In the face of disparate treatment, the trial court must first examine whether the directors properly perceived that *shareholder interests were enhanced*. In any event the board's 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.
>
> If on the basis of this enhanced *Unocal* scrutiny the trial court is satisfied that the test has been met, then the directors' actions necessarily are entitled to the protection of the business judgment rule.[264]

For the above enumerated reasons, the Delaware high court reversed the trial judge's refusal to enjoin the lock-up, the no-shop clause and the expense agreements.

VII. Evaluation of Macmillan II

A. *Proper Standard of Review*

As the *Macmillan II* opinion noted, choice of the standard of review is frequently outcome-determinative.[265] Therefore, perhaps the most important of the unanswered questions addressed by *Macmillan II* is the standard of review that applies in a *Revlon* auction context.

Macmillan II solidifies a three-tiered system of court review of the actions of corporate boards. The three levels of review are: (a) standard business judgment rule protection for every day decisions; (b) strict entire fairness review where a direct financial conflict of interest clearly exists; and (c) an intermediate *Unocal* "enhanced" review for decisions made in tender offers where no blatant financial conflict of interest appears, but where there remains that "omnipresent specter" of management self-interest

264 *Id.* at 1288 (citations omitted) (emphasis added).
265 *Id.* at 1279.

because of the control issues.[266]

In *Macmillan II*, because of the deceit and concealment by the financially-interested officer and the accompanying, or resulting, failure of oversight by the board, the entire fairness test was applied and deemed not to be met.[267] Fortunately for those attorneys seeking clarification, the Delaware Supreme Court went on to pronounce, presumably in dicta, that in a *Revlon* auction where no conflict of interest exists, the "enhanced" *Unocal* standard of review will apply.[268]

Obviously, *Unocal*'s standards, as originally enunciated, do not fit comfortably into the auction context. The key question in an auction is often whether the target board was justified in favoring one bidder over another. The court's attempt to meld together the two tests—(a) whether shareholder interests were enhanced by the board's favoring of one bidder; and (b) whether the board's actions were reasonable in relation to the advantage sought to be gained or threat to be avoided—seems to be a sensible accommodation.[269]

An enhanced standard of review is definitely justified in the *Revlon* context. The possibility of abuse of the auction process has been demonstrated in several other cases,[270] but perhaps in none so clearly as in *Macmillan II* itself.

Requiring enhanced review in a *Revlon* auction where there is no obvious financial conflict of interest, says Professor Gilson, is arguably "overbroad."[271] However, Gilson justifies the higher standard of review on two grounds. First, management has a "final period problem" in that errors it makes in selling the company will not be punished in the marketplace as will other types of decisions.[272] Second, a challenge to the conduct of a sale is

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266 *Id.* at 1279-80, 1287 (quoting Unocal Corp. v. Mesa Petroleum Corp., 493 A.2d 946, 954 (Del. 1985)).

267 *Id.* at 1279.

268 *Id.* at 1287.

269 *Id.* at 1287-88.

270 Many courts have approved auction processes over their own objections to the "suspicious" or unfair circumstances. *E.g.*, *In re* Fort Howard Corp. Shareholders Litig., No. 9991, Slip Op. at 30-38 (Del. Ch. Aug. 8, 1988) (favoritism to management group approved where court found no bad faith); *In re* KDI Corp. Shareholders Litig., No. 10278 (Del. Ch. Oct. 26, 1988) (approving auction despite "suspicious" circumstances; *In re* Amsted Indus., No. 8224, slip op. at 19-21 (Del. Ch. Aug. 24, 1988) (upholding MBO despite failure to shop the company).

271 Gilson, *supra* note 126, at 628. Typically, a direct financial conflict of interest has been required before an "entire fairness" or "intrinsic fairness" standard was applied.

272 *Id. See also* Carney, *Controlling Management Opportunism in the Market for Corporate*

less difficult for a court to evaluate than challenges to routine business decisions, especially since the matter usually turns on the simple question of whether someone was willing to pay a higher price.[273] *Macmillan II* is praiseworthy in this regard.

Refining the application further, what happens in an MBO? The *Macmillan* dicta is not completely clear. *Macmillan II* clearly holds that if the independent directors are misled and abdicate their oversight responsibility in the auction setting, the stringent entire fairness test will be applied.[274] What of the situation where the independent directors are not misled and do actively structure the auction but in so doing confer advantages upon the management-sponsored bidder? *Macmillan II* can be read to require a *Unocal* enhanced scrutiny.[275] It is clear that the stricter entire fairness test is, however, more appropriate. *Macmillan II* was properly skeptical of the independence of the "independent" directors in this particular case.[276] The numerous cases illustrating the past failure of outside directors and special committees to run truly fair auctions,[277] however, support application of the entire fairness test to any MBO regardless of how many purportedly independent directors are on the board or how active a role they play.

In applying the first step of the *Unocal* test in the non-auction setting, courts have too often found that a board of directors acted in good faith if its actions received the approval of a majority of outside directors or of a special committee of outside directors.[278] Unfortunately, the automatic assumption that the decision of outside directors is impartial is unduly generous. There

Control: An Agency Cost Model, 1988 WIS. L. REV. 385, 407 ("[U]ntil a bidder appears, investors frequently cannot tell how their managers will respond, and then it is too late to constrain the disloyal managers.").

273 Gilson, *supra* note 126, at 628.

274 *Macmillan II*, 559 A.2d at 1279.

275 *Id.* at 1279-80. On the other hand, if the target management is not financially interested in either of the two bidders, *Unocal* enhanced scrutiny, as modified by *Macmillan II*, is clearly appropriate. Vice-Chancellor Hartnett used this standard in *In re* Holly Farms Corp. Shareholders' Litigation, Fed. Sec. L. Rep. (CCH) ¶ 94,486 (Del. Ch., June 14, 1989) (approving advantages granted to highest bidder, reasoning that board could reasonably fear that the bid might be withdrawn unless the advantages were extended).

276 *Id.* at 1281.

277 *See* cases cited *supra* note 270.

278 *E.g.*, BNS, Inc. v. Koppers Co., 683 F. Supp. 458, 475 (D. Del. 1988); Citron v. Fairchild Camera and Instrument Co., [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,915, at 90,103 (Del. Ch. May 19, 1988); CRTF Corp. v. Federated Dep't Stores, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,711, at 98,298 (S.D.N.Y. Apr. 14, 1988), at 98,298; *In re* Damon Corp. Stockholders Litig.,

is substantial evidence that corporate boards of directors have not employed meaningful checks on corporate managers, particularly the CEO.[279] The CEO typically controls selection of the corporation's directors,[280] who, as a result, usually share economic and psychological ties with the corporation's managers.[281] Persons who challenge management are not chosen as directors.[282] Many directors are chosen for the prestige that their names can lend to the company's annual reports, not for their ability to monitor management in the interests of the shareholder.[283] Therefore, reliance on outside directors to ensure the good faith of board's actions is often misplaced.

These factors combine to produce a situation where the outside directors' business judgment may be clouded by their loyalty to the corporation's management.[284] Outside directors as well as inside directors feel strong pressure to conform to management wishes.[285] In the tender offer context, these pressures do not disappear; indeed, the judgment of outside directors is sorely tested.[286] This is also very true in the auction context as the benefits conferred on the management bidders in *Macmillan II* so clearly demonstrated.

Application of the "entire fairness" test does not eliminate MBO's as an alternative for target management in the hostile takeover context. Many times an extensive search will yield no willing white knight. A management-sponsored bid may therefore be the best hope for raising the premium for target share-

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[1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,040, at 90,871 (Del. Ch. Sept. 16, 1988).

279 *E.g.*, H. GENEEN, MANAGING 255-57 (1984); E. HERMAN, CORPORATE CONTROL, CORPORATE POWER 38-40 (1981); M. MACE, DIRECTORS: MYTH AND REALITY 2, 3, 41 (1971).

280 M. MACE, *supra* note 279, at 94-101. *See generally*, Seligman, *A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project*, 55 GEO. WASH. L. REV. 325, 330-35 (1987).

281 M. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 144-45 (1976). *See also* Baum, *The Job Nobody Wants: Outside Directors Find that the Risks and Hassles Just Aren't Worth It*, BUS. WK., Sept. 8, 1986, at 56 ("[T]oday there are a lot of so-called outside directors who are not all that independent: They are close friends of the chief executive, or perhaps of the company's banker, lawyer, or management consultant.").

282 Seligman, *supra* note 280, at 332.

283 M. MACE, *supra* note 279, at 89, 90.

284 Williams, *supra* note 135, at 208.

285 Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U.L. REV. 96, 113 (1980).

286 Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 631 n.87 (1981).

holders.[287] Application of this standard will help ensure that the auction is run fairly in a situation rife with opportunities for management favoritism.

Recapitalizations and other restructurings involve a variety of situations including: (a) those which transfer control to management and those that do not; and (b) those undertaken in the heat of a tender offer battle and those adopted before a tender offer occurs. What standard of review is appropriate for these transactions?

As noted earlier, recaps and other forms of restructuring typically increase the percentage of shares held and controlled by management. When a recapitalization leads to a shift of control to management, the entire fairness standard should apply, whether the action was taken in the heat of battle or as a preemptive maneuver before a hostile offer is launched. Professor DeMott argues for a different level of review for MBO's and recapitalizations. She contends that a milder form of review is appropriate for recapitalizations because: (a) in a recap, the public shareholders are not frozen out altogether and can still profit by virtue of their "stub" shares; and (b) in a recap, fewer valuation decisions giving management a chance to "fudge" occur.[288]

Professor DeMott's distinction is well-taken in a recap which does not change control. There is, however, precious little practical difference between a full MBO on the one hand, and, on the other a recap which leads to the management group holding only a controlling interest in shares. The only true distinction between the two transactions lies in the fact that in the recap, the public shareholders have a continuing (but minority) presence in the recapitalized company, whereas in an MBO the public shareholders are eliminated entirely. This distinction retains little significance given that, as a minority, the public shareholders after a recap will be subjected to the will of the majority.[289] This new minority status leaves public shareholders with no greater protection than they might have commanded during an MBO. In addition, to the extent that the will of the majority shareholder (*i.e.*, target management) diverges from that of the minority in

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[287] Coffee, *Shareholders versus Managers: The Strain in the Corporation Web*, 85 MICH. L. REV. 1, 86-87 (1986).

[288] Demott, *supra* note 114, at 526.

[289] The majority is, of course, constrained by the fiduciary duty that it owes to the minority.

the operation of the company, management will face a conflict of interest almost identical to that arising in an MBO.

What if a recap does not confer control upon management? If it comes as a response to a hostile offer and shareholders are not given a vote, it is a "just say no" defense, that should be subject to the traditional *Unocal* standard of review. If it is used as a blocking device, but shareholders are given a choice of other alternatives, then the enhanced but modified *Unocal* standard of review suggested in *Macmillan II* should apply.

But what if the recap not conferring control on management is adopted routinely as a defensive measure before any hostile tender offer is launched? Because of the antitakeover effects of such a recapitalization, enhanced review is tempting. On the other hand, many routine board actions have antitakeover effects. Can extending enhanced review to those actions be justified? Although this is a close call, the answer is "yes." In many cases of the early 1980's, court review focused on the purpose of the board action, asking whether it was primarily to entrench corporate management.[290] A better approach to routine recapitalizations would be to subject them to enhanced *Unocal* review whenever a primary effect of their implementation would be to obstruct a takeover, irrespective of any inquiry into intent.

This would require a new set of questions. A two-step *Unocal* inquiry in this context would ask: (a) is there likely to be a positive financial effect for the corporation and shareholders arising from the recapitalization or restructuring; and (b) is that effect likely to outweigh the antitakeover impact? Enhanced review is justified in this context, especially since, as noted above, the evidence indicates that most recapitalizations and restructurings have been prompted by antitakeover considerations.[291] Nonetheless, where there is no hostile bid, even enhanced review of such actions could not be too searching. It would be appropriate in most cases, to accept management's projections regarding the favorable financial impact of the recapitalization and management's fears of coercive and/or bust-up offers that might be made in the future. In summary, the best approach is aggressive judicial review, even though in this particular context practical considerations may limit the scope of that review.

Macmillan II clearly illustrates an abusive case of manage-

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290 *E.g.*, Klaus v. Hi-Shear Corp., 528 F.2d 225, 234 (9th Cir. 1975) (invalidating management action only if its primary purpose was maintaining control).

291 *See supra* note 116.

ment self-promotion under the lax aegis of a passive board. This type of abuse, however, has been disappearing slowly in recent years, as target boards have increasingly asserted themselves in order to protect shareholders from management misconduct.[292] The main factors accounting for this increased vigilance by target boards are stringent court review, concrete guidelines laid out in cases such as *Unocal* and *Revlon*, and liability imposed in cases like *Van Gorkom*.[293] Abuses such as those seen in *Macmillan II* can never be eliminated, but definitely can be minimized *if* court review is made even stricter.

B. The Auction Duty

With occasional exceptions, such as *Polaroid I's* use of the entire fairness test,[294] most pre-*Macmillan II* cases had judged restructurings, recapitalizations, and MBO's by either the two-step *Unocal* analysis or the *Revlon* auction duty. Some commentators argued that cases decided in late 1988 indicated that *Revlon* had largely "swallowed" the *Unocal* test.[295] As suggested in the earlier summary of the *Macmillan II* holding, however, the Delaware Supreme Court has revived *Unocal* and even extended the reach of its enhanced review into the *Revlon* auction context.

Nonetheless, clarification of when the *Revlon* auction duty arises is still quite important because auctions are not always required and because *Unocal* requires the asking of different questions in the auction context. It is fortunate that *Macmillan II* helped to clarify the matter. The court explicitly noted that the company was for sale throughout the events leading to both the *Macmillan I* and the *Macmillan II* litigation, and thus it did not have to decide when the auction duty arose in this particular case.[296] The court went on to hold impliedly that any change of "control," whether in the form of an active auction, an MBO, or a restructuring, will trigger the *Revlon* auction duty.[297]

In so ruling, the Delaware Supreme Court implicitly approved the earlier holdings of several lower courts which had

292 Dobrzynski, *Taking Charge*, BUS. WK., July 3, 1989, at 66.

293 Galen, *A Seat on the Board is Getting Hotter*, BUS. WK., July 3, 1989, at 72.

294 Shamrock Holdings v. Polaroid Corp., 559 A.2d 257, 271 (Del. Ch. 1989).

295 *E.g.*, Coffee, *supra* note 96, at 985.

296 Mills Acquisition Co. v. Macmillan Inc., 559 A.2d 1261, 1285 (Del. 1988) (*Macmillan II*).

297 *Id.* (*Revlon*'s auction duty applies "whether the 'sale' takes the form of an active auction, a management buyout, or a 'restructuring' such as that which the Court of Chancery enjoined in *Macmillan I*.").

been reluctant to extend the auction duty too far. Some courts had held that the duty to auction does not arise automatically just because a hostile offer had been launched.[298] At least one court had held that the duty to auction does not arise simply from a target board's investigation of what parties other than a hostile offeror might be willing to pay for the target.[299] And *Interco* had held that a major restructuring, which apparently did not result in any significant increase in management control of the corporation, did not trigger the auction duty.[300] *Macmillan II* clearly indicates that these cases were properly decided. Any other ruling would hang a "For Sale" sign on the door of virtually every corporate headquarters in America.

Macmillan II also confirms the propriety of several cases on the other end of the spectrum which have found a duty to auction even when a sale was not "inevitable," as in *Revlon*. For example, *Black & Decker Corp. v. American Standard, Inc.*[301] imposed an auction duty when a defensive recapitalization resulted in a shift of majority voting power of the target.[302] The recapitalization in *Black & Decker* reduced the public shareholders' stake in the company from 92.6% to 45.5% while simultaneously increasing the share controlled by management and an ESOP to 54.5%. A similar result was properly reached in *Edelman v. Fruehauf Corp.*,[303] where a defensive MBO resulted in management gaining control of the company with 77% of the common shares.

Commentators had argued that a simple recapitalization did not generally give rise to the auction duty, but that when an MBO or even a leveraged recap shifted voting control, the duty to auction did arise.[304] *Macmillan II* wisely adopted this view, even for the situation where less than a majority of shares are transferred.

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298 Robert M. Bass Group v. Evans, 552 A.2d 1227, 1241 (Del. Ch. 1988) (Macmillan I); Lewis v. Honeywell, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,565, at 97,534 (Del. Ch. July 28, 1987).

299 Buckhorn, Inc. v. Ropak Corp., 656 F. Supp. 209, 228 (S.D. Ohio 1987).

300 City Capital Assoc. v. Interco, 551 A.2d 787, 803 (1988) (restructuring which included sale of assets generating half of Interco's sales, massive borrowing, and the distribution to shareholders of cash and debt securities equal to 85% of the market value of Interco stock did not give rise to duty to auction; board had duty to consider relevant information, but once it probed the market and decided in good faith that a recap was in the best interests of the shareholders, no auction duty arose).

301 682 F. Supp. 772 (D. Del. 1988).

302 *Id.* at 781-82.

303 798 F.2d 882, 884-85 (6th Cir. 1986).

304 DeMott, *supra* note 114, at 547, 551-52.

It recognizes, as did the chancery court in *Macmillan I*,[305] that a shift of control, one of the most important aspects of ownership, can be produced by a transfer of less than the majority of a public corporation's shares. Its holding dovetails nicely with many state tender offer laws of the "control share acquisition" type[306] which typically recognize that corporate control can shift when a buyer obtains 20% or 33% of a public company's stock, as well as when it acquires 50%.[307] Given the wide dispersal of holdings of most public corporations,[308] it is unrealistic to ignore the fact that control can shift along with the ownership of a minority block of

[305] 552 A.2d 1227 (Del. Ch. 1988). *Cf. In re* Sea-Land Corp. Shareholders Litig., [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,923 (Del. Ch. May 13, 1988) (holding that a 39.5% block of shares gave only "leverage," not actual control).

[306] For a broad categorization of the various types of second and third generation state antitakeover statues, *see* Pinto, *Takeover Statutes: The Dormant Commerce Clause and State Corporate Law*, 41 U. MIAMI L. REV. 473, 478-82 (1987).

[307] Indiana's statute is typical of one major type of second generation statute, defining a "control share acquisition" as an acquisition by a single entity of shares in an "issuing public corporation" which gives the acquirer 20%, 33-1/3% or 50% of the voting power. IND. CODE ANN. § 23-1-17-3(a) (Burns Supp. 1987). Under the Indiana act, any person acquiring such a "control" share shall have only the voting rights approved by other shareholders. If the other shareholders do not approve, the shares remain non-voting. *See generally* Prentice, *The Role of States in Tender Offers: An Analysis of* CTS, 1988 COLUM. BUS. L. REV. 1, 30-32 (1988) (examining the decision in CTS Corp. v. Dynamics Corp. of America, 107 S. Ct. 1637 (1987)).

After the Supreme Court approved Indiana's "control share acquisition" statute in CTS Corp. v. Dynamics Corp. of America, 107 S. Ct. 1637 (1987), a large number of states jumped on the bandwagon, adopting similar statutes which defined "control" in similar fashion. *See* Lipman, *Another Generation of Anti-Takeover Laws Beginning to Develop*, Nat'l L.J., Feb. 20, 1989, at 18, col. 3.

Changes of "control" are also deemed to occur at levels less than 50% in many "poison pill" provisions. Such a provision protects bondholders in the event of a highly leveraged hostile takeover. They typically allow a bondholder to put the bond back to the issuer if a "designated event" occurs. A typical event triggering the pill is a change of control, defined in Becton Corp's pill as the acquisition by any party of 20% of the voting shares of the company, and in Northwest Pipeline's as an acquisition of 30%. *See* Heberling, *Event Risk Provisions Protect Bondholders Against Takeovers*, Nat'l L.J., May 5, 1989, at 22, col. 1.

Poison pills have long had triggers which also assumed that "control" shifted at levels of 33-1/3% and even as low as 20%. *See* Note, *Shareholders Rights Plans—Do They Render Shareholders Defenseless Against Their Own Management?*, 12 DEL. J. CORP. L. 991, 1001 (1987).

[308] M. EISENBERG, *supra* note 281, at 43 ("the holdings of many, if not most of the shareholders, of [the very largest] corporations are likely to be negligible in terms of relative size . . . "). Eisenberg goes on to point out the well-known fact that institutional holdings are on the rise, but because fiduciary responsibilities almost automatically force them to tender their shares, they tend not to factor significantly in a battle for control.

shares.[309]

Macmillan II clarifies the Delaware Supreme Court's earlier holding in *Ivanhoe Partners v. Newmont Mining Corp.*,[310] where a special dividend form of recapitalization that financed a white squire's street sweep was deemed not to give rise to the *Revlon* duty. The holding turned on a collateral agreement limiting the white squire's representation on the board to 40% and an additional standstill agreement.[311] The court's opinion explained that this recapitalization did not trigger the *Revlon* auction duty because:

> [T]here was neither a bidding contest, nor a sale. The only bidder for Newmont was Ivanhoe [the tender offeror]. Gold Fields [the white squire] was not a bidder, but wished only to protect its already substantial interest in the company. It did so through the street sweep. Thus, the Newmont board did not "sell" the company to Gold Fields. . . . Even though Newmont's declaration of the dividend facilitated the street sweep, it did not constitute a "sale" of the company by Newmont.[312]

It is arguable that *Ivanhoe* was wrongly decided, but the *Macmillan II* opinion carefully distinguished the case.[313] If *Ivanhoe* had become precedent for standard recapitalizations and restructurings, it would have caused serious problems. In the typical recapitalization or restructuring, the *Revlon* duty should arise from a change of control, *Ivanhoe* notwithstanding.

Macmillan II indicates that certain other cases were wrongly decided. For example, in *Gelco Corp. v. Coniston Partners*,[314] a transfer of a large block of voting shares to target management's investment adviser, Merrill Lynch, did not raise the court's eyebrows simply because there was no formal agreement as to how Merrill Lynch would vote those shares. The court's ruling was, it seems, somewhat naive.[315]

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309 *See* Bebchuck, *supra* note 90, at 1718 (explaining how, in such conditions, a minority block of shares can easily control a corporation).

310 535 A.2d 1334 (Del. 1987).

311 *Id.* at 1344-45.

312 *Id.* at 1345.

313 *Macmillan II* explained that *Ivanhoe* was a case of "special facts and circumstances [because the target's board] . . . faced two potentially coercive offers." Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1285 n.35 (Del. 1988) (Macmillan II).

314 652 F. Supp. 829 (D. Minn. 1986), *aff'd in part, vacated in part on other grounds*, 811 F.2d 414 (8th Cir. 1987).

315 *Macmillan* not only requires a rethinking of *Gelco*, it also seems to indicate that Reder was wrong when he argued that *Revlon*'s auction duty is limited to "break-

Indeed, even *Polaroid II* deserves some scrutiny. Vice-Chancellor Berger never mentioned the *Revlon* auction duty, though the Polaroid restructuring put 33% of the shares in the hands of the ESOP and the white squire Corporate Partners.[316] Vice-Chancellor Berger rejected offeror Shamrock's contention that this transfer effectively precluded a takeover. She was probably wrong in this conclusion, especially since Corporate Partners had basically advertised itself as a shill for target management[317] and the ESOP was structured so that employee shareholders had virtually no incentive to tender.[318] This must be considered in the context of Delaware's antitakeover law which requires the ownership of 85% of a target's shares in order to avoid several barriers to obtaining complete control.[319] Clearly, Polaroid's management created a strong blocking position which the court underestimated.

In summary, it is clear that a simple recapitalization will not give rise to the *Revlon* auction duty, whereas a full-fledged MBO will. Between these polar extremes lies the gray area that *Macmillan II* has now clarified. A restructuring or recapitalization which results in a shift of control gives rise to the auction duty. Obviously, all circumstances must be carefully considered in determining whether a change of control has occurred, invoking the *Revlon* duty. Many questions remain to be answered, as the recent litigation between Paramount Communications and Time, Inc. illustrates.[320]

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up" cases. Reder, *supra* note 218, at 279 (viewing it as unfortunate that courts had not interpreted *Revlon*'s language to apply only to break-up transactions and had *mis*interpreted *Revlon* "to require an auction or equivalent whenever a company is to be sold or there is to be a change in control").

316 Shamrock Holdings v. Polaroid Corp., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,340 (Del. Ch. Mar. 17, 1989).

317 *See supra* note 203.

318 Although there was "mirror" voting, so that the trustee would tender the unallocated shares in the same percentages as the employees tendered, such a small percentage of the shares were allocated that the employees had virtually no financial incentive to tender. Shamrock Holdings v. Polaroid Corp., 559 A.2d 257, 273 (Del. Ch. 1989).

319 DEL. CODE. ANN. tit. 8, § 203 (1983). The Delaware law is a "business combination" or "moratorium" type of second generation antitakeover statute and is patterned after New York's law. N.Y. BUS. CORP. LAW § 912 (McKinney 1986). To simplify, its thrust is to delay for three years an acquirer's ability to complete a freeze-out merger and gain full ownership of the corporation *unless* the acquirer is able to obtain 85% of the shares through the tender offer. *See generally* Veasey, Finkelstein & Shaughnessy, *The Delaware Takeover Law: Some Issues, Strategies and Comparisons*, 43 BUS. LAW. 865 (1988) (legal issues in hostile battles implicate state law).

320 Time had planned a stock swap "merger of equals" with Warner when Paramount sought to make a hostile bid for control of Time. Time viewed the Paramount bid as inadequate, but fearing that its shareholders would tender, restructured the deal with Warner so as not to require a shareholder vote. Under

C. Non-Shareholder Interests

It is easy to be sympathetic to the non-shareholder stakeholders of a target corporation. There is substantial evidence that such stakeholders as employees,[321] bondholders,[322] suppli-

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the new structure, Time would acquire Warner at a significant premium and, as under the old structure, the new board would consist of half Time and half Warner directors. It was agreed that the CEO for five years would be from Warner and that he would be ultimately replaced by a Time executive.

Paramount sought to block the Time-Warner deal so that it could pursue its bid for Time. Paramount argued that by considering a merger, Time had put itself on the auction block for *Revlon* purposes especially since Warner shareholders would own more than 50% of Time when the deal was completed.

Chancellor Allen of the Delaware Court of Chancery, stressing the authority of a board of directors to manage for the long-term, stated that a merger of equals did not place Time on the auction block. He concluded that *Macmillan II* made a change of control the key issue. Although the initial stock swap plan would have placed 62% of Time's shares in the hands of Warner shareholders, Chancellor Allen found no change of control:

> If the appropriate inquiry is whether a change in control is contemplated, the answer must be sought in the specific circumstances surrounding the transaction. Surely under some circumstances a stock for stock merger could reflect a transfer of corporate control. That would, for example, plainly be the case here if Warner were a private company. *But where, as here, the shares of both constituent corporations are widely held, corporate control can be expected to remain unaffected by a stock for stock merger . . .* [N]either corporation would be said to be acquiring the other. Control of both remained in a large, fluid, changeable and changing market.

Paramount Communications v. Time, Inc., Civ. No. 10866 (Del. Ch. July 14, 1989), *aff'd*, 1989 WL 88712 (Del. July 24, 1989) (oral ruling with written opinion to follow).

See generally Goldman & Walsh, *Delaware Courts Revisit Landmark* Revlon, Nat'l L.J., Sept. 25, 1989, at 54, col. 1; Monks & Minow, *Time Can't Heal This Wound*, Legal Times, July 31, 1989, at 19, col. 1; Mirvis, *Opinion*, 3 M. & A. L. Rep. 325 (1989); Bloomenthal, *Time-Paramount — Long-Term vs. Short-Term Value Maximization*, Sec. & Fed. Corp. L. Rep. 57 (Sept. 1989).

Compare the *Time* holding to the earlier ruling in *In re* Holly Farms Corp. Shareholders' Litigation, Civ. No. 10350 (Del. Ch. Dec. 30, 1988) (holding that a stock for stock merger would give rise to *Revlon* auction duties if occurring in reaction to a hostile bid) and the later ruling in Rand v. Western Air Lines, No. 8630 (Del Ch. Sept. 11, 1989) (refusing to dismiss shareholder challenge to lock-up option and no-shop clause granted to friendly merger partner, functionally holding that *Revlon* auction duties applies to a *friendly merger where no competing bidders appeared*).

[321] *See, e.g.*, Note, *Takeover Dangers and Non-Shareholders: Who Should be Our Brothers' Keeper?*, 1988 COLUM. BUS. L. REV. 301, 305 (1988) ("Liquidations may spur structural unemployment and lead to the failure of businesses that had been established to fulfill the needs of the target and its employees."); Andre, *Tender Offers for Corporate Control: A Critical Analysis and Proposals for Reform*, 12 DEL. J. CORP. L. 865, 876 (1987); Norcia, *Mergers, Takeovers, and a Property Ethic*, 7 J. BUS. ETHICS 109, 115 (1988) (takeover risk falls "mostly on employees"). *But see Grundfest Challenges Argument That Takeovers Cause Job Losses*, 20 SEC. REG. & L. REP. (BNA) 423 (1988); Brown & Medoff, *The Impact of Firm Acquisitions on Labor*, in CORPORATE TAKEOVERS:

ers,[323] communities,[324] and more tangentially, taxpayers[325] all may suffer when tender offers succeed. Indeed, there is evidence that the gains to target shareholders[326] that occur in tender offers stem from transfers of wealth from these other stakeholders,[327] most particularly (according to Professor Coffee), the employees.[328] Similar injuries may be inflicted by restructurings and MBO's which are currently encouraged as alternatives to tender offers.[329]

CAUSES AND CONSEQUENCES 9 (A. Auerbach, ed. 1988) (study finds mergers lead to job losses, but cause wage increases).

322 Highly leveraged hostile offers, as well as defensive MBOs, can have a devastating impact on the target's bondholders. *See* Winkler & Herman, *Takeover Fears Rack Corporate Bonds*, Wall St. J., Oct. 25, 1988, at C1, col. 4 (S.W. ed.); Farrell, *Takeovers and Buyouts Clobber Blue-Chip Bondholders*, BUS. WK., Nov. 11, 1985, at 113.

323 *See* Note *supra* note 321, at 305; Andre, *supra* note 321, at 876.

324 H.R. REP. No. 1028, 98th Cong., 2d Sess. 22 (1984):

> A change in control of a company can result in plant closings, employee layoffs, a change in the location of corporate headquarters and other significant matters, which impact on the employees and communities involved . . . . The Mobil/Marathon takeover battle is but one of a number that have threatened to or actually have had an adverse impact on employees and communities in which major corporate operations were located.

Id.

325 To the extent that some acquisitions are motivated by favorable tax consequences, the taxpayer can be seen as a stakeholder injured by such takeovers. Although the evidence is quite mixed, one expert in the area has stated that "[m]y own experience is that very often there are quantifiable net tax benefits in an acquisition, and at least some of them would not be achievable in a different way." Ginsburg, *Comment*, in KRT *supra* note 5, at 367. *See also* Hayn, *Tax Attributes as Determinants of Shareholder Gains in Corporate Acquisitions*, 23 J. FIN. ECON. 121 (1989) ("tax considerations motivate acquisitions").

326 A. Shleifer & L. Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33, 53 (A. Auerbach ed. 1988) ("[T]ransfers from stakeholders to shareholders could make for a large part of the takeover premium."); Andre, *supra* note 321, at 878-79.

327 *See generally* A. Shleifer & L. Summers, *supra* note 326 (a comprehenive analysis of corporate takeovers); *see* Knoeber, *Golden Parachutes, Shark Repellents, and Hostile Tender Offers*, 76 AM. ECON. REV. 155, 159 (1986).

328 Coffee, *supra* note 287, at 81 ("[O]ne can argue that recent takeover developments have disrupted a prior system of implicit contracting and made possible involuntary wealth transfers from managers to shareholders.").

329 Stakeholders also suffer in restructurings and MBO's. Bratton, *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 95, 136-37 (1989) (recaps and restructuring transfer wealth from bondholders to equity holders); McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 206-11 (1988); Masulis, *The Impact of Capital Structure Change on Firm Value: Some Estimates*, 38 J. FIN. 107, 116 (1983) (recaps cause wealth transfers); Loomis, *LBOs are Taking Their Lumps*, FORTUNE, Dec. 7, 1987, at 63 (HBJ's recap led to suspension of charitable contributions); Sikorsky, *Leveraged Buyouts Punish Middle Management*, N.Y. Times, Dec. 18, 1988, at E22, col. 2 (letter to editor by attorney noting that for quick fix, easiest place to slash is middle management).

These transfers of wealth away from stakeholders are tolerable if the majority view, that tender offers benefit society, is an accurate one.[330] It is worth noting, however, that increasingly experts have expressed their doubts as to whether the overall impact of tender offers on the American economy is beneficial. Professor Coffee, for example, warns that target shareholder wealth does not necessarily constitute social wealth.[331] Professor Law finds "no credible evidence that social welfare has been increased by any of the acquisition binges of the postwar period."[332] Professor Magenheim concludes that "currently available evidence does not support the conclusion that the net effect of takeovers on the economy is positive."[333] Professor Roll argues that "takeover gains may have been overestimated, if they exist at all."[334] Even the Supreme Court has counseled that "there is no reason to *assume* that the type of conglomerate corporation that may result from repetitive takeovers necessarily will result [in] more effective management or otherwise be beneficial to shareholders."[335] Indeed, there is evidence that the tender offer binge is causing a short-term focus by corporations that negatively impacts America's competitive position,[336] a "de-

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330 *See generally* Pound, Lehn & Jarrell, *Are Takeovers Hostile to Economic Performance?* REGULATION, Sept.-Oct. 1986, at 25 (an effective summary of the arguments in favor of the view that tender offers improve economic performance). *See also* Uago, *LBOs, UFOs and Corporate Perestroika*, Wall St. J., July 19, 1989, at A14, col. 3 (singing praises of LBOs).

331 Coffee, *supra* note 287, at 104 ("Shareholder wealth and social wealth are not synonymous.").

332 Law, *Comment*, in KRT, *supra* note 5, at 260. *See also* Johnson, *supra* note 1, at 87 ("[T]he economic case for takeovers—largely dependent on stock price event studies—has not been made convincingly. There is simply too much evidence that raises serious doubts about the general utility of widespread takeover activity.").

333 Wallman & Ranard, *State Takeover Laws Work Well*, Legal Times, Sept. 21, 1987, at 22, col. 1 (quoting Prof. Magenheim).

334 Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197 (1986). *See also* Kuttner, *The Truth About Corporate Raiders*, NEW REPUBLIC, Jan. 20, 1986, at 17 ("Evidence is beginning to accumulate that the easy speculative takeovers of the '80s have substantial negative effects on particular firms and on the economy as a whole."). *See also* W. ADAMS & J. BROCK, DANGEROUS PURSUITS, 99 (1989).

335 CTS Corp. v. Dynamics Corp. of America, 107 S. Ct. 1637, 1651 n.13 (1987).

336 Former SEC Chairman Harold M. Williams has stated:

> A management spending its days and nights with lawyers, public relations firms, and investment bankers is not spending enough time developing new products, manufacturing more efficiently, or improving its balance sheet . . . . The loss in management effectiveness works against corporate and national productivity, the wages of employees, and returns to stockholders. It undermines our economy and our society.

Williams, *It's Time for a Takeover Moratorium*, FORTUNE July 22, 1985, at 133, 136.

See also Loescher, *Bureaucratic Measurement, Shuttling Stock/Shares, and Shortened*

capitalizing" of our corporations to the detriment of the economy,[337] serious damage to employee morale,[338] and various other adverse social and economic developments.[339]

A strong case can be made that stakeholder interests should be protected. The real question, however, is whether the target board of directors is the body to provide that protection. In the eyes of many, a board of directors is already viewed as a mediator of the concerns and interests that many entities have in the cor-

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Time Horizons: Implications for Economic Growth, 24 Q. REV. ECON. & BUS. 8 (1984) (recalling Schumpeter's admonition that any system that at every given point in time fully utilizes its possibilities to best advantage will probably not maximize efficiency in the long run); Saul, *Hostile Takeovers: What Is to Be Done?*, HARV. BUS. REV., Sept.-Oct. 1985, at 18, 22 (decision-making in an atmosphere heated by tender offers becomes a "mockery of careful corporate planning").

337 In the six years preceding 1989, nonfinancial American companies nearly doubled their debt to $1.8 trillion while retiring more than $400 billion in equity. Farrell, *Learning to Live with Leverage*, BUS. WK., Nov. 7, 1988, at 138. This meant that in 1989, American corporations were using nearly 50% of their taxable income to pay interest. Murray, *Corporate Debt Rises Despite Worries*, Wall St. J., June 26, 1989 at 1, col. 5 (S.W. ed.).

Many fear that this "decapitalization" of the economy will cause a variety of economic woes. *E.g.*, Farrell, *The LBO Isn't a Superior New Species*, BUS. WK., Oct. 23, 1989, at 126 ("companies with crushing debt payments are vulnerable to better-financed competitors, both here and abroad"); *Henry Kaufman: Corporate Debt Erodes Competition* (interview), BUS. WK., Mar. 20, 1989, at 40 (worrying that shift from equity to debt will erode competition and stunt innovation); Brilof, *Cannibalizing the Transcendent Margin: Reflections on Conglomeration, LBOs, Recapitalizations and Other Manifestations of Corporate Mania*, FIN. ANALYSTS J., May-June 1988, at 74, 79 (increased debt may hurt R&D investment and productivity); Chakravarty, "*When Everything's for Sale You Lose Something*", FORBES, Dec. 12, 1988, at 34, 36 (Harold Geneen sees takeover debt leading to short-term focus); Brownstein, *Where All the Money Comes From*, FORTUNE, Jan. 2, 1989, at 75, 80 (some experts fear that a downturn will cause the failure of many companies that have become highly leveraged in the takeover wars).

338 A. Shleifer & L. Summers, *supra* note 326, at 52 (takeover experience has led many workers to lose trust in and loyalty for employers); Karr, *The Checkoff*, Wall St. J., Nov. 11, 1989, at A-1, col. 5 (biggest cause of executive anxiety is fear of loss of jobs in takeover); *Merger Fallout: Beware Employee Dishonesty*, Wall St. J., Oct. 19, 1989, at B-1, col. 2 (merger mania spawns employee dissatisfaction and dishonesty).

339 A loss that is difficult to quantify, but is obvious to many college professors, is the brain drain from fields such as engineering and manufacturing to the less productive areas of law and finance. As Professor Law has pointed out, when students see investment bankers being paid approximately $126,000 per hour, they naturally move to that area for a career. Law, in KRT, *supra* note 5, at 262. *See also* L. LOWENSTEIN, WHAT'S WRONG WITH WALL STREET 4 (1988) ("It is terribly wasteful to have bright young scholars doing elaborate studies of whether prices move higher on Mondays. . . ."). The Japanese seem to be doing just fine while knowing little about the fancy financial gimmicks produced on Wall Street today. *See* Powell, *Japanese Execs: Financial Wizards, They're Not*, Wall St. J., Apr. 17, 1989, at A.10, col. 4 (S.W. ed.).

poration.[340] Many observers on the "corporate social responsibility" scene have argued strongly in favor of a corporate board's role as protector of non-shareholder interests.[341] In fact, a few corporations already view themselves as being operated for the benefit of all stakeholders, not just the shareholders.[342] This position is further illustrated by the many cases which have approved the authority of corporate boards to spend corporate funds on non-shareholder interests, such as charitable endeavors.[343] Several state codes authorize charitable contributions,[344] as does the new American Law Institute Corporate Governance Code proposal.[345]

In the tender offer context today, corporate boards inevitably weigh the interests of stakeholders when, for example, they

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340 Coffee, *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-Ups*, 1988 WIS. L. REV. 435, 449 (1988).

341 *E.g.*, C. STONE, WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR (1975) (recommending substantial changes in composition of boards); R. ACKERMAN & R. BAUER, CORPORATE SOCIAL RESPONSIVENESS: THE MODERN DILEMMA (1976); R. FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH (1984); Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611, 618-21 (1988); Nunan, *The Libertarian Conception of Corporate Property: A Critique of Milton Friedman's Views on the Social Responsibility of Business*, 7 J. BUS. ETHICS 891 (1988) (criticizing Friedman's view that corporations have no social responsibility other than to follow the law); Epstein, *Societal, Managerial, and Legal Perspectives on Corporate Social Responsibility—Product and Process*, 30 HASTINGS L.J. 1287 (1979).

342 *See* Exley, *The Masterstroke of Managing for Stakeholders*, 13 DIRECTORS & BOARDS 4 (Fall 1988); Melloan, *NCR's Exley Manages for his 'Stakeholders,'* Wall St. J., June 16, 1987, at 29, col. 3 (S.W. ed.). For criticism of this approach, *see* Boland, *Shareholders vs. 'Stakeholders,'* Wall St. J., Feb. 10, 1988, at 16, col. 3 (SW ed.).

343 *E.g.*, Herald Co. v. Seawell, 472 F.2d 1081, 1091 (10th Cir. 1972) (newspaper corporation's duties were threefold: "to the stockholders, to the employees, and to the public"); Theodora Holding Corp. v. Henderson, 257 A.2d 398, 405 (Del. Ch. 1969) (approving charitable contributions); Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548, 556 (1964) (board justified in considering employee unrest that would result from potential buyer's change of policy away from door-to-door sales force); Shlensky v. Wrigley, 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968) (refusing to second-guess board's decision to sacrifice potential profit to be a "good neighbor"); A.P. Smith Mfg. Co. v. Barlow, 13 N.J. 145, 160, 98 A.2d 581, 590 (1953), *appeal dismissed*, 346 U.S. 861 (approving charitable contributions).

344 *E.g.*, TEX. BUS. CORP. ACT ANN. art. 202A(14) (Vernon 1980).

345 PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS, art. 2.01(b-c) (Tent. Draft No. 2, 1984) (authorizing boards to "take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business" as well as to "devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes"). *See* Epstein, *The Corporate Social Policy Process and the Process of Corporate Governance*, 25 AM. BUS. L.J. 361 (1987); Schwartz, *Defining the Corporate Objective: Section 2.01 of the ALI's Principles*, 52 GEO. WASH. L. REV. 511 (1984). *See also* REVISED MODEL BUSINESS CORP. ACT § 3.02(13) (1984) (authorizing charitable contributions).

award golden parachutes[346] or tin parachutes[347] to employees. Several courts are cognizant of this fact and have authorized consideration of non-shareholder interests in tender offer defenses.[348]

In light of all this, and, no doubt, motivated largely by an attempt to preserve local industry and jobs,[349] several states have passed laws permitting[350] or even requiring[351] boards of directors in tender offer situations to consider the interests of non-

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[346] Consistent with *Macmillan II*, courts upholding golden parachutes have tended to do so on grounds that they served the best interests of the *shareholders*. *E.g.*, Buckhorn, Inc. v. Ropak Corp., 656 F. Supp. 209, 232-33 (S.D. Ohio 1987) (parachutes were valid response to target's concern about "losing its key management at a critical time of transition"). Where golden parachutes have been adopted in the middle of a tender offer battle and it appeared that they served no shareholder purpose, they have often been struck down. *E.g.*, Gaillard v. Natomas Co., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,369, at 92,428 (Cal. App. Mar. 23, 1989).

[347] Tin parachutes are, of course, miniature versions of golden parachutes given to a larger number of lower level employees.

[348] *E.g.*, cases approving consideration of nonshareholder interests include Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985); Amanda Acquisition Corp. v. Universal Foods Corp., 708 F. Supp. 984 (E.D. Wis. 1989), *aff'd on other grounds*, 877 F.2d 496 (7th Cir. 1989) (applying Wisconsin statute); GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016, 1020 (S.D.N.Y. 1985) (board's business judgment legitimately is concerned with interests of employees and management); Gelco Corp. v. Coniston Partners, 652 F. Supp. 829, 850 (D. Minn. 1987), *aff'd*, 811 F.2d 414 (9th Cir. 1987); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1342 (Del. 1987) (differentiating between interests of shareholders and that of the company facing break-up); TW Services, Inc. v. SWT Acquisition Corp., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,178 (Del. Ch. Mar. 2, 1989); Enterra Corp. v. SGS Assocs., 600 F. Supp. 678, 689 (E.D. Pa. 1985) (target's standstill agreement was approved, in part, because court viewed as a valid business reason that it would allay takeover concerns of suppliers, customers, and lenders); Keyser v. Commonwealth Nat'l Fin. Corp., 675 F. Supp. 238, 265-66 (M.D. Pa. 1987) (reading *Revlon* as not allowing consideration of non-shareholder constituencies in auction process, but stating that Pennsylvania law is different).

But see Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1986) (once corporation goes on the auction block, nonshareholder interests are irrelevant).

[349] Johnson, *supra* note 1, at 67-68; Langevoort, *The Supreme Court and the Politics of Corporate Takeovers: A Comment on CTS Corp v. Dynamics Corp. of America*, 101 HARV. L. REV. 96, 116 (1987).

[350] *See* Bryer, Wasserman & Katz, *Representing a Public Company in a Leveraged Buyout Transaction*, in LEVERAGED ACQUISITIONS AND BUYOUTS 423-27 (1989) (listing Idaho, Illinois, Indiana, Kentucky, Maine, Minnesota, Missouri, Nebraska, New Mexico, New York, Ohio, Pennsylvania, and Wisconsin).

A more recent source indicates that 22 states have passed statutes requiring consideration of non-shareholder constituencies, but noting that their effect is unclear. Franklin, *Legislative Toss-Up*, N.Y.L.J., July 6, 1989, at 5, col. 2.

[351] Only Arizona has *required* boards to consider the interests of other constituencies. ARIZ. REV. STAT. ANN. § 10-1202A (Supp. 1987) (emphasis added).

shareholder stakeholders. These laws are arguably constitutional.[352] Additionally, they may make economic sense, based on the argument that corporations will be able to attract and retain better employees, will be able to sign more attractive contracts with suppliers and will have more productive relationships with local communities in return for the promise to protect those entities in the event of a future tender offer.[353] Viewed *ex ante*, it is arguably the most efficient course to protect those other stakeholders as a means of advancing important shareholder interests.[354]

It is undeniable that the basic job of corporate management is to make a profit for shareholders.[355] Despite many attempts by advocates of corporate social responsibility, there has been no

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[352] However, they are the most likely of all the second and third generation statutes to be declared unconstitutional as conflicting with the Williams Act's primary goal of investor protection. Pinto, *supra* note 306, at 474-75.

[353] *See* Coffee, *supra* note 287, at 85; Note, *supra* note 321, at n.56.

[354] A variety of arguments have been made to support the theory that having a social conscience, acting ethically, considering the interests of stakeholders, etc. is *efficient* and beneficial for the shareholders in the long run. Coffee's argument about attracting and retaining employees is only one variant of this school of thought. *See, e.g.*, Silverstein, *Managing Corporate Social Responsibility in a Changing Legal Environment*, 25 AM. BUS. L.J. 523 (1987) (arguing that what is "right" today will probably be legally required tomorrow and that corporations will serve their shareholders well by doing what is right—for example, stop selling asbestos or Dalkon Shields—before the liability piles up); Bryan, *The Corporation and the Executive in the Community*, 1987 COLUM. BUS. L. REV. 695, 697 (arguing that contributions to charities and colleges will help attract employees, sell products and otherwise benefit the corporation); Low, *Farsighted Corporations Focus on Long-Term Gains*, 66 Bus. & Soc. Rev. 61, 64 (Summer 1988) ("Firms that have demonstrated a commitment to manage their affairs for the long-run benefit of all their stakeholders will find it much easier to obtain the support they need from their constituents in order to prepare for long-term competitiveness."); Saul, *supra* note 336, at 22 (well-run corporations will consider obligations to stakeholders and might even pass up acquisition opportunities to preserve corporate culture and build a storehouse of goodwill).

[355] Dodge v. Ford Motor Co., 204 Mich. 459, 507, 170 N.W. 668, 684 (1919) ("A corporation is organized and carried on primarily for the profit of its shareholders. The powers of the directors are to be employed for that end.").

See generally Johnson, *supra* note 1, at 39-44 (discussing various theories regarding management's role); Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 A.B.F. RES. J. 69, 97-100 (1980) (corporate law in general has, rightly or wrongly, identified investor welfare with social welfare).

Most courts hold that corporate boards owe no fiduciary duties to non-shareholder stakeholders. *E.g.*, Local 1330, United Steel Workers v. U.S. Steel Corp., 631 F.2d 1264, 1282 (6th Cir. 1980) ("community interests" need not be considered in plant closing); Simons v. Cogan, 549 A.2d 300 (Del. 1988) (board in squeeze-out merger has no duty to consider interests of bondholders); Harff v. Kerkorian, 324 A.2d 215 (Del. Ch. 1974), *rev'd on other grounds*, 347 A.2d 133 (Del. 1975) (no fiduciary duty to bondholders). *See also* Hartford Fire Ins. Co. v. Feder-

convincing evidence of a practical way to delegate to a target board of directors the responsibility to protect stakeholder interests when to do so injures shareholders. Given the overriding charge to produce profits, target boards cannot rationally reconcile interests of non-shareholder constituencies with the fiduciary obligation owed to shareholders when the two conflict.[356] Nor are boards of directors well-equipped to carry out such a task.[357] To ask boards of directors to assume this role would produce many problems,[358] with little hope of effectively protecting non-shareholder interests.[359]

Revlon has been applauded as effectively aligning the duties of the board of directors with the interests of the target shareholders.[360] *Macmillan II* properly clarifies *Revlon* by drawing the line in favor of allowing boards of directors to consider the interests of other stakeholders only as a means of protecting target shareholders, and assuming that this is possible only *before* an

ated Dept. Stores, No. 88 Civ. No. 8460 (S.D.N.Y. Oct. 12, 1989) (rejecting bondholders wide-ranging attack on tender offer).

356 Oesterle, *The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court*, 72 CORNELL L. REV. 117, 146 (1986) ("[I]t is unrealistic to assume that even well-intentioned managers can choose properly whom to represent and how vigorously to represent them"); Andre, *supra* note 321, at 882 ("A requirement that managers represent the interests of both groups [shareholders and non-shareholders] imposes a rule of divided loyalty which would be difficult, if not impossible, to implement."); Note, *supra* note 321, at 318 ([D]irectors could not "efficiently conduct socially responsible programs within profit-making enterprises . . . [because] they would simply be responsible to too many diverse interests."); Mahoney, *New Laws Place Directors in Untenable Position*, Nat'l L.J., July 4, 1988, at 26, col. 1; Note, *Stakeholder versus Stockholder: The Director's Proper Constituency in a Contest for Corporate Control*, 15 WM. MITCHELL L. REV. 475, 501 (1989) ("A manager who is simultaneously responsible to interests which oppose one another cannot possibly be accountable to either.").

357 Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 865 (1981) ("Target management has no special expertise in such decisions, nor is there any reason to believe that the vision of a just society held by management will be shared by any larger body, whether shareholders or not."); Rodewald, *The Corporate Social Responsibility Debate: Unanswered Questions About the Consequences of Moral Reform*, 25 AM. BUS. L.J. 443, 462 (1987) ("Many managers may know little about the existing noneconomic social circumstances outside of their particular business environment . . . ."); Hennessy, *The Ethics of Corporate Restructuring*, 13 DIRECTORS & BOARDS 8, 11 (Fall 1988) ("[m]ost business leaders aren't qualified by experience for these other responsibilities").

358 Johnson, *supra* note 1, at 50 (would "cause" a further erosion of shareholder influence over corporate affairs); Andre, *supra* note 321, at 883 (would cause abrogation of directors' fiduciary duty).

359 No one has suggested a feasible way of making target boards accountable to the stakeholders. Gilson, *A Fight For the Right to 'Just Say No' to Hostile Tender Offers*, Legal Times, June 26, 1989, at 19, col. 1 & 20, col. 1.

360 Johnson, *supra* note 1, at 38.

auction begins.[361] However, nothing in *Macmillan II* would prevent a board of directors from deciding that the corporation could have more profitable relationships with various stakeholders by providing them *ex ante* with protection in a time of hostile takeovers.[362]

Corporations have traditionally given to charity as a way of indirectly benefitting shareholders.[363] Corporate boards should be encouraged to discover the full range of situations in which shareholder interests can be advanced by protection of other stakeholders. The courts have recognized that golden parachutes—if granted before an auction begins—can benefit shareholders and stakeholders alike.[364] Similarly, contracts with suppliers or commitments to communities can also be beneficial. Certainly, there is nothing wrong with a corporate board's consideration of stakeholder interests in "breaking a tie" between two competing bids having virtually identical effects for shareholders,[365] or with a corporation's shareholders deciding to exercise their sense of social responsibility by placing in their corporation's articles a provision authorizing their boards to consider other constituencies when evaluating a tender offer.[366]

D. *Just Say No*

Whether or not a board of directors can invoke the "Nancy Reagan defense" and "just say no" even to an all-cash, all-shares

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361 Gilson, *supra* note 126, at 627.

362 Chancellor Allen noted in *TW Services, Inc. v. SWT Acquisition Corp.*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,178 (Del. Ch. Mar. 2, 1989) ("[D]irectors, in managing the business affairs of the corporation, may find it prudent to make decisions that are expected to promote corporate and shareholder long run interests. Even if short run share value can be expected to be negatively affected, directors in pursuit of long run corporate and shareholder values may be sensitive to the claims of other "corporate constituencies.").

363 Navarro, *Why Do Corporations Give to Charity?*, 61 J. Bus. 65, 90 (1988) (corporate charitable contributions are explained by profit motive).

364 Internat'l Ins. Co. v. Johns, 874 F.2d 1447 (11th Cir. 1989); Buckhorn, Inc. v. Ropak Corp., 656 F. Supp. 209, 232-33 (S.D. Ohio 1987); Gaillard v. Natomas Co., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,369, at 92,428 (Cal. App. Mar. 23, 1989).

See also Comment, 72 Va. L. Rev. 851, 859-60 (1986) (suggesting that providing job security for managers in event of takeover will improve long-term performance).

365 The RJR/Nabisco board of directors supported the KKR bid over the management-sponsored bid, in part, because of a better deal for employees which would avoid total dismemberment of the company. *See* Helyar & Burrough, *How Underdog KKR Won RJR Nabisco Without the Highest Bid*, Wall St. J., Dec. 2, 1988, at 1, col. 1.

366 *See* Bryer, Wasserman & Katz, *supra* note 350, at 423-27.

bid was a matter over which both courts[367] and commentators[368] were divided before *Macmillan II*. Unfortunately, after *Macmillan II* the commentators, at least, continued to be divided.[369]

Macmillan II comes close to approving a "just say no" defense, and even enumerates various factors to be evaluated by a board considering invoking it.[370] A limited right to just say no should be granted to boards of directors. The reasons are numerous and complex and their explication is beyond the scope of this article.[371] What is more important for present purposes is

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367 *See supra* notes 218 to 221.

368 *See supra* note 218.

369 Professor Gilson, for example, sees little guidance on the issue coming out of *Macmillan II*. Gilson, *supra* note 116, at 624. On the other hand, Warden & Feit believe that the right to "just say no" clearly existed before *Macmillan II* and continues to exist. Warden & Feit, *Macmillan: Outside Directors' Duties and Other Observations*, 3 MERGERS & ACQUISITIONS L. REP. 617 (1989). Cohen believes that the "just say no" defense will not survive in Delaware. Cohen, *supra* note 96, at 733.

370 Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1285 n.35 (1988) states:

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

Id. (citations omitted).

As of this writing, only one case has directly addressed the meaning of footnote 35. In Paramount Communications v. Time, Inc., Civ. No. 10866 (Del. Ch. July 14, 1989), *aff'd*, 1989 WL 88712 (Del. July 24, 1989) (oral ruling with written opinion to follow) Chancellor Allen approved a merger between Time and Warner that blocked Paramount's hostile takeover without giving Time's shareholders an opportunity to tender. That ruling could be viewed as supporting the "just say no" defense, but it arose in very unusual circumstances. Time had planned the Warner merger for a year, and had very strong evidence that the merger would serve the long-run interests of the company. Therefore, the ruling may not be strong support for a "just say no" defense in the usual tender offer context. *See also supra* note 320 (a detailed description of the facts).

Typically, the commentators disagree as to the meaning of this case for the future of the "just say no" defense. *See* Jarrell, *A Present-Value Lesson for Lawyers*, Wall St. J., July 13, 1989, at A10, col. 7 (predicting that a victory for time would allow entrenched managers to "just say no"); Dobrzynski, *From One Decision Flow a Lot of Hard Lessons*, BUS. WK., July 31, 1989, at 29, 30 (quoting an expert who concludes that case does *not* approve the "just say no" defense).

371 Indeed, the authors have written another article on this matter entitled *Hostile Tender Offers and the Nancy Reagan Defense: Can a Target Board "Just Say No?" Should It Be Allowed To?* The article will be appearing in the Delaware Journal of Corporation Law in early 1990. The article argues against the position that target boards should be passive in the face of hostile tender offers, and also rejects the more reasonable position that target boards should be allowed only to run an auction, but never to

that the Delaware Supreme Court resolve the issue once and for all by addressing it directly. The commentators will not be satisfied and the lower courts will not be properly guided until the issue is accorded more than footnote treatment.

VIII. Conclusion

Recent developments in Delaware corporate law have been very beneficial to target shareholders. *Unocal* and *Revlon* have combined with various non-legal elements, such as the enormous amount of available financing, to replace a regime of target board defensive "show stoppers" with a new world of recaps, spin-offs, restructurings, and MBO's. These transactions generally serve to raise the premiums paid in hostile takeovers.[372] There is a strong school of thought that harshly criticizes the discretion that has been left to target boards to slow down, and occasionally defeat, a hostile tender offer. Chicago School economists and others believe that such discretion leaves target shareholders at the untender mercies of their boards. However, from a target shareholder's perspective, it is difficult to argue with a regime which has produced record tender offer activity at record premiums.

Macmillan II goes a long way toward clarifying some difficult questions that the *Unocal* and *Revlon* rulings have raised. More is now known about the standard of review to be applied in the auction context. Additional details are left to be ironed out, but it seems obvious that a strict standard of review must be maintained. There is much opportunity for target board abuse, but stringent court review and the potential for liability if fiduciary breaches occur have combined to improve the performance of outside directors on target boards.

Macmillan II properly indicated that recaps and restructurings, if they transfer control to a management group, do give rise

act to block a tender offer. Instead, the article suggests that target boards should be allowed to "just say no" in limited circumstances, *e.g.*, to defeat illegal or coercive bids, to induce a hostile offeror to raise its bid, to effectively run an auction, and to protect the shareholders in "special circumstances" where even a bid carrying a high premium might not be in their best interests. The article concludes that potential abuse of the "just say no" power by target boards can be minimized by coupling a strong presumption in favor of an auction with strict court review. *Id.*

[372] The running of an auction raises premiums for target shareholders. *See* Browne & Rosengren, *Are Hostile Takeovers Different*, in MERGER BOOM 208 (L. Browne & E. Rosengren eds. 1988); Walking & Edmister, *Determinants of Tender Offer Premiums*, 41 FIN. ANALYSTS J. 27 (1985) (premiums are higher if bidder faces an opposing suitor).

to the *Revlon* duty to auction. This is as it should be and helps to ensure a fair premium for target shareholders. The combination of auction duty and the availability of so many restructuring options has helped lead to a situation where experts have concluded that virtually every premium paid in a hostile tender offer in the past couple of years has been fair to target shareholders.[373] Coercive bids, show stopper defenses, and inadequate auctions have become largely relics of the past.

Macmillan II also emphasized that the target board's primary responsibility is to target shareholders. To impose on corporate directors a fiduciary duty to non-shareholder constituents is to ask the impossible. At the same time, there are many instances where a corporate board can serve its shareholders best by protecting stakeholders, and *Macmillan II* should not be interpreted to discourage that type of activity.

Macmillan II leaves open the question of whether a target board may ever "just say no." It does however, indicate a strong presumption that the creation of alternatives is preferable to blocking a bid altogether. This presumption, if not a conclusive one, serves target shareholders' interests by maximizing the number of instances where they will be able to sell their shares at the fabulous premiums available today.[374]

Ultimately, *Macmillan II* represents one more step in the slow but inexorable march by the Delaware courts to create a legal regime which will closely monitor target board defenses in tender offers in order to facilitate white knight bids, recapitalizations, MBO's, and other alternatives serving to benefit target shareholders.

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[373] *Roundtable*, MERGERS & ACQUISITIONS, May-June, 1989, at 40 (quoting William Rifkin of Salomon Brothers who concluded that "over the last couple of years . . . [a] lot of the initial bids were inadequate but were countered by an auction or creation of an alternative for shareholders such as a restructuring. But in the end, I can't think of a deal that was not deemed fair").

[374] Lowenstein & Millstein, *The American Corporation and the Institutional Investor: Are There Lessons from Abroad? Introduction*, 1988 COLUM. BUS. L. REV. 739, 740 (1988) (noting that average premium for hostile bids is about 80%).