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PUBLIC CONTESTS FOR CORPORATE CONTROL

13.1 INTRODUCTION

Control contests occupy a central place in the theory of U.S. corporate governance. The simplest form of the theory goes something like this: Share prices fall when companies underperform, which in turn attracts the attention of potential acquirers who believe they can do better than incumbent managers and are prepared to offer a premium price for their targets' shares. When incumbent directors agree, they conclude a friendly deal; when they disagree, the stage is set for a hostile contest for corporate control. Thus, successful control contests allow acquiring managers the opportunity to create new value and give target shareholders the opportunity to share in this new value.[1] The flip side is that control contests are profoundly unpleasant for incumbent managers. But many have argued that for this very reason, the threat of a takeover has the salutary effect of encouraging all managers to deliver shareholder value. Thus, control contests can be an important potential constraint on managerial agency costs generally.[2] This chapter reviews the landmark cases in the law of control contests and brings developments in this area up to date.

1. Of course, a developed account of the market for corporate control must go well beyond this simple sketch. One also must consider that the evolution of defensive tactics largely excludes the bareknuckle hostile tender offers of the 1980s. Today's best analogy to the hostile takeover contests of that time are activist hedge fund campaigns that were briefly reviewed in Chapter 6.

2. Credit for first articulating the key governance role of control contests goes to Henry Manne. See Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965). For subsequent development of the governance role of control contests, see two classic articles from the early 1980s: Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to Hostile Takeovers*, 94 Harv. L. Rev. 1161 (1981); and Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan. L. Rev. 819 (1981).

Law is one of the principal determinants of the scope of the takeover market. Traditionally, Anglo-American law opened two avenues for initiating a hostile change in control. The first was the proxy contest — running an insurgent slate of candidates for election to the board. Although the proxy contest is costly and often unsuccessful (at least at first),[3] it was nevertheless the only insurgent technique employed during the infrequent contests for control over widely held companies prior to the 1960s. Moreover, the proxy contest has returned with the rise of activist hedge funds who use proxy fights — or more often, the threat of proxy fights — to press their alternative business plans on corporate boards. But as we discussed in Chapter 6, hedge funds seldom pursue complete control of target companies but rather seek to place a minority of their candidates on target company boards with the aim of promoting change through "constructive engagement" with other board members.

The second technique for obtaining control over a target company is, of course, the tender offer which, as discussed in Chapter 11, is the simple expedient of purchasing enough stock oneself to obtain voting control rather than soliciting the proxies of others. Clearly, a tender offer is even more expensive than a proxy contest if one includes the costs of buying shares. But launching a tender offer also has the great comparative advantage of offering stockholders cash or other consideration up front, rather than seeking to win their votes with promises of future performance. In recent years, moreover, the proxy contest and the tender offer have sometimes merged into a single hybrid form of hostile takeover, as the law's acceptance of potent defensive tactics has sometimes made it difficult to pursue either avenue alone.

The law of corporate control contests has developed in tandem with the steep rise in the number of M&A transactions in the U.S. economy over the past 45 years. At the outset of this period, courts reviewed a board's resistance to a contest for control just as they would review any other corporate action. If the response were self-interested in an immediate financial way, the board would be required to demonstrate that it was intrinsically fair;[4] otherwise, it would be reviewed under the business judgment standard.[5] But this dichotomous approach, which worked well for reviewing self-dealing transactions and disinterested business decisions, seemed less suitable for hostile tender offers and other acquisition-of-control transactions. Management and the board are never truly disinterested in efforts to acquire control over their corporation (and hence over their positions). Nevertheless, responses to takeover offers are not "self-interested" to the same extent as a self-dealing transaction. These offers *are* immensely complicated business propositions that can expose shareholders to serious risks of exploitation by third-party

3. Even in those instances in which incumbent managers defeat a proxy fight, history shows that there is a relatively strong probability that incumbent management will be changed within the following year.

4. *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107 (Del. 1952); *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

5. *Painter v. Marshall Field & Co.*, 646 F.2d 271, 293-295 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Johnson v. Trueblood*, 629 F.2d 287, 292-293 (3d Cir. 1980) (Seitz, C.J.); *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 382-383 (2d Cir. 1980).

bidders; boards of directors have a critical role in protecting and advising target shareholders in this context.

The Delaware Supreme Court first began to grapple seriously with the complexities of the board's duties in contests for corporate control in a series of three cases argued during 1985, which together set the framework for the analysis of directors' fiduciary duties in M&A transactions and for defenses against hostile takeovers. Each of these cases involved a different doctrinal question, but all concerned changes in corporate control. The wisdom of hindsight suggests that they were all aspects of a single effort to bring meaningful judicial review to control transactions. The first case was *Smith v. Van Gorkom*,[6] which arose out of a friendly cash-out merger. On its face, *Van Gorkom* appears to be chiefly about the corporate director's duty of care. Nevertheless, *Van Gorkom* held an entire board liable for "gross negligence" under circumstances in which most experts would have said its directors *had* met their standard of care: that is, they had attended all meetings and deliberated about the key corporate decisions at issue. To better understand this surprising case, we suggest looking at it in the context of the law of mergers. Later cases make clear that during this period the Delaware Supreme Court began a project of redefining the role of the corporate board in corporate control transactions.

The second major decision was *Unocal Corp. v. Mesa Petroleum Co.*,[7] which is excerpted below. It dealt with the Unocal board's efforts to defend against a hostile tender offer. *Unocal* articulated for the first time a standard of judicial review between lax business judgment review and tough entire fairness review to address board efforts to defend against a threatened change-in-control transaction.

The third significant case argued in 1985 was *Revlon v. MacAndrews and Forbes Holdings, Inc.*[8] *Revlon* also addressed the efforts of an incumbent board to resist an unwelcome takeover. Revlon's board, however, attempted to resist by pursuing an alternative transaction, which is the focus of the case. Again, the court adopted a form of heightened review short of intrinsic fairness. For want of better terminology, lawyers and judges came to talk of "*Revlon* duties," and more recently, "*Revlon* review" of similar cases in which it was alleged that boards were failing — or had failed — to seek top value for shareholders when their companies were sold. Yet for many years, no one was certain when a board's *Revlon* duties were triggered or exactly what they required.

Although these 1985 cases appeared revolutionary, they had precursors: two earlier cases that sought to introduce flexibility into the business judgment rule/entire fairness dichotomy. The first was *Cheff v. Mathes*,[9] a 1964 Delaware Supreme Court opinion in which shareholders attacked a corporate repurchase at a premium price of all the stock belonging to a dissident shareholder/director. The premium payment was attacked by another

6. 488 A.2d 858 (Del. 1985). See the discussion in Chapter 7.
7. 493 A.2d 946 (Del. 1985).
8. 506 A.2d 173 (Del. 1986).
9. 199 A.2d 548 (Del. 1964).

shareholder as a waste and the whole transaction as simply an effort to entrench the existing board. The court agreed that the repurchase had the effect of securing the directors in control but held that, as long as the board's *primary purpose* was to advance business policies, the buyback did not violate the board's fiduciary duty.[10] The second precursor was *Schnell v. Chris-Craft Industries*[11] which, in contrast to *Cheff*, did find a breach of fiduciary duty when a "disinterested" board advanced the date of the company's annual meeting, as it was permitted to do by statute, solely in order to make a hostile proxy solicitation impossible to mount.[12]

Although *Cheff* and *Schnell* had dealt intelligently with a board's use of corporate power to maintain control, neither case afforded useful doctrinal tools for examining entrenchment measures more generally. However, the extraordinary growth in the number of M&A transactions — and especially hostile tender offers — in the late 1970s and early 1980s made the question of a director's fiduciary duty in the face of a takeover bid inescapable. The courts addressed this question, and so did other institutions. State legislatures passed antitakeover statutes and promulgated standards for evaluating defensive action undertaken by boards. And more important still, private legal innovation, particularly the so-called poison pill, dramatically altered the law governing changes in control of public companies. In fact, this private innovation (together with copious case law that it has stimulated) has made most state takeover legislation, as well as much of the Williams Act (as discussed previously in Chapter 11), very much less significant.

13.2 Defending Against Hostile Tender Offers

UNOCAL CORP. v. MESA PETROLEUM CO.
493 A.2d 946 (Del. 1985)

MOORE, J.:

We confront an issue of first impression in Delaware — the validity of a corporation's self-tender for its own shares which excludes from participation a stockholder making a hostile tender offer for the company's stock. . . .

On April 8, 1985, Mesa, the owner of approximately 13% of Unocal's stock, commenced a two-tier "front loaded" cash tender offer for 64 million shares, or approximately 37%, of Unocal's outstanding stock at a price of $54 per share. The "back-end" was designed to eliminate the remaining publicly held shares by an exchange of securities purportedly worth $54 per share.

10. The shareholder attacked the corporation marketing strategy, which management defended as a source of real value. The board resolved the disagreement by causing the company to repurchase the dissident's stock at a premium over market price. Plaintiff shareholders claimed that this purchase was wasteful, since the company paid a premium to market price, and that the repurchase was made to entrench the directors in office.

11. 285 A.2d 437 (Del. 1971).

12. See §6.10 above.

However, pursuant to an order entered by the United States District Court for the Central District of California on April 26, 1985, Mesa issued a supplemental proxy statement to Unocal's stockholders disclosing that the securities offered in the second-step merger would be highly subordinated, and that Unocal's capitalization would differ significantly from its present structure. Unocal has rather aptly termed such securities "junk bonds."

Unocal's board consists of eight independent outside directors and six insiders. It met on April 13, 1985, to consider the Mesa tender offer. Thirteen directors were present, and the meeting lasted nine and one-half hours. The directors were given no agenda or written materials prior to the session. However, detailed presentations were made by legal counsel regarding the board's obligations under both Delaware corporate law and the federal securities laws. The board then received a presentation from Peter Sachs on behalf of Goldman Sachs & Co. (Goldman Sachs) and Dillon, Read & Co. (Dillon Read) discussing the bases for their opinions that the Mesa proposal was wholly inadequate. Mr. Sachs opined that the minimum cash value that could be expected from a sale or orderly liquidation for 100% of Unocal's stock was in excess of $60 per share. . . .

Mr. Sachs also presented various defensive strategies available to the board if it concluded that Mesa's two-step tender offer was inadequate and should be opposed. One of the devices outlined was a self-tender by Unocal for its own stock with a reasonable price range of $70 to $75 per share. The cost of such a proposal would cause the company to incur $6.1-6.5 billion of additional debt, and a presentation was made informing the board of Unocal's ability to handle it. The directors were told that the primary effect of this obligation would be to reduce exploratory drilling, but that the company would nonetheless remain a viable entity.

The eight outside directors, comprising a clear majority of the thirteen members present, then met separately with Unocal's financial advisors and attorneys. Thereafter, they unanimously agreed to advise the board that it should reject Mesa's tender offer as inadequate, and that Unocal should pursue a self-tender to provide the stockholders with a fairly priced alternative to the Mesa proposal. . . .

On April 15, the board met again. . . . Unocal's Vice President of Finance and its Assistant General Counsel made a detailed presentation of the proposed terms of the exchange offer. A price range between $70 and $80 per share was considered, and ultimately the directors agreed upon $72. . . . The board's decisions were made in reliance on the advice of its investment bankers. . . . Based upon this advice, . . . the directors unanimously approved the exchange offer. Their resolution provided that if Mesa acquired 64 million shares of Unocal stock through its own offer (the Mesa Purchase Condition), Unocal would buy the remaining 49% outstanding for an exchange of debt securities having an aggregate par value of $72 per share. The board resolution also stated that the offer would be subject to other conditions. . . .

Legal counsel advised that under Delaware law Mesa could only be excluded for what the directors reasonably believed to be a valid corporate purpose. The directors' discussion centered on the objective of adequately compensating shareholders at the "back-end" of Mesa's proposal, which the latter would finance with "junk bonds." To include Mesa would defeat that goal, because under the proration aspect of the exchange offer (49%) every Mesa share accepted by Unocal would displace one held by another stockholder. Further, if Mesa were permitted to tender to Unocal the latter would in effect be financing Mesa's own inadequate proposal. . . .

[Unocal's board subsequently waived the Mesa Purchase Condition as to 50 million shares (roughly 30 percent of outstanding shares), five days after the commencement of its April 17 exchange offer. This waiver — in effect, a self-tender for 30 percent of Unocal — was meant to placate institutional shareholders who correctly anticipated that Unocal's offer would defeat Mesa's bid and feared that it would also lead stock prices to decline to the $30 level, where they had languished prior to Mesa's bid.]

We begin with the basic issue of the power of a board of directors of a Delaware corporation to adopt a defensive measure of this type. . . .

The board has a large reservoir of authority upon which to draw. Its duties and responsibilities proceed from the inherent powers conferred by 8 Del. C. §141(a), respecting management of the corporation's "business and affairs." Additionally, the powers here being exercised derive from 8 Del. C. §160(a), conferring broad authority upon a corporation to deal in its own stock. From this it is now well established that in the acquisition of its shares a Delaware corporation may deal selectively with its stockholders, provided the directors have not acted out of a sole or primary purpose to entrench themselves in office. *Cheff v. Mathes*, Del. Supr., 199 A.2d 548, 554 (1964). . . .

Finally, the board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived, irrespective of its source. . . .

When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interest of the corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment. . . . There are, however, certain caveats to a proper exercise of this function. Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred. . . .

In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership. . . .

[C]orporate directors have a fiduciary duty to act in the best interests of the corporation's stockholders. . . . As we have noted, their duty of care extends to protecting the corporation and its owners from perceived harm whether a threat originates from third parties or other shareholders.[10] But such powers are not absolute. A corporation does not have unbridled discretion to defeat any perceived threat by any Draconian means available.

10. It has been suggested that a board's response to a takeover threat should be a passive one. Frank H. Easterbrook & Daniel R. Fischel, *Takeover Bids, Defensive Tactics, and*

The restriction placed upon a selective stock repurchase is that the directors may not have acted solely or primarily out of a desire to perpetuate themselves in office . . . [or take] inequitable action. . . .

A further aspect is the element of balance. If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed. This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on "constituencies" other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of non-consummation, and the quality of securities being offered in the exchange. See Lipton and Brownstein, *Takeover Responses and Directors' Responsibilities: An Update*, p. 7, ABA National Institute on the Dynamics of Corporate Control (December 8, 1983). While not a controlling factor, it also seems to us that a board may reasonably consider the basic stockholder interests at stake, including those of short-term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor.[11] Here, the threat posed was viewed by the Unocal board as a grossly inadequate two-tier coercive tender offer coupled with the threat of greenmail.

Specifically, the Unocal directors had concluded that the value of Unocal was substantially above the $54 per share offered in cash at the front end. Furthermore, they determined that the subordinated securities to be exchanged in Mesa's announced squeeze out of the remaining shareholders in the "back-end" merger were "junk bonds" worth far less than $54. It is now well recognized that such offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction. Wholly beyond the coercive aspect of an inadequate two-tier tender offer, the threat was posed by a corporate raider with a national reputation as a "greenmailer."[13]

In adopting the selective exchange offer, the board stated that its objective was either to defeat the inadequate Mesa offer or, should the offer still succeed, provide the 49% of its stockholders, who would otherwise be forced

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Shareholders' Welfare, 36 Business Lawyer (ABA) at 1750 (1981). However, that clearly is not the law of Delaware, and as the proponents of this rule of passivity readily concede, it has not been adopted either by courts or state legislatures. Easterbrook & Fischel, *supra* at note 2, 94 Harv. L. Rev. at 1194 (1981).

11. There has been much debate respecting such stockholder interests. One rather impressive study indicates that the stock of over 50 percent of target companies, who resisted hostile takeovers, later traded at higher market prices than the rejected offer price, or were acquired after the tender offer was defeated by another company at a price higher than the offer price. See Martin Lipton, [*Takeover Bids in the Target's Boardroom*, 35 Bus. Law. 101 (1979)] at 106-109, 132-133. Moreover, an update by Kidder Peabody & Company of this study, involving the stock prices of target companies that have defeated hostile tender offers during the period from 1973 to 1982 demonstrates that in a majority of cases the target's shareholders benefited from the defeat. . . .

13. The term "greenmail" refers to the practice of buying out a takeover bidder's stock at a premium that is not available to other shareholders in order to prevent the takeover. . . .

to accept "junk bonds," with $72 worth of senior debt. We find that both purposes are valid.

However, such efforts would have been thwarted by Mesa's participation in the exchange offer. First, if Mesa could tender its shares, Unocal would effectively be subsidizing the former's continuing effort to buy Unocal stock at $54 per share. Second, Mesa could not, by definition, fit within the class of shareholders being protected from its own coercive and inadequate tender offer.

Thus, we are satisfied that the selective exchange offer is reasonably related to the threats posed. . . . Thus, the board's decision to offer what it determined to be the fair value of the corporation to the 49% of its shareholders, who would otherwise be forced to accept highly subordinated "junk bonds," is reasonable and consistent with the directors' duty to ensure that the minority stockholders receive equal value for their shares.

Mesa contends that it is unlawful, and the trial court agreed, for a corporation to discriminate in this fashion against one shareholder. It argues correctly that no case has ever sanctioned a device that precludes a raider from sharing in a benefit available to all other stockholders. However, as we have noted earlier, the principle of selective stock repurchases by a Delaware corporation is neither unknown nor unauthorized. . . . The only difference is that heretofore the approved transaction was the payment of "greenmail" to a raider or dissident posing a threat to the corporate enterprise. All other stockholders were denied such favored treatment, and given Mesa's past history of greenmail, its claims here are rather ironic.

However, our corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs. . . .

[A]s the sophistication of both raiders and targets has developed, a host of other defensive measures to counter such ever mounting threats have evolved and received judicial sanction. These include defensive charter amendments and other devices bearing some rather exotic, but apt, names: Crown Jewel, White Knight, Pac Man, and Golden Parachute. Each has highly selective features, the object of which is to deter or defeat the raider.

Thus, while the exchange offer is a form of selective treatment, given the nature of the threat posed here the response is neither unlawful nor unreasonable. If the board of directors is disinterested, has acted in good faith and with due care, its decision in the absence of an abuse of discretion will be upheld as a proper exercise of business judgment. . . .

In conclusion, there was directorial power to oppose the Mesa tender offer, and to undertake a selective stock exchange made in good faith and upon a reasonable investigation pursuant to a clear duty to protect the corporate enterprise. Further, the selective stock repurchase plan chosen by Unocal is reasonable in relation to the threat that the board rationally and reasonably believed was posed by Mesa's inadequate and coercive two-tier tender offer. Under those circumstances the board's action is entitled to be measured by the standards of the business judgment rule. Thus, unless it is shown by a preponderance of the evidence that the directors' decisions were primarily based on perpetuating themselves in office, or some other breach of fiduciary duty such as fraud, overreaching, lack of good faith, or being uninformed, a Court will not substitute its judgment for that of the board.

. . . If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out. . . .

QUESTIONS AND NOTES ON UNOCAL

1. What does it mean to characterize the Mesa offer as "coercive"? In what sense can Mesa's two-tier offer be coercive if the pre-bid market price for Unocal shares was, say, \$33/share, Pickens's cash price for 37 percent of Unocal was \$55/share, and Pickens's back-end cash-out price for the remaining 50 percent of Unocal's shares was around \$45/share (the likely market value of junk bonds with a face value of \$55/share)? Even the "back end" of the Pickens offer was generally acknowledged to be worth a lot more than Unocal's pre-bid market price.

2. Was the Unocal exchange offer also coercive?

3. What was the logical relevance of Mesa's reputation as a greenmailer to the court's analysis?

4. What are we to make of a discriminatory self-tender? Is it any different from greenmail, which the Delaware Supreme Court had authorized to protect corporate policies since the *Cheff* case? The SEC presumably thought so, since it effectively overruled this aspect of *Unocal* by promulgating Rule 13e-4, which bars discriminatory self-tenders. No SEC rule bars greenmail.

5. Is Justice Moore abandoning shareholder primacy in this opinion? Is the fundamental duty of boards to further the interests of shareholders, to balance the interests of all corporate "constituencies," or to do something else?

6. In footnote 11 of its opinion, the court cites empirical evidence from Martin Lipton and Kidder Peabody indicating that targets remaining independent achieve higher returns for their shareholders than targets that sell to the hostile bidder. The court does not cite Professor Ronald Gilson, who points out several flaws in Lipton's study, including no adjustment for market effects or the time value of money. When these and other factors are considered, Gilson states that "Lipton's data refute his own conclusion."[13] A more recent study, examining targets that remained independent between 1996 and 2002, shows that shareholders received lower returns than they would have received if the company had been sold to the initial bidder or to a white knight[14] — the opposite of what Lipton and Kidder Peabody found 20 years earlier. Whatever the general tendency is, it seems clear, as well, that in individual cases of hostile takeover attempts, shareholders have been made better

13. See Gilson, *supra* note 2, at 857-858.

14. Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 Stan. L. Rev. 885 (2002).

13.3 Private Law Innovation: The Poison Pill

We turn now to a most remarkable innovation in corporate law, the shareholders' rights plan or "poison pill." This was an audacious invention that has proven to be remarkably effective, although it continues to be controversial. In an arm's length merger, the counter-party must negotiate an agreement with the target board of directors; in a tender offer for corporate control, as of the early 1980s, the board had no formal role. The shareholders' rights plan operates to give a target's board the same bargaining power over a hostile tender offer as DGCL §251 grants the board over merger proposals.

What is now colloquially named the "poison pill" is a private law device, variously said to have been invented by Wachtell Lipton or another prominent law firm. But regardless of who has bragging rights, the pill would not enjoy the prominence it does today without the encouragement of the Delaware courts. The pill was first validated in 1985 by the Delaware Supreme Court in *Moran v. Household International, Inc.*[18] Many academics of the day believed (and still believe) that hostile tender offers are a useful device for disciplining corporate management. But boards and managers believed the success of hostile bids revealed a profound weakness in corporate governance by leaving disaggregated shareholders vulnerable to abusive tender offer tactics. Moreover, in the late 1970s and early 1980s, the practices of certain takeover entrepreneurs made management's arguments plausible. "Front-end loaded, two-tier" tender offers could unquestionably induce shareholders to sell, even if they believed that the tender offer price was well below what their shares were worth. This much was confirmed by academic research.[19] And to managers and boards, if not necessarily the academic commentators of the day, the implication was clear: Only a loyal bargaining agent — namely, the board — could remedy the bargaining infirmities and collective action problems of dispersed shareholders. The poison pill did just this. it empowered the board to be the shareholders' gatekeeper and bargaining agent.

Shareholders' rights plans take the form of capital instruments: rights to buy a capital asset, such as a bond, common share, or preferred share. Yet, their only real function is to alter the allocation of power between shareholders and boards. The most common form of rights plans today does this rather like the Mesa exclusion in *Unocal*. The rights to buy a company security are "distributed" to all shareholders. (Shareholders do not literally receive a new piece of paper; the rights trade with the stock.) But upon the happening of a triggering event — generally the acquisition by a hostile party of a set percentage of the company's stock (often 10 or 15 percent) — the rights automatically convert into the right to buy the company's stock at a greatly discounted price. Moreover (and this is the key), the person whose stock acquisition triggers the exercise of the rights is itself excluded from buying discounted stock. Thus, its holdings are severely diluted; it retains only a small fraction of its prior voting rights and may lose most of the value of its investment in the

18. 500 A.2d 1346 (Del. 1985).

19. See, e.g., Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 Harv. L. Rev. 1639 (1985).

company stock. The result is that buying a substantial block of stock without the prior consent of the target's board is ruinously expensive and the dilution of voting rights is even more extreme. These consequences give the board an effective veto over a hostile tender offer. However, if the hostile party successfully negotiates a friendly deal with the board before crossing the triggering percentage, the board can waive the pill (called "redeeming" the pill). Thus typical pills always have a so-called "board-out" provision.

Consider this hypothetical example of the pill's operation. T Corp. distributes as a dividend the Shareholders' Rights. Each Right purports to be a right to buy 1/100 of a share of the company's common stock in the future for an extravagant, "out of the money" price: say, $500 (or $5,000 per share) when its common stock is selling for $75 a share. Given its terms, no one really expects this Right ever to be exercised (although the company's lawyers might argue that the Right's high exercise price represents the hidden long-term value of the company's stock). The Rights do not trade separately at this point but are embedded in the common stock on which the dividend is paid. However, should a "triggering event" occur, the Rights detach and are tradable separately. Today, a triggering event might be the acquisition of 10 percent of the company's stock by any single entity or an affiliated group of persons, or the announcement of a tender offer for 10 percent or more of the company's stock.[20]

If a person or group did acquire a 10 percent block, then under a "flip-in" pill, each outstanding Right would "flip-into" a right to acquire some number of shares of the target's common stock at one-half of the market price for that stock. (It could be one-third or some other number, but it usually is one-half.) In other words, the Right's holder would be able to buy stock from the company at half price. Now, if every Right holder bought stock at half price, the aggregate effect is to increase the proportionate holdings of all shareholders *except* the "triggering person," whose Right would be canceled upon the occurrence of the triggering event and who, as a result, would only own a much smaller interest in the company than that for which she initially paid.[21]

20. When rights plans were first introduced in the 1980s, triggering events typically involved 30 percent of the company's stock. The size of the triggering threshold has steadily receded, however, and since 1990, triggers have been typically 10 percent. Once the rights are triggered, they are no longer redeemable by the company, and ten days later they are exercisable. For a commentary that examines pill design choices with respect to redeemability, see Guhan Subramanian, *Bargaining in the Shadow of PeopleSoft's (Defective) Poison Pill*, 12 Harv. Neg. L. Rev. 41 (2007).

21. The original rights plans were not "flip-in" plans, but "flip-over" plans which purported to create a right to buy some number of shares *in the corporation whose acquisition of target stock had triggered the right*. In this plan, a triggering event — acquiring a certain percentage of target's shares (when followed by a second triggering event: a merger or sale of more than 50 percent of the target's assets to the triggering shareholder or an affiliate) results in the rights being exercisable. How can the target's board create a right that requires a third party to sell its stock at half price to the target's shareholders? Well, we are not certain that it can be done, since the question of whether a *triggering* shareholder must respect an obligation created by a flip-over plan has never been litigated. The reason these plans are *supposed* to work, however, is that they purport to compel the target's board, as a party to the second triggering event, to put terms in any merger agreement (or asset sale agreement, etc.) with the acquirer that will force the acquirer to recognize flip-over rights.

Rights plans were, and to some extent remain, controversial. One can easily see how they could be beneficial to shareholders, but it is just as easy to see ways in which they might be misused to protect the status quo. When rights plans were first introduced, it was fairly clear that most boards were authorized to issue rights, like those created by rights plans, to raise capital, but whether they could do so solely as a takeover defense was less clear.[22] In *Moran*, the Delaware Supreme Court held that Delaware corporations have the statutory power to issue both shares (DGCL §151) and rights to acquire securities (DGCL §157) even when they are not raising capital; and the accompanying rights do not preclude shareholders from receiving tender offers (although the shareholders may be required to change the board to do so). In approving the power that boards have to adopt rights plans, the Court relied expressly on the fiduciary duty of the board in stating that boards would have a continuing obligation to monitor the rights and to redeem them under the (then) newly adopted *Unocal* test if a tender offer did not represent a threat to the corporation or its shareholders. The use of the pill was thus approved as a takeover defense, but unlike many other takeover defenses, it blocked hostile offers without requiring any real changes to the corporation's business plans, shares, or assets.

Immediately after *Moran* was decided, commentary on Delaware law came to focus on how a target company's board could satisfy its burden to show that, under *Unocal*, an unsolicited tender offer represented a threat to corporate policy or to shareholders that justified leaving a rights plan in place.

QUESTIONS AND NOTES ON STOCK RIGHTS PLANS

1. *Moran* was the first judicial opinion to validate shareholders' rights plans. Other jurisdictions split on their validity at first, but that equivocation ended, state by state. As Professors Emiliano Catan and Marcel Kahan report: "Between 1986 and 1989, court decisions rendered under the laws of Colorado, Georgia, New Jersey, New York, Virginia, and Wisconsin held or strongly suggested that flip-in pills are invalid. The basis for these decisions was that the discriminatory treatment of raiders in flip-in pills violated a statutory requirement that all shares of the same class be treated equally. Court decisions under the laws of Indiana, Maine, Maryland, Michigan, Minnesota, Texas and Wisconsin upheld flip-in pills, reasoning that any discrimination

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Because of their second trigger, flip-over plans are less effective than flip-in plans. In a flip-over plan, a hostile party may acquire a large block of target stock but propose no transaction which would act as the second trigger activating the rights. It may wait to elect a new board. Indeed, this weakness was demonstrated in one instance and flip-in pills, which did not require the hostile acquirer to take any second step in order to execute the punishing dilution, were designed in response.

22. Firm charters usually had provisions authorizing the board to issue classes of preferred stock (along with deciding on their voting rights, preferences, and so forth) without needing any further stockholder approval. These so-called "blank check" preferred stocks were used by transactional lawyers to set up the pill.

required when selling a company. The classic *Revlon* case occurs when two bidders are engaged in a bidding contest for the target. Here, as in *Revlon* itself, "the directors may not use defensive tactics that destroy the auction process. [F]airness forbids directors from using defensive mechanisms to thwart an auction or to favor one bidder over another."[30] But what if there is only a single bidder at the table? The *Barkan* court stated that the essence of the *Revlon* requirement is that a board be well informed. An auction is a very good way to know what the company is worth, but not the only or the required way. Before becoming bound, the board may engage in a so-called market check to see if a higher bid is available, unless "the directors possess a body of reliable evidence with which to evaluate the fairness of a transaction."[31] Such a check may occur post-signing of the deal provided that the deal does not place serious impediments to the emergence of a higher valuing buyer, such as an unreasonable termination fee (discussed below). We discuss the substance of so-called *Revlon* review in Section 13.6.

4. "*Revlon*" questions haunted Delaware law for years: What *are Revlon* duties specifically; just what do they require, and when are they triggered? It took years of litigation for the confusion to gradually lift. It is now established that *Revlon* created no new duties but dealt with a modified standard of judicial review of the duties of care and loyalty in a particular context.

5. In the 2001 case *In re Pennaco Energy, Inc.* 787 A.2d 691 (Del. Ch. 2001), the board negotiated exclusively with Marathon Oil and reached an agreement at $19 cash per share, with a 3 percent breakup fee and a right for Marathon to match any higher offer that might emerge. Despite the absence of any pre-signing market check of the company, the Court of Chancery found that the target directors had met their *Revlon* duties on the theory that the relatively modest breakup fee and chance for others to come in were they interested in paying more was one reasonable way to sell the business. *Pennaco* shows that while *Revlon* continues to be the brand name opinion, the spirit of *Barkan v. Amsted* captures far better the approach to change of control duties that courts tend to take. See below also for the latest word in the Delaware Supreme Court's 2014 opinion in *C&J Energy Services, Inc. v. City of Miami Employees Union* in Section 13.6.

13.5 Pulling Together *Unocal* and *Revlon*

During this evolutionary period, whether a hostile takeover succeeded came down to whether the incumbent board eventually gave in under shareholder pressure or the Delaware courts ordered the company's poison pill be redeemed, which happened in the late 1980s, but very rarely. A much-discussed Delaware Supreme Court decision of 1989, *Paramount Communications, Inc. v. Time, Inc.*, addressed both the question of whether the board has a duty to redeem its poison pill and the issue of what triggers

30. Id. at 1286-1287.
31. Id. at 1287.

Revlon duties. Discussion of the first issue was dicta, since *Time, Inc.*, the corporate defendant, had not relied on its poison pill to defend against a hostile attack by Paramount Communications, Inc. That characterization, however, detracts little from the force of the court's statements.

PARAMOUNT COMMUNICATIONS, INC. v. TIME, INC.

571 A.2d 1140 (Del. 1989)

[Paramount Communications' unsuccessful bid for Time, Inc. was perhaps the most famous hostile takeover attempt of the 1980s. In brief, Paramount launched its bid after Time had already initiated a friendly merger transaction with Warner Communications. Time succeeded in thwarting Paramount by transforming its original merger deal into a tender offer by Time for Warner, thereby making itself too large (and debt-ridden) to be an attractive target for Paramount. Prior to Time's tender offer, both Paramount and several groups of Time's shareholders sought to enjoin the tender offer in order to give Time's shareholders an opportunity to choose between this offer and Paramount's bid. The Delaware Court of Chancery recognized that Time's shareholders apparently preferred the higher price offered by the Paramount deal but nonetheless refused to enjoin Time's tender offer, on the grounds that, since Time's board was not under a *Revlon* duty to optimize Time's current stock value, the board had acted reasonably in pursuing its long-term plan to create business value.

The facts of the case were as follows. Time's long-term business strategy was to expand from a publishing company into a diversified multimedia and entertainment company. Pursuant to this strategy, Time initiated merger negotiations with Warner Communications. As both companies were in the $10-$12 billion range, the proposed combination was to be a "merger of equals." The negotiations were protracted. The chief sticking points were the management structure of the combined company and the role that Steven Ross, Warner's extraordinarily successful CEO, would play in the new entity.

On March 3, 1989, the parties signed a stock-for-stock merger agreement that cast Time in the role of the surviving corporation but would have transferred 62 percent of Time's common stock to Warner shareholders at an exchange ratio reflecting the current market price of the shares in the two firms (i.e., Warner had a somewhat larger market capitalization). The agreement also provided that the surviving corporation would be renamed Time-Warner Corporation, would have an expanded board to be divided equally between the old Time and Warner directors, and would have shared management with a succession plan. Under the management arrangement, there would be co-CEOs for a period of five years. One would be from the Time organization (Nicholas) and one from the Warner organization (Ross). After the five-year period, Ross would retire and Nicholas would continue as the sole CEO. Ross received a compensation package valued at roughly $200 million. Thus, Time bargained hard to assure the ultimate ascendancy of its managers in the combined firm. A final provision of the agreement gave each party the option to trigger a share exchange in which Time would receive

9.4 percent of Warner's stock and Warner would receive 11.1 percent of Time's stock. The purpose of this option was to deter third-party bids for Time or Warner prior to the merger vote.

On June 7, 1989, Paramount announced a $175 per share cash bid for all of Time's shares, contingent on the termination of the share exchange agreement, the redemption of Time's poison pill, and the resolution of legal difficulties attending the transfer of Time properties to Paramount. Paramount's offer came two weeks before Time's shareholders were scheduled to vote on the Warner merger. Time's shares had traded at a high of $50 prior to the Warner merger agreement and $122 prior to Paramount's offer. After Paramount's offer, they jumped to a high of $188/share.

Time's board rejected Paramount's price as grossly inadequate and concluded that the Warner deal was a better vehicle for Time's strategic goals. On June 16, Wasserstein, Perella, Time's investment banker, informed Time's board that a "control market value" for Time would exceed $250/share, although an earlier Wasserstein valuation conducted in connection with the Time-Warner agreement had valued Time at between $189 and $212 per share. In addition, Wasserstein estimated that Time's stock would trade at between $106 and $188 if the Time-Warner combination succeeded.

Having rejected Paramount's offer, however, Time's management faced a dilemma: It had planned the stock-for-stock merger that required a shareholder vote. But if Time's shareholders were to vote, they would almost certainly reject the proposed merger in the hope of tendering into the higher Paramount offer. Therefore, Time and Warner abandoned their merger agreement and agreed that Time would make a friendly cash tender offer to Warner shareholders and that, following the closing of that offer, a merger between Time and Warner would be effectuated. The governance terms in the new Time-Warner agreement were identical to those in the old agreement. The chief difference was that Time was forced to borrow $10 billion to purchase Warner shares at a 56 percent cash premium over their preagreement market price.

As a result of various delays that were caused by Paramount getting regulatory approval to acquire Time's programming and cable TV franchises, Paramount could not pursue its offer for Time immediately. On June 22, Paramount increased its cash offer to $200/share in the hope of dissuading Time from buying Warner, but to no avail. Paramount then sought to enjoin Time's offer in the Delaware Chancery Court, where it was joined by several groups of Time shareholders also seeking to block Time's maneuver. It was clear that if Time's offer went forward, Paramount would lack the incentive and the resources to bid for the heavily indebted Time-Warner entity that would emerge.

Here we pick up the Delaware Supreme Court's opinion after the statement of facts.]

HORSEY, J.:

The Shareholder Plaintiffs first assert a *Revlon* claim. They contend that the March 4 Time-Warner [Original Stock-for-Stock Merger] agreement effectively put Time up for sale, triggering *Revlon* duties, requiring Time's board to enhance short-term shareholder value and to treat all other interested acquirers on an equal basis. The Shareholder Plaintiffs base this argument on two facts: (i) the ultimate Time-Warner exchange ratio of .465 favoring Warner, resulting in Warner shareholders' receipt of 62% of the combined company; and (ii) the subjective intent of Time's directors as evidenced in their statements that the market might perceive the Time-Warner merger as putting Time up "for sale" and their adoption of various defensive measures.

The Shareholder Plaintiffs further contend that Time's directors, in structuring the original merger transaction to be "takeover-proof," triggered *Revlon* duties by foreclosing their shareholders from any prospect of obtaining a control premium. In short, plaintiffs argue that Time's board's decision to merge with Warner imposed a fiduciary duty to maximize immediate share value and not erect unreasonable barriers to further bids. . . .

Paramount asserts only a *Unocal* claim in which the shareholder plaintiffs join. Paramount contends that the Chancellor, in applying the first part of the *Unocal* test, erred in finding that Time's board had reasonable grounds to believe that Paramount posed both a legally cognizable threat to Time shareholders and a danger to Time's corporate policy and effectiveness. Paramount also contests the court's finding that Time's board made a reasonable and objective investigation of Paramount's offer so as to be informed before rejecting it. Paramount further claims that the court erred in applying *Unocal*'s second part in finding Time's response to be "reasonable." Paramount points primarily to the preclusive effect of the revised agreement which denied Time shareholders the opportunity both to vote on the agreement and to respond to Paramount's tender offer. Paramount argues that the underlying motivation of Time's board in adopting these defensive measures was management's desire to perpetuate itself in office.

The Court of Chancery posed the pivotal question presented by this case to be: Under what circumstances must a board of directors abandon an in-place plan of corporate development in order to provide its shareholders with the option to elect and realize an immediate control premium? . . .

While we affirm the result reached by the Chancellor, we think it unwise to place undue emphasis upon long-term versus short-term corporate strategy. Two key predicates underpin our analysis. First, Delaware law imposes on a board of directors the duty to manage the business and affairs of the corporation. 8 Del. C. §141(a). This broad mandate includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability. Thus, the question of "long-term" versus "short-term" values is largely irrelevant because directors, generally, are obliged to charter a course for a corporation which is in its best interest without regard to a fixed investment horizon. Second, absent a limited set of circumstances as defined under *Revlon*, a board of directors, while always required to act in an informed manner, is not under any per se duty to maximize shareholder value in the short term, even in the context of a takeover. In our view, the pivotal question presented by this case is: "Did Time, by entering into the proposed merger with Warner, put itself up for sale?" A resolution of that issue through application of *Revlon* has a significant [b]earing upon the resolution of the derivative *Unocal* issue. . . .

We first take up plaintiffs' principal *Revlon* argument, summarized above. In rejecting this argument, the Chancellor found the original Time-Warner merger agreement not to constitute a "change of control" and concluded that the transaction did not trigger *Revlon* duties. The Chancellor's conclusion is premised on a finding that "[b]efore the merger agreement was signed, control of the corporation existed in a fluid aggregation of unaffiliated shareholders representing a voting majority — in other words, in the market." The Chancellor's findings of fact are supported by the record and his conclusion is correct as a matter of law. However, we premise our rejection of plaintiffs' *Revlon* claim on different grounds, namely, the absence of any substantial evidence to conclude that Time's board, in negotiating with Warner, made the dissolution or breakup of the corporate entity inevitable, as was the case in *Revlon.*

Under Delaware law there are, generally speaking and without excluding other possibilities, two circumstances which may implicate *Revlon* duties. The first, and clearer one, is when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company. . . . However, *Revlon* duties may also be triggered where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction also involving the breakup of the company. Thus, in *Revlon,* when the board responded to Pantry Pride's offer by contemplating a "bust-up" sale of assets in a leveraged acquisition, we imposed upon the board a duty to maximize immediate shareholder value and an obligation to auction the company fairly. If, however, the board's reaction to a hostile tender offer is found to constitute only a defensive response and not an abandonment of the corporation's continued existence, *Revlon* duties are not triggered, though *Unocal* duties attach. . . .

Finally, we do not find in Time's recasting of its merger agreement with Warner from a share exchange to a share purchase a basis to conclude that Time had either abandoned its strategic plan or made a sale of Time inevitable. The Chancellor found that although the merged Time-Warner company would be large (with a value approaching approximately $30 billion), recent takeover cases have proven that acquisition of the combined company might nonetheless be possible. The legal consequence is that *Unocal* alone applies to determine whether the business judgment rule attaches to the revised agreement. . . .

We turn now to plaintiffs' *Unocal* claim. . . .

. . . Time's decision in 1988 to combine with Warner was made only after what could be fairly characterized as an exhaustive appraisal of Time's future as a corporation. After concluding in 1983-84 that the corporation must expand to survive, and beyond journalism into entertainment, the board combed the field of available entertainment companies. By 1987 Time had focused upon Warner; by late July 1988 Time's board was convinced that Warner would provide the best "fit" for Time to achieve its strategic objectives. The record attests to the zealousness of Time's executives, fully supported by their directors, in seeing to the preservation of Time's "culture," i.e., its perceived editorial integrity in journalism. We find ample evidence in the record to support the Chancellor's conclusion that the Time board's decision to expand the business of the company through its March 3 merger with Warner was entitled to the protection of the business judgment rule. . . .

The Chancellor reached a different conclusion in addressing the Time-Warner transaction as revised three months later. He found that the revised agreement was defense-motivated. . . . Thus, the court . . . analyzed the Time board's June 16 decision under *Unocal.* The court ruled that *Unocal* applied to all director actions taken, following receipt of Paramount's hostile tender offer, that were reasonably determined to be defensive. Clearly that was a correct ruling. . . .

Unocal involved a two-tier, highly coercive tender offer. In such a case, the threat is obvious: shareholders may be compelled to tender to avoid being treated adversely in the second stage of the transaction. . . .

Since Paramount's offer was [not two-tier, but all-shares and] all-cash, the only conceivable "threat," plaintiffs argue, was inadequate value. We disapprove of such a narrow and rigid construction of *Unocal,* for the reasons which follow.

Plaintiffs' position represents a fundamental misconception of our standard of review under *Unocal* principally because it would involve the court in substituting its judgment as to what is a "better" deal for that of a corporation's board of directors. To the extent that the Court of Chancery has recently done so in certain of its opinions, we hereby reject such approach as not in keeping with a proper *Unocal* analysis. See, e.g., *Interco,* 551 A.2d 787, and its progeny. . . .

The usefulness of *Unocal* as an analytical tool is precisely its flexibility in the face of a variety of fact scenarios. *Unocal* is not intended as an abstract standard; neither is it a structured and mechanistic procedure of appraisal. Thus, we have said that directors may consider, when evaluating the threat posed by a takeover bid, the "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders, the risk of nonconsummation and the quality of securities being offered in the exchange." 493 A.2d at 955. The open-ended analysis mandated by *Unocal* is not intended to lead to a simple mathematical exercise: that is, of comparing the discounted value of Time-Warner's expected trading price at some future date with Paramount's offer and determining which is the higher. Indeed, in our view, precepts underlying the business judgment rule militate against a court's engaging in the process of attempting to appraise and evaluate the relative merits of a long-term versus a short-term investment goal for shareholders. To engage in such an exercise is a distortion of the *Unocal* process and, in particular, the application of the second part of *Unocal*'s test, discussed below.

In this case, the Time board reasonably determined that inadequate value was not the only legally cognizable threat that Paramount's all-cash, all-shares offer could present. Time's board concluded that Paramount's eleventh hour offer posed other threats. One concern was that Time shareholders might elect to tender into Paramount's cash offer in ignorance or a mistaken belief of the strategic benefit which a business combination with Warner might produce. Moreover, Time viewed the conditions attached to Paramount's offer as introducing a degree of uncertainty that skewed a comparative analysis.

Further, the timing of Paramount's offer to follow issuance of Time's proxy notice was viewed as arguably designed to upset, if not confuse, the Time stockholders' vote. Given this record evidence, we cannot conclude that the Time board's decision of June 6 that Paramount's offer posed a threat to corporate policy and effectiveness was lacking in good faith or dominated by motives of either entrenchment or self-interest. . . .

We turn to the second part of the *Unocal* analysis. . . . As applied to the facts of this case, the question is whether the record evidence supports the Court of Chancery's conclusion that the restructuring of the Time-Warner transaction, including the adoption of several preclusive defensive measures, was a reasonable response in relation to a perceived threat.

Paramount argues that, assuming its tender offer posed a threat, Time's response was unreasonable in precluding Time's shareholders from accepting the tender offer or receiving a control premium in the immediately foreseeable future. Once again, the contention stems, we believe, from a fundamental misunderstanding of where the power of corporate governance lies. Delaware law confers the management of the corporate enterprise to the stockholders' duly elected board representatives. The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders. Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy. See, e.g., *Revlon*, 506 A.2d 173.

Although the Chancellor blurred somewhat the discrete analyses required under *Unocal,* he did conclude that Time's board reasonably perceived Paramount's offer to be a significant threat to the planned Time-Warner merger and that Time's response was not "overly broad." . . .

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

QUESTIONS AND NOTES ON TIME-WARNER

1. Under *Time-Warner*'s restatement of the *Unocal* doctrine, can a hostile bidder ever force management to redeem a poison pill that is said to protect a company's existing business plan? Does it matter whether the business plan appears to constitute a "break-up" of the company as it has existed, such as those in *Interco*? Does it matter whether the plan was in place prior to the offer?

2. *Time-Warner* might be read to imply that a board may maintain a pill defense indefinitely whenever it is pursuing an established business plan, but it fears that shareholders might "mistakenly" conclude that a hostile offer is fairly priced. Can this view be reconciled with *Time-Warner*'s repudiation of *Interco,* in which the Chancery Court had pulled the pill after the company's board had abandoned its prior business plan in order to pursue a leveraged recapitalization (little different from what the hostile bidder proposed).[32]

3. Does a board's fiduciary duty to be informed require it to negotiate with every plausible acquirer that approaches the corporation with a takeover proposal? Since the dominant view among practitioners, managers, and politicians during the 1980s was that there were too many takeovers,[33] it is hardly surprising that the Delaware courts did not construe the duty of care or the duty to be informed in this way. That is, a board that had decided that its company was not for sale could "just say no" without negotiating with would-be acquirers.[34]

4. *Air Products & Chemicals v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011) is one of latest cases to examine pill redemption. In February 2010, after its friendly overtures were rebuffed, Air Products launched a hostile tender offer for its competitor Airgas, initially at $60 cash per share and eventually reaching $70 as a "best and final" price. The Airgas board rejected these offers, claiming that Airgas was worth at least $78 per share. (Airgas had been trading in the $40s and $50s for most of 2007-2008. Between October 2009 and January 2011, Airgas's stock price ranged from a low of $41.64 to a high of $71.28.) Airgas had a poison pill with a 15 percent trigger and a three-class staggered board comprised of nine members. At the September 2010 Airgas annual meeting, Air Products successfully replaced three Airgas directors with its own nominees. In what was a stunning development, once they joined the board, all three of the new directors, advised by their own bankers and lawyers, agreed with the incumbent directors that the Air Products $70 per share offer was inadequate. The pill stayed in place. Air Products filed a motion in its pending Delaware Chancery Court suit against the Airgas board seeking an injunction against all of the Airgas defenses that impeded its offer from being acted upon by the Airgas shareholders. While expressing personal misgivings about the continued use of a pill against a structurally non-coercive, all-cash offer, Chancellor Chandler upheld Airgas's use of the

32. The *Time-Warner* court added at the end of the excerpt reproduced above that "we have found that even in light of a valid threat, management actions that are coercive in nature or force upon shareholders a management-sponsored alternative to a hostile offer may be struck down as unreasonable and non-proportionate responses" (citing *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1989), and *AC Acquisition Corp.*, 519 A.2d 103 (Del. Ch. 1986)).

33. This was not, of course, the dominant view among financial economists or corporate law professors.

34. That is, boards have the legal power to "just say no" under Delaware case law. As managers in both *Unocal* and *Revlon* learned, however, as a practical matter it may be impossible to say no without offering shareholders an alternative transaction designed to give value comparable to what the acquirer offers.

poison pill: "[T]here seems to be no threat here — the stockholders know what they need to know (about both the offer and the Airgas board's opinion of the offer) to make an informed decision. That being said, however, as I understand binding Delaware precedent, I may not substitute my business judgment for that of the Airgas board. [citing *Unitrin* and *Time-Warner*]."[35] The Chancellor also observed in a footnote: "Our law would be more credible if the Supreme Court acknowledged that its later rulings have modified *Moran* and have allowed a board acting in good faith (and with a reasonable basis for believing that a tender offer is inadequate) to remit the bidder to the election process as its only recourse. The tender offer is in fact precluded and the only bypass of the pill is electing a new board. If that is the law, it would be best to be honest and abandon the pretense that preclusive action is *per se* unreasonable."[36]

Air Products then dropped its offer and over the following year the stock of the target Airgas outperformed the stock of Air Products by a significant margin. In 2015 Airgas agreed to be acquired by a European company for $143 a share.

5. On the *Revlon* side of the *Unocal-Revlon* doctrinal dichotomy, the Delaware Supreme Court in *Time-Warner* appeared to reject the change-in-control test as the trigger for invoking judicial scrutiny. But stay tuned — the moving hand writes, and having written . . ., sometimes writes again. The next chapter in Delaware's law of corporate takeovers, the *QVC* case, which follows, returns to the sale-of-control test for *Revlon* duties.

PARAMOUNT COMMUNICATIONS, INC. v. QVC NETWORK, INC.

637 A.2d 34 (Del. 1994)

[This case features another instance of the Media Industry merger battles which started in the 1980s. This time Paramount is the target firm and the potential acquirers are Viacom (controlled and run by Sumner Redstone) and QVC, whose CEO — Barry Diller — was once CEO of Paramount. Of these three firms only Viacom had a controlling shareholder. The original Paramount-Viacom deal had Viacom making a blended cash and stock offer to acquire Paramount for around $69 per share. The deal had a number of other important terms including (i) a "No-Shop" provision which prohibited Paramount from negotiating or discussing a deal with an alternative bidder unless it was an unsolicited written offer with no financing contingencies and Paramount's Board considered negotiating/discussing necessary to comply with its fiduciary duties; (ii) a termination fee of $100 million if the deal fails for certain specified reasons; and (iii) a Stock Option Plan (SOP), triggered by the same conditions as the termination fee, which grants Viacom the option to purchase 19.9% of Paramount stock at about $69 per share. The SOP was

35. *Air Products & Chemicals v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011).
36. Id. at 122 n.480.

disrupt the balance between bidders and targets that Congress envisioned. Some scholars assert that all three courts left open the possibility that future evidence could influence, and possibly change, the constitutional conclusion and that subsequent evidence shows that no bidder has subsequently achieved 85 percent on a hostile basis in a tender offer. See Guhan Subramanian, Steven Herscovici & Brian Barbetta, *Is Delaware's Antitakeover Statute Unconstitutional? Evidence from 1988-2008*, 65 Bus. Law. 685 (2010). A second example of the post-*CTS* statutes is the disgorgement statute, which has been adopted by Pennsylvania, 15 Pa. Consol. Stat. Ann. §§2561-2567, and Ohio, Ohio Rev. Code Ann. §1707.043. These statutes mandate the disgorgement of profits made by bidders upon the sale of either stock in the target or assets of the target. Any bidder who acquires a fixed percentage of voting rights, including (in some acts) voting rights acquired by proxy solicitation, is subject to this statute. Thus, under the Pennsylvania statute, any profit realized by a "controlling person" from the sale of any equity security of the target within 18 months of becoming a "controlling person" belongs to the target. A "controlling person" includes any person or group who has acquired, offered to acquire, or publicly disclosed the intent to acquire over 20 percent of the total voting rights. Since the emphasis is on voting rights, a solicitation of proxies triggers the disgorgement provision. The Ohio statute is more circumscribed, providing safe harbors to management proxy solicitations. It also provides safe harbors to insurgent solicitations made in accordance with federal proxy rules where the solicitation of the voting right is limited to the matters described in the proxy statement and constrained by the instructions of the proxy giver. The constitutionality of these statutes remains untested.

"Constituency statutes" comprise the last major class of third-generation statutes.[65] They allow, or in some states require, the board of a target corporation to consider the interests of constituencies other than the shareholders when determining what response to take to a hostile takeover offer. These statutes deter takeovers by releasing directors from some of the fiduciary constraints imposed by case law in the takeover context, thus allowing the board to use a broader range of potential justifications for taking defensive measures.

13.11 Proxy Contests for Corporate Control

In a world in which corporations are defended by poison pills, those seeing opportunity in a change of management have only two alternatives. The first is to negotiate with the incumbent board. In some cases, board leadership might be convinced that a change-in-control transaction is a good thing. The odds of persuasion are increased by lucrative inducements for CEOs, such as substantial non-vested options that will vest in a change-in-control transaction,

65. There are other, more idiosyncratic antitakeover statutes as well. The less common statutes include those that prohibit targets from adopting golden parachutes for their executives or paying greenmail without shareholder approval, Ariz. Rev. Stat. §§1202, 1204; authorize the adoption of discriminatory rights plans without shareholder approval, NYBCL §§501, 505; or require appraisals in management-led buyouts, Cal. Gen. Corp. L. §§181, 1001, 1101.

consultation agreements, or other deal-related compensation. Therefore, one might predict that, as the Delaware Supreme Court will permit boards to leave poison pills in place indefinitely, the number of "friendly deals" will increase.[66]

The second alternative for displacing management is the hostile option of running both a proxy contest and a tender offer simultaneously. In this case, closing the tender offer is conditioned on electing the acquirer's nominees to the board and the board's redemption of the target's poison pill. See, e.g., *Hilton Hotels, Inc. v. ITT Corp.*, 978 F. Supp. 1342 (D. Nev. 1997). Contests of this type leave open a variety of further defensive steps that the target may attempt to take. For example, the target board may attempt to affect the outcome of the proxy fight by issuing stock into friendly hands; it may move the meeting date; it may sell assets that the "raider" presumably treasures — and it may sell them to a friendly party for high-vote stock; it may put covenants in new loan agreements that impede the takeover, and so forth. In other words, a target board may engage in a wide variety of actions that are designed to impede an insurgent from gathering enough support to oust the current board through a shareholder vote. The following cases address the legal test for evaluating board actions that affect proxy contests.

BLASIUS INDUSTRIES, INC. v. ATLAS CORP.
564 A.2d 651 (Del. Ch. 1988)

[Blasius Industries, the owner of about 9 percent of the stock of the Atlas Corporation, proposed a restructuring to Atlas's management that would have resulted in a major sale of Atlas assets, an infusion of new debt financing, and the disbursement of a very large cash dividend to Atlas's shareholders. When management rejected the restructuring proposal, Blasius announced that it would pursue a campaign to obtain shareholder consents to increase Atlas's board from seven to fifteen members, the maximum size allowed by Atlas's charter, and to fill the new board seats with Blasius's nominees. The Atlas board, however, preempted Blasius's campaign by immediately amending the bylaws to add two new board seats and filling these seats with its own candidates. (Remember the "Unfireable CEO" problem in Section 6.2? The Atlas board was classified, needless to say.)]

ALLEN, C.:

. . .

THE MOTIVATION OF THE INCUMBENT BOARD IN EXPANDING THE BOARD AND APPOINTING NEW MEMBERS

In increasing the size of Atlas' board by two and filling the newly created positions, the members of the board realized that they were thereby

66. See, e.g., Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. Chi. L. Rev. 871 (2002).

precluding the holders of a majority of the Company's shares from placing a majority of new directors on the board through Blasius' consent solicitation, should they want to do so. Indeed the evidence establishes that that was the principal motivation in so acting.

The conclusion that, in creating two new board positions on December 31 and electing Messrs. Devaney and Winters to fill those positions the board was principally motivated to prevent or delay the shareholders from possibly placing a majority of new members on the board, is critical to my analysis of the central issue posed by the first filed of the two pending cases. If the board in fact was not so motivated, but rather had taken action completely independently of the consent solicitation, which merely had an incidental impact upon the possible effectuation of any action authorized by the shareholders, it is very unlikely that such action would be subject to judicial nullification. . . . The board, as a general matter, is under no fiduciary obligation to suspend its active management of the firm while the consent solicitation process goes forward. . . .

I conclude that, while the addition of these qualified men would, under other circumstances, be clearly appropriate as an independent step, such a step was in fact taken in order to impede or preclude a majority of the shareholders from effectively adopting the course proposed by Blasius. . . .

Plaintiff attacks the December 31 board action as a selfishly motivated effort to protect the incumbent board from a perceived threat to its control of Atlas. Their conduct is said to constitute a violation of the principle, applied in such cases as *Schnell v. Chris Craft Industries*, Del. Supr., 285 A.2d 437 (1971), that directors hold legal powers subjected to a supervening duty to exercise such powers in good faith pursuit of what they reasonably believe to be in the corporation's interest. . . .

On balance, I cannot conclude that the board was acting out of a self-interested motive in any important respect on December 31. I conclude rather that the board saw the "threat" of the Blasius recapitalization proposal as posing vital policy differences between itself and Blasius. It acted, I conclude, in a good faith effort to protect its incumbency, not selfishly, but in order to thwart implementation of the recapitalization that it feared, reasonably, would cause great injury to the Company.

The real question the case presents, to my mind, is whether, in these circumstances, the board, even if it is acting with subjective good faith (which will typically, if not always, be a contestable or debatable judicial conclusion), may validly act for the principal purpose of preventing the shareholders from electing a majority of new directors. The question thus posed is not one of intentional wrong (or even negligence), but one of authority as between the fiduciary and the beneficiary (not simply legal authority, i.e., as between the fiduciary and the world at large).

It is established in our law that a board may take certain steps — such as the purchase by the corporation of its own stock — that have the effect of defeating a threatened change in corporate control, when those steps are taken advisedly, in good faith pursuit of a corporate interest, and are reasonable in relation to a threat to legitimate corporate interests posed by the proposed change in control. See *Unocal Corp. v. Mesa Petroleum Co.*, Del. Supr., 493 A.2d 946 (1985). . . . Does this rule—that the reason able exercise of good faith and due care generally validates, in equity, the exercise of legal authority even if the act has an entrenchment effect—apply to action designed for the primary purpose of interfering with the effectiveness of a stockholder vote? Our authorities, as well as sound principles, suggest that the central importance of the franchise to the scheme of corporate governance, requires that, in this setting, that rule not be applied and that closer scrutiny be accorded to such transaction. . . .

The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests. Generally, shareholders have only two protections against perceived inadequate business performance. They may sell their stock (which, if done in sufficient numbers, may so affect security prices as to create an incentive for altered managerial performance), or they may vote to replace incumbent board members.

It has, for a long time, been conventional to dismiss the stockholder vote as a vestige or ritual of little practical importance. It may be that we are now witnessing the emergence of new institutional voices and arrangements that will make the stockholder vote a less predictable affair than it has been. Be that as it may, however, whether the vote is seen functionally as an unimportant formalism, or as an important tool of discipline, it is clear that it is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own. Thus, when viewed from a broad, institutional perspective, it can be seen that matters involving the integrity of the shareholder voting process involve consideration not present in any other context in which directors exercise delegated power.

The distinctive nature of the shareholder franchise context also appears when the matter is viewed from a less generalized, doctrinal point of view. From this point of view, as well, it appears that the ordinary considerations to which the business judgment rule originally responded are simply not present in the shareholder-voting context.[2] That is, a decision by the board to act for the primary purpose of preventing the effectiveness of a shareholder vote inevitably involves the question who, as between the principal and the agent,

2. Delaware courts have long exercised a most sensitive and protective regard for the free and effective exercise of voting rights. This concern suffuses our law, manifesting itself in various settings. For example, the perceived importance of the franchise explains the cases that hold that a director's fiduciary duty requires disclosure to shareholders asked to authorize a transaction of all material information in the corporation's possession, even if the transaction is not a self-dealing one. See, e.g., *Smith v. Van Gorkom*, Del. Supr., 488 A.2d 858 (1985). . . . A similar concern, for credible corporate democracy, underlies those cases that strike down board action that sets or moves an annual meeting date upon a finding that such action was intended to thwart a shareholder group from effectively mounting an election campaign. See, e.g., *Schnell v. Chris Craft*. . . . The cases invalidating stock issued for the primary purpose of diluting the voting power of a control block also reflect the law's concern that a credible form of corporate democracy be maintained. . . . Similarly, a concern for corporate democracy is reflected (1) in our statutory requirement of annual meetings (8 Del. C. §211). and in the cases that aggressively and summarily enforce that right. . . .

has authority with respect to a matter of internal corporate governance. That, of course, is true in a very specific way in this case which deals with the question who should constitute the board of directors of the corporation, but it will be true in every instance in which an incumbent board seeks to thwart a shareholder majority. A board's decision to act to prevent the shareholders from creating a majority of new board positions and filling them does not involve the exercise of the corporation's power over its property, or with respect to its rights or obligations; rather, it involves allocation, between shareholders as a class and the board, of effective power with respect to governance of the corporation. This need not be the case with respect to other forms of corporate action that may have an entrenchment effect. . . . Action designed principally to interfere with the effectiveness of a vote inevitably involves a conflict between the board and a shareholder majority. Judicial review of such action involves a determination of the legal and equitable obligations of an agent towards his principal. This is not, in my opinion, a question that a court may leave to the agent finally to decide so long as he does so honestly and competently; that is, it may not be left to the agent's business judgment. . . .

QUESTIONS AND NOTES ON BLASIUS

1. Which of the following actions by the board may be prohibited under the *Blasius* rationale? Under what circumstances?

   a. During a heated proxy contest for control of the board, the incumbent board purchases stock selectively from a large shareholder who is otherwise likely to vote for the insurgents.

   b. Under the same circumstances, the incumbent board issues a large block of additional stock at the market price to shareholders who are likely to support the incumbent board.

   c. Under the same circumstances, the incumbent board delays the annual meeting after the meeting date is set when its initial proxy returns suggest that the insurgents may win.

2. In *Blasius* the court went on to reject a per se rule, instead holding that the board bears the "heavy burden of demonstrating a compelling justification" after the plaintiff has established that the board "has acted for the primary purpose of thwarting the exercise of a shareholder vote." Yet it is not easy to fortify the vote with strong fiduciary protections. Since manipulations of the voting process can often be characterized as "defensive," courts may apply *Unocal* which is less demanding than review under *Blasius*. The structure of analysis under either review standard, however, is the same. In both instances, directors have the burden to establish compliance with a standard, and in both instances, the standard is a relative one. In *Unocal*, the action must be reasonable in light of something else (a threat that the act is directed against). Under *Blasius*, the justification for the act must be deemed compelling in light of something else (the threat that the act is directed against). The substantive difference is one of emphasis. *Blasius* requires a very powerful justification to thwart a shareholder franchise for an extended period. But

where a board delays a shareholder vote for a week or two, a less compelling justification may suffice.[67]

There is, however, one critical difference between review under *Unocal* and review under *Blasius*. The Delaware Supreme Court's *Time-Warner* opinion seems to authorize a target board to take defensive action if the company is threatened by what the court terms "substantive coercion." This, in the end, is simply the board's belief that the tender offer is inadequate and that the shareholders do not understand that. Under *Blasius*, however, corporate action to defeat a proxy contest cannot be justified by a parallel belief that the voters simply do not understand the foolishness of voting for the insurgent slate.

Blasius continues to be a significant precedent where board action specifically attempts to impede a shareholder vote. However, *Blasius* is not a radical departure from prior case law, nor is it revolutionary; it is a special case evaluating board conduct under the general principles of fiduciary duty.

3. *Liquid Audio v. MM Companies, Inc.*[68] is a case that lies at the intersection of *Unocal* and *Blasius*. Liquid Audio (LA) was yet another victim of the dot-com bubble, reaching $48 per share at its peak but down to less than $3 per share by 2001. The *Wall Street Journal* reported that LA's business strategy suffered because rivals "offer[ed] similar services free of charge." (How's that for a business problem?) LA rejected a cash offer from MM Companies in favor of a stock-for-stock merger with Alliance Entertainment. MM then forced LA to hold its annual meeting, at which MM planned to: (1) challenge the two incumbent directors who were up for reelection; and (2) propose a bylaw amendment expanding the board from five to nine members. In August 2002, LA added two directors, increasing the board size from five to seven. At the annual meeting one month later, shareholders elected the two MM candidates to replace the LA incumbents, but rejected the MM proposal to add four more board seats. MM brought suit alleging *Blasius* and *Unocal* violations. Vice Chancellor Jack Jacobs upheld LA's defensive tactics under *Unocal*, and declined to apply *Blasius* because LA's actions would not have prevented MM from achieving board control had its board expansion amendment succeeded.[69] The Delaware Supreme Court reversed, holding that *Blasius* applied and invalidated LA's board expansion from five to seven because the "primary purpose" of LA's actions was to reduce the MM directors' ability to influence board decisions.[70]

4. In *Mercier v. Inter-Tel*,[71] the Inter-Tel board delayed a merger vote by 25 days in order to provide more information to shareholders, and because it became clear that shareholders were not going to approve the merger on the original meeting date. Vice Chancellor Strine applied the *Blasius* standard but held that the standard "ought to be consistent with the *Unocal* framework": Directors should bear the burden of proving that their action

67. See *Mercier v. Inter-Tel*, *infra*.
68. 929 A.2d 786 (Del. Ch. 2007).
69. *MM Companies v. Liquid Audio*, 813 A.2d 1118 (Del. 2003).
70. *MM Companies v. Liquid Audio, Inc.*, 813 A.2d 1118, 1132 (Del. 2003).
71. 929 A.2d 786 (Del. Ch. 2007).

(1) serves, and is motivated by, a legitimate corporate objective; and (2) is reasonable in relation to the legitimate objective and not preclusive or coercive. Under this recasting of *Blasius* the Inter-Tel board had met its burden, but the court still noted some room between *Blasius* and *Unocal*: "Lest there be confusion, I do not believe that the use of a test of this kind should signal a tolerance of the concept of 'substantive coercion' in the director election process." A few years later, Strine commented in *Kallick v. Sandridge Energy, Inc.*, 68 A.3d 242, 258-59 (Del. Ch. 2013) that *Blasius*' compelling justification would be invoked when a challenged activity was "taken for the sole or primary purpose of thwarting a shareholder vote." However, he further said "*Blasius*' importance rests more in its emphatic and enduring critical role in underscoring the serious scrutiny that Delaware law gives to director action that threatens to undermine the integrity of the electoral process, than in its articulation of a useful standard of review to decide actual cases."[72]

13.12 Deals Jurisprudence and Contractual Freedom

The current standards for reviewing deals place considerable and often dispositive weight on fair process. Thus, if *MFW*'s conditions are adopted *ab initio* and followed scrupulously, a freeze-out merger is likely to receive business judgment review. Similarly, following *Corwin*'s prescription of an informed uncoerced shareholder vote is likely to ensure business judgment review of all transactions apart from those engineered by a controlling shareholder. And even in appraisal proceedings, a deal price negotiated at arm's length would seem to be a ceiling on a company's fair value — and thus, the major determinant of fair price — unless egregious conflicts of interest or other process failures were to compromise deal price. Of course, the process behind every deal is unique. Nevertheless, the thrust of the new case law is to suggest that appropriate processes are effective substitutes for robust equitable review under most circumstances.

How should we understand this development? If we focus only on deals, we might infer that if the deal process proxies for arm's length negotiations, deal price is less worrisome than the prospect of wasteful and costly deal litigation. However, a focus on deals may be too narrow. We suggest that a full explanation of the development of the law in the M&A context might also be seen as part of a broader trend across many areas of the law of business organizations to limit equitable review in deference to contractual protections.

72. In *Pell v. Kill*, 135 A.3d 764, 785 (Del. Ch. 2016), the Chancery Court said that "the shift from reasonable to compelling requires that directors establish a closer fit between means and ends" and that *Blasius* was not a separate standard of review, but within the enhanced scrutiny standard of review. The court went on to note that it would examine justifications with a "gimlet eye" if the board was aware that the election was likely to be contested. For a critique of cases that appear to narrow *Blasius*, see James D. Cox & Randall S. Thomas, *Delaware's Retreat: Exploring Developing Fissures and Tectonic Shifts in Delaware Corporate Law*, 42 Del. J. of Corp. L. 323, 360-369 (2018).